

# BUSINESS ISSUES BULLETIN

CAMBODIA

No. 5



## The Garment Sector in Cambodia: Post-MFA Outlook

No other industry in Cambodia has grown as substantially as the garment sector. Starting from a very low base in 1995, with an export value of only US\$26 million, garment exports reached US\$1.6 billion in 2003. This represents 80% of total Cambodian exports.

The industry's impressive export performance, however, has depended heavily on exports to the American and European markets. To the US, these were offered originally under the Multi Fiber Agreement (MFA) and then the World Trade Organization Agreement on Textiles and Clothing Framework (ATC). The European Union also offered preferential treatment beginning in the late 1990s. Seventy percent (US\$1.121 billion) of the industry's exports in 2003 were to the US and 63% of those were under the quota system.

In the lead up to the expiration of garment quotas at the end of 2004, there were serious concerns about the prospects for Cambodia's garment sector, and the estimated 230,000 jobs it has created. What follows is a summary of recent donor agency reports as well as comments from industry experts that highlight the garment industry's significance to the local economy, its competitive characteristics, the constraints it faces, and the prospects for its survival after the ending of the quota system.<sup>1</sup>

### The Multi-Fiber Agreement and the Agreement on Textiles and Clothing

The MFA, introduced in the late 1960s, was meant as a protection measure for the garment industries of developed countries. These were steadily losing market share to major garment exporters in developing countries. The MFA imposed quotas (quantitative restrictions) on these exporters through bilateral negotiation, and sometimes unilaterally. This helped countries that previously were not active in the garment sector (such as Cambodia), as garment producers moved their operations to countries with no quota or unmet quota.

Trade negotiations that led to the formation of the WTO in 1995, put in place the WTO Agreement on Textiles and Clothing. This set the date for the termination of quotas by January 1, 2005. After this date, WTO members would face no quotas in their garment exports. In theory, this should prompt garment producers to move their operations to countries where production costs are low and productivity levels are high – a precarious situation for countries, like Cambodia, with less competitive production.

### Significance of the garment industry in Cambodia

In Cambodia, the estimated added value of garment exports in 2002 and 2003 was almost US\$500 million per year, accounting for 12% of the Cambodian gross domestic product (GDP). To put this into perspective, in 2002 industrial production (including garments) accounted for 22.1% of GDP, while agriculture, which employs 80% of the population, accounted for 40.5% of GDP. The service sector, another significant employer, accounted for 32.6% of GDP.<sup>2</sup>

The garment industry provides direct employment for an estimated 230,000 workers, of whom 85-90% are women, and mostly from rural areas. This accounts for about

<sup>1</sup> Unless otherwise noted, the information provided in this *Bulletin* including statistics, conclusions and recommendations are drawn from the Asian Development Bank's 2004 Phase 1 Report—*Cambodia's Garment Industry: Meeting the Challenges of the Post-Quota Environment*—under TA No. 4131-CAM: Preventing Poverty and Empowering Female Garment Workers Affected by the Changing International Trade.

<sup>2</sup> IMF (2004), *Cambodia: Statistical Appendix* (<http://www.imf.org/external/pubs/ft/scr/2004/cr04330.pdf>). Accessed on November 9, 2004.



The "Business Issues Bulletin" provides those interested in business issues with a short summary and analysis of a particular topic affecting the business environment in Cambodia, and exposure to different opinions held by various stakeholders on the topic.

This bulletin is published with support from the Mekong Private Sector Development Facility (MPDF), a multi-donor funded initiative managed by the International Finance Corporation (IFC), the private-sector arm of the World Bank Group.

The statements and opinions presented here are only meant to provide additional reference material and do not reflect the official opinion of the Mekong Private Sector Development Facility or IFC.

65% of total employment in the manufacturing sector. It is estimated that these women send home around 50% of their monthly wages to support their rural families.<sup>3</sup> In addition, another estimated 150,000 jobs are indirectly associated with the garment industry. Assuming that each garment worker (including those with indirect employment) supports an average of 4 persons, the garment industry helps alleviate the poverty of approximately 1.5 million people. Hence, the survival and expansion of the garment sector is vital to the Cambodian economy and to poverty reduction.

## Competitiveness of the garment industry

The survival of the garment industry in Cambodia depends on its ability to compete in a quota-free world. This requires maintaining high labor standards to capitalize on Cambodia's reputation as a "sweatshop-free" garment producing country, which is increasingly becoming a factor for consumers in the West. It also requires that costs, both production-related and bureaucratic, are lower than those of competitors. Table 1 below compares Cambodia's costs to those of its main competitors.

