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Competitiveness of Nepalese ready-made garments after expiry of the Agreement on Textiles and Clothing

By

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Contents

Executive summary

The fierce competition in the global textiles and clothing (T&C) market unleashed by the expiry of the World Trade Organization's (WTO) Agreement on Textiles and Clothing (ATC) on 31 December 2004 has adversely affected Nepal's ready-made garment (RMG) industry, which ranks among the two top export products of the country.

While Nepal's RMG exports started declining after 2001 due to the combined effects of domestic conflict, the adverse international climate following the 9/11 attacks and the global abolition of T&C quotas covering major Nepalese RMG exports, the ATC expiry almost sounded the death knell for the country's RMG industry. RMG export earnings declined by a compound annual rate of 14.2 per cent between 2000 and 2007, and by 21.2 per cent from 2005 to 2007. In the United States of America market, earnings declined by 18.5 per cent and 28.4 per cent, respectively, during the two periods.

A revealed comparative advantage analysis shows that Nepal's RMG sector under Chapters 61 and 62 of the Harmonized Commodities Description and Coding System (HS) as well as the top 12 exports (for 2006) at the HS six-digit level continue to possess a comparative advantage in the post-ATC period in the United States market. However, the RMG sector as a whole as well as HS 61 and HS 62 products are under threat from increased competition in the United States market because the revealed comparative advantage (RCA) indices for the exports of the products have declined. The top three product lines – HS 620342, HS 620462 and HS 611020, representing more than 53 per cent of total RMG exports by Nepal – are also in the threatened category, as are the tenth- and eleventh-ranking product lines – HS 621142 and HS 610510. These results indicate that the ATC expiry has led to a deterioration in Nepal's competitiveness position in the United States market In contrast, HS 620630, 620452, 620520, 620920, 620292, 620640 and 611120 (ranking fourth to ninth, and twelfth, respectively, in Nepal's total RMG exports) appear to have remained competitively positioned even after the ATC expiry.

Likewise, the RMG industry as a whole as well as HS 61 and 62 taken separately have a lower comparative advantage in the post-ATC period compared with 1997-2000. The same holds true for the top product line, HS 620342, and for HS 621142 and HS 610510 – all three of which were found to be "threatened" when compared with the 2001-2004 period. Clearly, the competitiveness of HS 620342 has declined since the 1997-2000 period, after which the impact of the phasing out of global T&C quotas, coinciding with the intensification of domestic conflict, began to hit Nepal's RMG industry.

A small-scale survey of Nepal's RMG firms and interviews with key informants showed that the ATC expiry has adversely affected the country's RMG sector. The industry is finding it difficult to compete in the United States market. Firms rely completely on imports for raw materials – which are sourced mostly from India, followed by China. This raises costs compared with rival RMG-producing countries. RMG entrepreneurs believe that getting duty-free access to the United States market will increase exports to that destination. Export policy, tax incentives, the labour market, availability of skilled manpower, market access and availability of machinery are important factors affecting RMG exports. Export policy, labour market and tax incentives are identified as the three most important factors (in that order) that the government must address. Among trade, competition, tax and infrastructure/financial sector development policies, trade policy is considered the most important, followed by tax policy and infrastructure/financial sector development policy, and competition policy

The country's rigid labour law is identified as the most serious constraint on export competitiveness. Bad industrial and export policies, severe power cuts and poor infrastructure are other constraints. The possibility of Chinese investment in Nepal's RMG sector is considered low due to the differences in language and culture as well as the rigid labour law and poor infrastructure.

Introduction

A. Background

The world textiles trade was not regulated prior to the early 1960s. In 1961, a Short-term Arrangement (STA) in cotton textiles trade was reached under the General Agreement on Tariffs and Trade (GATT). This was followed in 1966 by a Long-term Arrangement (LTA) in international trade in cotton textiles, imposing percentage limits on imports of cotton products from developing countries. The regulation of global T&C trade became more precise with the implementation of the Multi-Fibre Arrangement (MFA) in January 1974. The MFA exempted textiles and clothing from GATT disciplines, allowing industrial countries to place bilateral quotas on imports of various textiles and garment product categories. The quota system was directed to protect the market of industrial countries so as to allow them to restructure and adapt to competition from cheaper imports from developing countries. The Uruguay Round of multilateral trade negotiations (1986-1994), which led to the establishment of WTO in 1995, brought about a change in T&C trade. In the process of negotiation, GATT contracting parties agreed that the MFA would be phased out with the implementation of the ATC. Accordingly, on 1 January 2005, the quota system was abolished, paving the way for more or less unrestricted global trade in T&C.

