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Textiles and clothing in Asian graduating LDCs

Firm-level analysis

About the paper

This report analyses the impact of the least developed country (LDC) graduation on the textile and clothing (T&C) industry in Bangladesh, Cambodia, Lao PDR and Nepal from a firm level perspective. The findings are based on consultations with up to 40 T&C manufacturers in each LDC country and around 30 leading international fashion companies (i.e., brands, retailers, and sourcing agents) from May to August 2021. The summary and main findings of this report are refelecvted in the joint UN-DESA, WTO, UNCTAD and ITC report “Textiles and clothing in Asian graduating LDCs – Challenges and Options”, which was published by the WTO in January 2022.

The report was written by Professor Sheng Lu with the support of M Pisey Khin, Er Prakash Jha, Ramon Bruesseler and Mohammad A. Razzaque under the supervision of and contributions from Matthias Knappe. It was elaborated undet the ITC Global Textiles and Clothing (GTEX) Programme, financed by the Government of Switzerland under the State Secretariat of Economic Affairs (SECO).

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Acronyms

ALGI	Association of the Lao Garment Industry
ASEAN	Association of Southest Asian Nations
CMT	Cut, Make and Trim
BGMEA	Bangladesh Garment Manufacturers and Exporters Association
EBA	Everything But Arms
ESG	Environemental, Social and Governance
EU	European Union
FDI	Foreign Direct Investments
GMAC	Garment Manufacturers Association in Cambodia
ITC	International Trade Centre
LDC	Least Developed Country
MFA	Multi-Fabric Arrangement
SOE	State-Owned Entreprises
T&C	Textile and Clothing

OVERVIEW OF THE T&C SECTOR IN BANGLADESH, CAMBODIA, LAO PDR AND, NEPAL AND ENTERPRISE STRATEGIES TO REMAIN COMPETITIVE

Like many other LDC countries, the T&C sector, in general, plays a critical role in generating economic growth, creating jobs, and promoting social-economic development in Bangladesh, Cambodia, Lao PDR and Nepal. According to the survey results, the T&C sectors in the four LDC countries have several essential features.

First, regarding firm ownership, the T&C companies in the four LDC countries are mostly private owned. While the surveyed T&C manufacturers see the financial support from the local government as essential (except for manufacturers in Lao PDR, which reported no financial support provided by the government), few of them were state-owned enterprises (SOEs).

Second, foreign direct investment (FDI) plays a significant role in building and developing the T&C industry in these four countries. For example, more than half of the surveyed garment factories report foreign ownership in Lao PDR and Cambodia, whereas most factories in Bangladesh work exclusively on contracts for foreign buyers. Almost all the leading investors come from Asia, led by China (including Hong Kong), Taiwan, Province of China, the Republic of Korea, Japan, and European Union (EU) countries in the case of Lao PDR.

Third, T&C manufacturers in all the four LDC countries have formed their respective trade associations. The leading T&C trade associations in these countries include the Bangladesh Garment Manufacturers and Exporters Association (BGMEA), Association of the Lao Garment Industry (ALGI), Garment Manufacturers Association in Cambodia (GMAC), and Garment Association of Nepal. The surveyed T&C manufacturers also see these trade associations as strong advocators for their members on policy issues before their local government and other stakeholders, domestic and foreign.

Fourth, the T&C sector in the four LDC countries relies on exports heavily. However, their exports concentrate on a limited few market with intense competition. Specifically:

- The surveyed T&C manufacturers in the four LDC countries typically export to 3-5 different export markets. These markets concentrate on the EU, the United States, the United Kingdom (UK), Canada, and Japan, accounting for 80-90 percent of respondents' total export volume. In the case of Nepal, India is another critical export market due to its geographic location.

  The EU, in particular, is a leading export market for the surveyed T&C manufacturers because of its Everything but Arms (EBA) program. Notably, EU's EBA program offers quota-free and duty-free market access for qualifying apparel exports from the four LDC countries with very liberal rules of origin (ROO).

- The size of the factory and the nature of the products could affect its export diversification level. For example, in Bangladesh, woven apparel manufacturers, in general, adopt a more diversified export market than those making knitwear products.

- Despite the intense competition, many T&C manufacturers still hope to expand their exports to the conventional markets, including the EU, UK, and the US. In comparison, expanding into a new export market does not seem to be a priority for most surveyed T&C manufacturers, given the unknown market potential and the additional resources required.

Fifth, T&C manufacturers in the four LDC countries primarily produce apparel products that target the mass market. They also heavily rely on imported textile raw materials due to limited domestic production capability.

Most surveyed T&C manufacturers in Bangladesh, Cambodia, and Lao PDR report engaging only in the "cut, make and trim (CMT)" function. Except for a few respondents in Bangladesh, most surveyed T&C factories say they rely on imported textile raw materials, including yarns, fabrics, and accessories. In comparison, the local textile industry in Cambodia, Lao PDR, and Nepal remains nascent with minimal production capacity.

In Bangladesh, the local textile industry has a considerable capacity but supplies mainly to domestic consumers, and the backward integration in the knitwear sector is strong.

Because of the regional supply chain, the four LDC countries' raw textile materials primarily come from Asia, supplied by China, Taiwan, Province of China, the Republic of Korea, and India. Notably, China is playing an increasingly critical role as a leading textile supplier for the four LDC countries.