*There won't be any significant change in the garment sector during the next three years because workers' rights and unions' rights are respected. This will encourage buyers to continue supporting the garment sector in Cambodia. The Ministry will continue to promote these factors for the benefit of the sector and the nation.*

*H.E. Nheb Bunchin, Minister of Labor and Vocational Training*

*The prospects for the Cambodian garment industry are very uncertain. They depend tremendously on what the government will do from now on, the success of our lobbying efforts, and the cooperation between unions and management. Otherwise, garment factories will close down.*

*The overall industry strategy is to increase productivity so that we remain competitive after the expiration of the MFA. This can be achieved by drawing on experiences of other countries, training workers, cooperation from unions, and government taking action to reduce corruption and improve bureaucratic processes. GMAC will continue to promote these strategies.*

*We saw some increases in orders during the latter part of 2004, but prices of these orders were significantly lower than in the past.*

*Dr. Ken Loo, Secretary General of the Garment Manufacturers Association in Cambodia (GMAC)*

The Cambodian garment sector also faces disadvantages in terms of operating costs. Of special note is the cost of electricity. Cambodia's manufacturers pay the highest cost for electricity among its competitors (US\$0.15/KWhr). In Bangladesh, electricity costs US\$0.065/KWhr; in China, US\$0.047-0.08/KWhr; and in India, US\$0.1042/KWhr (the second highest rate after Cambodia). With the international norm for power at US\$0.06/KWhr, Cambodia's rate is 150% higher.

*We started our operations in 2000 to set up a world-class factory in Cambodia. Hence, the expiration of MFA is not an issue for us, since we operate based on the three pillars of good reputation, good quality, and efficiency.*

**Table 1. Benchmarking of Labor Costs**

Competitive Factors	Cambodia	Bangladesh	China	India	Indonesia	Pakistan	Sri Lanka
<b>Wages (US\$/hr including social charges)</b>							
Textile sector	0.27-0.35	0.30-0.54	0.44-0.76	0.30-0.62	0.30-0.42	0.37-0.42	0.42-0.50
Garment sector	0.27-0.35	0.28-0.36	0.32-0.48	0.30-0.45	0.29-0.36	0.32-0.39	0.32-0.40

Source: ADB Report, page 39.

As can be seen from the table above, in comparison with major competitors, Cambodia has competitive advantage in terms of labor costs. The country's hourly wages are the lowest – between US\$0.27-0.35 for both the textile and garment sectors. In Bangladesh, Cambodia's nearest competitor, the wages of textile producers are US\$0.30-0.54, and garment producers earn US\$0.28-0.36.

While Cambodia has marginally lower labor costs, labor accounts for only 15% of total input costs. By comparison, materials and accessories account for 65% of input costs, as most have to be imported. This subjects garment producers to an array of bureaucratic expenses.<sup>4</sup> In addition, productivity of Cambodia's garment workers is very low relative to competitors. Productivity of Cambodian garment workers is only 25% of German equivalents (the best performers). Garment workers in Indonesia, Thailand and China, the countries that are Cambodia's strongest competition, are at least twice as productive as workers in Cambodia.

*We have faith in our Cambodian plant after MFA. It is well integrated into the overall business plan of Quantum, our parent company. We will not leave Cambodia in four or five years. In fact, we are expanding our operations. We'll be moving to our new plant in February 2005.*

*Competitiveness plays a key role for Cambodia, as it does for China. Companies with business ethics will be able to maintain and enhance buyers' commitment to support Cambodia. This requires strong and genuine cooperation between employees, management and the buyers working together for mutual benefit.*

*Mr. Adrian Ross, General Manager, New Island Clothing (Cambodia) Ltd.*

Bureaucratic constraints are well documented. As discussed in a previous MPDF *Business Issues Bulletin* that was based on the World Bank *Value Chain* report,<sup>5</sup> the high costs of customs clearance and "red tape" put major strains on Cambodia's competitiveness. The *Bulletin* points out that managers in the garment industry

<sup>3</sup> Asian Development Bank. *Garment Employees in Cambodia: A Socio-Economic Survey*. Prepared by the Cambodian Researchers for Development, February 2004 under TA 4131.

