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Export-driven SME Development in Kyrgyzstan: The Garment Manufacturing Sector

Nurbek Jenish



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Abstract

This paper examines recent developments in the garment production sector in Kyrgyzstan that contributes significantly to GDP and employment. The paper analyses the factors that led to the impressive growth of garment manufacturing. The export volume of Kyrgyz clothing to the Russian Federation and Kazakhstan increased ten-fold from 2002 to 2012. The main reasons for this growth include open trade regime and simplified weight-based customs clearance, which allowed for relatively cheap acquisition of fabrics; favourable patent-based tax treatment; and the solid entrepreneurial skills of Kyrgyz entrepreneurs. In-depth interviews were conducted with garment manufacturers and wholesale order customers and informed a profile of the structure and workings of the garment industry. This study also examines the impact of recent policy changes, including import tariff increases on fabrics and clothing accessories, as well as the possible implications of Customs Union accession by Kyrgyzstan on its garment production sector. Other key findings can be summarised as follows: (i) 2013 saw a decline in demand for Kyrgyz clothing in key markets of the Russian Federation and Kazakhstan, likely due to: import tariff increases, resultant decreases in imported Chinese fabrics and increased production costs; and a shift in preferences from Kyrgyz to Belarusian apparel, which is perceived as the closest competitor to Kyrgyz clothing; (ii) The production cost of clothing would increase by 10 to 20 percent after the country enters the Customs Union. Kyrgyz products would be still cheaper than Belarusian counterparts but the price differential would decrease. This, combined with enormous support of the Belarusian government to its clothing sector, may result in Kyrgyz products losing some of its middle-class customers in the Russian Federation and Kazakhstan.

Keywords

garment production, trade, Kyrgyzstan, Customs Union of Belarus, Kazakhstan and the Russian Federation
JEL codes: F19, O53.

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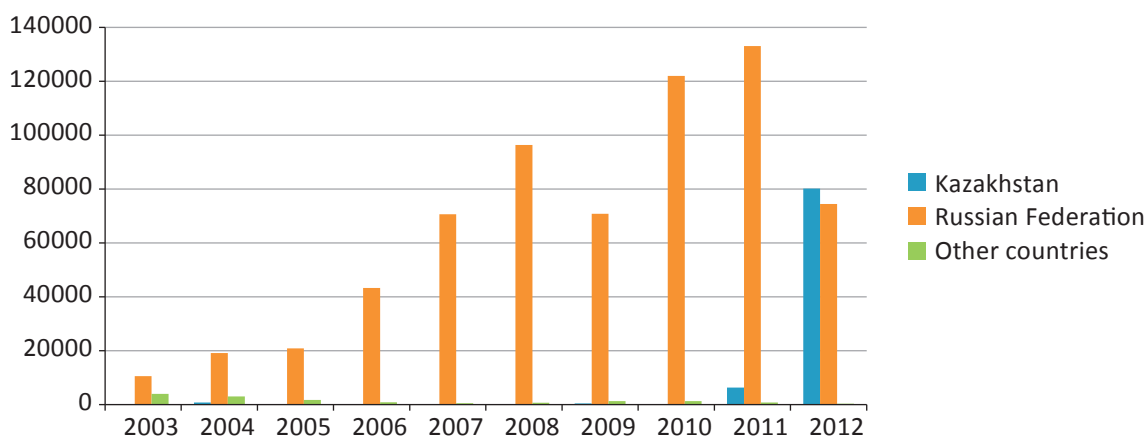
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1. Introduction*

In the last 10 years, Kyrgyzstan has recorded impressive growth in its garment production industry. According to estimates by the largest Kyrgyz garment and textile producer associations, Legprom and Souztextil, the contribution of the sector to gross domestic product (GDP) ranges from 5 to 15 percent, and employs more than 100,000 people.¹ The strong development of the sector in the past decade is mainly due to increased garment exports. Exports increased ten-fold, from around \$15 million in 2003 to \$155 million in 2012, with the Russian Federation and Kazakhstan being the main export destinations (Figure 1).

Figure 1. Kyrgyz Garment Exports (US\$ thousands)²



Source: UN Comtrade

What were the factors behind the strong expansion of the Kyrgyz garment production sector? Recent studies argue that both macro and microeconomic conditions played a significant role.³ Firstly, accession by Kyrgyzstan to the World Trade Organisation (WTO) in 1998

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¹ In 2012, the total labour force constituted about 2.4 million people.

