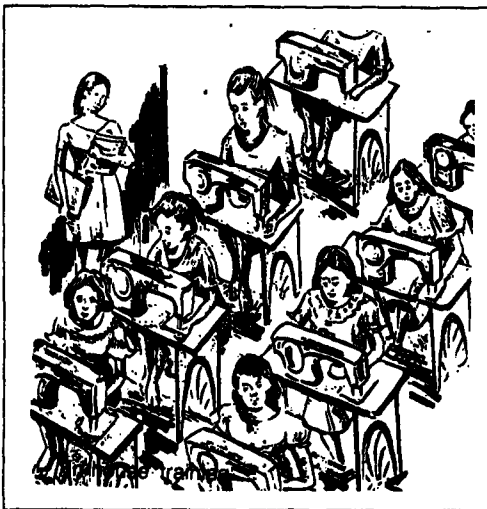


The conclusion of the Uruguay Round, the most ambitious round of General Agreement for Trade & Tariff (GATT) negotiations at Marrakesh on 15th April 1994 is undoubtedly the most significant achievement witnessed in the recent history of the international trade regime. It expanded the scope of the multilateral trading system to cover three major areas which were not within the purview of GATT, namely General Agreement of Trade in Services (GATS), trade-related intellectual property rights (TRIPS) and trade-related investment measures (TRIMS). In addition, the Uruguay Round addressed agriculture and textiles, the two major product sectors which had previously remained outside GATT. Moreover, the Uruguay Round resulted in the establishment of the World Trade Organisation (WTO), a common and permanent institutional framework for the conduct of trade relations among its members on matters related to the Uruguay Round agreements and associated legal instruments. GATT, the mechanism which governed international trade in manufactures from 1947, has now become part of the WTO.

The WTO regulations, which advocate progressive liberalisation of trade



The WTO and the Textile and Clothing Industry of Sri Lanka



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in goods, services and other related areas, will have a variety of consequences on the economies of both developed and developing countries. According to some critical analysts, the WTO has become the main tool for the developed countries to organise and enforce global economic governance to their advantage. However, proponents of liberalisation argue that the world community as a whole will benefit from the WTO, since the regime generates more trade and ensures optimum utilisation of resources across the globe. In the light of these contending claims, it is important for us to examine the merits of the Uruguay Round agreements vis-à-vis particular countries and particular commodities. This paper assesses the implications of the abolition of the Multi-Fibre Arrangement (MFA) on the textile and clothing industry in Sri Lanka and makes some policy recommendations.

The MFA, which was initially meant to be temporary, has been in existence for nearly a quarter-century, with four successive extensions in 1977, 1981, 1986 and 1994. However, the WTO now requires integration of textiles and

clothing trade into the GATT/WTO over a period of ten years from January 1995 by abolishing all existing textile agreements concluded under the framework of the MFA. Consequently, the quota system which restricts the developing-country exports of textile and clothing products will be phased out totally by 2005.

The abolition of quotas is likely to have mixed consequences on both developed and developing countries which currently regulate their textiles and clothing trade under bilateral agreements. While the developed countries are expected to face severe competition from low-cost imports, the developing countries will have an even more difficult task of retaining their market shares which have been protected by the present quota system. The removal of quantitative restrictions from world textile and clothing trade by the year 2005 is likely to pose a difficult challenge for the textile and clothing industry of Sri Lanka.

Apart from the abolition of quotas, North American Free Trade Agreement (NAFTA), emerging trade relations between eastern-European

countries and the west, the EU's termination of GSP (Generalised System of Preferences) treatments against Sri Lankan apparels, the recent depreciation of currencies in several countries in the Asian region, etc. are also likely to pose considerable challenges to the Sri Lankan textile and clothing industry. In the light of the possible implications of these additional factors, it is rather difficult to assess the impact of the removal of quotas in isolation. However, in the context of this paper, the focus is confined to the phasing out of MFA-quotas.

The Textile and Clothing Industry of Sri Lanka

From a modest beginning in the early 1960s, the textile and clothing industry has developed over a relatively short period to become the largest industry in the Sri Lankan economy. In 1996, 40 per cent of the country's industrial production was from the textile and clothing sector. While this sector accounted for 46 per cent of exports, its share of industrial exports reached as high as 63 per cent¹.

