# Ready-Made Garment Industry in Sri Lanka: Preparing to Face the Global Challenges

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## ABSTRACT

With the phasing out of the Multi-Fibre Arrangement (MFA), the Sri Lankan economy, highly dependent on garment exports, has become vulnerable to the changing scenario affecting this industry in the global trading system. In such a global environment, strengthening the competitiveness of the garment industry has become a sine qua non for Sri Lanka to remain one of the suppliers of choice in her major markets. The industry therefore needs to articulate new response mechanisms to address the emerging challenges. A realistic course of action should involve addressing the major constraints in both the supply and demand sides of the industry. This paper highlights these issues and suggests some strategies for coping with the new global challenges.

## 1. INTRODUCTION

The garment industry in Sri Lanka expanded rapidly after the liberalization of the economy in 1977. During the 1990s, the garment industry grew at 18.5 per cent per annum. The export-led expansion of the industry led to the replacement of tea by garments as the nation's largest foreign exchange earner. Moreover, the industry has been contributing to the livelihood of nearly 1.2 million people. However, the boom

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period for the industry is gradually coming to an end, with the quota system having ended on 1 January 2005, regional trading blocs and bilateral free trade agreements proliferating and governing nearly 33 per cent of global trade, and China emerging as a major supplier of garments at very competitive rates. The Sri Lankan garment industry is now gearing itself to face these challenges.

This paper provides a broad overview of the industry and analyses how the industry is preparing itself to meet the global challenges. Section 2 provides a brief overview of the garment industry in Sri Lanka. Section 3 gives a broad picture of the competitiveness of the Sri Lankan garment industry. New trends in the global trading environment and Sri Lanka's measures to meet the challenges are discussed in section 4. Concluding remarks appear in section 5.

## 2. THE GARMENT INDUSTRY IN SRI LANKA: A BRIEF OVERVIEW

When Sri Lanka liberalized its economy in 1977, the country's garment industry took off immediately, mainly as a result of quota-hopping East Asian garment exporters who were attracted by the country's liberal trade regime and relocated their already well-established garment businesses to Sri Lanka. This relocation encouraged local entrepreneurs to start their own garment enterprises to exploit markets guaranteed by quotas, assisted by the liberal trade regime for importation, and subsequently, incentives granted by the Board of Investment (BOI) to selected industries.[1] Paradoxically, protectionism in the form of MFA quotas helped Sri Lanka and many other developing countries to develop their export-oriented garment industries by insulating them from direct competition from established producers.

Sri Lanka did not have a well-developed export-quality textile industry base; neither did it have a base for garment industry accessories. Thus, from the very beginning, garment production was based on imported inputs and the value added remained low – close to 30 per cent. By about the early 1980s, garment exports were growing rapidly and by 1986 garments accounted for the largest share of all exports (27 per cent). By the late 1980s, garment industry in Sri Lanka was referred to as "glorified tailor shops" because, despite a decade of growth, its links with other industries remained low and the value added remained low as before.

In 1992, BOI came into operation. BOI offered an attractive incentive package to entice garment producers to move to rural areas of Sri Lanka under the so-called 200 Garment Factory Programme (GFP). A textile quota board was established in the same year to streamline the allocation of quotas for the garment industry, including

[1] The Board of Investment at the time of the take-off of garment exports, was known as the Greater Colombo Economic Commission (GCEC).

those coming under the 200 GFP. This Programme enticed well-established garment producers to open a rural branch and, in addition, new enterprises with no background in garment production came into operation to make use of the quotas. Under GFP, 154 factories were in operation and 6 factories had closed down or been merged by 1996 (Heward, 1997, p. 12). By 1992, the garment industry had become the largest foreign exchange earner in the country (US$ 400 million) – overtaking the tea industry.

By 2002, Sri Lanka's textile and garment sector accounted for 6 per cent of GDP, 39 per cent of industrial production, 33 per cent of manufacturing employment, 52 per cent of total exports and 67 per cent of industrial exports (see tables 1 and 2). Sri Lanka commands 1.34 per cent of global garment exports (see table 2).

