Part I

Introduction

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Preview, Purpose, and Scope

Saman Kelegama

1. The Ready Made Garment Industry in the Global Context and Emerging Issues

Global export of textiles and ready-made garment (RMG) exceeds US $ 300 billion per year, well over one-third of which is accounted for by developing countries. Textile and garment industries have traditionally been the first step towards industrialization in developing countries and continue to play very important economic roles in the developing world, where they are not only a significant earner of foreign exchange, but also a substantial generator of local employment and incomes.

In 1980, only China, Hong Kong, South Korea, Taiwan, and USA were major global garment exporters. In the 1990s, India and Pakistan from South Asia and Malaysia, Thailand, and Indonesia from East Asia were added to this list. By the late 1990s, Bangladesh and Sri Lanka from South Asia and Philippines and Vietnam from East Asia too came into the list.

Over the past 40 years, the textile and garment sector has been protected by most countries with not only high levels of tariffs (compared to other manufactures), but also bilateral agreements generally not in accordance with the fundamental GATT principle of non-discrimination. Trade was governed by the Multi-Fibre Arrangement (MFA), where developed countries negotiated bilateral agreements with individual trading partners in order to restrict the quantity of exports of specific product categories by their trading partners. The intention of the MFA was to protect domestic producers in the developed countries from market disruptions. The USA, EU, Canada and Norway were some of the key nations that negotiated bilateral agreements.

The origins of the MFA go back to the Short-Term Cotton Agreement of 1961. In 1974, several separate agreements restricting world trade in textiles and garments were incorporated into the Short Term Cotton Agreement to create the MFA. Basically, MFA is a complex system of bilateral import quotas aimed at protecting developed country producers. The MFA covered most major industrial country importers and developing country exporters, allotting to each signatory an import or export quota. The MFA with around 100 bilateral agreements is estimated to cover almost 80 per cent of world textile and garment trade.[1] Thus, trading in garments has been taking place in a distorted international trading environment.

A compromise Agreement on Textiles and Clothing (ATC) was only reached in the Uruguay Round to abolish the MFA with a view to integrating this sector fully into the multilateral rules over a 10-year transitional period (1995-2005) through a sequenced phase-out of all quotas.

The MFA provoked a shift of foreign investment to countries which benefitted from more export quotas. The textile and garment industries grew phenomenally in Asian countries; in some cases this was a direct response to the quota system, in others it was obviously based on comparative advantage derived from wage differentials. Some of the original textile and garments exporters decreased their relative and absolute exports of textiles and garments as they developed. The very quota system that allowed some countries to benefit by restricting supply of large producers might have also distorted incentives for domestic allocation of resources to a sector no longer efficient on grounds of comparative advantage. While some Asian countries, individually and through the mechanism of the International Textiles and Clothing Bureau pressed strongly for the elimination of the MFA, considering that they would have benefited far more if they had freer access to industrial markets, others have lobbied for an extension of the MFA. More recently, the former group has even pressed for the accelerated elimination of the staged

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[1] The MFA was institutionalized by four successive phases: MFA I (1974-1977), MFA II (1978-1981), MFA III (1982-1986), and MFA IV (1986-1994).

phase-out of quotas by 1 January 2005 and the latter group has signed an initiative called the Istanbul Declaration to exert pressure on the WTO to extend the deadline till 01 January 2008.[2] However, expectations of gains and losses within the developing world are unevenly spread, for many existing suppliers fear the impacts of heightened competition from the bigger players like China and India.

While the ATC is a distinctive WTO agreement with a transitional longevity of just ten years, its success is contingent upon how commitments to liberalize are implemented by developed countries. So far, the "end-loading" feature of the integration process has allowed the rich countries to postpone the removal of quotas on almost half the imports right until the expiry date in end-2004. This almost defeats the purpose of a "transitional" agreement, which was introduced to precisely smoothen the process of transition and integration. Even after integration, however, other instruments such as anti-dumping duties or safeguard actions can potentially be invoked to restrict imports, despite a stipulation in the ATC that these be used "sparingly". These can be revoked under Article XIX of the GATT. Firms in developing countries are ill-equipped and ill-prepared to defend against the use of such sophisticated instruments.