² Export of garments is calculated as the sum of products under HS2002 codes 61 and 62, which are knitted and crocheted clothes and not knitted and not crocheted clothes, respectively. There were no Kyrgyz garment exports to Kazakhstan until 2011. There are two potential explanations. First, the accession of Kazakhstan to the Customs Union (CU) in 2010 substantially increased its import duties, which resulted in higher prices of imported goods. However, tariffs on imports from Kyrgyzstan have not changed with the formation of the CU thanks to existing free trade regimes between CU countries and Kyrgyzstan, Tajikistan, Turkmenistan and Uzbekistan. Second, the stricter implementation of CU rules led to more accurate statistical accounting of goods imported to CU countries.

³ For a discussion and overview of the Kyrgyz apparel industry and its development, please see Academy of Public Management (APM), "Structural Analysis of Textile Sector," *Study prepared for APM under the President of the Kyrgyz Republic* (Bishkek: APM, 2013); Laura Birkman, Maria Kaloshkina, Maliha Khan, Umar Shavurov and Sarah Smallhouse, "Textile and Apparel Cluster in Kyrgyzstan," *Student Project* (Cambridge: Harvard Kennedy School and Harvard Business School, May 2012) www.isc.hbs.edu/pdf/Student_Projects/2012%20MOC%20Papers/Kyrgyzstan_Textile%20and%20Apparel%20Cluster_Final_May%204%202012.pdf; and SIAR Research and Consulting, "Economic Impact of Kyrgyzstan's Participation in the World Trade Organisation: Textile and Apparel Sector," *Study prepared for Ministry of Economy of the Kyrgyz Republic* (Bishkek: SIAR, 2008) www.mineconom.kg/files/WTO%20textile.doc.

and an open trade regime greatly contributed to the vibrant growth of the apparel industry. Cheap imported fabrics and accessories from China, (to a lesser extent) Turkey and other countries combined with simplified weight-based customs clearance protocol turned the apparel sector into a locomotive of light industry. In 2012, according to Legprom and Souztextil, garment production constituted more than 80 percent of light industry production,⁴ with over 3,000 small and medium-sized enterprises (SMEs) exporting more than 90 percent of their production to the Russian Federation and Kazakhstan.

Secondly, favourable tax treatment of garment manufacturing enterprises played an important role in promoting the apparel sector. Enterprises are allowed to operate under the patent system, which substantially eases their tax burden. Moreover, the patent system helped to bring a substantial number of apparel SMEs out from the shadow economy.

Thirdly, the Kyrgyz Government and donors, namely the German Agency for International Cooperation (GIZ), the Asian Development Bank (ADB) and the International Trade Centre (ITC), joint efforts to promote the apparel industry.⁵ The Government and GIZ developed the National Strategy for the Textile Sector aimed at strengthening industry competitiveness and expansion of markets of product distribution. ADB, through its Vocational Education and Skills Development Project, developed a competency-based modular sewing training curriculum offered at 25 lyceums throughout Kyrgyzstan. ITC provided a series of training programmes and advisory services to assist companies to transition from make-through to conveyor type production systems and attract larger orders and new customers.

Finally, the presence of relatively large Kyrgyz diasporas in the Russian Federation and Kazakhstan, market knowledge of the region and regional tastes facilitated the creation of efficient distribution and sales networks.

Despite strong growth in the clothing sector, there are concerns as to whether such growth can be maintained in the medium term. A key challenge is the planned accession of the country to the Customs Union (CU) of Belarus, Kazakhstan and the Russian Federation. If Kyrgyzstan joins the Union, the common external value-based tariff, which is larger than the current weight-based one, will be applied on imported fabrics and other supplies needed for garment production. Kyrgyzstan has virtually no domestic fabric production and relies predominantly on imported fabrics. So, this would substantially increase the cost of apparel production in Kyrgyzstan and may result in Kyrgyz products becoming less competitive in CU markets. Additionally, overall prices are expected to increase substantially after the country joins the Union. This would automatically increase the cost of labour and the unit cost of garment production.

The contribution of this study is threefold: (i) it offers a detailed analysis of how Kyrgyz apparel industry functions; (ii) examines recent developments in the garment production sec-

⁴ Knitwear production constitutes a small part of all apparel production. In 2008, it made up only 10 percent of all apparel production and did not see significant growth due to lack of finance and outdated technologies.

⁵ For a detailed overview of donor support for the apparel and textile sector in Kyrgyzstan, please see United States Agency for International Development (USAID), "Assessment of the Textile Sector in Kyrgyzstan" (Bishkek: USAID, 2011) <http://ldp.kg/wp-content/uploads/2012/07/Textile-Sector-Assessment-2011.pdf>.

tor, including the impact of recent policy changes and (iii) assesses the consequences of CU accession for the sector.

