

# **ECONOMIC POLICY NETWORK**

**Policy Paper 3**

## **SUSTAINING NEPALESE GARMENT INDUSTRY AFTER QUOTA ABOLITION**

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Inputs from various stakeholders during interactions at GAN, the Advisory Committee meeting, and the workshop organized by the EPN Focal Unit have been incorporated in the report.

## Foreword

Economic Policy Network (EPN) is an undertaking of His Majesty's Government of Nepal (HMG/N) since August 2004 with an Asian Development Bank (ADB) technical assistance (TA) to develop and institutionalize an open, responsive and result oriented economic policy formulation process based on sound economic analysis and dialogues with the partnership of public and private sector, academia, and independent professionals, to support and consolidate the Government's economic policy reforms on poverty reduction strategy. The initial focus has been in the areas of macroeconomic management, trade, investment, employment, infrastructure, tourism, agriculture, and regional development through four thematic advisory committees chaired by the secretaries of the respective implementing ministries, and guided by a high-level steering committee. The present study is an outcome of the initiative under the Advisory Committee for Economic Policy on International Trade, Investment, and Employment chaired by the Secretary of the Ministry of Industry, Commerce, and Supplies.

The study analyzes the position of the Nepalese garment industry in the context of the emerging global textile regime, and makes recommendations to compete in the international market. The recommendations are the outcome of consensus reached among major stakeholders through various consultations and the EPN workshop. I hope the findings and recommendations will be helpful for policy makers for future reforms.

I would like to thank the Garment Association Nepal (GAN) for leading the study, and Mr. Bijendra Man Shakya for carrying out the study on their behalf. I also thank all those who have provided inputs for the report during the interactions at GAN, the advisory committee meetings, and the EPN workshop. The work of the Advisory Committee for Economic Policy on International Trade, Investment, and Employment is to be commended for selecting the issue and for following through with the study. I would also like to appreciate the entire EPN team for their hard work. I also thank the former Steering Committee chairperson (the then Chief Secretary of HMG/N) Dr. Bimal Prasad Koirala, for his guidance during his tenure. Last but not least, I would like to thank the ADB for supporting this initiative.



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# SUSTAINING NEPALESE GARMENT INDUSTRY AFTER QUOTA ABOLITION

*Trade environmental analysis with recommendation for policy intervention to protect  
garment industry in a quota free trade*

## Abbreviation

ACP	African, Caribbean and Pacific
AGOA	African Growth and Opportunity Act
ASEAN	Association of South East Asian Nations
ATC	Agreement on Textiles and Clothing
CAD/CAM	Computerized aided designing/computerized aided manufacturing
CAFTA	Central American Free Trade Agreement
CBTPA	Caribbean Basin Trade Partnership Act
CMT	Cut-make-trim
DDA	Doha Development Agenda
DDP	Duty delivered paid
EBA	Everything but Arm
EPC	Export Promotion Committee
EPZ	Export Processing Zone
EU	European Union
FTA	Free trade agreement
GAN	Garment Association – Nepal
GPZ	Garment Processing Zone
GSP	Generalized System of Preference
HMG	His Majesty's Government
HS	Harmonized system
ICD	Inland Container Depot
LC	Letter of credit
LDC	Least developed country
MFA	Multifibre arrangement
MFN	Most Favoured Nation
MMF	Man-made fibre
MTS	Multi-lateral trading system
NAFTA	North American Free Trade Agreement
NAMA	Non-agriculture market access
NCTO	National Council of Textile Organization (US)
NRB	Nepal Rastra Bank
OPT	Outward processing trade
RGEPC	Readymade Garment Export Promotion Committee
SAARC	South Asian Association for Regional Cooperation
TPC	Trade Promotion Centre
US	United States
VAT	Value added tax
WTO	World Trade Organization

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## Executive Summary

The Nepalese garment sector is in doldrums since the abolition of MFA quotas in the global textiles and clothing trade, beginning this year. More than expected, the impact of end of MFA regime looks more pronounced in the case of Nepal as has already been marginalized its position by the drastic change in the competitive environment for the trade in this sector. The quasi-guaranteed market access as enjoyed by Nepalese apparels, particularly in the American market, has gone with a complete phase out of quotas. The loss of protected market has prompted garment manufacturers to stop their production en masse, bringing down the number of operating industries to less than twenty from over 100 just a year before. Nepal is the only country in the region whose export to the United States has nose-dived: minus 50% in the first two months of 2005, compared to the same period last year. In contrary, Bangladesh, Cambodia and Sri Lanka - the countries without textile base like Nepal – saw their exports increased, ranging from 10-20% each, despite they were also cited likely victims of the quota free trade.

One of the reasons to reach at this critical situation could be due to insufficient commitments at the industry and policy levels to respond to the foreseen adjustment problems in trade without quotas. The industry's capacity to utilize quotas in only a selective items in the past and overly dependent on the American market some how revealed its reluctance to product and market diversification, as long as it had the easier and protected market access. The industry's initiative to cut output cost and raise delivery efficiency was largely restrained by lack of commitments to overcome persistent internal bottlenecks. Steps were taken to convert the guaranteed market access in the US into preferential market access at the last moment. But no adequate efforts were put on to compensate the market share loss in the US, by diverting export to the markets with preferences elsewhere. Neither the industry nor the government had substantially took any concrete measure to exploit the opportunities in the EU and Canada, which indicated promising signs due to the already existing preferential treatment, with relatively relaxed origin rules for Nepalese apparels in the respective markets. Taken into account of the performance during the protected regime and assessing the implications of the liberalized trading system, this report takes a stock of the current situation and appraises the internal and external environments in the changed context to build a capacity to respond to these issues for sustainability of the Nepalese apparel industry.

The first chapter of this report reviews and analyses the macro economic importance of the apparel sector. It indicated a sharp decline in the number of operating industries and export volume concurrently. The position of Nepal in the US market, which absorbed over 80% of the country's total apparel export every year, is fast shrinking. No matter how small were the EU and Canadian markets, in terms of current export values, they could emerge as alternatives to sustain, as they already provide duty free market access to Nepalese apparels. The performance in both markets looks encouraging, but not that boastful, however. Considering the overall export performance, including the product and market mix analysis, this study emphasizes the need for the two separate strategies, focusing on the preferential and non-preferential markets.

The quota free system has changed the trading environment for apparels abruptly. Working of the market forces internationally has greatly influenced the sourcing decisions, giving discretionary power to buyers. Consequently, the international buyers' priority has gone for countries having a massive scale of output and a capacity for vertical production: from fabric to fashion designing. These are immediate factors determining the competitiveness in the changed context. But Nepalese garment industry lagged behind in both cases. Already the impact of the reduced number of countries for sourcing by the American buyers is being widely felt by the Nepalese exporters. They have been suffering from a continuous market share losses in the United States since 2004. Essentially, Nepal should be vigilant of the monopolization of big suppliers, particularly China, in the world apparel market. Because China saw an unprecedented growth in its export of the items, which were also major products for Nepalese manufacturers. Compared to last year, the export of cotton and man-made trousers from China increased by more than 1500% in the first quarter of this year. The product category used to secure a key position in Nepal's apparel export basket.

The down spiral in the world apparel prices since the end of quotas seems to be a serious concern to Nepal. The China syndrome looks more threatening in terms of price competition as the average price for Chinese apparels, removed from quotas, declined by 48% between 2001 and March 2004. And the prices for items interested to Nepalese exporters have fallen by 58%. Compared to China, the Nepalese average export price for selected items is 40% costlier, because the unit price for Nepalese apparels has gone up from US \$ 3 in 1990 to approximately \$ 3.5 after a decade. But the price is lower by 40%, if compared to the average

price for rest of world. This gives some scope for survival of the industry, provided it matches with the post MFA situation.

The issue of apparel tariffs still matters greatly to Nepal. Nepalese apparels are subject to average tariffs of about 15% in the US, which is almost ten times greater than the US average MFN rate for other products. The average tariffs for apparels in rich countries are about four times higher than the rate for other goods, whereas the rate is no less intense in developing countries. The application of tariffs in the US has further aggravated price competitiveness of Nepalese apparels, which are already finding difficult to face the situation due to higher production and transaction costs. In addition, Nepal has lost the level playing field after the US provided duty free to the clothing made in sub-Saharan poor countries, under the AGOA Bill. Although the issue of non-tariff barriers looks not that serious presently, it is advisable for Nepal to take into account of the possible adverse effect from measures, such as imposition of trade remedies; respect to intellectual rights, and compliance to eco label and socio label, among others, for timely preparation.

The initiative taken for the US preferential treatment to Nepalese apparels becomes more meaningful in a trade with escalated tariffs. But it is not appropriate to exclusively depend upon preferential market access forever. The preference is not binding and it is subject to various conditions and tough rules of origin. Moreover, the preferential margin is eroding with reduced tariffs for non-agricultural products. If the WTO negotiation on non-agricultural market access (NAMA) reduces the rates as stipulated in the Doha Development Agenda (DDA), the margin of preference would further erode, perhaps making the preference virtually meaningless. The significance of preferential treatment should be assessed in terms of complying with the preferential rules of origin, which is normally stricter in apparels. Nepal's poor utilization capacity for preferential treatment in the EU, despite derogation from the preferential origin rules, needs a careful attention to really benefit from the preferential market access elsewhere. The chapter two of this report elaborates about these issues with suggestions to cope with.

The advantage of duty privilege should be considered as an extra leverage to compete in international markets, only temporarily. There is no alternative to better managing the internal bottlenecks to face the competitive environment for survival of the industry in the changed context. Chapter three of the report has identified the internal constraints to the

industry with necessary steps to overcome them. Without enough investment for technology upgradation and skill development of the workers, the issue of low productivity would remain unresolved. The industry's ability to compete will depend not just upon availability of cheap labors, but also depend on how skillful they are. It is also essential to think over higher transaction costs and inadequacy of trade support services, which are impending to efficiency of the industry as a whole. The report finds widespread problems in administration and policy matters. Administrative complications with regard to bank guarantee, and refund of VAT and duties are aggravating the problem. Difficult access to easier banking financing has become obstacle to industry protection and plant expansion. The policies on labor and income tax are still rigid, instead of making them flexible as incentive to rescue the ailing industry. The stability of policy also becomes indispensable to promote ancillary industries for streamlining backward linkage development.

Equally important is also to build a capacity to face the adjustment problems brought about by the abolition of quotas. Chapter four finds the five core areas for strengthening capacity to cash-in-on the opportunities given by the changed trading environment. Primarily, the capacity should be increased for exploiting the market access opportunities after quota abolition. The benefit of the preferential market access already existing in the EU and Canadian markets should be maximized, as the share in total apparel export to these markets is growing modestly. As mentioned before, the strategy one should be intensified lobbying for privileged market access in the US to gain a level playing field and to offset the increased output cost through duty advantage. Strategy two should be for the intensified measures for utilizing preferences in the EU and Canada to substitute the immediate loss incurred in the American market. The opportunities in Indian market should not be underestimated as well. The capacity to product innovation and skill development, as well as institutional development for monitoring of regional and multilateral trading system, vis-à-vis the international apparel trade is also crucially important.