A more immediate concern within the exporting developing countries is that the guaranteed access hitherto enjoyed by less efficient and smaller producers will open the market to the more efficient and large suppliers that will no longer be restricted by quotas. Globally, this will help the maximizing of incomes and employment and channel resources where they are productive to do so; but a freer competition is also likely to create a profound change in the balance sheet of beneficiaries and losers. In Bangladesh, for example, impact assessments indicate that 80 per cent of families of garment workers may fall below the poverty line following the closure or downsizing of their garment units subject to new competition from countries like, say, China

[2] The Istanbul Declaration signed in April, 2004 is a private sector initiative of 26 countries, which include some Textile Organizations in developed countries. This may prove to be a futile exercise given the fact that three phases of integration have already taken place.

(ILO, 2002). Overall, however, although tariffs in textiles and garments remain quite high, most developing countries foresee mixed results from commitments to liberalize these sectors further, as encouraged in Annex II of the Doha Declaration.[3]

In South Asia, India and Pakistan, which are endowed with large competitive primary textile sectors, and which appeared to have been constrained by the quota system in gaining greater market access, will indeed benefit from the post-2004 quota elimination while Bangladesh, Nepal, and Sri Lanka — where ready-made garments dominated the textiles and clothing sector — which were the beneficiaries of the quota system, may stand to lose. Besides, there are number of concerns:

a) In garments, a few countries still account for a large share of imports. In 2001, for instance, over 85 per cent of world imports of garments were accounted by seven major markets (if EU is treated as one).

b) Despite the increased availability of quota entitlements due to application of growth-on-growth provisions of the ATC a number of quotas continue to get exhausted, obliging quota managers to tap into the possibility of advance use of entitlement from next year "under the so-called carry forward provisions of the quota system". However, since 2004 is the last year of the quota regime there will be no carry forward available from the following year, there being no quotas in 2005. This means there will effectively be lower market access available in 2004.

c) The tariff reduction for textiles and garments is lower than for other industrial exports because tariffs did not receive adequate attention during the preparation of ATC. Average tariffs for manufactured products have come down by 39 per cent (from 6.3 per cent during pre-Uruguay Round to about 3.8 per cent today) while for textiles and garments it has reduced

[3] Annex II of the Declaration provides developing country garment exporters an opportunity to obtain equal status with Least Developed Country garment exporters resulting in better market access.

less. For garments the average tariffs in US is 19 per cent and in the EU it is 12 per cent.

d) Regional Trade Arrangements have played a key role in increasing shares of neighbourhood countries. For example, Mexico's share of textiles and garments in the USA market increased from 2.4 per cent in 1990 to 13.5 per cent in 2000. By contrast, India which had a share of 2.8 per cent in 1990 (higher than Mexico) increased by a mere one per cent in 2000 to reach 3.8 per cent. The preferential route is strengthened by the USA introducing the Africa Growth and Opportunity Act (AGOA), Caribbean Basin Initiative (CBI), ANDEAN PTA, and bilateral Free Trade Agreements (FTAs) with individual countries such as Jordan, Chile, and Singapore. Under the AGOA, for some member countries, preferences for garments are tightly linked to reverse preferences for using American fabrics. The EU countries have established Outward-Processing Tariffs (OPT) to shift garment production from high costing Western Europe to low costing Eastern Europe nations. In the EU market, Romania increased its share from 1.1 per cent in 1990 to 5 per cent in 2000, likewise, Poland's share increased from 1.8 per cent to 3.7 per cent, and Turkey from 7.9 per cent to 10.4 per cent. The sourcing of clothing is being gradually shifted to the Mediterranean rim countries also. The "Everything But Arms" initiative known as EBA that EU introduced in 2001 to eliminate trade barriers for 49 LDCs allow duty free access to garments of LDCs.

