KYRGYZ REPUBLIC

THE GARMENT SECTOR: IMPACT OF JOINING THE CUSTOMS UNION AND OPTIONS TO INCREASE COMPETITIVENESS

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Abstract

This note analyzes the impact that joining the Eurasian Customs Union will have on the Kyrgyz Republic's garment sector and options for improving the sector's competitiveness. The paper finds that joining the Eurasian Customs Union will lead to higher prices for the textiles and cloth used in garment production. This will increase the cost of producing garments in the Kyrgyz Republic and will more than likely place downward pressure on exports from the Kyrgyz Republic, which will induce firms, particularly less competitive ones, to exit from the garment sector. To offset the increase in cost from higher tariffs, it is recommended that the Kyrgyz Government aims to increase productivity by lifting the constraints that reduce the sector's competitiveness. This can be done through interventions to increase the use of new technology, improve knowledge of consumer markets, and strengthen skills and education. This paper discusses these issues in four parts. The first provides an economic context for the discussion (Section I), which is followed by a discussion of the development of the garment sector and its importance for the economy (Section II). The paper then assesses the impact that joining the Customs Union (Section III) will have on production costs in the garment sector. Section IV describes the constraints the sector's competitiveness and possible interventions to lift these constraints.

(*) **Acknowledgements** - Prepared by a team led by Jieun Choi (Economist, World Bank Group) and comprised of Alberto Portugal (Senior Trade Economist, World Bank Group) and Andrew Myburgh (Consultant, World Bank Group). Michael Ferrantino (Lead Trade Economist, World Bank Group) reviewed the document. The views presented in this document belong solely to the team. The document results from a broad consultation exercise implemented by the World Bank Group in the Kyrgyz Republic.

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Executive Summary

Over the last twenty years the garment sector has been a remarkable success story for the Kyrgyz economy. The country had a successful garment industry when it belonged to the Soviet bloc but the sector basically collapsed when the Soviet Union broke up. This decline reversed when local entrepreneurs set up a number of companies in the 1990s. The industry grew rapidly in the early 2000s and production increased seven times from 2004 to 2012. The sector is now thought to employ as many as 150,000 people.

The sector now faces challenging times. Over the last few years exports to the Russian Federation have fallen. This is attributable to Russia's decision to join the WTO, which reduced market protection mechanisms and affected the competitiveness of Kyrgyz's products. The sector now faces the prospect of joining the Eurasian Customs Union. Joining the Customs Union will lead to increased tariffs on imports and more formalization at the border, both of which can be expected to increase the cost of textiles. This will reduce the industry's competitiveness. Simulations described in this paper suggest that production costs may increase between 3.6 percent and 7.7 percent or perhaps even more. This would place further pressure on the sector.

To continue to succeed in international markets, the sector will need to overcome a number of constraints that are harming firms' ability to compete. To date, firms' success in the market has been based on focused strategies that are dependent on better market knowledge. This has enabled them to find and serve niche market segments that are underserved by foreign competitors. To continue to succeed, firms need to adapt to increasing competition. To do this they need better market intelligence and more employees with design and marketing skills. A lack of administrative and operational management skills, as well as technical skills, are inhibiting firms from increasing their size to take advantage of economies of scale. This lack of capacities and technical expertise and new equipment and production processes has made it difficult for firms to implement modern equipment and production processes. Other factors that are inhibiting firms from taking on new technology include limited access to finance and advice on which equipment and processes are needed. The sector is also hampered by poor access to electricity, and by corruption.

To overcome the main constraints holding back the sector, this paper recommends three interventions. The first involves instituting trade promotion services to improve firms' knowledge of consumers in export markets. This will help companies find and effectively serve niche markets. The second intervention aims to strengthen education and training. This requires an increase in funding, and coordination between industry and the institutions providing training. The third set of interventions focuses on increasing the use of new equipment and production processes. It is recommended that industrial extension services be provided to advise firms on the improvements they can make by adopting new equipment and processes. This report suggests establishing a lease-financing program to support this effort, which will offer firms financing terms that reduce the risks of purchasing new equipment.

THE GARMENT SECTOR: IMPACT OF JOINING THE CUSTOMS UNION AND OPTIONS TO INCREASE COMPETITIVENESS

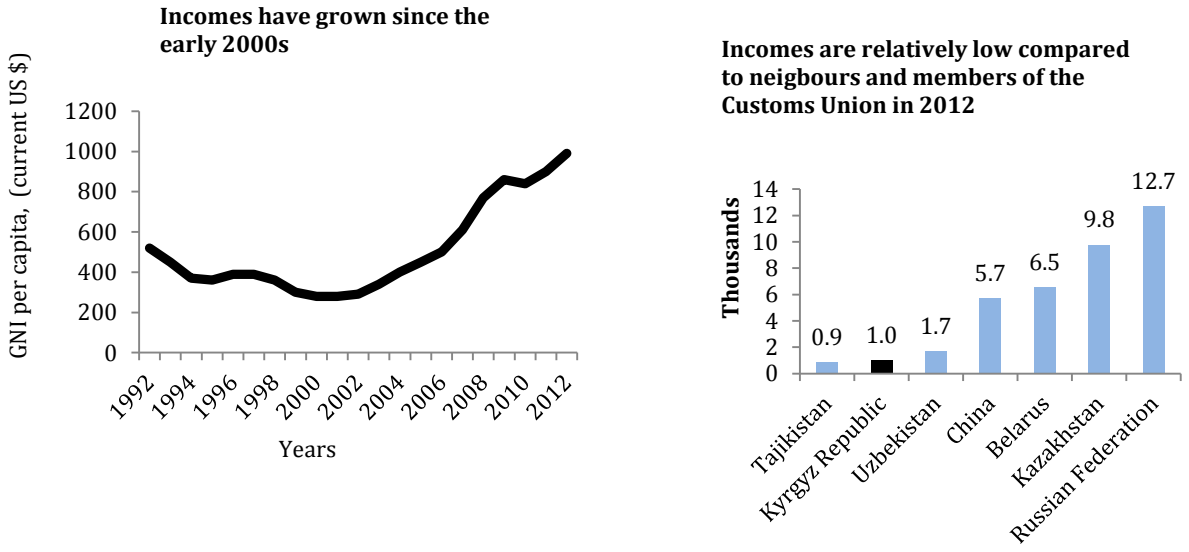
Introduction

This paper describes the impact that joining the Eurasian Customs Union will have on the Kyrgyz garment industry and what can be done to strengthen the sector's competitiveness. It starts by providing an economic context. It then moves on to describe the development of the garment industry and its importance to the Kyrgyz economy. This is a followed by a discussion of the impact of joining the Customs Union, which is determined by computing the increase in production costs that will arise after adopting higher tariffs in textiles and the value-added tax. The findings indicate that joining the Eurasian Customs Union will raise input costs and subsequently reduce the sector's competitiveness. The next section describes a number of recommended interventions to help increase the sector's competitiveness, based on an analysis of the factors that supported the sector's success in international markets and the constraints that are undermining the sector's competitiveness. To overcome these constraints a number of recommendations are made. These include: supporting trade promotion, strengthening skills and education, and supporting the adoption of new equipment and production processes. The paper does not discuss two issues discussed in more depth elsewhere: (a) quality certification for garments, and (b) issues around changes to the border regime.

I. Economic context

1. **Despite consistent growth since the mid-1990s, incomes in the Kyrgyz Republic remain relatively low.** With a GNI per capita of under US$1,000 in 2012 the country has one of the lowest levels of incomes in the ECA region. As can be seen in Figure 1 this is far lower than that of the other members of the Customs Union (Belarus, Kazakhstan and the Russian Federation). Incomes are low despite steady growth since the mid to late 1990s and reflect the fact that the country has had a difficult time recovering in the post-independence period. When the Kyrgyz Republic gained independence from the USSR, the economy struggled when subsidies and market access were reduced. In the three years after independence incomes fell by around 40 percent on a purchasing power parity basis. The economy grew consistently in the years after that, but some of these gains were reversed due the global economic crisis and political instability.

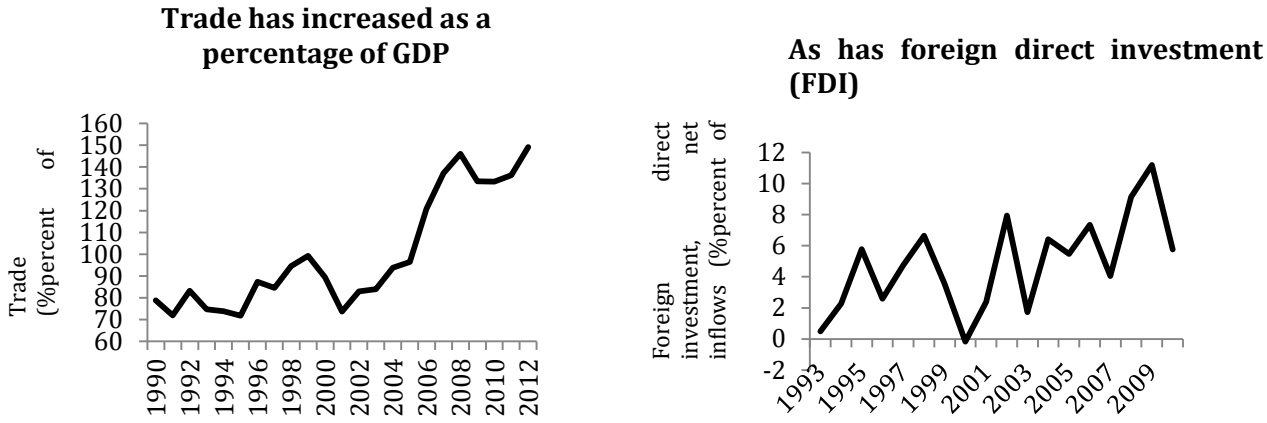
Figure 1: GNI per capita in the Kyrgyz Republic



Source: *WDI*

2. **Economic growth has coincided with increasing openness to international trade and investment.** As is shown in **Error! Reference source not found.**, trade made up 140 percent of GDP in 2012; this reflects the steady increase in trade as a percentage of GDP seen since the early 2000s. The country has also attracted greater volumes of foreign direct investment (FDI) over time. On UNCTAD's FDI performance index, the country is currently ranked 36. This increased openness in part reflects a liberal foreign trade policy, full currency convertibility, and limited restrictions on FDI.

