A WORLD BANK STUDY

Making the Cut?

LOW-INCOME COUNTRIES AND THE GLOBAL CLOTHING VALUE CHAIN IN A POST-QUOTA AND POST-CRISIS WORLD

THE WORLD BANK

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1 2 3 4 13 12 11 10

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ISBN: 978-0-8213-8636-1
eISBN: 978-0-8213-8642-2
DOI: 10.1596/978-0-8213-8636-1

Library of Congress Cataloging-in-Publication Data

Staritz, Cornelia.
Making the cut? : low-income countries and the global clothing value chain in a post-quota and post-crisis world / Cornelia Staritz.
p. cm.
ISBN 978-0-8213-8636-1 — ISBN 978-0-8213-8642-2
1. Clothing trade--Developing countries--Case studies. 2. Exports--Developing countries--Case studies. 3. Global Financial Crisis, 2008-2009. I. Title.
HD9940.D462S73 2011
338.8'87870091724--dc22 2010043472

Acknowledgments

This study was prepared by Cornelia Staritz (Junior Professional Officer, International Trade Department, World Bank). Many thanks to representatives of buyers in the United States, the European Union, and South Africa and to representatives of clothing firms, industry associations, research institutes, and other institutions in Kenya, South Africa, Lesotho, Swaziland, Mauritius, Cambodia, and Bangladesh, who took time to discuss dynamics and challenges in the clothing sector in the post-quota and post-crisis world. Without their time and valuable insights this study would not have been possible. Many thanks also to Thomas Farole, Ian Gillson, Paul Brenton, Mona Haddad, Gary Gereffi, Ganesh Rasagan, Smita Kuriakose, Zeinab Partow, William Milberg, Gladys Lopez, Jose Cuesta, Patrick Conway, and Leonhard Plank for comments on an earlier draft of this study, as well as to Mike Morris for support and discussions on the research on Sub-Saharan Africa, to Diepak Elmer, Md. Abul Basher, and Sanjay Kathuria for support and comments on the chapter on Bangladesh, and to Stephane Guimbert, Huot Chea, and Julian Latimer Clarke for support and comments on the chapter on Cambodia. Melissa Mahoney provided excellent research support for the trade data analysis; Thomas Frank excellent editing; and Stacey Chow excellent publishing support. Finally, thanks to the governments of Finland, Norway, Sweden, and the United Kingdom, which supported this study through the Multidonor Trust Fund for Trade and Development. The study was carried out under the overall supervision of Mona Haddad (Sector Manager, PRMTR). Peer reviewers were Zeinab Partow (AFTP1), Ganesh Rasagan (AFTFP/PSD), and Gary Gereffi (Duke University).

Executive Summary

The clothing sector has traditionally been a gateway to export diversification and industrial development for low-income countries (LICs) but recent developments may condition this role. In most developed and middle-income countries, the clothing sector was central in the industrialization process. Given its low entry barriers (low fixed costs and relatively simple technology) and its labor-intensive nature, the sector absorbed large numbers of unskilled, mostly female, workers, and provided upgrading opportunities into higher value-added activities within and across sectors. Recently, however, the environment for global clothing trade has changed significantly, driven by the rise of organizational buyers and their global sourcing strategies, the phase-out of the Multi-Fibre Arrangement (MFA) at the end of 2004, and the global economic crisis in 2008–09. These changes may condition the role of the clothing sector in today's LICs with regard to export diversification and industrial development.

Recent developments have led to global consolidation whereby leading clothing supplier countries and firms have strengthened their position. In the context of the MFA phase-out and the global economic crisis, low-cost clothing exporter countries such as China, Bangladesh, India, and Vietnam have increased their market share in the main import markets of the United States and the European Union (EU). This has happened primarily at the expense of regional supplier countries, including Mexico and Central American and Caribbean suppliers to the United States as well as North African and Central and Eastern European suppliers to the EU, Sub-Saharan Africa (SSA) clothing suppliers, and smaller LICs in different regions. At the firm level the increasing adoption of supply chain rationalization strategies by global buyers has benefited larger and more capable suppliers to the detriment of smaller and marginal suppliers in all countries.

