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TRADE DEVELOPMENT

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Improving trade competitiveness: Cambodian garment exports

Significance

Garments are Cambodia's largest export and constitute the bulk of its manufacturing sector. More people are employed in the garment sector than any other industrial sector in Cambodia and, as a result, Cambodia's rapid growth in attracting garment factories has led to rapid progress in the alleviation of poverty.

Although the industry has been successful in linking Cambodia to regional production networks stretching from Taiwan to Indonesia, the type of cut-make-trim activities carried out in Cambodia typically add little value to exports, implying that Cambodia could increase its share of this industry by adopting more sophistication into garment processing. Cambodia's challenge is to solidify its industrial expansion by encouraging sophisticated forms of garment manufacturing and to use the garment sector as a means of attracting diversified industries outside the garment sector to establish manufacturing activities in the country.

The World Bank published a Transport and Trade Facilitation Assessment (TTFA) report in 2013, designed as a snapshot of a country's trading environment, viewed from the perspective of four key industries, including the garments industry. The report dissects the inputs and outputs of the sector by analyzing how the inputs arrive at the processing plant and are then exported. Each step of the value chain is examined for logistical issues. The analysis and recommendations are designed to provide an overview of logistics issues that affect the private sector, and to assist the Government in implementing its garments policy.

Background

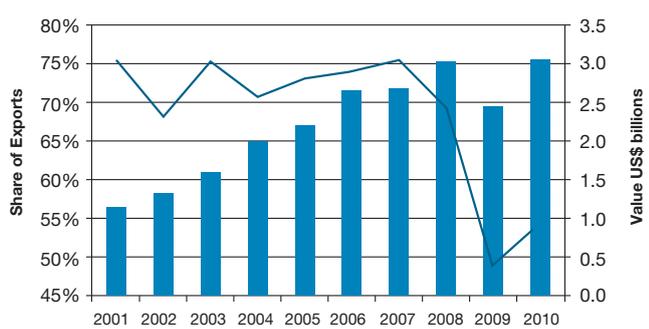
Cambodia's export-led growth strategy has paid off in terms of GDP growth, employment and poverty reduction, with garments accounting for some 80 percent of export revenues. The industry has tripled its share in the global market place over that period, but it still faces constraints in its ability to lead Cambodia's growth up the value chain, or towards more sophisticated export product diversity. This poses questions on the benefits and limitations of the current industry structure.

Export growth has been achieved through an increase in foreign investment, which led in turn to rapid growth in the number of factories and associated employment. The majority of garment factories in Cambodia are owned by investors from Taiwan, China, and Hong Kong. The average level of employment per factory is about 1,100 employees, while the larger firms employ between 6,000 and 9,000. The social welfare benefits thus rest in the hands of foreign investors.

Trade and Markets

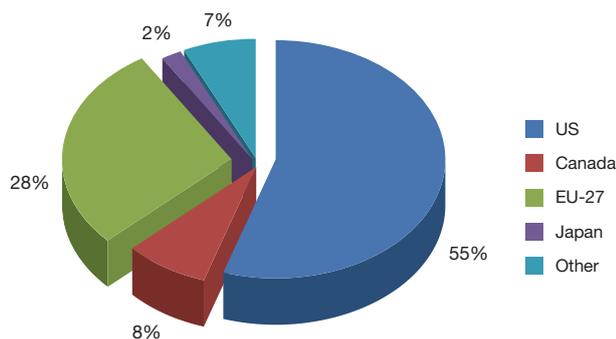
The potential instability of Cambodia's reliance on foreign investment in the garment industry was illustrated in the financial crisis of 2008. The contraction brought a halt to new investments. The fast pace of recovery since 2010, however, has allowed exports to return to pre-crisis levels, although employment, the number of factories and the management structure have remained relatively unchanged. Recently, there has been renewed interest from foreign investors in relocating garment factories to Cambodia and a number of proposals for investment are awaiting government approval.

Figure 1: Cambodian Garment Exports Source: GMAC, 2011



Cambodia serves a relatively small number of markets with a limited number of products. The principal export destination is North America followed by the EU. ASEAN accounts for less than 1 percent of garment exports, most of which is rag trade sent to Singapore, presumably for re-export. The concentration on markets in the US and EU has been encouraged by preferential access agreements, such as the EU's Everything-But-Arms (EBA) initiative.

