

Maintaining a competitive edge for Cambodian industry: widening or deepening the standards spectrum

By Jodie Keane and Kong Ratha

The explicit link between adherence to International Labour Organisation (ILO) Core Labour Conventions and additional export quotas expired in 2005 with the end of the Multi Fibre Agreement (MFA). However, the link still exists in terms of enabling duty free and quota free market access under the US Generalised System of Preferences (GSP). This has become a growing trend, with the EU also offering GSP ‘+’ to countries that adhere to social and environmental standards, as well as others related to good governance.

This Background Note summarises a recent competitiveness assessment of the garment industry in Cambodia since the end of the MFA. The assessment was undertaken in parallel to other sector assessments, including: Tourism; Construction; IT and Agriculture; on behalf of ‘Insights for Action’, United Nations Development Programme (UNDP), Cambodia in late 2008 (UNDP 2009). It also incorporates more recent findings of a preliminary stock-take of the impacts of the global financial crisis (GFC) on Cambodia and its industry as of March 2009 (Jalilian et al. 2009).

The competitiveness of the Cambodian garment industry has been related to the deepening of preferential access, made possible by early commitment to ILO labour standards. However, this competitive edge has been eroded and is now under pressure. There are policy concerns on whether the standards spectrum and associated tripartite arrangements should be broadened across products and, therefore, markets. Rather than raising the labour standards bar to maintain a market niche (which is eroded over time), first mover

advantage could be sought in other products and markets. This note explores why the latter strategy might prove more effective than the former at the current time. First, it presents a summary of the recent growth performance of the garment industry in Cambodia, post MFA. This is followed by a critical review of the role of labour standards in enabling market access and enhancing labour productivity. Finally, changes in the external trade policy environment (including preference erosion) and external demand are outlined in terms of their implications for future policy initiatives in promoting industrial development.

Leapfrogging into regional production networks

The growth in Cambodia’s clothing exports since the late 1990s is impressive. By 2006 it had superseded more established manufacturers, to feature within the world’s top 20 clothing exporters. The growth of the industry globally and the entry of new and exit of old players, reflects the competitiveness of the industry: there are relatively low barriers to entry in the ‘cut-make-trim’ component of the value chain that relies primarily on the abundance of low skilled labour.

The climate in which low income countries can drive development based on the textiles and clothing sector is now framed by the presence of extremely large supplying countries in the global market, such as China (Brenton and Hoppe, 2007). Cambodia is situated between two giants of textiles and clothing production, India and China, as well as other larger producers such as Thailand and Vietnam.

Cambodia has had to carve out its niche in production. Preferential access to the US market (i.e. increased quota) based on adherence to labour

Table 1: Types of Asian textile and clothing exporters

Countries with large production capability in both textile and apparel production	China, India
Countries that have limited production capability in both textiles and apparel	Indonesia, Pakistan, Thailand, Vietnam
Middle income countries that mainly have apparel production capability	Philippines, Sri Lanka
Less Developed Countries (LDCs)	Bangladesh, Cambodia

standards was both a response to and subsequent driver of the industry’s success. Fears of a ‘race to the bottom’ through the use of low-skilled labour in Cambodia by other Asian manufacturers were allayed through adherence to ILO core conventions, embedded in National systems. Higher labour standards in production are attractive to buyers who adhere to corporate social responsibility not only because they reduce reputational risks, but also because National monitoring systems are in place, which reduce the need for company/brand specific inspections and therefore costs.

Labour standards: enabling market access and increasing productivity?

Adhering to labour standards has obvious benefits, but there may also be costs of compliance that raise barriers to entry for local firms (Ellis and Keane 2008). The garment industry in Cambodia is more than 90% foreign owned, with most investors coming from the Association of Southeast Asian Nations (ASEAN) and East Asian region.

Although labour standards are justifiable to avoid a ‘race to the bottom’, they should be adapted to the local context in as far as possible. Cambodia’s National labour law (1997) places a legal obligation on manufacturers to adhere to ILO core labour conventions. But strict adherence to all ILO core conventions, coupled with high worker awareness and weak institutions, has meant that the ‘freedom to associate’ article included within the core convention has been liable to abuse on a partisan basis.

