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LESSONS LEARNED FROM THE PHASE-OUT OF THE
MFAs: MOVING FROM MANAGED DISTORTION TO
MANAGED DISTORTION

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A circular image showing a close-up of a cotton boll with its seeds, set against a light blue background with a subtle circular pattern.

Cotton Economics Research Institute Report

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Introduction

The establishment and the eventual phase-out of the Multi-Fiber Arrangements (MFAs) have the potential to offer lessons about managed trade. While many factors have influenced the market outcomes in textiles and clothing (T&C), this paper attempts to distill key elements that can form the foundation of a better understanding of changes in managed trade systems for the future. Filtering past history can be difficult because of the myriad of confounding causal factors that result in observed behavior. Nevertheless, a retrospective can be useful because it passes observations through a prism that can delineate some root causes and consequences. This paper proceeds as follows. First, a brief history of textile and clothing MFAs is presented. Next, some of the unintended consequences of textile trade policy are discussed. Third, the pre-MFA phase-out estimates of impacts and compare those with actual outcomes are summarized. Fourth, an overview of the MFA phase-out and some of the policy responses in the wake (or in conjunction with) the phase-out is provided. Finally, we offer some lessons learned from the MFA removal process and some questions for the future.

A Brief History

The MFAs, and more broadly, managed textile trade, was a source of consternation for many in an increasingly global industry for many years. Much of the developed world today began its development process with textile production during the Industrial Revolution of the 1700s. The early American colonies, for example, were major suppliers of raw cotton into British textile factories until a

viable textile industry arose in the American north. Because of the importance of these industries in developed countries, they developed political influence.

To some extent, textile manufacturing had begun a slow transition to developing countries by the end of the 1920s, but that transition was significantly disrupted during World War II. By the 1950s, countries like Japan had resumed rapid expansion of textile production as a means of development and recovery. These producing countries quickly began to gain economies of scale and use that lower cost of production to capture market share in developed countries (Reinert, 2000; Hayashi, 2005; Finger and Harrison, 1994; Spinanger, 1999).

The pressure quickly began to build in developed countries to somehow control or manage the imports of textiles from developing countries. In fact, in 1955, European countries elected to invoke Article XXXV of the General Agreement on Tariffs and Trade (GATT) and withhold trading rights with Japan (Finger and Harrison, 1994; Spinanger, 1999). At the same time (perhaps in return for the United States' support for Japan's membership in GATT), Japan agreed to voluntary export restraints on textile and apparel exports to the U.S.

After a number of alternative short-term arrangements, countries ultimately agreed to a Long-Term Agreement (LTA) on trade in textiles in 1962. This agreement provided for quantitative restrictions on trade of textile products, allowing for some growth in quotas. This agreement was extended in 1967 and 1970. The growth in man-made fiber (MMF) production complicated this process because MMF production was not covered in the LTA. After extensive negotiation, the LTA was extended to cover MMFs, resulting in the modern MFA system in 1974 (Reinert, 2000; Hayashi, 2005; Finger and Harrison, 1994; Spinanger, 1999).

The MFA was subsequently used to negotiate numerous bilateral agreements between the U.S. and major textile producers, a practice that was adopted quickly by the European Union (EU) and other

developed countries. This system enabled developed importing countries to impose quotas against imports from developing countries (and newly developed countries like Japan) considered as low cost suppliers of textiles and clothing (T&C). After several renewals, political pressure was building in developing countries questioning the rationality of the MFA system, and by the mid-1980s, there was a strong desire to negotiate an end to the MFA system. The MFAs were subsumed during the Uruguay Round of negotiations in the Agreement on Textiles and Clothing (ATC) that took effect in 1995. The ATC provided for the eventual elimination of MFA quotas in 2005.

Unintended Consequences of the MFAs

There are both intended and unintended consequences in any intervention into markets. The unintended consequences arise because of hidden incentives that support behaviors that were not desired or anticipated. The MFA is no exception. In this section, we outline a few of the unintended consequences that are critical to understanding the outcome of the MFA phase-out.

