

**OUTSOURCING, WEALTH CREATION, AND SMEs: THE  
INTERNATIONALIZATION OF SERVICES WITHIN THE GLOBAL  
TEXTILES AND APPAREL INDUSTRY: EASTERN EUROPE AND  
SOUTH AFRICA – 1989-2004**

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**ABSTRACT**

This paper examines the global textiles and apparel industry within Eastern Europe and South Africa during the period of rapid globalization (from 1980 to 2003). In doing so, this paper develops two “outsourcing” models by which heretofore low-value-added “blue-collar” small and medium-sized firms (SMEs) capture increasing wealth and expand internationally by evolving into high-value added global service providers. An important way in which developing regions and countries can gain access to Western markets and capital is through their initial role as host countries to Western industry in outsourcing activity. Indeed, recent research shows a strong connection between such outsourcing activity by Western companies in developing countries and the long-term economic growth of these developing “host” countries. This link exists because, from its experience in contracting to more advanced economies, over time, the host country gains knowledge, technology, business skills, and, most importantly, international contacts, especially within the global service network. This internationalization process, in turn, creates wealth in the developing country because, as they internationalize in this way, the SMEs in the developing country evolve from undertaking low value added “blue-collar” manufacturing to higher value added “white-collar” global services that reside further up the value chain of the industries within which the SMEs operate. This means that SMEs can create and capture more wealth and plow that added retained earning back into the company for further growth and economic and even political leverage within the international services community. This wealth creation lifts the company, industry, and ultimately, country up economically. In examining these issues, this study focuses on and compares and contrasts a particular industry –the global textiles and apparel industry—within two regions: Eastern Europe and Sub-Sahara Africa. The textile and apparel industry is one of the central industries in each region. It is also the model industry when one discusses outsourcing in today’s global world. Too often, in discussions of this industry, the focus is on the blue-collar aspect of this outsourcing whereby industrialized countries outsource the low value, “blue collar” jobs –such as cutting and sewing—to less developed and low wage countries. By describing the value chain of the industry, we will show that “Inward-Outward” Internationalization is resulting in wealth creation as textile and apparel SMEs evolve into higher value added international services (as retailers, marketers, designers). We will compare and contrast this wealth creation process within the Apparel and Textiles industry within two regions in Eastern Europe: the Baltic States and the Balkan Region. The model developed from this comparative analysis will then be applied to one of the most vital non-European regions: Sub-Sahara Africa. We will show that Sub-Sahara Africa represents a hybrid of the Baltic and Balkan models.

## I. INTRODUCTION

The internationalization process has for a number of years riveted the attention of the academic (and non-academic) business community. More recently, research has been gaining momentum on the rate and direction of internationalization within the especially within the small and medium-sized firm (SMEs) sector. The fall in trade barriers over the last few decades, the increasing importance for the world's economies of innovation and new technology, and the general expansion in globalization has meant a growing role of small and medium sized firms (SMEs) in international markets (Oviatt and McDougall, 1994, 1999).

As part of these studies, investigations examine the rise within, and internationalization of SMEs from, a growing range of countries. The SME community within Eastern Europe is of particular interest. As the EU has expanded and become more integrated, Central and Eastern European SMEs find themselves with greater access to international markets (Roolah, 2002). Thus attention increasingly has been shifting to how these so-called transition economies -- Hungary, Poland, The Czech Republic, the Baltic States, etc.-- can effectively compete internationally with Western Europe and the US through an effective internationalization program. For example, the ability of these countries to tap into the growing and more cohesive markets within the European Union

More recent studies have questioned whether internationalization of SMEs must necessarily lead to long-term and sustainable economic benefits for Eastern European (as well as other developing) countries. There are after all different modes of internationalization, and they do not all lead to the same level of economic growth for companies and countries. For example, the undertaking of sub-contract work for larger companies located in Western Europe for work that involves very simple operations captures only a small portion of the total potential value within an industry's value chain. In these cases, Western European countries take advantage of low-wage labor in the Eastern European country and provide their sub-contractors with low levels of compensation. The latter as a consequence cannot capture sufficient value to modernize and expand and integrate operations. Thus, they do not have the means to themselves tap into Western markets and capture a greater share of value this entails.

Consequently, in attempting to understand whether the internationalization process within the SME sector can help a country and region to progress economically in the era of globalization, one must investigate the relationship between internationalization and value creation. Indeed, Certain recent theories linking SME development, value creation and the internationalization process look at the reasons why SMEs increase the breadth and depth of their exporting activities (Knight, 1997). When barriers arise to internationalization, these investigations tend to focus on internal problems in a country, such as political instability, decaying infrastructure, and so forth. But, beyond this more empirical focus, are broader theories that advance either an incremental (staged) or "rapid leap" models of international expansion and value creation. In the radical leap model, firms, often guided by internationally savvy executives, come into being as fully formed international entities. In the former case, rapid SME internationalization is assumed

unlikely because of financial constraints, the lack of international market experience or information, cultural friction, and other factors. Thus the incrementalists hold that SMEs will internationalize and create value for a country in gradual steps, first undertaking the least complex forms of entry (e.g. exporting) and then evolving into more complicated types of market entry strategies—from the rather passive forms of contracting work to the more active entry modes of licensing, joint venturing, and merging and acquiring.

In these studies, the role of outsourcing plays an important role in the internationalization and value creation processes. Much has been written on outsourcing, internationalization, and value creation and also on relation between outsourcing and value creation in services in production and services (Bhagwati, Panagariya and Srinivasan, 2004; Bhagwati, 1984). It is through outsourcing that an SME enjoys its first taste of being a player in the international business arena. Usually, an SME is nothing more than a sub-contractor to a larger Western European firm. In this arrangement, the SME provides the contractor cheap labor to undertake simple, labor-intensive operations. In this arrangement, the SME captures relatively little value and is often paid a small amount per item or service completed. In many such cases, the contractor provides materials, transportation, and controls the higher levels of the value chain. Over time, many SMEs use this opportunity to establish linkages with the developed business network. This helps provide the firms with critical information and guidance as well as customers of their own. Investment capital also begins to flow into the SME from the West, which provides it the opportunity to modernize, expand, and integrate equipment and functional operations. Such a process highlights the “inward” and “outward” relationships that exist in the incrementalist model of internationalization (Welch and Luostarinen, 1993). Ultimately, as the firm grows and matures as an international player, it may form an equal joint partnership with its former contractor (or other larger Western firms). At this stage, the firm—which may evolve out of the SME classification—controls a major portion of its value chain. This model is one of wealth creation within developing countries—such as Eastern Europe—wherein the bulk (over 95%) of the national economies are dependent on their SMEs and their ability to wrest from Western European contractors a growing percentage of possible wealth contained within their industry’s value chain. Another way to view this scenario is that developing countries in Eastern Europe (and elsewhere) must evolve from low value added “blue-collar” type sub-contractors performing the simpler, labor-intensive operations situated on the lower rings of the value chain to the high value added “white collar” type technical and administrative functions located higher up the value chain.

This paper emerges out of the authors’ continued research trajectory in the relationship between the internationalization process and value creation within the SME sector of Eastern Europe and other developing non-European countries and regions. While previous studies have examined outsourcing in the production sectors or outsourcing and value creation in the emerging service sectors (Bhagwati, Panagariya and Srinivasan, 2004), little research has as yet looked at the process by which the blue-collar production sector evolves by steps to the higher value-added white collar service sector. The questions we have asked ourselves as we have proceeded in investigating this evolution have been “How relevant is the incrementalist model of internationalization for the SME sector, such as in Eastern Europe? “What

differences exist in the rate and direction of SME internationalization within different regions and countries?” More specifically, why have certain regions and countries been able to progress up the value chain and so evolve from a blue collar to white collar capability –and so retain an increasing proportion of potential wealth—while other regions and countries do not evolve this way but rather remain trapped within the blue collar arena, unable to escape low value-added operations at the bottom of the value chain”? And finally, what do the differences tell us about the broad implication of globalization in the 21<sup>st</sup> century?”

This paper explores this critical evolutionary process within two regions of the world: Eastern Europe and Sub-Saharan Africa. In doing so we look for those common factors that help us understand the mechanism or model that explains why certain countries and regions progress into a service economy while others remain entrapped in the simpler production modality. In our investigation, we stress that neither Eastern Europe nor Sub-Saharan Africa should be seen as uniform regions. Rather, Each is composed of sub-regions that must be compared and contrasted with one another

## **II. METHODOLOGY**

Our studies to date have examined two critical geographical areas within Eastern Europe: the Baltic countries and the Balkan region. These regions have not yet been explored in a comparative way to any great extent in previous studies, even though they are both seen as critical to the future of the EU. Both regions can be characterized as developing areas that experienced the movement toward privatization (and SME creation) in the early 1990s. Therefore, SMEs dominate both regions across a wide swath of industrial sectors. Despite these similarities, they offer sharply contrasting pictures of SME growth that offers insights into the relationship between internationalization, value creation, and the progress from blue-collar production to white-collar services. Our research in Eastern Europe provides a template for understanding –and even predicting—the course of internationalization and value creation in various regions and countries.