T&C exports from the four LDC countries focus on relatively simple products, especially tops (e.g., T-shirts) and bottoms (e.g., trousers). The surveyed T&C manufacturers see LDC preferences, lower wage levels, and production costs as their critical competitive edge.

Sixth, T&C manufacturers from the four LDC countries expect LDC graduation to impact their export performance significantly.

The vast majority of surveyed T&C manufacturers (over 90 percent) say their apparel exports currently took advantage of the preferential market access provided by respective import markets for LDC countries. Consistent with the trade volume, respondents see EU's EBA program and trade preference programs adopted by the US, Japan, and Canada as the most critical in supporting their exports.

In general, the surveyed T&C manufacturers were very concerned about the negative impact of LDC graduation on their apparel exports. Given the intense price competition, many T&C manufacturers were worried about competing with other world's leading apparel suppliers, such as Viet Nam, once their apparel exports lost the eligibility for LDC trade preference programs.

While trade programs like the free trade agreement or the Generalized System of Preferences (GSP) may help mitigate the negative impacts of LDC graduation, complying with these programs' more restrictive rules origin could be another challenge. Notably, most T&C factories from the four LDC countries do not seem to be ready to comply with rules of origin that are more restrictive than the "cut and sew" rules they currently enjoy under the LDC-style trade preference programs. Besides the minimal local textile production capacity in most countries, it is not uncommon to see the surveyed T&C manufacturers lack sufficient knowledge about the details of the complex rules of origin.

As the timeline for LDC graduation is far from clear, many surveyed T&C factories admit they have no response plan yet. The surveyed T&C manufacturers stressed the importance of continued financial support from their national government (e.g., Bangladesh and Nepal), skills development, policies to attract investment and the negotiation of trade agreements or alternative preferential arrangements such as the EU's GSP+ program following graduation.

Country Profiles

Bangladesh

Bangladesh ranked the world's third-largest apparel exporters in 2020 by value. Consistent with the findings of previous studies, domestic investors owned most surveyed T&A manufacturers (i.e., 84 percent) in Bangladesh. Foreign-invested factories and jointed ventures accounted for another 15 percent.

Reflecting Bangladesh's T&C production capability, over 90 percent of surveyed manufacturers reported producing garments only (i.e., 52.8 percent making knitted apparel and 38.7 percent making woven apparel). In comparison, only around 6.3 percent of respondents were fabric manufacturers, and less than 1.7 percent reported making yarns. Further, nearly two-thirds of the respondents engaged in contract-based manufacturing, i.e., fulfilling short-term sourcing orders directly from vendors or sub-contracted.

Most surveyed T&C manufacturers in Bangladesh were export oriented. Notably, more than 97 percent of respondents say at least 80 percent of their revenues come from export. In general, there was a lack of export market diversification among respondents. Over one-third of surveyed factories report exporting to 3-5 countries only, and another 16 percent exported to 6-10 countries or regions. Woven manufacturers adopted a relatively more diversified export market than knitwear manufacturers among respondents.

Respondents' export markets mirror the national trade statistics. The EU 27 countries accounted for nearly half of the export value or volume, followed by the United States (18.9 percent), the United Kingdom (10.3

percent), Japan (6 percent), Canada (2.8 percent), the Republic of Korea (2.1 percent), and Australia (1.5 percent). Meanwhile, a few respondents say they were actively exploring new export opportunities in Brazil, China, India, and South Africa.

Top apparel exports from Bangladesh primarily focus on relatively simple products such as T-shirts and trousers, especially cotton made. While surveyed T&C manufacturers in Bangladesh understood they operate in relatively low-value stages of cut, make and trim (CMT), they also believe “bulk production capacity” was a unique advantage difficulty to match by competitors. Meanwhile, some surveyed Bangladeshi T&C manufacturers have started to produce relatively more complex products such as jackets. Unlike basic knitwear or woven products (T-shirts, polo-shirts), making these items requires more specialized skills and complex production facilities.

The surveyed T&C manufacturers in Bangladesh consider Viet Nam their top competitor in the export markets, followed by China, India, other exporters from Bangladesh and Cambodia. Myanmar was also regarded as a potential competitor in the EU market because of its faster speed to market (i.e., 15-20 days for Bangladesh and 5-7 days for Myanmar suppliers)

Most surveyed Bangladeshi T&C manufacturers say they are aware of LDC trade preferences. However, only about three quarters reported enjoying duty-free market access in their export markets. Notably, the United States, one of the key export markets for Bangladesh, currently does not offer tariff preference for most textile and apparel items for LDC countries.

Related, as high as 90 percent of surveyed Bangladeshi T&C manufacturers say they “know the rules of origin requirements for duty-free market access.” Similarly, 88 percent of surveyed Bangladeshi T&C manufacturers say they can “fulfil the rules of origin requirement for all (duty-free) apparel exports,” and another 12 percent can satisfy the requirements for some of their exports. In general, factories making knitwear were more likely to meet the rules of origin requirements than those making woven apparel.

Like many other developing countries, the Bangladeshi garment industry relies on imported textile materials. According to the survey results, respondents sourced about half of their needed textiles from overseas. In general, Bangladesh demonstrated a better backward linkage for knitwear than woven apparel. About 62.3 percent of knitwear respondents say they used domestic-made yarns, dyes, chemicals, and accessories, higher than only 36 percent of surveyed woven apparel manufacturers. Further, respondents say that domestic-made yarn and fabric often were lower quality and more expensive than imported raw materials. However, some respondents expressed confidence that more accessories (such as zippers, hangers, buttons, and packaging materials) could be locally sourced.