The rest of the paper is organized as follows. Sections 2 and 3 provide a description of the study methodology, an overview of the profile and functioning of garment sector, and an examination of the main competitors. Section 4 discusses the possible consequences of CU accession on the sector. Section 5 summarises key findings and their policy implications.

2. Analysis of Recent Developments in the Garment Production Sector

2.1 Methodology

To gain better insights into recent developments in the apparel production sector in the country, eight in-depth interviews with owners of sewing shops (enterprises) and two with wholesale order customers were conducted. In addition, a series of discussions were held with experts in this sector as well as with distributors of Kyrgyz garments in the Russian Federation.⁶ Table 1 presents profile of the enterprises whose owners were interviewed. As can be seen from the table, the respondents represent medium and small size enterprises that produce different types of apparel for men, women, and children. Of those interviewed, the “youngest” enterprise has been operating for two years, whereas the “oldest” for 11 years.

Table 1. Profile of Respondents’ Enterprises

| Enterprise Characteristics | Enterprise 1 | Enterprise 2 | Enterprise 3 | Enterprise 4 | Enterprise 5 | Enterprise 6 | Enterprise 7 | Enterprise 8 |
|-----------------------------------|----------------------------------|-------------------------------------|----------------------------|---|---|--------------------------------------|--------------------------|-------------------------|
| Size (no. of sewing machines) | 56 | 20 | 16 | 35 | 40 | 5 | 5 | 20 |
| Length of operation (years) | 11 | 6 | 7 | 4 (owner worked 10 years in the industry) | 8 (23 years in the industry) | 3 (15 years in the industry) | 2 | 4 |
| Ownership | Individual entrepreneur | Individual entrepreneur | Individual entrepreneur | Individual entrepreneur | Individual entrepreneur | Individual entrepreneur | Individual entrepreneur | Individual entrepreneur |
| Product type (women/men/children) | Women’s mainly and men’s | Women’s and children’s | Women’s | Women’s | Summer clothing for women and children; winter clothing for men | Children’s and women’s | Women’s | Men’s and children’s |
| Garment items | Jackets, dresses, coats, blouses | Creepers, jackets, blouses, dresses | Any type of women clothing | Dresses, skirts, pants, jackets, blouses | Summer dresses, school uniforms, men’s shirts, winter jackets | Creepers, blouses, dresses, costumes | Skirts, blouses, dresses | Pants, school uniforms |

⁶ Guidelines for use for the in-depth interviews can be obtained from the author upon request.

Apart from the in-depth interviews, United Nation's Commodity Trade Statistics (Comtrade) and Chinese Customs Office's statistics have been used to examine the trade flows.

2.2 Profile of the Industry

Seasonality

The apparel production sector is characterised by seasonality. The high season lasts from March through November, and the low season is from December through February. In March and April, enterprises work at 50 to 70 percent capacity. From May through August, they usually work at full capacity. From September through November, operations are at about half capacity.

During the summer, enterprises receive the majority of their large orders. During the high season they hire more workers and expand their working schedule and load. At the peak of the season, an average enterprise with 40 sewing machines is able to produce 8,000 units of blouses in one week. Towards the end of the season, the same enterprise produces just 1,000 units of men's jackets⁷ in 10 days.

Larger enterprises with stable wholesale orders during the peak of the season might be overloaded and may not complete their orders in time. Thus, they usually find small enterprises (with 5-10 sewing machines), which have no permanent wholesale order customers, and outsource or "share" some part of their order with them.

Most small enterprises stop working by the middle or end of December, and have no orders in January and February. During this period, enterprises that rent working space work only to cover their rent and do not generate any profits. Workers usually try to find jobs at larger enterprises which continue to have orders.

Size

There are three main groups of clothing enterprises, based on size, which is measured with the number of sewing machines that they own:

Small enterprises or mini-workshops have between five and fifteen sewing machines. They do not require a large workspace, a lot of workers or large investments. Most industry entrants start as mini-workshops and, if successful, expand. The majority of small enterprises are located in new settlements around Bishkek.

Medium enterprises have between 20 and 70 sewing machines. Most have been in operation for more than five years and have a stable number of orders and regular wholesale customers.

Large enterprises have more than 70 sewing machines. These enterprises are not just pure "operators"; they might design their own models of clothing and do most of the work related to supply of materials and the product distribution. These companies usually own their

⁷ Producing one jacket takes approximately twice as much time as producing one blouse.

space in Dordoi bazaar⁸ or even have their own brand shop. Moreover, they have their own distribution chains in Kazakhstan and Russia.

