SUPPORT TO THE JORDANIAN GARMENT MANUFACTURING SECTOR

Global Apparel Trends
Final Report

September 15, 2008

This publication was produced for review by the United States Agency for International Development. It was prepared by Sergio Gonzalez / J.E. Austin Associates

SUPPORT TO THE JORDANIAN GARMENT MANUFACTURING SECTOR

GLOBAL APPAREL TRENDS

FINAL REPORT

USAID JORDAN ECONOMIC DEVELOPMENT PROGRAM

CONTRACT NUMBER: 278-C-00-06-00332-00

BEARINGPOINT, INC.

USAID/JORDAN
USAID/ OFFICE OF ECONOMIC GROWTH (EG)

SEPTEMBER 15, 2008

AUTHOR: SERGIO GONZALEZ / J.E. AUSTIN ASSOCIATES

DELIVERABLE N^{O}: 4.11.4.27.1.5

CONTENTS

1.0 EXECUTIVE SUMMARY

The United States of America's (USA) apparel industry is going through a period of profound change. The elimination of quotas has led to an intense competition from manufacturers in low cost countries. As a result, retail buyers are placing strict demands on apparel manufacturers in terms of product quality and delivery times. Furthermore, firms are facing more challenges in the form of; rising raw material costs, high-energy and food prices, and a faltering US economy.

2.0 NEW SOURCING STRATEGIES

In order to adapt to this situation and remain competitive, US apparel firms have been forced to respond by undergoing some significant changes in their sourcing strategies. Such changes took the form of;

- Fostering Relationships and Partnerships

A popular course of action has been to configure portfolios of foreign suppliers. Many firms have decided to foster close strategic relationships and partnerships with suppliers in order to minimize costs, maximize quality and optimize lead times.

- Manufacturing Initiatives to improve Customer Service

Another response has been to invest in special manufacturing capabilities to enable firms to offer a better overall customer service. Such capabilities include; total quality management systems, modern design facilities, logistics and transportation functionality, and information technology (IT) infrastructure.

Hence, the future of US apparel industry appears to be in the hands of efficient and "well-capitalized" producers who have abandoned conventional buying strategies such as "country of the month" and "factory of the season" in favour of long-term partnerships. Those manufacturers who have not kept up with the competition face a tough up-hill struggle over the next few years.

3.0 INDIA AND CHINA AS MAJOR HUBS FOR GLOBAL APPAREL SOURCING

In the post-quota era, India and China are emerging as the major hubs for global apparel sourcing, mainly to the US and the European Union.

- India's textile sector's size and competitiveness

India's development into a major hub has its roots in the following factors;

- Significant size of the apparel industry and its competitiveness makes it one of the world's leading apparel exporters,
- Vast sources of raw materials,
- Low labour costs ,
- Wealth of entrepreneurship, product development, and manufacturing experience which enables the Indian traders to produce apparel of high quality,
- Changes in policies paving the way for integration into the global economy.

Changes in the policies adopted by the Indian government has allowed for the opening up of the Indian economy to the outside world, which has led to a rise in the volume of exports. Indian apparel firms are quick in adapting to change in such a way as in expanding their capacity and adopting new technology, keeping in view the growing demand for Indian apparel all over the world. India has a large source of cotton domestically.

- Rising Indian and Chinese Exports to the US and European Markets

About 75% of India's exports are cotton items. No other country, except for China, can quite match India's apparel industry. During 2005 when the quota system was abolished India's exports grew by 34% and 30% to the USA and the European markets respectively.
Most of India's exports are to the USA and the European Union accounting for around 70% of exports. India's apparel exports are rising; however; they are still behind those of China. The rapid rise of Chinese exports raised concern in the European Union and in the USA with safeguards measures imposed by both countries.

As a result, many Chinese traders have started concentrating on other markets such as the Japanese and Australian markets.

Some firms have started increasing sales in their domestic markets. Many firms have started stepping up on their research and development measures in order to improve quality.

Traders have started using eco-friendly materials in the production of fabric. However, in spite of safeguards measures adopted by the European and the US markets to limit Chinese exports, most of the traders in China are increasing (stepping up) production in anticipation of further growth in exports.

With India and China emerging as major centers for apparel sourcing globally, the need has been raised for Indian and Chinese traders to (a) understand the culture of the host country, (b) adapt to their working style and (c) develop a working relationship with the people of that country. This has become necessary in order to develop an effective product, which would be readily accepted in a foreign market.

Traders are required to undertake a detailed study of the market of the host country and the prevailing trends. They are required to work with different time zones and deal with people belonging to a different culture and hence having a different mentality from theirs. They need to develop a product for customers who are very different from them and sell the product to them. Various factors such as cost, time and the market in which the product is to be sold has to be considered. This is a rather difficult task to undertake as a result of distance and the difference in the culture.