e) China emerging as a major supplier of clothing is another worry. It is the largest garment exporter in the world and its share in the world garment exports amount to 20 per cent. With its WTO entry in 2001, China is bound to benefit in the post-2004 period. The World Bank estimates that China's share in world garment exports will increase to about 50 per cent by 2010 (*The Economist*, 15 February, 2003: 63). According to the estimates of the McKinsey Report (2004) the share of the rest of Asia will fall from 32 per cent in 2000 to 20 per cent in 2008. Today, investors refer to China as 'a global factory' and comparison is made with Manchester during the Industrial Revolution. China is becoming the 'workshop of the world'.

2. The RMG Industry in Sri Lanka: Facing the Global Challenge

Since the late 1970s, Sri Lanka's garment sector has grown rapidly and by 2001 the sector contributed approximately 51 per cent of export earnings, 44 per cent of industrial output, and provided employment for roughly 6 per cent of the total labour force. After two decades of rapid growth the RMG industry is facing challenges. These include heavy dependence on the US and EU markets and the phasing out of the quotas in 2005 under the WTO - ATC which would no longer guarantee these markets in the West. Moreover, with the formation of regional blocs, granting of preferential trading terms to selected developing countries and heightening of competition in the trade from low cost suppliers like China, there would be a threat to the domestic industry as well as the country's future.

In regard to the post-2004 period, two viewpoints prevail in Sri Lanka. One school of thought presents a positive scenario. They argue that world trade in ready-made garments has been undergoing expansion over the years. In 2000, world garment exports amounted to US $ 196 billion and this is expected to increase to some US $ 350 billion by 2005/6 (World Bank, data). In such a global environment, they argue that Sri Lanka can gain because 72 per cent of garment exports is accounted by 12 per cent of factories and these firms have developed strong market contacts and are well established, producing value added garments.[4] It is believed that while some industries may have to close down operation, most others will be used for sub-contracting activities, or subject to acquisition or merger by the 12 per cent of the dominant firms (CBSL, 2002). It is also argued that these firms are already competing in the non-quota market in the EU and they have not faced many problems in

[4] The top twelve per cent exporters accounted for 69.5 per cent of exports in 2000, 72 per cent of exports in 2001, and 73 per cent of exports in 2002. This trend indicates consolidation of exports among the top twelve per cent of firms.

regard to competition in the EU market.[5] Thus, it is argued that the post-2004 scenario would not be a problematic period for the garment sector other than a few industrial closures.

The other school of thought paints a more pessimistic scenario. They argue that despite the global growth of the RMG sector, the Sri Lankan RMG industry is not competitive enough and the investment made on forward integration and market consolidation and backward integration is inadequate to compete with all varieties of garments made in particular from China and India (Lakshman, 1994; People's Bank, 1999). A statement by the American Textile Manufacturers Institute (dated 22 January 2003) to the US International Trade Commission stated: "After January 01, 2005, US imports of textiles and apparels will be dominated by China, with Vietnam, India, Pakistan plus some of those countries which enjoy preferential access to USA playing secondary roles. Any country not included in the previous sentence is simply out of the game, its textile and apparel exports to the US will be a thing of the past." A recent study by USITC (2004), however, has softened this position and observes that Sri Lanka's share in US apparel imports is likely to fall, but it is expected to be a niche supplier for certain categories.