The idea of industry consolidation under the concept of garment processing zone (GPZ) makes a lot of sense with regard to new competitive measures developed by the efficient countries, such as the "supply chain city" in China. The benefit of cost sharing and cooperative purchasing for costly and sophisticated technology and other inputs can be expected from this concept. It can help to form industrial cluster, bringing all sorts of ancillary manufacturers and services closer to the production. The simplified trade and

administrative procedure can support efficient functioning of the industrial cluster. With all these things together, the GPZ paves a way for backward and forward linkages, ultimately meeting the vertical production. Overall, the industry will be able to meet efficient production and delivery goals, and attract international investors and buyers. The internal bottlenecks and capacity building for responding to the changed situation is not possible without a good coordination between the private sector and the government. Thus, it recommends activating the existing Readymade Garment Export Promotion Committee (RGEPC), which represents most of the concerning bodies from both sides, with more coordination and authority for intervention, rather than instituting a new body. The body should be restructured, by representing all concerning organizations and technical expertise, and should be responsible for formulating national level programmes and monitoring of the activities, regarding the sustainability of the apparel sector as a whole.



## CHAPTER I

### **Sustaining garment industry in quota free trade**

With complete elimination of the MFA<sup>1</sup> quotas, as stipulated in the Agreement on Textiles and Clothing (ATC)<sup>2</sup> of the WTO, the competitive environment to Nepalese garment exporters have changed drastically. Protected by a quasi-guaranteed market access, due to spill over businesses from quota constraint supplying countries, until the last stage of the quota phase out period, the export-oriented Nepalese garment industry is now faced with arduous adjustment problems. The abolition of quotas has basically affected the feature of Nepal's "artificial" comparative advantage and the benefits from managed trade in the past regime. The production and trade in this sector would be determined by reallocation of economic resources under market forces, rather than protected by quota rents. That will create a more complicated and competitive situation for the garment manufacturers and traders to adapt to the new regime, which is without quotas, but not without tariffs and other trade barriers.

As usual, the core competitive factors in quota free trade will be the product price, quality and delivery, but the ways and means to respond to these factors would change substantially for sustainability of Nepal's garment industry in the future. The new political economy in trade in this sector would, thus, calls for Nepalese apparel manufacturers to address the issues relating to persistent internal bottlenecks, with regard to productivity enhancement and competitiveness, for exploiting the market access opportunities. Without these capabilities, the changed scenario would generate more challenges than opportunities to apparel industry, with most likely chances of marginalizing its position in the liberalized international clothing market. If no measures are taken, both at the enterprise and the industry levels, with a national policy, addressing all factors influencing the new trading environment, the chances of sustaining the industry looks very slim.

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<sup>1</sup> MFA or the multifibre arrangement introduced since 1974 was intended to impose restriction through quotas on imports of textiles and clothing by rich countries, notably the US, Canada, EU and Norway.

<sup>2</sup> The Agreement on Textiles and Clothing of the WTO agreed to phase out the quotas, imposed under the MFA, in four phases, starting from 16% in 1995, 17% in 1998, 18% in 2002 and 49% in 2004.

i. Review of the industry and trade status

Until the mid-Eighties, export of readymade garments from Nepal was minuscule due to a small-scale and a traditional way of doing business. Afterwards, relocation of industries from quota constraint neighboring countries, mainly from India, proliferated the number of garment industries and increased the export volume unexpectedly. The number of registered garment firms increased from 58 in the early 1980s to over 750 in the beginning of 1990s, and reached a peak of over 1,000 after five years. However, the number declined, at first due to change in the internal quota distribution mechanism, and presently due to the elimination of the MFA quotas: from 1067 in 1994-95 to 323 in 1995-96 and to 212 in 2000-2001. Currently, only 130 are registered, and out of that hardly 20% are in actual operation.

By the mid 1990, the garment industry became one of the prime sectors of the economy with total investment of Rs. 6 billion and direct employment of over 50,000. Its contribution to the manufacturing was about 8%. Although the import content for the garment industry was very high, the value addition was estimated to range between 30 – 35%. It shared almost one-fifth of the total export earning all through the Nineties, against only about 3% in the early 1980. On average, the US has been buying more than 85% of total apparels made in Nepal every year (Table 1). But compared to other major South Asian countries, Nepal shared less than one per cent of the total US imports. Except for the other two major buyers -- the EU and Canada - - there were no other significant markets to take into account for market potentiality. Overly depended on one single market -- the USA, and the minuscule export shares of the EU and Canada, had subjected to high volatility of the industry as a whole.

TABLE 1  
Performance of Nepal's apparel export trade

*Value in million Rs.*

Year	Value of apparel export to USA	Total value of apparel export	Total value of national export	% share of US in total apparel export	% share of apparel in total national export
1992-93	3,258	3,726	17,266	87.44	21.58
1993-94	5,258	5,756*	19,293	91.35	29.83
1994-95	4,636	5,362	17,639	86.46	30.40
1995-96	4,671	5,417	19,881	86.23	27.25
1996-97	4,692	5,620	22,637	83.49	24.83
1997-98	5,626	6,800	27,513	82.74	24.72
1998-99	7,531	8,195	35,676	91.90	22.97
1999-00	10,769	13,942	49,822	77.24	23.70
2000-01	11,350	13,122	55,654	86.49	20.88
2001-02	6,023	7,752*	46,944	77.70	16.51
2002-03	9,921**	11,613	49,245	85.43	23.58

*Source: TPC, NRB and GAN*

*\* Excluding export to India*

*\*\* Estimated figure from July 2002 to June 2003, based on data available at GAN.*

Nepal's export value was not directly affected by quota elimination until the fourth phase of quota elimination, mainly because of "backloading"<sup>3</sup> of the items interested to Nepalese exporters, particularly by the US and the EU. The trade was slightly threatened by diversion of orders to countries with preferential agreement with the US after 2000 at the cost of Nepal, including other LDCs. The export started to take a downtrend with drastic cut in orders from the US only after the fourth step of the MFA phase out in 2004 as the quotas on major export interest items from Nepal was eliminated, among others. The only country in South Asia, which is a real loser in the US, is Nepal (Table 2). Other countries, without textile base in the region: Bangladesh and Sri Lanka, managed to increase their export in the first quarter of 2005, despite they were treated as likely victims of the quota elimination.

<sup>3</sup> Backloading refers to delaying of quota liberalization of the most sensitive items, such as cotton products, as did by importing countries, the US and EU, among others.

TABLE 2  
**US import of apparel from selected Asian countries**  
*(Jan-Feb 2005 against Jan-Feb 2004)*

Country	Value '000 US \$, current price				
	Jan-Feb 2004	Jan-Feb 2005	% change	Market share in 2004	Market share in 2005
China	1,500,389	2,634,115	75.56	7.61	23.61
India	375,139	499,277	33.09	1.90	4.48
Bangladesh	289,396	325,748	12.56	1.47	2.92
Sri Lanka	250,889	299,208	19.26	1.27	2.68
Cambodia	230,612	253,783	10.05	1.17	2.27
Pakistan	157,120	174,449	11.03	0.80	1.56
Nepal	22,278	11,105	-50.15	0.11	0.10

*Source: US International Trade Commission*

Although the exports to the EU and Canada were not encouraging, the performance in these markets indicated minor improvements during latter years due to duty free treatment to Nepalese apparels given by these countries (Table 3). The benefit from preference has, however, been not fully exploited by Nepal, as many Nepalese exporters were concentrated to the US, which gave a protected market access through quotas.

The reasons for inability to exploit the preferential markets were due to constraints to meet the preferential rules of origin<sup>4</sup>, on the one hand, and lack of marketing strategies for these markets, on the other. Against this backdrop, Nepal has two differentiated markets with respect to marketing strategies even in the post MFA: the preferential and non-preferential markets (Issues on preferential market access is elaborated in the following chapters.)

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<sup>4</sup> The rules of origin for preferential market access generally requires a substantial change of materials, and in the case of apparels, it needs two stages of production, i.e. making of fabric and apparels in the same country.

**TABLE 3**  
**Export of Nepalese apparels to preferential markets**

*Value in million Rs.*

Year	Canada	EU
1995-96	68	563
1996-97	117	700
1997-98	50	966
1998-99	78	805
1999-00	184	2,474
2000-01	191	1,957
2001-02	122	1,389

*Source: TPC and NRB*

ii. Analysis of product and market mix

The product concentration with respect to the two markets also differed significantly. In general, Nepalese manufacturers exported standard product categories, such as T-shirts, ladies dresses and men's/boys' shirts and trousers made out of cotton textiles. Besides the higher rate of US quota utilization for cotton trousers and shorts, the capacity to utilize quota in other items were fairly low. The quota utilization rate for hot items under category 336/636, 340 and 347/348<sup>5</sup> crossed 90% while the rate for even some cotton categories were fairly low. In the latter years, only the category 347/348 crossed the 90% mark. The price was the major factor determining the success of the items interested to Nepalese manufacturers as these items had relatively less value of fashion and designs for marketing. Most of the Nepalese manufacturers focused on these lower end product categories, with higher degree of competition. Considering the competitive environment and the trend, which has shifted from cheap imports to high priced and high fashioned clothing in rich country markets in recent years, it becomes necessary to concentrate on higher quality casual fashion and items with own brand image to avoid competition from suppliers in the region. Nepalese exporters should not undermine the growing competition from the suppliers in the Caribbean region as the top suppliers in the US imports in the cotton product categories interested to Nepalese suppliers are from the countries such as Dominican Republic, Guatemala, Honduras, El Salvador and Mexico. Competition from the

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<sup>5</sup> The category 340 includes men's/boys cotton shirt; 336/636 is ladies dress of cotton and rayon, and 347/348 is men's/boys trousers, and shorts.

suppliers in these countries would escalate as they have advantage of geographical proximity and preferential market access in the US.

However, unlike the US market, export items to the EU contained relatively higher price tags. The high value pashmina, shawls and stoles, with a good Nepalese brand image, emerged as promising signs during the late 1990s. But the product saturated with

**TABLE 4**  
**Major apparel categories exported to USA and EU**

USA	EU
<ul style="list-style-type: none"> <li>• Women's/girls' cotton trousers and shorts</li> <li>• Men's/boys' cotton trousers and shorts</li> <li>• Pullover and cardigans</li> <li>• T-shirts, singlets and other vests</li> </ul>	<ul style="list-style-type: none"> <li>• Shawls and scarves of wool or fine animal hair</li> <li>• Pullovers, cardigans and similar articles of cotton</li> <li>• Women's/girls' cotton trousers and shorts</li> <li>• Pullovers and cardigans</li> </ul>

*Source: Garment Association – Nepal (GAN)*

oversupply, poor quality control and change in international fashion trend in a very short period. To revive the pasmina export, a positive brand image of Nepal as a quality producer needs to be created, by strictly enforcing the use of quality labels to check poor quality goods.

### iii. Overview of apparel trade relations

Nepal's trade relation with the US and EU for textiles and apparels was governed by separate bilateral agreements signed with the respective countries. The agreement relating to trade in cotton textiles and apparel products with the US was done in 1986. Since then Nepal was also subjected to quota limitations.