Figure 2: Summary of Customs Union expected Common External Tariff in 2015 and 2020 for chapters 50 to 63



Source: WDI

3. **Trade exports remain concentrated in gold and other minerals**. The country's other exports include electricity from the country's hydroelectric plants, agricultural products, garments and tourism. There is also an industry based on the import and re-export of finished Chinese products.[i] Another important source of foreign exchange is remittances, which made up almost 30 percent of GDP in 2008.[ii]

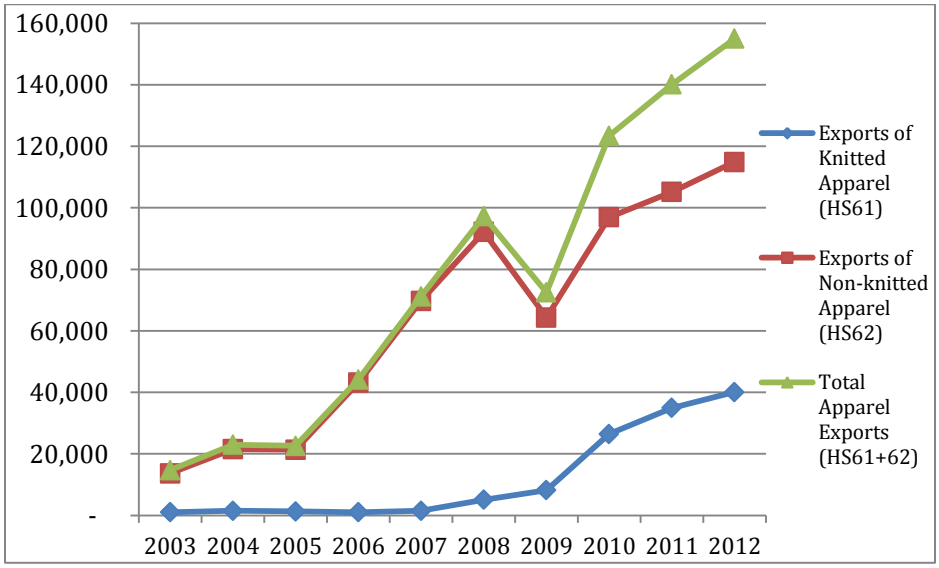
4. **The country's business climate has been successfully reformed in a number of areas but remains challenging overall.** The country is a leading performer on certain Doing Business indicators such as starting a business, registering a property, and getting credit, where it ranks among the top twenty in the world. However, the country has performed relatively poorly in several other components of the Doing Business index. For instance, it is ranked below 120 for the Doing Business indicators relative to resolving insolvency, paying taxes and getting electricity. Overall, the country ranked 68 on Doing Business. Another index that rates the environment for private business, the World Economic Forum's Global Competitiveness Index (GCI), ranked the Kyrgyz Republic 127 in 2012–13.

II. The garment sector

A. Development of the sector

5. **The apparel industry in Kyrgyzstan has grown dramatically in the last 10 years**. Garment exports increased just over ten-fold from US$14.7 million to US$155 million as shown in Figure 3, with a brief interruption in 2009 that coincided with the recession that followed the financial crisis. Industry growth has been the result of the gradual conversion from pure re-exporting of mainly Chinese apparel to producing garments using foreign inputs and Kyrgyz labor. Compared to textile production, apparel making is more intensive in low-skilled labor and as such, low-income countries attract tend to attract this industry.

Figure 3: Kyrgyz Apparel Exports (US$ thousands)

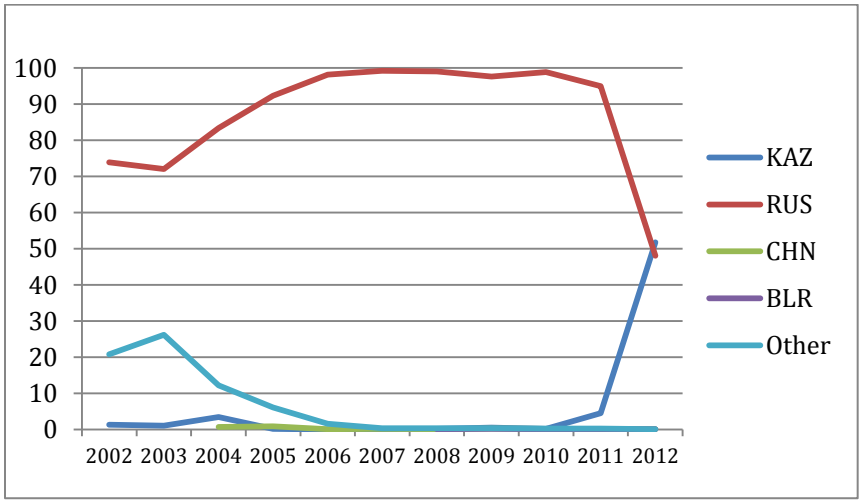


Source: Staff's calculation with data from COMTRADE.

6. **Exports in the sector are mainly concentrated in non-knitted apparel (cut and sew) but knitted apparel exports have been growing in the last four years.** Knit apparel production of knitted is relatively more intensive in capital, whereas the production of non-knitted apparel is more intensive in labor. There are around 400 firms in "Legprom," a representative agency that is mainly comprised of cut and sew companies, and slightly more than twenty companies are currently registered in the knitted wear representative agency "Soyuztextile."

7. **Exports of Kyrgyz garment are mainly concentrated in Russia and Kazakhstan.** Estimates indicate that only five percent of production is sold in the domestic market, where it faces fierce competition from low cost Chinese imports. Russia was the most important market for Kyrgyz garments until 2011. In 2012, the share of exports to Kazakhstan was higher than the share of exports to Russia, as shown in Figure 4. It is likely that Kazakhstan has been used as a re-export platform into Russia as they are part of the Eurasian Customs.

Figure 4: Share of garment exports to main destinations (in percentage)



Source: Staff calculation with data from COMTRADE.

8. **Diverse factors lie behind the robust expansion of Kyrgyz garments.** First, the accession of Kyrgyz Republic to the WTO in 1998 has been conducive to a more open trade regime with simplified customs clearances. According to Legprom and Souztextil, garment production constitutes more than 80 percent of light industry production with over 3,000 small and medium-sized enterprises (SMEs). Second, a simplified customs clearance procedure has been applied to imported textiles, which contemplates a tariff that is applied by weight: US$0.35 per 1 kg regardless of the type of textile[1], instead of an ad-valorem tariff (i.e. a percentage of the imported value). The simplified regime has facilitated the import of cheap fabrics and accessories from China, Turkey and, at to a lesser extent, from other countries. Notice that the higher the quality and the value of the textile, the lower the tariff in ad-valorem terms. This procedure was initially applied to support Kyrgyzstan's re-exportation policy. Naturally, this procedure makes it more difficult to collect statistics.

9. **Third, a Patent System helped drive the sector by providing garment manufacturers with favorable tax treatment.** The patent system provides for a simplified means to pay taxes. This provided a good number of SMEs that to formalize who had previously worked in the informal economy with an incentive to formalize been garments. Yet, it is estimated that 26 percent of firms are still in the informal sector. Currently, around two thirds of formal companies operate under the patent system (Jenish, 2014).

10. **Fourth, Kyrgyz garment producers seem to have better knowledge regarding the tastes and preferences of Russian and Kazak consumers than Chinese competitors.** The producers that have been interviewed agreed that their apparel designs are preferred by Russian

[1] The rate used to be US$0,28 per 1 kg between August 2012 and 2010, US$0,15 per 1 kg prior to 2010, according to Syar (2011)

consumers compared to Chinese designs. The presence of relatively large Kyrgyz diasporas in Russia and Kazakhstan are likely to improve market knowledge of the region.

11. **Finally, the Kyrgyz Government, multilateral organizations and donors have been actively promoting the garment industry.** For instance, GIZ helped the government develop a National Strategy for the Textile Sector to support industry competitiveness and exports diversification. ADB, through its Vocational Education and Skills Development Project, developed a competency-based modular sewing training curriculum offered at 25 lyceums throughout Kyrgyzstan. ITC provided a series of training programs and advisory services to garment companies.

12. **Firms in the sector tend to range in size from less than twenty employees to around one hundred.** There are a few larger, previously state owned firms with up to a thousand employees. New entrants into the cut and sew sector tend to establish mini-workshops with five to fifteen machines. Firms take one to three years to establish a stable client base.[2] It appears that the most productive firms have one hundred workers on staff and were established ten to twenty years ago.

B. The sector's importance to the economy

13. **The apparel and textile sector makes a substantial contribution to GDP and employment**. Much of the activity in the sector goes unrecorded, which lends to uncertainty about the sector's actual size. Nevertheless, as demonstrated in **Error! Reference source not found.**, a number of estimates suggest that the sector's size is substantial. Estimates indicate that it accounts for 5 to 15 percent of GDP and employs between 90 and 300 thousand people. This is between 4 and 12 percent of total employment. Many of the firms are owned by women, who make up around 70 to 85 percent of employees (Birkman, 2012).