**Table 1. Sri Lanka textile and garment sector: macro data**

| | | *Under Agreement on Textile and Clothing (ATC)* | | |
|---|---|---|---|---|
| | *Under MFA regime* | *After first phase-out* | *After second phase-out* | *After third phase-out* |
| | *1990* | *1995* | *1998* | *2002* |
| Textile & garment exports (US$ Mn) | 643.5 | 1852.5 | 2466.2 | 2425.5 |
| as percentage of total exports | 33 | 49 | 52 | 52 |
| as percentage of industrial exports | 64 | 65 | 69 | 67 |
| Export market (as a percentage of total textile & garment exports) | | | | |
| United States | 67 | 61 | 64 | 63 |
| United Kingdom | 6 | 14 | 18 | 20 |
| Cotton yarn & textile imports (US$ Mn) | 427.8 | 1237.1 | 1477.6 | 1429.0 |
| Employment | 102 000 | 250 000 | 227 000 | 330 000 |
| No. of establishments (garments) | 142 | 678 | 891 | NA |
| Cumulative foreign investment (US$ Mn)[a] | 36 | 108 | 158 | 158 |
| Average exchange rate (Rs per US$) | 41.37 | 51.25 | 64.59 | 95.66 |

*Source:* Central Bank of Sri Lanka; Department of Census & Statistics, *Annual Report* (various issues); *Annual Survey of Industries* (various issues); *Sri Lanka Garments,* issue No. 80; and the data is derived from *The Apparel Digest/Sri Lanka Garment Journal,* 2001. (It should be noted that it is sometimes difficult to separate the data for garments from the data for joint textiles and garments.)

*Note:*

[a] Realized cumulative investment in garments at the end of the year, Board of Investment, Sri Lanka.

NA – not available.

These statistics clearly indicate that Sri Lanka is highly dependent on the industry for both employment and foreign exchange earnings. Foreign direct investment (FDI) has been very significant in the sector, accounting for 10.4 per cent of total cumulative FDI in 2003. According to the available data from BOI, foreign investors own close to 50 per cent of total garment factories and account for nearly 50 per cent of total textile and garment exports (USITC, 2004).[2] Greater dependence on imported textile materials indicates that Sri Lanka has a large export-oriented garment sector, but a small textile industry that has no capacity to supply the quantity or quality of yarn and fabrics required by the garment industry.

**Table 2: Export performance of the textile and garment industry in Sri Lanka: key indicators for 1995-2003**

| | *Export Value (Millions of US dollars)* | | | *Export indices of T & G 1990=100* | | | *T & G exports as a percentage of total merchandise exports* | *Sri Lanka's share of world garment exports (%)* |
|---|---|---|---|---|---|---|---|---|
| *Year* | *Textile (T)* | *Garments (G)* | *T & G* | *Volume* | *Value** | *Unit value** | | |
| 1995 | 43.2 | 1465.5 | 1852.6 | 226 | 295 | 130 | 48.7 | 1.00 |
| 1996 | 199.2 | 1688.6 | 1905.9 | 237 | 303 | 128 | 46.4 | |
| 1997 | 306.7 | 1972.6 | 2279.3 | 264 | 363 | 137 | 49.0 | |
| 1998 | 228.6 | 2237.8 | 2466.4 | 272 | 393 | 144 | 51.3 | |
| 1999 | 225.2 | 2205.1 | 2430.3 | 291 | 387 | 133 | 52.6 | |
| 2000 | 271.5 | 2723.1 | 2994.6 | 341 | 477 | 140 | 54.0 | 1.33 |
| 2001 | 209.7 | 2334.6 | 2544.3 | 302 | 405 | 134 | 52.8 | |
| 2002 | 179.1 | 2246.4 | 2425.5 | 306 | 386 | 126 | 51.6 | 1.34 |
| 2003 | 175.3 | 2400.0 | 2575.3 | 313 | 410 | 131 | 50.2 | |

*Source:* Central Bank of Sri Lanka.

*Note:* * In constant 1990 dollars.

In the early 1990s, a concerted effort was made to promote backward linkages in the garment industry. Government-appointed delegations were sent overseas to attract large textile producers to Sri Lanka. A number of textile producers that had come up during the pre-1977 import-substitution regime and had found it difficult to survive in the liberalized economy were privatized in the early 1990s. Despite all such efforts, the development of backward linkages from the garment industry to the textiles sector was very slow for a number of reasons (Kelegama and Foley, 1999). In 1997, the textile industry faced a major setback. The East Asian crisis had triggered a currency depreciation in Indonesia and the Philippines – two of Sri Lanka's competitors in

[2] All firms with FDI are treated as foreign firms regardless of the size of the ownership share.

garment exports. The garment exporters found it difficult to compete without a devaluation of the Sri Lankan currency, and started to lobby the Government to this effect. Since the Government did not allow a devaluation of the currency, the garment industry lobbied for duty-free status for textile imports with the aim of bringing down their production costs.[3] The Government granted this request without considering the repercussions on the domestic textile industry. Consequently, the textile industry virtually collapsed and no effort made by the government, for example, by offering subsidized interest rates to rescue the textile industry, had any major impact. In fact, three of the privatized textile factories (Veyangoda, Pugoda and Mattegoda) that were gradually switching to manufacture textiles to meet the needs of the export-oriented garment producers had to be closed down.