The agreement with the EU for trade in textiles was initialed in 1999 and 2002 for quantitative limitations and for access to the generalized system of preferences (GSP) for Nepalese textile products. Since 1997 Nepal has been facilitated by the derogation from the EU GSP rules of origin, and the provision has been renewed by the EU for two times at Nepal's request, and the latest provision has been revised in 2004 and is

effective until 2006.<sup>6</sup> (More about the EU derogation is discussed in Chapter II) Nepal is also a beneficiary of the EU's "Everything but Arms" scheme, which provided duty and quota free market access to all LDC products since 2001.<sup>7</sup> Canada also announced GSP treatment to all LDC apparel exports under the new scheme since 2003. As requirement, Nepal has signed a memorandum of understanding with Canada for duty free privilege for export of Nepalese apparels to the latter.<sup>8</sup>

Nepal as a WTO member is supposed to be benefited from market access to the US and the EU, including to all WTO members, without quantitative restriction. As Nepal did not have to face a problem of quota constraint in the MFA regime, the trade without quotas is of a little significance. However, Nepal benefited from the US quota growth rate after its accession to WTO in 2003.<sup>9</sup> Although the immediate benefit from the WTO membership with regard to the apparel trade is not apparent, Nepal can form an alliance with other LDCs to raise the issues of common interest, particularly to protect the interest in textiles and clothing trade in the future.

At the call of the Garment Association – Nepal (GAN), His Majesty's Government (HMG) expressed its support to the Mauritius effort to formally convene a WTO emergency meeting for assessing the impact of quota elimination, as a result of the monopolization of the textile and clothing market by a few countries to detriment of developing and LDCs, which had some degree of market share in developed countries, in the wake of the last stage of quota phase out. The Mauritius call was later supported by other countries of the alliance formed under the Istanbul Declaration in early 2004.<sup>10</sup>

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<sup>6</sup> However, in order to ensure fair treatment to both for Nepal and for other LDCs, the continuing need for derogation will be reviewed once the new rules of origin comes into effect in the context of the new GSP, as mentioned in the new Commission Regulation (EU) No. 2187/2004 of 20 December 2004.

<sup>7</sup> The EU introduced EBA scheme for GSP privilege to all LDC imports, including apparels since 2001.

<sup>8</sup> The MOU between Nepal and Canada was particularly for purpose of assisting Canada in verification and investigation of the rules of origin by providing necessary information and also cooperating with the Canadian customs officials for the purpose.

<sup>9</sup> The notice of the Committee for the Implementation of Textile Agreement (CITA) of the US adjusted with increase in the limits for imports of certain cotton and man-made fibre products made in Nepal and exported to US during 2004.

<sup>10</sup> The international coalition called Global Alliance for Fair Textile Trade – GAFTT – endorsed the Istanbul Declaration, that requested the WTO Director General to hold an emergency meeting to consider extension of the deadline for quota elimination. The move was supported by the GAN by joining the GAFTT alliance on 8 June 2004.

## CHAPTER II

### **Major issues in trade without quotas and coping with them**

The end of quota, since 1 January 2005, has marked the beginning of the liberalized trade in textiles and apparel. The trade was disturbed by a series of international agreements for controlling export from developing countries to developed nations, for more than four decades.<sup>11</sup> The liberalized trading system offered both opportunities and challenges. Competition in leading markets has increased fiercely, resulting in increased international demand with reduced prices. The US and Europe will remain important markets for apparels in post MFA, but high and middle income developing nations in South East Asia would develop as new markets as growth rate might slow down in other affluent markets, like Europe, North America and Japan.

Increased demand has gradually created shortages of labor and raised their costs in many leading Asian producing and exporting countries, in recent years. That has led to shift their production facilities to lower cost countries, converting them from major exporters to major importers of intermediate inputs for manufacturing. This biggest transformation in international trade could mean triumph to a number of developing nations, but not for Nepal, which never had to face the problem of quota constraint in the past and which did not have a “pure” comparative advantage. Considering the new developments in trade without quotas, the survival of Nepalese garment industry would be determined by the factors relating to buyers' intention to cut number of sourcing countries; Chinese domination in the global textile markets; plummeting prices; the existing tariff and non-tariff barriers; and the effectiveness of discriminatory preferential trading arrangements.

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<sup>11</sup> The international textile trade was actually restrained by the Short and Long-term Agreements on Trade in Cotton of the 1960s. Later, it was replaced by the MFA, covering trade in wool, man-made fiber and made up textiles, apart from cotton.

i. Reduced number of countries for sourcing

In a trade without quotas, the international buyers will have more discretionary power to decide on where to source for textiles and apparels from. They are not required to search for countries without quota constraints anymore and would give priority to the countries with a large production capacity with a vertical production. Nor the countries with quota constraints previously are required to pay quota premiums any more. As a result, the immediate impact has been the reduced number of countries for sourcing by the international buyers, on the one hand, and the down spiral of apparel prices in the efficient supplying countries, on the other. As Nepal is without a textile base to consolidate production and lacks access to preferential market in the US to subside the higher price, its position in the world's largest market tends to be very vulnerable, both in terms of supply capacity and price competitiveness. As another disadvantage, Nepal does not have proximity to major world apparel markets to gain competitiveness. Consequently, Nepal has already witnessed a negative growth to the US since 2004, and the situation has further aggravated with the beginning of 2005 (Table 5). The US importers and retailers have already started to consolidate sourcing in few countries with a meaningful production capacity. The number of countries for sourcing in the US is expected to reduce by half in 2005-06<sup>12</sup> at the cost of inefficient and small supplier countries, including Nepal. Bangladesh already shares a major chunk of the total size of apparel imports from all LDCs in EU and Canada.

TABLE 5  
**Month-wise export to USA**  
(Jan-May 2004 and 2005)

	Value in US \$		
	2004	2005	% change
January	11,344,957.84	6,085,516.46	-46
February	9,905,349.28	4,455,332.08	-55
March	10,638,028.95	6,241,703.96	-41
April	7,351,875.46	6,228,833.08	-15
May	8,330,391.08	4,204,902.94	-50

Source: GAN

<sup>12</sup> A report by the US Department of Commerce to the Congressional Textile Caucus said that the buyers will reduce the number of countries they source from by half in 2005-06 and by another third by 2010.

ii. The Chinese domination

China, as a dominant supplier, may be not a direct and immediate threat to Nepal, whose trade volume is incomparable to China's. But there are reasons to keep vigilance of the rapid development China has made in this sector to anticipate its impact on Nepal's position. It is essential to study the achievement China has made in the world market due to its intensified competitiveness and the subsidies it gave to apparel manufacturers.<sup>13</sup>

During the first quarter of 2005, China's exports of some categories, which were also important to Nepalese exporters, increased exceptionally, some of them crossing even more than one thousand percent. The growth rate for a key product, such as cotton trousers (Category 347/348), rose by 1521%. (TABLE 6) If this is any indication, the Chinese growth would gradually gobble up all potential export items of Nepalese traders, if nothing changes. In Europe, Nepal's advantage of duty privilege to reduce price would also be meaningless if the Chinese subsidies undercut their apparel prices.

TABLE 6  
**Growth rate of selected Chinese clothing imports to US**

Key individual category/description	Quantity (Jan. – March 2005 compared to Jan. – March 2004)	Percentage change
Cotton knit shirts	+ 6,521,795 dozen	+1257.87%
Non-knit shirts	+1,422,603 dozen	+284.12%
Cotton and MMF trousers	+6,176,504 dozen	+1521.04%
MMF knit shirts	+2,128,603 dozen	+331%
MMF trousers	+1,597,270 dozen	269.16%

*MMF = man-made fiber*

Source: American Manufacturing Trade Coalition (AMTAC), 27 April 2005

<sup>13</sup> According to the US textiles related associations, the Chinese manufacturers are privileged by export subsidies of export tax rebate equivalent to 13%; free capital; direct state subsidies to textile industry; plus other benefits of tax holiday, power and freight subsidies and currency manipulation of 40 percentage advantage.

Apparently, China has emerged as a monopoly in the post MFA international clothing market. Its strength to capture the world market came out of its capacity for vertical production, availability of unlimited supply of cheap labor with relatively higher productivity<sup>14</sup> and investment in modern manufacturing and trade infrastructure. All these advantages gave China to increase market share enormously in the US and Europe immediately after quota abolition. China's market share in US in products, removed from quotas, increased from less than 10% in 2001 to over 70% as of June 2004, and also saw substantial growth in its market share in the EU, capturing from 30% to 50% in several key categories.<sup>15</sup> A recent World Bank study predicted that China and India would be the only significant beneficiaries of quota elimination, sharing more than 71% of the global market. Except for China and India, all supplying countries are anticipated to lose their market share in the US in trade without quotas.<sup>16</sup> A WTO study revealed China's share in US to grow from 12% in 2001 to 56% in post MFA and India from 4% to 15%.

However, the action taken against import surge from China by the US<sup>17</sup> and EU would likely divert trade to other suppliers. Even if the positive effect of curb on Chinese export seems to be unlikely in the short-run, it seems inevitable. The US has hold up items of cotton shirts and trousers, which are important items to Nepalese exporters, under the transitional safeguard. It is very important for Nepal to understand to what extent should it require to make adjustment, vis-à-vis the China syndrome, which is challenging not only to smaller suppliers like Nepal, but also to the bigger and competitive ones. The transitional measures initiated by the US and

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<sup>14</sup> But according to a news article in *The Economist* (9 Oct. 2004), China started to face shortage of cheap labor and now particularly evident in the belt of manufacturing cities along the coasts from Guangdong up through Zhejiang Province, south of Shanghai.

<sup>15</sup> This was stated in the *GAFTT News*, 24 September 2004

<sup>16</sup> According to the National Council of Textile Organization in USA, 31 countries suffered a loss of 75% - 100% market share in categories removed from the US quotas and 40 countries suffered a 50% - 74% decline in market share and 17 others suffered a 25% to 49% loss of market. Nepal belonged to the third group of countries.

<sup>17</sup> As agreed during negotiation for China's accession to WTO, the US has invoked safeguard quotas on three items: cotton knitted fabric, cotton and man-made fibre dressing gowns and bathrobes and cotton and man-made fibre brassiers in December 2003. And also imposed action on three additional items – cotton knit shirt and blouses, cotton trousers, and cotton and man-made fibre underwear in April 2005, which are the products interest to Nepalese exporters also.

EU should also be taken into consideration for a positive impact on Nepal's export potentiality.

### iii. Down spiral of the world apparel price

The average world apparel price is rapidly falling down with abolition of quotas and intensified competition. A study in 2003 revealed that the international apparel price has declined by almost 32% in the 1992-dollar price.<sup>18</sup> The trend seems to continue with increased world production, reduced distribution costs, and transformation of production bases to cheaper locations. Disappearance of the additional cost of quota premium has also reduced transaction costs at enterprise level, cutting the product price in quota constraint countries.<sup>19</sup> It is estimated that the US wholesale price would come down to one-fifth of the existing price after 2005. The prices for Chinese goods are tumbling down, with an average of 48% reduction from 2001 to 2004, and seem to escalate down spiral in the categories, which had been abolished from quotas in 2004. (Table 7) According to a recent study by the US based National Council of Textile Organization (NCTO), the prices for Chinese cotton trousers, shirts and underwear and like products are 58% below the world average price for the same, indicating the possibility of deteriorating terms of trade for countries like Nepal.