The surveyed Bangladeshi T&C manufacturers call for more support to help them mitigate the impact of LDC graduation. Specifically:

- Over two-thirds of respondents say continuing to enjoy the LDC-style trade preferences would be “extremely important” for their business survival. Most respondents (74 percent) also say that maintaining duty-free market access is “very important” for keeping their exports competitive.
- Respondents estimate that they currently enjoy around 10-12 percent tariff advantage in primary export markets over their competitors without the LDC status. Losing such benefits could entail “huge competitive pressure” on companies’ exports.
- Nearly 80 percent of respondents say reaching a free trade agreement with most critical trading partners could help mitigate the LDC-graduation impact. The EU, the United States, Canada, the United Kingdom, Japan, and Australia were the top priorities for potential trade agreement considerations.
- Around 85 percent of respondents say they plan to upgrade their products or improve labour productivity to stay competitive. Respondents’ specific strategies include using automation technologies (e.g., auto knitting machines and auto hand and lay cutting), worker technology training, and more investments in research and development.

Cambodia

Cambodia's clothing industry started to enjoy fast growth in the early 1990s, thanks to the new government economic policies that boosted foreign investments and supported the development of the export-oriented manufacturing sector. Of the approximately 250,000 textile and apparel mills currently operating in Cambodia, around two-thirds are garment factories.

Reflecting the national trend, most surveyed T&C factories in Cambodia were also foreign-owned. These investors primarily came from China (including Hong Kong), Taiwan, Province of China, the Republic of Korea, and Japan. Factories directly owned by local investors accounted for only around 6 percent of the respondents. Meanwhile, the vast majority of the respondents say they make garments only. Most respondents were members of the Garment Manufacturers Association in Cambodia (GMAC). Established in 1996, GMAC is the largest trade association representing the T&C sector in Cambodia, with more than 600 member factories as of June 2021.

Due to limited production techniques and capital availability, clothing manufacturers in Cambodia are still primarily engaged in cut-make-trim (CMT) activities, meaning they rely heavily on imported textile raw material and can only make a marginal profit on low-value-added sewing work. According to respondents, their production and exports focus on relatively simple and basic clothing items such as T-shirts, tanks, trousers, and shirts. Further, nearly all respondents say their products target the mass and value markets.

The surveyed T&C manufacturers in Cambodia reported an overall concentrated export market led by the European Union (EU), the United States, Japan, and China. Notably, more than half of the respondents (55 percent) export to 3-5 countries only, whereas more than 62 percent say at least 40 percent of their total exports went to one or two top export markets. Meanwhile, most respondents do not have any concrete plan to diversify their export market. Instead, the surveyed T&C manufacturers in Cambodia still regard the EU and the United States as their top export priority in the years to come.

Respondents say their textile raw materials, including yarns, fabrics, and various accessories, depend on imports mainly from China (over 70 percent). Other leading textile suppliers for the respondents include Taiwan, Province of China, the Republic of Korea, and Viet Nam. In comparison, nearly 60 percent of respondents say they do NOT use domestic-made textile raw materials due to limited supply. Another 40 percent say they source less than 10 percent of their total textile inputs made in Cambodia, and these products are limited to packaging materials and label printing services.

Overall, the surveyed T&C manufacturers in Cambodia expect LDC graduation to impact their exports negatively. Nearly 45 percent of respondents anticipated a shift in demand for their products in key export markets, such as the European Union when they lost the LDC-style preferential market access. Respondents, in particular, expressed concerns about their lack of export competitiveness other than the tariff exemption provided for LDC countries.

Further, nearly 66 percent of respondents say they do not have any plan in response to the LDC graduation. Only a third of respondents say they plan to reduce production costs and improve efficiency through adopting new technologies and automation after LDC graduation.

Case Study I: Towards Sustainable Fashion, Workforce Upskilling, and Industrial Transformation: The Story of 4A Yarn Dyeing Ltd. on gearing up for LDC graduation

4A Yarn Dyeing Ltd started its journey with buying a sweater factory in 2009 and transforming it into one of the leading jacket-exporting units of Bangladesh. Located in the Baipail area of Savar at the outskirts of Dhaka, its factory has quadrupled its production capacity since its inception and employs some 6,500 workers, 70 percent of whom are women.

4A Yarn Dyeing Ltd focuses on synthetic-fabric-based jacket production – a highly specialized outerwear manufacturing activity. Almost 90 percent of the required raw materials is sourced from imported synthetic fabric. Given the increasing global shift in demand from cotton to synthetic fabric and the rise of sustainable fashion trends, the company is now optimistic about further ramping up its production through its expertise in the use of synthetic fabrics.

Taking cognizance of Bangladesh's looming LDC graduation, the factory management is already mindful to diversify its export market that is now mainly focused on European Union. To avoid the drawbacks of preference erosion in these markets in the post-LDC period, 4A Yarn Dyeing Ltd. is proactively searching for new export destinations. In this connection, the company has already started strengthening its footing in the markets of Japan, India, and the Republic of Korea, among others. The Bangladesh Government's cash-assistance incentives for RMG exporters to explore new markets have been important for this company.