Today, the Sri Lankan garment industry remains a low value-added industry, though some backward linkages had developed by the mid-1990s. There were 891 garment factories in operation in 1999 — out of which 18 per cent was categorized as large, 50 per cent medium and 32 per cent small (TVEC, 1999). In 1999, 72 per cent of the businesses were geographically located in the Western Province. Just 12 per cent of the factories control around 72 per cent of the exports (CBSL, 2002:103). Some of the top producers have developed strong and reliable links with well-known international retailers indirectly by buying intermediaries. Sri Lankan garments that were highly quota-dependent initially have now become less dependent on quotas, with 47 per cent of exports coming under the non-quota system in 2002.[4] Most Sri Lankan garment exports are destined for the United States (63 per cent) and European Union (30 per cent); hence, there is not much market diversification. The key varieties of garments that Sri Lanka exports are: HS 6204 (women's or girls' suits, and similar items under this category), HS 6203 (men's or boys' suits, and similar items under this category), and HS 6206 (women's or girls' blouses, and similar items under this category). Sri Lanka is well known as a top exporter of women's lingerie.

Sri Lanka's garment industry has a fairly reputable status in the international market. Sri Lankan garment exports to the United States market coped well with the emergence of NAFTA in 1994 despite many pessimistic views expressed at that time.[5] Sri Lankan garment industrialists have opened factories in Bangladesh, Maldives, Jordan, Kenya and Mauritius, among others, and are performing well. The large and well-established garment producers have featured in published works (Friedman, 2000). The Sri Lankan garment industry has gone through turbulent times; for instance, during the 1988-1989 civil conflict; in 1993, when countervailing duties and embargo were

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[3] The benefit of this would accrue mainly to non-BOI garment exporters, which constituted a majority in terms of numbers at that time.

[4] Sri Lanka depends less on quotas compared to Bangladesh (95 per cent), Pakistan (90 per cent), Nepal (80 per cent), and India (73 per cent) (ILO, 2002).

[5] Sri Lanka's competitive position in the United States market was not significantly disturbed by NAFTA (for details, see chapter 7, Kelegama, 2004 ed.).

imposed by the United States; and in 2001, when war-risk premiums and surcharges were imposed after the bomb attack on Colombo International Airport. The industry currently employs around 330,000 people and sustains the livelihood of around 1.2 million others.

## 3. COMPETITIVENESS OF THE SRI LANKAN GARMENT INDUSTRY

The competitive strength of the Sri Lankan garment industry is based on cheap labour, a literate labour force, high labour standards, investment-friendly government policies and strategic shipping lanes. On the other hand, there are also competitive disadvantages, such as long lead times, weak marketing, lack of product development and low labour productivity partly due to outdated technology.

In 1983, Sri Lanka experienced civil conflict and many foreign investors, including foreign garment industrialists, shied away from the country. Some moved to Bangladesh; others moved to newly emerging low labour-cost East Asian countries, such as Cambodia and Viet Nam. Labour costs were comparatively low in these countries and, by the mid-1990s, Sri Lanka could no longer compete on the basis of low-cost labour and measures had to be taken to improve the productivity of the sector. Low productivity has offset to some extent the low labour-cost advantage of Sri Lanka.

A study on the productivity of the garment sector shows that there are a number of issues pertaining to low labour productivity in the garment industry and that there is substantial room for improvement (Kelegama and Epaarachchi, 2002). One area that requires upgrading is the development of human skills to deal with the technological changes taking place in the garment industry. To meet the growing demand for semi-skilled workers in the industry, two training institutions, *viz*, the Textile Training Centre and Service Centre and the Clothing Industry Training Institute came into operation, both in 1984. In addition, a private sector training institute, the Phoenix Clothing Training Institute, was established in 1998.

A number of design schools have emerged, with the Department of Textile & Clothing Technology in the University of Moratuwa becoming the apex body for design. Design courses have been introduced, with the collaboration of the London School of Fashion Design, to keep pace with the latest fashion developments in the world and to train workers to match the demand. The Asian Development Bank (ADB) has given a grant to set up a major fashion school at the University of Moratuwa that is expected to be in operation by 2005.

Labour costs, however, amount to 15 to 20 per cent of the overall cost. Thus, there are a number of non-labour aspects that contribute to low productivity. The introduction of CAD/CAM machinery to the garment industry has been painfully slow. At the firm level, competitive issues have not featured in strategic planning owing to the

assured market guaranteed by the quota system and the laid-back attitude of some entrepreneurs (Fonseka and Fonseka, 1998). Most companies have made little effort to produce high value-added garments and there is a heavy dependence on buyers to channel garments to international markets (about 65 per cent of garment exports).[6] Until recently, most garment orders were on a no foreign exchange (NFE) basis and many garment producers preferred such orders because there was less risk involved.[7] Little effort has been made at the firm level to reduce wastage and improve the quality of work.