In our most current research, we have begun applying the model of “blue collar-white collar” evolution we have developed for Europe to other regions and countries. This paper discusses these results in the case of South Africa. in particular. South Africa represents a reasonable region in which to expand our model. As in Eastern Europe –albeit for different reasons—its economy reached an important benchmark in the late 1980s and early 1990s. As in Eastern Europe as well, SMEs have become an important part of the country’s post 1990 economy. Over the last fifteen years, its SME sector within certain critical industries has been attempting without great success to expand its markets outwards into the Sub-Saharan region into the EU and US. As in parts of Eastern Europe –in particular the Balkans—South Africa’s SME sector within certain of its important industries cannot easily extricate itself from the low value added blue-collar modalities and evolve into the higher wealth creation possibilities of white collar services. In this paper we apply the European model to this country in attempting to understand possible evolutionary routes.

In developing its model, this paper focuses in on the case study industry of textiles and apparel. This industry is one of the world's most global industries, and constitutes an important source of income, GDP, and employment for both Eastern Europe and South Africa. In addition, SMEs generally dominate these industries in each of these countries. Because of low investment cost per operator, the garment industry is often one of the first to emerge as a center of SME activity in the transition and increasingly privatized economies. It is in this industry that international activity has become very active since the early 1990s. Indeed, for the textile and apparel industry within both countries, entering into and thriving in international markets are critical requirements for future economic growth. Thus, a study of this industry allows a close examination of the internationalization process within a common SME sector operating in different and highly contrasting countries. It is also a sector that has been increasingly pressured by the growing momentum of globalization and the resulting threat of cheap imports from Asia. This threat as we will see is a major factor shaping the model of "blue collar-to-white collar" evolution. Thus a focus in this industry highlights the growing relevance of China, India, and other Asian countries in internationalization and value creation.

The research for this paper draws broadly on empirical data from a range of sources. This is fundamentally a qualitative, rather than econometric, study. Such an approach has been taken as most appropriate for an analysis that is essentially 'comparison and contrast'. Such a study requires rich contextual analysis obtainable from a pool of relevant studies and assessments undertaken by the international community, the textile and apparel industry itself, as well as agencies and departments of the individual country governments involved. In addition to these sources, international agencies such as the World Bank, United Nations, International Monetary Fund, and European Union provide data and information on the regions –and specific countries-- under study. There is considerable data and information regarding the Baltic region as it has become one of the newer members of the EU and a growing amount of sources related to the Balkans, generally on a country-by-country basis. We have supplemented our sources of Eastern Europe and South Africa with a series of interviews conducted over the last year with selected managers, executives, and government officials working in or knowledgeable about the textile and clothing industries within these regions.

Structurally, this paper first looks at the value chain concept in general and as it applies to the textile and apparel industry in general. It then analyzes the industry within the Baltic region thus showing the example of a robust evolution from blue collar to white collar capability. The paper then compares and contrast this situation with the Balkans, examining such countries as Moldova, Macedonia, and Croatia, where the textile and apparel industry remains trapped in the low value added blue collar level of the value chain. In this paper, we first introduce the nature of the value chain for a particular case industry. We then examine two sub-regions within Eastern Europe. From this analysis, we develop a European-wide "blue collar-to-white collar" evolutionary model. We then consider the more general application of this model outside the European context by incorporating the nature of internationalization and value creation in Sub-Saharan Africa.

### III. THE VALUE CHAIN IN THE GLOBAL TEXTILE AND APPAREL INDUSTRY

Each industry has its own unique supply-chain profile often referred to as the value chain (Porter, 1980; 1985). Before proceeding, it is essential that we understand the nature of the value chain that exists within the textile and apparel industry in general. The concept of the value chain and its role in competitive strategies is a central concern in attempting to understand the structure and dynamics of the clothing and apparel industry

The value chain of the textile and apparel industry is made up of a number of steps; each one creating more value than the step that precedes it. The following table outlines each of the stages in the value chain. It indicates what each stage represents, the technology and skills required within each stage, the control over the process represented by each stage (in terms of % value added captured), and whether the stage is mostly blue collar (pure, low-level production) or white collar (more service oriented) in nature (referred to here as “Modality”). Therefore, the evolution of a firm from blue collar to white collar modality would mean that it is progressing from stage 1 to the higher-level stages.

At the lowest end is the so-called ‘cut and manufacture’ (CM). This lowest part of the chain is a purely outsourcing activity of relatively simple operations. In this stage, the customer (the EU company) typically provides design specs, furnishes all the materials, handles compliance with norms and standards, and markets and distributes the finished goods to the end consumer. For example, Steilmann, one of the largest apparel groups in Germany, has a joint venture factory in one of the Balkan countries (Moldova) producing ladies coats, jackets, and blazers. Production, marketing, and distribution is planned and controlled by Steilmann’s corporate offices in Germany. The only skills and technology required of the producer – generally an SME--who operates within this early stage are manufacturing and production machinery. The most important comparative advantage a country in this stage can have is cheap labor. A firm “stuck” in the first stage can, on average, claim no more than 15%-25% value input per garment.

A contracted firm might do a little better in terms of value added in the next stage, known as ‘cut, manufacture, and trim’ (CMT). Everything that applies to the CM stage applies for CMT as well except that contracted firm has some responsibility in the purchase of secondary material (e.g., trim). But for both CM and CMT, the contracted firm is mostly cut off from the final market –located in the EU for example--and at the mercy of the middleman customer that is looking for the lowest price. The CM and CMT phases in the value chain does not require high management skills and firms stuck in this lowest portion of the value chain establish few contacts with the West. In general, for these firms, the only means of competition is the price and speed to market if geographically well placed. CM and CMT create the lowest level of loyalty on the customer side (larger EU firm), as it is relatively easy to move production to another location if more favorable terms appear. At the same time, the SME firms operating at these levels can stay afloat as sub-contractors and thus help to create jobs. In addition, these firms may benefit from a certain amount of FDI from the EU as customers attempt to upgrade sub-contractor facilities in order to help them maintain quality, costs, and production schedules.

A sub-contracting firm can capture a significantly greater percentage of value added if it can move from CMT to the FOB level. To operate at the FOB level, the supplier must at least have the know how, skills, and financial means for sourcing materials internationally. For this, he needs direct contacts to the weaving mills and continuous visits to fabric fairs required to be current in fashion information. FOB producer must be able to finance material purchases. Because FOB suppliers offer more value to their customers, customers become more dependent on them. Further, FOBs can approach the retail customers directly and can achieve higher margins by bypassing wholesalers. Firms that reach this level can capture up to 50% (or more) of total value added. In addition to production machinery, they require Internet access in order to contact and communicate with suppliers. In some cases, as well, design and CAD capability is required, especially for the larger and more diversified FOB producers.

With private label capability, the producer searches and secures materials, designs collections, and presents customers with product development ideas. However, the producer who reached this level remains a de facto sub-contractor, albeit on close to an equal basis with his customer. This is so because final decision on design and products are still made by the customers and products are supplied under the customer's label (or brand). This level is the highest level of value adding before "Own Label Sales" in which producer designs collections and sells them under his own labels and brands. It is only at these upper stages of the value chain that the producer can hope to create and retain significant profits. In these segments, brand equity value accounts for an enormous portion of value added. As the producers moves up the chain into these realms, he retains an increasing percentage of this value.