The survey done for Chapter 4 indicates that at least 40 per cent of the firms may go out of production.[6] The Five Year Strategy taking into account the post-2004 challenges have made a growth forecast of 12 per cent for the industry from 2003-2008 – 6 percentage points lower that the 18 per cent growth rate of the industry during the last 20 years. Thus, the industrialists accept the fact that the garment industry will contract after 2004, but has set a goal to increase exports from the US $ 2.3 billion in 2001 to US $ 4.5 billion

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[5] The fact that non-quota exports increased does not mean as much as the Central Bank claims (CBSL, 2002), because most of Sri Lankan non-quota exports are still under quota for other developing countries like Pakistan and India. It is when these quota exports of such countries become non-quota that a conclusive statement could be made about the real performance of Sri Lanka's current non-quota exports. There are more items under quota in most South Asian countries than that of Sri Lanka (ILO, 2002).

[6] According to some leaders of the garment industry, 150 firms out of the 859 factories that were in operation had closed down by mid-2002 (*The Island*, 21 June 2002).

by 2007. In other words, the industry admits that consolidation will take place and is optimistic that the top firms can perform better in the quota-free world.

How valid is the optimism and how valid is the pessimism expressed by others ? For this purpose, it would be pertinent to examine the competitiveness of the RMG sector, its backward and forward linkages, and how it is geared to face the turbulence in the external trading environment. The purpose of this book is to shed light on some of these issues so that the industry and the government are aware of the key factors that need to be addressed.

3. Scope and Outline of the Book

There is a large body of scattered literature on the garment industry in Sri Lanka. However, a comprehensive volume on the subject is lacking, other than the three special issues of the *Economic Review* published by the Research Department of the People's Bank (August 1980, April 1989, and June/July 1999) and the JICA report on the Apparel Industry prepared for the Ministry of Industries (UNIDO, 2000). The coverage of issues in these publications/ reports are limited.[7] This book fills this gap by including research papers that have covered vital areas of policy issues and concerns in the context of the garment industry.

The second Chapter in this Part (I) provides a broad overview of the garment industry in Sri Lanka, including its key milestones. The remaining nine chapters that follow are grouped into four major parts. Part II contains two chapters (3 and 4) on 'Competitiveness Issues of the Garment Industry'.

Chapter 3 examines the competitive strength of the garment industry and planning process at the firm level. The study, based on a 14-firm survey, shows that the level of sophistication achieved by the industry is very low.

[7] Since of late, a number of MBA theses coming out of the Postgraduate Institute of Management, University of Sri Jayawardenapura, Sri Lanka, has focused on the problems and challenges in the Sri Lankan garment industry.

Strategy is not company-driven, but driven by foreign intermediaries. They provide all product details to the local manufacturer and then handle the entire overseas marketing operation. The industry in general lacks a basis of sustainable competitive advantage and is ill-equipped to meet the impending challenge. The study concludes by providing some strategic directions for the industry.

Chapter 4 examines the labour productivity and job quality in the garment industry. It is argued that while labour standards are high in well-established firms, the same cannot be said about other firms, in particular, the small and medium scale firms. A number of factors have been identified both from the employers' and employees' side that contribute to low labour productivity. Some future scenarios pertaining to labour issues are also discussed.

Part III of the book consists of two chapters (5 and 6). Chapter 5 examines the backward linkages from the industry while Chapter 6 examines the forward linkages and supply capacity of the industry.

Chapter 5 looks at the impediments to promoting backward linkages in the garment industry in Sri Lanka. The slow growth of backward linkages from the garment industries (export-oriented) in developing countries and the policy merits of promoting these linkages have considerable contemporary relevance. Backward linkages are useful particularly for a garment industry to reduce the lead time and remain competitive in the international market. However, local suppliers to the garment industry cannot function unless conditions exist which allow them to be competitive. Furthermore, in a world where multinational garment buying firms are dominant, a large import dependence in the garment industry does not necessarily imply that there are many opportunities to create local supplies and thereby create backward linkages. These factors are shown from Sri Lanka's attempts to promote backward linkages in the garment industry. It is argued that formation of backward linkages in the garment industry that operates in an open economy like in Sri Lanka will be a natural outcome of industrial deepening and therefore will be time-dependent. It is noted that even with less backward linkages, the garment industry in Sri Lanka has contributed significantly to foreign exchange earnings and employment creation in the country.

