Within-Firm Responses to Import Competition: Quality Upgrading and Exporting in the Peruvian Apparel Industry

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Abstract

Since China entered the WTO in 2001, the Peruvian apparel industry has been considerably affected by the dramatic inflow of Chinese garments. Unlike neighboring countries, the industry was able to keep afloat by firm-level responses that led to unprecedented growth in exports, driven by sales of high-quality apparel. While firm-level responses to import competition are now a well-established empirical fact in the economic literature, few papers have provided a precise mechanism by which they occur. This paper is one of the first to show that both quality upgrades and increases in export activity can be direct outcomes of import competition, and quantify their importance.

To capture both responses, I build and estimate a structural dynamic equilibrium model that hinges on the redeployment of less mobile factors when firms are exposed to import competition. If firms are highly exposed to import competition in the domestic market, within-firm factor reallocation results in an increase in exporting activity. Considering richer foreign markets have a higher taste for quality, firms will tend to export high-quality apparel. I use the estimated model to analyze: (1) whether firms’ ability to escape competition by moving across products and destinations proved key for Peruvian firms’ success, and (2) the effect on welfare and industry growth of commonly used trade policies such as tariffs. I find that allowing firms to re-optimize their product mix alleviates negative trade shocks by raising annual industry sales by as much as 17.5%. Moreover, even though raising import tariffs by 15% can expand the domestic industry’s revenues and employment by 5%, it would do so with an annual 7% reduction in consumer welfare –US$ 133 millions. In contrast, alternative policies that cut the up-front costs of exporting high-quality in half would achieve the same objectives at no cost for consumers.

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