The history of the Sri Lanka textile and clothing industry could be divided into two stages - the period from the 1950s to the late 1970s and the period after the late 1970s. Sri Lanka began to promote its textile industry in 1950s as an import substitution industry (ISI). Since cotton is not produced in Sri Lanka, the industry relied on imports for its requirements. Consequently, the Sri Lankan textile industry was confined to three stages of production: (a) spinning (production of yarn); (b) weaving or knitting (production of grey fabric); and (c) finishing, dyeing and/or printing (production of finished fabric).

A few large-scale textile mills, established under government ownership, accounted for the majority of the locally produced textiles. In addition, a considerable number of power-loom and handloom centres were engaged in the production of yarn and fabrics.

Importation and distribution of raw materials were tightly controlled by the government. Imports of fabrics were either restricted in order to support the infant domestic industry. The textiles produced by these government-owned factories as well as power-loom and hand-loom centres were basically for the domestic market. As in the case of many import substitution industries, the textile industry did not at this stage make much progress in the process of production and marketing. The product range was limited to a few standardised varieties. As the market was highly protected, there were hardly any initiatives to enhance the quality of the product.

The clothing industry, which commenced during mid-1960s, possesses a modest beginning. Unlike the textile industry, the clothing industry was mainly run by the private sector. Initially, almost 100 per cent of the apparels produced by these manufacturers were for domestic consumption. A majority of the production was for the lower end of the market. A large share

of the industry was in the hands of a few leading companies. Since importation of fabrics was either banned or highly restricted, the clothing industry was mainly fed by locally produced materials. As both textile and clothing industries continued to focus on the domestic market, there were hardly any exports during this period.

Period after the late 1970s

The period after the late 1970s saw a rapid expansion of the clothing industry in Sri Lanka. The impressive growth witnessed during this period can be attributed to two major factors. The first is the market-oriented liberal economic policies introduced in 1977. The market-friendly economic reforms, which identified the private sector as the engine of growth, placed greater emphasis on the export-led industries. The supportive measures taken by the government in this direction included: exchange-rate devaluation; subsidy and duty rebate schemes; duty-free imports of machinery and raw materials; lower corporate taxes including tax holidays; etc. These incentives, coupled with the availability of easily trainable cheap labour made Sri Lanka an attractive location for labour-intensive industries such as garments.

The second important factor which contributed to the remarkable expansion of the Sri Lankan textile and clothing industry is the MFA. Sri Lanka is one of the countries that benefitted from the previously described "quota hopping" investments.² The overseas manufacturers of garments who relocated their production facilities in Sri Lanka include firms from both East Asian NICs and Europe. While the NIC firms moved their operations mainly as a means of "quota hopping", the



motivation for producers of countries such as Germany and the UK to move into Sri Lanka was the rising production costs in their home countries. Given the easy separability of the different stages of the clothing industry, these overseas producers were able to disintegrate their production lines into low-cost countries like Sri Lanka without much difficulty. Investments by these two categories of foreign manufacturers fuelled the growth of the Sri Lankan clothing industry to a large extent. In fact, the factories set up as joint ventures and wholly owned foreign companies account for almost half of the total export earnings from garments.³

Sri Lanka's liberal economic conditions, cheap labour and, more importantly, the underutilised quotas also prompted a fairly large number of local entrepreneurs into the clothing industry. As a result, about 80 to 85 per cent of garment factories are currently owned by the local industrialists.⁴ However, except for a limited number of firms, their production volumes have been rather small.

200 Garment Factories Programme (200 GFP)

In view of the better infrastructure facilities and close proximity to the port and airport facilities etc. most textiles and clothing manufacturers concentrated their operations in or around the Western province, where the country's capital is located. As a result, unemployment - one of the major problems faced by Sri Lanka - continued to remain high in the other parts of the island. Growing unemployment resulted in youth unrest in most of the rural areas. Thus, in 1990, a Cabinet Sub-Committee recommended that garment factories should be opened in provincial areas

other than the Western Province. Consequently, the 200 Garment Factories Programme (200 GFP) was launched with the idea of opening at least one garment factory in each of the 200 Assistant Government Agent (AGA) divisions.

