1. INTRODUCTION

Production in the world economy has become increasingly globalized. Producers scan the globe to select the distribution of production processes that result in the lowest total production and transportation costs. Significant advances in production, communication, and transportation technologies on the one hand and multilateral liberalization of international trade and investment policies on the other have led to shifts in the world’s comparative advantages and consequently in the geographical distribution of production activities.

However, these geographical shifts in production are not simple shifts from one country to another. Very often fragmentation of the production process occurs first, with labor-intensive processes being shifted to countries where labor is more plentiful and cheaper. Capital-intensive processes tend to be shifted later, if at all, and knowledge-intensive processes like design, engineering, and marketing often stay in the original country. In the end production may stabilize into a cooperative system in which several territories take advantage of their respective comparative advantages to collectively produce the most cost-efficient article possible. The history of Hong Kong’s textile and clothing industries provides a vivid illustration of this production-fragmentation process.

As a reaction to the fragmentation process, producers in importing countries that are hurt by shifts in comparative advantages often seek protection from their national governments. Even though they are not always successful in reversing the general trend of trade and investment liberalization, local producers seeking relief from global competition remain a powerful counterforce that can bring about various sorts of trade restrictions. Moreover, geopolitical objectives tend to favor producers in some regions but discriminate against those in others.

Regardless of whether protectionist policies are the results of national or regional political economy, they represent deviations from the principle of comparative advantage and cause distortions in efficient global production. One of the tools of trade restrictions is changing the “rules of origin.” (For an excellent exposition of the distortions in production and trade caused by rules of origin as they are used, see Lloyd [2000].) This non-cost-based distortion
is yet another factor that concerns producers of textile and clothing products and impacts their decisions about which countries to include in the production process. Thus in this paper we also analyze the impact of the rules of origin pertaining to textile and clothing products on Hong Kong’s own production, its outward processing scheme, and trade. In addition, we point out the distortions these rules cause.

2. A BRIEF HISTORY OF HONG KONG’S TEXTILE AND CLOTHING INDUSTRIES

Hong Kong’s founding in 1842 was initiated by Britain’s need for a permanent entrepôt to the People’s Republic of China (PRC), and the former British colony was precisely that from 1842 to 1949. However, with the founding of the PRC in 1949, the subsequent embargo of Chinese goods following the Korean War, and the lowering of the “Bamboo Curtain,” that role came to an abrupt end. For 30 years, from 1949 to 1979, Hong Kong essentially lost its place as the PRC’s entrepôt.

Fortunately, the arrival of over a million refugees from the PRC heralded the onset of Hong Kong’s success as a center for labor-intensive industries. Among the first industries to be established in the territory were the textile and clothing industries. These industries were well established in the PRC, especially in Shanghai, and Shanghai industrialists brought capital, expertise, and plants and equipment to Hong Kong after 1949. Thus began Hong Kong’s rise as one of the world’s premier exporters of clothing from the 1950s to the 1970s.

The textile and clothing industries were largely vertical all the way from yarn spinning to finished garments. The import of raw materials was confined to raw cotton and wool tops. Later, man-made fabrics, silk, and leather would also be imported. Even as Hong Kong flourished thanks to its success with export industries, the seeds of its loss of competitiveness were germinating. The territory’s dependence on labor-intensive manufacturing industries, of which the textile and clothing industries were the largest and most important, meant that its competitiveness was being steadily eroded as the standard of living and wages rose. By the 1970s industrialists in these industries found themselves facing the following choices: (1) give up labor-intensive industries to less developed countries (LDCs), or (2) invest in LDCs, and shift labor-intensive production processes overseas while keeping capital- and knowledge-intensive production processes at home.

They chose option 2. In the late 1960s and early 1970s Hong Kong’s textile and clothing industrialists began to invest in neighboring economies including Taiwan, Singapore, Malaysia, Thailand, and Indonesia, thus beginning the process of production fragmentation. However, it was not until Deng Xiaopeng’s “open-door policy” came into effect in 1979 that Hong Kong’s “hinterland” (the PRC) was restored to it, allowing for a true division of labor on a much greater scale.¹