<sup>4</sup> World Bank. *Towards a Private Sector-led Growth Strategy for Cambodia, Volume 1: Value Chain Analysis*. Prepared by Yasuo Konichi, June 2003

spend an especially large percentage of their time (16%), dealing with government officials. The ADB report indicates that in the garment industry, complexity of export procedures, corruption and bribery account for 7% of total sales value.

## Post-quota outlook for the Cambodian garment sector

Up until the end of 2004, Cambodia's garment sector was able to compete with major players because these competitors had to pay a quota premium if they wanted to sell more than their quota to the US and EU markets. Now that quotas have ended, Cambodian garment companies will find it difficult to compete with producers in other countries, given their higher production costs. This could have serious implications for employment and the national economy.

For the immediate term, Cambodia will benefit from its reputation as a country where high labor standards are maintained. Since 2001, with the help of the International Labor Organization (ILO), the government has monitored garment companies to ensure compliance with the Labor Law and ILO standards. A recent World Bank Group survey of major buyers reports that high labor standards is one of the most important criteria when making purchasing decisions from Cambodia. Sixty percent of buyers interviewed in this survey plan to increase their purchases from Cambodia, 40% will "wait and see" and none plan to buy less.<sup>6</sup>

Beyond this, there is hope for the industry if bureaucratic constraints and market-related cost factors are addressed. Table 2 presents two possible scenarios for the Cambodian garment sector, a baseline and a growth scenario. These depend on policy and related actions by government and relevant stakeholders.

*The imminent expiration of the garment quotas affects workers' lives. A number of small garment factories have recently closed and 20,000 workers have lost their jobs. While some workers have returned to the provinces, others are still waiting, looking for short-term jobs in big garment factories.*

*I hope the situation will get better, because even though the small factories that have short-term investment plans will close, the big ones with long-term investment plan to stay open, expand their activities and absorb more laborers.*

*Ms. Chhorn Sokha, Vice President of the Coalition of Cambodian Apparel Workers Democratic Union*

The baseline scenario assumes that the government does not take corrective actions to improve the business environment and that the general characteristics of the garment sector remain the same. Under this scenario, garment exports will decline by US\$110 million in 2007 and by US\$296 million in 2010. Employment will decline by 11,000 and 32,000 jobs respectively. This will lower real GDP growth by 1% and 1.5% in 2007 and 2010, respectively. If this scenario happens, those affected the most will be female workers and their rural families.

The growth scenario assumes that government implements sound economic and legal reforms to improve the business environment. Under these circumstances garment exports would increase by US\$508 million in 2007 and US\$991 million in 2010. Similarly, employment could increase by 35,000 jobs in 2007 and 64,000 jobs in 2010. This scenario will maintain the present level of real annual GDP growth at 5%.

*Cambodia still has some potential to compete immediately after the expiration of the MFA. The main threat to the global garment and textile trade is competing against China. That won't happen until 2008, as China will have to export under quota until then. And, there has been an increasing niche of "fair trade" consumers in North America and Europe. These are consumers who seek to buy products from factories where workers' rights of collective bargaining are respected. Cambodia scores a high mark on this among buyers, so they continue to place orders. Moreover, Cambodia enjoys a labor cost advantage against major competitors. If we can address other cost factors, we can compete. Further, Cambodia enjoys more trade preferential treatment from the EU than many other countries. Under*

**Table 2. Macroeconomic Impact: Analysis of Scenarios**

		Actual	Changes			
Scenario		2003 (1)	2007 (2)	2010 (3)	(2)-(1) (3)	(3)-(1)
<b>Garment Industry Variables</b>						
Exports (mn US\$)	Baseline	1,608	1,497	1,312	-110	-296
	Growth	1,608	2,115	2,599	508	991
Employment ('000)	Baseline	230	219	198	-11	-32
	Growth	230	265	294	35	64
<b>Macroeconomic Variables</b>						
Nominal GDP (mn US\$)	Baseline	4,000	4,680	5,350	680	1,350
	Growth	4,000	5,020	6,350	1,020	2,350
Real GDP Growth (%)	Baseline	5.0%	4.0%	3.5%	-1.0%	-1.5%
	Growth	5.0%	5.0%	5.0%	0.0%	0.0%

Source: ADB Report, page iv.

<sup>5</sup> MPDF. *Constraints to the Competitiveness of Cambodia's Private Sector*. Business Issues Bulletin No.3.

<sup>6</sup> FIAS. *Cambodia: Corporate Social Responsibility and the Apparel Sector - Buyer Survey Results*. December 2004.