One of the unintended consequences of the MFA was to create T&C industries in poorer, least developed countries (LDCs) as quota-constrained economies shifted investments to countries with low levels of quota utilization (which can be called quota-hopping foreign investment). Korean companies established factories in Bangladesh, Caribbean countries, and Sub-Saharan Africa, Chinese companies set up factories in some Asian and African locations, Indian companies in Nepal and even small businesses in Sri Lanka and Mauritius organized factories in the Maldives and Madagascar (Adhikari and Yamamoto, 2007). While some of these economies were able to indigenize the T&C industry, others were unable to generate local investments into the sector. This latter set of countries was able to increase their exports without needing to improve both their essential competitive strengths and infrastructure. This occurrence represents a production pattern brought about by misaligned incentives

(not necessarily due to comparative advantage) for resource allocation in response to quotas under the MFA (UNDP, 2005).

Exporting countries can be grouped into four categories based on their T&C system arrangement: (1) countries with vertically integrated production in both textiles and clothing such as China and India; (2) countries that have limited capability in both textiles and apparel such as Pakistan, Thailand and Vietnam; (3) middle income countries that have mainly apparel capability like Sri Lanka and the Philippines, and (4) least-developed countries such as Bangladesh, Cambodia, Lao PDR and Nepal (Adhikari and Weeratunge, 2006). Where a country lies in these categories appears to have an important correlation with their post-MFA success. Category 1 appears to have had the cash reserves necessary to create vertically integrated systems that could capture the benefits of the MFA removal. As we move down the categories, countries rely more on imported fabrics and accessories; this underscores the importance of infrastructure and trade facilitation.

Another example of an unintended effect of the MFAs was transshipment of clothing to falsely declare items as originating from countries with unused quota or to allow for residual upgrading (adding buttons to shirts, for instance) (Dayaratna-Banda and Whalley, 2007). Here, some countries with significant T&C “production” had no apparent basis for being T&C producers (that is, no apparent comparative advantage or policy instrument that would lead to competitive advantage). Besides generating trade flows that were counterintuitive, the existence of transshipment activities exacted more resource costs on importing countries to prevent circumvention than would have been incurred absent transshipment.

Of course, the normal ebbs and flows of trade and production based on economic incentives did occur. For example, over time, economies like Korea, Hong Kong, Malaysia, and Taiwan (that were highly competitive in the T&C sector until the early 1980s) shifted to higher value-added, less labor-

intensive products. Today, Bangladesh, China, India, Indonesia, Pakistan, and Vietnam have taken over the labor-intensive segments of the world T&C sector (Adhikari and Weeratunge, 2006).¹ But, as noted in the next section, the anticipated effects of MFA removal were not always as expected.

MFA Elimination: What Was Projected and What Has Transpired

Generally, the elimination of the MFA was presumed to be a net global benefit because it represented an elimination of a distortionary set of trade agreements. But, that presumption was based on the assumption that the underlying global trading regime was based on free trade principles. However, due to the trading pattern that has emerged after the MFA – with production infrastructure and trading rules based on distortionary incentives so entrenched into the system, the global trading regime after the elimination of quotas is still far short of free.

It is worth emphasizing that MFA elimination has not ended trade restrictions in T&C; it merely did away with the bilateral trade quotas set by developed T&C importing countries, dominated by the U.S. and the E.U., for exporting developing countries (Feldman, 2009). The T&C trading system is still substantially restricted by tariffs, subsidies, preferential trade agreements, and other non-tariff barriers. It is further worth noting that the models used in analyzing the expected adjustments typically assumed that the adjustments are driven primarily by economic (cost) differentials among countries and relatively little by non-economic (policy) forces across countries. Additionally, the studies typically assumed that international trade markets are effectively structurally competitive (absent of monopolistic or oligopolistic influences), which may not be a valid assumption (Ethridge, 2007).

Most of the studies that projected the adjustments from MFA to the current ACT accurately anticipated the *direction* of T&C trade flow pattern changes for the *major importers* (U.S. and E.U.) and

¹ China, however, has been producing more higher-quality, less labor-intensive products in recent years as evidenced by its declining revealed comparative advantage in textiles and clothing (Martin, 2007).

the *major exporters* (China and India). However, the increase in volume of T&C trade did not materialize, and there may have been a decrease in the rate of trade increase since the MFA phase-out (see Figure 1). Further, the generally anticipated price decreases in T&C have been less than were anticipated by most studies (Ahmad and Diaz, 2008). Thus, the trade shifts *in the aggregate* have been less dramatic than most models projected.