**TABLE 7**  
**Change in average Chinese prices**  
(Quota-free apparel categories per square meter)

2001	2002	Dec. 2003	Mar. 2004	Change: 2001 – March 04
\$ 6.23	\$ 3.37	\$ 2.65	\$ 3.12	- 48%

*Source: National Council of Textile Organizations, USA*

In contrary, the average unit price for Nepalese apparels has increased from approximately US \$ 3 in early 1990 to \$ 3.5 after a decade. For categories, such as trousers and shirts, which were major items in Nepal's export, are roughly US \$ 3 on average against US \$ 2.13 in China, making Nepalese apparels 40% costlier than the Chinese. However, Nepalese price is cheaper by 40%, if compared to the rest of the

<sup>18</sup> According to A.T.Kearney's Consultancy as published in The Economist 9 August 2003

<sup>19</sup> For example, Chinese companies had to pay premium to buy quotas from state owned companies, seeking extra cost of US \$ 80 for 12 pairs of cotton trousers whose price was only \$ 120, bringing Chinese price at par with quota free southeast Asian countries.

world average price, revealing a scope for market expansion, provided the production and delivery match the post MFA situation (Table 8).

**TABLE 8**  
Comparison of Nepalese apparel prices with China and rest of the world

Category	Chinese average export price	Average rest of world price	Average Nepalese export price*
<b>Cotton trousers (347/8)</b>	\$ 2.87	\$ 7.73	\$ 3.86
<b>MMF Trousers (647/8)</b>	\$ 2.16	\$ 4.90	\$ 2.50
<b>Men's woven shirts (340/640)</b>	\$2.83	\$ 4.16	\$ 3.12
<b>Cotton knit shirts (338/9)</b>	\$ 1.29	\$ 4.29	\$ 2.71
<b>MMF knit shirts (638/9)</b>	\$ 1.50	\$ 4.37	\$ 3.0

*Source: NCTO (US) \* Calculation based on information available at GAN*

#### iv. Tariff and non-tariff barriers

The issue of tariff and non-tariff barriers would be more crucial factor determining competitiveness of Nepalese apparels in a quota free trade. The use of tariffs would escalate to undermine intense price competition and import surge in developed countries, most prominently in the US and EU. The average tariff rate on apparels in rich countries still remains significantly higher than on other industrial goods. The post Uruguay Round unweighted average tariff in industrialized nations for the product category is 12%, which is almost four times greater than the rates applied on other products imported to these countries. About half of textiles and clothing items entering the American market are subject to tariffs in between 15% to 35%, and that is about 9% in the EU and 7.6% in Japan.

Some major items exported to the US, EU and Canada are almost ten times the average MFN rates in the respective countries, and almost fifteen times than they applied to imports from other rich countries (Table 9). Nepalese apparels face the

tariff rate of 14.6% on average in the US. The tariff revenue from Nepalese goods imports in US is shockingly high.<sup>20</sup>

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<sup>20</sup> The US collected \$ 25 million in tariff revenue from Nepalese imports in 2001, accounting to 12.3% of the total export value. Whereas the revenue from countries like, Ireland and France were only 0.2% and 1.1% of their total values respectively. This was mentioned in an article “Toughest on the Poor: America's Flawed Tariff System”, by Edward Gresser in Foreign Affairs, Nov./Dec. 2002.

TABLE 9

*Tariffs for major Nepalese apparels in US*

Product HS code	Product description	Applied MFN (Total ad valorem equivalent)
620462	Women's/girls' trousers and shorts, not knitted, of cotton	Max.16.60% - Min. 0.00% Av. 8.15%
620342	Men's/boys' trousers and shorts, not knitted or crocheted, of cotton	Max. 16.60% -Min. 0.00% Av. 8.96%
611020	Pullovers and similar articles, knitted or crocheted, of cotton	Max. 16.5% - Min. 5.0% Av. 10.50%
610910	T-shirts, singlets and similar garments, knitted or crocheted, of cotton	16.50%
620630	Women/girls' blouses and shirts, not knitted, of cotton	Max. 15.40% - Min. 9.00% Av. 3.50%
620640	Women's/girls' blouses and shirts, not knitted, of MMF	Max. 26.90% - Min. 4.00% Av. 14.63

Source: ITC Macmap, 2002

Tariffs on clothing in developing countries are no less intense. Some of the higher tariff- imposing countries included, India (39%), Pakistan (20%) and Thailand (25%). Nepal can benefit from tariff reform in large developing countries for market diversification. The bilateral preferential trade relations with India would be more meaningful to Nepal with respect to tariff advantage and geographical proximity for effective market diversification strategy and to compensate the loss of market share in the US.

Even if the tariffs are relatively higher they are predictable as they are bound by the WTO negotiations. But the application of non-tariff barriers, which is arbitrary and non-transparent, could be more threatening to Nepalese traders, regarding the market access problems in the post MFA. Among other non-tariff barriers, Nepalese traders were required to follow the social compliance and the work place code of conduct as instructed by the international buyers. Particularly the US textile industries are mounting pressure on large importing companies and buyers to source from “ethically correct”. Compliance to these requirements is likely to be more stringent in the future, resulting in increased output cost of the Nepalese apparel industries. Other measures,

which will be increasingly used by the developed countries, are relating to safeguards and anti-dumping actions,<sup>21</sup> but is not serious in context of Nepalese export as of now.

The application of measures, such as the eco-labeling and adoption of stringent rules for use of chemicals in textiles,<sup>22</sup> could hamper market entry into developed countries. The requirement of eco labeling is more widespread in Europe than in the US. Although the requirement is voluntary as of now, the EU intends to increase public awareness campaign on the importance of the labels that could mount pressure on Nepalese apparel manufacturers to follow the scheme for the market entry. The US textile manufacturers are interested to consider issues of the intellectual property rights and copyrights for textile designs, and also strict enforcement of prohibition against duty evasion and other customs fraud.<sup>23</sup> Although Nepalese exporters did not have to confront with these kinds of obstacles at full scale so far, they should be acquainted with such measures to manage the market access without problems in the future.

#### v. Preferential trading arrangements

As already mentioned, the post MFA international clothing trade will be not completely liberal, but seems to be protected by higher tariffs and could even escalate application of such practices to substitute quotas in most of the countries. The arrangement of preferential trading, vis-à-vis the escalated tariffs has already been an important factor influencing the clothing trade. The number of bilateral and regional trading agreements giving preferences to trade in textiles and clothing has proliferated in recent years.

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<sup>21</sup> For example India faced anti-dumping action on its export of bed-linen in the EU in 1997. The US has taken steps to impose curb on import of Chinese textile products in 2003, 2004 and in early this year on the basis of threat to the US textile industries, under the special safeguard clause.

<sup>22</sup> The US and EU are considering to adopt regulations for the use of chemicals under the system called REACH – registration, evaluation and authorization of chemicals. The US Department of Commerce has already identified about 3,000 chemical substances to be regulated under the REACH system, intensifying the problem to comply with such requirements by developing and least developed countries, including Nepal.

<sup>23</sup> As mentioned in the statement of American Textile Manufacturing Institute to the US House Committee on Ways & Means, February 26, 2003.

Arrangement of such kind has already been affected non-member countries from exclusion and discrimination in trade, which in fact goes against the WTO principle.<sup>24</sup> Major international buyers, like the US and EU, have established preferential trading arrangement in different forms to meet their objective which were not allowed under the multilateral system. Consequently, Nepalese traders will have to face more complex and discriminatory situation, impacting its competitiveness.

Despite textiles is supposed to be a sensitive product and excluded from the Generalized System of Preference (GSP),<sup>25</sup> the US has most prominently established a number of preferential agreements in this sector, discriminating Nepal, among other LDCs. The US has preferential arrangement for trade in textiles with Mexico, and a host of countries in the Caribbean and the sub-Saharan region, under the NAFTA, CBTPA and AGOA agreements respectively.<sup>26</sup> Bilaterally, it has signed agreements with Jordan, and most recently with Morocco, Singapore, Australia and Chile.<sup>27</sup> It is also all set to sign the similar agreement with five central American countries under the CAFTA, diverting the US apparel import at the cost of weaker countries like Nepal. The impact of AGOA was more pronounced in the case of Nepal as it has lost the level playing field as it suffered from threat of US buyers to divert export orders to the AGOA countries. Similarly, the EU has made an arrangement for the outward processing trade (OPT) in clothing, to shift labor-intensive production process from high costing Western European nations to low cost Eastern countries. The basic objective of this is to retain capital-intensive textile production in the former, and affecting other developing and LDCs, which lack preferential trading arrangement and proximity to market.<sup>28</sup>

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<sup>24</sup> However, the regional and bilateral trading arrangements are becoming more popular due to the permission for deviation from MFN among the members within the group as based on the WTO Article XXIV.

<sup>25</sup> Under the GSP system, industrialized nations grant duty free market access to poor country products unilaterally. But textile and apparels were excluded from the facility until quite recently by some countries, and the US still does not provide the facility to all developing countries.

<sup>26</sup> The NAFTA provides duty free to Mexican textile products, whereas the CBTPA and AGOA, which stem from the US Trade and Development Act (USTDA), enabled 23 Caribbean Basin countries and 38 African countries eligible for duty free market access for textiles products in US.

<sup>27</sup> Jordan and US trade apparels under a bilateral arrangement called qualifying industrial zones (QIZ) and Jordan has noticeably been able to increase its textile items export to US by 30% in the first quarter of 2005 from a low base.

<sup>28</sup> For instance Italy, Germany, France and UK have arranged for re-importing finished textile products, including apparels, without tariffs from countries like Poland, Romania and Hungary, as well

The US and the EU unilaterally grant the GSP privilege in textile related imports from developing countries, but in a most selective way. For example, the US GSP excludes duty concession to textile items in general, but provides to African and Caribbean developing nations, under separate bills as mentioned above. Whereas, the EU provides duty reduction of up to 20% for eligible GSP countries,<sup>29</sup> and 100% duty advantage to all LDCs, including Nepal, under the EBA.<sup>30</sup> But Nepalese apparels are not eligible for the GSP privilege in US, which is one of the prime markets in terms of the total export share.

The possible favourable impact of the GSP preference should not be underestimated if Nepalese apparel exporters had to survive. It could be one of the important mechanisms to off set the prevailing higher production cost to improve the competitive edge. Currently, Nepalese apparels enjoy duty free market access under the GSP in the EU and Canada, which could be promoted as alternative markets. However, the performance in both markets had so far a minimal impact on Nepal's market diversification initiative. Nevertheless, the export to EU in recent years indicated promising signs (see table 3), due to the GSP facility under the EBA programme, providing zero duty and quota free treatment for an unlimited period without subject to periodic review. As the EBA scheme guarantees greater certainty of market access to the EU, it gives a lee way to Nepalese producers to stimulate production capacity and product diversification, provided they can face price volatility and overcome domestic supply constraints.