Figure 2: Cambodian Garment Export Destinations 2010 Source: GMAC, 2011



Business Models

The type of factory ownership may have an impact on Cambodia's ability to move up the garment value chain, as the current structure limits growth in knowledge spillovers from foreign experts into the broader economy. Most of the foreign-owned firms are vendor factories. Their parent companies operate as Original Equipment Manufacturers (OEM), sourcing the inputs used by their factories and, in some cases, as Original Design Manufacturers (ODM) providing the designs for the goods produced in their factories. Therefore, the factories located in Cambodia tend to be tightly controlled by offshore owners, with very little room for local initiative or entrepreneurship.

The parent company distributes orders among factories that it owns across several countries, including Cambodia, according to their available capacity, unit production costs, and required skill level. It then arranges delivery of the inputs to the factory according to the buyers' requests. The factory has little ability to attract orders or identify markets into which it could expand.

Most of the contract manufacturers are foreign-owned but operate as independent enterprises providing Cut, Make, Trim (CMT) / Assembly services. Some take orders from buyers who provide the designs and specify the inputs; others operate as OEMs, assuming responsibility for sourcing inputs and preparing samples for approval by the buyer. A few factories operate as ODMs, but these

are generally small operations. The basic nature of this work and the claustrophobic management structure, in which all decisions for the factories are made offshore, contribute little to Cambodia's ability to move up the value chain.

Vendor factories have the advantage of scale through their relation with the parent company, which provides access to finance, regional suppliers and global markets. This gives them a distinct advantage over the smaller, locally-owned factories, which produce only for the domestic market and sub-contract to larger producers. This may be a reason why locally-owned factories comprise just 6 percent of the garment manufacturing sector.

Supply Chain

The TTFA approach looks at the upstream and downstream supply chain. To that end, the supplier and buyer relationships are seen as crucial factors in analysing the garment sector.

Supply Chain Performance

Despite continued growth, the apparel industry in Cambodia faces a number of challenges. The immediate concerns are the rising cost of production due to increasing wages and the high cost of energy. While the value of exports is expected to grow in the short term as more factories are established, this industry may become increasingly vulnerable unless changes in the structure and management of factories take place. At the present time, most factories have minimal investments in fixed assets and can easily relocate if operating costs are no longer competitive. The main challenge is to solidify the foreign investment in this sector, perhaps by fostering the span of control of local factories.

In the medium term, the industry needs to move away from basic apparel, because of strong competition from larger exporters, such as Vietnam, Bangladesh, China and India, that can offer economies of scale. If it is to compete for the production of higher-value goods, the industry needs to become more efficient, primarily by improving the performance of its inbound and outbound supply chains.

The major challenge for the factories is to retain skilled labor and secure adequate energy supplies. Logistics is not considered a major problem, although the high cost for land transport and difficulties with submission of various shipping documents and with clearing the cargoes are among the concerns mentioned by factory managers.

Customs declarations can be submitted electronically for imports but hardcopies must be submitted together with supporting documents, which is seen as inefficient. A Report of Finding from the PSI is required for imports

worth more than US\$4,000. Clearance may be delayed if customs officials are unavailable for processing. An import license may be required for specific commodities. The application for import permits should take only one day but, in practice, can require three to four days. Finally, the level of inspection remains high.

For exports, the major source of delay is associated with the issue of the certificate of origin (CO), which can only be issued after shipment and can require 5-10 days. This delays the transfer of documents to the buyer and payments to the exporter

International Competitiveness

The recent upward pressure on wages of Cambodian workers is creating a problem for Cambodia's garment manufacturers, who compete primarily on price. There is greater competition from China, which has reasserted itself in the low end of the market. Also, opportunities for reducing the order cycle are limited, since about 70 percent of the order cycle is taken up by delivery of inputs and international shipping of exports.

For Cambodian manufacturers to provide more value-addition, however, access to credit for garment factories that have been incorporated locally or that wish to evolve to become ODMs may need to be facilitated. For the same reason there is less concern about foreign exchange risk, in addition to the fact that there are few restrictions on foreign currency transactions in Cambodia.

Objectives and Strategies

The objective for the industry is to sustain growth in the value of exports and thereby continue its contribution to economic growth. The strategy for accomplishing this objective must have separate components for vendor factories and contract manufacturers.

For vendor factories, logistics need to be improved to reduce time and cost for the inbound and outbound supply chains, and to address shortages of labor and power. It is also important to facilitate foreign investments that will produce higher-value garments, and open new markets, while also providing access to credit for local manufacturers.