The main incentive which encouraged the private sector to take part in this programme was quotas. For this purpose, the remote areas of the country were classified into three categories, namely non-difficult, difficult and most difficult. Quotas were allocated on the basis of the location of the industry. The more isolated and difficult the area, the higher was the quota allocated. While about 40 per cent of the areas were identified as difficult, just over 40 per cent fell within the most difficult category. The rest, just under 20 per cent, were classified as non-difficult.⁵ In addition to quotas, the factories set up under the 200 GFP were also offered various other incentives such as tax holidays or lower corporate taxes, duty-free importation of machinery and raw materials, loans from foreign currency banking units, etc. As the main thrust behind the 200 GFP was the high unemployment in the rural sector, each factory was intended to employ at least 500 workers. By the end of 1996, there were 154 factories in commercial operation under this programme, providing 76,821 employment opportunities.⁶

The Role of Textile and Clothing Industry in the Sri Lankan Economy

At the time Sri Lanka began to pursue liberal economic policies in 1977, the textile and clothing industry played only a minor role in the country's economy. In the light of the broad-based economic liberalisation and the benign impact of the MFA, the industry since then has recorded a re-

markable growth and assumed a key role in the economy. While garments accounted for the largest share of all commodity exports (27 per cent) in 1986, it became the largest foreign exchange earner (US\$ 0.4 billion) by 1992. By 1995, garments exports exceeded US\$ 1.5 billion - nearly half of all commodity exports.⁷

Of the 21 per cent contribution made by the manufacturing industries to the country's GDP in 1996, 40 per cent was from the textile and clothing sector. In fact, this has now become the largest industry within the manufacturing sector. The growth of the garments industry was particularly rapid in 1992 and 1993 due to the attempts taken by the government under the 200 GFP to decentralise the industry away from the Western Province. Although the textile and clothing sector registered a slow growth of 5.1 per cent against 14.8 per cent in 1995, it still accounted for 33.7 per cent of the growth witnessed in the private sector industrial output.⁸ (The slow growth in 1996 was primarily because of the continued power cuts due to prolonged drought). According to the Ministry of Industrial Development, there has been a total of 845 garment factories at the end of 1996 while the number of textile manufacturing firms stood over 140, with less than 10 companies accounting for most of the output. The largest garment factories (in terms of employment) were located within the free-trade-zones (FTZs) run by the Board of Investment of Sri Lanka (BOISL) - the authority responsible for the promotion of foreign direct investment.

Today, the textile and clothing sector has replaced the tea industry - the traditional front line export industry - as the leading foreign exchange earner. Specially, the growth

of garment exports has been highly impressive. For instance during the period 1980 to 1990 the value of apparel exports increased from US\$ 100 million to US \$ 620 million. In terms of quantity, the exports grew from 52 million pieces to 212 million pieces during the same decade. Exports of garments, which was only 10 per cent of Sri Lanka's total exports in 1980, reached nearly half in 1993, registering an average annual increase of 30 per cent.⁹ In 1996, the textile and clothing sector accounted for 46 per cent of the country's total exports earnings. Its share among the industrial exports reached as high as 63 per cent. The highest growth, (21 per cent) was in the woven fabric categories.

The textile and clothing sector has also been an outstanding source in generating employment opportunities. Being a highly labour-intensive industry, this sector has been successful in absorbing a fairly large number of workers. By the end of 1996, the manufacturing sector as a whole represented about 14 per cent of the 5.5 million of the country's total employed work-force.¹⁰ Approximately 40 per cent of which was engaged in the textile and clothing sector. Of the total work-force employed in the textile and clothing in-

dustry, more than 60 per cent was with the clothing sector.

Major Markets of Sri Lanka

Since more than 90 per cent of exports from the Sri Lanka's textile and clothing industries consists of ready-made clothing, the focus here is on clothing.

Sri Lanka currently maintain bilateral textile agreements in the context of the MFA with Canada, the EU and the USA. More than 90 per cent of Sri Lanka's exports of clothing are accounted by only two markets - the EU and the USA (Please see Table I).

As indicated in the table above, the USA continues to account for about 60 per cent of total clothing exports from Sri Lanka. About 90 per cent of exports (by value) to the USA consists of quota items.¹¹ The bilateral agreement between the US and Sri Lanka contains more than 30 quota categories, covering over 50 clothing items. While the quota performance against the US market is generally high, the utilisation rate of certain quota categories such as knitted shirts and blouses, trousers, underwear, coveralls and overalls, terry and other pile towels etc. has reached almost 100 per cent during the recent years.