Global consolidation has increased entry barriers at the country and firm level, which challenges LIC suppliers. The MFA phase-out led to increasing entry barriers at the country level as quotas no longer secure market access for LICs. At the firm level, global buyers' supply chain rationalization strategies have resulted in increased entry barriers as more capabilities and higher standards are expected from suppliers. Thus, firms are only able to enter supply chains of global buyers if they can offer high manufacturing capabilities, including low costs, high quality, short lead times, production flexibility, and labor compliance. In addition, buyers increasingly demand nonmanufacturing capabilities, including input sourcing on suppliers' accounts, product development and design, inventory management, logistics, and communications. These capabilities require financial and human resources at the firm level as well as reliable and low-cost infrastructure and backbone services, education and training facilities, and access to finance at the country level. For LICs these new developments are challenging as low labor costs and preferential market access are not enough to be competitive in today's clothing sector.

On the positive side, suppliers able to provide broader capabilities have developed strategic relationships with global buyers. Strategic relationships with core suppliers have become key in buyers' sourcing strategies. This trend has been accelerated in the context of the MFA phase-out and the global economic crisis as buyers have confined relationships to their most capable suppliers. These suppliers face further learning and upgrading opportunities—at least up to a certain level where upgrading does not encroach on buyers' core competencies. Some first-tier suppliers and intermediaries, in particular transnational producers and global trading houses, have captured high value-added activities and control far-flung sourcing networks. This may even signal a shift in the governance structure of global clothing value chains that may limit the power of global buyers.

Marginal and new suppliers are still able to enter global clothing value chains through intermediaries but face limited upgrading opportunities. The persistence of intermediaries implies that in spite of global buyers' supply chain rationalization strategies, there remains a role for second-tier suppliers, which are integrated into global clothing value chains via intermediaries. In particular, in triangular manufacturing networks of transnational producers, entry barriers are substantially lower and suppliers that only offer basic manufacturing functions may enter. However, upgrading opportunities are also limited by the intermediaries' control over key decisions and functions. A main motivation for intermediaries to source from LICs has been preferential market access (and before 2005, MFA quota hopping), and the competitiveness of certain LICs, in particular in SSA, has heavily depended on these preferences.

Many LICs are integrated into global clothing value chains via foreign direct investment (FDI) and triangular manufacturing networks of transnational producers where entry is easy but upgrading is limited. LICs (for instance SSA countries and Cambodia) are integrated into global clothing value chains via FDI and triangular manufacturing networks of transnational producers. These producers are mainly based in Taiwan, China; Hong Kong SAR, China; and the Republic of Korea; but also in Singapore, Malaysia, China, and India. On the one hand, this type of integration has promoted access to global sourcing and merchandising networks and, hence, facilitated entry to export clothing. On the other hand, it has limited upgrading possibilities as critical decision-making and certain higher-value functions are confined to the headquarters of transnational producers. Headquarters are generally in charge of input sourcing, product development and design, logistics, merchandising, and marketing, and have direct relationships with buyers. Transnational producers are able to leverage the capabilities of their headquarters and global sourcing networks for value-adding activities, which sets limits for capacity building, investment, and upgrading in lower-tier supplier firms.

Many LICs face challenges in how to use FDI and triangular manufacturing networks as a basis for upgrading and building locally embedded clothing industries. FDI has been central in the development of export clothing sectors in LICs. However, integration via triangular manufacturing networks in particular has locked LIC suppliers into second-tier positions and has resulted in limited development of local skills, linkages, and spillovers. Building a locally embedded clothing sector is a precondition for sustainable upgrading, but local involvement is largely absent in many LICs today (such as SSA countries or Cambodia). Other developing countries, for instance Bangladesh and Mauritius, have been successful in developing locally embedded industries. The timing of integration, local skills and entrepreneurship, the structure of local business systems, as well as government policies have played central roles in raising local involvement. In the 1970s and 1980s entry barriers in the clothing sector were lower and local firms were able to start exporting on a small scale. Moreover, market access was guaranteed by MFA quotas. However, increasing entry barriers have raised the bar for local firms in

LICs such as Cambodia or SSA countries where the export clothing sector only started on a larger scale in the late 1990s and early 2000s. In contrast to Mauritius, which had an entrepreneurial tradition, Bangladesh had no relevant entrepreneurial tradition. But government support was crucial in both countries. In SSA LICs and in Cambodia there are limited entrepreneurial traditions and policies to support local skills, linkages and spillovers, as well as locally owned firms.

Changes in global supply and demand structures have increased competition between LIC exporters but also offer new opportunities in fast-growing emerging markets. The second half of the twentieth century was characterized by a rising demand for clothing and the replacement of developed countries' domestic production by imports from developing countries. Today, however, demand has stagnated and import penetration levels are close to 100 percent in most developed countries. Thus, the growth of clothing exports from a few developing countries largely comes at the expense of clothing producers in other developing countries. The heightened competition between developing countries has been reinforced by overcapacity in the global clothing industry since the MFA phase-out and has been accelerated by the global economic crisis. However, changes in demand structures post-crisis may lead to new opportunities. While import demand for clothing in the Unites States, the EU, and Japan might stagnate, demand will increase in fast-growing emerging markets.

