



Economic Policy Reform and Competitiveness Project

MONGOLIAN GARMENT INDUSTRY: LIKELY EFFECTS OF ABOLITION OF QUOTAS AND ACTIONS THAT ARE URGENTLY REQUIRED

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Likely Effects of Abolition of Quotas and Actions that are Urgently Required***
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ABBREVIATIONS AND ACRONYMS

EPRC	Mongolia Economic Policy Reform and Competitiveness Project
TRC	Training and Resource Centre
TIFA	Trade and Investment Framework Agreement

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INTRODUCTION AND PHILOSOPHY

This brief report is compiled primarily to address the problems of the garment industry in Mongolia. The industry is already affected and is about to be very seriously affected by the removal of preferential quotas in the Multi-Fiber Agreement on 1st January 2005 - just seven weeks away.

It has been known for several years that these quotas would be removed in January 2005 and many countries and companies have been preparing for this day. Unfortunately Mongolia is ill-prepared for this change and the seriousness of the likely effects would appear to have only recently been realised even though there have been several reports on the subject in recent years.

The Economic Policy Reform and Competitiveness Project has, at the urgent request of the Mongolian Government, undertaken a series of meetings, visits, discussions and investigations into the garment industry. This has also touched upon other aspects of the related fiber and textile industries in the country. The consultants have received the utmost co-operation and been provided with relevant statistics and related information by the Mongolian Ministry of Trade and Industry.

January 2005 is only 7 weeks away. In considering the actions that are recommended, the consultants have also needed to formulate a possible long term plan for the industry as without such a long term plan, the short-term recommendations are unlikely to succeed. It is essential that such short-term measures dovetail with the long term plans.

The seriousness of the situation cannot be over-emphasised. This sector employs approximately 20,000 people (already down from almost 30,000 only 5 years ago). These 20,000 workers are the effective breadwinners for between 80 – 100,000 people. The Industry represents 29.2% of the country's exports.

The purpose of all measures taken needs to be focused, firstly to establish the correct climate which will persuade companies to stay and secondly a climate, which will attract further investment in the industry. These measures need to ensure that Mongolian Industry can compete internationally in this highly competitive international industry.

Mongolia is a land locked country without direct access to seaports. However it is bordering China the world's largest manufacturer of fabric – the vital ingredient for the garment industry. This needs to be seen as a potential asset not a threat.

FORMAT OF REPORT

This report endeavours to be concise and to the point. Some reference material is available but not necessarily appended. The consultants have drawn heavily on their experience and knowledge of the industry worldwide. Much of the material which the consultants are able to call upon is confidential and cannot be reproduced.

The conclusions of this report are intended to form a basis for further action by the Mongolian Government, facilitators and interested foreign governments and supporters. It is hoped that this report will be a catalyst to prevent the catastrophic demise of an industry, a demise which would have serious impacts on Mongolia.

EXECUTIVE SUMMARY

The garment industry of Mongolia will be seriously affected by the removal of quotas in January 2005. Unfortunately the industry is already affected as customers, suppliers and international companies implement their plans. Many of those companies visited expressed their desire to remain in Mongolia but considered that in the present circumstances the future prospects were very bleak. Many of the companies forming the garment industry in Mongolia were established to take advantage of the quota system which is now being scrapped. These companies are particularly vulnerable to closure – some of them only planned to operate until January 2005.

However, the consultants work reveals that the removal of quotas is really the proverbial straw that breaks the camels back. The underlying problems of the industry are many and cover many topics – each of which seriously affects effective industry performance.

Various reports have been written in recent years by official bodies and the industry leaders themselves. All these reports indicate a multitude of actions that need to be taken urgently by both the Mongolian Government and others to alleviate and reverse the decline of the Mongolian garment industry. The competitive issues are mentioned in detail in the following sections.

Time is short. Actions need to be taken immediately to establish the confidence of the Industry. Once factories are closed it will be difficult to re-open them.

The present proposed changes recommended by the government (document provided by the Government) are a significant move in the right direction. However the presently recorded proposed changes are not sufficient or specific enough to correct the situation.