The EU has been absorbing about 35 per cent of Sri Lanka's total exports of clothing every year. The largest buyer of Sri Lankan garments within the EU is the UK (about 45%) which is followed by Germany (about 20%), the Netherlands (about 9%), France (about 5.5%), Belgium- Luxembourg (about 5%) and the rest Sri Lanka's exports to the EU has been subject to quotas under four categories - namely, 06 (trousers), 07 (blouses), 08 (shirts) and 21 (jackets). The utilisation rate of quotas of the first three categories

(most sensitive ones) during 1996 was 84 per cent, 101 per cent and 73 per cent respectively, while the rate of the fourth category was nearly 30 per cent.

Canada continues to account for about 1.5 per cent of Sri Lanka's total exports of garments. While Sri Lanka's bilateral textile agreement with Canada contains about 15 product categories under quotas, the average rate of quota utilisation has been around 55-60 per cent in the recent past, although it dropped to 38 per cent in 1996. Australia, Japan, South Korea and Switzerland have been among the other importers of Sri Lankan garments. Although the exports of garments from Sri Lanka have been steadily increasing over the last several years, they still remain less than 2 per cent of the world total.¹²

The Removal of MFA Quotas: The Implications

On the eve of the phasing out of the MFA, contrasting views are been expressed about the future of the Sri Lankan textile and clothing industry. For example an article in the Japanese Textile and Garment Newsgroup (JTN) Quarterly (in 1995), which paints an optimistic picture, states that:

"All in all, the Sri Lankan garment industry will grow rapidly for the next 20 years and there are no signs of Sri Lanka losing its comparative advantages in garments exports to newcomers such as Vietnam and Cambodia."¹³

In contrast to this optimistic view, a study by Page and Davenport suggests that Sri Lanka would be among the net losers from the phasing out

Country	Value (SL Rs.Mn)		Percentage of Total Value	
	1995	1996	1995	1996
Canada	1,420	1,252	1.7	1.3
The EU	29,035	32,945	34.2	35.1
The USA	51,448	56,251	60.7	60.0
Others	2,903	3,366	3.4	3.6
Total	84,806	93,814	100.0	100.0

Source: Sri Lanka Customs

of quotas.¹⁴ Further, the Central Bank of Sri Lanka, commenting on the textile and clothing industry of Sri Lanka, warns that:

Therefore, it is important to recognise that Sri Lanka, as well as other developing countries, who have benefitted by the present quota system will have to face effectively a more competitive trading environment in the foreseeable future and to be prepared with necessary structural changes in the industry to meet this challenge.¹⁵

What is evident is that the abolition of quotas will result in increased competition among the exporting countries of textile and clothing products. The major importing countries like the USA and the EU have been able to avoid integrating most of the product categories that are of export interest to developing country exporters during the first two phases. Hence, increased competition among the exporting countries will appear only with the beginning of the third phase of the integration process, i.e. from January 2002. The biggest challenge for small producers like Sri Lanka will be from the large-scale, low-cost countries like China who have enormous comparative advantages.

The following five major drawbacks are likely to make Sri Lanka a net loser with the removal of quotas.

- (1) declining competitiveness
- (2) heavy reliance on quota categories
- (3) high concentration on a few markets
- (4) lack of direct marketing links with major buyers
- (5) heavy dependence on imported inputs

Declining Competitiveness

Current trends indicate a reversal and slowing down of the initial momentum of Sri Lankan garment industry, which could lead to a serious decline and loss of its competitive edge unless remedial measures are implemented soon.

The above statement from the Ceylon Daily News gives a clear warning that the Sri Lankan clothing industry is likely to lose its competitive edge unless timely action is taken to remedy the situation.

The clothing industry in Sri Lanka is one of a large number of small production units with considerable subcontracting. At the start of 1990s, Sri Lanka's garment industry consisted of 350 direct export firms and over 500 smaller sub-contractors.¹⁶ Therefore, many of the factories in Sri Lanka are below the minimum efficient size.¹⁷ The small size of the factories has prevented them from achieving technical economies of scale in the garment industry as a whole. In addition, it has been difficult for the industry to enjoy financial economies of scale such as obtaining better discounts on orders of fabrics and other accessories as well as proper prices for their finished products.