3.1 POTENTIAL SOURCING SHIFT FROM CHINA

China’s exports of apparel to the US market may slow down in 2008 as a result of (a) higher production costs, (b) rapidly rising Yuan and (c) surging competition from Vietnam, while US quotas in most sensitive product categories, which are of high volume, are still maintained until the end of the year.

The latest US official data reflect a sign of a possible shift to other sources since the Yuan is currently rapidly appreciating and production costs are increasing Chinese prices. During last December, according to the statistics of the US Department of Commerce, imports of US apparel from China decreased. The surprising decrease may be partly due (a) to higher quota fill rates in 2007 and (b) a consecutive lack of exports licenses at the end of last year in China.

Those latest data seem to confirm statements from the largest trading houses, announcing a potential shift in sourcing from China to other origins, due to a series of factors:

- Yuan’s Appreciation

The Chinese currency grew at a much higher pace of about 8% from the same period a year ago. With a majority of orders being placed six months in advance, the rise in the Yuan is adding to uncertainties and maybe the decisive factor behind limiting imports from China.

- Higher Production Costs

A new labour law in China is in favor of employees, which would result in a significant increase in production costs. Even if the law is not fully endorsed, as widely expected, wages are increasing in China, in line with inflation and especially in light of the higher food and energy prices.

- Lower Government Support

The Government of China aims at becoming less dependent on foreign markets by developing domestic consumption. VAT tax rebates, paid by exporters, were reduced from 13% to 11% in 2007 and should be further cut this year. Demand for apparels and apparel is surging in China's domestic market, limiting the share of export markets from total sales.

- US Economy Slowdown

The mortgage crisis has resulted in a slowdown in the US retail sales. Apparel chains reported decreases in comparable (same-store) sales for December and January, possibly leading to lower apparel imports in the near term. In addition to limiting the volume of imports, the economic slowdown will force US importers to put more pressure on prices. This should negatively affect business with Chinese suppliers who need to raise their prices at the same time.

3.2 SHIFTS TO EUROPE AND VIETNAM

With the value of the Euro remaining at a high level, Chinese exports may increase to the Euro zone in 2008. In addition, European quotas were eliminated on the 1st of January while US quotas will be maintained until the end of the year.

While shipments have decreased this year from China, US imports of apparel are increasing from Vietnam where costs and prices are relatively lower. Relocation of certain Chinese apparel production capacities to Vietnam may also explain such a trend.

4.0 INFLATION TAKES A HOLD IN THE APPAREL SUPPLY CHAIN

Sales have been decreasing as a result of inflation. Rising costs are affecting practically all apparel suppliers and buyers will need to start adjusting their strategies if they are going to find better value.

Some buyers are trying to stop the United States from removing quotas, which will allow at the end of this year a cap of products being imported from China into the United States on certain imports; others are lobbying the EU to impose import duties on apparel, newly liberalized from quota. The recent removal of quotas is flooding Europe with products being manufactured in China.

Meanwhile, one group of low- income countries (mostly Cambodia and Bangladesh) are lobbying the US to lower import duties, while other countries such as South Africa who happen to be richer than Bangladesh or Cambodia, are lobbying to keep those duties high. During the period of 1990 to 2007, apparel production was predictable. However, with all the above, prices of apparel as end items kept on getting cheaper because Western customers moved apparel production to countries where the apparel industry was a success .

With unemployment or underemployment rampant in every developing country, there was no shortage of people prepared to work for what seemed to be low wages relative to those in the developed countries.

If prices were set to rise, factory owners had to squeeze costs as western buyers demanded constant price reductions. Workers often found the cost that had to decrease to be their wages.

For most of the past decade, China was the center of all this. Even though Chinese wages have steadily moved up since the year 2000, the ingenuity of Chinese businesses in reducing costs has pushed down the price of Chinese manufactured goods on the world market. In addition, China has not been alone.

Currently, inflation in China has been widely publicized. A quote by a Chinese manufacturer predicted a 40% rise on Chinese prices. However, the consultant tends to disagree. The problem is affecting practically all emerging market apparel suppliers, which means virtually all apparel suppliers.

- Rising Cost of Living

Emerging market consumers are paying more for the basic items. Rapid rises of global food and energy prices hit low-income countries (like Cambodia) worse than the affluent west or medium-income countries (like Mexico).

The process of rising prices has hit countries with an appreciating currency (like India and Thailand) much less than countries (like Bangladesh) whose currencies have stayed constant.