Action needs to be taken by the Mongolian Government, the garment industry and the international community. The Mongolian Government alone will not be able to prevent wholesale closure of the Industry, but it can set the climate to encourage industry not only to stay but also to develop for the future.

Specific actions include:-

- Mongolian Government together with industry should adopt and promote a long-term mission for the industry.
- Immediate actions to improve the fiscal and structural climate to enable companies to compete in international markets.
- Removal of distinction between foreign and Mongolian companies to permit Mongolian companies to compete
- Removal of taxes on raw materials, fibre, yarn and fabric used by the industry whether the manufactured goods are for export or home trade
- Removal of taxes, duties etc. on imported spare parts and accessories used by the industry
- Removal of tax on companies employing foreign skilled workers
- Allow legitimate business expenses relating to employee benefits and encourage provision of such services
- Establish a working party comprising textile industrialists, textile trade unions, government and international textile experts to recommend changes to improve the industry and the employment situation.

- Establishment of an independent Textile and Garment Resource Centre in Ulaanbaatar to facilitate operative training, marketing training, quality awareness, computer design facilities, testing facilities, etc. This could be partially funded by international donors and the Mongolian Government. A possible location would be at the Mongolian Textile Institute which already undertakes some of the work but is seriously hampered by not having any modern equipment. The Textile and Garment Resource Centre would be a catalyst for establishing vocational training in other towns
- Removal of discrimination against industry by heating tariffs
- Incentivate industry to save energy
- Re-distribution of social security burdens
- Reduce transportation costs and bureaucracy
- Establish a climate of quality excellence
- Continue to negotiate with USA for a TIFA (Trade and Investment Framework Agreement) and/or other schemes of preference
- Develop international links with Europe, Japan and other countries to avoid dependency on USA markets
- Develop links with China to access supply of fabric
- Provide appropriate modern, energy efficient, low-cost single story factory buildings for the industry for rent at internationally competitive rents
- Develop the whole textile, garment and related industries with an integrated approach moving away from commodity low-cost products towards unique higher added value-added products
- Undertake a textile orientated project to correct the textile processing problems in the natural fibre industry. This is a natural follow on from the German report. It would hopefully address a number of recognised inconsistencies in the quality of Mongolian cashmere production.

SECTION I: INTERNATIONAL TRADE

The Mongolian Ministry of Trade and Industry provided statistics on the import and export of textile products in recent years. The particular pertinent points to arise from analysis of those statistics are as follows:-

- Total values of exported sewn and knitted articles in 2003 had risen to 97.0 Million US\$
- The total quantity was 37.12 million items
- This provides a unit value of 2.61 US\$ per item
- USA is the predominant market taking over 97% of both knitted and sewn products categories.

If we analyse the data for the year 2000 and compare it with 2003 we find that the unit cost of knitted goods exported to the USA has dropped from an average value of 5.46 US\$ per item to 2.01 US\$ per item. The USA is Mongolia's largest market purchasing 97% of sewn articles produced and 98% of all knitted articles produced.

The data for sewn items reveals that unit values have dropped from 4.24US\$ per item to 3.17US\$ per item in 2003. The total quantities of sewn items has increased from 16.9 million items to 18.6 million items but the revenue received has dropped from 71.7 million US\$ to 59.2 million dollars.

This shows a decline in the added value of production.

The policy of the Industry, encouraged by the Government, needs to be one of developing the industry to one which shows a move upwards to higher value added articles. Unfortunately the opposite has been happening over the last four years. This trend needs to be reversed. During our visits to factories we often saw sewing rooms which were capable of manufacturing, coats, anoraks, suits, etc. but which were now producing, polo shirts, casual garments and items of a basic nature.

There is no future in producing basic commodity items. These items are best produced in areas and countries closer to the plentiful raw materials.

