1. Uzbekistan on its Way to the WTO: Risks and Benefits for the Textile and Apparel Industries

This article is the first in a series focused on the analysis of the economic impact of the anticipated accession of Uzbekistan into the WTO. The article was drafted on the basis of the respective report of the Center for Effective Economic Policy (CEEP) with assistance from the USAID-BearingPoint Uzbekistan Economic Reform Project. The following authors contributed to the report: Ms. Valentina Baturina, Mr. Jakhonghir Muinov and Ms. Evgenia Elfimova, who were supported on behalf of the Uzbekistan Economic Reform Project by Mr. Philipp Eddleston, Mr. David Martin and Mr. Eshref Trushin. Opinions expressed in this article are those of the respective authors alone and should in no way be taken to reflect the opinions of any organizations.

The article analyzes benefits and losses for the textile and apparel industries, and reviews basic motives, risks and costs of the WTO accession. The authors have concluded that a reduction of import tariffs would not result in considerable losses in output or employment for the textile and apparel industries. High import tariffs have not yet facilitated significant expansion of textile and apparel production due to the number of institutional barriers, quality factors and illicit imports. In addition, import tariffs increase the cost of living and add to the costs of production in the apparel industry. The textile and apparel industries should be export-oriented and therefore a favorable business environment should be established for the production and placement of foreign investments and orders.

Introduction

Rationale for Joining the WTO. At present, 146 countries, including such CIS countries as Kyrgyzstan, Georgia, Armenia and Moldova, are members of the WTO, accounting for about 95% of world trade turnover[1]. Therefore, membership in the WTO is an indicator of integration into the world trade system.

About 30 additional countries, including Uzbekistan, have already applied for membership in the World Trade Organization. Accession to the WTO is made on the basis of consensus and every member country may set forth additional specific requirements, aimed at reducing protectionism for new entrants. Joining the WTO in the near future may enable Uzbekistan to avoid additional requirements for reducing protectionism from countries which may join the WTO earlier than Uzbekistan[2].

Openness to foreign trade facilitates economic growth and poverty reduction[3]. Stiglitz[4] argues that true development entails a transformation of society. He emphasizes that openness to trade opens up new possibilities by forcing firms to innovate and by offering them new inputs and goods that embody new knowledge. The WTO Secretariat study[5] has come to the conclusion that trade liberalization is generally a positive contributor to poverty alleviation. Although it may create some losers and poverty may be exacerbated temporarily, this challenge should be tackled with facilitating adjustments and the strengthening of social security. These factors should be considered while making decisions on regulating trade relations and adapting the economic reform process to WTO accession.

Coughlin and Chrystal[6] have summarized the basic findings in the literature on protectionism and concluded that: (i) protected industries are subsidized (in one way or another) by the rest of the economy; (ii) protectionism, as a rule, leads to higher prices of the protected goods and this harms domestic consumers; (iii) low-income families are affected more than those with high incomes; (iv) cost-per-job-saved due to protectionism is usually very high and much higher for domestic consumers than the value of benefits for a protected industry, and protection leads to job loss in downstream production; (v) there are significant efficiency losses due to the excess domestic production and reduction in consumption caused by protectionism; (vi) the administration of protectionism per se may be very costly; (vii) protectionism of one sector may evoke similar requests from other sectors, which hinders economic reform; and, (viii) while import tariffs represent the simplest types of subsidies, since they generate revenue for the government and provide additional income for the respective industries out of the pockets of consumers, there are also direct methods of regulating sectors which are more effective than protectionism.

[1] http://www.wto.org/english/thewto_e/whatis_e/tif_e/org6_e.htm
[2] United Nations Economic and Social Commission for Asia and the Pacific, "Accession to the WTO", p.38
[3] e.g.: Dollar D. and Aart Kraay, 2001 Trade, Growth, and Poverty, World Bank, Development Research Group, March 2001 (available on:www.worldbank.org/research/growth/wpdate.htm; Srinivasan T.N. and Bhagwati J. Outward-orientation and development: Are revisionists right?, September 17, 1999, available on: http://www.columbia.edu/~jb38/papers.htm.
[4] Stiglitz J. Two Principles for the Next Round, Geneva, September 21, 1999, available on: http://www.worldbank.org/knowledge/chiefecon/stiglitz.htm.
[5] Ben-David D., H.Nordstrom, L.Winters. Trade, Income Disparity and Poverty, WTO Secretariat Special Study, 2000, p.5-6. (see: http://www.wto.org/english/news_e/pres00_e/pov1_e.pdf).
[6] Coughlin C., Chrystal A., Wood G. Protectionist Trade Policies: A Survey of Theory, Evidence, and Rationale, in: International Political Economy, ed. By J.Frieden and D.Lake, 3rd ed., St. Martin Press, 1995, p.323-338.