Table 1: Estimates of economic activity and employment in the garment sector

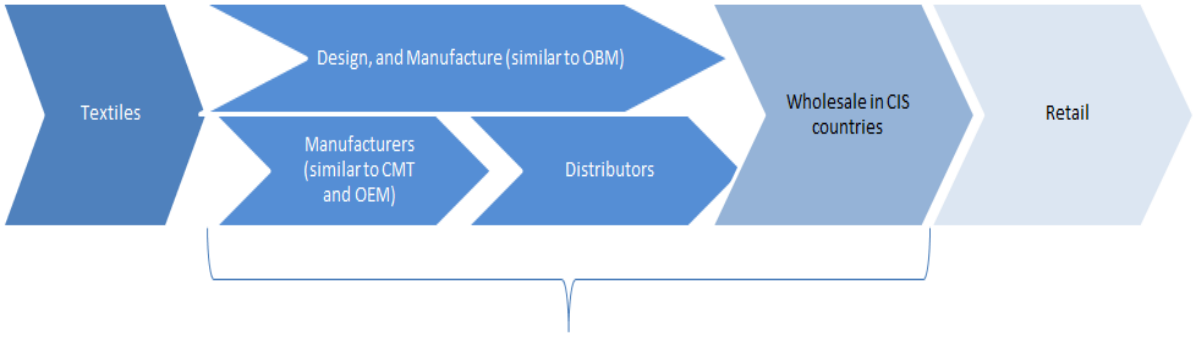
Source	Production (US$ million)	Employment	Year
Official (National Statistics Committee)	165	114,000	2011
Unofficial estimate Birkman, et al. (2012)	300 - 1,320	150,000 - 300,000	2010
Unofficial estimate SIAR for USAID (2011)	375	90,000 - 150,000	2010
Figure used in this report (average of mid-point of Birkman and SIAR)	593	172,500	

Source: OECD (2014) and staff calculations

[2]

14. The sector has the potential to be a stepping stone to higher value added activities. Historically, for many countries the first step in engaging with the global economy has been to develop their apparel sector. The United Kingdom, Japan and the United States had an "apparel phase" during industrialization. The garment sector often acts as a gateway into manufacturing for countries and workers whose alternatives might be in agriculture, or low productivity services. It plays this role for three reasons: (a) firms can open with relatively small capital investments and training costs; (b) the garment sector is integrated into the global economy with nearly 70 percent of garment exports coming from low income countries and (c) there are opportunities to move up the value chain. Companies can enter at the simplest stages of production and then move into more complicated processes with higher value added.

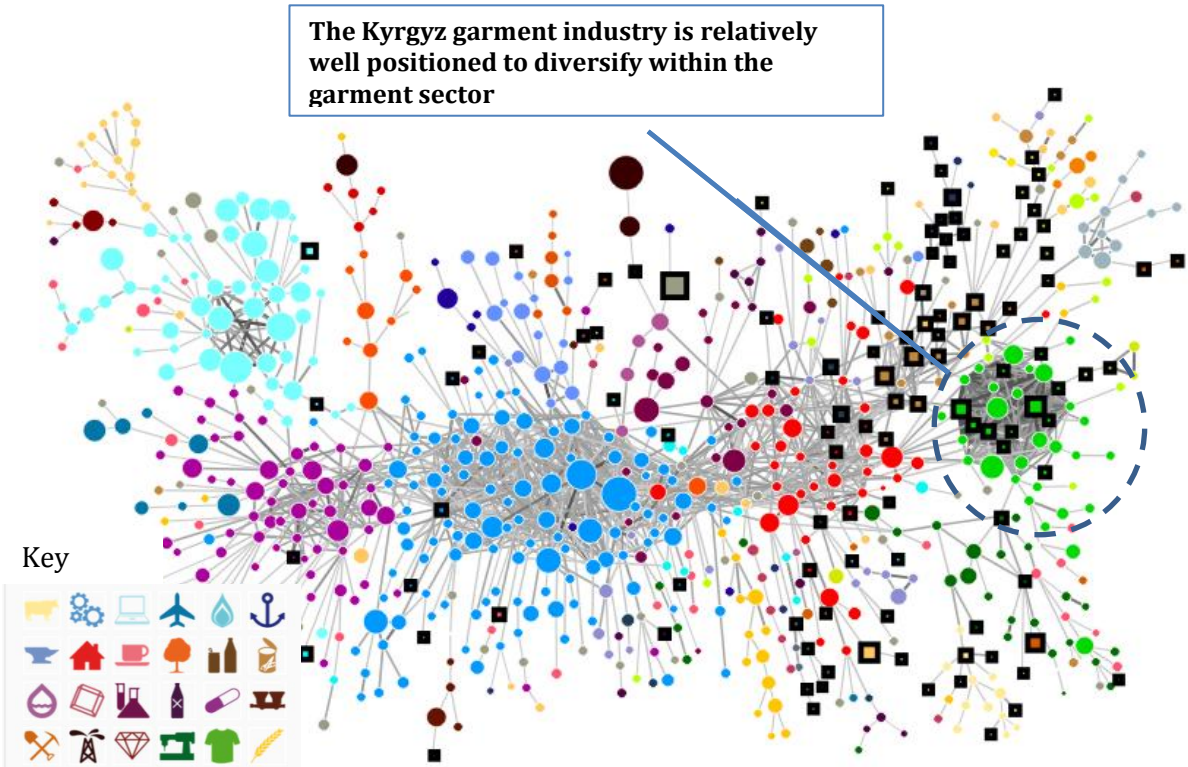
15. **It is relatively easy to diversify within the garment sector.**



Kyrgyz firms are operational through to distribution in CIS countries

shows how easy it would be for the Kyrgyz Republic to diversify into new industries. The sectors in which the Kyrgyz Republic already has a comparative advantage are represented by black squares and the colored circles show global export industries. As shown in the key, different colors represent different industries.. For instance, green reflects the garment industry and brown the mining industry. The distance from the squares to the colored circles is a measure of how easy it should be for Kyrgyz's economy to diversify from the industries in which the country has a comparative advantage into new industries. As can be seen in the diagram, many of the industries in which the Kyrgyz Republic operates (the black squares) are relatively distant from other industries (the colored circles) and as such do not provide a good platform for diversification. By contrast, it is relatively easy to diversify within the garment sector as shown by the cluster of green circles.

Figure 5: Kyrgyz Republic, industries with RCA greater than 1 in in the product space



Notes: The product space provides a visual representation of (a) how difficult it is for a country to move into particular sectors – the further away a node is the more difficult it is for the country to make the jump to exporting that product, and (b) what products does the country have a revealed comparative advantage in. **For more explanation on the Product Space please see Hausmann, Hidalgo et al. "Atlas of Economic Complexity, Mapping the paths to prosperity"[http://atlas.media.mit.edu/media/atlas/pdf/HarvardMIT_AtlasOfEconomicComplexity.pdf]**
Source: The data for the graph comes from the Observatory of Economic Complexity, **http://atlas.media.mit.edu http://atlas.media.mit.edu**

III. The potential impact of joining the Eurasian Customs Union (ECU) on Kyrgyz exports

16. **If the Kyrgyz Republic joins the Eurasian Customs Union (ECU), the Common External Tariff (CET) should, in principle, replace the current MFN tariffs and the simplified tariff regime in textiles.** The ECU member countries agreed that the Common External Tariff (CET) schedule will be adjusted over time to reflect Russia's commitments to the WTO. Russia's WTO membership was approved in December 2011. Russia's WTO commitments imply gradual import tariff cuts for trade of goods: one-third of Russia's tariff lines were reduced at the date of accession, one-quarter will be reduced within 3 years, and the rest within the next 7 years until 2020(mainly cars and planes). Given a significant phased-in liberalization, the process of fully implementing the ECU tariffs will involve some transition dynamics.

Table 2: Summary of Customs Union expected Common External Tariff in 2015 and 2020 for chapters 50 to 63 Summary of Customs Union expected Common External Tariff in 2015 and 2020 for chapters 50 to 63

Chapter (HS2)	Brief description	*# of HS6 products*	Customs Union 2015 tariffs			Customs Union 2020 tariffs		
			average	min.	max.	average	min.	max.
50	Silk	9	4.25	2.25	5.00	4.25	2.25	5.00
51	Wool, coarse animal hair, etc	38	6.52	3.00	11.30	6.18	3.00	10.00
52	Cotton	124	7.74	0.00	12.50	7.61	0.00	10.00
53	Other fibres	23	7.48	3.00	12.00	7.13	3.00	10.00
54	Man-made filaments	70	6.48	0.00	14.00	6.42	0.00	14.00
55	Man-mad staple fibres	107	7.18	5.00	10.00	7.18	5.00	10.00
56	Wadding and other nonwovens	31	7.16	3.75	12.00	6.57	3.75	10.00
57	Carpets and other	21	9.04	2.57	15.76	4.97	1.26	14.12
58	Special woven fabrics	40	13.63	10.00	15.00	10.23	10.00	13.00
59	impregnated, coated or laminated	24	5.95	5.00	13.71	5.86	5.00	13.71
60	Knitted fabrics	43	7.37	5.00	8.00	7.37	5.00	8.00
61	Knitted apparel	106	9.58	3.14	27.54	9.58	3.14	27.54
62	Non knitted apparel	113	9.35	2.08	21.23	9.34	2.08	21.17
63	Other made up textile articles	52	12.42	4.17	22.01	12.01	4.17	22.01
50-53	***Raw materials***	**194**	**6.50**	**0.00**	**12.50**	**6.29**	**0.00**	**10.00**
54-60	***Processed materials***	**336**	**8.11**	**0.00**	**15.76**	**6.94**	**0.00**	**14.12**
61-62	***Apparel***	**219**	**9.47**	**2.08**	**27.54**	**9.46**	**2.08**	**27.54**

Source: Author's calculations based on data from WTO and Shepotylo

17. **Most ECU tariffs related to the textile and garment sectors will be phased out by 2015, the year Kyrgyz Republic may join the Customs Union.** Table 2 describes the schedule of tariffs for chapters 50 to 63 in 2015 and 2020 by providing the number of products in each Chapter at the

HS6 level of disaggregation as well as the average, the minimum and maximum tariffs. It also provides aggregate statistics for the following broad categories: Raw Materials (CH50-53), processed products (CH54-60), and apparel (CH61-62). All tariff lines in chapters 50, 55, 60 and 61 are expected to be phased out by 2015, as shown by identical tariff schedules. Most tariff lines for other chapters are also expected to be phased out by 2015, as there are no major changes in the tariff configuration between 2015 and 2020.

18. **The average CU ad-valorem tariff for processed materials (CH54-60) is expected to be 8.1 percent in 2015 and 6.9 in 2020, as shown in Table 2**. .In contrast, a significant share of these products is currently imported in Kyrgyzstan under the simplified tariff regime paying US$ and pay US$0.35 per kilogram. If the Kyrgyz Republic joins the Customs Union and no exceptions regarding tariffs on textiles are negotiated, CU tariffs should replace the simplified regime.