Chapter 6 describes the changing requirements of buyers and the capabilities that suppliers ought to have in order to match these demands. The global apparel industry is undergoing a rapid transformation with respect to the demands of buyers and the strategies adopted by suppliers to meet these demands. The study which covered twenty Sri Lankan export firms manufacturing basic garments and ten factories producing high value apparel looks at the significant gap that lies between the exacting requirements of buyers and the capabilities of local suppliers. The chapter concludes by proposing measures that need to be adopted in order to bridge this gap.

Parts IV and V of the book essentially examine the challenges for the garment industry from the external trading environment. Part IV of the book has three chapters (7, 8 and 9). Chapter 7 analyses the impact of the Regional Trade Arrangement – NAFTA on the Sri Lanka garment industry, while Chapters 8 and 9 examine the impact of bilateral free trade agreements on the garment industry by taking two case studies, the Indo-Sri Lanka Bilateral Free Trade Agreement (ILBFTA) and the proposed FTA with the USA.

Chapter 7 looks at the implications of NAFTA for the garment industry. In 1994, nearly 36 per cent of Sri Lankan exports were concentrated in the US market and out of this amount, nearly 78 per cent were garments. Thus, in 1994, garment exports remain the major concern for Sri Lanka in the context of NAFTA because they could have been displaced in the US market by garments produced in Mexico — a country that has cheap labour relative to the USA. Using a comparative static framework, the chapter has examined the competitiveness of Sri Lankan garments vis-a-vis Mexico in the US market. It is shown that Mexico's advantage over Sri Lanka in transport cost, labour productivity, preferential tariff, and access to a quota-free market is more than offset by Sri Lanka's cheap labour and low cost of production. It is argued that the competitive advantage of Mexico in terms of proximity is applicable only to a particular category of garments and not to others. Mexico's advantages were to a great extent in existence before the formation of NAFTA, and whatever new advantages that were gained after the formation of NAFTA were inadequate to pose a serious threat to Sri Lanka due, *inter alia*, to NAFTA's rules of origin, supply constraints and relatively high cost of production in Mexico.

Chapter 8 examines the garment exports to India in the context of the ILBFTA. It is shown that the industry's perception that the ILBFTA garment concessions are a 'non-starter' is accurate given that Sri Lankan garments cannot become competitive in the Indian market after fulfilling rules of origin, and facing various para-tariffs. Many impediments have to be removed for Sri Lankan garments to make an impact in the Indian market. In Chapter 9, it is shown that the expected gains from a US-Sri Lanka FTA may be marginal given the fact that the Agreement will come into operation (if at all) after 2004. The damage to the industry would have already been incurred by the time the FTA comes to the rescue of the industry. The conclusion from this Chapter is that the industry has to become competitive, then irrespective of the preferential advantage for market access (to US) of a competitor (like Mexico), Sri Lanka can still maintain its foothold in the same market. An FTA that involves Sri Lanka should not be seen as a panacea for inability to become competitive in the global market.

Part V of the book has two Chapters (10 and 11). Chapter 10 examines the threat from China for the garment industry while Chapter 11 examines the implications of the WTO Agreement on Textiles and Clothing on the Sri Lankan garment industry.

Chapter 10 argues that there is certainly a threat from the emergence of China as a major supplier of garments in the post-2004 period. However, the chapter argues that the threat may be a bit over-exaggerated because there are various checks and balances, which would ensure that China will not totally overwhelm other exporters. Moreover, on particular garment items, Sri Lanka can remain competitive despite China.

Finally, Chapter 11 looks at the phase-out of the MFA and the implications for the garment industry. With the expected phase-out of quotas under the Multi-Fibre Arrangement in 2005, the industry will face significant challenges from an increasingly competitive international market. The chapter evaluates the performance of the Sri Lankan garment industry to identify the threats and opportunities that lie ahead as the MFA is progressively phased out.

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