The following factors to be achieved after WTO accession,[1] listed by their degree of importance, may create a positive impact on the economy of Uzbekistan:
- Increased competition between commodity producers and lower costs of goods and services on the domestic market, due in part to the reduction of import tariffs and other trade restrictions.
- Limitation of protectionism, including its non-tariff forms; a more open and transparent trade regime and reorientation of economic resources towards competitive sectors.
- Improvement of the business climate and a higher reputation for the transparent economy following international standards of trade.
- Better legal protection for domestic producers in external markets.

Concerns about Joining the WTO. Uzbekistan is currently at the initial "questions and commentaries" stage of negotiations on accession to the WTO[2] and formal negotiations on specific terms for accession are beginning. Uzbekistan currently has several practices that do not conform with WTO regulations and will have to be changed before it will be permitted to join. The most significant of these provisions include the following:
- Tax breaks for exporters;
- State programs on localization;
- Redistribution of production according to production and marketing forecasts – another main point of concern since some of these plans might imply hidden subsidies for exporting industries;
- Certain non-tariff barriers for imports; and
- Lack of efficiency in protecting intellectual property rights.

Some regulatory measures could be undertaken without connection to foreign trade, i.e. transformed in a way not contradicting the WTO rules. The WTO rules also envisage a transition period of several years so that the country may establish a trade regime fully conforming to the rules of this organization.

Major costs that potentially could be incurred by joining the WTO:
- If the country opens up as required by the WTO, domestic enterprises may be forced to reduce production and employment and the Government could lose tax revenues.
- The Government could be forced to increase social spending to ameliorate the impact on workers if employment is reduced.
- It might be necessary for the budget to pay additional fixed costs in order to comply with the requirements of the WTO on intellectual property rights, certification and the standardization of goods and services, including customs procedures and sanitary regulations in Uzbekistan, and representations in the WTO.

On the sectoral level joining the WTO will benefit competitive export-oriented sectors while import-substitution ones would be in a rather difficult position. The impact on the service sector would basically be indirect and would depend on the growth of the economy as a result of trade liberalization, as services are mainly rendered in the domestic market.

WTO membership requires permitting foreign firms equal access with local firms to domestic markets. Therefore foreign companies would be enjoying better access to banking, insurance and building services markets in Uzbekistan. The area of concern here is financial services, due to the necessity of specific regulations in this sphere for the public interest.

Protectionism and subsidies of the agricultural sector are not too strictly constrained by the WTO. Furthermore, WTO membership might increase Uzbek access to some markets which will be advantageous for Uzbekistan.

Industry contributes about 15 percent to GDP and is clearly the area most at risk from trade liberalization. However even this sector has the potential for development after WTO accession. For instance, the fertilizer industry is sufficiently efficient that transportation costs more than offset any lower costs that foreign competitors from Russia or China might offer. Oil, gas, gold and non-ferrous metals mining also have nothing to worry about in terms of threats from foreign competition.

Given the conditions in Uzbekistan, measures for creating a favorable business climate and developing industries with comparative advantages, i.e. labor and domestic natural resource-intensive as well as IT sectors, are preferable. It should be emphasized that the double-land-locked position of Uzbekistan already

[1] Eskender Trushin. Membership in the World Trade Organization, see. "Central Asia and South Caucasus Affairs: 2002", pages 61-103.
[2] Current Status of Individual Accessions to the World Trade Organization (available at http://www.wto.org/wto/english/thewto_e/acc_e/status_e.htm)

provides natural protection for domestic industry since transportation costs are very high. Reducing import tariffs will decrease the attractiveness of smuggling goods and thus may contribute to the increase of government revenues from import duties.

Cost and Benefits Analysis for the Textile and Apparel Industries
Textile and apparel industries are important to Uzbekistan as they are linked to the country's industry development prospects (see Table 1.1). Some mistakenly believe that the reduction of import tariffs may result in a great loss of market for domestic producers. However, this is untrue. For example, ginning contributes about 57% of the total production in the textile industry and, along with cotton yarn weaving, is unlikely to be at risk after trade liberalization.

In addition, the textile and apparel industries have already adapted to the existing demand after a significant downturn transition period when the number of workers in the industry fell five-to-eight-fold to the level at the end of the 1980's.