The company also reports that U.S.-China trade tensions have brought in new US buyers. Large-volume orders from US buyers allow the factory to produce at scale. "In the post-LDC era, if our exports were to face 10 percent tariffs in European Markets, then it would definitely hurt our competitiveness. So, we must look for potential ways to recoup this excess cost and explore alternative markets to expand exports. Addressing the infrastructure bottlenecks and logistical challenges can help gain competitiveness. In the meantime, aiming for big markets is also critically important", Imtiaz Ahmed, who also looks after the marketing of 4A Yarn Dyeing Ltd, added. In particular, as LDC graduation approaches, the company is now trying to build a deepened relationship with buyers from North and South America.

The company also reports that U.S.-China trade tensions have brought in new US buyers. Large-volume orders from US buyers allow the factory to produce at scale. “In the post-LDC era, if our exports were to face 10 percent tariffs in European Markets, then it would definitely hurt our competitiveness. So, we must look for potential ways to recoup this excess cost and explore alternative markets to expand exports. Addressing the infrastructure bottlenecks and logistical challenges can help gain competitiveness. In the meantime, aiming for big markets is also critically important”, Imtiaz Ahmed, who also looks after the marketing of 4A Yarn Dyeing Ltd, added. In particular, as LDC graduation approaches, the company is now trying to build a deepened relationship with buyers from North and South America.

4A Yarn Dyeing Ltd. has placed continuous skill development and automation at the heart of its current business strategy to cushion the adverse impacts of future shocks emanating from LDC graduation. “Our goal is to increase our overall efficiency by at least 10 per cent from the current state. We are aiming to achieve this by two means: i) regularly arranging training for our workers; and ii) investing heavily on advanced machineries. Automation also enables us to deliver products with better design and finishing, but we will also need skilled workers to operate these machines”.

Source: Interview with Mr Imtiaz Ahmed, Executive Director of 4A Yarn Dyeing Ltd.

Lao PDR

The garment industry started to enjoy fast growth in Lao PDR in the mid-1980s when the Lao government decided to move from a centrally planned economy towards a market-oriented one. Foreign investment, in particular, plays a critical role in building the garment industry in Lao PDR. For example, more than half of the surveyed T&C factories were foreign owned, with investments coming from China, Japan, the European Union (EU), and Thailand.

Founded in 1995, the Association of the Lao Garment Industry (ALGI) serves as the leading trade association representing the garment industry in Lao PDR. ALGI regularly consults with its 50 members, sharing industry best practices and voicing its concerns before policymakers.

The T&C industry in Lao today mainly produces garments for export purposes. According to respondents, their production and exports focus on relatively simple products such as underwear, T-shirts, jerseys, pullovers, and shirts. Meanwhile, the T&C manufacturers in Lao PDR were small-scale (i.e., with fewer than 1,500 workers), making them challenging to fulfil large sourcing orders.

Like many other LDC countries, the export-oriented garment industry in Lao PDR depends on imports for needed textile raw materials due to a lack of domestic backward linkages. Most Lao garment factories, including the survey respondents, conduct cut, make and trim (CMT) only. Many surveyed T&C manufacturers are sub-contractors of larger companies headquartered in other countries.

Regarding the export markets, respondents say they primarily target those countries that offer Lao PDR the LDC-style preferential market access, including duty-free treatment and liberal rules of origin. Respondents’ top export markets include the European Union (more than 60 percent measured by value), the United States, Japan, the Association of Southeast Asian Nations (ASEAN), China, and Canada.

Respondents also expressed concerns about the potential impacts of LDC graduation. Specifically:

- Respondents say that the loss of preferential market access to the EU due to LDC graduation could significantly impact their production and exports. Notably, the EU currently serves as the single largest export market for many garment factories in Lao PDR. Nearly all of Lao's garment exports to the EU took advantage of the LDC-style preferential market access. Some argue that LDC graduation would disproportionally hurt Lao's exports of relatively simple products to the EU (such as T-shirts) but much less so for more sophisticated products. Even if Lao's apparel exports to the EU may still be eligible for the EU's GSP + program after losing the LDC status, meeting the more restrictive rules of origin is regarded as challenging.

- Respondents' garment exports to Japan currently 100 percent took advantage of the LDC-style preferential market access. Because of the ASEAN-Japan Comprehensive Economic Partnership Agreement enforced in 2008, clothing exports from Lao to Japan still could enjoy duty-free market access, implying a less significant impact of LDC graduation. Likewise, the ASEAN-China Free Trade Agreement entered into force in 2005 could also offset the impact of LDC graduation on Lao's garment exports to China.

- Respondents see a minor impact of LDC graduation on their apparel exports to the United States also. The US Generalized System of Preferences program currently excludes most textile and apparel products.

- Some surveyed Lao garment manufacturers plan to improve the sophistication of their products or invest in technologies to improve the genuine competitiveness of their exports in response to LDC graduation. However, the lack of a skilled labour force remains a concern. As noted by one respondent, "*Automation in the Lao garment industry is rather difficult due to lack of skilled labour. The lack of skilled labour is not only an issue when it comes to operating more sophisticated machines but also maintaining them. On the other hand, extensive automation would lead to many fewer jobs and thus reduce the main benefit the sector provides to the country.*"

Case study II : Mascot International A/S in Lao PDR – Favourable Rules of Origin critical after graduation

Mascot International A/S is a family-owned Danish company specializing in workwear. The company produces 79% of the workwear it sells and employs about 2,400 people at its production sites in Viet Nam and the Lao PDR.

MASCOT International (Lao) Sole Co., Ltd., a subsidiary of MASCOT International A/S, officially opened in December 2013 in the VITA Industrial Park in Vientiane Capital. The company, which is currently expanding significantly, is one of very few in the country that produce workwear. It is subcontractor for Mascot International, using cut-make-trim (CMT) operations.