19. **China, and to a lesser to extent Turkey, provides most of the textiles imported by Kyrgyzstan.** According to mirrored import data (i.e. reported by exporters of textiles), China and Turkey accounted for about 89 percent and 4 percent of all imported textiles respectively in Kyrgyzstan in 2012. Table 3 shows the quantity and value of imported textiles across chapters 52 to 60 that are likely to be imported under the simplified regime as well as the average unit value per category. On average, the unit value for textiles from China is about US$6.5 per kilo, whereas this figure is US$5.4 for textiles from Turkey.

Table 3: Estimated ad-valorem equivalent of tariffs under the simplified tariff regime in Kyrgyz Republic for 2012**Table 3: Estimated ad-valorem equivalent of tariffs under the simplified tariff regime in Kyrgyz Republic for 2012**

Chapter HS2	# of textile products at HS6 level	Quantity of Imported textiles [Q] (in 1'000 Kg)		Value of imported textiles [V] (in 1'000 $)		Unit value [V/Q] (in $/Kg)		Estimated ad-valorem-equivalent of tariffs [Q*0.35/V]	
		from China	from Turkey	from China	from Turkey	from China	from Turkey	from China	from Turkey
52	5	31,200	-	292,000	-	9.4		3.7%	
53	1	2	-	6	-	3.3		10.5%	
54	36	48,200	445	296,000	5,179	6.1	11.6	5.7%	3.0%
55	11	10,500	51	76,900	306	7.3	6.0	4.8%	5.8%
56	19	2,889	310	7,549	846	2.6	2.7	13.4%	12.8%
57	7	433	4,460	2,618	21,900	6.0	4.9	5.8%	7.1%
58	11	913	42	8,623	267	9.4	6.4	3.7%	5.4%
59	17	10,500	47	90,100	260	8.6	5.6	4.1%	6.3%
60	11	50,500	121	236,000	875	4.7	7.3	7.5%	4.8%
Total	118	155,137	5,475	1,009,797	29,633				
Average						6.5	5.4	5.38%	6.47%
							6.47	5.41%	

Source: Staff calculation using mirrored trade data from COMTRADE

20. **Rough estimates show that the ad-valorem equivalent of tariffs collected on textiles imported by the Kyrgyz Republic was about 5 percent in 2012**. Table 3 shows how the

estimated ad-valorem equivalent of tariffs has been calculated for textiles imported from China and Turkey. Ad-valorem equivalents in table 3 may be slightly overestimated as the value of imported textiles reported by exporters are FOB (free on board) and do not consider insurance and transport costs. In contrast, the value of merchandise recorded at customs by importing countries are CIF (cost-insurance, and freight) including insurance and transport costs.

21. **Average figures may mask the existing heterogeneity as imported textiles are taxed per weight under the simplified regime at US$0.35 per kilogram**. Indeed, importers of cheaper textiles that pay a lower cost per kilogram will pay more in ad-valorem terms than importers of finer textiles, which imply a higher cost per kilogram. Therefore, replacing the simplified tariff regime with the CU's common external tariff will tend to increase production costs disproportionately for firms that use more expensive textiles to produce garments.

22. **Assuming that a value added tax (VAT) of 12 percent will be enforced in Kyrgyzstan when it joins the Customs Union, production costs are estimated to increase in the range of 3.7 percent to 7.7 percent.** Table 4 below provides the assumptions for the estimating the increase in total production costs for a high-impact and a low-impact scenario. We assume that the VAT will only be applied to the value added in the country as a tax system may be implemented in which the tax paid on imported inputs is deducted from taxes on sales. [3] Figures on the share of imported textiles and value added are drawn from Annex 1 in Jenish (2014), which provides production costs for different types of garments in Kyrgyzstan and represents upper and lower-bound figures. [4] We take the average ad-valorem equivalent of the low-impact scenario and the lower average ad-valorem estimate in Table 4 for the high-impact one. Finally, we take the average CET tariff for processed materials in 2015 and 2020 reported in Table 2 for the low-impact and high impact scenarios. Most of the increase in total costs is due to the implementation of a value added tax (VAT) of 12 percent. If the VAT is higher, its contribution to VAT will be higher. Notice that these estimates are illustrative and they may hide heterogeneity as less competitive firms may be hit disproportionately and be less able to absorb the increase in production costs. More competitive firms producing differentiated garments with their own designs may have more market power and/or a bigger profit and can better absorb the increase in production costs by reducing profits or charging a higher sales price in Russia or Kazakhstan up to a certain limit.

[3] A firm's value added can be seen as the sum of production costs and profits. As our focus is the increase in production costs, in our estimates VAT only applies to firm production and excludes the portion of VAT that is applied to profits.

[4] The share of imported textiles in the low-impact scenario roughly corresponds to men's shirts, and the share in the high-impact scenario corresponds to dress "Kacheli". The share of production costs in the low-impact scenario corresponds to winter jacket/parka and the share in the high-impact scenario also represents dress "Kacheli".

Table 4: Estimates of the total increase in production costs of Kyrgyz garment following accession to the Customs Union.

Assumptions	Low-impact scenario	High-impact scenario
Share of imported textiles/fabric costs in total costs (f)	50%	70%
Share of production costs in total costs (p)	24%	48%
Ad-valorem equivalent of current tariff regime (t)	5.4%	3.7%
Customs Union Common external tariff (T)	6.9%	8.1%
Value added tax (VAT)	12%	12%
Expected Outcomes		
Increase in tariffs (T-t)	1.5%	2.7%
Increase in total costs due to :		
- tariff increase (T-t)*f	0.8%	1.9%
- collected VAT (VAT*p)	2.9%	5.8%
Total increase in total costs: (T-t)*f+(VAT*p)	***3.7%***	***7.7%***

Source: Author's estimates and description in text.

IV. Strengthening the garment's sector's competitiveness

23. **This section proposes interventions to improve the garment sector's competitiveness**. These interventions aim to increase garment companies productivity and thus strengthen their competitiveness in international markets. The analysis has four parts. The first section reviews the competitive strategies that underpin firm's competitiveness. The second discusses education and training needs in the sector. This is followed by a discussion of access to finance and adopting modern production technology. The fourth section discusses government failures that undermine the sector's performance as well as beneficial co-ordination in the sector. This is followed with recommendations in the fifth section.

24. **The section begins by analyzing the constraints to the sector's competitiveness**. It does this by reviewing the competitive strategies used by companies to compete in international markets. This is followed by an analysis that benchmarks companies in Kyrgyz's garment sector with companies in several other countries. The benchmarking exercise compares Kyrgyz garment companies to twelve countries that are garment exporters or are in the Eurasian Customs Union. They reflect a range of incomes from Bangladesh (which has a lower income than the Kyrgyz Republic's) to the Russian Federation and Turkey, which have much higher income levels.

25. **The recommended interventions aim to overcome market and government failures, which are inhibiting the sector from increasing its productivity.** The failures addressed include the pressing lack of training and education, industrial upgrades and financing. This section does not discuss two areas that are extensively discussed elsewhere, including formalizing the border and the quality certification required in the Customs Union.

Box5: Benchmarking countries

This section compares the Kyrgyz Republic to a number of benchmark countries. The benchmark exercise compares the Kyrgyz Republic's garment sector to (a) countries whose companies compete with Kyrgyz firms, and to (b) countries exporting into the European Union and internationally. The countries were selected for inclusion as benchmark countries for three reasons (with some countries included for more than one reason):

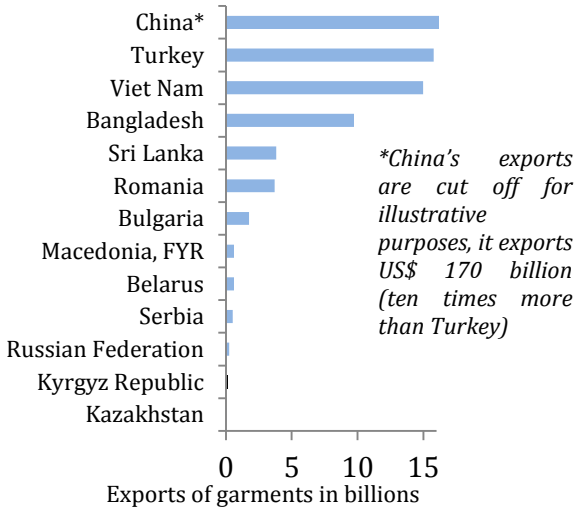
- Countries whose firms compete directly with garment firms from the Kyrgyz Republic firms Companies in the Kyrgyz Republic reported competing most directly with firms from Belarus, and to a lesser extent Turkey, in high quality segments, and with firms from China in lower quality segments.
- International exporters. This includes countries whose companies largely export into the European Union (Bulgaria, Romania, Turkey, and FYR Macedonia), as well as companies exporting internationally (Bangladesh, China, Sri Lanka and Vietnam).
- Membership of the Eurasian Customs Union, the Customs Union are the main markets for the Kyrgyz Republic's exports, in particular the Russian Federation. These countries have garment companies that can directly compete with sectors which Kyrgyz companies from these countries are in a position to compete with Kyrgyz firms currently. The countries included were the Russian Federation, Kazakhstan and Belarus.

The benchmark countries garment sectors in the benchmark countries represent quite different levels and types of competitiveness. With few exports, the garment sectors in the Russian Federation and Kazakhstan garment sectors appear to only be competitive only in their domestic markets. East and South Asian countries such as Bangladesh and Vietnam are relatively low cost production centers. In contrast, costs are higher in Eastern Europe but many companies in these countries able to turn around orders relatively quickly.

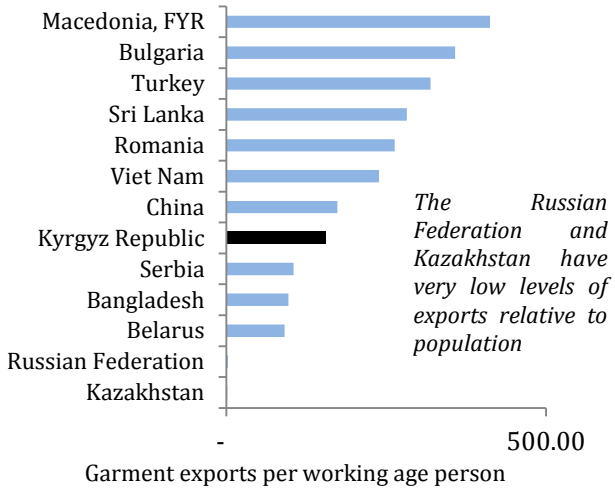
The benchmarking exercise is largely conducted using data from the World Bank's 'Bank' Enterprise Surveys. These are firm-level surveys of a representative sample of an economy's private sector. Since 2002, the World Bank has collected this data from face-to-face interviews with top managers and business owners in over 130,000 companies in 135 economies. The surveys cover firms in the formal sector that employ more than five workers.