Table 1 shows the stages toward increased value-added production and the percentages of total value added captured in each stage. As suggested by the above descriptions of the various levels, as a producer ascends to higher levels along the "value-added stairway," it takes greater control of the production and distribution functions. To do so, cheap labor becomes less a comparative advantage. Rather, it must expand the breadth and depth of its skill base and technological capability. It must also incorporate greater strategic management, logistical (e.g., just-in-time), design, and marketing/distribution capabilities. Then, EU producers play a less dominant role in the contractor-sub-contractor (usually joint venture) relationships. This is so because as a firm takes on more shares of the production, marketing, and distribution function, it relies less on its European partner to handle these matters and becomes more dependent on its own resources and those offered within his country. In this case, the costs of transportation, logistics, and related matters increases as the firm take on more of the responsibilities of the production cycle (World Bank, 2004)

**Table 1** Value-added stairway of the international garment trade

| Stage |  | Meaning | Skills Needed | Technology Needed | Control over Process | Modality: Blue-Collar vs. White |
|-------|--|---------|---------------|-------------------|----------------------|---------------------------------|
|-------|--|---------|---------------|-------------------|----------------------|---------------------------------|

|      |     |  |   |   | (% of value added) | Collar                   |
|------|-----|--|---|---|--------------------|--------------------------|
| I.   | CM  | <u>Cut &amp; Make</u><br><br>Manufacturer sells cutting and manufacturing services only. Temporary imports of all materials, which are owned by the customer. Manufacturer buys no materials (which are all supplied by customer). | Manufacturing                                     | Production Machinery  | 15%-20%            | Blue Collar              |
| II.  | CMT | <u>Cut, Make, &amp; Trim</u><br><br>For CMT, same as for CM, except manufacturer buys some of the accessories and trimmings, such as buttons, threads, etc.  |   | Production Machinery, Internet  | 20%-25%            | Blue Collar              |
| III. | FOB | <u>Full Price, Full Package:</u><br><br>Manufacturer buys  | Manufacturing, Materials Sourcing, Pattern Design | Production Machinery, Pattern Design CAD, Internet Simple Quality Control | 25%-50%            | Blue Collar/White Collar |



|     |    |   |  |   |          |              |
|-----|----|---|--|---|----------|--------------|
|     |    | all materials according to the customers specs and styling and at delivery invoices full value of the product,  |  |   |          |              |
| IV. | PL | <u>Private Label</u> :<br><br>Manufacturer designs collections independently or jointly with the customer. The full value products are delivered under customer's trademark | Manufacturing,<br>Materials Sourcing,<br>Pattern Design,<br>Garment Design               | Production Machinery,<br>Pattern Design CAD,<br>Internet, Garment Design CAD<br>Advanced Quality Cont.              | 50%-75%  | White Collar |
| IV. | OL | <u>Own Label</u>  | Manufacturing,<br>Materials Sourcing,<br>Pattern Design,<br>Garment Design,<br>Marketing | Production Machinery,<br>Pattern Design CAD,<br>Internet, Garment Design CAD<br>Advanced Quality Cont.<br>Marketing | 75%-100% | White Collar |

Source: Gereffi and Memedovic, 2003; Nordas, 2004.

#### IV. EASTERN EUROPE

The privatization movement in post-Socialist Eastern Europe during the 1990s resulted in the creation of economies based on small and medium-sized enterprises (SMEs). This was so within a number of industries and in particular in textiles and apparel. These were formed in part from the fragmenting of the larger and previously state-run enterprises. SMEs also came into being as start up firms, some of which were entrepreneurial in nature, that attempted to take advantage of Eastern Europe's free market

economies. In most of the Eastern European countries, SMEs accounted for over 90% of the firms operating in different countries.

As Pickles notes, starting as early as the mid-1980s, textile and apparel SME –as well as other— producers in Poland, Hungary, and the Czech Republic became increasingly linked to outward processing arrangement with larger Western European companies by which these firms undertook for Western European companies simple activities at the bottom of the supply chain with only limited possibilities for higher value added activity. Then, in the mid-1990s, a second tier of SMEs emerged in Eastern Europe that found its own links to the EU. During this period, we find that the first tier countries graduated to higher-level activities approaching the white-collar echelons in the value chain. The second tier companies then began taking over these more simple activities, not only for Western European companies but also expanding companies located in the first tier countries of Poland and Hungary. More recently, as these second tier countries themselves moved ahead up the value chain, a third tier has emerged that has taken its place working at the bottom rungs of the value chain. These third tier countries and their SMEs continue to wait their turn to ascend the value chain ladder as other Eastern European countries have done before them over the last twenty years. (Pickles, 2005).

The following table, which shows average subcontracting costs in textiles and apparel for different regions and countries clearly indicates the progress made by first and second tier countries and the difficulties faced by third tier countries in capturing value for their work. Whereas the cost of subcontracting continues to rise in the former groups, it remains low for the latter, blue-collar embedded economies of the latter group. These low costs entice Western European companies to subcontract low value activities to these countries.

The table also shows the competition afforded by Asia in terms of unit costs to make standardized textile and clothing products. This reflects such factors as rate of subsidization by the Chinese government to the textile and apparel industry. With the ending of the World Trade Organization (WTO) Textiles and Clothing agreement in 2005, Asian competition has intensified throughout Europe as quotas restricting textile imports to the EU, already progressively reduced, were removed entirely. This has important implications for Eastern Europe as well, including both the Baltic region and Balkan group of countries.

**Table 2:** Subcontracting costs per minute for international comparison - 2002

| Country       | Subcontracting costs per minute<br>in EURO | Trend: 2002/2004 |
|---------------|--|------------------|
| Germany       | 0.61                                       | ++               |
| South Europe: |  |                  |
| -Italy        | 0.55                                       | ++               |
| -Greece       | 0.36                                       | ++               |
| -Portugal     | 0.39                                       | ++               |
| -Spain        | 0.46                                       | ++               |

|                      |      |    |
|----------------------|------|----|
| Eastern Europe:      |      |    |
| -Poland              | 0.15 | ++ |
| -Hungary             | 0.17 | ++ |
| -Czech Republic      | 0.18 | +  |
| -Slovakia            | 0.14 | +  |
| -Slovenia            | 0.20 | ++ |
| -Croatia             | 0.16 | +  |
| -Romania             | 0.09 | 0  |
| -Bulgaria            | 0.08 | 0  |
| -Baltic States       | 0.12 | ++ |
| -Moldova             | 0.07 | 0  |
| -Ukraine             | 0.06 | 0  |
| -Belarus             | 0.06 | 0  |
| -Serbia & Montenegro | 0.05 | 0  |
| -Macedonia           | 0.07 | 0  |
| Africa:              |      |    |
| -Morocco             | 0.16 | ++ |
| -Tunisia             | 0.14 | 0  |
| -Egypt               | 0.15 | 0  |
| -Mauritius           | 0.21 | ++ |
| -Botswana            | 0.11 | 0  |
| Asia:                |      |    |
| -Turkey              | 0.18 | +  |
| -Hong Kong           | 0.32 | ++ |
| -China               | 0.05 | 0  |
| -Vietnam             | 0.06 | 0  |
| -India               | 0.08 | 0  |
| -Bangladesh          | 0.05 | 0  |
| -Indonesia           | 0.09 | 0  |
| -Philippines         | 0.11 | +  |
| -Pakistan            | 0.07 | 0  |

Source: SECO Sector Consulting, Market Survey 2002.

0 = Neither Increasing nor Decreasing

+ = Moderately Increasing

++ = Increasing at a Rapid Rate

## **1. The Baltic Region**

The Baltic States –Lithuania, Estonia, and Latvia—is a region within which its clothing and apparel industries have been gradually moving up the value chain. As countries with growing economies, their SMEs are, on average, somewhat larger and therefore possess more resources than their counterparts in a number of Eastern European countries. This is true in particular of those small and medium-sized firms within the textile and clothing industry. Indeed, the textile and apparel industry traditionally has been a critical sector of the country. Lithuania is the largest supplier of clothing by far and thus the biggest producer of clothing and textiles combined within the Baltic region.

As in many Eastern European countries, the Baltic countries local market is far too small to be able to absorb the production of their textile and apparel industry. Accordingly, access to export markets, especially within the EU, is critical for success of the Baltic’s clothing and textiles industry.

As was true of a number of European countries, the Baltic’s textiles and clothing industry suffered from a fairly rapid decline in the early 1990s. This decline was due to the economic-financial crisis in the Russian market, a once important market for the industries of Lithuania and Estonia in particular. This crisis made clear that the Baltic region had to radically reorient its trade, especially in textiles and clothing, toward western markets. The Baltic’s proximity to EU stood it in good stead to establish trade links with a number of EU countries, and especially Germany, the UK, France, and the Scandinavian countries. Since 1997, we see steady growth in the industry, both with respect to its domestic and foreign markets. Examining Lithuania, for example, in 2003, Lithuania ranked second only to Portugal of the EU countries in terms of number of employees in the industry per 10,000 inhabitants (for Lithuania, this number is 141 compared to 251 for Portugal). Between 1997 and 2003, the domestic market for textiles and clothing increased nearly 50%, representing an average annual growth of 7.2%. Production of textiles and sewn garments represents 14% of Lithuanian GDP. Further, textiles and apparel is Lithuania’s leading export product, with the industry accounting for 15% of total exports, with 85% of textiles, 92% of apparel, and 72% of leather products exported, mostly to the EU. (EKT Group, 2004.)

The question remains as to the nature of that growth and trade. A large number of the Baltic textile and apparel companies work on a CM and CMT basis. This means that many Baltic textile and apparel companies are little more than junior members of joint venture arrangements with European companies. The latter supply all (or most) of the materials that are imported into the Baltic for processing. These European firms moreover control marketing, distribution, and branding. These smaller textile and apparel firms perform essentially tolling functions. In these cases, value added in the process is lost to the Baltic industry as it is generated by the larger Western apparel firms. For these companies, especially the smaller ones, profit margins remain small and little money is created that can be rolled back into the company to modernize equipment and plant and, in turn, allow the company to be competitive in international –and especially Western—markets (CRPM, 2005).