Owing to the lack of a fabric and accessory base (lack of vertical integration), the turn-around time of Sri Lanka's garment industry remains close to 90-150 days compared with the ideal international lead time of around 60 days. This large turn-around time is an issue in the context of competitiveness, particularly when Eastern European countries have become major suppliers of garments to the European Union, and Mexico and Caribbean countries have become major suppliers to the United States under preferential tariff arrangements. Moreover, this problem is of particular concern at a time when "just-in-time" delivery has become an accepted principle and requirement in the global market.[8]

Sri Lanka's lack of competitiveness in garment products is not solely determined by low labour productivity, firm level inadequacies and high turn-around time but also by government policies. The cost of production in Sri Lanka has escalated in recent times owing to the high cost of public utilities, such as electricity, water and telecommunications (IPS, 2003). In fact, Sri Lanka's electricity charges remain the highest in Asia as a result of poor government policies contributing to mismanagement in the electric power sector.

If Sri Lanka is to gear itself to the post-2004 challenges, a number of restructuring measures have to be taken in the garment industry. Some measures have already been taken. Until recently, the Sri Lankan garment industry did not have a strategy or plan for its future expansion. In 2002, the industry came up with a five-year strategy report. This report contains a comprehensive analysis of "strengths", "weaknesses", "opportunities", and "threats" (SWOT) and recommends a strategy for eliminating weakness, consolidating strengths, making use of opportunities and minimizing threats. The report argues for the establishment of a special research cell

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[6] Business Page, *The Island*, 22 February 2004.

[7] A no foreign exchange basis means that the buyer provides inputs and the garment manufacturer makes no payment for these inputs; thus, there is no importation on the part of the manufacturer.

[8] Electronic point-of-sale technology – that is, the bar code – has been increasing retailers' command over suppliers since the 1980s. Retailers no longer have to buy goods up front and carry the risk of selling them. Now, when consumer purchases are tracked with bar codes, retailers can automatically reorder just enough of a product just in time to restock their shelves. It maximizes their retail sales per square metre of shop space and shifts order risks back onto suppliers and producers. With this just-in-time response comes the pressure on producers to deliver smaller orders, in less time, and according to tightly planned shipping schedules – or face fines for delays.

for the industry to keep track of international trends in garment trading, and this cell came into operation in late 2002. Having realized the need to speak with one voice in order to achieve a common goal, garment industrialists and stakeholders set up the Joint Apparel Association Forum (JAAF), a consortium of five different associations, in 2002.[9]

Meanwhile, the airport bomb attack in mid-2001 gave the industry a wake-up call. After this event, a war risk insurance charge was imposed on Sri Lankan exports undermining the competitiveness of the garment industry. This triggered a social engineering process in the industry whereby many companies started implementing various cost-cutting measures to make the industry more competitive.

Although Sri Lanka supplies garments to many leading retailers, such as Victoria's Secret, Liz Claiborne, May Department Stores, Marks & Spencer and C & A, the country does not possess well-known local brand names. Most garment exporters do not have direct contact with the final buyer and remain suppliers to such leading stores via buying offices. To address this lacuna, the industry introduced a garment-marketing course in collaboration with the Chartered Institute of Marketing in the United Kingdom. Recognizing the need for a brand that could withstand shocks in the Western market, two leading companies (Phoenix Ventures and Jewelknit) took measures to merge and develop a branded product (Brandix) in 2003. This was a positive sign in the overall progress of the garment industry in Sri Lanka.

## 4. NEW TRENDS IN THE GLOBAL TRADING ENVIRONMENT: MEETING THE CHALLENGES

The Sri Lankan garment industry not only needs to become competitive to face the post-2004 quota-free global challenges, but also has to take cognizance of the new trends in the global trading environment. There are new trends in the European Union and United States markets, while the emergence of China as a significant global supplier is also an important issue.