The export-oriented RMG industry has been one of the most successful industries in Nepal. Still in its formative years, the industry grew very rapidly in the 1980s and the 1990s, which were the two decades during which the country underwent sweeping transformations in its political, economic and social systems. When the Government of the United States imposed quotas on RMG imports from developing countries, Nepal became an attractive location for Indian exporters who started to invest in production in Nepal to meet their quota deficiencies and manufacture garments for the United States market (BM 1999). Before the inflow of Indian investment, Nepali industrialists had not realized the export potential of the RMG industry. The industry's significance stemmed from the speed of industry growth and the dynamism with which it was transformed into a sophisticated industry – unmatched by any other industry in Nepal.

According to the Garment Association of Nepal (GAN), the RMG industry in Nepal – which is the country's largest foreign currency earner – recorded a financial net worth of US$ 80 million and a collective turnover of US$ 160 million in 2002. The industry comprised about 212 factories, each employing from 200 to 1,500 workers, concentrated in two areas: the peripheries of the Kathmandu Valley and the industrial areas of the south-eastern district of Jhapa. The RMG industry contributed approximately 25 per cent of Nepal's total exports annually between 1991/92 and 1999/2000. The industry's contribution to national exports gradually increased after 1994/95 and reached a record 49 per cent in 1999/2000 before entering a downturn. During the peak year of 1994/95, the industry had 1,067 registered factories, with several more operating without official registration. The sector employed some 50,000 workers in 1999/2000, but in 2006 it was providing direct employment for only 4,450 people (ActionAid and SAWTEE, 2007). The share of women employees in the RMG sector varies with data sources. According to SAWTEE and ActionAid (2007), nearly 45 per cent of the employees were women, while according to the Census of Manufacturing Establishments conducted by the Central Bureau of Statistics, the proportion was 27 per cent in 2001.

The share of RMG exports in total national exports was 17.8 per cent in 2004, a year before the abolition of the quota regime, and 6.7 per cent in 2007. Similarly, the share of RMG exports to the United States was 13.4 per cent in 2004, but which decreased to about 4 per cent in 2007 (Trade and Export Promotion Centre, 2008). In addition to the widespread insurgency that was making it difficult to do business in Nepal, the gradual abolition of the global quota regime in T&C triggered a withdrawal of investment/capital by Indian investors, who had invested in the RMG sector in Nepal to exploit the quotas provided mainly by the United States to Nepal.

B. Research problem

Nepal’s geography is a major constraint to realizing its trade potential, *ceteris paribus*. It is a landlocked country with a population of more than 25 million, on the southern slopes of the Himalayas, bordering China to the north and India in all other directions. The RMG industry in Nepal experienced rapid growth from the mid-1980s mainly due to the quota facility provided by the industrialized countries such as the United States. Capitalizing on the quota “rents”, during 10 years the sector also became the biggest export-oriented manufacturing industry of the country (ActionAid and SAWTEE, 2007). In 1994/95, although the industry accounted for less than a 1 per cent share in the global RMG trade, its exports made up 29 per cent of the country's total exports.

However, the industry has been facing stiff competition in the global market since the phase-out of all T&C quotas from 1 January 2005 under the ATC. Exports have been falling steadily since 2000/01 except for a rebound in 2002/03. The share of RMG exports in the total exports plunged from 28.1 per cent in 1999/2000 to 6.7 per cent in 2006/07. Similarly, national total exports growth declined to negative (-1.4 per cent) in 2006/07 from 39.7 per cent in 1999/2000. The contribution of total national exports to gross domestic product (GDP) was 13.6 per cent in 1999/2000, declining to 8.2 per cent in 2006/07 (Ministry of Finance, 2007). The United States absorbed more than 80 per cent of Nepal's total RMG exports before the quota phase-out. Since the complete removal of quotas, Nepalese suppliers have been contending with the preferences granted by the United States to selected African and Caribbean countries. On the other hand, although Nepal does have duty- and quota-free access to the European Union market under the “Everything-But Arms” (EBA) scheme, it has not been able to fully exploit the preferential scheme to its advantage – despite the relaxation of standard European Union rules of origin – due to supply-side constraints.

The new trading environment offers opportunities to efficient suppliers of garments. Several RMG-exporting countries, such as Bangladesh, Cambodia and China, have capitalized on the freeing up of the global RMG trade. However, Nepal’s RMG industry is hampered by a loss of competitiveness coinciding with the change in the international trading environment. A range cost-raising and productivity growth constraints exist, including the relatively high transaction costs of doing business in Nepal, labour regulations that constrain productivity growth, high transportation costs, and poor marketing networks (World Bank/Federation of Nepalese Chambers of Commerce and Industry, 2003).