However, since the mid-1990s, the general trend for the Baltic region's textile and clothing industry is expansion in terms of production and exports and an evolutionary progress towards more advanced production and high-value white-collar service capability. This is indicated in Table 2, which, for the Baltic region, shows high labor costs (relative to other second and third tier Eastern European countries). In addition, in 2002, these costs were continuing to rise at a rapid rate. In the case of Estonia, for example, the 1990-1994 period saw industrial decline and cumulative decline in GDP of 36%. This decline was the result of the collapse of Eastern and Russian markets for Estonian products. The growth after 1995 followed Estonia's rapid ability to realign its international activity from contracting Eastern to the expanding Western European markets. As it did so, it expanded its exports to the west and, taking advantage of Western investments, contacts, and know-how, modernized its production and entered into the higher value added service capabilities. A similar story occurred in Lithuania during this same period.

That an increasing number of the Baltic's textiles and apparel SMEs could accomplish this in only a few years is remarkable given the internal problems faced by the Baltic countries at this time that should have prevented the inflow of critical foreign direct investment. In the early 1990s, subcontracting costs per minute (in Euros) was no more than .05. This meant that Western European companies that wished to take advantage of cheap labor in this region had little incentive to invest here, as that would only spur a rise in the price of labor. Moreover, the Baltic was not part of the European Union nor did its products meet the EU's standards. A large share of the products that it attempted to make on its own and sell to Western Europe did not adhere to the standards and norms of the EU Single Market. Thus, these products proved unacceptable, and were denied access, to the markets of the Western European countries. The Baltic countries thus came to understand that special standards, quality requirements, and other regulations, as well as differences in legislation and complicated administrative procedures, could be important trade barriers to market access in the EU.

Then too, internal conditions within the Baltic region posed problems for, and potential barriers to, outside investment required for improved product quality and movement by SMEs up the textile and apparel value chain. Limitations existed with regard to transportation and logistics support as well as infrastructural necessities. More critically, there were serious restrictions and inflexibilities in the supply of labor. The Baltic countries were also saddled with complicated regulations that acted as a deterrent to much needed foreign direct investment. For example, capital transactions, which often had to be registered with the country's central bank, involved much red tape and bureaucratic delays. Moreover, the judicial systems within the Baltic countries proved slow and unreliable for foreign businesses. This was in part the result of large judicial backlogs of cases. Also, because of its communist history, enforcement of contracts and protection of property rights proved too often unreliable and inconsistent. Most seriously, the Baltic region, and Lithuania in particular, had a reputation of being corrupt as indicated by the fact that Lithuania ranked 46<sup>th</sup> out of 158 countries in corruption rate on Transparency International's Scale of Corruption.

Yet despite these obstacles, we find that, since 1995, The Western Europe has invested significantly in the Baltic countries to the point that now Estonia ranks as one of top Eastern European regions to capture

FDI from Europe: As a result, as a EU report concludes, “while the textiles and clothing industry [in the Baltic] is still small in size [it is] expanding rapidly and gaining importance in the domestic economies as well as on the International Markets [these] rising stars are successfully taking advantage of their cheap and skilled labor force, with the Baltic states putting special emphasis on [FDI and] on modernization and technology.”

What then accounts for this flow of outside investment –so critical for the growth and progress of the region’s textile and apparel industry—into the Baltic starting in the mid-1990s? Possibly the most important causative factor was the existence of countries that --for historic, cultural, and economic reasons-- “championed” the region’s entrance into the European Union and its Single Market structure. The case of Estonia is illustrative. The vital link here is the country’s close connection with Finland. Finland pursued the integration of Estonia into the EU. Traditionally, the countries are tied together by similar languages and customs and interlinked economies. Finland, one of the more advanced of the Western European countries, also understood the critical position of the Baltic region as a potential economic link between Western Europe and the other post-socialist Eastern European countries. Finland’s role in the Baltic in general, and Estonia in particular, was critical after 1995. Finland imparted to Estonia what the Western market economy was like and what the main rules of a democratic economy are in general. This compensated for the tightly closed iron curtain society under which the Baltic States had been under. Critical exchange of information –economic, political, technical--occurred regularly between Estonia and Finland. In this manner, Estonia rapidly realigned itself into to a market economy, accompanied by, again under Finland’s influence, the introduction of modern banking and finance. Finland also acted as a mediator for Estonian entrepreneurs, and especially the SME sector. Finland thus became Estonia’s initial main source of Western European foreign direct investment. The enterprises that were created and sustained on the basis of those investments tend to trade with Finland (Transformations in the Estonian Economy, 2000).

It is clear then that “This close economic connection played a significant role in [the Baltic’s] reorientation of foreign trade from East to West and supported later integration with the Western world and particularly with the EU.” Finland guided Estonia –and via Estonia the Baltic Region as a whole—through the EU integration process, from its inclusion in a EU-Baltic Free Trade Area in the mid 1990s through its application and negotiations for full EU membership. During this period, armed with knowledge, investment, and contacts, the Estonian textiles and apparel industry rapidly and progressively harmonized its industrial processes and quality control capability to meet EU standards. This meant modernization and before too long expanded capability in the higher value activities. The exports of products made in Estonia to the EU increased considerably during this period while those going to Easter Europe declines. Between 1995 and 2000, Estonian exports to the EU increased from 11.4 billion Kroner to over 27 billion Kroner. By 2000, nearly 60% of Estonian exports went to the EU. During this same period, exports to the EFTA (European Free Trade Agreement countries. and CIS countries increased only slightly and in any case together represented only a small percentage of Estonia’s total exports.

In the case of Lithuania, Sweden and Denmark appears to be the critical link and “champion.” Following Finland’s model, Sweden helped usher Lithuania into the EU. During this process, Swedish companies invested heavily in Lithuania, including its textile and apparel industry. Sweden also became one of the main trading partners for Lithuania’s light industry (followed by Germany, Denmark, and the UK following suit). Soon, other EU firms began to seek out Lithuanian companies. Such important EU clothing and textile groups such as Marzotto from Italy, Tuch Fabrik Wilhelm Becker from Germany, Chargeurs from France and Tolaram from Singapore joined forces with the larger and growing Lithuania textile and apparel firms to explore new market arenas in Eastern Europe. This close collaboration and interaction with EU firms and organizations has resulted in knowledge transfer thus allowing Lithuanian companies to expand its capabilities in production, marketing, and distribution. The larger Lithuanian companies have established relations with the best Italian and Swiss equipment manufacturers that further enhance the companies’ ability to meet EU environmental and quality standards. On the marketing side, Lithuanian companies increasingly collaborate with designers from Italy and France and the chance to exhibit their products at European fabric fairs in Brussels, Germany, and other countries on the fair circuit. In general, Lithuanian firms are increasingly using the experience and knowledge of style, patterns, fabric selection and production methods developed from export contacts to develop in-house capacity to develop own-design manufacturing (ODM) and less commonly own brand manufacturing. This is resulting in close association with EU retailers and catalog firms, and the establishment of in-house design capability and the selling of their own brand name products in EU fashion houses and outlets. \*

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\* In Lithuania, strong brand trademarks being developed --Audimas, Utenos Trikotazas (UT), Lelija, 3S, Nijole -- that successfully competed in export markets. (EKT Group, 2004.)

These contacts meant increased capital flow in the form of FDI from Western Europe into the Baltic. The bulk of the investments and subsidies that helped modernize and refurbish Lithuania's better-run textile and apparel plants came externally from these EU countries. In 2003, while Lithuania's domestic capital sources invested only 30 million Euros into the industry, foreign sources provided four times this amount --120 million Euros. As of January 2003, More than 900 foreign companies have invested in joint ventures in Lithuania's textile industry. As Lithuania became increasingly integrated within the European Union, the EU itself serves as a source of guidance and funding for Lithuania's (and the other Baltic States') textile and apparel industry. Located in an accession country preparing for entrance, companies like Uteanao Trikotazas in the late 1990s could work with the European Bank for Reconstruction and Development for funding and financial help and guidance in meeting European-wide and ISO standards. Being in accord with the production and market standards of other European companies put Lithuanian's firms on an equal footing competitively with their European counterparts. And served as an incentive for the formation of integrated, full-service companies competing within both Western and Eastern European markets.

Through the initial auspices of the Scandinavians, then, the Baltic states gradually integrated within the Western European economy. This was the crucial step in expanding their relationships with EU countries, first as junior members of CM and CMT-based joint venture ships, and eventually into more equal partnerships by which Lithuanian firms moved gradually but decidedly up the value-creation chain. (Anson, 2002; EKT Group). Subsidies and investments became increasingly linked with integration into the EU system of product standards, thus furthering the Baltic States' attractiveness as a growing center of textiles and high-end clothing.