SECTION II: COMPETITIVE ISSUES

Discussions have taken place with leaders of industry, trade union leaders and members. Visitations have been made to factories in Ulaanbaatar and neighbouring towns. Many common problems and parameters which disadvantaged the companies were detected. A whole host of problems discourage the garment manufacturing industry to develop and prosper. Virtually all companies raised the same topics. There was certainly a uniformity of identification of the problems affecting the Industry

The specific topics covered in the section which directly affect competitiveness are:

- Discrimination between Mongolian and foreign companies
- Transportation
- Documentary procedures
- Social Security issues
- Employment law
- Electricity costs
- Heating costs
- Building rents
- Import / export procedures
- Taxes and customs duties
- Training
- Resources to support the industry
- Moves towards higher valued-added products

A. Mongolian v foreign companies

There is a feeling in the Industry that Mongolian companies are discriminated against as foreign companies are given incentives to come to Mongolia. All garment producing companies, whether foreign or Mongolian owned should be encouraged to operate in Mongolia. Incentives may need to be given to attract companies to Mongolia but this administration needs to provide adequate safeguards to ensure that these benefits are not abused. Various models can be used. Other countries have already experienced these problems. Mongolia can learn from these experiences. Specific categorisation i.e. Mongolian or foreign only encourages companies to find ways of circumventing the regulations.

B. Transportation

Mongolia is land locked and the majority of goods exported need to travel through China or Russia. Two aspects put the industry at a disadvantage. Transport costs are high. This situation affects all industries and a review is presently being undertaken by the EPRC. Various measures needed to be implemented. Time of transportation between supplier and garment maker and again between garment maker and customer needs to be minimised. This requires all procedures involving transportation, customs clearance, etc to be reviewed to provide a speedy service to industry. If Mongolia does not speedily service its customers, other countries will gladly step in and service the international customers.

C. Documentary procedures

Movement of goods between countries is a competitive business. Those countries which provide speedy procedures are those countries which customers will prefer to use. An example of such effects is given in the above section on Transportation. Other examples are quoted by companies. All procedures should be scrutinised and simplified wherever possible.

D. Social Security issues

The EPRC is presently involved in suggesting changes to the system. The present system puts an inappropriate burden on employees for the liabilities of previous employment. This discourages the employment of older and experienced people (also see rules of employment)

E. Labour law

Present employment law has several clearly unintended detrimental effects on the ability of companies to produce products effectively.

Personnel need to be encouraged to have a greater responsibility to their provider of work – their employer. Employment turnover rates of 50% per annum were regularly quoted by companies. The same employee regularly leaving and returning was not unusual. The present situation of employee benefits being determined by their length of service in employment rather than determined by the length of time of service with their present or latest employer works to the detriment of the company. (Article 79 of Labour Law of Mongolia)

Article 40 of the Labour Law on the Annulment of Contract of Labour Law is meant to protect workers. However clauses 40.1.1 / 40.5 whilst ostensibly protecting workers could very well result in companies declaring insolvency and leaving the employees with nothing. We would suggest that discussions take place with employers and the relevant facilitators to improve the situation. (This is related to the Social Security Issues mentioned above)

We would recommend that the situation should be reviewed in line with international competitive practices.

At present companies are taxed 80,000 Togrogs per month per foreign employee. (*Law of Mongolia on sending labour force abroad and receiving labour force and specialists from abroad April 2001, Articles 9.1 and 9.2*) Companies employ foreign workers when specific skills are not available locally, e.g. technicians, specialists etc. This tax should be removed for skilled workers and the opposite should be encouraged. Companies need this skilled input. Incentives should be provided to encourage companies to seek assistance from knowledgeable personnel.

F. Electricity costs

This subject was raised by several companies. The EPRC is already involved in this subject. At the moment it would appear that industry needs to be encouraged to use appropriate electricity wisely. Generating costs are unlikely to reduce in the near future but a fair pricing structure is needed so that industry is not penalised.

G. Heating costs

This subject is also the work of the EPRC. At present some companies are clearly at a disadvantage, particularly those which are paying for heat in rented buildings where the cost is

based on the volume of the building. In addition to whatever measures are about to be introduced concerning heating tariffs and charges, companies should be encouraged to save heat, to insulate and to move to metered consumption or independent heat generation. Examples were quoted to us where tariffs for industry (based on volume) were effectively three or four times those of domestic tariffs based on area. The majority of the buildings occupied by garment making companies are totally inappropriate in today's commercial world. (See recommendations below) Eventually companies should be encouraged to convert fuel to heat at their own site. Central or District heating systems when located in cold climates are an ineffective way of distributing heat. Distribution losses are significant.