A more disaggregated view (that is, country-by-country) of bilateral trade flows of individual countries shows significant deviations from projections. Trade flow shifts were generally less dramatic than was anticipated. This may be partially explained by the industry anticipating adjustments and being proactive in adjusting to the changes they had anticipated. That aside, it appears that both China and India have captured less of the U.S. and E.U. markets than was anticipated (Ahmad and Diaz, 2008; Martin, 2009; Baleix, 2005). The E.U.'s imports of clothing were forecast to increase by 20%, with the biggest increases from China (27%), India (12%), and Korea (10%) (Baleix, 2005), while the actual increase from 2004 to 2007 was 6.5%, and imports from Korea declined by 22.5% (Ahmad and Diaz, 2008). China's total T&C exports have grown faster than its T&C exports to the U.S. (Martin, 2007). China's share of global T&C exports increased sharply in 2005 following steady growth since 1999, but has slowed since 2005 (Martin, 2009).

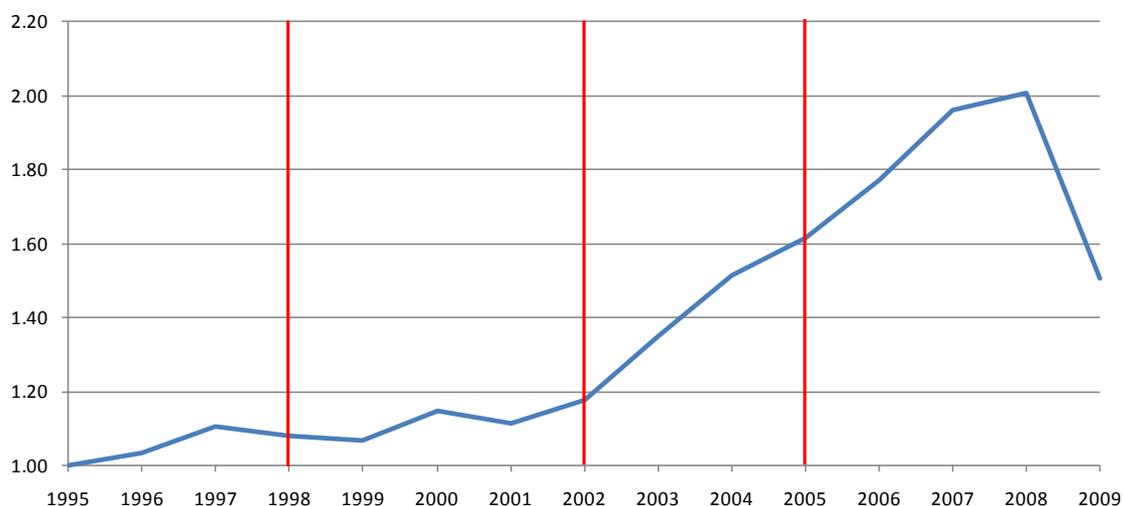
China and India could have been engaging in "quota hopping foreign direct investment" in order to by-pass earlier quota restrictions thereby leading to less expansion in Chinese exports to the U.S. and E.U. post-MFA phase-out. Further, as China's T&C production and exports have grown, labor costs in China have risen and China has expanded its manufacturing into lower labor cost countries, primarily in Asia (Wang et al., 2008). Could some of the less-than-anticipated increase in post-MFA T&C exports from China be accounted for by these hypotheses?

Conversely, several developing countries (e.g., Bangladesh and Cambodia) have held or increased their T&C exports, counter to most *a priori* projections (Ahmad and Diaz, 2008). What factors

explain the relative successes in these cases? Could these countries have benefitted from foreign direct investment to build their T&C infrastructure during the MFA period and subsequently capitalized on those through preferential trading arrangements in the aftermath of the MFA? Or, could these countries have benefitted from the MFA indirectly and now have to be using direct and indirect subsidies to keep their less efficient T&C sectors viable? Or, could the phase-out of the MFA have simply opened the doors for some countries with a natural comparative advantage in T&C to flourish? Answers may be relevant to understanding the future directions of the global industry.

Looking back, the global recession that became obvious in 2008 was an unanticipated event that slowed T&C consumption and trade; still, the slowdown in T&C trade growth seemed to have already been underway prior to the recession.² The U.S. and E.U. markets have dominated the global picture in T&C for many years, at least on the consumption side. Most analysts implicitly assume that this will continue to be the case. However, with countries such as China and India growing in population and economic influence, they may become larger consumer markets as well. Are China's and India's potential as consumer markets being overlooked because we are assuming that those countries will continue their protectionist policies?

² Because textile production is easier to adjust than other industrial processes, it may be that the textile and clothing slowdown was a leading indicator for the recession.