SMEs tend to be more flexible than larger enterprises in taking orders and producing different styles of clothing. For them, it usually takes three days to prepare a new style from the scratch based on an existing design, and about one week to have finished a line of ready-to-wear clothing. Additionally SMEs do not usually deal with ordering fabric and accessories or the distribution of the final product, but focus exclusively on sewing.

Profit, Taxes and Other Costs

Enterprises, on average, add up 30 percent to the cost of labour (including sewers, ironers, cutters, etc), depending on the type of clothing.⁹ Out of this 30%, enterprises pay public utilities (heat, electricity, water, etc.), rent, patent (lump sum tax), and maintenance of machines. What remains represents profit of a sewing enterprise.

Public utilities for a medium-sized enterprise (30-40 sewing machines) make up about \$30 per month in summer and autumn (mainly electricity)¹⁰. Rent costs differ according to the location of the enterprise. For 40-machines companies it is about \$400 per month if it is located in the outskirts of the city or in one of new settlements, and more if in the city center. Equipment maintenance costs depend on the type of sewing machine. On average, service technicians charge \$4 per machine per examination, and more for repairs (depending on the nature of the breakdown).

Almost all enterprises function under the juridical status of individual entrepreneur based on a patent purchased from tax authorities. The patent, introduced by Kyrgyz authorities to bring small business out of the shadow economy, exempts entrepreneurs from paying VAT and sales tax. The price of a patent is considered fair at \$40 (2,000 soms) per month for the first 10 sewing machines, and \$20 (1,000 soms) for an additional 10 machines. The entrepreneur also pays \$5.6 (280 soms) monthly for each worker in tax, and \$11 (550 soms) as social security contribution, which is shared with the worker (350 soms or \$7 are paid by entrepreneur). The smallest enterprises, with 5 to 10 machines, usually do not register and avoid paying taxes.

2.3 How Enterprises Function

Market Entry

About 70 percent of enterprises starting in the apparel industry are owned by people with no specialised education. Entering the market costs between \$5,000 and \$10,000, depending on the number and quality of sewing machines that are bought. Most enterprises in the industry work with Chinese equipment and a few have Italian machines. Chinese sewing machines

⁸ Dordoi bazaar in Bishkek is the country's largest wholesale and retail markets and one of the largest public market places in Asia.

⁹ 30 percent represents the mark-up charged by a sewing enterprise. Thus, ignoring the cost of fabric and other accessories, the final price paid by wholesale order customer to a sewing enterprise for clothing consists of labour costs and additional 30 percent of labour costs. Annex 1 provides information on labour costs associated with the production of different garments.

¹⁰ In this paper, the exchange rate used is US\$1=50 Kyrgyz som.

cost from \$450 for better quality to \$250 for the simplest machine. Market entrants can buy second-hand machines costing \$150 each.

Industry entrants tend to first open a mini-workshop with five to fifteen machines. The main challenges they face are related to securing wholesale orders and qualified workers. It takes time for young enterprises to find stable and trustworthy wholesalers. Usually, they find them through advertisements in newspapers and on television or through word of mouth. According to the interviewed entrepreneurs, there are some “guest customers” who find inexperienced enterprises, pay for a few orders, and then leave without paying for the next larger order.¹¹ It might take several years for an enterprise to form a stable wholesale customer base. Entrepreneurs that have functioned for more than 3 years have on average one to four permanent wholesale customers that provide them with work throughout the year. Entrepreneurs that have been working for less than three years reported having no permanent customers.

New enterprises have to respond to demand. *“We must not be choosers. Before there was not such a big competition, and we could make just pants or dresses. Now there are so many clothing enterprises that we take orders for any type of garment. We sew everything,”* said an informant.

Labour Force

Finding and keeping workers is a big challenge for enterprises of all sizes. Worker turnover in the industry is very high; the average tenure is between one and two years. Usually, workers move to other clothing enterprises or they leave to work in Russia. Young clothing enterprises find workers through advertising, but as enterprises mature workers themselves seek them out. Some enterprises have connections with vocational colleges, which connect them with sewing course graduates. Large enterprisers may “borrow” workers from smaller enterprises during peak season.

Informants say that it is difficult to establish good employer-worker relationships with each sewer and reduce attrition. The growth in the number of enterprises in the industry has led to a concurrent growth in demand for qualified labour. Disgruntled workers usually leave their employees the day after they receive their salary, which is paid every seven to nine days.