H. Building rents, etc

Many of the factories visited occupied floors of multi storey buildings. These are totally inappropriate buildings from many aspects. Effective garment manufacture cannot be undertaken in such premises which are expensive to rent, expensive to heat, do not facilitate work flow but the industry needs do impair product quality. Long-term the industry needs single storey, well insulated, long span, open plan factory units at competitive rents. Other countries do this. To be competitive Mongolia needs to do this also. (see German report for details March 2004)

I. Import / export procedures

As mentioned earlier it is important that all documentary procedures required should enable speedy movement of goods. We would suggest that a working party of industrial representatives and government officials assisted by experienced international specialists should study these matters and aim to improve the situation within a specific timeframe such as 12 months from now.

J. Taxes and customs duties

Numerous examples were quoted to us of instances where companies are disadvantaged by having to pay taxes and duties on vital raw materials and spare parts. In order to make industry competitive taxes and duties should not be levied on such items. If they are, immediate automatic offset or relief should be available.

At present no taxes are levied on raw materials where the products are ultimately exported. We recommend that no taxes should be levied on any imports of raw material whether for home use or export. The time to take the tax should either be after manufacture or at ultimate sale or both, but not before manufacture takes place. The present system puts Mongolian companies producing for the home market at a distinct disadvantage.

In discussions with company representatives we detected bureaucratic problems with the present situation concerning waste and substandard raw materials and products, particularly when the company was producing for export. Because of the present rules no mechanism appears to be in place to deal with these items (i.e. disposal of substandard raw material or products into the normally accepted trade outlets - the home market). This puts companies in a dilemma. The commercially logical and economic method would require them to break the law.

Clearly this anomaly and restriction should be removed. If all companies were treated the same and taxes removed from raw materials this anomaly would disappear

We also detected numerous examples of bureaucratic pressures which were put on companies.

These varied from expectation of companies to contribute to “events” and to the “necessity” to have a luncheon meeting before goods would be cleared by Customs. Such insidious pressures should be removed. Companies have enough to cope with without these hidden pressures and expenses.

In addition to the removal of taxes and discrimination between classes of company, we would suggest that a working party, similar to that referred to in Import / export procedures, should be set up, with additional action to be taken within a month to ensure that all petty restrictions are removed.

K. Business expenses and social issues

The corporate income tax law appears to disadvantage industry in general, including the textile industry by either limiting or not permitting many legitimate business expenses to be totally tax deductible. In addition to the limitation on training discussed in Section L. following, there are numerous prohibitions on expenses contained in the law that should be considered to be valid deductions. Among these are wear and tear on goods and inventories, bonuses and allowances and additional insurance premiums. These are being addressed by EPRC in a separate activity.

Specific to the textile industry is the issue of transport of workers and provision of basic meals, etc. Employers should be encouraged to provide employee benefits which are in turn beneficial to the company in that they reduce employee tardiness, minimize lost time and encourage healthy activities. The present system has the opposite effect. Employers should be encouraged to provide an atmosphere of improving excellence, in quality of production, quality of employment and satisfaction amongst its workers. We suggest a working party of textile industrialists, trade union leaders and international experts to investigate and recommend changes in practice and regulation that would form a positive approach to an improving industry and an improving climate of employment in the industry.

L. Training and Resources

It was sad to see virtually no serious training taking place in the industry. Industry regularly complained of the non-availability of trained workers but companies were only inclined to undertake the minimum of training necessary. The fear of trained personnel leaving companies was inhibiting the training taking place in the first place.

We understand that the corporate income tax law provides restricts combined training and advertising/promotion to a total of 10% of net taxable income. Decisions regarding training expenditures should be made on a management cost/benefit analysis, whereby management trains its employees to the extent that the company receives enhanced productivity, quality, etc. Thus, all training should be allowable against tax, provided the training serves a relevant business purpose. Rather than discourage training, incentives should be given to encourage training. Equipment used in training should be similarly incentivised. Companies should be encouraged to provide off the job training facilities or to use a central training facility.