Figure 6: Comparison between Kyrgyz Republic and benchmark countries

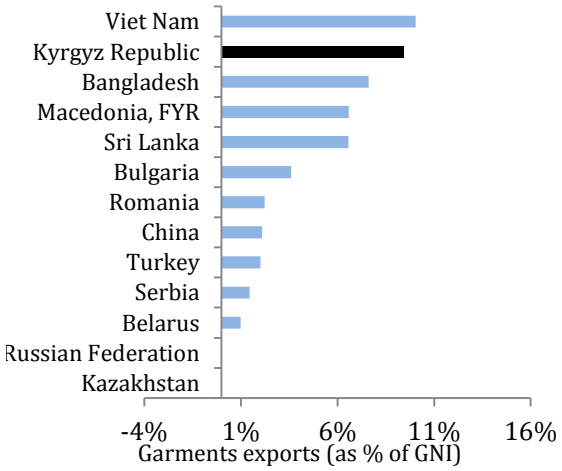
The Kyrgyz Republic exports far fewer garments than the benchmark countries



However, it exports more when its relatively small population is taken into account



The sector is relatively large compared to the size of the economy



In part, this reflects the Kyrgyz economy's relatively low GNI per capita

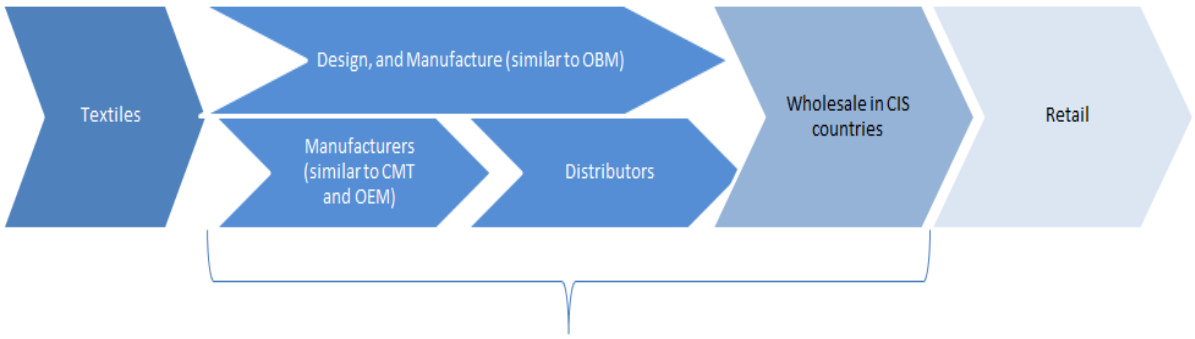
Note: Export figures are for HS 61, 62 and 63. Figures for Bangladesh are for 2007 (the latest available data), and the figures for the Kyrgyz Republic have been scaled up in line with the figures shown in **Error! Reference source not found.**

Source: World Development Indicators and UN Comtrade

A. Kyrgyz Republic companies have succeeded by focusing on under-served market segments

26. **Successful Kyrgyz companies have focused on particular customer segments,** for example, selling a particular style of women's' jackets in the Russian Federation. Other companies have produced goods on order from distributors who are familiar with market demand. In some cases these goods are replicas of goods that have been designed in the Kyrgyz Republic or elsewhere. Behind this success is the fact that companies in Kyrgyz have been able to serve certain market segments more effectively than competitors that aim to serve a broader range of customers.

27. **Knowledge of market needs has been crucial to the success of Kyrgyz companies.** Firms have been able to find and serve niche market segments not served effectively by producers from other countries. Some companies are engaged in brand, design and manufacture. Although, these relatively small firms don't fit neatly into standard categories for the sector, they could be described as Original Brand Manufacturers (OBM). Another important approach has been a distributor – manufacturer supply chain where distributors in the Kyrgyz Republic have outsourced manufacturing to Cut-Make-Trim (CMT) and Original Equipment Manufacturer (OEM) companies. The resulting supply chain for the industry is shown in



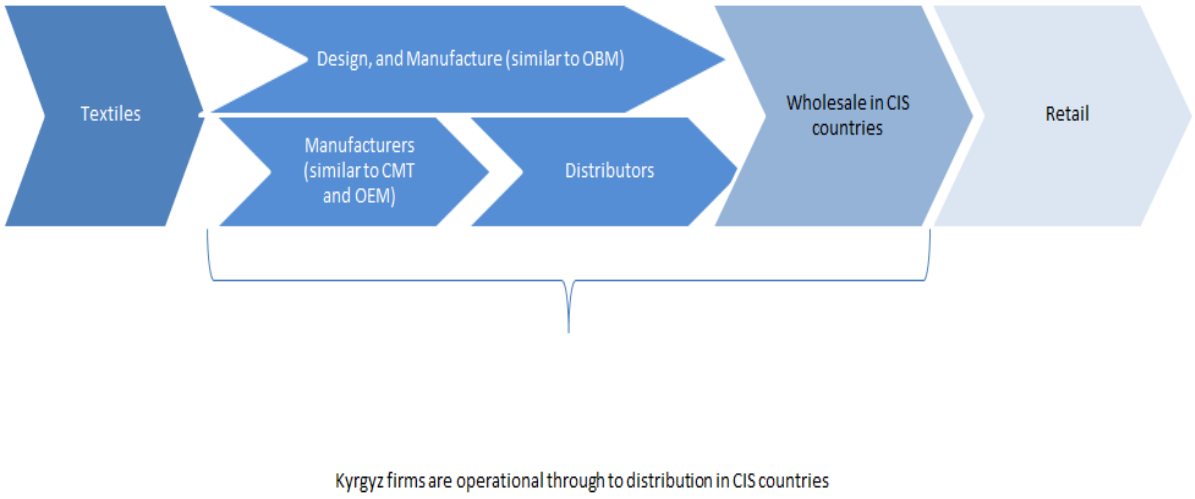
Kyrgyz firms are operational through to distribution in CIS countries

.

Firms earn higher returns from designing and marketing clothing than from manufacturing. This trend is consistent with a global trend whereby garment manufacture has become increasingly commoditized and concentrated in low wage countries. The value added in the industry is increasingly concentrated in points closer to customers (OECD, 2014). [5]

[5] For further background on the various levels of firm capabilities and country capabilities in apparel supply chains , see Gereffi and Frederick (2010) .

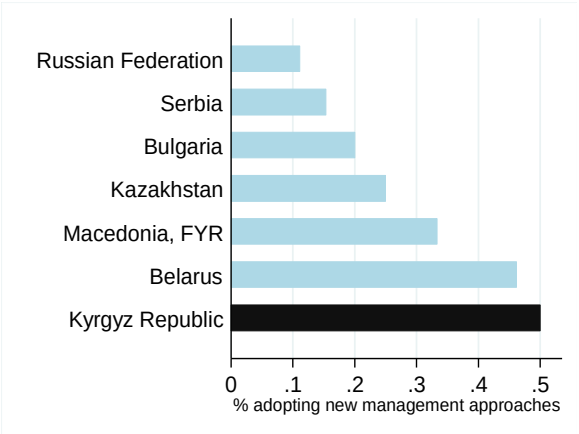
Figure 7: Supply chain for garment companies



28. **High levels of innovation are core elements in the firms' focused strategies**. As shown Figure 7, Kyrgyz firms are more likely than firms in the benchmark countries to introduce new products and adopt new marketing as well as management approaches.

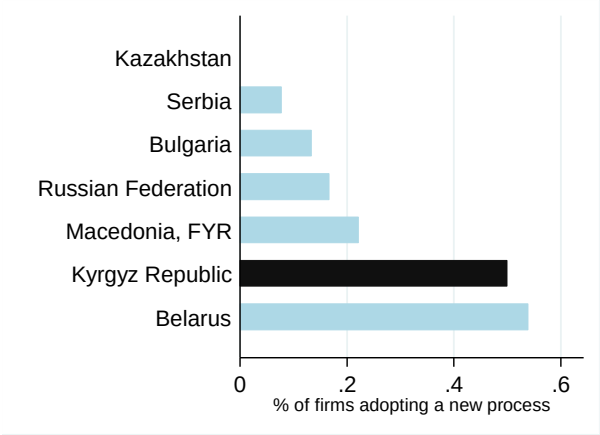
Figure 7: Kyrgyz garment firms are relatively innovative in terms of management, marketing, processes and introducing new products

In Kyrgyz a relatively high proportion of firms introduce new management approaches,

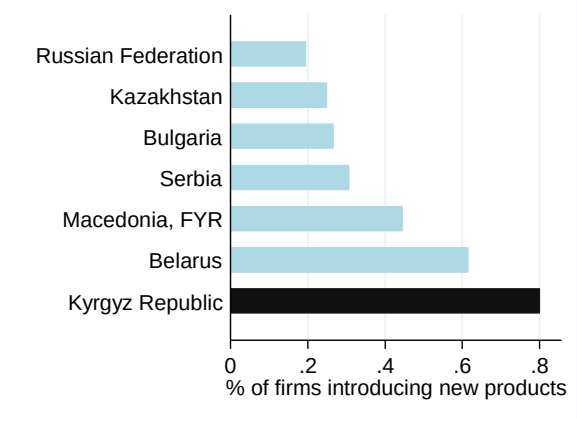


New marketing approaches,

New processes



And new products



Note: Data only available for Europe and Central Asia
Source: Enterprise Surveys (http://www.enterprisesurveys.org), The World Bank

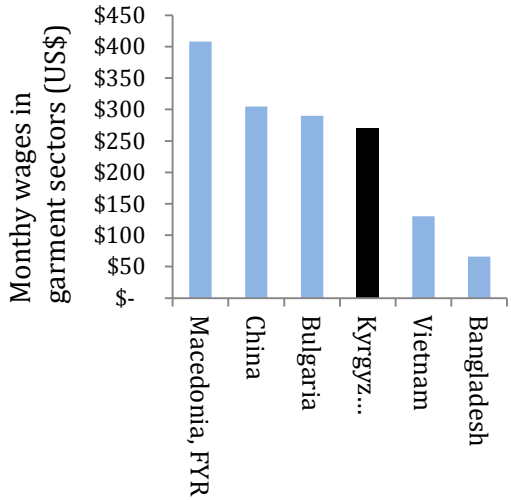
29. **Firms have been able to sustain relatively high wages.** As can be seen in Figure 8, wages are far higher in Kyrgyz than in low cost producers in Asia such as Bangladesh and Vietnam, which have a similar level of income (see Figure 6 on page 206). Wages are reported to be comparable to those in Bulgaria and China which may indicate of comparable levels of productivity. The presumably high levels of productivity appear to largely arise from firms' ability to charge relatively high prices.