An in-depth study is thus required in order to analyse Nepal’s RMG competitiveness in the United States market – one of the largest RMG markets in the world – including following the termination of ATC, together with the factors that need to be addressed to enhance its competitiveness.

C. Research questions, the objective and structure of this paper

This paper examines the following research questions:

- What has been the export performance of the RMG industry in Nepal in the post-ATC period with a focus on the United States market?
- How has the expiry of the ATC impacted Nepal's competitiveness in RMG exports in the United States market?

The objective of the paper is:

- To review the status of Nepal's RMG industry;
- To examine the impact of the ATC expiry on RMG exports by Nepal and the competitiveness of those exports; and
- To analyse production and export coherency issues from the trade competitiveness perspective.

The paper consists of six sections. Section I involves a literature review. The second section describes the methodology and data used. The third section presents an overview of the Nepalese RMG industry and its performance before and after ATC termination. The fourth section presents the findings of the RCA analysis. The fifth section presents the findings of a small-scale survey of RMG firms and key informant interviews. Section VI presents the conclusion.

I. Literature review

A. Impact of the Agreement on Textiles and Clothing expiry at the global level

The T&C sector is a major source of export earnings, government revenue and employment for most Asian countries. The elimination of T&C quotas due to the ATC expiry of the ATC has had a significant impact on the countries within the region. Due to their excessive reliance on the quota system and lack of preparedness to face a fully competitive trading environment in the post-quota period, some Asian countries have either experienced a significant loss or are in the process of losing their shares in the markets of developed countries (Adhikari, 2007). The post-quota phase has brought about some interesting trends in the movements of textiles and clothing products. The position of the European Union as the most favoured destination of T&C exports has been established, leaving the United States a long way behind (Nayak and Raout, undated).

Nordås (2004) concluded that the outcome of the phasing out of quotas would depend much more on prevailing tariff rates and preference margins of countries receiving such preferences than had been captured by conventional estimates. Further, she showed that the phasing out of quotas benefited China and India, enabling them to dominate world trade in T&C. Countries that are close to their major markets are likely to be less affected by competition from China and India. Both countries will gain market shares in the European Union, the United States and Canada to a significant extent, but the expected surge in market shares may be less than anticipated, as proximity to major markets assumes increasing economic significance while tariffs are increasingly restraining trade due to the fact that products cross borders several times.

A competitive analysis of Indian T&C exports to the European Union (Nayak and Raout, undated) showed that in the post-ATC period, the Indian T&C export basket was contracting in terms of product diversification and was focusing more on specialized items. Raihan and others (2007), in analysing the impact of ATC expiry on selected Asian LDCs, found that while temporary safeguards on China had provided breathing space for Bangladesh and Cambodia (the two have done much better than expected), and while the Lao People's Democratic Republic was holding on to its past gains, Nepal was losing ground.

B. Impact on Nepal

Shakya (2005) attributed the severe impact on the Nepalese RMG sector of quota phase-out to, among other things, insufficient commitments at the industry and policy levels to responding to the foreseen adjustment problems in trade without quotas. He argued that the industry's capacity to utilize quotas in only a few items before the ATC expiry as well as over-dependence on the United States market reflected its reluctance to go for product and market diversification as long as it had an easy and protected market access. The industry's initiative to cut output cost and raise delivery efficiency was largely restrained by lack of commitment to overcoming persistent internal bottlenecks. Steps were taken to convert the guaranteed market access in the United States into preferential market access at the last moment. However, no adequate efforts were made to compensate the market share loss in the United States by diverting export to preference-granting markets elsewhere. Neither the industry nor the Government of Nepal took any concrete measures to exploit the opportunities in the European Union and Canada, which offered preferential treatment coupled with relatively relaxed rules of origin for Nepalese apparel.

The working of market forces internationally brought about by the end of the quota regime has greatly influenced sourcing decisions, giving discretionary power to buyers. Consequently, the international buyers' priority has gone to countries having a massive scale of output and a capacity for vertical production – from fabric to fashion designing. The Nepalese garment industry lagged behind in both these factors determining international competitiveness. The downward spiral in world prices since the end of the quota regime is of serious concern for Nepal.

However, while the average price of select Nepalese products is 40 per cent higher than that of Chinese ones, it is still 40 per cent lower than the average price for the rest of the world, indicating some scope for the survival of the industry in the post-ATC era. The application of tariffs in the United States further eroded the price competitiveness of Nepalese