We were pleased to learn that the Government was sponsoring the training of some of the unemployed to become linking machine operators. Not only do we recommend that employment laws be modified to encourage employee loyalty, but we also recommend that the Government establish a Textile and Garment Industry Resource Centre located in Ulaanbaatar.

This would provide essential services to the industry and encourage and facilitate the training of skilled workers. It would ensure that the quality of training would be improved. It would facilitate a supply of highly trained workers for the industry. Other international competitive countries do this. It is an extension of education but independent from it.

We visited the Textile Institute section of the Mongolian University of Science and Technology. The staff there are endeavouring to teach textiles without having virtually any modern equipment. They desperately need appropriate technology, including computer design equipment, laboratory and testing equipment etc.

Initially funding for a Textile and Garment Industry Resource Centre could possibly be applied for from funds such as the Millennium Challenge. Initially it would require commitment and funding from central sources for a period of several years until industry was in a position to pay for some of the services. Such a resource centre would be able to assist companies to develop their marketing skills and expertise.

M. Resources to Support the Industry

In addition to training mentioned above there are a number of other topics where Mongolia does not have the required infrastructure to support the industry. This puts Mongolian Industry at a distinct disadvantage. Several of these areas are mentioned below. They include, design services, boxes of high quality, thread, accessories, labels, etc.

Most garment factories rely on imported garment designs. Where designs are originated in Mongolia they are done manually. The present methodology is slow, expensive, prone to problems of accuracy, and wasteful in the use of material and time. A resource centre could introduce industry to the unique advantages of computer design technology and techniques. It could also provide such a service to Industry. This has many possibilities with links to international customers, designers and Universities.

The garment industry in Mongolia appears to be almost totally dependent on imported cartons for transporting goods. Comparable Quality products are reportedly not available in Mongolia. This situation should be investigated and appropriate action taken to attract such a manufacturing facility. It is better to import dense paper to make into board rather than import empty corrugated boxes which consist of 80% air.

A similar situation exists with embroidery. Many high fashion garments increasingly use embroidered logos, symbols etc. We understand that only one facility exists in Mongolia to produce these items. This is a facility that can be demonstrated in a resource centre so that industry can be encouraged to invest in such technology at their own factory knowing that trained operatives will be available. We visited several factories which were affected by the lack of supply of labels. They were waiting for imported supplies. Modern techniques are to print labels in the factory adjacent to the production line. A Resource centre could demonstrate this technology and train appropriate workers.

There is a need for a central resource providing assistance with monitoring of garment production. A central resource could provide such machines for demonstration, training and service to industry.

Details of the structure of the Textile Training and Resource Centre need to be finalised. We recommend that a panel of industrialists, Government department officials, donors and

international textile experts meet urgently to finalise details which would enable such a resource to be established quickly.

N. Natural Fibre Industry

This topic is not included in the terms of reference of the report. However, a report on the garment industry inter alia would not be effective if the natural fibre industry of Mongolia was not taken into consideration. In general terms this is primarily the cashmere industry.

Several reports have been written in recent years about this subject, in particular the report dated March 2004 on the cashmere industry by the German – Mongolian Project. That report provides much detail upon the Industry and comparative statistics between Mongolian and Chinese operations.

That report identifies the present capacity limitations of the industry and some of the other production and marketing limitations of the industry.

The future of the Mongolian garment industry and the Mongolian cashmere and related fibre industry should be considered together.

Mongolia has a reputation for high quality cashmere. However that reputation is based on past reputations. Unfortunately much Mongolian cashmere production has deteriorated in quality, unlike Chinese cashmere which has improved.

Visits were made to different cashmere processing factories. The consultant was disturbed to note that all was not well. In some instances the cashmere was generally harsher to handle than it should be and some of the operations appeared to be saddled with the legacies of the past. There was an appreciation that all was not well. In the opinion of the consultant the problem is likely to be more fundamental than that perceived.