30. **The high wages in the sector reflect, in part, integration in regional markets**. ILO (2012) suggests that "the national labor market is competing with foreign markets for the same categories of labor". More than half a million Kyrgyz nationals work outside the country, mainly in

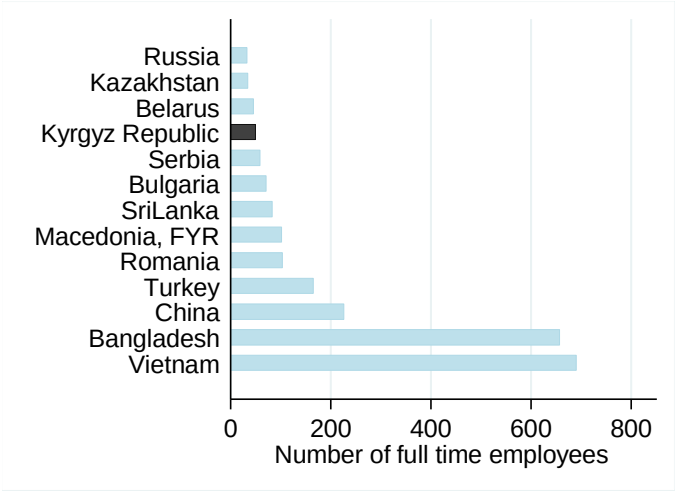
the Russian Federation and Kazakhstan. These countries have substantially higher incomes, which can be expected to lead to upward pressure on wages in the Kyrgyz Republic. When firms pay relatively high wages, they need to sustain higher levels of productivity and pricing to remain competitive.

Figure 8: Wages in the garment sector are relatively high, and firms relatively small

Firms pay relatively high wages



But are relatively small compared to the benchmark countries



Note: Data shown for countries where data is available. Figures for wages in the benchmark countries are from 2011, except for those from Bangladesh, which are from 2014. Jenish (2014) reports wage levels for 2013; the wage rate shown is at the lower end of a range of wages reported by Jenish. The ILO (2012) reports far lower wage rates in the garment sector. This discrepancy may reflect under-reporting by firms or seasonality's effects on average wages. That said, it means there is considerable uncertainty regard what true wages in the sector actually are.

Source: Benchmark countries wages are from Global Development Solutions, LLC, figures for Kyrgyz are from Jenish (2014). Figures on the number of employees comes from Enterprise Surveys (http://www.enterprisesurveys.org), The World Bank

31. **Firms in the sector appear to be operating below minimum efficient scale**. Kyrgyz firms are notably smaller than companies in most benchmark countries. Kyrgyz firms are far smaller than countries with the lowest cost base engaged in long turn around Cut Make Trim activities. It is notable that Kyrgyz firms are smaller than companies in Turkey and China which have similar wage rates. In both these markets, many firms engage in manufacture and design. This suggests that Kyrgyz companies could take advantage of economies of scale by expanding. Studies have found that there are economies of scale in the production of garments (for example see Datta and Christofferen, (2004)). Branding provides substantial economies of scale. Larger firms find it easier to sell their products to larger retailers and distributors.

32. **In part, companies can currently operate at lower scale due to fragmentation in the Russian Federation's retail sector**. The top eight retail chains make up less than 20 percent of sales in the Russian Federation. There are few retailers in rural areas and open air markets still

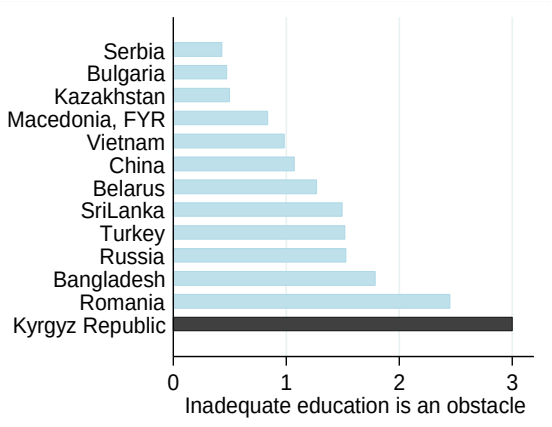
account for a notable share of garment sales. This fragmented retail structure has made it easier for smaller firms to distribute their product. However, this is expected to change as major retailers continue to grow and traditional retail formats such as markets decline (Kolchenikova, 2013). This will place pressure on smaller firms, which are likely to find it more difficult to access these markets.

i. A lack of skills and education is undermining the sector's competitiveness

33. **A large proportion of companies report that uneducated workers are an obstacle to their business operations**. As shown in Figure 9, a far higher proportion of firms in the Kyrgyz report that this is an obstacle than companies in the benchmark countries. As **Error! Reference source not found.** shows firms are struggling to find a broad range of skills. The most pronounced shortages are in professional level skills such as designers and dyers. Firms are also struggling to find seamstresses and technician level positions such as cutters (ILO, 2012). As discussed in STED (2011), the demand for a number of these skills is expected to continue into the foreseeable future with firms reporting that in the next five years the most in-demand workers will be designers (23 percent), universal sewing machinists (18.4 percent), process engineers (15.8 percent) and dress cutters (15.8 percent).

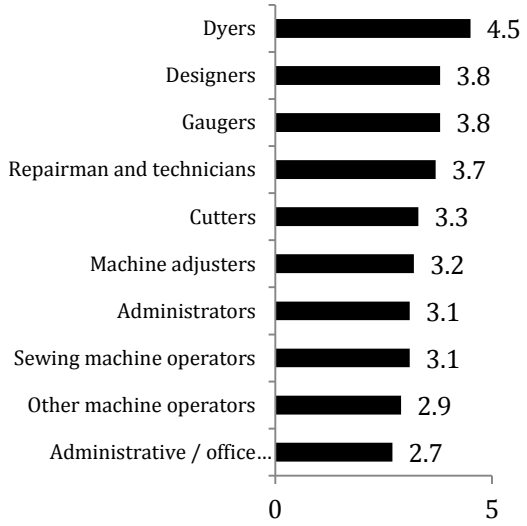
Figure 9: Firms report difficulties finding skilled workers

A lack of education and skills is a far larger constraint for Kyrgyz garment companies than it is for the benchmark countries



Extent to which issue is an obstacle to the current operations of the business measured from 0 "no obstacle" to 4 "very severe obstacle"

The most difficult to find skills range from production, to design, and include processing workers, skilled workers and professional staff



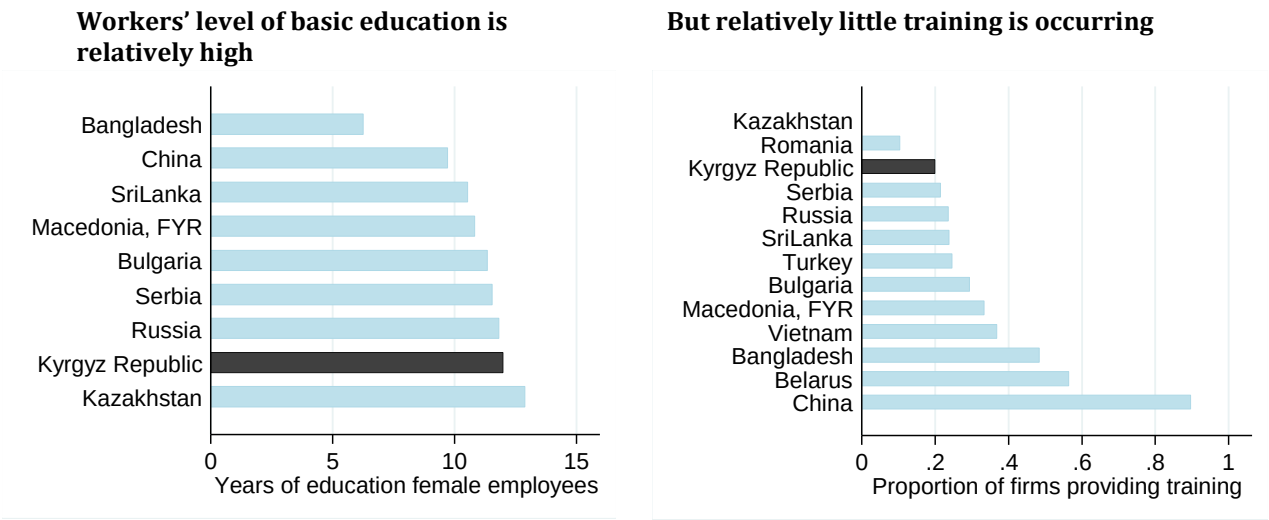
Assessment of difficulties related to finding workers with certain skills; 5-points scale (where 5-very difficult to find, 1- not difficult to find)

Source: Enterprise Surveys (http://www.enterprisesurveys.org), The World Bank and for shortages of specific skills, STED Kyrgyzstan Survey (2011) as reported in ILO (2012), Skills for trade and economic diversification in the Kyrgyz garment sector, ILO, Geneva. Only skills with a score above 2.5 shown.

34. **Relatively little training is being provided by firms. Error! Reference source not found.** shows that training in Kyrgyz firms is low compared to that provided in benchmark countries and Belarus in particular, where more than 50 percent of firms provide training. The problem does not appear to be a lack of basic education. **Error! Reference source not found.** shows that Kyrgyz workers have more years of schooling than workers in a number of benchmark countries.