The clothing sector still provides opportunities for export diversification and industrial development, but proactive policies will be needed to increase the competitiveness and local embedding of LIC clothing exporters. Entry into and upgrading in global clothing value chains have become more difficult for LICs in the post-quota and post-crisis world. Besides country differences, there are common internal challenges faced by LIC clothing exporters, which have to be addressed to increase competitiveness and to secure a sustainable impact of clothing exports on export diversification, industrial development, and economic growth. Main policy recommendations for LIC governments, industry associations and clothing firms can be summarized as follows and are discussed in more detail below:

1. Improve productivity, skills, and capabilities within firms and develop from cut-make-trim (CMT) to full package suppliers.
2. Increase backward linkages and reduce lead times.
3. Improve physical and bureaucratic infrastructure.
4. Improve labor and environmental compliance.
5. Diversify end markets to fast-growing emerging markets.
6. Increase regional integration.
7. Build locally embedded clothing industries.

First, increasing productivity and upgrading production capabilities as well as skills is crucial for LIC clothing exporters in the context of supply chain rationalization strategies. Buyers increasingly demand advanced manufacturing capabilities including low costs, high quality, short lead times, production flexibility, and labor compliance, as well as a broader range of capabilities such as input sourcing on suppliers' accounts, product development and design, inventory management, logistics, and communications. In this context, suppliers have to move away from CMT and develop full package capabilities. Firms will play a central role in this upgrading effort but a government-supported 'upgrading fund' could help by offering low-cost funds for investments in new machinery, technology, and skills. Education and training of production workers, and of supervisory and management staff in particular, will be central to overcome skill deficits that hinder productivity improvements and upgrading.

Second, lead times have significantly increased in importance in buyers' sourcing decisions and this development has been accelerated in the post-quota and post-crisis world. The largest lead time reduction would occur through backward linkages into textiles. Hence, a favorable environment for textile investment should be ensured, including the provision of long-term loans for textile investments, the attraction of FDI or joint ventures in the textile sector, and greater emphasis on skill development in areas relevant for textile production. Increasing local textile supply is however challenging and there are complementary policies to reduce lead times, including improvements in decision-making processes, production structures, and supply chain management at the firm level; improvements in trade facilitation; increasing the capacity of the dyeing and finishing industry to be able to dye and finish fabric quickly and close to the production of clothing; establishing central bonded warehouses to be able to stock up inputs that manufacturers can purchase directly as export orders are received; and increasing regional sourcing.

Third, improvements in physical and bureaucratic infrastructure are crucial for competitiveness in the post-quota and post-crisis world as exporters are faced with higher demands from buyers. Infrastructure and regulatory weaknesses that limit access to and raise costs of backbone services have to be addressed urgently by LIC clothing exporters, particularly in the areas of transport, logistics, customs facilities, energy, water, and waste treatment. If these challenges are not addressed it will become increasingly difficult for LIC clothing exporters to compete in the global clothing value chain. In addition, access to low-cost finance is central when firms develop from CMT to free on board (FOB) and full package suppliers, because they will need to finance inputs and production and offer credit lines to buyers. A stable exchange rate also constitutes a crucial macroeconomic requirement for export competitiveness.

Fourth, labor and environmental compliance has become central in sourcing policies of global buyers and often constitutes a precondition to enter sourcing networks. LICs could approach labor compliance proactively and promote themselves as 'countries of choice' for global buyers. Departments of labor in LICs often have limited resources to implement and enforce labor compliance. Nevertheless, as in Cambodia's Better Factories Program, LIC governments and industry associations could only provide export licenses to firms that are part of industry-wide compliance and monitoring programs. Additionally, governments could work together with the International Labour Organization (ILO) and the International Finance Corporation (IFC) in their newly established Better Work program. Recently, pressures from buyers have also increased in the area of environmental compliance, which will be mandatory to compete in the future.