Sri Lanka gained quota-free status entry to the European Union market in March 2001, with the expectation of increased garment supply to that market. Sri Lanka currently faces competition in the European Union market from (a) least developed countries (LDCs), such as Bangladesh, which has duty- and quota-free access to the European Union under the Everything-But-Arms (EBA) scheme; (b) African, Caribbean and Pacific (ACP) countries, which enjoy preferential market access to the European Union under the Cotonou Agreement; and lately (c) Eastern European countries, some of which have become European Union members and to which some European garment

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[9] The five associations are: Sri Lanka Apparel Exporters Association, National Apparel Exporters Association, Sri Lanka Chamber of Garment Exporters, Free Trade Zone Manufacturers Association and Sri Lanka Garment Buying Offices Association.

factories have relocated to exploit cheap labour and proximity to their market. A comparison of Sri Lankan export performance with other countries' export performance in that market during 2000-2003 does not provide strong evidence that the quota-free entry has resulted in significant gains for Sri Lankan garment exports (Kelegama, 2004 ed., chapter 2). It appears that the window of opportunity for European Union market consolidation has been lost because of the relatively late quota-free entry.[10]

However, Sri Lanka has gained from a reduction by the European Union of GSP rates for Sri Lankan garment exports.[11] Sri Lanka has managed to maintain relatively high labour standards in factories to convince European Union inspectors that working conditions in factories are relatively satisfactory.[12] There are doubts whether these concessions would be significantly beneficial given the fact that GSP concessions are conditional on fulfilling the SAARC rules of origin (RIS, 1999).[13]

After the enactment of the Trade and Development Act of 2000, the United States adopted the Caribbean Basin Trade Partnership Act (CBTPA), the Andean Trade Preference Act (ATPA) and the African Growth and Opportunity Act (AGOA) in 2001-2002. Under these acts, garment exports from Caribbean, Latin American and sub-Saharan African countries are entitled to quota-free and preferential duty entry to the United States market after fulfilling certain conditions. These conditions are mainly related to selected textile and garment articles and fulfilling the applicable rules of origin (or reverse preferences) involving the use of United States fabrics and other inputs, which the United States demands as a *quid pro quo* and is known as the "yarn-forward rule".

There are mixed views as to the effectiveness of these arrangements. While some critics claim that the built-in reversed preferences governing these agreements have nullified the preferential advantages (Bhagwati, *The Economist*, June 2002), others have argued that, despite the reverse preference conditionality, there are overall gains

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10 Sri Lanka's ability to sustain itself in the European Union market might weaken further when the Union phases out quota restrictions on garment exports from India and China.

11 The overall reduction is about 40 per cent for the garment sector – 20 per cent under the GSP and 20 per cent under a Special Incentive Arrangement. For details, see *Quarterly Economic Review: Sri Lanka, Fourth Quarter 2003,* The Ceylon Chamber of Commerce (2004, pp. 9-10).

12 Apparel-industry Labour Rights Movement (AlaRM) Sri Lanka will not necessarily agree with this view (see also, Kelegama and Epaarachchi, 2002).

13 The rules of origin stipulate that the fabric must be knitted or woven in the SAARC region from yarn of the same SAARC country. Cumulation can only take place between two SAARC countries; for example, yarn spun and woven in India and garment made in Sri Lanka. Imported woven fabric can be used if it has been printed and finished in the SAARC region on condition that the imported greige ("grey goods", i.e., any woven fabric just off the loom that has not yet been dyed or finished) accounts for no more than 47.5 per cent of the ex-works value of the finished fabric. Non-originating non-textile trims (e.g., buttons and zippers) can be used freely. Non-originating textile trims (e.g., elastic) can be used provided that they do not exceed 8 per cent of the value of the ex-factory price of the finished garments. The use of non-originating linings or interlinings will automatically disqualify the garment product for GSP.

from these agreements (UNCTAD, 2003; Mattoo et al., 2003). In fact, a number of Sri Lankan garment entrepreneurs have set up businesses in Mauritius, Madagascar and Kenya as well as other African countries to exploit the advantages of AGOA, just as East Asian quota-hopping garment manufacturers did in Sri Lanka in the late 1970s to gain the quota advantage there.

The United States departure from multilateralism is not confined to these arrangements. Of late, the United States has been offering bilateral agreements to various countries on the basis of "WTO-Plus" considerations.[14] Chile, Singapore and Jordan have already completed bilateral free trade agreements (BFTAs) with the United States. These agreements were signed on the basis of initial agreements called trade and investment framework agreements (TIFAs).

Sri Lankan garment companies hold the view that, if a United States-Sri Lanka bilateral free trade agreement can be worked out any time soon, Sri Lanka could consolidate its garment export share in the United States market (2.7 per cent of United States garment imports in 2003 were from Sri Lanka, and 63 per cent of Sri Lankan overall garment exports are destined for the United States market) and thus could face the post-2004 challenges more effectively. In July 2002, the two countries signed a TIFA and since then substantial groundwork has been done to convert the TIFA to a full-fledged bilateral free trade agreement.[15] Sri Lanka's enthusiasm for a bilateral free trade agreement with the United States was such that, at the Fifth WTO Ministerial Conference, held in Cancún, Mexico, the country departed completely from the position of the developing countries on some issues and supported the position of the United States (Kelegama and Mukherji, 2003). Obviously, it was a *quid pro quo* to expedite the possible United States-Sri Lanka bilateral free trade agreement.