Table 1.1. Share of Textiles and Apparel Industries in Production, GDP and Employment in 2002

Sector	Share of GDP, %	Share of industrial value added, %	Production, billion Soum	Share of employment in total, %
Textiles	2.5	18.0	806.9	1.2
Ginning	1.4	10.0	448.9	0.25
Spinning and weaving	0.9	6.4	285.4	0.6
Knitting, including hosiery	0.05	0.3	15.05	0.09
Other	0.15	1.3	57.5	0.26
Apparel	0.16	1.1	50.7	0.34

Source: CEEP

At present, in the apparel industry, the main contracts are connected with the production of uniforms for various state agencies, as well as the production of traditional clothes, which would not be subject to attack from imports. Therefore, the negative effects of trade liberalization would not be considerable for the apparel industry.

Employment at risk due to trade liberalization in companies with direct foreign investment is almost negligible and these companies should be seen as a growth point, able to generate much future employment and import substitution. Some companies with a considerable share of government ownership have relatively modern designing, patterning, and fabric utilization equipment. With the expansion of the market, and the use of international experts to bring increased productivity, management and marketing, these skills can be enhanced to the point where most or all have a future, and can grow significantly.

The apparel industry is a relatively low-tech one (the principles of stitching machine operation have not changed over the last 100 years), and is a matter of organization techniques, rather than new equipment. Some domestic apparel factories have efficient computerized equipment for the production of patterns and cutting, which is often idle due to the small amount of current orders. Such equipment could be a competitive advantage for export production.

The main industries at risk after trade liberalization are those in the production of knitted wear, the cotton industry, and garments, which in 2002 employed about 93.6 thousand people (only about 1% to the total employment in the economy), produced goods worth 98 bill. Soum and contributed about 1.3% to the GDP.

In addition, many textile enterprises export a significant part of their production, i.e. can compete in the world market. For example, the share of exports in production was 36.5% for cotton yarn and 22.8% for fabrics in 2002.

Enterprises in these sectors are divided into two distinct groups – the state controlled enterprises (SCEs) and the private sector, usually with foreign involvement. In the private group, the equipment is relatively new, is highly productive, and economical. We would estimate that the foreign-invested primary textile companies have a secure future. This group had high capacity utilization of about 80% in 2002 and produced about 74% of all domestically made cotton yarn, 53% of cotton fabrics, and almost all knitted goods.

In the other group many state sector textile companies are full of obsolete equipment which cannot return to economical production as the domestic market is not sufficient to achieve significant economy of scale. Such textile factories do not have stable sales markets, resulting in a lack of working capital. As a rule, capacity utilization there is rather low (about 33% in 2002) and they are at risk of financial instability in any case. The considerable decrease in production which began at the end of the Soviet period was not matched with a decrease in fixed production costs due to the large size of the enterprises. As with the majority of state-owned enterprises (SOEs), they lack marketing and management skills while maintaining some production skills.

The recent development of textile equipment has been so rapid that machines lagging two generations behind are hopelessly obsolete and cannot compete. It is not even worthwhile to sell such machines for spare parts. For instance, modern spinning machines work at a speed of 100 thous. revolutions per minute, while equipment with a speed of 20 thous. revolutions per minute is not competitive. For weaving machines the width of fabric should be 150 cm and wider, while a width of 90 cm is not efficient for stitching and there is no demand for it on the global market. Modern weaving tools operate at a speed of 700 revolutions per minute while old Soviet-type machines STB, which are very common in local textile mills, operate at a speed of 210 revolutions per minute and even slower.

This group of companies is losing money and without radical investment or sale, most likely as joint ventures, many will inevitably close, whether or not tariffs are reduced. A possible mitigating factor would be the gradual closure of this capacity, that is the closure of one facility, and its order book consolidated into the others, together with better use of existing facilities through productivity measures.

Our extrapolation of assessments on the basis of surveyed enterprises in the textile sector is the following: the maximum decrease of the contribution of the textile industry to the GDP after trade liberalization should not exceed 0.5% of GDP with a 0.3% loss in total employment in the worst case.

There is an overly optimistic opinion that the domestic market for domestically produced textile and apparel goods can be captured by domestic industries with the help of high import tariffs. The approximate value for domestic consumption of apparel and knitwear is about 5% of disposable income spent on those goods, or about 310 million dollars. At first glance this is a sufficient market for import substitution, at least for a few factories. The sustainable development of existing capacities needs bigger markets, i.e. export ones.