Mascot employs in Lao PDR about 1,450 people, 83% of whom are female. Products are sophisticated and complicated, so every new staff needs training. This limits the intake of new workers, although there is a huge waiting list since only a certain number can be trained in parallel.

All raw materials are imported since they cannot be sourced domestically in the required quantity or quality. The finished products are 100% exported, mainly to Europe. 98% of these are shipped to the parent company in Denmark and only 2% shipped directly to the final customer.

The management is well aware of the existing trade preference schemes and sees them as very important for their business model, particularly the EU's Everything But Arms (EBA) scheme, of which it makes use for 100% of its products. It is therefore assumed that the loss of these trade privileges and the application of stricter Rules of Origin (RoO) could have a negative impact, although there is less concern that buyers might shift to new sources, reasoning that if all major producers lose their trade privileges choices will be limited. Another reason is that more sophisticated products will per se be less affected by increased tariff duties.

Mascot hopes the Lao Government can negotiate a GSP+ arrangement with the EU and emphasizes that the regulations regarding the RoO are crucial for any future arrangement since the quality of domestically or regionally sourced raw material is insufficient.

The main strategy to cope with the potential loss of trade privileges is the constant upgrading of products to meet new requirements and fashion trends. The parent company in Denmark undertakes market research, develops new products, and tries to be on top of – or even shape – market developments. Digitalization is ongoing, e-commerce

Nepal

Nepal's garment industry started to enjoy fast growth in the 1980s. As clothing exports from India faced quota limits under the Multi-Fibre Arrangement (MFA), importers switched to Nepal, thus significantly expanding the country's clothing production capability. Foreign investments have played a critical role in supporting the development of the T&C sector in Nepal, particularly those from nearby Asian countries like China and India.

Consistent with the national trends, the surveyed T&C manufacturers in Nepal were mostly small and medium-sized (87 percent), with annual revenues ranging from less than 1 million to $81 million. Almost all respondents were privately owned. Further, most respondents were members of three leading T&C-related trade associations, namely the Garment Association of Nepal, Nepal Textile Associations, or Export Council of Nepal.

Most respondents produce garments only, primarily focusing on basic items such as T-shirts, sweaters, jumpers, trousers, and shorts. These products were also mostly cotton-based (over 80 percent). The surveyed T&C manufacturers in Nepal admit that garment manufacturing, although labour-intensive, does not require specialized skills.

In general, garment manufacturers in Nepal rely on imported textile materials due to limited domestic production capability. Respondents say India is their top textile supplier (i.e., yarns and fabrics) for cotton-related apparel items, followed by China. For man-made fibre clothing, China is Nepal's leading textile supplier, whereas Nepal imported most cashmere or wool yarns from China and New Zealand.

On average, respondents reported exporting to around three markets, led by the European Union (EU), the United States, and Japan. Some respondents also exported to New Zealand, the Republic of Korea, and Australia.

According to respondents, almost all their clothing exports took advantage of the trade preference programs provided by respective importing countries for LDC countries. In particular, the EU's Everything But Arms (EBA) program plays a uniquely critical role in supporting Nepal's garment exports. Respondents say that their clothing export to Japan, the Republic of Korea, and Australia also claimed the duty-free benefits for LDC countries.

Overall, respondents expressed concerns about the negative impacts of LDC graduation on their export and business operations. Specifically:

- Nearly 75 percent of respondents say they currently do NOT have a plan or strategy in response to the LDC graduation. For respondents who claimed to have a plan, their primary approach is to reduce production costs (for example, seeking a discount for electricity from Nepal's government).
- Some respondents anticipate their apparel exports may still be qualified for preferential duty market access through trade programs like free trade agreements after LDC graduation. However, many respondents expressed concerns about not meeting the rules of origin requirements in these trade programs as they are more restrictive than the LDC-style cut and sew rules of origin.

FASHION BRANDS AND RETAILERS' SOURCING STRATEGY IN RESPONSE TO THE LDC GRADUATION

Today, fashion brands and retailers adopt a diverse sourcing base to balance the needs for various sourcing factors, ranging from sourcing cost, speed to market, flexibility, agility, and compliance risks. As Table 1.1 shows, more than 70 percent of surveyed respondents currently source from more than six different countries, including nearly 40 percent report sourcing from more than ten different countries. Larger companies, in general, adopt a more diversified sourcing base than smaller ones.

Table 1.1 Sourcing diversification of surveyed respondents

Diversification	All respondents	Respondents with 1,000+ employees	Respondents with <1,000 employees
Source from 1-5 different countries	26.60%	11.80%	44.50%
Source from 6-10 different countries	36.70%	35.30%	33.30%
Source from 11-20 different countries	23.30%	29.40%	22.20%
Source from more than 20 different countries	13.30%	23.50%	0.00%

Consistent with macro trade statistics, the surveyed fashion brands and retailers report much higher utilization rates of Bangladesh and Cambodia as a sourcing base than Nepal and Lao PDR (Table 5.2). However, the surveyed fashion brands and retailers mostly see the four LDC countries as part of their diverse sourcing base. In most cases, fashion companies place less than 10% of their total sourcing value or volume from each of these four LDC countries. Meanwhile, respondents see China and Viet Nam overall as more critical sourcing bases. For EU-based fashion companies, Turkey is another major sourcing destination.