What is clear is that a United States-Sri Lanka FTA has been delayed owing to the fact that 2004 was an election year in the United States with the political establishment under pressure for more protectionist measures by the clothing sector, and it was also an election year in Sri Lanka with considerable political instability. The disaster that resulted from the December 2004 tsunami may lead to further delays as immediate government priorities lie elsewhere. Such delays may lead to the conclusion of an FTA that may be too late to be of significant assistance, similarly to the European Union quota-free status mentioned above.

The Indo-Sri Lanka Bilateral Free Trade Agreement went into effect in March 2000, and one objective of this Agreement was to afford Sri Lankan garment exporters an opportunity to diversify and capture a share of the Indian market. However, given the various para-tariffs and specific duties operating in that market and the rules of origin governing the Agreement, Sri Lankan garments have not been very competitive, to the extent that only a small number of garments have been exported to India and the quota under the ILBFTA remains significantly unmet (Kelegama, 2004, ed., chapter 8).

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[14] See, for instance, Kelegama and Mukherji (2003).

[15] *Daily Mirror*, 20 February 2004.

China's threat to garment exports from other developing countries is important and cannot be set aside. The World Bank has predicted that China's share of garment exports in the world will rise to 50 per cent by 2010.[16] In other words, Chinese exports are expected to double in six years, mostly at the expense of other developing countries. Already, the rapid rise of China's garment exports in particular categories after earlier quota removals has demonstrated how China could swallow up the share of garment exports of other developing countries.

In addition to possessing a low wage rate per worker (average US$ 40 per month), China benefits from a disciplined workforce, economies of scale through large-scale production, and the presence of many transnational corporations (TNCs) in the garment industry. Moreover, upon its accession to WTO in December 2001, China enjoys MFN status for its exports – a privilege that did not exist before. The number of product items under quota in China amounted to 20 per cent of Chinese garment exports before 1 January 2005, which is a large number. Thus, it is believed that there will be significant dominance by Chinese clothing in the post-2004 period.

However, it has also been argued that the threat from China may be exaggerated. First, it is argued that, with WTO entry, China will have to become more transparent and some of its past practices to maintain low cost of production may have to be abandoned. Consequently, the low cost advantage may become somewhat eroded (RIS, 2002). It is also argued that, although labour wages in the provinces remain low, there has been a significant increase in wages in the eastern coast, where the key garment producers are located. Monthly wages in some of these factories exceed US$ 90, which is higher than the monthly wages in Indonesia, Bangladesh, Viet Nam, India and Sri Lanka. Secondly, there is a view that the United States and the European Union will have significant control over the expansion of Chinese garments in their respective markets because of two prevailing legislative regulations: (a) the safeguard regulation from 2005-2008; and (b) the anti-dumping regulation from 2005-2015.[17] It is argued that both of these regulations will give the United States and the European Union significant power to guard against a sudden influx of Chinese garments and thus preserve the existing foothold of other developing countries in the United States and

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[16] *The Economist,* 15 February 2003.

[17] The Textile and Clothing Safeguard regulation that China agreed to as part of its WTO accession package allows WTO member countries to impose temporary quotas on Chinese textile and clothing imports in the event these imports cause "market disruption" (instead of the standard "serious injury" clause). The anti-dumping measures that China agreed to are defined as unilateral remedies that can be applied by a WTO member after an investigation and determination by the member that an imported good is "dumped" and that dumped imports are causing material injury to a domestic industry producing a like product. In response to these, the Government of China announced export tariffs on 148 textile and clothing products. However, the tariffs are low; for instance, for men's cotton shirts the levy is 0.2 yuan, or 2.5 cents – a price increase of about 1 per cent. Despite this marginal difference, the low profit margins in China make it difficult to impose a higher tariff.

European Union markets.[18] It is also argued that the United States may exert pressure on China to revalue its currency – the yuan – as in the case of Japan in 1971. A revaluation of the Chinese currency would further erode the competitive price advantage of Chinese garments.