*the “Everything but Arms” scheme, the EU offers Cambodia (and other 48 countries) the opportunity to export all products except arms free of quota and import duties. Although other countries can export garment products to the EU free of quota, they still have to pay import duties.*

*Nevertheless, competing after 2004 requires that the garment sector in Cambodia reduce costs and increase the value of our garment products. Both require that the government take proactive measures to improve the business environment to protect the sector’s investments. For its part, the government has established a “trade facilitation” working group to work on reducing the amount of paperwork, cost, and time required for importing and exporting goods.*

*We are also working hard on market access for Cambodian garments by marketing Cambodia as a producing country that practices “fair trade.” Assistance has been sought from France to publicize our fair trade practices, in cooperation with the ILO, in Europe.*

*H.E. Mao Thora, Undersecretary of State, Ministry of Commerce*

*My company generates 50% of our revenues from business transactions with the garment sector and the remaining 50% with import companies.*

*I expect revenue from the garment sector in 2005 to be the same as 2004. It will not be affected by the termination of quotas, as many of my customers do not export under the quota scheme – many are supported by their buyers. The larger producers are even expanding their factories.*

*I believe that before a company decides to expand its operations, it looks at least two to three years ahead. Hence, I expect to continue doing business with the garment sector until at least 2007.*

*Mr. Chhim Sokan, Director of Sokhan Transport Co., Ltd.*

If reforms are not made to improve the competitiveness of the garment sector, the lost opportunity cost (growth less baseline) by 2010 could be that of export values worth almost US\$1.3 billion. Also lost could be almost 100,000 jobs, GDP of US\$1 billion (equivalent to 1.5% annual real GDP growth), and estimated remittances to rural areas worth as much as US\$90 million.

## **Recommendations**

Whether the bright prospects of the growth scenario will be achieved depends on the efforts made by all stakeholders. Cambodia should enhance its competitiveness by building on its strength as a country with high labor standards. This requires concerted efforts to maintain the existing labor compliance monitoring mechanism and publicizing its existence to potential buyers and the end-consumers who are concerned about labor standards and will pressure manufacturers to comply. On operational issues, the industry and donors can work together to help improve workers’ productivity by developing their skills.

The Cambodian garment industry’s competitiveness could also be enhanced by backward-linkage investments in knit fabric processing, woven fabric dyeing and finishing, and other support

activities and services. Increasing the availability of locally produced fabrics and reducing the reliance on imported fabrics would lower production costs. The development of other support activities could help the industry produce a fuller range of garment products as well as move the industry higher up the value chain, rather than doing primarily “cut-make-trim,” as is currently the case.

For any market-based solutions to be functionally effective, however, the prerequisite is that the government addresses the major bureaucratic impediments. This includes reducing transaction costs (money and time), particularly those incurred in dealing with public officials. The costs of electricity must also be reduced to levels that are comparable to international norms. Otherwise, the Cambodian garment industry could face the fate envisioned in the baseline scenario, that of losing tens of thousands of jobs – serious consequences not only for the workers, most of whom are women, but also for the estimated 1.5 million rural family members that their salaries support.

*Controlling costs and increasing productivity are the keys to staying competitive after the expiration of the MFA. These are our internal factors. External factors also affect our competitiveness and are attributable to the Cambodian government. Therefore, the prospects for the garment industry after the expiration of the MFA will be good if the private sector and the government work together to reduce costs and time in processing export documents.*

*The government should also improve infrastructure and reduce infrastructure-related costs. Finally, if Cambodia stops being a good place to do business because issues such as simplification of export processes are not addressed, it will affect buyers’ purchasing decisions—we will then withdraw our business. The government should remain ahead of other places to make Cambodia an attractive place for investment.*

*Mr. Larry Kao, General Manager of Manhattan Textile Garment Corporation - Cambodia*

*FIAS surveyed 15 of the largest US and EU buyers, together accounting for 45% of Cambodia’s garment exports. Buyers consider labor standards as one of the most important criteria in making purchasing decisions, and Cambodia clearly ranked ahead of regional competitors on labor standards. It should be noted that labor standards is the only issue on which buyers believe Cambodia outperforms its regional competitors. Cambodia needs to build this into a sustainable competitive advantage if it is to retain its buyers and investors and improve the industry’s performance more generally.*

*Reducing corruption, red tape, and high energy costs would help make production costs more competitive against China. Succeed with those areas over the next three years, and the industry should have a promising future.*

*Nigel Twose, Manager, Foreign Investment Advisory Service (FIAS), the World Bank Group*