The EU GSP has contributed to growth potentiality of Nepal's apparel export as the former provided facility of derogation from the standard GSP rules of origin to the latter since 1997, and effective till 2006.<sup>31</sup> Accordingly, the provision required Nepalese manufacturers only one processing operation from fabric originating not

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as from Mediterranean rim, such as Morocco and Tunisia, to save higher labor cost. The preferential market access has helped to increase apparel trade volume between these countries remarkably.

<sup>29</sup> However, the eligible country may be graduated from the list once it crosses the certain level of limits of the benefit.

<sup>30</sup> The EU has currently three forms of GSP schemes: EBA giving duty and quota free access to all LDC products, except for a couple of sensitive items; a general GSP applicable to all eligible countries; and a new GSP+ initiative giving tariff preferences to countries with special development needs.

<sup>31</sup> The derogation facility has been extended by the EU for Nepal for two times in 2001 and 2004. The latest revision is effective until 2006, upon request made by Nepal.

only in countries in the SAARC region,<sup>32</sup> but also in ASEAN and ACP countries to meet the GSP origin rules. This provision bears more value in an effort to market diversification and for sustainability of the industry in post MFA, if the position deteriorates in the American market or nothing changes in favour of Nepal there.

Nepal made request for duty free treatment in apparels, equal to the AGOA, reasoning for level playing field in the US. Accordingly, the bills, granting preferential treatment to certain Nepalese apparels, were introduced at the US Senate and House of Representative, but could not get cosponsors for further proceeding.<sup>33</sup> However, a new legislation with regard to preferential market access for apparels of 14 LDCs in Asia and the Pacific, including Nepal, has been introduced at the respective Houses this year.<sup>34</sup> Enactment of the new bill would be more meaningful to retain Nepal's position in the US and also to regain the losses it has faced after the quota elimination. But this privilege can act only as a cushion to adjust with the changed context for a certain period. It is also not desirable to totally depend upon a unilateral preferential treatment in the long run, as it is discretionary in application and also not binding to the preference giving countries. Just because the GSP is unilateral and non-reciprocal, this is at discretion of the preference giving countries as the preference can be subject to conditions of strict rules of origin and can be withdrawn without any reason.<sup>35</sup>

#### vi. Erosion of the preferential margin

The significance of preferential market access to Nepalese apparels will largely depend on the criteria for rules of origin and the existing margin of preference in the respective preference giving countries. In general, the origin rules for apparels were

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<sup>32</sup> Nepalese apparels could already meet the rules of origin under the SAARC cumulation system as provided by the EU, which permits the use of materials from the countries within the SAARC regional grouping.

<sup>33</sup> The Nepal Bill which was suppose to grant the AGOA status to Nepalese apparels was proposed by Senator Dianne Feinstein at the Senate on 19 March 2003 and followed by a proposal by Congressman James T. Walsh at the House of Representatives on 5 September 2003. It is said that the Bill was obstructed by a dispute between Nepal Electricity Authority (NEA) and Panda Energy, a US company, over payments for power purchase between the two.

<sup>34</sup> The Tariff Reduction Assistance for Developing Economies Act or the TRADE Act 2005, which has already seven sponsors at the Senate and two at the House of Representatives, has been referred to the Finance Committee and the Ways and Means Committee respectively. Later, the legislation was referred to the House Sub-committee on Trade. The eligible LDCs for the privilege include Afghanistan, Bangladesh, Bhutan, Cambodia, Kiribati, Laos, Maldives, Nepal, Samoa, Solomon Islands, East Timor, Tuvalu, Vanuatu, and Yemen, and Sri Lanka as a Tsunami affected country.

<sup>35</sup> In US, the textile manufacturers are strongly opposing preference to textile products and advocating for strict rules of origin criteria in recent years.

based on the yarn-forward and substantial transformation principles, requiring the preference receiving countries to make clothing from the yarn or fabric made in those countries. <sup>36</sup> Since Nepal does not have a textile base presently, it would be impossible for Nepalese apparel exporters to gain from the GSP preference with cumbersome and strict conditions. Had there been no derogation facility from the standard preferential rules of origin, the EU GSP would also be meaningless for Nepalese exporters. Nepal has only one and half year to fully exploit the facility of the EU derogation. <sup>37</sup> Bearing that, it has to develop a textile base to gain from the preference to a greater extent in the long run. However, the intensity of relatively more capital in fabric industries could hinder development of such industries, unless there is a concrete policy to attract enough capital in this sector. Failure to meet the strict rules of origin is already limiting Nepal's capacity to utilize the preference to a greater extent.

Compared to the EU MFN rate in apparel imports, Nepal enjoys 100% preferential margin in absolute terms. But the margin is less than that, if compared to the rate of concession applied to developing countries, because they also benefit from reduced rate of tariffs. Since the competitors for Nepalese exporters in the EU are either LDCs or developing countries from the region, which are also facilitated by the preference at more or less of same degree, the existing margin of preference would not allow Nepalese

apparels to comfortably gain a competitive edge, unless it develops some sorts of cost cutting measures to enforce their position. One of the underlying facts is that the existing preference margin would most likely be affected by the outcome of the non-agricultural market access (NAMA) negotiations under the Doha Development Agenda (DDA). Under the DDA the WTO member countries have, in principle, agreed to reduce high tariff, tariff peaks and tariff escalations. Although it does not separately consider the textiles and clothing for negotiation, the preference will most probably erode, depending on how formula will be applied to cut subsequent tariff rates. If the NAMA negotiation reduces tariffs on apparels with higher percentage cut,

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<sup>36</sup> However, a highly flexible origin criteria is foreseen in Canadian preferential scheme for LDCs since 2003 and the use of third country fabric is permitted under special apparel provision under the AGOA.

<sup>37</sup> Because there is a very slim chance for extension of the derogation from the EU GSP rules of origin as the EU is revising the GSP scheme and the general preferential rules of origin, beyond 2006.

the preferential margin for Nepalese apparels will further deteriorate, losing its value as market access privilege in the future.

### CHAPTER III

#### **Persistent internal bottlenecks and implementation problems**

The constraints to strengthen Nepalese garment industry stem from internal bottlenecks of different intensity. But the industry has managed to cope with the problems in the past regime as almost all Nepalese apparel industries were confined to a production based only on CMT (cut, make and trim), requiring them to manage labour as the only major input. The trading system was, therefore, greatly influenced by the international buyers, and the manufacturers had to follow the buyers'

instruction for supply sources and delivery of goods. But with end of the CMT business practices, the buyers will ask for more services, giving more responsibility to Nepalese manufacturers for export orders. Thus, the degree of internal challenges will intensify with changes in external factors, as explained in the previous chapter, on the one hand, and with increased demand for more services from buyers, on the other, in a quota free trade. Bearing that, the most prominent internal limitations to growth prospect of the Nepalese apparel sector, therefore, include:

i. Constraints to supply efficiency

Supply side of the Nepalese apparel industry is impeded particularly by low productivity and higher transaction costs. The use of outdated and non-competitive technology, including the lack of methods to rationalize production with research and development (R & D) has already inhibited Nepalese producers' ability to compete efficiently on the basis of price, quality and delivery as the quotas were removed. None of the factory is based on the sophisticated computerized system for pattern making, designing or for cutting. It is high time that they apply CAD/CAM system, which helps to increase designing efficiency and to respond to the buyers' requirement as unique advantages. The sophisticated system such as CAD/CAM is hardly affordable by an individual industry, so that it can be installed on an industry group basis or with the support from the government. A matching fund under the Export Promotion Fund of Export Promotion Committee can be mobilized for this purpose. Neither the government nor an individual industry has taken any step with regard to the essence of adapting new technologies and R & D for enhanced competitiveness, whereas the governments in the neighboring countries have already initiated various kinds of measures, including funds to upgrade technology, to cope with the situation.<sup>38</sup>

Relatively low labor cost is the only distinct advantage that Nepal has, but low labor productivity remains obstacle to competitiveness. As one of the studies shows, except for Bangladesh, the per hour labor cost in garment industry in China and India is higher than in Nepal, but the productivity of Nepalese worker is lower by more than

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<sup>38</sup> India has already instituted a textile upgradation fund to modernize its textile industry, whereas Pakistan and Sri Lanka have also taken similar measures to strengthen supply side.

half of the Chinese or Indian workers, who are supposed to be competitive in the changed context. The ability to compete in post MFA will largely depend not just on cheap labor cost, but on a workforce that is both relatively cheap and technically skilled. Trained manpower would also be essential in the fields of merchandising, production management, and marketing to increase the efficiency in overall production. The problem of low labour productivity and a dearth of skill manpower can be overcome by activating the existing textile-training center under the Department of Cottage & Small Industry. Restructuring of the center and transfer of its ownership to the GAN can be an option for activating and proper functioning of the center (See also Chapter IV. iii).

It is also important to note that the low labor cost has a little significance to reduce output cost among Nepalese manufacturers. Compared to the cost of imported materials, the labor content is relatively less in total cost to manufacture garments in Nepal. Thus, the cheap labor seems to be insufficient cost advantage to effectively surmount relatively higher component of other cost in production and delivery. For instance, the component of labor in the total cost for making a garment in Nepal is only about 29% as against more than 60% of the cost required for imported materials, reflecting a very little scope to reduce the increased product price to be competitive (Table 10). But the labor cost can have a greater influence in pricing of products if its component shares larger portion, compared to other contents in terms of cost. However, the higher portion of labour cost content can be turned into advantage by increasing productivity. This will require increased ratio of inputs and skill development training facility to respond to the buyers' requirement in the changed context (See also Chapter IV. ii for more on skill development).

Apart from low labor productivity, the supply efficiency is also adversely affected by higher transaction cost, owing to inadequate transportation and logistic facility; high cost customs procedures; and cumbersome administrative process. The access to Kolkata port

TABLE 10

### Assumption of standard costing format for apparels

Description	Cost per pc of garment (Men's cotton trouser)	In percentage
1. Total raw material/accessories cost (Fabric ex HK @ US \$ 1.45 pr. Yd 120 days sight LC), inclusive of pocketing lining, hang tag, price tag, thread	US \$ 2.61	61.41%
2. Import expenses	US \$ 0.08	1.88%
3. Making charges (Labor cost)	US \$ 1.24	29.17%
4. Export expenses + CCU Transport (Calcutta)	US \$ 0.17	4.0%
5. Financing cost	US \$ 0.07	1.64%
6. Sales commission	US \$ 0.08	1.88%
<b>TOTAL COST</b>	<b>US \$ 4.25</b>	<b>100%</b>

*Source: Ami Apparel (Pvt.) Ltd./2004*

as the only transit point for Nepal's trade with third countries has also resulted in a cumbersome and costly transit procedure as it required additional charges for clearing, customs and transit documentation, and inspection costs. In this regard, the facilitated transit point, such as the efficient implementation of ICD in Birgunj, cannot be overlooked to reduce land transit times through reduced handling and less cumbersome procedures.