Data received from the Garment Manufacturers Association in Cambodia (GMAC) suggests that the number of strikes for the first nine months of 2008 was higher than previous years. Costs for the industry are likely to have increased as a result of heightened worker disruption, which may have caused delays to orders. However, most of the manufacturers consulted expected the situation to ‘calm down’ in the latter half of 2008, in part because of a recent increase in mini-

Box 1: Rationalising worker representation

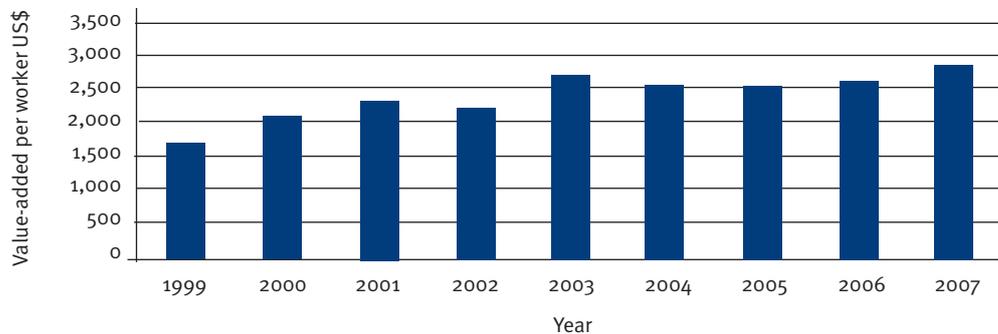
At the 14th Government-Private Sector Forum, the Working Group on Industrial Relations recommended that the most representative union at each factory should be defined as the union that represents 51% or more of the workers in the factory; with paid up dues from 33% of its members. The ‘most representative’ union is the one with at least 51% of the workers as members, and has the right to bargain collectively on behalf of all workers in the enterprise. However, it was also acknowledged that without a labour or commercial court, enforcement mechanisms are likely to remain weak.

imum wages and the announcement of the results of the National Election (July 2008).

All of the garment factory representatives consulted felt there should be a limit of one union per factory, with an average of two per factory surveyed (though there are some reports that as many as seven may exist in an average factory size of just over 1,000 workers). As one respondent put it: ‘more unions equal more problems’. In some cases, although labour disputes were taken to the Labour Arbitration Council (LAC) and a ruling made, enforcement mechanisms remain weak. The LAC is recognised by the Ministry of Labour, but no commercial court operates at present in Cambodia. This creates difficulties for employers seeking to adhere and apply the law, as well as uncertainty. Almost all strikes are ‘illegal’, because 99% occur before the dispute has been before the arbitration council (Okhna Dr Nang Sothy 2008)

Have higher labour standards increased productivity? As shown in Figure 1, value added per worker has not increased linearly, although it appears to have improved over time. Unit labour costs are an additional indicator of labour productivity. This measure provides a direct link to productivity: if wages increase but labour productivity remains the same then unit labour costs rise. Table 2 presents the estimated unit labour cost of labour employed in the garment industry since 2002 to 2007, based on production line data from the Ministry of Commerce. Estimates are based on the monthly wages paid to the total number of local employees in September each year, multiplied by 12 to obtain an average annual figure. This is then divided by the total value of garment exports for each year.

On the whole, wage increases in Cambodia have been matched by productivity growth, which appears to be modest as well as highly variable year to year. This may be reflective of strikes reducing output (both value added and unit labour measures use garment industry output within their calculation). Cambodia’s relative productivity in manufacturing industries is lower than that found in some other ASEAN com-

Figure 1: Estimated value-added per garment worker (1999-2007)

Notes: Output is measured as the total \$ production value of the garment industry, minus the inflation-adjusted value of such inputs as raw materials, semi-finished products and energy used in the manufacture, converted to \$ on the basis of the nominal exchange rate, minus the value of the administrative costs of production and export.

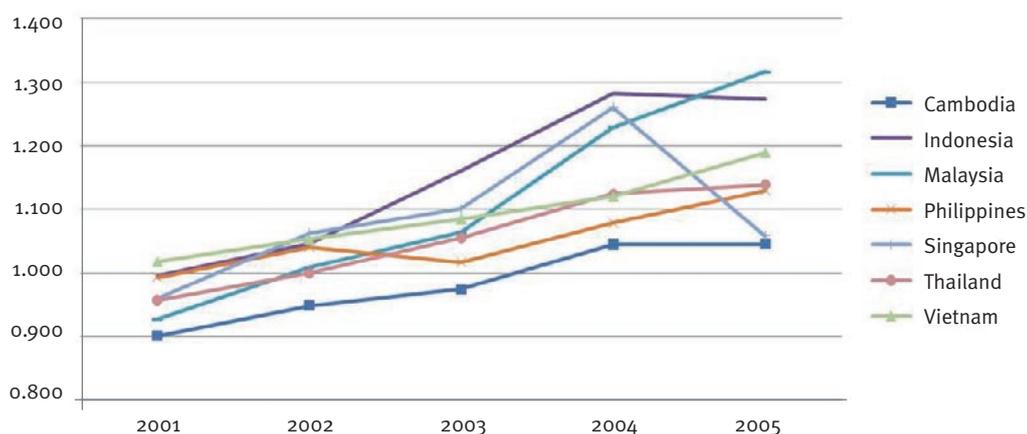
Source: Bargawi (2005); EIC (2007); Ministry of Economy and Finance.