However, despite high import duties, a large part of the expenditure of the population is spent on imported goods. Statistically, registered imports already have a significant share (Table 1.2). For example, according to official statistics, both domestically-produced and imported knitted goods and garments were about 3350 Soum ($4.3) in 2002 in per capita annual terms. Domestic production of some consumer goods is very low. For example, only 0.5 pairs of hosiery, 1.3 pieces of knitwear, and about 2000 Soum ($2.6) worth of garments were produced per capita by domestic industries in 2002.

Table 1.2. Ratio of imports to domestic production for key textile goods

	Ratio of imports to domestic consumption, % (registered)			
	2001	2002	2003	Average: 2001-2003
Cotton fabrics	1.2	2.1	0.7	1.3
Garments	31.8	53.8	28.2	37.9
Knitted goods	15.6	38.5	3.6	19.2
Hosiery	25.8	190.1	9.0	41.6

*Note: registered imports and exports
Source: CEEP

Given that people in Uzbekistan spend only about 5% of their disposable income on apparel and knitted wear, one can estimate that the share of statistically registered domestic production and imported garment and knitted wear per capita is about 30-35% of what people in Uzbekistan should really consume. Thus high import tariffs fail to achieve the goal of squeezing out imports.

High import tariffs are not the key and efficient tool for upgrading domestic production from low to high value-added. Currently, import duty for most garments and textile goods is 30 percent. However, high import tariffs cannot compensate for high costs of production due to adverse institutional factors. Institutional factors affecting management and marketing of enterprises, various types of administrative barriers, as well as access to raw materials and sales markets, rather than protectionism, are determining factors. High taxes and social payments result in high costs for labor-intensive sectors such as the garment sector, decreasing their competitiveness and attractiveness for direct foreign investment.

However, in situations where many enterprises in Uzbekistan have very slight or negative profits, any factor that can increase sales, such as protectionism, can make a significant difference for their income account.

Import tariffs without clear conditionality for the development of industry are rather counter-productive, as they do not provide development incentives for enterprises, due to the lack of competition. In addition, high tariffs promote smuggling and the shadow economy.

Actually, the protection of the textile industry hampers the development of the garment industry. For example, 30% import tariffs on intermediate goods (like chemical fibers: 5407-5408 by SITC classification, and stockinet: SITC 6001-6006) and 10% import tariffs on other chemical fibers (SITC 5401-5406) and garment accessories only hamper the domestic production of the textile and garment industries. To produce good hosiery, some chemical fiber component is needed.

The textile industry may indirectly support garment production through the production of cheap and high quality fabrics. Regretfully many factories still have to use imported fabrics, as domestically-produced fabric does not fully meet requirements for quality, price and style.

It would be overly optimistic to believe that the strategy of first capturing the domestic market and then developing exports can succeed in the textile and apparel industries. The strong import-substitution drive of the economy for the period 1995-2002 did not significantly increase the share of domestically processed cotton, which is still at the level of 20-25%. The bulk of exported cotton fabrics are grey fabrics with low value added. Foreign-invested companies are largely in the primary textile industry – spinning and weaving. They are operators of efficient, economical, high capital cost equipment which employ relatively few people. Together with the cotton-growing sector, they export raw, unfinished products, products of the smallest added value.

Domestic textile producers would not be able to sustainably fund their modernization. Textile equipment is rather costly and requires vast sales markets to become profitable. The best way for modernization of the textile industry is the attraction of foreign direct investment, which also brings corresponding marketing and management skills. Accession to the WTO would encourage foreign direct investments, and the renovation of light industry would not need to be paid from government revenues.

The textile industry is capital-intensive. The average cost of creating one job as a result of building one textile facility in Uzbekistan approximated 30-45 mill. Soum or 38-45 thous. doll. in 2001-2003, whereas the creation of one job in the garment industry may cost only about 2-5 thousand dollars. Therefore the garment (apparel) industry will help to resolve employment issues in a more efficient way and contribute to the policy of social stability.

In Uzbekistan the main consumers of garments are the 16–35 year-olds. They as a rule buy fashion merchandise because it carries known brand names and is fashionable, and such demand may not be satisfied by simple import substitution. There is a lot of diversity in fashions and they may change 6-8 times a season in developed countries, which are major consumers of garments. Of course there are garments where fashions do not change so briskly, however competition in such markets in extremely high.

The absence of a strong marketing network, fierce competition, rapid fashion changes, and protectionism on the world's markets for fabrics and garments will hamper expansion of high value-added goods from Uzbekistan without a strong marketing network or marketing partnership with foreign partners. Many foreign garment producers are part of well-established world technological chains: the design of goods taking into account the most recent trends in fashions – production of accessories – stitching and packing – sale to end consumers. Uzbekistan producers would have difficulties competing with such a well-functioning mechanism on their own.