35. **Little industry-specific education is being provided**. The ILO (2012) reports that vocational lyceums focus on training machinists and provide little training for technical or professional positions. Moreover, the benefits of this training appear to be limited. More than fifty percent of firms did not know if they employed a graduate of one of these institutions. This suggests that firms place little weight on the training that the lyceums provide. The Shvei-Profi, which was started with support from industry associations and the GIZ, was a promising program. Unfortunately, it appears that this effort has been discontinued (OECD, 2014).

Figure 10: Difficulties finding skilled workers in the garment sector appear to reflect a lack of training rather than low levels of basic education



Note: Level of education for female employees is shown because data on male employees or the overall workforce was not available
Source: Enterprise Surveys (http://www.enterprisesurveys.org), The World Bank

36. **Training and education will be under-provided if left to market forces.** The sector suffers from a number of market failures. Prospective students often don't know what skills are needed by the market and don't have access to credit to fund their education and training. Firms' incentives to train workers are reduced by the possibility that workers will leave their jobs, thus taking the benefits of their training to another company. This is a particular concern in Kyrgyz's flexible labor market where employees move easily and often between jobs.

ii. The sector lacks access to finance and new production technology

37. **Firms struggle to access financing and relatively few are adopting foreign technology.** For this reason it is important to increase access to capital, particularly for knitwear companies that

are capital intensive. It is also important to assist companies in accessing and adopting new technologies – for instance through industrial extension services and financial services such as financial leasing, which reduces the risk of adopting new technology.

iii. The sector is lagging in the adoption of technology

38. **Firms are not investing in innovative machinery and business approaches.** This is reflected in

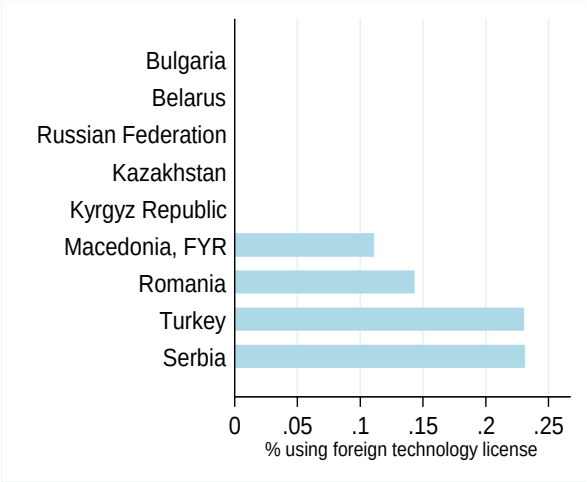
39. Figure 11: Kyrgyz firms have low levels of foreign technology and process adoption

40. , which shows relatively low adoption of technology that requires licensing fees. It also shows that no garment or textile firms have ISO9001 certificates. The ISO9001 certifies that firms have adopted systems and processes that ensure quality. It is a measure of firms' adoption of modern business practices and is often a requirement to access global value chains.

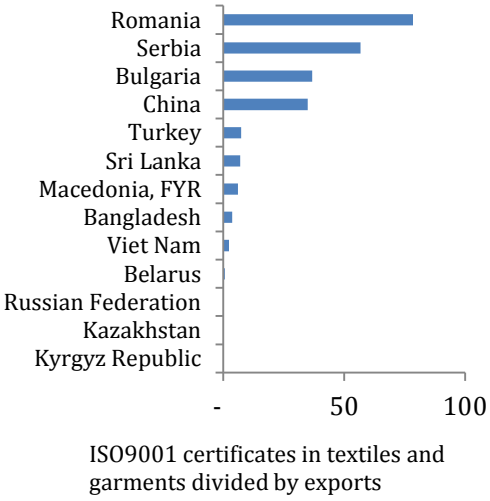
41. **Small and medium firms that dominate the garment sector often struggle to adopt new technologies and business practices.** This reflects, at least in part, the skill shortages described on page **Error! Bookmark not defined.**. However, international experience suggests this is common. "Managers often are unaware of the flaws and opportunities for improvement in their own businesses. When administrators' responses to questions on their own performance in the use of modern methods and technologies of industrial management were weighed against the productivity of their businesses, their perceptions of their performance ranked well above average, but they ranked far below average in their application of best management practices" (World Bank, 2013). This tendency is one manifestation of various information-related market failures that inhibit firms from adopting new technologies and business practices. These market failures can be overcome through manufacturing extension services and foreign direct investment.

Figure 11: Kyrgyz firms have low levels of foreign technology and process adoption

Relatively few firms are paying fees for the use of foreign technology



And there are no ISO9001 certificates in the sector (these certify adoption of up-to-date systems and processes to ensure quality)



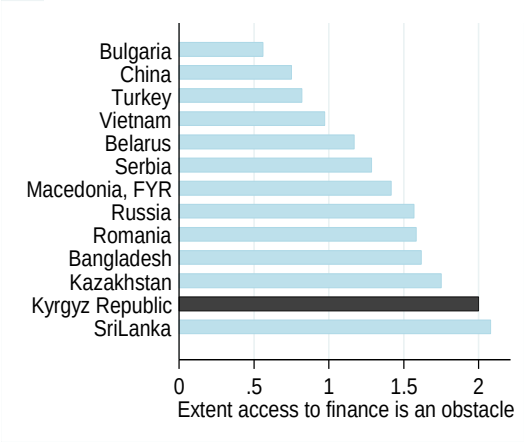
Source: Firms using foreign technology the source is Enterprise Surveys (http://www.enterprisesurveys.org*http://www.enterprisesurveys.org*) and data is only available for Europe and Central Asia, The World Bank, and for the ISO9001 data the source is www.iso.org*www.iso.org* for data on industry specific ISO9001 adoption and for exports Comtrade

iv. Firms have limited access to finance

42. **As shown in Figure 12, Kyrgyz firms report that access to finance is an important obstacle to conducting business**. In an OECD survey, more than 50 percent of firms reported that they lack access to the financing they need to operate their business. This reflects, at least in part, the country's low bank credit-to-GDP ratio of less than ten, which is substantially lower than the ratio posted by benchmark countries. Further, 75 percent of firms report that high interest rates are an issue when seeking financing (OECD, 2014).

Figure 12: Access to finance is a major constraint for garment companies

Kyrgyz firms find access to finance to be more of an obstacle than companies in benchmark countries



Extent to which issue is an obstacle to the current operations of the business measured from 0 "no obstacle" to 4 "very severe obstacle"

Source: *Enterprise Surveys (http://www.enterprisesurveys.org), The World Bank*

Kyrgyz firms report using few external funds for working capital

Source: *World Development Indicators, World Bank*

43. The absence of financing is a constraint to firms' working capital. As shown in **Error! Reference source not found.**, none of the Kyrgyz firms in the survey reported access to external financing for working capital. This makes it more difficult for firms to meet the demand for their goods and makes them more vulnerable to financial distress. Access to financing is particularly important for joining global value chains. The OECD/WTO report (2013) indicates that access to financing represents the most significant barrier when firms attempt to penetrate global value chains. This is due to the fact that firms that enter into supply chain relationships want to know that their counterparts are financially stable.

44. **Access to financing is likely to be a particularly binding constraint for knitwear companies**. These companies are more capital intensive than sewing companies. This suggests that initiatives to expand access to financing should focus on these companies.

v. There is relatively little FDI in the sector

45. FDI can bring new technology to the sector, including modern machinery, and improve business practice. As such, it is troubling that according to Birkman (2012) "most foreign investors in apparel left the country after the 2010 revolt". In the rest of the economy, the country has been relatively successful at attracting relatively high levels of FDI. In fact, it has attracted more FDI to the manufacturing sector relative to GDP than the benchmark countries.[6] The overall level of FDI is relatively high compared to GDP according to UNCTAD data. The country's success at drawing FDI

6 According to FDI data from the FT times

is consistent with policy initiatives to make it attractive for foreign investors, including the Doing Business reforms.

B. Supporting institutions and infrastructure have strengths and weaknesses

i. Industry level co-operation is a source of strength

46. **The industry currently benefits from strong industry associations.** For example, the two largest industry associations, Legprom and Soyuztextile, actively represent their members' interests and provide a range of services. This has included engagement in a number of donor-led initiatives to strengthen the sector's competitiveness.

ii. Firms show willingness to cooperate.

47. More than two thirds of firms report that they are willing to cooperate in promoting the sector (76 percent), organizing training to develop employee skills (72 percent) and gather market information on client tastes, new designs, suppliers and customers (68 percent) (OECD, 2014). Cooperation between companies is particularly important given the small scale of the majority of firms, as shown in Figure 8 on page 23.

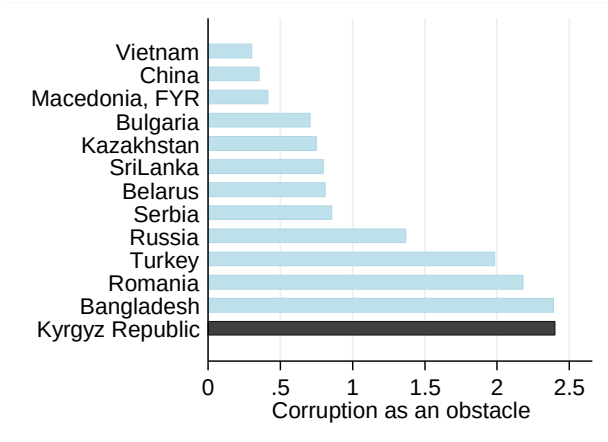
iii. Corruption is a major obstacle

48. **As shown in Figure 13, corruption is a major obstacle.** Corruption is more of an obstacle for Kyrgyz garment companies than it is for companies in the benchmark countries. It is reported to be a more severe constraint than the lack of access to financing and comparable to the constraint posed by limited access to electricity. This can be expected to reduce investment and as such, employment growth (Hallward-Driemeier, 2010).

49. **Simplified regimes have reduced obstacles for businesses.** As shown in Figure 13, customs and regulations are a less onerous constraint for businesses. The same is true for business licenses. The experience of Kyrgyz's firms can be contrasted with that of Kazakhstan and Bangladesh, where customs and trade regulations represent a much greater obstacle.