Table 1.2 Current sourcing portfolio of surveyed respondents

Sourcing Destinations	>50% of total sourcing quantity/value	31-50% of total sourcing quantity/value	11-30% of total sourcing quantity/value
Bangladesh	0.0%	10.0%	25.5%
Cambodia	0.0%	0.0%	0.0%
Lao PDR	0.0%	0.0%	0.0%
Nepal	0.0%	0.0%	0.0%
China	13.3%	13.3%	36.7%
Viet Nam	3.3%	13.3%	56.7%
Turkey	0.0%	3.3%	21.0%

Further, as Table 1.3 shows, basic clothing items like T-shirts and bottoms account for a substantial share of respondents' total apparel imports from the four LDC countries. In comparison, respondents' source fewer complex products (such as dresses and outwear) from the four LDC countries due to their limited production capacity. The results are compatible with the survey results of T&C manufacturers from these four LDC countries mentioned earlier in the chapter.

Table 1.3 Types of products typically sourced from the four LDC countries

Categories	Bangladesh	Cambodia	Lao PDR	Nepal
T-shirts	23.40%	14.80%	10.20%	18.30%
Tops other than T-shirts	21.00%	21.90%	16.10%	38.40%
Bottoms	30.50%	21.40%	51.50%	15.40%
Outwear	8.50%	4.70%	9.60%	11.70%
Dresses	2.30%	14.90%	1.30%	7.50%
Underwear	1.90%	0.90%	0.00%	1.50%
Others	12.40%	21.40%	11.30%	7.20%

Regarding the competitiveness of the four LDC countries as a sourcing destination, as summarized in Table 1.4:

- The surveyed fashion brands and retailers say Bangladesh, Cambodia, Lao PDR, and Nepal can offer competitive prices, mainly due to their relatively low wage levels. Compared with China and Viet Nam, the four LDC countries also enjoy a notable tariff advantage thanks to their LDC preferential market access to the world's leading apparel import markets such as the EU, Japan, and Canada. However, some EU-based respondents explicitly expressed concerns about Cambodia's partial loss of the EU's Everything But Arms (EBA) program eligibility in 2020, which offset the tariff benefits.

- Respondents overall do not see the four LDC countries competitive in speed to market, flexibility, and agility due to their limited production capacity. For example, regarding "vertical integration /ability to source raw material," "innovation and ability to develop products with vendors," and "flexibility of order quantity," most of the four LDC countries received a medium to low rating.

- Respondents also expressed concerns about the relatively high social and environmental compliance risks when sourcing from Bangladesh and Cambodia. Frequent and consistent media coverage about various social responsibility issues in the two countries, from garment workers' low payment during COVID-19 to human rights concerns, may affect respondents' assessment. Recent studies also highlight the significant impact of non-economic factors on fashion companies' sourcing decisions, particularly the perceived social compliance and political risks

Table 1.4 Competitiveness as a souring base against the primary sourcing matrix

Criteria/Country	Bangladesh	Cambodia	Lao PDR	Nepal	China	Viet Nam
Production quality	3.5	3.5	3.5	2.0	4.5	4.5
Ability to create value added products	3.0	3.0	2.5	2.0	4.5	4.0
Vertical integration/ability to source raw materials	2.0	2.0	2.5	3.0	5.0	3.0
Innovation and ability to develop products with buyers	3.0	2.0	2.5	2.5	4.5	4.0
Efficiency	3.0	3.0	2.0	3.0	4.5	4.0
Lead time	3.5	3.0	2.0	2.0	4.0	4.5
Price	4.5	4.5	3.0	3.0	3.0	4.0
Tariffs advantages	3.5	2.0	3.0	3.0	2.0	3.0
Flexibility of order quantity	3.0	2.5	2.5	2.5	4.0	4.0
Financial stability	2.0	1.5	2.0	2.0	3.0	3.0
Political stability	2.5	3.5	3.0	3.0	2.5	4.5
Compliance / sustainability	2.0	2.5	2.0	2.0	2.0	3.5

Note: The results are based on respondents' average rating for each country on a scale of 1 (much lower performance than the average) to 5 (much higher performance than the average). In the table, means strength as a sourcing base (rating score between 5.0-4.0); means average performance (rating score between 3.0-3.9); means weakness as a sourcing base (rating score between 1.0-2.9). However, the results do NOT reflect the author's evaluation of each country.

Further, fashion brands and retailers say LDC graduation could modestly affect their sourcing from Bangladesh, Cambodia, Lao PDR, and Nepal. Two trends are noteworthy:

First, as Figure 1.1 shows, a good proportion of surveyed fashion brands and retailers plan to expand apparel sourcing from Bangladesh and Cambodia over the next 3-5 years (i.e., through 2025). Fashion brands and retailers' intention to diversify their sourcing away from China and the limited capacity available in Viet Nam are critical contributing factors. Other recent studies suggest similar trends also. In comparison, respondents are more conservative about expanding apparel sourcing from Nepal and Lao PDR over the next 3-5 years, given companies' limited knowledge about these two countries' production capability (See figure 1.2).