By January 2008, inflation in almost all of the top 20 apparel-exporting countries was at least twice the average of developed countries, with China's cost of living up by 7.2% from 2007. In Vietnam, the cost of living rose from 6% in January 2007 to 15.7% in February 2008.

- Inflationary Influences

The shortage of suitable workers where clothes are made in China is reflected around Saigon, Bangkok and Jakarta. Moving factories to remote areas of the country has rarely worked. Fewer workers show interest in working at apparel factories as a result of (a) the prevailing notion that development in such workplaces is limited and (b) layoffs are common. Therefore, factories have to import migrant workers – notably from Bangladesh.

China's age group of 15 to 19 year olds will decrease every year until 2020. There is also an increase in other growing industries. In most apparel-exporting countries, the overall economy is growing faster than the workforce in the apparel industry is. Currently in some countries such as Bangladesh or Egypt, wages are lower than consumer prices for the past decade. If wages keep lagging, buyers will almost inevitably struggle to cope with the resultant low wage scandals.

These scandals do not just affect countries with low wages: 2007 saw repeated scandals – in Jordan, Malaysia and Mauritius – over immigrant workers earning substantially less than the country's minimum wage. This situation affected the reputation of the Western retailers whose factories employed the migrant workers.

- Inflation in other Prices

The Vietnamese government's anti-inflation policies have pushed interest rates on business loans up to 15%. Countries with appreciating currencies using local fabric (such as Brazil, Turkey, India, and Thailand) have seen the costs of raw materials soar. However, China's substantial raw material imports became relatively cheaper as its currency appreciated. Manufacturers' greater preference is for local sales; because they are more profitable than foreign buyers who demand lower prices. With local sales up 29% during 2006, few Chinese manufacturers need lower prices to keep buyers. India's local market is growing almost as fast.

- Manufacturers getting out of China

In Hong Kong, the prediction for the apparel industry is for more and more closures every day. This is contradictory to the buyer's pressure of: "bring your prices down or we will pull out". This approach is double edged and has been improving some countries overall competitiveness. India is currently developing textile parks, possibly as a simple real estate speculation, but is also offering substantial expansion to its limited apparel making capacity. Among Turkey's major manufacturers, the trend is towards switching out of Turkish textiles altogether and investing heavily in new Egyptian apparel and textile facilities. Meanwhile, more Taiwanese and Koreans are setting up fabric and fiber operations in Vietnam and Bangladesh with both until now held back by the need to import fabric from abroad. So what does this imply for buyers and sellers?

It is tempting to conclude that China is a great place not to be right now, especially with Western retail sales slowing down. However, the consultant tends to disagree. It was uncalled for in 2005 to conclude that China was the only place to be and equally unjustified to think that the end of some lines has been reached. Prices of raw materials are going up all over the world, and China's currency appreciation implies that these prices are hitting China less than many other countries. Business people in China have a long history of running businesses much more efficiently than outsiders predict, and we have yet to see the impact of the formidable factory building outside the Shanghai-Guangdong belt.

Business people in Hong Kong are saying how expensive China is getting just at the same time when the EU is contemplating using an anti-dumping duty and the lobbyists in the US are starting to campaign in favor of keeping quotas.

Inflation is not unique to China. Inflation is not just a result of fluctuating currencies or China's new labor laws, it is not going to be affected by the slowdown in the Western demand nor is it going to move downward quickly. Buyers need to start adjusting their strategies!

5.0 REGIONAL OVERVIEW

5.1 EGYPT

Egypt Qualified Industrial Zones (QIZ): A trade deal with the US and Israel to boost textiles. The QIZ agreement came into effect in 2005.

The QIZ deal allows Egyptians to export to the US tariff-free as long as they use certain percentage of Israeli goods. The US initiative is intended to foster peace through trade. However, for the Egyptian apparel producers, it has meant a chance to stand up to the competition posed by Asian producers. In 2006, and according to official estimates Egyptian apparel exports to the US rose by 41%. Egypt is one of two countries in the Middle East with a peace agreement with Israel, but relations are often described as being in a state of "cold peace". Over 200 companies are taking advantage of that arrangement provided through QIZs, including 15 foreign firms from Turkey, India, China, Pakistan and Taiwan.

The deal has not only led to increased production, but has also encouraged companies to upgrade their technology and expand vertically. This year, Egypt's total apparel exports are expected to reach $1.5bn, with a target of $3bn by 2010. The figures are still insignificant compared with the leading textile exporters, but the result is that some buyers have returned to Egypt and others have entered the market from Europe. The US consumes about 60% of Egyptian apparel' exports, up from 45% before the setting up of the QIZ. There could be improvements.