It is difficult to exactly say what threat China will pose to a garment exporter in Sri Lanka. At least from the Sri Lankan experience thus far, the threat seems to be real. Three items – bag and luggage (670), W/G [Women's or Girls'] Coats (835), W/G Suits (844) – that were removed from the quotas in January 2002 went completely out of production by mid–2003 owing to competition from China. Two leading producers of some of the above-mentioned items, which employed a large number of people, had to close down consequently.[19]

The prevailing uncertainty has been aggravated by the WTO Agreement on Textiles and Clothing (ATC), which stipulates the phasing out of the MFA. Developed countries did not strictly adhere to the phase-out mechanism of the MFA, however. For instance, by 1 January 1998, compared with the target of 33 per cent of product integration, the United States and the European Union had integrated only 1 per cent and 7 per cent, respectively (ESCAP, 2000, p. 71). Moreover, developed countries have exploited a loophole in the MFA, where the ATC does not impose any obligation on countries to limit their integration to particular products subject to restrictions. Therefore, Sri Lanka will not feel the full impact of the final phasing out of the MFA until early 2005.

It has been estimated that the items for which restrictions were relaxed in 2002 constituted only about 4 per cent of all restricted products exported by Sri Lanka to the United States. The remaining 96 per cent were under restraint until end-2004 (Weerakoon and Wijayasiri, 2004). Thus, a sense of complacency crept in among garment companies towards making the required adjustments, although this changed somewhat after the social engineering process that started after mid-2001 and may change altogether in the course of 2005.

An earlier study highlighted the fact that nearly 40 per cent of Sri Lankan garment producers will go out of production after 2004 (Kelegama and Epaarachchi, 2002). The study argues that a number of new mergers and acquisitions will take place in the industry. Some large producers may resort to subcontracting through small units, while small units that fail to obtain orders will have to close down. To support small and medium-sized units in the garment industry, the Government has launched a credit guarantee scheme, as proposed in the 2004 Budget. Under this scheme, loans could be obtained without collateral.

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[18] The American Textile Manufacturers Institute recently estimated that, without safeguards, approximately 1,300 firms could go out of production, with the loss of 630,000 jobs by 2006 (*The Island*, 27 August 2003).

[19] A total of 6,450 jobs were lost owing to the closure of North Carolina Sheet and Towel and Pillowtext Corporation (*The Island*, 27 August 2003).

In its Five-Year Strategy, JAAF has argued that Sri Lanka should now shift from the low end of the market to the middle and upper levels. Currently, only 10 per cent of local manufactures end up in specialty brands, while 50 per cent is taken by foreign department stores and the balance by foreign discount stores. During the five-year period ending in 2007, the industry plans to increase penetration into specialty stores by 20 per cent and department stores by 60-70 per cent and reduce the dependence on discount stores by 10-30 per cent.

The plan outlines a format for achieving these objectives with a detailed discussion on: (a) a strategic framework for implementation; (b) a strategic initiative and relevant action plans for the industry; (c) an additional strategic initiative in support of small and medium-scale enterprises; (d) implementation plans; and (e) cost estimates for the strategic plan. The industry has formed eight committees to look into various aspects of the industry: (1) bilateral and multilateral issues; (2) marketing; (3) logistics and infrastructure; (4) backward integration; (5) small and medium-scale enterprises; (6) human resources, technology and productivity; (7) labour; and (8) finance. The government has allocated Rs. 100 million to increase productivity in the garment industry through the Five-Year Strategy.

The Sri Lanka Joint Apparel Association Forum coordinates the strategy management. The Association has hired a number of experts to coordinate and support its work. Although strategies have been implemented to face the post-2004 challenges effectively, the debate goes on for the post-2004 scenario – both optimistic and pessimistic views have been voiced. Optimists, such as the Central Bank of Sri Lanka, have put forward the following viewpoints: first, it is stated that, since 12 per cent of the garment manufacturers control 72 per cent of exports, there are reasons to believe that these top-end factory units are well established, commanding market niches and thus well placed to meet the post-2004 challenges. Thus, it is argued that these top-end manufacturing units can absorb some of the smaller factories and expand their production to be competitive in the market. Secondly, it is argued that the non-quota exports at present amount to 47 per cent of garment exports; thus, a quota phase-out will not create a serious problem. Thirdly, it is argued that, if the high end of the market could be captured by producing value-added garment products – which larger units have done – Sri Lanka need not worry about competing in the world market

While one can agree with the first point, there are serious reservations about the others. First, it is inappropriate to form a judgment based on increasing non-quota exports because what is a non-quota product for Sri Lanka may be under quota for another country, such as China. The performance of such a non-quota product when the same product comes out of quota in China – at least if one goes by past experience – may not be positive. Second, the top end of the market is equally competitive; other countries that see their quotas in this segment removed will also be aiming at this segment and competition would therefore intensify at this end of the market as well. Sri Lanka will face an uphill battle to be competitive at the top end of the market (Fonseka, 2004).