Figure 1 Respondents' prospect of sourcing decrease over the next 3-5 years

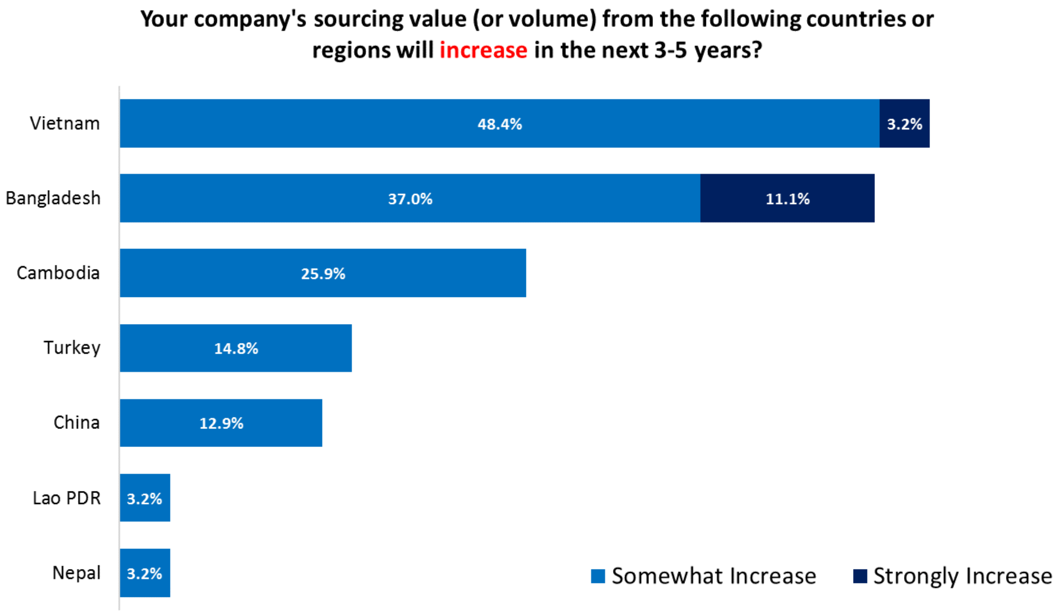
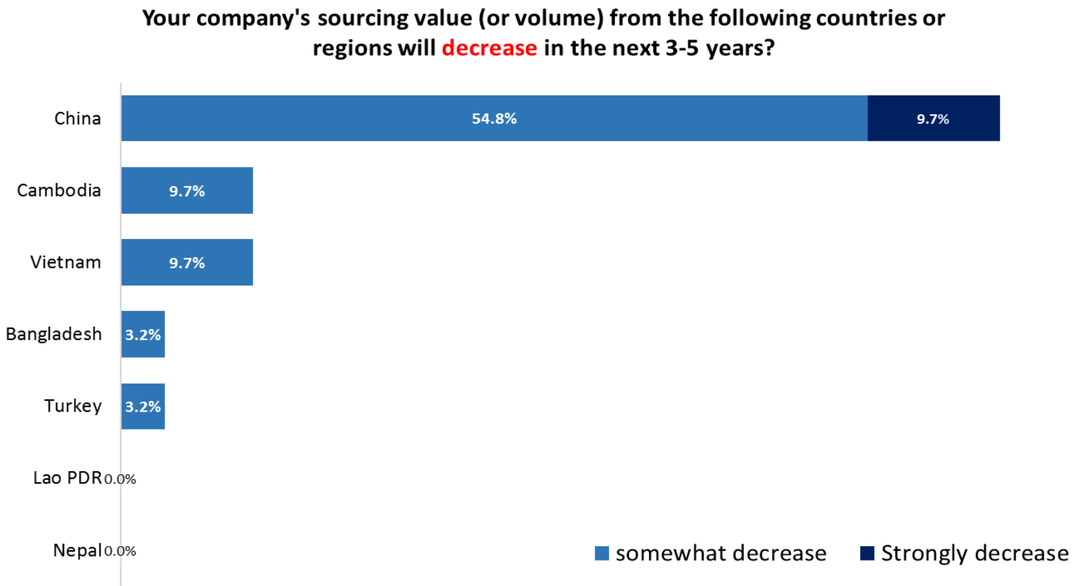


Figure 2 Respondents' prospect of sourcing decrease over the next 3-5 years



Second, fashion brands and retailers actively use trade preference programs, such as the EU EBA program, when sourcing from the four LDC countries. Companies find little challenge in complying with the liberal "cut and sew" rules of origin (or known as the single transformation rule) adopted by these trade preference programs. The "cut and sew" rule typically allows qualifying apparel to flexibly use textile raw materials sourced from anywhere in the world.

Thanks to other free trade agreements or trade preference programs, fashion brands and retailers may still enjoy preferential duty treatment when sourcing apparel from Bangladesh, Cambodia, Lao PDR, and Nepal after their LDC graduation. However, most free trade agreements enacted in the leading apparel importing countries adopt more restrictive "double transformation" (e.g., the EU) or even "triple transformation" (i.e., Japan and the United States) rules of origin. These less lenient rules of origin, in general, require fabrics or even yarns to be produced by members of a free trade agreement for qualifying apparel.

In their qualitative comments, respondents expressed two different views regarding the sourcing implications of LDC graduation and having to comply with more restrictive rules of origin. On the one hand, some respondents expressed concerns that complying with more restrictive rules of origin and the high cost of meeting the additional documentation requirements could discourage them from sourcing from Bangladesh, Cambodia, Lao PDR, and Nepal.

However, others argue that as long as the apparel sourcing volume becomes large enough, the less lenient rules of origin could help the four LDC countries, particularly Bangladesh and Cambodia, attract more foreign investments to develop the local textile industry. The booming investment in Viet Nam's textile industry during the Trans-Pacific Partnership (TPP) negotiation was also driven by the agreement's restrictive apparel-specific rules of origin.