When the agreement first came into effect, Egyptian companies had to use a minimum of 11.7% of Israeli goods to produce their products. The difficulty for producers is that Israeli items such as zippers and pocket lining are more expensive relative to those available from Asian countries. There has also been a bottleneck in the availability of Israeli inputs. In October, the required amount of Israeli inputs was reduced to 10.5%.

Egyptians feel that the Israeli input should be around 8%, which is similar to that percentage offered to companies operating under QIZ in Jordan. However, that is contingent upon future negotiations between the Israeli and Egyptian officials. Israeli imports to Egypt totaled $126m in 2006, up from $30m in 2004.

The leading challenge facing the growth of QIZ in Egypt is the availability of skilled labor. This challenge is also relevant to other industries. In spite of Egypt's high unemployment level, there is a current shortage of more than 200,000 workers with a need for another 300,000 workers over the next three years. In spite of the fact, that in the textile industry the skill requirements are minimal, producers are still facing a shortage of workers. This is partly due to cultural with young Egyptians preferring government jobs to factory work despite the country's large population and unemployment rate of around 10%.Wages in the textile sector have increased in recent years, but are still considered low. The average monthly salary is between $100 and $120, up from $60 to $90 with productivity remaining to be a problem. Although large-scale factories are trying to improve productivity through creating training centers productivity remains to be a challenge.

5.2 JORDAN

Jordan is an attractive location for the United States apparel manufacturers and has been since 1998, when the US initiated the Qualifying Industrial Zones (QIZ) initiative. This arrangement allows goods produced in Jordan duty-free access to the US market provided that the products contain inputs from Israel. The objective of this initiative, as sighted above, was to foster economic cooperation, closer ties, and peaceful relations between Israel and Jordan.

The US Jordan Free Trade Agreement (FTA) went into effect in December 2001 and strengthened Jordan's preferential access. Jordan became the fourth country to have a free trade agreement with the US. As of January 1, 2006, the US was a party to six FTAs.

Despite the positive impact of apparel to export volumes in Jordan, the future of Jordan's manufacturing strength is uncertain. On the one hand, Jordan's low wage rate and preferential duty access to the US market gives it a competitive edge, but on the other hand, Jordan's manufacturers face critical challenges in remaining globally competitive. Low wages are not enough to provide a competitive edge. Speed-to-market, labor availability and higher-value added products and services now play a far more crucial role in determining international competitiveness. Jordan's most pressing challenges relate to labor shortages and higher productivity costs. Such challenges if not addressed will greatly affect the ability of manufacturers to compete in the long-term.

The US apparel industry is going through a period of profound change. New strategies for closer relationships with suppliers have been developed in order to minimize costs, maximize quality and optimize lead times. Buyers will always look at cost, quality, and deliveries.

Buyers are looking at new ways to maintain or improve key items and this can create opportunities for stable current businesses or new businesses for Jordanian manufacturers. Manufacturers in Jordan should focus on these items and work to become the best option.

It is taken into consideration that there are other countries that have cheaper labor costs, but it can be overshadowed by making product ldp (landed duty pay) comparisons with competitive low cost countries, as duty free advantages (more so in synthetic products) play an important advantage in the end product. To sustain such competitive lower end cost advantages, manufacturers will need to work in parallel with the recruitment of local labor and the improvement of manufacturing process to maximize production, efficiency, material utilization and the quality of products. These initiatives will form part of an ongoing process and will strengthen the manufacturing foundation, which will also allow fulfilling delivery commitments.

Jordan's lead times can become very competitive through (1) the growth of regional suppliers and (2) working with buyers that have warehousing in the northeast of the US. The consultant highly recommends engaging with the Economic Development Program's (SABEQ) initiatives of;

- Training and Development Programs,
- Recruitment of local labor,
- Working together to incorporate business strategies,
- Analyzing the supply chain to create better foundations for manufacturing.

6.0 CONCLUSION

Prices of raw materials are increasing all over the world, and China's currency appreciation means that buyers are diversifying their country source portfolio. Buyers are reviewing country strategies and evaluating product cost, quality and delivery, as a country or as a region.

Jordan can show its attractive advantages in light of the current changes in the global apparel trends. Duty free preferential access to goods exported to the US market play a significant cost difference to the landed product cost, especially to the northeast of the US, where lead time are much faster than Asian countries. Growing interest in Egypt, due to lower labor cost and preferential agreements, creates regional advantages over other Asian regions.

The apparel industry is changing and Jordan must identify not only their short and long term challenges, but capitalize on current opportunities.

7.0 APPENDIX I - PRESENTATION - GLOBAL APPAREL TRENDS

USAID Jordan Economic Development Program
Salem Center, Sequleyah Street
Al Rabieh, Amman
Phone: +962 6 550 3050
Fax: +962 6 550 3069
Web address: **http://www.sabeq-jordan.org**