#### ii. Inadequate institutional and trade support services

The problems with regard to institutional and trade support services in the garment sector are primarily related to poor logistics and cargo services; difficulty of international market and price information; as well as complicated export financing mechanism. Poor logistics and transportation has affected the efficiency in terms of cost and delivery time. The cost for logistics and transit is approximately 20% of the ex-work price for garments, mainly due to higher cost for air and sea cargo rates.

However, it is estimated that the transportation cost would come down by 40% after full implementation of the ICD facilities in Birgunj. Garment entrepreneurs have been suggesting for establishment of a Garment Processing Zone (GPZ) near to the ICD to reduce transaction cost and to increase delivery efficiency by exploiting the gains from ICD.

The cost for transporting a 20-foot container can cost up to US \$ 2000, inclusive of additional clearing charges (the cost for an incoming container is around US \$ 900 as against \$ 1400 for outgoing.) in Nepal as against \$ 600-800 in India and Bangladesh for the same. Nepalese traders have to pay full container charge and full clearance charges in Kolkata regardless of the volume of its import or export. The cost for less container load is almost equal to the full container load. Lack of adequate transit points and access to port facilities has also adversely affected the delivery efficiency as the time required from date of dispatch of goods to the US from Nepal takes around 40-42 days, which is almost 50% longer than the time required by the exporters in India or Bangladesh. The transit time to or from Kolkata takes around 10-12 days, and the shipping time takes around 25-30 days, depending upon the final destination of the consignments.<sup>39</sup>

The lack of direct marketing network by Nepalese garment companies has held up their capacity to directly access for international product, market and price information. There are no responsible institutions to provide these facilities in order to make the industry more flexible with the competitive environment in a quota free trade. From the private sector, the GAN can be strengthened as an institution to assist the garment industries on the issues such as compliance with buying policies, market access opportunities and barriers, training policies etc. Parallel to that the Trade Promotion Centre (TPC) can also be made a responsible organization for handling those issues on behalf of the government to serve the private sector.

The problem related to bank financing has intensified further. Instead of giving a privilege to the sector, which is actually facing with the difficult adjustment problems, the commercial banks are increasingly becoming reluctant to make new investment in this sector and initiating stricter actions against debtors, impending further growth of

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<sup>39</sup> In contrary, the lead-time for Indian or Bangladesh exporters is maximum of 30 days.

the industry, as most of the garment entrepreneurs have complained about it. In addition, the garment sector, among other export-oriented industries, had to pay relatively higher bank rates and subject to higher collateral requirements than in other countries in the region. This has added extra cost to their financing. To make the bank financing more efficient, in order to reduce the industry's financing cost, there should be an intervention by NRB to prioritize the garment sector for bank loans.

The bank finance should encourage project loans without prejudice. Interest rates and bank commissions are also required revision for the financing efficiency. The bank-lending rate for the garment sector should not exceed 6% in interest. To reduce the burden of collateral, the banks should ask collateral on funding loans only, instead of applying equally to the non-funding loans also. Another rescue measure, with regard to bank financing, could be immediate implementation of the provision seeking commercial banks to release loans on the basis of the letter of credit (LC) of the garment exporters.<sup>40</sup> The loans based on LC can be applied for pre and post shipment financing to encourage the export trade.

### iii. Administrative complications

Administrative hassles are more widespread with regard to the bonded warehouse facility, bank guarantee and rebate of VAT, as imposed on the exported products. The new provision has created even more administrative complications and delayed the release of bank guarantee, maintained for the use of bonded warehouse facility and rebate of the VAT. The new provision required garment exporters to get two separate recommendations from the Department of Customs and the Department of Internal Revenue, instead of a single recommendation, from the Customs Department, as was the case before, to release the bank guarantee. Considering the objective of minimizing transaction cost, it is necessary to revert to the previous system and apply only one bank guarantee for both purposes.

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<sup>40</sup> Actually, there was a provision of providing a pre-shipment financing of up to 35% of the value of confirmed export LC, as announced in the budget sometime back. But the provision has never been effective.

The process of refunding VAT should be simplified to reduce the prevailing higher transaction cost.<sup>41</sup> The process of refund should be made within 30 days from the date of claim made by the exporters. The documents required for this purpose should also be mentioned specifically to overcome the hassles faced by the exporters while on the administrative process.

The administrative process for recognizing an industry as export oriented for the privilege looks inconsistent as well. While the Customs Department grants tariff rebate for an industry, which exports 80% of the total production, the Department of Internal Revenue seeks 90% for the same in case of refunding VAT. Likewise, the tariff is rebated for the cancelled export orders, whereas the refund of VAT does not. Administrative norms with respect to these provisions are urgently needed harmonization to reduce administrative complications.

#### iv. Policy drawback

The government's policy toward labor regulations and income tax has an adverse effect on productivity and competitiveness of the garment industry as a whole. The workers biased labor law has prevented many garment firms from employing permanent workforce due to extreme difficulty in making firing permanent workforce. In order to escape this provision, the law has, paradoxically, encouraged employers to hire workforce under contract system. This issue has considerably strained industrial relations system in Nepal. The lack of flexibility in the labor law has discouraged employers from hiring permanent workers and investing in workers' training, affecting labor turnover, long-term labor productivity and competitiveness. Though the practice is said to be in decline, the rigidity in labor law is also reckoned to be the factor responsible for encouraging employers to hire workers from neighboring country.

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<sup>41</sup> The transaction costs in the export process for cotton shirts could amount to over 5% of the value added in Nepal and represents as much as 25% of the labor cost incurred due to unnecessarily incurred costs, according to a report by a team constituted by HMG to study Nepal's trade competitiveness in 2003.

A labor policy must be designed to have stable labor-management relations in the country. Though in theory the existing labor law is designed to protect the workforce, due to lack of strong law enforcement mechanism, the law has not been implemented. The employers who have not implemented the provisions of labor law had an advantage over those employers who have abided the law. If uniform applicability of the law is one issue then there is other issue of balancing the employers' demand for flexible labor law,<sup>42</sup> having right to hiring and firing of labours, with workers' demand for increased job security amid uncertain business conditions. As Nepal's garment industry is export-oriented business, the industry is also at the constant glare of international community. The industry had to abide by the international labor standards related to working conditions and health and safety issues. Therefore, any policy designed to have congenial labor relations in garment industry should take into account its unique business characteristics (export orientation, high labor intensity and prevailing uncertainty), demands of the workforce and international labor practices.

Likewise, the policy of income tax on export earning has been one of the prolonged contentious issues. As privilege to the export-oriented industry, the garment exporters have been urging the government for a total rebate of income tax on earning from export, as was the case some years ago. Considering the deteriorating situation of the industry, it is urgently needed to revise the income tax to reduce the tax burden on exporters. It is advisable to impose income tax on flat rate not exceeding 0.50% of the total export earning to match with the new income tax rates as announced in the latest budget and the tax should be collected at the source of export to simplify the tax procedure and reduce administrative complications.

#### v. Limitations to developing backward linkages

As explained above, the portion of imported inputs for manufacturing garments in Nepal is relatively very large. The industry depends on almost all imported materials, starting from fabrics to all kinds of ancillaries. Except for packing materials, a very few accessories, such as zipper, button, neck boards, threads, printed labels, hang

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<sup>42</sup> The garment entrepreneurs have been urging the government to introduce more flexible labour law with relaxation on "hire and fire" decisions in light of changing business conditions of the industry.

tags, plastic collar inserts and clips, are produced internally. One of estimates shows that the use of locally made fabrics by the export-oriented garment industry is hardly 2%, as they do not meet international buyers' requirement, vis-à-vis, the standardized size and consistency in quality and color. The manufacturers are unable to meet the quantity and delivery requirements as well. With regard to other accessories, the garment manufacturers were forced to use imported ones due to favorable business terms, consistency in quality and delivery, and competitive pricing. One of the basic problems in domestic sourcing is the lack of dependency for a larger quantity in a very short period. Actually the absence of these basic ancillary industries had created difficulty of operation, and sometimes mismatching or creating shortages between imports of the materials and their requirements.

Establishment of the basic types of ancillary industries are important to add more values to the industry's output, on the one hand, and to expedite sourcing of the industry, on the other. However, there is a problem of making these industries viable in terms of the economies of scale with regard to domestic demand. In that situation the government may find it difficult to make a rational decision on protecting such type of industries. That is why the tendency towards import through bonded warehouse has become preferable to save from losing export market share. But the industry cannot sustain without giving priority to efficient domestic ancillary suppliers in the long run. This is also more valuable to maximize the gain from preferential market access, which seeks the preferential rules of origin, requiring higher percentage of value addition or the garment made out of domestic textiles. For enhancing these types of ancillary industries, the industrial policy should treat the supply made by domestic ancillary industries to garment industry as deemed export, based on the authenticity. The policy should initially encourage low cost ancillary industries based on production of poly bags and packing materials, zippers, and thread, and the services needed for garment manufacturing, like washing and dyeing units. Establishment of these types of industries can be attracted inside the GPZ (as will be elaborated in chapter IV), which has been conceptualized for the industry consolidation and clustering to face the changed competitive environment in clothing trade.

## CHAPTER IV

### **Capacity building to face post MFA situation**

The WTO's ATC, in fact, gave ten years for Nepal, among others, to prepare itself to face with adjustment issues after the complete phase out of MFA quotas. It was globally anticipated that the intensified competition in the post MFA would concentrate garment industries in countries with availability of textile base, trade infrastructure, favourable trading terms, proximity to major markets, and low wages with capacity to respond to the buyers' tastes and a fashion trend. But Nepal did not possessed strong positions in none of these competitive factors, besides the labor endowment.

During the ten-year preparatory period, the impact of MFA and ATC was widely discussed, but no concrete measures and strategies were envisaged to adapt with the changing pattern of the trade in textile and clothing. The only step seriously initiated was the lobbying for a preferential treatment for Nepalese apparels in the US, which was obstructed later on (See Chapter II for more.). Whereas, no efforts were put on to exploit the preferential market access for Nepalese apparels in the EU, which was

already available. This paradox clearly reflected a mismatch or a deficiency in a strategy for the post MFA preparation. As already mentioned in the previous chapters, the preferential market access remains an important factor vis-à-vis Nepal's competitiveness and the practices over these arrangements that prevailed internationally. But it shouldn't be a long-term goal in any way. Ultimately, the survival of the Nepalese garment industry will depend upon how it builds capacity towards providing a full package of manufacturing and delivery system, taking into consideration of the changed trading environment. Bearing that, the major areas of concentration should include as follows:

i. Market access opportunities

The markets for Nepalese garments in a quota free trade can be observed distinctly on the preferential and non-preferential market access opportunities. With two different market behaviours, it is required to build two separate strategies to retain positions in the respective markets and contribute to growth of the overall export volume. The US remains a major destination in terms of size, but not with regard to easier market access opportunity. Because Nepal has lost the comparative benefit, due to fierce competition from previously quota constraint countries, on the one hand, and lost a level playing field with countries benefited by the US duty preference, on the other. Considering this reality, the immediate strategy for American market should be an intensified lobbying for the US duty-free market access, aiming at the level playing field and also achieving a means to off set the high price through a duty advantage.