As a result of this, an increasing number of textile and apparel SMEs have been growing in size (in terms of number of employees, for example) to the point where they can no longer be considered within the SME category. In some cases, this growth has been dramatic. Even more, these firms have become increasingly competitive internationally, in large part, through the re-equipping of its factories. These firms are characterized by their evolution up the process value chain. We note then that a growing number of Lithuania's textile and apparel firms are rising above the lower CM and CMT stages of production. Indeed, we see that several firms begin to employ designers and start their own collections, as well as offer FOB and private label services to foreign customers. These countries are host to a swelling number of clothing and apparel joint ventures and fully foreign-owned firms. These, in turn, bring in further know-how and trigger new and well-organized spin-off companies, leading to an expanding capability in design, marketing, finance, and merchandizing. Many large companies are integrating forward with retail shops in large cities. Several companies operate their own chains of clothing stores in Lithuania and neighboring countries. As a number of textile and apparel firms in the first-tier Eastern European did earlier, the Baltic States have, with the help of extensive FDI and resource transfer from Western firms, been able to build on their earlier experience and network of contacts with buyers and producers in the West to extend their process, technical, and service capabilities. Specifically, firms are increasingly using the experience and



knowledge of style, patterns, fabric selection, retailing, branding, and advertising from earlier export contacts to develop in-house own-design and own-brand manufacturing. The earlier establishment of business contacts with suppliers, producers and retailers in Western Europe (Italy, Germany, Scandinavia) has been especially important in terms of networking, and capital and knowledge inflows.

The company, Utenos Trikotazas, offers one case example. In 2005, this company stood as Lithuania's second largest textile and clothing manufacturer and its leading knitwear producer. Privatized in 1993, the firm has sustained growth over the last decade. The company, which now operates independently of any joint venture arrangement, employs over 1,000 persons. Its products are sold to both the retail and wholesale markets. (Anson, 2002). The company is highly integrated. Its production processes consist of knitting, finishing, dyeing, cutting, printing, sewing, embroidery, quality control and packaging. All processes take place under one roof. Utenos uses state of the art machinery and processes. In 2001, the company became the first Lithuanian textile company to obtain an ISO 14001 certificate for environmental management, which raised its competitive position in Western European markets. Approximately 90% of its output is exported, mostly to such EU countries as Sweden, Spain, Germany, Denmark, Finland, Switzerland, and the UK. Utenos also manages a network of 20 shops throughout Lithuania, Latvia, and the Ukraine and has retail and wholesale subsidiaries. Utenos has begun to brand its own line of clothes and will be opening up retail shops in Western European countries within the next few years. (EKT Group, 2004).

This is indicated in Table 3 that shows estimates of the percentage distribution of Lithuania's textile and apparel SMEs between 1990 and 2002, according to stage in the value chain at which firms are operating. This period was when the EU grew in extent and began integrating. It was in this period as well that Lithuania began preparing itself for eventual entry. As is seen, between 1990 and 2002, an increasing percentage of firms moved from simple offshore contracting to EU firms and began operating at higher levels within the value chain with an increasing percentage obtaining the ability to function at the fully integrated clothing enterprises.

**Table 3.** Estimate of Distribution of the textile and apparel SMEs in Lithuania, by stage in the value chain. (%): 1990-2002

| Stage | 1990 | 1995 | 2002 |
|-------|------|------|------|
| I     | 97   | 82   | 70   |
| II    | 2    | 10   | 14   |
| III   | 1    | 5    | 8    |
| IV    | 0    | 2    | 5    |
| V     | 0    | 1    | 3    |

Source: EKT Group, 2004; Lasiauskas, L., 2004; Roolaht, 2002; Coster, 2004.; Anson, 2002.

## 2. The Balkans

As with Lithuania, the textile and apparel industry is an important source of economic activity in the Balkans. It is estimated that apparel and clothing account for 10% of all employment and 15% of all of the Balkan's exports. Nevertheless, the Balkans presents us with a different situation than we have seen in the Baltic Region. The Balkan countries are, in general, categorized as the third tier countries with respect to their industries' ability to rise up the value chain. This is especially true of their textile and apparel firms. Table 2 shows that, labor costs for many of the Balkan countries at the low end of the scale. This indicates that the textile and apparel companies are undertaking as sub-contractors the relatively simple, low value added operations. In other words, the Balkan textile and apparel firms –for the most part SMEs—have not made the move up the value chain.

Indeed, as a group of countries, the Balkan region has been making slow progress in their development of an entrepreneur-based economy (IMF, 2005). This is true of the textile and apparel industry itself. While the Balkan countries are a diverse lot with unique history with respect to their textiles and apparel industry, a common thread is that they as a group have not as yet been able to evolve from blue collar to white-collar capability. This is indicated in Table 4 that shows estimates of the aggregate percentage distribution of a sampling of textile and apparel SMEs within different Balkan countries between 1990 and 2002, according to stage in the value chain at which firms are operating. This table offers a useful comparison with the parallel table for Baltic Region. In contrast to the Baltic States, the table suggests virtual stagnation within the Balkans, with its textile and apparel firms “stuck” in the low value added end of the value chain ((SIPO, 2004).

**Table 4.** Estimate of Distribution of textile and apparel SMEs in Moldova, by stage in the value chain.  
(%): 1990-2002

| Stage | 1990 | 1995 | 2002 |
|-------|------|------|------|
| I     | 99   | 98   | 98   |
| II    | 1    | 2    | 1    |
| III   | 0    | 0    | 1    |
| IV    | 0    | 0    | 0    |
| V     | 0    | 0    | 0    |

Source: Business Consulting Institute, 2004; Central European Chamber of Commerce, 2004; Development alternatives, Inc., 2004; Pro Era Group, 2004.

As Table 4 shows, these the textile and apparel SMEs in these countries “continue to rely on simple activities at the bottom of the supply chain in which the possibilities for higher value added activity is limited; firms tend to sew garments from patterns and designs provided by [Western] buyers and contractors; cloth may be already received already pre-cut by the contractor; contract prices yield tight margins, strict conditionalities, and heavy penalties for failure to meet delivery deadlines; and access to capital [and FDI] is difficult. One consequence for these...firms is increasing difficulty in obtaining contracts, and heightened difficulty the new service demands contractors are requiring (such as larger orders, shorter delivery schedules, and higher levels of quality.)” (Pickles, 2005).

The case study of one particular Balkan country, Moldova, is instructive. Prior to 1989, Moldova’s textile and clothing industry traded with the Soviet Union and its satellites. The Soviet central government essentially subcontracted CM and CMT work to Moldavian firms. After 1989, with the collapse of the Russian economy, the industry attempted to turn Westward to the EU. This redirection Westward succeeded, but only up to a point. European clothing firms increasingly turned to Moldova as a subcontractor. Moldova’s cheap labor supply was only a part of the reason for this realignment of trade westward. EU regulations themselves were instrumental in inducing the creation of this system. Indeed, it is believed that this West to East outsourcing or OPT (“Outward Processing Traffic”) is the main driving force for the formation of the sub-contractor relationships that developed between the EU and Moldova since the 1990s. OPT is a special EU regulation allowing preferential customs treatment to EU companies that outsource apparel production through the providing of materials of EU origin. In this case, import duty by EU companies is paid only on the value added at re-entry to the EU. In this system, EU customers supply materials –yarn and fabrics— to Moldova-based companies who then process the materials in the form of sewing and packing. In 2001, more than 80% of textile materials were imported from EU customers for processing by Moldova with 75% of apparel exports heading back to the EU (Italy, Germany, the Netherlands, and Belgium). The period 1998 to 2003 saw 25% annual growth in the export of apparel to the EU.

This “cut and make” activity on the part of Moldavian firms is essentially a tolling function that creates little value added in Moldova itself. Such tolling activity generates little income for the firms and helps to exacerbate Moldova’s trade deficit situation. Regional studies of the Balti, Soroca, and Chisnau regions of Moldova show that the value added that is captured in these areas vary from 2% to 15%. Though the incentive to retain greater value added and therefore profits exists in Moldova, as it does in Lithuania and Estonia, there is little evidence that this is happening. Some of the larger apparel, carpet and leather firms, such as Zorile, Ionel, Floare, and Coavare have attempted to integrate forward by setting up retail stores at their factory sites as well as offices in (for example) downtown Chisneau to sell apparel, shoes, and carpet that come directly from the factory. But these products are of poor design, low quality, non-branded and have few buyers. Virtually no links have been made between these forms and shops and the important European clothing and fashion industry in the EU countries. Overall, Moldova’s apparel and clothing industry sells 93% of their capacity on a Cut-and-Make” (CM) basis, and less than 2% on full price

subcontracting or under their own label. None of Moldova's apparel companies sell private label services. With such low value added permeating the industry, very little income is generated within Moldavian apparel firms. Consequently, these SME firms cannot by themselves generate sufficient cash to modernize plants and equipment, such as advanced machinery and computerized pattern design. For Moldova's clothing and apparel industry, the next important step in its internationalization is to move up the value chain in the production process –beyond the simple and passive “cut and make” operation-- so that the industry creates and captures a greater proportion of the total value added in the making and selling of clothing products.