Table 2: Cambodia's Unit Labour Costs in Garment Manufacturing

	2002	2003	2004	2005	2006	2007
Unit Labour Cost (\$)	108	105	114	101	103	109

Note: The differences between these and the results from Bargawi (2005) may be the result of the total value of garment exports being used as a measure of output rather than volume.

Source: Ministry of Commerce and Ministry of Economy and Finance.

Figure 2: Labour productivity in manufacturing industries (index 2000 = 1.0)

Source: Asian Productivity Organisation (2008).

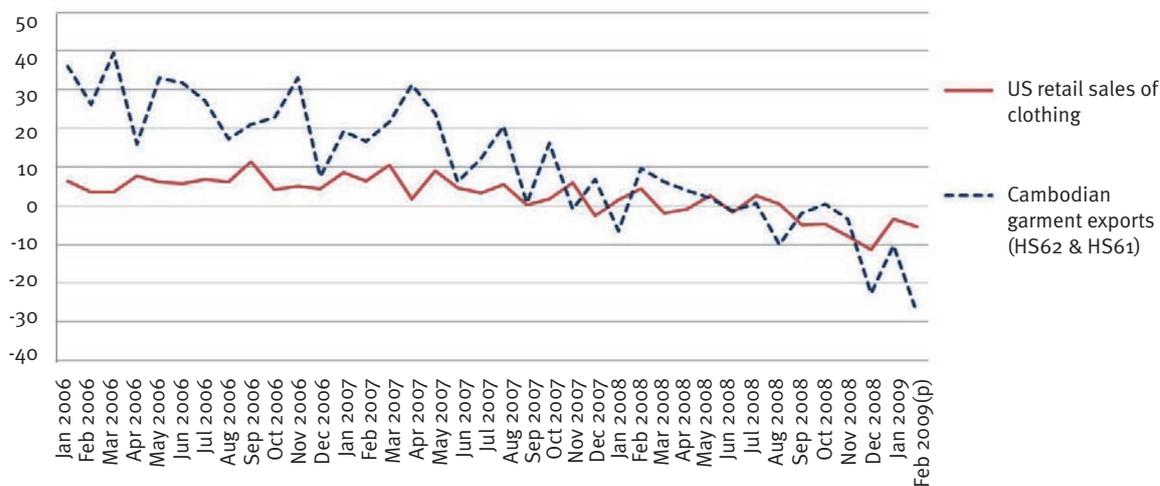
petitors as shown by Figure 2, although it is clear that Cambodia has made rapid strides in catching up.

The external trade environment and changing demand

The Cambodian economy is highly dependent on the garment industry, which accounted for around 17% of GDP in 2008 (Jalilian et al. 2009). There is also a

high dependence on a limited number of products and markets – the USA and EU together accounted for almost 90% of Cambodia's garment exports in 2008. The industry is, therefore, highly vulnerable to the current economic slowdown in these markets. It was, however, already under pressure before the full extent of the current global financial crisis became apparent.

Figure 3: Cambodian garment exports and US retail sales of clothing (% change year on year)



Notes: Garments have been defined based on categories HS61 (knit products) and HS62 (not knit). Retail sales have been calculated on categories 448-4482 recorded by the US Census Bureau for US retail sales. Figures for February 2009 are preliminary estimates; figures for March 2009 are advanced estimates.
Source: US Census Bureau and USITC.

The external trade policy environment

The challenges facing Cambodia in 2009 relate to the external trade policy environment more generally. Cambodia no longer has preferential access to the US market relative to Vietnam (as of January 2007) or, as of the end of 2008, China (with the removal of WTO safeguards). Between 2005 and 2007 Cambodia lost market share in some of its most valuable garment exports to China, which increased market share despite safeguard measures being in place.