Note: Textiles and clothing refer to products covered by HS Section XI (HS Chapters 50 through 63) excluding agricultural textile raw materials classified under HS 5001-03, 5101-03, 5201-03 and 5301-02.

Figure 1. Index of World T&C Exports (by Value) with Major Quota Phase-Out Periods

Demarcated, 1995-2009 (Base Year = 1995)

An Overview of the Phase Out of Quotas

Under the ATC, importing countries phased out quotas for a given percentage of their volume of trade in T&C at the start of the years 1995, 1998, 2002, and 2005.³ Figure 1 presents global T&C exports indexed to 1995 and marked by quota phase-out years. It is apparent in Figure 1 that most of

³ Using a country's 1990 import volume as a base, import quotas were eliminated in four phases (expressed as a percentage of the base): 16% on 1 January 1995, an additional 17% on 1 January 1998, another 18% on 1 January 2002, and the remaining 49% on 1 January 2005. Products not yet liberalized but subject to quotas or restrained in some manner had their quota growth rates increase by 16%, 25% and 27% in each phase, respectively. Although the ATC required importing countries to integrate articles from each of 4 categories: tops/yarns, fabrics, made-ups, and clothing, they were given the flexibility to select which articles to integrate at each phase as no allocation percentages were specified. Also, the universal set of product lines included not just items that were previously subject to the MFA but also articles that had never been restricted for some importing countries. This flexibility allowed for developed importing countries to defer integration (also called "backloading") until 1 January 2005; 89% of apparel imports (most of which are high-value-added clothing items) and 47% of textile imports were left to be integrated in 2005 (USITC, 2004) while those integrated in the first three stages were either not subject to MFA quotas or were subject to non-binding quotas or quotas not fully utilized by exporting countries.

the expansion in world trade in T&C did not occur until after 2002 (as importing countries waited for the last minute to eliminate quotas on items that have high quota or full utilization as these items are of domestic interest). Moreover, while the anticipated increase in world trade after the end of the ATC in 2005 did occur, the increase was not as steep as anticipated. And following 2007, the expansion in world trade started to decline. Two hypotheses can be gleaned from Figure 1. First, prior to the end of the quotas, some adjustments may have already taken place. Second, the anticipated expansion in world T&C trade after 2005 was less dramatic than expected. Weak T&C trade growth after 2005 aside, one should not discount the effects of the quota elimination; from 1995 through 2008, world exports doubled in value. Rather, the point of this discussion is to highlight that despite the gains, trade growth did not meet expectations.

Several factors likely contributed to the lower-than-expected expansion. These include the safeguard provisions against China, trading arrangements, remaining tariff barriers, and other forms of government intervention by both developed and developing countries. These factors are discussed briefly below.

Safeguard Measures Against China

First, Chinese textiles and clothing were subject to special textiles safeguard provision under ATC until 31 December 2008, and the U.S. and the E.U. invoked this mechanism. This had the effect of muting the expansion of trade after 2005. Second, from 2009 to 2013, WTO members can apply a standard WTO safeguard mechanism selectively targeting only China. Third, China is considered a non-market economy (where domestic prices are fixed by the State) in determining anti-dumping and countervailing measures for 15 years after the date of accession until December 2016. This allows importing countries to reject information on costs and prices in China (Dayaratna-Banda and Whalley, 2007). Instead of having quotas against several countries, the current trading environment imposes

quotas on China. Several countries, apart from the US and EU, are looking at invoking these safeguard measures against China in the near future (Martin, 2007).

Tariffs and Preferential Trading Arrangements

A further response to the MFA of developed importing countries involves the creation of preferential trading arrangements (PTAs) that allowed for importing countries to preserve domestic backward linkages (e.g., yarn) to the international T&C sectors. Under PTAs, exports of countries willing to abide by certain rules of origin (ROOs) with respect to raw materials used in the finished products enter the importing country duty- and quota-free. ROOs ensured that imports incorporated as much domestic content as possible by allowing foreign firms to process goods offshore and avoid paying duty on domestic components incorporated in the finished, re-imported items. The U.S. currently has preferential agreements with a range of Sub-Saharan African countries under the Africa Growth and Opportunity Act (AGOA), with Bolivia, Colombia, Ecuador and Peru under the Andean Trade Preference Act (ATPA), with various economies in the Caribbean under the Caribbean Basin Initiative (CBI), and with Mexico and Canada under the North American Free Trade Agreement (NAFTA).