OTHER MARKET FACTORS RELATED TO THE IMPACT OF LDC GRADUATION

A few other factors could affect the post-LDC graduation scenario facing Bangladesh, Cambodia, Lao PDR and Nepal.

First, as a notable trend, nearly half of the surveyed respondents say over the next 3-5 years, they plan to reduce the number of vendors they work with to improve operational efficiency and strengthen the relationship with key vendors (see Table 1.6). As suggested by other recent studies, this strategy is prevalent among relatively large-scale fashion companies. While the most competitive vendors in a country are likely to receive more sourcing orders and see their business grow, this new trend also means the competition among vendors in the same country could intensify. Smaller and less competitive garment factories in these four LDC countries need additional help to mitigate the negative impact of LDC graduation.

Table 1.6 Respondents' sourcing strategy over the next 3-5 years

Sourcing Strategies	%
Source from the **same** number of countries, but work with **fewer** suppliers	43.3%
Source from the **same** number of countries, but work with **more** suppliers	20.0%
Source from **more** countries and work with **more** suppliers	16.7%
Source from **fewer** countries and work with **fewer** suppliers	13.3%
No change	3.3%
Source from **fewer** countries, but work with **more** suppliers in these countries	3.3%

Second, LDC graduation could make it even more challenging for the T&C industry in Bangladesh, Cambodia, Lao PDR and, Nepal to attract foreign investments. On the one hand, investors who build textile and apparel factories in these four LDC countries intend to take advantage of their eligibility for duty-free market access to key markets such as the European Union. In comparison, building production capacity to serve the local market is not yet a significant investment model for these four LDC countries, given their low-income levels.

On the other hand, these four LDC countries have to compete for investments with other more popular and mature sourcing destinations, such as Vietnam. Take China's foreign direct investment (FDI) strategies in the T&C sector, for example. As Table 5.7 shows, Bangladesh, Lao PDR, and Nepal were NOT among the top FDI destinations of China's T&C companies. Even Cambodia accounted for less than 3 percent of China's total FDI in the T&C sector from 2015 to 2018, measured by value.

Table 1.7 Top FDI destinations of China's textile and clothing companies 2015-2018*

Rank	FDI destination	Value of FDI ($100 million USD)
1	Hong Kong (China)	25.99
2	Vietnam	10.71

3	Singapore	7.71
4	British Virgin Islands	2.58
5	United States	2.14
6	Ethiopia	1.85
7	Myanmar	1.52
8	Egypt	1.47
9	Cayman Islands	1.32
10	Cambodia	1.25
11	Malaysia	1.02
12	France	0.92
13	Pakistan	0.85

Source: Ministry of Commerce, PRC (2021).

Note: The data in the table only reflects investments from companies based in mainland China.

Interviews with Chinese T&C companies reveal that two major strategies drove their FDI decisions. One is to develop a "China + Southeast Asia + Africa" apparel production base to improve production flexibility and agility. As mentioned earlier, the duty-free market access to the leading apparel importing countries and the liberal rules of origin (i.e., using Chinese yarns and fabrics) were regarded as essential for attracting the FDI. Understandably, the prospect of losing the LDC-style market access in the world's leading apparel import market could hurt Bangladesh, Cambodia, Lao PDR and, Nepal's attractiveness as an FDI destination for Chinese T&C companies.

The size effect matters also. For example, some Chinese T&C sourcing agents and manufacturers say they prefer to build new factories in places where they can be part of a regional production cluster. Such clusters could provide essential support from labour recruitment to raw material supply. Likewise, investors are more likely to build textile factories in places where the local apparel production and export capacity have reached a particular scale.

Another China's FDI strategy is to access unique resources (such as raw materials and technology) and move up in the value chain. This explains why the United States and some Western EU countries (e.g., France) were among China's top FDI destinations in the T&C sector.

Additionally, the growing popularity of "near-sourcing" or "reshoring" among fashion brands and retailers could further complicate the scenario of LDC graduation for Bangladesh, Cambodia, Nepal, and Lao PDR. Notably, U.S.-based apparel companies have demonstrated a strong interest in expanding more sourcing from the Western Hemisphere, including Mexico and Central American countries. Meanwhile, EU-based brands and retailers have been actively exploring increasing apparel sourcing from Eastern EU countries and Turkey. The "near-sourcing" and "reshoring" trend could add more competitive pressures on Bangladesh, Cambodia, Nepal, and Lao PDR suppliers.

CONCLUSIONS AND RECOMMENDATIONS

In conclusion, several measures can mitigate the potential negative impact of LDC graduation on Bangladesh, Cambodia, Nepal, and Lao PDR. Specifically:

- Providing a transition period will help T&C factories in the four LDC countries develop more concrete strategies in response to the LDC graduation and aimed at survival of their business.
- More flexible rules of origin in free trade agreements and standard Generalized System of Preferences programs would allow graduating LDC countries to continue enjoying preferential market access without reshuffling their existing supply chains.
- It is essential to continue strengthening capacity building in the four LDC countries, especially helping them gradually develop the local textile production capacity, improve their genuine export competitiveness beyond price, and strengthen compliance with environmental, social and governance (ESG) requirements in export markets.
- Besides a country-wide support program, policymakers should provide special support to small and medium-sized factories in these four LDC countries, given their lack of resources and more vulnerability in the new business environment.