Preferential market access is considered to be the main motivation for garment manufacturers to locate in Cambodia. Despite more than ten years of such access, additional favourable terms may still be required to persuade garment manufacturers to stay in Cambodia, as became clear in a number of interviews with firms. If the US Trade Act (2005) is passed – in part a response to the concerns of the Least Developed Countries (LDCs) of preference erosion vis-à-vis African exporters under the African Growth and Opportunity Act (2000) – it will grant duty free quota free (DFQF) access to LDCs such as Cambodia, Laos PDR and Bangladesh; but not other ASEAN competitors or China. However, most commentators expect that if the US Trade Act is passed, it will not be until the new US administration has settled in and could be as late as 2010.

Reduced consumer demand

Depressed retail consumption in the USA has resulted in cuts in purchasing orders and the closure of factories. According to Nelmes (2009) Cambodia’s garment

exports depend on US retail sales and these have recently collapsed. However, Figure 3 shows that the value of Cambodian garment exports supplied to the US market has declined far more than recent falls in total US retail sales of clothing (year on year, percentage terms). Reported exports for the first four months of 2009, compared to 2008 show a 20% decline in terms of value, year on year, according to information from the Ministry of Commerce.

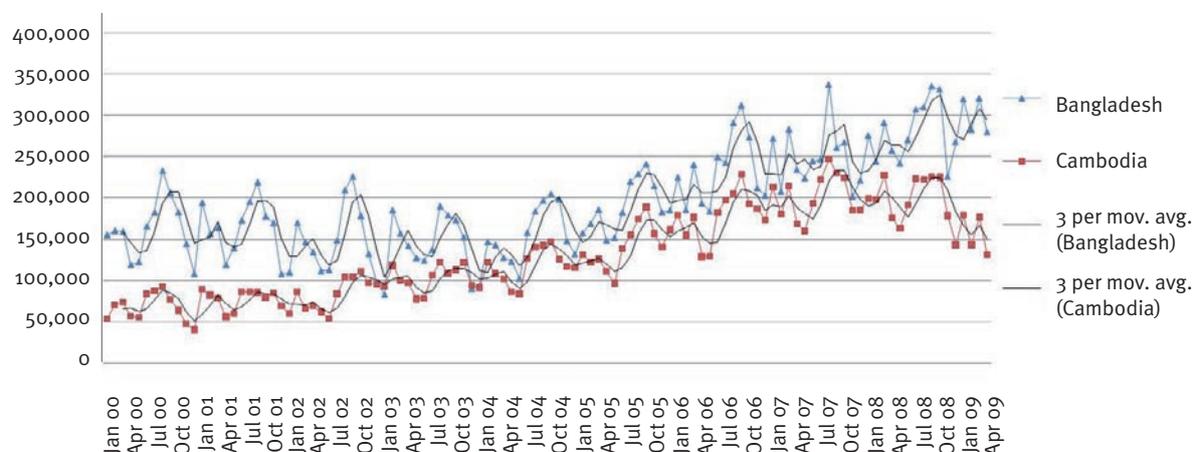
Factory closures are estimated to have resulted in job losses of 27,000 in 2008 and a further 19,000 job losses are expected in 2009, according to the Cambodia Institute of Development Studies and the ILO (2009). This already equates to more than 10% of the industry’s labour force. The impact of declines in exports and factory closures is likely to have severe socio-economic ramifications if workers are unable to find employment elsewhere and recent government announcements include re-training programmes for laid off workers (Jalilian at al. 2009).

Changing demand – Cambodia and Bangladesh

While both Cambodia and Bangladesh depend on the US market, they occupy different positions within it: Bangladeshi exports are not marketed on adherence to high labour standards; while Cambodian garment exports often have higher unit values, according to an analysis of a number of garment exports. Data for the first quarter of 2009 suggest Cambodia may be seeing a more rapid decline in demand for its garment exports in the US market than Bangladesh (Figure 4).