The other main factor which could lead to the erosion of the competitive edge of the garment industry concerns higher labour costs. International buyers no longer consider Sri Lanka as a low-wage country. The minimum wage has been fixed at Rs 2,000 (about US\$ 35), and in fact average monthly wages in the Sri Lankan garment sector are US\$ 55. In contrast, average monthly wages lie at US\$ 35 in Bangladesh and US\$ 22 in upcoming garment exporters such as Vietnam and Cambodia.¹⁸ Moreover, it is widely believed (although relevant statistics are not available) that labour productivity in the Sri Lankan garment sector is rather low due to lack of proper training, wastage, absenteeism, etc.

Lack of investment in advanced technology is another crucial factor which could affect the competitiveness of the Sri Lankan garment industry. The majority of the factories are owned by small-scale domestic entrepreneurs who have not made serious efforts to introduce new production techniques into the garment sector. More than half the firms who are operating as sub-contractors have continued to produce a narrow range of items by using simple sewing machines. Case studies of German



involvement in Sri Lanka's clothing industry show that the acquisition of various technological capabilities was necessary for the Sri Lankan firms to achieve international competitiveness. The process entails the careful choice of technology, efficient implementation of process know-how, transfer of product technology, quality control and marketing of the final product.¹⁹

Relatively high electricity charges have also contributed to the higher production costs in the garment sector. Sri Lanka is not well placed when it comes to electricity costs. Although Sri Lanka's rates are comparable to Bangladesh and Hong Kong, its electricity is almost twice as expensive as those of South Korea.²⁰ Moreover, since Sri Lanka is still highly dependent on hydroelectricity, unfavourable weather conditions have hampered the continuous supply of electricity from time to time. For example, reduced garment production in 1996 mainly caused by the long hours of power-cuts which resulted from prolonged drought.

High financial costs such as interest on bank loans and other banking charges have been another disadvantage for the Sri Lankan clothing industry. The commercial bank's weighted average prime lending rate was 18.4 per cent during 1996. In 1995, it was still higher at 20.1 per cent. With regard to finance charges, Sri Lankan investors are badly situated, with real interest rates very high relative to those in developed countries.²¹

Heavy Reliance on Quota Categories

The MFA quotas were one of the key factors behind the rapid expansion of the Sri Lankan textile and clothing industry. They played a

significant role in attracting foreign investors who were shifting their production facilities as a means of quota hopping. This trend was further accelerated by the salutary impact of liberal economic policies adopted by Sri Lanka from late 1970s onwards.

Despite the rapid growth of the industry witnessed over the last two decades, the bulk of clothing exports from Sri Lanka remain confined to a limited range of items which are subject to quotas. More than 90 per cent of Sri Lanka's garment exports (by volume) to the US market consist of quota categories such as shirts, blouses, trousers, jackets and undergarments of a standardised kind. In the case of the EU, however, the share of exports subject to quotas (by volume) has been around 20 per cent. Sri Lanka is firmly established in the export of standardised, low-price and low-quality garments. It has not moved into high fashion, expensive branded clothing.²²

In view of the continuing high dependence on low-priced quota categories, the Sri Lankan clothing industry is certain to face severe competition in the absence of the MFA. This point is stressed by S. Kelegama and I. Unamboowe who state that:

"Of the total Sri Lankan garments exports to the USA, more than 93 per cent come under quota and less than 7 per cent under non-quota. Sri Lanka can not afford to be complacent with such a small share of the US non-quota market. This is because the MFA is going to be phased out during the 10 year period, 1995-2005"²³

High Concentration on a Few Quota Markets

As pointed earlier the USA and the EU - the two major markets protected by quotas - collectively absorb about 95

per cent of Sri Lanka's total clothing exports. With the inclusion of Canada, the other quota market, the figure reached 96.4 per cent in 1996. (Recall Table - I). As MFA quotas are gradually phased out, this over dependence on a few destinations increases the vulnerability of the Sri Lankan textile and clothing industry in the international market.

With its current limited foothold in the non-quota market, Sri Lanka will find it increasingly difficult to compete with large-scale, low-cost suppliers in the international market which would no longer be protected by quotas.

Attempts made by Sri Lanka since 1992 to diversify its export markets have generated some encouraging results. However, they have been far from adequate to make significant changes in the overall situation explained above. It seems that most of the garment manufacturers in Sri Lanka who are geared to produce standardised products for the western quota markets are not flexible enough to undertake orders from the buyers in countries like Japan who generally prefer a wide range of different products with a smaller number of units in each variety.