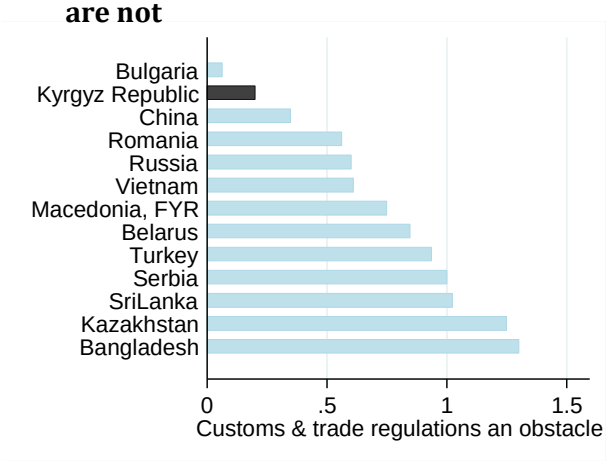
Figure 13: Corruption is a major obstacle to conducting business

Corruption is a major obstacle



Extent to which issue is an obstacle to the current operations of the business measured from 0 "no obstacle" to 4 "very severe obstacle"

But customs and trade regulations are not



Extent to which issue is an obstacle to the current operations of the business measured from 0 "no obstacle" to 4 "very severe obstacle"

Source: Enterprise Surveys (http://www.enterprisesurveys.org), The World Bank

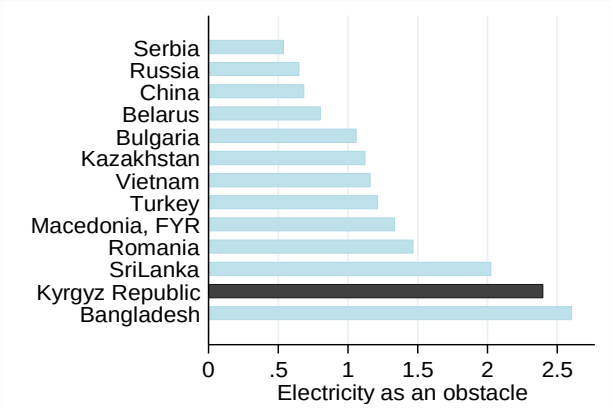
iv. Firms report that electricity is a major obstacle, but land and transport are not

50. **The difficulties raised by electricity are reflected in Figure 14.Figure 15**. The constraint imposed by electricity is mitigated to some extent by the relatively low cost of electricity in the Kyrgyz Republic compared to costs in benchmark countries and the fact that the garment industry is not a heavy user of electricity (electricity represents only a small percentage of costs).

51.

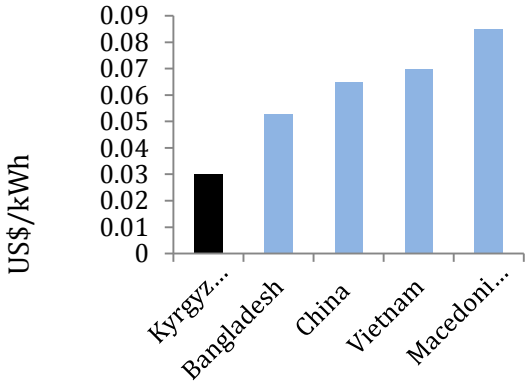
Figure 14: Access to electricity is reported to be a major obstacle

Electricity is reported to be an obstacle



Extent to which issue is an obstacle to the current operations of the business measured from 0 "no obstacle" to 4 "very severe obstacle"

This is somewhat offset by the lower cost of electricity from the grid

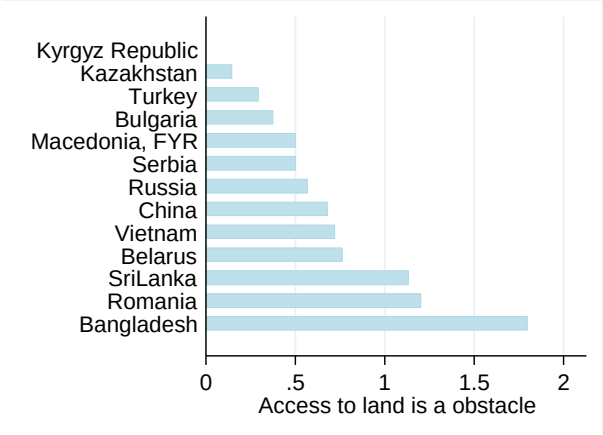


Source: Enterprise Surveys (http://www.enterprisesurveys.org), The World Bank for electricity, for costs of electricity figures are from Abylaev (2013) and Nathan (2009)

52. **Firms report that land and transportation costs are not obstacles**. This can be seen in **Figure 15**. It is reported that rentals in the Kyrgyz Republic are relatively low. Costs in Kyrgyz are half of rates charged in Bangladesh and represent around 60 percent of figures reported for China. In contrast, land and transportation are more problematic in benchmark countries, particularly in Sri Lanka and Bangladesh.

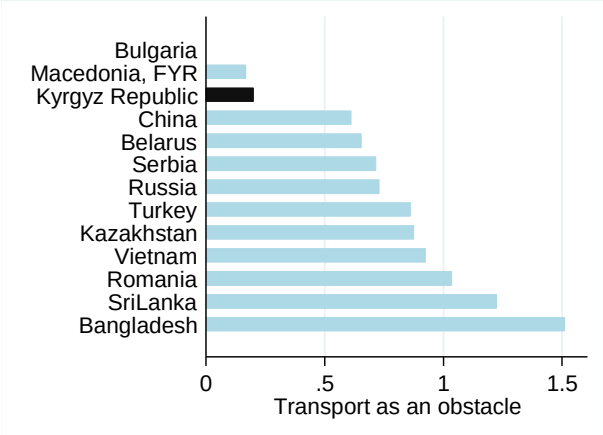
Figure 15: Access to land and transport infrastructure is not an obstacle

Firms don't report that land is a constraint to their operations



Extent to which issue is an obstacle to the current operations of the business measured from 0 "no obstacle" to 4 "very severe obstacle"

Nor is transport



Extent to which issue is an obstacle to the current operations of the business measured from 0 "no obstacle" to 4 "very severe obstacle"

Source: Enterprise Surveys (http://www.enterprisesurveys.org), The World Bank

V. Recommendations

53. This section first proposes three initiatives to strengthen the sector. It then provides three approaches to guide implementation of these initiatives.

A. Initiatives to strengthen the sector

i. Improve market information through trade promotion

54. **The sector's trade promotion programs should be extended and strengthened.** The industry associations are engaged in trade promotion, and GIZ and ITC have established a trade promotion program that has assisted companies in their efforts to participate in trade shows abroad and develop communication materials. These activities should be continued and increased. They could be complemented by providing research into customer markets, fashion and design trends.

v. Strengthening skills through education and training

55. There is a strong rationale for the government, the donor community and industry to fund initiatives to increase training and education in the sector. These initiatives should aim to reduce the cost borne by students and by companies that receive training. Training is needed for all activities in the sector. That said, the country needs to develop more professional skills such as management and administration as well as technical skills, such as those employed designers and dyers. The courses taught should be closely coordinated with industry. This will ensure that the curriculum reflects industry needs and will link students to potential employers. Representatives of industry could engage in the governance of training and education institutions to bolster results.

vi. Increase the adoption of new equipment through lease financing and industrial extension

56. **The initiatives to strengthen education and training are important to efforts to increase the** sector's absorption of new technology. It is recommended that the following points be implemented:

a) **An industrial extension program**. This would guide companies on ways to improve their production processes and educate them about machinery they are unfamiliar with. This advice should initially be provided for free and as such be fully subsidized. Once companies have established relationships with the program, they should pay fees and start to bear a larger portion of the cost of service provision.

b) A financial leasing program focused on financing modern equipment acquisitions and the knitwear sectors. Financial leases can be structured to reduce the risk of purchasing new equipment. The firm finances the purchase of the equipment with a lease. If the purchase is successful, the firm can purchase the equipment. However, if the purchase of the equipment was not successful, the firm can return the equipment after paying a moderate fee. This reduces the loss for the firm if the new equipment is not successfully incorporated into the business. A large proportion of the cost of this program can be covered with the interest and fees charged to lease recipients.

57. **A number of initiatives have been implemented to increase access to finance and technology.** For instance, the revolving loan program provides money for the purchase of new equipment. Firms are only given a year to pay back the amount borrowed but no interest is charged. Another example is the USAID program. This was a similar to a manufacturing extension program. Around thirty firms were provided with innovative machinery garment companies received training. Companies were provided the equipment for little or no charge. The programs have been well received by the garment companies that have benefitted from them. The USAID program has found significant increases in productivity in firms that received equipment and training.

B. Approaches to Implement the Recommended Interventions

i. Create permanent institutions

58. Consideration should be given to establishing public-private partnerships to implement programs to strengthen the sector's competitiveness. These institutions would help ensure continuity, retain institutional knowledge and make it easier to scale up programs.

ii. Leverage industry associations and cooperation between firms

59. The sector benefits from established industry associations and the firms' willingness to cooperate. Policies should take advantage of this by including representatives of industry in governance structures. The sector should also actively work to strength coordination by promoting social networks among industry players.

iii. Increase the sustainability of funding for the sector

60. Consideration should be given to increase coordination of funding in the sector. Funding for initiatives in the sector comes from industry, the donor community and government. This funding

does not appear to be coordinated and there is little long term commitment to funding programs. A sector-wide approach (SWAP) would strengthen coordination and allow for more long term planning.

Conclusion

This paper has focused on four topics:

1. **The importance of the garment sector** – The sector makes a substantial contribution to economic activity. It also has plays an important strategic role. The garment sector has been an important stepping stone for economies in the process of industrializing.
2. **How the sector will be affected by joining the Eurasian Customs Union** – The analysis suggests that the impact of joining the Customs Union will be reflected in an increase in the cost of material inputs for the garment sector. This will reduce the sector's competitiveness.
3. **A number of interventions are proposed to increase competitiveness**. This includes promoting trade, increasing training and education, and extending the program and support for a financial leasing program.
4. **These interventions will overcome a number of constraints that undermine the sector's competitiveness if implemented effectively.** These constraints include a dramatic shortage of skills, difficulty in accessing financing and low levels of technology adoption.

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