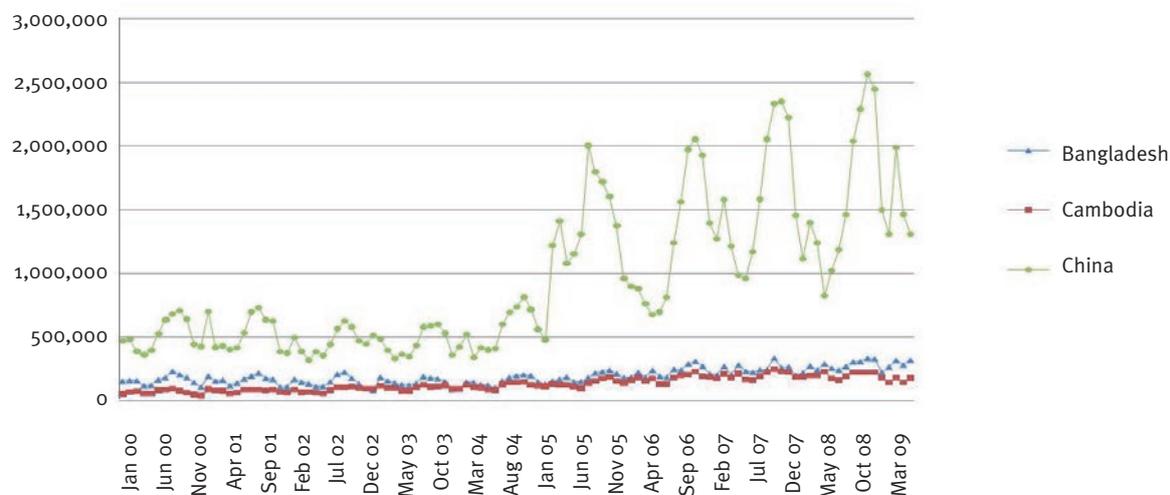
Bangladeshi garment exporters could benefit from

Figure 4: Cambodian and Bangladeshi exports of apparels to the US Market (\$'ooo)



Notes: Garments have been defined based on categories HS61 (knit products) and HS62 (not knit). Retail sales have been calculated on categories 448-4482 recorded by the US Census Bureau for US retail sales. Figures for February 2009 are preliminary estimates; figures for March 2009 are advanced estimates.
Source: US Census Bureau and USITC.

Figure 5: Chinese and other Asian exports of apparels to the US Market (\$'ooo)



Notes: Garments have been defined based on categories HS61 (knit products) and HS62 (not knit).
Source: USITC.

the ‘Walmart’ effect – as unemployment rises in the US, consumers may reduce their spending by buying cheaper clothing than (Rahman et al. 2009). Both exporters appear to have maintained their position in the US market, despite the end of MFA quotas in 2005 vis-à-vis China. This indicates that the US market, up to the latter quarter of 2008, was growing (Figure 5). The challenge for exporters, like Cambodia, is how to position themselves as demand slows and consumer behaviour changes.

Broadening the standards spectrum

Cambodia is expected to experience the steepest fall

in growth in East Asia (World Bank 2009). As demand weakens in the US market, and as consumers change their behaviour and start to buy cheaper products, Cambodia may lose out relative to producers such as Bangladesh. This is a risk for many developing country producers across the product spectrum. But in the case of Cambodia, it does suggest that a strategy of increasing labour standards to maintain a market niche may not be the optimum approach at the current time.

It is worth bearing in mind that although the recent dramatic declines in garment exports and their resultant impact on formal unemployment levels

gives cause for alarm, the garment industry employs around 4% of the formal labour force of Cambodia. Most migrant labourers laid off are expected to return to the agricultural sector, the major employer in Cambodia. Increased agricultural exports, such as rice, are expected to pick up manufacturing's slack in 2009 (Jalilian et al. 2009)

As Cambodia has developed in adherence to labour standards, it needs to do so again to position itself to tap into other types of production networks that operate in the region. There is, for example, much industry expertise on which to build. Consideration of regional production networks could also apply to other types of agro-processing. The greater Mekong sub-region (GMS) is becoming inter-linked as a result of improved transportation and this may present opportunities for a renewed push for growth in agricultural exports to meet regional demand.

The existing tripartite arrangements that have attracted and retained investment in the garment industry and built a worldwide reputation based on adherence to process standards (such as those relating to labour) could be replicated within other sectors of the economy, including agriculture. The benefits

of adhering to such standards, however, may need to be linked more demonstrably to productivity to be adopted more widely.

The global financial crisis will challenge Cambodia's current development path. But it also provides an opportunity to review and reconsider existing policy and instruments. Greater consideration should be given to broadening the standards spectrum and associated tripartite arrangements for export promotion, across products and therefore markets. Taking such an approach could enable Cambodia to better position itself both within the region and globally, for the upturn.

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Useful ODI resources:

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