Conclusion and Recommendations

A more adequate strategy for capturing the domestic market would be building local producers into this world technological chain, through export orientation and the attraction of direct foreign investment. This would allow the production of garments attractive for domestic consumers, i.e. import substitutes.

Garment factories should be viewed as a growth pole for the entire industry as such factories have competitive advantages and may easily create many jobs with little capital investment. Efficiency in the sector could be increased within several years without costly investment, by improving management and achieving economy of scale in production.

Considerable growth of exports could be achieved by creating friendly a business environment for foreign investors and for receiving foreign orders from CMT and C&M[1] operators. Export buyers as a rule do not want to buy ready garments. They want to buy manufacturing capacity to service their design, development and marketing machines. They are in the market for low unit-price manufacturing sources, and are scouring

[1] CMT (Cut, Make and Trim) - with fabric and trims – linings, buttons, zips, thread, labels, bags, etc. provided; C&M (cut and make) cut and stitch only, with or without final packaging.

the world for such. Foreign partners may order the production of garments at Uzbekistan factories and provide their fabrics and accessories as in many countries of the world. Developing in this way, domestic garment makers would be able to increase demand for domestic fabrics as well.

The availability of quality, innovative, cotton or cotton-blend fabrics as input for the stitching industry would certainly be seen as a competitive advantage for garment factories in Uzbekistan. It would be necessary to improve customs clearing and transportation services for the continuous supply of inputs (fabrics and accessories) and export of ready-made products.

The recent experience of developing joint stock companies in former socialist countries demonstrates that foreign partners desire to build new garment factories with optimal placement of equipment in industrially developed areas rather than buy old facilities. Foreign firms also tend to hire young staff and train them in new skills.

The main export markets are in the USA, EU and Japan. These countries have quotas for the import of textiles and garments. The quotas for Uzbekistan are still not fully utilized and there are great opportunities for exports. It is important for export that it takes from 20 to 30-35 days to deliver goods by sea to EU markets from India, China, Vietnam and Indonesia, which is comparable to the time required for shipment from Uzbekistan. Labor costs make up 60 % of all costs of garment production. Labor productivity at advanced Uzbek companies is comparable with the above countries.

In view of the above it would be reasonable to:

- Develop a time-scale for the reduction of import tariffs and other complementary measures for the adaptation of sectors to accession to the WTO jointly with the Consumers' Rights Protection Society, Association of Light Industry and Economy Research Centers.
- Eliminate import tariffs for intermediate goods for the garment industry (fabrics and accessories) which will facilitate the growth of production and employment.
- Give up practices prohibited by WTO rules; protection from imported goods and export incentives could be efficiently ensured by reducing the real exchange rate of the national currency.
- Accelerate financial restructuring, reorganization and privatization for the preparation of enterprises for increased competition with imported goods.
- Considerably decrease payroll taxes and social payments.
- Expand operations of the Commodity Exchange,[1] ensuring equal opportunities for domestic producers for the purchase of cotton fiber and other inputs necessary for production volume and quality.
- Create a Trade and Industry agency (a one-stop shop) to assist and reassure foreign investors and customers. This Agency will have high government status and include representatives of private export-oriented producers in its Board of Directors. The Agency will develop and implement a program "Locate to Uzbekistan" in Uzbek Embassies in key foreign countries and vest in the officials a right to resolve appropriate issues, budget financing and mechanisms for self-financing. The objective of the Agency shall be to render assistance in:

– giving advice and assistance in overcoming bureaucratic and legislative difficulties for foreign investors;
– establishing production facilities and locating sites or partners with whom to work;
– creating special industrial zones[2] for the establishment of textile enterprises with foreign investments;
– lobbying the government for the removal of bureaucratic obstacles and taxes and the development of a favorable climate for foreign investment and for placing orders with domestic enterprises.

- Establish a specialized Center for studying foreign practices and the development and implementation of Quality Testing and Quality Assurance programs for textile and garment sectors.

- Promote the acknowledgement of Ethical Standards in the industry. All major buyers of garments in the world market now require a statement of ethical standards from all suppliers. This will cover the obvious areas of work practices, fairness to employees and elimination of any form of discrimination. It will also cover environment matters, of particular relevance to textile finishers. Such policies should be opened for inspections and monitoring.

[1] Envisaged by the Cabinet of Ministers Resolution dated 5 February 2004, "On introducing market mechanisms of sale of high liquidity products"
[2] This implies getting permission for the planning and placing of production in such zones, establishing power supplies, drainage, water supplies and the availability of labor and transportation routes.