In attempting to locate possible causes for the restraints in Moldova –and within the Balkans as a whole-- attention is often drawn to internal problems, including weaknesses in –and high costs associated with-- transportation and logistics networks, customs and bureaucratic inefficiencies and costs, underdeveloped financial institutions, and destructive taxation policies (in particular, value added tax on cutting wastes). Certainly, these problems compromise Moldova's capability to compete internationally in apparel and clothing markets. Moldova's advantage --low cost labor and geographical closeness-- become compromised due to numerous trade barriers created by the Moldavian Government. For example, customers cannot exploit the same speed to market advantages as EU and other CIS countries. This is important for fashion products where speed to market is critical. Corruption in the courts and government is also leveled at a number of the Balkan countries.

But how important these constraints are in explaining the barriers to achieving greater value added services are unclear. We have seen that in the case of the Baltic States significant internal problems – including uncertain judicial process, bureaucratic delays, the perception of corruption, and so forth-- jeopardized the significant inflow of FDI from the West. Yet, despite these problems, investment did indeed flow into the region. and, as it did, these internal problems began to alleviate. Moreover, a number of countries in the Balkans offer a number of advantages that could be viewed as an enticement to outside investment. Many of the countries have a strong textile and apparel traditions with strong production infrastructure. In countries such as Macedonia, foreign-owned trucking and transportation companies have been operating. These low-cost transportation networks allow the ready movement of materials into and out of the country. The banking community has been growing and offering a more complete range of financial services. Business transactions are becoming standardized and streamlined. While corruption remains an issue for the region, Lithuania is rated more corrupt than a number of the Balkan States. Further, trade in the region has become far more liberalized than in the past. For example, over 80% of trade exchanges of Macedonia is being carried out under preferential conditions from Bilateral and Multilateral Free Trade Agreements In Macedonia, over 80% of trade exchanges are carried out under preferential conditions from Bilateral and Multilateral Free Trade Agreements (EFTA with EFTA states (Switzerland, Norway, Iceland and Liechtenstein) and the Stabilization and Association Agreement with the European Community.

In attempting to better understand the specific dynamic behind the observed difficulties experienced by the Balkan countries, we can refer to what we have learned about the Baltic Region, which, as we see, has been more successful in advancing to an international service economy. This region in its success teaches us that three factors must be in place for a country or region to become trapped in the lower blue-collar rings of the value chain. First, the industry within a country or region must have a relatively cheap, semi-skilled labor supply. This will attract low-level subcontracting work from larger companies in Western Europe and the US. All else being equal, these Western firms will not be enticed to invest greatly in the less developed country or region because this will only serve to raise wages and so undercut an advantage that attracted the Western firms to outsource to the country in the first place. This means that the West will attempt to keep the country to which it outsources simple and low value added operations in the lower level of the value chain.

Second, the country or region cannot have a “champion” well positioned and with influence in the West that will undertake the job of gradually integrating it within the Western market network. While the Baltic region initially attracted low-level outsourced work from larger Western textile and apparel firms because of low labor costs, champions appeared in the form of Finland and Sweden that believed the Baltic could serve the larger economic goals of Scandinavia and, ultimately, the European Union as a whole. If the Baltic’s textiles and apparel industry could be upgraded, modernized, and integrated in the forward direction, it would become an active and equal trading partner with the Scandinavian industry and eventually the European-wide industry. Important economies and synergies would be generated with the important western textile and apparel firms. Moreover, it was well understood in the West that the Baltic region is favorably positioned geographically to serve as a vital link between the markets of Western Europe and those of the Eastern European states newly arrived (2004) within the EU. In the case of the Baltic region, then, these potential advantages overrode the more limited benefits to the West of a cheap labor market. Accordingly, with the champion country acting as the crucial bridge between, and integrating agent binding together, the EU and the Baltic, Western investment, technology, and economic and technical know how flowed into the region and catalyzed the process by which the textile and apparel industries within Lithuania and Estonia in particular evolved from low value-added sub-contracting to high-value added service capability, including administration, retailing, and marketing. This has not been the case for the Balkan States. Years of wars and civil strife, no obvious geographical advantages, distance from Western markets, lack of extensive trading networks with the West, continued links to Russia and socialist traditions, diverse cultures, economies and industrial capabilities, all converge to deter the coming forward of a regional champion that, as Finland did for the Balkans, lead the countries as a block into greater integration with the West. As a result, the West continues to view the Balkans as useful only as a source of cheap labor and low-value-based outsourcing in order to free the larger firms in Europe to undertake higher value added activity. Thus, there is no incentive to invest in this region to any extent, as that would jeopardize these very real –if limited—benefits (CRPM, 2005).

Third, the European Union has had to undergo expansion and integration in a way that prevents “outsider” countries and regions from gaining ready access to its markets. Even if no champion appeared but an outlier country –such as Moldova—could gain access to these markets by other means, then Western capital and, via resource transfer effects, technology and information would like flow into that county. This, in turn would allow an evolution to occur up the value chain. But in fact, while the rise of the EU is generally considered a positive economic force, its structure has the effect of closing out from its markets non-accession countries in the East and thus perpetuating the cycle of poverty and industrial and economic stagnation in this part of the world. The role of the EU in Moldova’s internationalization efforts offers a compelling illustration.

If the EU proved a spur to value creation in Lithuania, it acts more as a brake to Moldova’s garment and clothing SMEs in their attempts to evolve along the industry’s value chain. There are certainly indirect constraints that arise from the fact that the EU is expanding and integrating, that Moldova is not considered a likely candidate for accession, at least in the foreseeable future, and that the industry is composed mostly of small, low net profit firms. There is the issue of customs requirements, for example. The more a company attempts to move up the value chain, the more expensive and time consuming become customs clearance, import duty procedures, and related EU requirements. Especially onerous are the costs and time required to satisfy EU customs authorities on the “rules of origin” requirements in order to obtain preferential treatment. In order to access the EU on a preferential basis, Moldova producers would have to prove that they exported their fabric from the EU rather than from low cost areas, such as India and China. Currently, the costs and responsibilities for doing this rest with the dominant, European “joint” partners. But, if companies in Moldova were to attempt to move up the value chain, they would need to take over these responsibilities for themselves. In doing so, they would be placed in a potentially untenable economic position: to employ cheap labor countries and forego critical trade preferences in entering EU markets, or to enter the Union under preferential treatment but at considerable expense and time proving “rule of origin” requirements and prohibited from taking advantage of important economies by sourcing from non-EU cheap labor countries.

There is the issue of international standards. Just as the rise of the global supermarket within the EU constructed barriers to entry into Europe by Moldova’s agricultural and wine producing sectors, so the recent influence of international standards in clothing and apparel is a serious hindrance for Moldova’s firms to enter into higher stages of the value chain. In particular, the industry standards developed by the International Organization for Standardization (ISO 9000) are a product of, and closely embraced by, the EU community. In part this is because, in contrast to the US legal system, the EU legal regime is based largely on a code system that is less reliant on private (civil) litigation than in the US. European consumers who purchase products that fail cannot readily seek redress in the courts. As a consequence, Europe relies more heavily on certification requirements in general and ISO quality management standards (ISO 9000) in particular across the EU. As the EU has grown, meeting ISO quality standards has become increasingly critical for any company to do business in the region. But meeting ISO standards in European markets is

difficult and costly, involving the performing of multiple tests and the obtaining of different certificates of conformity. The small firm in Moldova does not generally have the resources to obtain the needed ISO 9000 certification. Currently, Moldova has very few companies with ISO 9000 certification. Attempts to move into higher stages, he becomes progressively more responsible for quality control. Without the financial means –or his own government’s help—in adopting ISO quality standards, the company cannot attract FDI from Europe nor could it effectively compete against other ISO-compliant firms in the European market.

Furthermore, with the evolution of the European single market, customers throughout the EU expect to be provided with full service by clothing and apparel companies, including garment and pattern design, material sourcing, and manufacturing. This provides an added incentive for European companies to retain as much control over the entire process as possible. If they form joint ventures with companies in cheap labor countries such as Moldova, companies such as Steilmann’s want to be sure to retain the dominant role. In any case, and in contrast to the situation in Lithuania, it is difficult for Moldavian firms to piggy back off the reputation and contacts of the EU venture partners. The venture partner simply does not allow it. This is so because the EU contractor does not see Moldavian clothing firms as being on any higher level than simple sub-contracted production. This is so for a number of reasons: Moldova is not part of EU and so not linked to standards of the country. There is therefore a persistent concern in just securing proper production quality. Moldova’s SMEs have limited access to ready-to-use services spaces and must themselves make investments in water, heating, and power networks since foreign firms do not pay such infrastructural expenditures. This serves to further reduce profit margins and limit future growth. Even larger, growing companies have trouble enticing investment from European partners. Such was the case with the company Zorile which recently has been looking for a buyer/investor to assist company’s management to increase production, explore new markets for exports, upgrade existing equipment, and increase working capital. The company’s German partner demonstrated little interest resulting the company becoming employee-owned.