Fifth, end-market diversification is crucial as LIC clothing exports are concentrated in few end markets and clothing import structures will change post-crisis. Besides general problems and risks associated with end-market concentration, recent developments reinforce diversification: (i) demand for clothing in the major import markets of the EU and the United States may remain at a lower level post-crisis; (ii) clothing demand in fast-growing emerging markets, in particular China, India, the Middle East, Turkey, the

Russian Federation, Mexico, Brazil, and Argentina will increase; and (iii) regional and domestic end markets have gained in importance in LICs' clothing sales in the context of the global economic crisis. Hence, it will be central for LICs to diversify export markets and refocus on fast-growing emerging, regional, and (if relevant) domestic markets. It will be important to understand these new markets and the sourcing policies of buyers selling in these markets. Negotiating favorable market access in the context of bilateral or regional trade agreements has to be complemented by marketing, promotional, and networking initiatives.

Sixth, regional integration is crucial for improving the competitiveness of LIC clothing producers in the post-quota and post-crisis world. Regional integration could play a central role in reducing lead times and costs, capturing more value added in the region and diversifying end markets. Different complementary advantages in regions could be leveraged and economies of scale, vertical integration, and horizontal specialization could be promoted. The most important challenge to intraregional trade and investment are intraregional trade barriers as tariff and non-tariff barriers on clothing and textile products have remained high in many developing countries. Improvements in intraregional transport, logistics, and customs facilities are also central to reduce costs and lead times of regional trade. Moreover, intraregional trade must be actively promoted by facilitating partnerships between textile mills, clothing factories, and regional buyers.

Seventh, building locally embedded clothing industries is crucial for upgrading and for using the sector as a basis for export diversification and industrial development. FDI has been central in the development of export clothing sectors in most late-industrializing countries, but eventually local involvement, skills, linkages, and spillovers have increased. Such developments are largely absent in many LICs today (such as SSA countries or Cambodia), which limits upgrading possibilities and undermines the sustainability of the sector. Other developing countries (for instance Bangladesh and Mauritius) have been successful in developing locally embedded industries. Besides the timing of integration, local skills and entrepreneurship, the structure of local business systems, and government policies are central to explain different developments in LICs. There are no straightforward policy recommendations for developing local entrepreneurship. However, certain policies are at least preconditions for local entrepreneurial activities: (i) access to low-cost and long-term finance as well as to insurance facilities to leverage certain risks; (ii) access to education and specific training in areas such as management, merchandising and sales, and technical and design/fashion skills; (iii) support in establishing relationships with foreign investors, buyers, and input suppliers; (iv) access to at least the same (or higher) incentives for local and foreign investment with regard to duty free imports, providing infrastructure, fees for public services, access to land and factory shells, and tax holidays; and (v) incentives to hire locals at the management level.

Acronyms and Abbreviations

ACP	African, Caribbean, and Pacific countries
ACE	ASEAN Competitiveness Enhancement Project
ACTIF	African Cotton and Textile Industries Federation
AFTA	ASEAN Free Trade Area
AFTEX	ASEAN Federation of Textile Industries
AGOA	African Growth and Opportunity Act
ASEAN	Association of Southeast Asian Nations
ATC	Agreement on Textile and Clothing
BGMEA	Bangladesh Garment Manufacturers and Exporters Association
BIFT	Bangladesh Institute of Fashion and Technology
BIMSTEC	Bay of Bengal Initiative for Multi-Sectoral Economic Cooperation
BKMEA	Bangladesh Knitwear Manufacturers and Exporters Associations
BTMA	Bangladesh Textile Mill Association
CASDEC	Cambodia Skills Development Center
CBW	central bonded warehouse
CEE	Central and Eastern Europe
CEPT	Common Effective Preferential Tariff
CGTC	Cambodia Garment Training Center
CMT	cut-make-trim
CoC	Codes of Conduct
CSR	corporate social responsibility
DCC	Duty Credit Certificate
EAC	East African Community
EBA	Everything but Arms Initiative
EDI	electronic data interchange
EPA	Economic Partnership Agreement
EPZ	export processing zone
FBO	free on board
FDI	foreign direct investment
FIAS	Foreign Investment Advisory Service
FTU	Free Trade Union
GATT	General Agreement on Tariffs and Trade
GIPC	Garment Industry Productivity Center
GMAC	Garment Manufacturing Association in Cambodia
GMROI	gross margin return on inventory investment
GSP	Generalized System of Preferences
HHI	Herfindahl-Hirschman Index
IFC	International Finance Corporation
ILO	International Labour Organization