It is important to note here that the three separate HMG-private sector delegations, led by the high-level government representative, had visited the US for support from the Senate and Congressmen for the Nepal Bill, granting preferential treatment to certain Nepalese apparels, during 2003 and 2004. The programmes were launched under the joint financial participation of HMG and the GAN. Unfortunately, the Bill remained defunct. However, in the long run, the market access opportunity would purely depend on the strategy based on production efficiency and the marketing mix. (See sections below.) In the meantime, Nepal can see the EU and Canada as two potential markets with preferential treatment. The share of EU in Nepal's total apparel export

indicated promising signs in latter years, whereas the Canadian share remained insignificant (Table 12).

TABLE 11

**Share of EU and Canada in Nepal's apparel export value**

In percentage

Year	Canada	EU
1991-92	3.12	2.54
1995-96	1.26	10.44
1996-97	2.09	12.53
1997-98	0.74	14.30
1998-99	0.89	9.22
1999-00	1.28	17.14
2000-01	1.26	12.95
2001-02	1.51	17.23

*Source: Own calculation based on available data at GAN and other sources.*

Equally important is to note that Nepalese exporters are unable to exploit the preference in EU to a fuller extent, partly due to lack of economic order size and promotional activities, despite that Nepalese apparels got duty free privilege with relaxed origin rule for the same. Considering a rapidly losing American market share, it is high time that Nepalese exporters concentrate to the EU and Canada by escalating promotional programmes on priority basis.<sup>43</sup> This is primarily important to market diversification effort, so that Nepal can compensate the loss incurred in the American market. Nepalese producers should concentrate on man-made fiber items to gain higher rate of protection in EU as these items are subject to higher tariffs. A provision of a separate programme and fund, under the public-private sector approach, should be envisaged for market promotion in the EU immediately. The Export Promotion Committee (EPC) and the GAN should play lead role from the respective sides.

The prospect of Indian market for Nepalese garments should not be undermined. With faster export growth rate, due to abolition of quotas, India has emerged as one of the leading suppliers after China. But a gradual rise in input and output costs in India

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<sup>43</sup> Although Nepalese exporters take part in American trade fairs on regular basis, they have hardly given priority to the EU trade fairs for promotion of garments, despite there was prospect of market expansion. Consequently, they lacked adequate knowledge for marketing in the EU.

already indicated search for cheaper production location.<sup>44</sup> If that is any indication, the chances of Indian business spill over to Nepal is imminent, as the former would see the latter the best place to locate manufacturing or for sourcing from, due to a bilateral preferential trade treaty between the two and geographical proximity. Advantage of cheaper labor cost and the lower mark-up in pricing among relatively small Nepalese manufacturing could be another attractions for Indians. The idea of consolidating Nepalese garment industry, with the new concept of a GPZ (See below), could give extra leverage to Nepal for attracting Indian business spillover, as the apparel sector in India is not yet well prepared to fully exploit the gain from liberalization as China did.<sup>45</sup>

## ii. Product innovation and skill development

As mentioned elsewhere, the commodity type items have been dominating the production of Nepalese apparel manufacturers. The reasons for confining to the low priced items in the past were due to lack of indigenous skill for design and fashion, and also because of the practice to follow only the buyers' design and requirements. The past practice had not encouraged Nepalese producers to divert from the product mix of commodity type to high fashion wears and to product innovation. With increased competition in commodity type items in a quota free trade, Nepalese producers should focus on fashion-oriented high value products for niche markets. But identification and production of such high value added category cannot be made without development of trained manpower and fashion institutes. Presently, there are no fashion institutes or vocational centers for textile and garments, which are effectively working. Initiative should be immediately taken in the form of a partnership between the private sector and the government to establish or strengthen the existing textile training centers for immediate improvement in productivity and innovation through skill development (as explained in Chapter III).

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<sup>44</sup> The booming business in India has already increased input costs, due to change in factor demand and the internal tax structure, affecting profitability and the existing export subsidy.

<sup>45</sup> According to an article by Arvind Panagaria in *The Economic Times* (16 Nov. 2004), unless India undertakes major reforms of its textile sector by facilitating entry of larger scale industries to substitute currently fragmented apparel industry with tiny units, it won't be able to exploit the prospect of open trade to expectation.

The Readymade Garment Training Centre, which was established under the JICA and HMG, was operating since 1981. The Department of Cottage & Small Industry took responsibility to run the training center after termination of the JICA assistance, by signing a memorandum of understanding with the GAN in 1919 for absorbing the manpower produced by the centre. However, the manpower produced by the center could not be absorbed by the existing garment industries as they were not trained to be able to meet international requirements and also lacked talents to run modern equipment and perceive the latest international fashion trend. It would be advisable to activate the existing training institute under the Department by restructuring and strengthening with modern equipment, including a fashion and design curriculum to match with the latest trend, and coordinating with regional fashion training centers.

<sup>46</sup> The training center can

be converted into a specialized institute for textile and garment research for quality and design, with ownership of the GAN. For effective results, the institute can be established inside the GPZ with intention of coordinating demand for and supply of the skilled manpower.

### iii. Adaptation to the changing trade environment

Although it seems difficult to sketch an exact picture of the international apparel trading environment, except for some latest developments as explained in chapter II, more changes are imminent. The policies with regard to regional and multilateral negotiations have a special bearing on international clothing trade. There is a very likely chance of escalating use of trade remedy measures, such as safeguards and anti-dumping, by major importing countries, as is the case that the US and EU have recently taken against the Chinese import surge in the respective markets. The action against China has created uncertainty to place orders by importers, diverting their export orders to other countries. Seemingly, such kind of actions have nothing to do with the Nepalese garment industry, but they could turn into benefits to Nepalese exporters, provided they understand the environment and have capacity to absorb the business in a competitive way. Although the trade diversion benefit is not

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<sup>46</sup> The most appropriate links for Nepalese garment sector initially would be with the Textile Training and Services Centre in Colombo and BGMEA Institute of Fashion and Technology in Dhaka.

immediately expected, it is suggested that Nepalese manufacturers get prepared to attract the business spillover.

Since the Nepalese apparel industry is totally based on exports, it is required for them to keep abreast of the likely effect of the changes taking place in international trade policies, regarding various forms of non-tariff barriers, and requirement to social compliance including the environmental and socio-labels, which could take new forms of application. It would be important for Nepalese manufacturers to understand their positioning in international market and their competitive strength vis-à-vis their competitors in the region and elsewhere for adapting to the environment. Failure to understand the preferential rules of origin has actually resulted in Nepalese producers' inability to exploit the advantage of preferential market access in EU and Canada as already explained above.

Although a number of Nepalese products are subject to duty free treatment under the GSP schemes in developed country markets, export of garments are still excluded from the privilege in a major market like the US. Nepal should take a lead role in forming alliance among the LDCs to raise the apparel issue at the WTO forum and give pressure to make the duty free market access for all LDC exports, including clothing, binding. The developments made under the NAMA negotiation of the DDA should be carefully watched to raise the issue at the forthcoming WTO Hong Kong ministerial meeting (See also Chapter II).

Currently, there is no any government or private sector institution responsible for analysis and dissemination of information on the environmental aspect of the international clothing trade in Nepal. The WTO divisions at the MoICS and GAN should be working in parallel and be equipped with required infrastructure and human resources for taking over these activities to strengthen negotiation capacity at the multilateral level and also to build an ability to adapt with the multilateral trading environment. This is important not only for market penetration, but also to coordinate between the government and private sector for negotiation capacity at the WTO and also to minimize the cost incurred due to ignorance. In addition to that these organizations can jointly launch training and workshops for garment entrepreneurs and the government officials for the proactive roles to be played from the respective sectors.

#### iv. Vertical production and consolidation of industry through GPZ

Considering the need of a large-scale operation with a greater control over the management of sourcing and supply chain, the concept of GPZ<sup>47</sup> was floated in the GAN's report to the government in 2002. The concept has a lot of sense to Nepalese garment industry, which is more vulnerable to the new trading system. A detail study of the concept and the modality of its structure and implementation should be undertaken without delay.

Conceptually, the GPZ and EPZ look similar, but there is a mark difference between the two. Unlike the EPZ, which is primarily for facilitating rebate from taxes and to effectively implement the duty drawback, the GPZ intends to industry consolidation as a short-run objective and the vertical production in the long run. The GPZ, as being a product specific and export oriented should meet various special functional areas to match international excellence. It should be well equipped with all kinds of basic infrastructure, trade support services, and also the individual factory commitments.

The GPZ as an industrial estate can facilitate the output at a larger scale with economies, by concentrating garment manufacturers closely and helping them to consolidate the overall output. For strengthening of the industry as a whole the participating firm can also jointly establish sophisticated and costly technology (as explained in chapter III), which could have been expensive on individual industry basis. They can also initiate cooperative purchasing of imported raw materials, mainly high value fabrics and materials, at the most competitive price to reduce manufacturing cost.

The idea of GPZ could be an instrumental for clustering of ancillary industries and also providing all kinds of services near to the production. Initially, the establishment of basic raw material manufacturing (such as gray fabric, threads, label, plastic inserts and clips, tags, zippers, buttons, and packing materials among others) with low investment can be streamlined. Other service providers to garment manufacturing and

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<sup>47</sup> Foreseeing constraints in quota free trade, the GAN proposed the idea with basic objectives for production consolidation, procedural simplification, and meeting buyers' requirement for work place condition, to HMG in 2002. According to an informal source, the idea has been agreed in principle by the government and in the process of materializing this.

trade, as for example fabric engineers, technicians, fashion designers, cargo and logistic suppliers, as well as the commercial banks and other facilities, can be attracted at one location. By doing this there could be a greater control over the entire sourcing and supply chain to expedite production and delivery.

The idea of industrial cluster has more significance with regard to the increased responsibility of suppliers over international buyers in the changed context. Unlike in the past, buyers will give all responsibilities to suppliers and probably be asking delivery at DDP term. The services, which were excluded by the agents, will have to be handled by Nepalese exporters themselves. The production units within the zone could be developed according to the international buyers' requirement to comply with work place conditions. Most of the industries had not met the work-place code appropriately, as they were located in rented residential houses at center of Kathmandu, which were not meant for garment industries. An intervention for a special provision of bank financing for factory plants within the zone is highly recommendable.

With regard to cumbersome trade and transit procedures, the GPZ can contribute to procedural simplification by establishing a single window system, within the zone, for all kinds of government and export documentation (for instance, collection of export license, recommendation letters, certificate of origin, GSP forms, etc.). It is very important for GPZ to be constructed near to the inland container depot (ICD) in Birgunj, which is supposed to be the country's main transit point for external trade. The proximity to the transit point is basically meant for cutting down land transit times through reduced handling and less cumbersome procedures. The connection with Birgunj ICD is also crucial to optimize transportation time and container space, which is most prominently faced by the Nepalese traders at Kolkata port.