We would strongly recommend that a team of textile consultants (it requires several different specialists), should produce a report on the textile effectiveness of processing cashmere. Such work could be vital to ensure the future of the entire industry. If radical changes are not made then the whole cashmere fibre industry could easily go to China together with the garment-making jobs which Mongolia so desperately needs.

SECTION III: RECOMMENDED ACTIONS

A. Urgent

- Mongolian Government together with Industry, to publicise and promote a long-term mission for the Industry.

The Mission statement could possibly be:

“The Government of Mongolia encourages the Textile and Garment Industries of Mongolia to provide internationally competitive operations which will improve the economy of the country and the wealth of its people. Such a policy will require building upon the natural resources of the country, and investing in facilities to produce efficient customer service, making higher quality and higher added value products in order to meet the needs of the discerning international markets.”

To facilitate this, a Training and Resource Centre would become an essential element.

However, the garment industry, which is the subject of this report, should also be considered together with the raw textile industry of Mongolia (cashmere, wool, camel etc). The two sectors of industry should not be considered to be separate. Instead of exporting high value raw material such as cashmere, this raw material should be converted to high value-added products within Mongolia. (see the section on cashmere processing industry in Section II page 6.)

- Facilitate a climate which enables companies to compete with international competitors.

The purpose of the Government is to encourage industry to be effective, efficient and profitable so that the industry can contribute to the prosperity of the country and to the wealth of its people. The following items are just a few specific suggestions which would enable this to happen. If such measures are not taken there will not be an industry which pays employees or taxes.

- Removal of distinction between foreign and Mongolian companies to permit Mongolian companies to compete
- Removal of taxes on raw materials, fibre, yarn and fabric used by the industry whether the manufactured goods are for export or home trade
- Removal of taxes, duties etc on imported spare parts and accessories used by the industry
- Removal of tax on companies for employing foreign skilled workers
- Allow legitimate business expenses relating to employee benefits and encourage companies to provide such benefits
- Establish a working party of textile industrialists, textile trade unions, government representatives and international experts to recommend changes required by government and the industry to improve the competitiveness of the industry in international markets
- Removal of discrimination against industry by heating tariffs
- Incentivate industry to save energy
- Re-distribution of social security burdens
- Reduce transportation costs and bureaucracy
- Establish a climate of quality excellence

- Negotiate preferential trade agreements with trading partners
- Develop international links with Europe, Japan and other countries to avoid dependency on USA markets
- Develop links (both physical and diplomatic) with China to encourage access by Mongolian companies to the largest supplier of fabrics
- Establishment of a Textile and Garment Resource centre in Ulaanbaatar to facilitate operative training, marketing training, quality awareness, computer design facilities, modern manufacturing techniques and testing facilities, etc. This could be partially funded by international donors and the Mongolian Government.
- Undertake an investigation into the textile effectiveness (as opposed to an economic report) of the natural fibre processing industry and the changes that are required for it to survive

B. Complete within 12 Month – 3 year Period

- Provide modern, energy efficient, low-cost, single-storey factory buildings for the industry
- Develop the whole textile, garment and related industries with an integrated approach moving away from commodity low cost products towards unique higher added value
- Continue to negotiate with USA for a TIFA (Trade and Investment Framework Agreement) and/or other schemes of preference
- Facilitate the transformation of the natural fibre industry (cashmere, wool, camel etc) to become a higher quality orientated industry.

C. Longer term, 5 year maximum

- Develop transport links to provide lower cost fast links with China and Russia

APPENDIX A: COMPANIES VISITED DURING THIS SURVEY

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1. Magic Suit Co Ltd.,
2. Mongol Samic JVC
3. Diorva-Mongol company
4. Ajliin Khuvtsas company
5. Buteelch uils company - Barrage
6. Mongol Khun Khua company
7. Dady Mongol company
8. Tianpin
9. Gobi Corporation
10. Mongolian cashmere, camel wool company
11. Golden Eagle cashmere company
12. Good profits (Mongolia) garment company
13. Mongolian Textile Institute
14. Federation of Mongolian trade unions*
15. Ministry of Industry and Trade

** Representatives from 20 textile companies attended this meeting*