Lack of Direct Links with Major Markets

Most of the internationally reputed buyers place their orders for Sri Lankan garments through Colombo-based buying offices which act as their purchasing agents. These buying agents are the ones who negotiate orders with the Sri Lankan manufacturers/exporters. At the end of 1997, there were about 185 such buying missions, operating in the country.

Despite the relationship with Colombo based buying offices, Sri Lanka has not been successful in establishing direct and strong marketing links with major buyers in important export markets. For example, most US entrepreneurs hardly know about Sri Lanka.²⁴ This has prevented Sri Lankan manufacturers from obtaining the best prices for their products.

More than half of the Sri Lankan manufacturers of garments hardly have any marketing experience vis-a-vis overseas markets as they have been continuously in the field of sub-contracting. The marketing efforts taken by the rest of the firms those who are engaged in direct exports have largely been confined to the foreign buying offices operating in Colombo.

In this context, Kelegama and Unamboowe have stated that:

"There are no big US garment industrialists who would lobby in favour of Sri Lankan exporters on issues such as the removal of countervailing duties which caused an annual loss in the region of SL Rs I.0 billion for Sri Lanka... Thus, there is an urgent need for establishing stronger market links with US buyers."²⁵

Heavy Dependence on Imported Inputs

Although the Sri Lankan garment industry has been able to achieve remarkable growth over the last two decades, the development of supporting industries such as fabrics and accessories has not been that impressive. Consequently, the garment industry continues to be heavily dependent on imported input. On average,

over 65 per cent of material inputs needed in the industry are imported. As a result the domestic value-added of this industry is remarkably low: indeed, one of the lowest among all industries in Sri Lanka.²⁶

As a majority of the inputs needed for the clothing industry are sourced from abroad, the lead time taken by the Sri Lankan producers had continued to be rather long compared to manufacturers in countries such as Hong Kong, South Korea and Taiwan which have their own domestic sources of required inputs. Further, unexpected delays and other complications which may arise in the prices of securing required raw materials from overseas can greatly delay deliveries of finished orders from Sri Lanka to foreign buyers. In a highly competitive trading environment, heavy reliance of foreign raw materials can lead to severe disadvantages, while quick delivery periods act as an important cutting edge for the development of any industry.

In sum, given the current drawbacks in its textiles and clothing industry described above, Sri Lanka will find it increasingly difficult to compete with low-cost countries such as Bangladesh, Cambodia, China and Vietnam in a quota-free world. Moreover, the development like NAFTA, and the opening up of Eastern European economies are likely to aggravate the competition that results from the abolition of quotas.

In the event of the Sri Lankan textile and clothing industry losing its share in the international market, the country's economy is bound to suffer serious consequences. Industrial production, foreign exchange earnings and unemployment are the key areas that would be most affected in this process. Therefore, it is high time that Sri Lankan policy makers pay due

attention to these drawbacks and make necessary structural adjustments.

The Uruguay Round Agreement on Textiles and Clothing requires the MFA to be phased out over a period of ten years, commencing from 1 January 1995.

¹ Annual Report, Central Bank of Sri Lanka (1996:137)

² Edwards (1996:summary - pg v)

³ Mandelbaum (1993 : 72) - as quoted in Kelegama and Foley (1996:5)

⁴ Kelegama and Foley (1996:5)

⁵ Edwards (1996:11)

⁶ Annual Report, Central Bank of Sri Lanka (1996:53)

⁷ Kelegama and Foley (1996:51)

⁸ Annual Report, Central Bank of Sri Lanka (1996:52)

⁹ Edwards (1996 summary - pg.ii)

¹⁰ Annual Report, Central Bank of Sri Lanka (1996:110)

¹¹ Edwards (1996:17)

¹² Edwards (1996:summary - pg ii)

¹³ Edwards (1996:1)

¹⁴ Edwards (1996:57)

¹⁵ Annual Report, Central Bank of Sri Lanka (1996:53)

¹⁶ Annual Report, Central Bank of Sri Lanka (1996:53)

¹⁷ Navaretti (1995:223)

¹⁸ Jenkins (1993), cited in Edwards (1996:45)

¹⁹ Kelegama and Unamboowe (1994:28)

²⁰ Navaretti (1995:230)

²¹ Edwards (1996:43)

²² Ibid

²³ Navaretti (1995:224)

²⁴ Kelegama and Unamboowe (1994:10)

²⁵ Kelegama and Unamboowe (1994:26)

²⁶ Ibid

²⁷ Kelegama and Foley (1996"1)