In the long run, the collective demand for a larger quantity of textiles by the industries inside the GPZ can attract domestic and foreign investment in modern fabric industries, which are capital intensive and has relatively larger optimum size of operation. With development of fabric base, it can ultimately meet the vertical production with more possibility of import substitution. Apart from that it will also facilitate Nepalese apparels to meet stringent rules of origin for preferential market

access, wherever applicable. Moreover, the full-fledged GPZ will, on the one hand, help control cost at each level of production to be price competitive, and to reduce the lead-time for the efficient delivery, on the other. Also the idea of GPZ has become more valuable with regard to new competitive ways promoted in efficient countries.<sup>48</sup> As already mentioned above, the GPZ with an approach to industry consolidation and industrial cluster is also important to attract likely business spillover from India as the Indian producers could see consolidated production base in Nepal as an alternative to source from and also to offset the rising costs there.<sup>49</sup> The bilateral preferential trade arrangement between the two countries, together with the benefit of an open border system and geographical proximity, create more possibility of business transfer from India to Nepal in the post MFA trade, provided the GPZ materializes.

#### v. Public-private sector partnership approach

Considering the contribution of the garment sector to the economy and impact from its deteriorating situation, the private-public sector partnership is urgently needed. Instead of forming new bodies, the simplest way to facilitate this objective through the public-private sector partnership could be by broadening the role of the existing Readymade Garment Export Promotion Committee (RGEPC)<sup>50</sup> with more authority. Essentially, the body should pay special attention to the measures recommended by this report, among others, and develop them as an integrated framework to rescue the industry from the current situation. This is not possible without harmony, coordination and networking among the agencies related to the private and government sectors under the guidance of the committee.

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<sup>48</sup> Such as the "supply-chain city" as developed by a Chinese company in Dongguan, China, covering 180,000 sq. mt. industrial area with facilities to accommodate 4000 workers and capacity to house all kinds of manufacturing and services related to garment manufacturing at one location as preparation to meet the business orders from the opportunities in post MFA.

<sup>49</sup> Because there is a possibility of business spillover from India as the booming export trade after elimination of quotas is gradually making the Indian garment sector difficult time to face with rising input costs, due to change in factor demand, the internal tax structure, export subsidy and profitability. Although India has experienced a growth in export after 2004, the rate is not to expectation. It is said that unless it undertakes major reforms of its textile sector by facilitating entry of larger scale industries to substitute currently fragmented apparel industry with small units, it won't be able to exploit the opportunity.

<sup>50</sup> The RMGEPC, chaired by the Secretary at the Ministry of Industry, Commerce & Supply, is represented by Ministry of Finance, departments of Industry, Commerce, Customs, Cottage and Small Scale industries, and Labor and Employment Promotion. Representatives from Nepal Rastra Bank, Nepal Productivity & Economic Development Centre (NPEDC), Trade Promotion Centre (TPC), Garment Association – Nepal (GAN) and a representative from garment entrepreneurs, including a joint secretary at MoICS are also included.

Hence, the committee should, in general, be responsible for formulating strategies and programmes as guidance, and enforcing the decisions with a full authority and executive power, in particular. For simplification of trade procedure and administration, as already mentioned in chapter III, interventions are needed in administration and policy measures with time bound. That will immediately help reduce transaction cost to some extent and give relief to the ailing industry.

For a long-term goal, the scope of the public-private sector partnership should concurrently focus on three broader areas: continuity to lobbying for duty free market access in the US; intensified promotional programmes to exploit the GSP markets (Canada and EU); and development of a modality for construction and operation of the GPZ. A technical body, representing all concerned, should be immediately formed for designing operation and management modality of the GPZ. The body should, without delay, develop a framework for land allotment, provision for financial and managerial aspects, including the private sector ownership. It is also advisable to develop a modality to mobilize external resources to meet the financial requirement for construction of the GPZ. All these things cannot be determined without forming a technical committee, consisting of specialists in the industrial district designing and construction. Overall, a long-term policy for stability in implementation of various measures with regard to the garment sector has become indispensable.

## Policy action matrix

### 1. Solution to supply side problems

Constraints	Action/intervention	Expected outcome	Responsible body	Time frame
i. Non-competitive technology	Set up a matching fund.  Facilitate bank loans on sophisticated technology.	Manufacturing and designing efficiency.  Product diversification with high values.  Response to buyers' tastes and preferences.	EPF/EPC  NRB  Commercial banks	Immediate
ii. Low labour productivity	Restructure existing textile training center.  Transfer ownership to GAN and station at GPZ.	Enhanced productivity in manufacturing, merchandising and marketing.  Benefit of skill development programmes	MoICS  Dept of CSI	Short to medium term
iii. High transaction and transit costs	Fully operate Birgunj ICD and modernize other dry ports	Reduced land transit time; handling cost; and cumbersome procedure  Competitive charges for clearance container  Cuts lead time effectively	MoICS	Immediate
iv. Lack of direct marketing network and observation of international trade policy and buyers' requirement	Provision of specialized cells to monitor international trade and marketing policy	Compliance to buyers' requirement for product and price  Update and disseminate information on market access opportunities and border regulation (in importers' country)  Assess impact of international trade policy to adapt with changed environment	TPC  GAN	Immediate

\* Immediate = within next three months; Short term = within next 12 months; Medium term = within next 18 months

## 2. Overcoming administrative complications

Constraints	Action/Intervention	Expected outcome	Responsible body	Time frame
i. Complications in bank financing	<p>Prioritize garment sector for bank financing under soft loans.</p> <p>Reduce bank rate to 4-6% and also other bank commissions.</p> <p>Apply collateral requirement for funding loans only.</p> <p>Encourage project loans.</p> <p>Pre and post shipment financing based on LC.</p>	<p>Lower and competitive bank financing costs.</p> <p>Encouraged investment in latest technology.</p> <p>Expansion and modernization of industry plant.</p>	<p>NRB</p> <p>Commercial banks</p>	Immediate
ii. Cumbersome process in bank guarantee for bonded warehouse	<p>Approve single bank guarantee for recommendation of bonded warehouse.</p>	<p>Simplification of administrative procedure with reduced cost and time</p> <p>Effective implementation of export facility</p>	<p>Department of Internal Revenue</p> <p>Department of Customs</p>	Immediate
iii. Refunding VAT	<p>Refund within 30 days of request made for claim.</p>	<p>Simplification in tax clearance.</p>	<p>Dept. of Internal Revenue</p>	Immediate
iv. Discrepancy in recognizing export oriented industry for access to export benefits	<p>Make standard rate for compulsory export volume requirement for recognizing export oriented industry</p>	<p>Harmonized administrative procedure</p> <p>Minimize inconsistency in granting export facility</p>	<p>Department of Customs</p> <p>Department of Internal Revenue</p>	Immediate

\* Immediate = within next three months; Short term = within next 12 months; Medium term = within next 18 months

### 3. Intervention in policy issues

Constraints	Action/Intervention	Expected outcome	Responsible body	Time frame
i. Rigid labour law	Amend labour law with a hire and fire provision.  Make provision of contract labour law.	Increased employment and output.  High labour turnout with low frequency of workers' movement  Good labour – management relations  Respect to core international labour standards  Motivate workers' through training for productivity and skill development	MoLTM	Short term
ii. Cumbersome income tax clearance	Impose income tax on flat rate basis on total export earning, not exceeding 0.50%.  Collect income tax at source of export.	Simplification of income tax procedure.  Indirect incentive to rescue the industry from current situation.	MoF	Immediate

\* Immediate = within next three months; Short term = within next 12 months; Medium term = within next 18 months

#### 4. Exploitation of market access opportunities

Constraint	Action/Intervention	Expected outcome	Responsible body	Time frame
i. Mismatch in marketing strategy	<p>Introduce separate strategies for preferential and non-preferential markets</p> <p>Give continuity to lobbying for US duty free treatment</p> <p>Intensify promotional programmes in preferential markets, particularly in EU</p> <p>Establish separate EPC fund for EU market promotion</p>	<p>Utilization of preferential treatment</p> <p>Diversification of markets</p> <p>Compensation to loss of export business in US</p> <p>Increased response for business from buyers in preference giving countries</p>	<p>MoICS</p> <p>EPF/EPC</p>	Immediate
ii. Lack of product innovation and skill development	<p>Activate and restructure existing Readymade Garment Training Centre and promote private sector fashion institutes/centers</p> <p>Introduce relevant fashion and design curriculum</p>	<p>Skilled manpower for product development</p> <p>Quality control</p> <p>Shift from low to high value items</p> <p>Ability to monitor latest designs and market trends</p>	Dept of CSI	Short term
iii. Difficulty of understanding WTO issues and market access negotiation	<p>Coordinate between WTO divisions at MoICS and GAN</p> <p>Form alliance with LDCs to make preferential market access binding at WTO</p>	<p>Perceiving WTO issues with regard to market access; NTBs; and trade remedy measures.</p> <p>Understand preferential rules of origin and market access.</p> <p>Build market access negotiating capacity</p>	<p>MoICS</p> <p>GAN</p>	Immediate

\* Immediate = within next three months; Short term = within next 12 months; Medium term = within next 18 months

## 5. Development of vertical production and industrial consolidation

Constraints	Action/Intervention	Expected outcome	Responsible body	Time frame
i. Limitation to developing backward linkage	Introduce industrial policy with special focus on ancillary industries (poly bags, packing materials, gray fabric, zippers and threads etc.)	More value addition  Supports backward and forward linkage for import substitution and vertical production	MoICS	Short term
	Consider supply of domestic ancillary industries to export manufacturing as deemed export	Efficient management of sourcing	MoF	
ii. Lack of consolidated production and industrial clustering	Construct GPZ.	Consolidated production capacity	MoICS	Short term
	Form technical body to formulate operation and management modality of GPZ.	Clustering of industries and services for vertical production		
	Apply special labour law with provisions of fire and fire, and contact labour, with respect to standards for work-place code of conduct.	Cooperative purchasing of costly and sophisticated tech materials		
	Establish single window system for trade procedure	Control of sourcing and supply chain to reduce cost at each level of production and expedite delivery		
	Construct GPZ close to Birjung ICD	Attract textile industries to meet fabric based rules of origin		
	Privileged bank financing for plant construction inside the zone	Help meet work place code of conduct requirement		
		Attract likely business spillover		

\* Immediate = within next three months; Short term = within next 12 months; Medium term = within next 18 months

## 6. Private-public partnership approach

Constraint	Action/Intervention	Expected outcome	Responsible body	Time frame
i. Inadequate private-public sector partnership approach	<p>Broaden the role of existing RGEPC and give more authority with responsibility for decision-making and implementation.</p> <p>Give responsibility to RGEPC for:</p> <ul style="list-style-type: none"> <li>▪ Facilitating lobbying strategy for US duty free treatment;</li> <li>▪ Promotion in preferential markets; and</li> <li>▪ Expediting process for GPZ construction</li> </ul> <p>Formulate a long-term policy on garments</p>	<p>Develops coordination and networking between private and public sector units to overcome policy complications</p> <p>Support to national level strategy for common goal.</p> <p>Brings stability in implementation of policy measures.</p>	MOICS	Immediate

\* Immediate = within next three months; Short term = within next 12 months; Medium term = within next 18 months

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