ITGLWF	International Textile, Garment, and Leatherworkers Federation
L/C	letter of credit
LDC	least developed country
LIC	low-income country
LNDC	Lesotho National Development Corporation
MFA	Multi-Fibre Arrangement
NAMA	Non-Agricultural Market Access
NGO	nongovernmental organization
NIE	newly industrialized economy
ODM	original design manufacturer
OEM	original equipment manufacturer
PIP	Productivity Improvement Program
R&D	research and development
ROO	rules of origin
SAARC	South Asian Association for Regional Cooperation
SACU	Southern African Customs Union
SADC	Southern African Development Community
SAFTA	South Asian Free Trade Area
SAPTA	South Asian Preferential Trading Agreement
SAR	special administrative region
SIPA	Swaziland Investment Promotion Agency
SSA	Sub-Saharan Africa
STEA	Swaziland Textile Export Association
STEP	Skills and Training Enhancement Project
TUDS	technology upgradation fund scheme
TCF	Third Country Fabric
T&C	textile and clothing
TNC	transnational corporation
VAP	Vientiane Action Program
WTO	World Trade Organization

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CHAPTER 1

Introduction

Export diversification into higher value-added products and away from primary commodities remains a major development objective for low-income countries (LICs). The clothing sector has traditionally been a gateway to export diversification for LICs and is generally regarded as a first step for developing countries embarking on an export-oriented industrialization process. In most developed countries of today and newly industrialized economies (NIEs) the clothing (and textile) sector was central in the industrialization process (Dickerson 1999). Historically, this was the case in the United Kingdom; the Unites States; Germany; Japan; and in the NIEs of Hong Kong SAR, China; Taiwan, China; and the Republic of Korea. More recent cases are Malaysia, Thailand, Indonesia, Sri Lanka, China, Vietnam, Bangladesh, Cambodia, and Mauritius. Given its low entry barriers (low fixed costs and relatively simple technology) and its labor-intensive nature, the clothing sector absorbed large numbers of unskilled, mostly female, workers and provided upgrading opportunities into higher value-added activities within and across sectors.

Recently, however, the environment for global clothing trade has changed significantly, which may condition the role of the sector in promoting export diversification and industrial development in LICs today. The main drivers of change have been (i) changes in the strategies of lead firms, in particular the rise of organizational buyers and their global sourcing policies; (ii) changes in the regulatory system, in particular the phaseout of the Multi-Fibre Arrangement (MFA), which provided access for many LICs to the markets of developed countries, under the World Trade Organization (WTO) Agreement on Textile and Clothing (ATC); and (iii) the global economic crisis and the related downturn in global demand for clothing exports.

In the context of these changes, this study analyzes how the clothing sector can still provide a gateway to export diversification and industrial development for LICs today. Specifically, the study has three objectives. First, the study assesses main developments in the global clothing sector associated with the MFA phaseout, the global economic crisis, and global buyers and their sourcing strategies. Second, the study analyzes challenges that LICs are facing in the post-quota and post-crisis environment in entering global clothing value chains and upgrading within those chains. Third, the study identifies policy recommendations to increase the competitiveness of clothing producers and to further their integration into and improve their positions within global clothing value chains.

The methodology of the study involves trade data analysis as well as fieldwork, including semi-structured interviews with buyers and with a variety of representatives of firms and institutions in five LICs in Sub-Saharan Africa (SSA), Southeast Asia, and South Asia. Interviews with large global buyers in the United States and the EU[1] (in

June, July, and September 2009) and with regional buyers in South Africa[2] (in September 2009) were conducted with emphasis on their sourcing patterns and strategies. In the five case study countries, including Kenya, Lesotho, and Swaziland (in August and September 2009)[3] as well as Cambodia and Bangladesh (in January 2010), interviews with clothing firms, relevant institutional actors and sector experts were conducted. The interviews focused on challenges in the context of the MFA phaseout and the global economic crisis as well as generally in entering and upgrading within global clothing value chains.

The study is structured in five chapters. After this introductory chapter, chapter 2 discusses global dynamics in the global clothing value chain and how they relate to possibilities for LICs to enter these chains and upgrade within them. The following three chapters (chapters 3 to 5) assess country-specific experiences of important clothing-exporting LICs from different regions—SSA, Southeast Asia, and South Asia—in the post-quota and post-crisis world and show distinct types of integration into global clothing value chains, related outcomes, and challenges. The country-specific chapters are structured along similar lines and may have some overlap. However, this is necessary to allow for reading them independently from each other. The conclusions in chapter 6 bring together the global and country-specific developments and challenges, and discuss what they mean for entering global clothing value chains, upgrading within them, and for using the sector as a stepping stone for export diversification and industrial development in LICs today. The sections below present short overviews of the remaining chapters of this study.