The negotiation process itself that occurs between Moldavian clothing firms and EU companies is designed to maintain the latter as the dominant partner. A study of the industry in the Soroca region of Moldova shows that the clothing firms there suffer from a lack of price transparency in negotiation practice due to currency differences, lack of international experience on the part of Moldavian firms, and most critically EU’s attempts to keep hidden from non EU members standard negotiating practice within the Union. Interviews with entrepreneurs indicate that their ignorance of prices at the regional (EU) level makes them work way under regional price. This lack of knowledge and “savvy” is then exploited by EU firms to disadvantage when attempting to negotiate higher value.

Overall, “The impression remain that since the early 1990s, neither EU companies of government or EU Commission have really pushed to develop synergies with the textile and clothing sectors in [certain Eastern European] countries...As a result, these countries have lost key parts of their value chains”. (Coster, 2004). The conclusion then for the Balkans as a whole is expressed in a recent report on Kosovo:

“Given the small size of businesses operating in [the Balkans] and the absence of [market access to the West] and marketing know how as well as established commercial contacts with [western] international market”. The country cannot do better than accessing local and regional markets at best.

### **3. The EU, Eastern Europe, and the Seamless Industrial Network**

This study comparing the Baltic States with such Balkan countries as Moldova suggests that regionalization -such as typified by the expanding European Union—can directly and indirectly hinder the extent and intensity of internationalization activities, and in turn, value creation of other countries that are outlier, non-accession nations. One conclusion we can suggest from our study here is that an important advantage that the accession countries can claim is that they, because of common processing standards, currencies of exchange, and product quality requirements, more easily fit into the fabric of the pan-European industrial network. This is important because, with the rise of internet-based global production and distribution (such as electronic point of sales) and the demand for international just-in-time logistics, these stages in the value chain are becoming increasingly interdependent. The supply chain from sourcing of raw materials via design and production to distribution and marketing is being organized as an integrated production network where the production is strategically located to contribute value added capability.

The critical point is to make goods, information, and payments flow smoothly at each link in the production chain of an industry. To do this, a number of logistics and business services are needed. Integration of information and flows of goods and payments are only possible if all the links in the chain use compatible standards. For example, sub-contractors in the textile and apparel industry are increasingly required to add bar codes that comply with EU industry standards to garments before they are shipped.

Therefore, as countries join the EU, they also become part of the ever expanding and increasingly integrated production network that defines their industry (i.e., the European-wide textile and apparel industry network) The growth of an industry' network occurs as it becomes part of the overall production structure. The accession countries that join the network certainly achieve significant economies of scale over a number of dimensions that they did not have access to before.

But the EU, and the major companies working within it, also increasingly have a stake in assuring that these new additions to the network grow and prosper as they integrate more or less seamlessly into the pan-European industrial structure. This is so because successful additions to the network benefit all members through ever growing economies. Moreover, as the network expands and becomes increasingly interconnected, bottlenecks that occur anywhere in an industry's network cause problems throughout the system and that decrease the value in the activities of all members. In the apparel industry, for example, such problems can lead to delays in delivery thus reducing the final value of fashion-centered clothing

Moreover, this pan-European integrated network has become increasing important as the EU's textile and apparel industry has come under intense pressure from Asian imports (see Table 2 showing the cost advantages of Asian production relative to Western Europe). If the EU cannot compete against Asia's



significantly cheaper labor structure, it can do so through the economies, technologies, and specialization afforded by a pan-European industrial network. Despite the huge labor cost differences between those countries and Europe, the textile and clothing industry remains competitive due to higher productivity and the competitive strengths of innovation, quality, creativity, and design and fashion. Overall, the EU recognizes that better coordination required in strengthening the effectiveness and the synergy of numerous activities but interlinked activities.

The irony is that the liberalization of trade throughout the EU that has allowed greater competition from Asian countries also provides the context for competing against these imports. Essentially, collaboration between different parts of textiles and apparel throughout an integrated European market offers mutual benefits that supplies significant competitive benefits in ways that reinforce Porter’s theory of the value system. For example, it is well understood in Europe’s textile and apparel industry that different countries bring different and specialized strengths to the network. Table 5 shows the distribution of strengths within Europe’s textile and apparel industry for three major EU members: the US, Germany, and Italy. Within this free trade region, each country can specialize within its area(s) of expertise. Then coordination and interlinkages between these countries across Europe allows for powerful regional competitive advantage.

**Table 5** Distribution of Specialties in the textile and apparel industry: UK, Germany, and Italy

| Country | Production | Product Quality | Technology | Creative Design | Branding | Advertising | “Image” Placement | Corporate Communications | Retailing |
|---------|------------|-----------------|------------|-----------------|----------|-------------|-------------------|--------------------------|-----------|
| UK      |            |                 | X          | X               |          |             |                   | X                        | X         |
| Germany | X          | X               | X          |                 | X        | X           |                   |                          |           |
| Italy   |            | X               |            | X               | X        | X           | X                 |                          |           |
|         |            |                 |            |                 |          |             |                   |                          |           |

In contrast, the non-accession Balkan states simply do not figure into this equation and can actually serve to derail this finely balanced pan-European industrial network. The textile and apparel industry in the Balkans has not had an easy time more fully incorporating itself into Europe's production and distribution system. Quality, standards, currency, and even cultural issues have prevented this. As a result, the region’s textile and apparel firms have not been able to become a seamless part of the Pan European industry. Indeed the problem for the outlier countries extends even beyond these considerations to more structural issues. As the European Union has expanded and become a more consolidated industrial and market network, “contracts requiring larger production runs...favor manufacturers with larger capacities and more diverse [high value] services (input sourcing, pressing, packaging, labeling, branding, designing,

retailing” (Pickles). In their present state, of evolution, textile and apparel firms in these countries simply cannot meet these requirements.

Fundamentally, investing by the West in the Balkans does not add much to the value to the existing EU industrial network and indeed, might help to subvert the fine workings of the carefully constructed production and distribution system. This is not to say that Western European companies do not value the Balkan’s firms’ comparative advantage in cheap labor. In fact, this is the sole advantage these outliers provide to the developed world in its attempts to ward off Asian competition. But this is as far as it goes. Indeed, the very fact of this advantage -and that the EU has little incentive to help the country’s clothing industry move beyond it-- helps to maintain the Balkan’s textile and apparel industry in its subservient position in the value chain.

## **V. APPLICATION BEYOND EUROPE - SUB-SAHARAN AFRICA**

The case of Eastern Europe shows that there is a complex relationship between regionalization (as exemplified by the European Union) and internationalization. It is commonly believed that the rise, expansion, and progressive integration of the EU have been positive forces for the internationalization of European firms, especially the small and medium sized enterprise. Liberalized trade, the push towards the a European “Single Market,” increased transparency and business competition, a deeper pool of cheaper capital all should tend towards greater entrepreneurship, innovation, and, in turn, the evolution of SMEs up the value chain. We have seen that, within the Baltic region’s textiles and apparel industry, this was indeed the case. The case of the Balkan countries paints quite a different picture, one of firms imprisoned in low-value, blue-collar production activities with little prospect of progressing of integrating forward into the far more lucrative realm of white-collar services. Indeed, without a champion country to guide them into becoming an integral part of the EU’s expanding and more rigorously integrated single market, Europe condemns them to being low value subcontractors of simple production operations. This is so because, without obvious other strategic advantages (as the Baltic States offered), this is the only role they can play in Europe’s push for regional competitive advantage, especially as the Asian countries more intensely compete in Western markets.

But what of other regions in the world? Do the lessons learned in our comparative analysis of the Baltic regions and Balkan countries find applicability outside of the European context? In particular, increasing interest on the part of the business scholarly community is being directed toward Sub-Saharan Africa, a region where textiles and apparel plays so dominant a role. Does this region parallel that of the EU with respect to the relationship between regionalization and integration? We may ask as well whether it is realistic to expect that this region could actually becoming an integral part of the EU business network and, if so, if doing so would offer synergies to both the European and Sub-Saharan African textile and apparel industry. On the other hand, is the Sub-Saharan industry more similar to the Balkans, an outlier

region that offers little to the wider European markets except cheap labor and so is condemned to remain a low-level subcontractor to the West?