For contract manufacturers, the improvements in logistics should be complemented with improvements in the supply chains. There is also need for technical and financial support for the transition from CMT/Assembly operations to OEMs, so as to compete effectively with vendor factories.

Implementation

Cambodia may benefit from a strategic vision for the industry. Priority should be given to developing a vision of how to achieve the growth objectives mentioned above. This requires a coordinated effort involving the Government and private sector. It also requires an assessment of the market opportunities. Most of the management decisions are made outside Cambodia, with the result that the domestic industry lacks a consensus on the need for diversifying its products and markets, increasing the quality of its products and/or adding value within Cambodia.

There are a variety of markets for higher-value garments that Cambodia might consider, such as fashion basics, small brands and speciality garments. Each has slightly different requirement in terms of supply chain performance. While individual firms will continue to choose their markets, there is an advantage to selecting a target market for the garment industry, especially for the contract manufacturers. This would allow for a coordinated effort in developing the logistics and other capabilities that will provide a competitive advantage for that target market.

Most of the markets for higher-value garments will require a reduction in the order cycle times of up to 4 months. Efforts to reduce the order cycle to 2-3 months would require a tightening of the inbound supply chain, primarily through improvements in the trade corridor linking Phnom Penh with the international container terminals near Ho Chi Minh. Current efforts to finalize the transit agreement with Vietnam and to introduce simplified procedures for the movement of goods in transit should ensure reliable connections to scheduled container shipping services.

For Asian trade the savings in the transit time to Asian sources of fabric and to customers in Japan, South Korea and Taiwan should be 1-2 weeks, while for the European trade it would be 2-3 weeks.

Additional savings in transit time can be achieved through improvements in trade facilitation that are needed to reduce the clearance times for both imported fabrics and exported garments. These would build on the current Customs Reform and Modernization program, but target the border crossing at Bavet and the Phnom Penh port, and focus on the other border agencies, especially CamControl.

In addition to developing a single window for processing documents, greater use of risk management can reduce the amount of physical inspections, expedited testing procedures, less direct interaction between shippers and regulators and better control on hours of operations.

Another opportunity for reducing the order cycle is improving the management of the inbound supply chains. This applies primarily to contract manufacturers since the vendor factories already have tight control over their supply of inputs.

In order to create an environment that is attractive to foreign investors, Cambodia needs to develop garment clusters that can accommodate bonded factories, offer reliable utilities and logistics services, provide access to a large labor pool and attract supporting industries. An extensive network of special economic zones exists, but only three have had any success and these have a random collection of enterprises.

Currently, most garment manufacturers prefer to operate outside of the zone near Phnom Penh or in Kandal Province because they have the same ability to import fabric under temporary admission and set up bonded storage but

without restrictions on location or the activities they can pursue. To be successful, any new clusters should be designed jointly by the Government and GMAC and offer the same advantage.

Local contract manufacturers rely on retained earnings for working capital and limit their investments in new equipment. However, if they are to improve their control over the supply chains and produce higher-value goods with more costly inputs, then it is necessary to create financial instruments specifically for this sector.

Even with the development of clusters and better access to capital, the contract manufacturers need to develop knowledge-based competencies, and training activities in the areas of sourcing fabrics, supply chain management, lean retailing, managing financial risk and human resource development need to be expanded in both scope and scale.

Recommendations

1. Encourage contract manufacturers in particular to engage in collective ordering of inputs in order to benefit from economies of scale and reduce costs.
2. Incentivize garment manufacturers to move up the value chain from production of basic apparel, which is increasingly crowded, to producing niche higher value items.
3. Improve the performance of the trade corridors to ports in Vietnam which have more frequent vessels calls with direct shipping that would significantly reduce sailing times and so order cycle times.
4. Develop garment clusters that offer reliable utilities and logistics services, access to a large pool of labor, credit and support services, in order to attract more FDI.
5. Streamline and expedite the issuance of certificates of origin, and reduce renewal costs.

The World Bank Office



No. 113 Norodom Blvd. Phnom Penh - Cambodia
Tel: (855 23) 861 300
Fax: (855 23) 861 301/302

Visit our website:

<http://www.worldbank.org/cambodia>

This note reflects the views of the authors and not necessarily those of the World Bank and the donors.

For further information, please contact:

Julian Clarke
Senior Trade Specialist
(jclarke1@worldbank.org)

Vannara Sok
Operations Officer
(vsok@worldbank.org)

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