While PTAs afforded some protection and advantage to preference-receiving countries, the ROOs handicapped the production of raw materials such as yarn and fabric in these countries. Moreover, the ROOs precluded these countries from sourcing raw materials from cheaper sources such as China. At the same time, preferential market access continues to distort the tariff structure even after the quota removal in that poorer countries that do not receive any preference end up paying more than their preference receiving counterparts (Adhikari and Yamamoto, 2007). For example, in 2006, non-PTA countries such as Bangladesh, Sri Lanka, and Indonesia, among others, faced an average tariff of 9% on its T&C exports to the U.S., while PTA members faced average tariffs that ranged from 0% to 8.7% (WTO, 2008).

Government Support/Subsidies to the Textiles and Clothing Industry

The elimination of the quotas has illuminated the differences in technology and infrastructure among the different countries' T&C sectors. These differences have resulted in differential supports provided by various governments, especially in South Asia (Table 1).

Table 1. Government Support Measures to the T&C Sector in South Asian Countries

Support measures	Bangladesh	India	Nepal	Pakistan	Sri Lanka
Support for technological upgrading	√	√		√	√
Subsidized/preferential credit	√	√			√
Creation/designation of textile/garment cities/villages	√			√	
Special economic/export processing zones	√	√	√	√	√
Duty reduction for the import of inputs/machinery	√	√	√	√	√
Excise, sales tax, VAT refund/reduction	√	√	√	√	√
Income tax holiday/rebate/reduction	√		√	√	√
T&C specific infrastructure support		√			√
Incentives for use of local inputs/outputs	√				√
Reduction in price of infrastructure	√				
Export credit insurance	√				
Writing off unpaid debt/debt forgiveness					√
Human resource/skills development	√	√		√	√
Image building/quality improvement/market promotion	√	√	√	√	√
R&D support				√	
Strengthening domestic capacity to supply inputs		√		√	√

Source of basic data: Chart 1, Adhikari and Weeratunge (2006), p. 135.

These government support measures are WTO compliant since LDCs and developing countries with less than US\$1,000 per capita GNP are exempt from rules on subsidies under the Agreement on Subsidies and Countervailing Measures (ASCM). Also, subsidies given for production across the board to the entire industrial sector, based on some general criteria, can be provided together with subsidies for R&D and/or environmental conservation (Adhikari and Yamamoto, 2007). Indeed, the global trading landscape in textiles and clothing, while devoid of quotas, remains one of managed trade through various WTO compliant subsidies and measures that introduce new distortions to the sector (the size

and consequences of which are uncertain). What took 40 years to buildup in the T&C sector is rapidly being replaced by measures that now favor a new set of exporting countries.⁴

The governments of India and China also provide various support measures to the textile industry. In India, export oriented units (EOUs) and firms importing against an advance license receive a duty drawback (zero duty for EOUs, and duty discounts for others) on raw material imports for the export of value-added cotton textiles and other industries. Also, imports of capital goods and machinery are allowed at reduced duty rates against export obligations (zero duty for a 100% EOU). In addition, textile exporters are credited back 2% of the value of their exports (in the form of scrips) to the U.S. and EU which they can use for importing goods duty free (USDA FAS, 2010).⁵

China, in general, provides numerous subsidies at multiple levels of government that include cash grant rewards for exporting, preferential loans to exporters, research and development funding to develop new products for export, energy subsidies, loan forgiveness, and payments to lower the cost of export credit insurance (USTR, 2010). In particular, textile exporters are afforded value added tax rebates between 5% and 17% and preferential import duties on parts and material needed for research and development, such as textile machinery, among others, are provided to select enterprises (USTR, 2009).

The competition has reduced governments' ability to provide support so that countries with deeper pockets like China and India are able to advance more than their counterparts with more limited resources. How fast other economies can catch up with China and India may depend on government and private sector support. Perhaps in partial response, China has moved somewhat onto higher

⁴ It is important to note that developed countries such as the U.S. and E.U. do internally subsidize their textile sectors through mechanisms such as tax codes, as well as provide market distortions through some of the trade policies mentioned above. However, developing countries, by virtue of their exemptions through the WTO, are capable of subsidizing at much higher percentage rates when it is financially feasible.