Our initial research on the Sub-Saharan Region suggests certain common issues and themes. It is an excellent case application of the results found for Eastern Europe. We find in fact that the Sub-Sahara region presents a complex picture that is a hybrid of, and reflects characteristics of both, the Baltic and Balkan regions. In the first place, we note that patterns in the South African apparel and textiles industry offers a number of similarities with that of Eastern Europe. In the first place, as in the Eastern European countries, the industry is an important one for the South African economy. Textiles and apparel is the sixth largest industry in South Africa in terms of employment (employing a total of nearly 400,000 people), a major exporting industry and the second largest source of tax revenue. The industry accounts for 25% of manufacturing output and 4% of the country's total GDP. As in Eastern European countries, South Africa is dominated by the SMEs. Thus we find that 86% of all textile and apparel firms are small or medium-sized with the remaining 14% considered large firms. Moreover, as in Eastern Europe, a sea change in the political and economic context occurred in the late 1980s and early 90s which should have led to significant growth in industrial performance through the 1990s. The fall of Communism and the rise of privatization defined conditions in Eastern Europe. The fall of apartheid and the consequent end of Western economic sanctions played a similar role in South Africa (Bharath. K., 2004).

Yet, as with the outlier Balkan countries, South Africa's textile and apparel industry underwent economic hardship, experiencing stagnant or declining production post-1995. The industry experienced weak investment activity, which meant that capital stock became very dated. By the early 1990s, the average age of most equipment and machinery was between 14-20 years old. While investment levels in the industry rose sharply in 2000, the impact was not sufficient to cause a turn around in the industry's fortunes. By 2000, towns that were formerly hubs of textile activity (including spinning and fabric knitting) became industrial ghost towns accompanied by closures of South African clothing firms

In contrast to Eastern Europe, internal conditions in South Africa have played a significant role in the declining fortunes of the industry. Infrastructure is not the issue. South Africa has superior transportation, water, and electricity networks as well as a well-developed professional support service sector including financial, legal, and communications. Despite these advantages, two internal facts of life in South Africa have proven troublesome for the industry. First, the prominent role of labor unions in the industry means that labor costs in the country are very high, relative to other parts of the world. This is seen in Table 6.

**Table 6.** Hourly Compensation for Selected Countries: Textiles and Clothing  
2002 (US\$)

| Country  | Textiles  | Clothing  |
|----------|-----------|-----------|
| China    | 0.41-0.68 | 0.68-0.88 |
| India    | 0.57      | 0.38      |
| Pakistan | 0.34      | 0.41      |

|              |      |      |
|--------------|------|------|
| Mauritius    | 1.33 | 1.25 |
| South Africa | 2.17 | 1.38 |
| Indonesia    | 0.5  | 0.27 |
| Thailand     | 1.24 | 0.91 |

Source: Bharath, K. (2004) "Torn to Shreds: Africa's Clothing/Textile Industries Face Bleak Future" *Finance Week*: p. 62.

Secondly, there is a geographical and cultural reality that, while South Africans can be brand conscious, they tend not to be susceptible to Western fads. Both of these tendencies have resulted in a certain isolation of the industry from the markets of the developed countries. The high labor costs assure that the Western firms avoid South Africa as a place to do outsourcing business (Roberts and Thoburn, 2004). South Africa's lack of interest in Western designs further limits investment flows by the West into the country's textile and apparel industry and enables a continual turning inward of an industry that cannot –and will not—expand its international networks. This problem impacts a wide sector of the country's industries. It is not surprising then that, overall, South Africa's export volumes of manufactured goods have fallen 3% annually since the late 1990s. A particular concern has been the relative stagnation of clothing exports to the EU and US despite trade agreements between South Africa and both these regions. \* The imports of cheap textiles and clothes from Asia have exacerbated the situation for the South African industry (McRee, 2002).

We thus see similarities and differences with Eastern Europe. As with the non-accession outlier countries, like Moldova, the textile and clothing industry in South Africa remains stagnant. But, unlike Moldova and similar outlier countries of Eastern Europe, the state of South Africa's industry depends to a great extent on internal conditions, specifically the structure of the labor market and cultural and geographical forces that blunts interest in international trends and markets. The outlier Eastern European countries (e.g., Moldova) are held back from ascending the value chain ladder by external forces, that is, the expanding and increasingly integrated European Union has little use for these counties beyond low-value added outsourcing (Datamonitor, 2005). But to this limited extent, at least they are linked in some manner to the larger international markets. But South Africa is practically isolated internationally. It in effect holds itself a prisoner in the economic basement of the value chain. (RATES, 2005). It is not the EU (or US) that exerts this pressure, for very little outsourcing from the West occurs at all. This is so because the large international clothing producers source cloth globally in large quantities. This is an important part

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 \* The US Africa Growth Opportunities Act (2001), or AGOA provides qualifying African countries with reduced duties for exports of African-made clothing assembled from African or US fabric to the US market for an initial period of 8 years. The EU-SA Trade and Development Cooperation (Free Trade) Agreement: (2000) Provides for EU tariffs to be reduced to zero over 6 years and for South African tariffs to be reduced to half of MFN tariff level over 8 years,

of their competitive advantage. They then allocate production amongst their different plants located in low-cost countries. South Africa's labor costs –as well as its “Rules-of Origin” restrictions -- interferes with this process and renders this country a less advantageous location compared with other potential sourcing sites. This inwardness means that the South African textile and apparel industry has limited participation in global sourcing and difficulty in achieving economies of scale that could offset the high costs of capital. It also means few vertically integrated firms, insignificant capabilities by SMEs in the more valuable services that are demanded by western firms (for example, there is a lack of international experience by South African firms in marketing, advertising, retailing and other services) and inability of SMEs to internationalize through “inward-outward” mechanisms and so take advantage of the opportunities and long-run advantages of the larger and expanding foreign markets (Kaplan, D. , 2004).

An important advantage in the fact that the South African textile and apparel industry is constrained by internal rather than uncontrollable exogenous forces is that the industry and government can be the master of their own fate, as it will, and determine to set its own house in order in order to be more globally competitive. In doing so, South Africa must get away from the Balkan model and move to the Baltic paradigm of value chain ascendancy. In part, this means technology development and applications in order to achieve the capability to move up the value chain from blue-collar production to white-collar services. Some 80% of products manufactured in South Africa are commodity products, while only 5% of output can be considered high-technology products. Because of competition from the East in commodity products, it is critical that South Africa begin to switch from commodity to high tech, niche products, It is estimated that at least 20% of South Africa's commodity products must be in the high tech category. For example, the use of smart textiles, advanced design capabilities, and closer linking of design to market requirements. (Infomat, 2005).

These of course require investment and resource transfer from Western firms. We have learned from our investigation of Eastern Europe that this occurs when the West believes that a country or region has strategic value to the industrial network as a whole. In the case of the Baltic States, this strategic value overrode the more familiar benefits of cheap labor and easy outsourcing opportunities. In the case of South Africa, such strategic advantages would have to overcome the disadvantages of high labor costs and geographical distance in order to entice the EU into bringing the region into its expanding market and distribution network. In turn, this would release FDI, technology, and know how regarding international markets, strategic partners, distribution systems, and so forth. (Textiles Intelligence, 2001; Steyn, 2004). Such a strategic advantage would emerge by integrating the Sub-Saharan textile and clothing industry into an expanded regionally harmonized and vertically integrated regional industry. Just as in the EU, this approach would take advantage of the comparative specialized advantage of each of the countries in the region. Thus, for example, cotton would be grown in countries such as Zimbabwe, Zambia, Mozambique, and Malawi; cotton spinning would be located in another state; and final clothing manufacture elsewhere in the region. This would ensure economies of scale while also enabling the industry to exploit least-cost locations for these different processes (“Ducking and Weaving”, 1999).

This implies certain directions for government to take. Most importantly, to remove all trade boundaries in the Sub-Sahara region. Currently there are many bilateral agreements that have to be raised to regional level instead of country level. There must be promotion of intra-regional discussion and collaboration. There should be shared knowledge and learning. The appropriate human resource skills development must be well coordinated in the region in order to revitalize the textile manufacturing industry in the various countries in the region. This is critical because “The fragmentation into small sectors within the textile pipeline only promotes inward looking philosophy which is always counter productive, by looking at the value chain as a whole, integrated thing. The final goal is to produce expanded linkages, alliances, and networks, as well as sharing knowledge and resources between centers and pockets of excellence locally and regionally. This would result in “leaner production, agile production, on-line monitoring, and control and quick response [which] are all essential ingredients for a vibrant 21<sup>st</sup> century South African textile and clothing sector.” Just as the Baltic region, the Sub-Sahara region could begin to offer the EU strategic benefits that could be utilized to establish greater competitive positionings against Asian imports. Then, with the agency of a “champion,” the region could be integrated with a widening and more comprehensive EU “Single Market” structure. and enjoy the benefits of capital, knowledge, and technology that are sure to follow.

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