The Global Clothing Value Chain: Global Buyers, the MFA Phaseout, and the Global Economic Crisis

In chapter 2, main developments in the global clothing sector are discussed. The global clothing sector has expanded rapidly since the early 1970s and many LICs have been integrated into the global clothing value chain. However, there are important recent developments in the global clothing sector driven by (i) changes in the regulatory system, in particular the phaseout of the MFA; (ii) the global economic crisis; and (iii) changes in the strategies of global buyers and their sourcing policies, which have accelerated in the context of the MFA phaseout and the global economic crisis. These developments have had crucial implications for the role of LICs in the global clothing sector and on their possibilities to enter this sector and upgrade within it. Furthermore, there are underlying structural challenges, namely changing global supply and demand structures and asymmetric market and power relations within global clothing value chains, which have created a difficult context for clothing suppliers to capture gains and upgrade in global clothing value chains. The chapter examines the impact of these developments on the global clothing value chain, on import and export patterns, and on the possibilities of LICs to enter global clothing value chains and upgrade within them.

Clothing Exports in Sub-Saharan Africa: From Footloose to Regional Integration?

Chapter 3 assesses the clothing sector in SSA in the post-quota and post-crisis world. Over the past decade several SSA countries have developed export-oriented clothing sectors, in particular Kenya, Lesotho, Madagascar, Swaziland, and Mauritius (where the process had already started in the 1970s). This took place (i) within a policy framework of 'export-led growth' as governments hoped that the sector would play a central role in (starting) the industrialization process; and (ii) in light of MFA quota restrictions in large

Asian producing countries and based on agreements securing preferential market access to developed countries, in particular the African Growth and Opportunity Act (AGOA). Despite exceptional growth of these countries' clothing sectors in the beginning of the 2000s, the industry has declined quite drastically since 2004 in terms of production, exports, employment, and number of firms in all of the main SSA clothing exporter countries (although to different extents). The chapter presents an overview of recent developments of clothing exports in SSA and the specific ways SSA LICs have been integrated into global clothing value chains based on MFA quota hopping and preferential market access dominated by foreign investments and a disintegrated clothing industry with limited local or regional linkages. It also discusses main internal challenges of clothing exporters in SSA LICs, which are strongly linked to their specific integration, and identifies policy recommendations to increase the competitiveness and sustainability of the clothing sector. The last part focuses on regional integration. In particular, it assesses opportunities for and challenges of (i) using the region, in particular South Africa, as an end market by analyzing sourcing strategies of retailers in South Africa; and (ii) creating regional production networks by analyzing intraregional trade in cotton, yarn, and fabric.

Cambodia's Clothing Exports: From Assembly to Full Package Supplier?

Chapter 4 assesses the clothing sector in Cambodia in the post-quota and post-crisis world. Cambodia is a latecomer with regard to exporting clothing. But since its start in the mid-1990s the sector has played the leading role in Cambodia's development process and developed rapidly into the largest export sector, accounting for more than 80 percent of Cambodia's export revenues. The growth of the sector was driven by foreign direct investment (FDI), which was motivated by MFA quota hopping and preferential market access as well as by Cambodia's low labor costs. Although expectations on the impact of the MFA phaseout on Cambodia's clothing exports had been pessimistic, Cambodia was able to increase export value and market share after 2004. However, Cambodia's clothing industry has declined quite drastically since 2008 in the context of the global economic crisis and the phaseout of the China safeguards. This chapter traces the recent developments of Cambodia's clothing exports and discusses the specific way in which Cambodia has been integrated into global clothing value chains based on quota hopping and—at least partly—preferential market access dominated by foreign investments, cut-make-trim (CMT) production, and a disintegrated clothing industry with limited local or regional linkages. It further discusses main internal challenges of Cambodia's clothing exporters and identifies policy recommendations to increase the competitiveness and sustainability of the clothing sector.

Bangladesh's Clothing Exports: From Lowest Cost to Broader Capabilities?

Chapter 5 assesses the clothing sector in Bangladesh in the post-quota and post-crisis world. Bangladesh's clothing export sector started in the late 1970s and early 1980s when Korean and other East Asian manufacturers invested in and sourced from Bangladesh, motivated by MFA quota hopping and access to Bangladesh's abundant supply of low-cost labor. In the mid-1980s a period of rapid export growth started and clothing became the main export product of Bangladesh in the late 1980s. Foreign investment, the MFA quota system, and preferential market access to the EU as well as specific government support policies and local entrepreneurs have played central roles in the development of