The pessimists, on the other hand, argue that whatever the percentage of exports that is controlled by the top 12 per cent firms, the garment industry as a whole is not competitive enough to show a solid performance in the post-2004 period (Fonseka, 2004, and others). From the global demand front, it is said that the threat from China will be overwhelming. Moreover, it is argued that the share controlled by other Asian countries is expected to shrink from the current 32 to 20 per cent by 2010. Consequently, there will be competition among Asian countries to capture part of this shrinking share and in that process Sri Lanka may not necessarily be a winner.

Furthermore, inadequate preparation for the post-2004 period due to the back loading factor of the MFA phase-out is also highlighted by the pessimists. From the domestic supply side, the inadequate development of backward linkages, weak forward integration, low labour productivity and increasing production costs, inter alia, are pointed out by the pessimists to highlight the lack of competitiveness. Those who argue along these lines assert that at least 100,000 workers will lose their jobs and various new mechanisms will have to be devised to look after those displaced from the garment industry.

A mixed picture emerges from current trends in the garment industry. On the negative side, it is observed that, out of the 859 firms operating in 2001, about 150 had closed down by mid-2002.[20] Garment factories are experiencing a shortage of labour due to the poor working conditions and accommodations prevailing in some of the factories.[21] In 2003 and 2004, garment exports have shown a decline in performance compared with the year 2000 (see table 2). On the positive side, the top 12 per cent of factories are performing well, there has been an increase in the number of international orders, and a number of foreign garment companies, such as Levis, are opening factories in Sri Lanka.

Given the strong foundations of the garment industry, Sri Lanka still has a chance of being a supplier of choice in the major international markets; however, to retain such a position, substantial restructuring is essential. Thus, irrespective of the current mixed picture, there is an urgent need to restructure the industry to face the post-2004 period without complacency about a possible United States – Sri Lanka FTA that will come to Sri Lanka's rescue, or that the ATC will not be implemented properly after 2004, owing to concerns in the European Union and United States markets.

## 5. CONCLUDING REMARKS

The Sri Lankan garment industry is at a crossroads. The challenge lies in improving its competitiveness. Rectification of the anomalies highlighted in the preceding sections alone would be inadequate; other methods of increasing competi-

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[20] "Treasury officials fail to provide succour to garment industry" (*The Island*, 21 June 2002).

[21] JAAF recently launched a media programme to build the image of the garment employees after realizing that the shortage of workers is due to a social stigma attached to garment workers and the poor working conditions in some firms.

tiveness should be explored. One strategy is to reposition the Sri Lankan garment industry from a South Asian context and increase competitiveness by increasing vertical integration, capturing economies of scale, focusing on horizontal specialization, incorporating innovative designs and building a stake in global marketing networks.

A recent report by RIS (2004) argues that the region as a whole could meet the challenge collectively if it pursued horizontal integration, i.e., cooperation in the same or similar lines of production and exports. Such a South Asian strategy envisages a particular South Asian country that has gained export specialization in certain textile or clothing product lines acting as a host for relocated plants from other South Asian countries. In this way, the textile and clothing sector can become a regionally integrated sector as countries vacate certain lines of production and gain in other lines of production according to their relative competitive advantage in the global market. Such restructuring would promote intra-South Asian investment flows that would be trade-creating *vis-à-vis* the global and regional markets. Vertical integration from one stage of processing to another according to comparative advantage can be considered in the subsequent phase. South Asia would thus not lose in the value-added chain.

Ramaswamy and Gereffi (1998) showed that the buyer-determined value-added chain is prominent in garment manufacturing. One way of entering the chain is by having a stake in the global marketing network. For example, in the tea sector, the Indian company Tata bought over the global marketing network of Tetley. A similar strategy can be adopted in the garment sector, but a regional strategy in this regard will be more effective than an individual South Asian country effort. RIS (2004, p. 36) argues:

> "Much of the value addition in garments for instance takes place at the stage of branding and marketing. The South Asian countries should consider setting up South Asian level mega-companies to foster an integrated South Asian garment sector…In order to secure their market overseas and to realize a greater proportion of value added, the South Asian exporters should consider taking over a few marketing and distribution chains in their lines of production in developed countries. Given the scale of resources involved in such take-overs, it may be beyond the capacity of individual exporting companies or individual member countries. However, this could be done by forming a regional consortia of the South Asian exporters."

The Sri Lankan garment industry has gone through turbulent times and is now facing new challenges. The groundwork has already been laid to prepare and face this challenge. What Sri Lanka would like to see is a minimum disruption in the adjustment process because the garment sector is the largest foreign exchange earner and a key generator of employment. However, if Sri Lanka can no longer maintain its comparative advantage in the garment sector, then new sectors will emerge to replace it; in the short run, however, the economy will incur a significant cost from such industrial restructuring and there will be social costs. It is for this reason that both the Government and private sector industry are exerting themselves in support of the garment sector.

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