⁵ Scrip is any substitute for currency which is not legal tender usually in the form of credit.

quality, less labor intensive T&C product lines. Table 2 presents China's revealed comparative advantage (RCA) in T&C. China's RCA index in T&C is calculated as the share of T&C to China's total exports relative to the share of T&C to total world exports in the first 3 columns of Table 2. In the last column, China's RCA is computed relative to developing country exports instead of world exports. The higher a country's trade share, a higher RCA index is obtained, which suggests greater comparative advantage. Table 2 shows that China's comparative advantage in T&C relative to the world has diminished recently.

Table 2. China's Revealed Comparative Advantage in Textiles and Clothing

	Textiles ^a	Clothing ^a	Textiles & Clothing ^a	Textiles & Clothing ^b
1995	2.8	5.0	3.9	2.6
1996	2.6	5.1	3.9	2.9
1997	2.4	5.0	3.8	2.8
1998	2.3	4.7	3.6	2.5
1999	2.4	4.6	3.6	2.5
2000	2.4	4.6	3.6	2.7
2001	2.4	4.2	3.4	2.5
2002	2.4	3.9	3.2	2.4
2003	2.5	3.7	3.2	2.3
2004	2.5	3.5	3.1	2.3
2005	2.6	3.5	3.1	2.5
2006	2.6	3.7	3.2	2.9
2007	2.5	3.6	3.2	2.8
2008	2.5	3.0	2.8	2.9

^aRCA index calculated as share of T&C to China's total exports relative to the share of T&C to *world* exports

^bRCA index calculated as share of T&C to China's total exports relative to the share of T&C to *developing country* exports

Source: Table 14.8, Martin, 2008, p. 316

Conclusions

In retrospect, the phase-out of MFAs has several things to teach us about managed trade systems in general as well as specifically in the T&C sector. On a general level, one can ask if we are any closer to free trade in T&C than we were before the phase-out of the MFAs? The vestiges of the MFAs are present in the current T&C trading environment. On the supply side, misaligned incentives in response to the quotas have brought about production patterns that are not necessarily based on

comparative advantage and led to the creation of preferential trading arrangements that distort the tariff structure where rules of origin have handicapped the capability of raw materials production of PTA members. On the demand side, major importers are no longer managing trade on a bilateral basis. But, quotas have been traded for other nontariff measures such as safeguard mechanisms and heightened government support to address the infrastructure that was lacking when foreign investments were directed to low quota-utilization countries from quota-constrained countries – a decision not based on price or cost factors.

“Market power” in some respects has been shifted from the demand side of the market (U.S. and E.U.) to the supply side of the market (China and India) with the phase-out of the MFA. Many of the least developed countries who were previously “dependent” on the major importers are now “dependent” on the major exporters; and all of this has occurred with the tacit blessing of the WTO. That is, because of preferential treatment given to developing countries for internal subsidies and trade barriers, the policy-induced market power has been vested in the hands of developing countries with the financial wherewithal to subsidize by the WTO. In short, many of the least developed countries that were supposed to benefit from bilateral trade have been made no better or even worse off because of their inability to internally subsidize their textiles, all with the express permission of the WTO. Some developing countries have fared better in the trading regime change than most expected. How or why are relevant questions. Have some of those countries capitalized on their real comparative economic advantages, or have their successes just been the result of more political manipulation?

The trading landscape has moved from one of managed trade in a bilateral setting into another managed trade regime with measures sanctioned by the WTO in a multilateral setting, the consequences of which are uncertain. A central lesson we would offer is that the precursors and implementation of the MFA resulted in a trading system not based on economic comparative advantage. As such, this system created distortions that accumulated over time until the system was

sufficiently disjointed as to create political impetus for a change. We have, however, moved to another managed trading system that will create distortions that will accumulate over time. Are we simply headed for another crescendo of calls for a political change in the trading system in the not-so-distant future? The last political clash was between “developing” countries and the U.S. and E.U. Will the next clash be between the least developed countries and the “developing” countries? Only time will tell.

On a more general level, are there lessons from the MFA phase-out for the participants in the Doha round? Prior to Doha, multilateral negotiations focused primarily on multilateral reduction of trade barriers, and substantial progress was achieved, especially for industrial products. After the formation of WTO, objectives were expanded to include fostering development of LDCs. The approach of establishing perceived trade advantages for LDCs as a means of achieving that objective not only conflicts with the objective of freer trade, but may, as appears to be the case in T&C, work against development of some of the least developed countries. Are the WTO authorities more effective in achieving optimal results for all than free competitive markets?

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