“Sewers have a specific mindset: for them every extra tynn matters.¹² If they see another enterprise that pays one som more for similar clothing, they will leave you for sure. Yesterday, while you were paying salary to workers, you had 17 sewers, and today there are just two of them left.”

It is especially hard to find and retain sewers for enterprises located in the new settlements due to the distance and limited public transportation. To attract workers, some entrepreneurs in new settlements provide them sleeping quarters.

¹¹ Usually, wholesale customers do not make advance payments and pay after products are ready.

¹² 1 Kyrgyz som=100 tynn.

The majority of workers in the apparel industry of Kyrgyzstan are women, ranging in age from 16 to 50. There are gender differences among workers based on the type of work they do. All of the sewers are female, while cutters, ironers and packers are predominantly male. According to the respondents, employees in clothing enterprises do not usually have specialised training or education. Even enterprise owners do not always have special training in clothing production; many were attracted by the relatively small initial investment and low entrance barriers. Most employees have a high school education and have migrated to cities from rural areas. Despite this, their learning ability is quite high, and of those who could not sew, 80 percent of them eventually learn how to make clothing. One reason for this may be that sewers usually form a close-knit community and help each other learn and work.

Work Conditions

The working schedule of employees depends on the location of the enterprise and the season. Some enterprises are operational from 8.00 am until 7.00 pm. Others have extended hours from 7.00 am until 10.00 pm. An average working day can be between 11 to 13 hours, and during peak season, sewers can work up to 15 hours a day.

Working conditions differ according to the size of the enterprise. Larger workshops with a more stable customer base can afford to provide better work conditions than newer, smaller workshops. Respondent entrepreneurs stated that they attempt to retain qualified workers by providing better working conditions. However, none of them reported providing employee benefits such as paid maternity or sick leave.

Salaries and Payment

Apparel sector workers' pay is based on piece-work, which means that their wage depends on the quantity of clothing they produce. According to industry representatives, overall wage is determined by the difficulty of the style of the items that are sewed, the frequency with which new styles appear, and the individual productivity of each worker.

On average, during peak season, the fastest sewers can earn between \$340 and \$500 (17-20 thousand soms), compared to an average sewer, who earns between \$240 and \$300 (12-15 thousand soms) every 10 days, resulting in a range of \$720 to \$1500 per month. The off-peak monthly wage for sewers is about \$400 per month. Dress cutters earn an average of \$600 per month.

For a comparison, according to the National Statistical Committee of Kyrgyz Republic, in November 2013 the average monthly wage in the financial sector was around \$490 (24,470 soms). Therefore, one may conclude that qualified sewers are paid pretty well and the source of competitiveness of the Kyrgyz apparel sector is not in low wages, but in something else, which is discussed in the following sections.

Some enterprises pay for each finished item, while others pay for different parts, such as the base part of the clothing, pockets, and finishing with overlock stitches. The approximate payment per item is from \$1.20 to \$1.80 (60-90 soms) per blouse; \$1.20 to \$1.50 (60-75 soms) per jacket; \$4.40 (220 soms) per coat. An average sewer is able to produce between 20 and 25 jackets a day.

2.4 Product Profile

Style and Design

Enterprises do not usually develop the styles of the clothing that they produce. Wholesale order customers are responsible for selecting or designing styles, based on market and retail preferences. According to the survey, they tend to pick and replicate popular styles of clothing produced in Turkey, China (Beijing), and Korea. Sometimes enterprises are asked to copy clothing made by another sewing Kyrgyz enterprise based on an already replicated (Turkish, Chinese or Korean) model. Overall, the majority of apparel industry representatives do not design their own models of clothing.¹³

When a style is chosen, the wholesale order customer goes to a design bureau to make individual curves and template, or finds an enterprise that has its own template designer. Previously, all designing was done by hand, a task that took two to three days to complete. Increasingly, enterprises and design bureaus are switching to computer-based work. The licensed version of the necessary software package costs between 5,000 – 10,000 Euros, which the majority of Kyrgyz clothing companies cannot afford. They usually buy and install a non-licensed version of the same package for \$500.

If a company switches to computer based garment design, in addition to investments in software, it also needs to train its designers. Training for each worker who has a background in design takes several months and costs about \$600. It takes a further six months for a trained designer to get the necessary experience working with the software and increase their productivity. Designing garments on the computer is more attractive in terms of speed and accuracy in the long rather than in short run. The price of designing a template is between \$30 to \$60 (1,500 – 3,000 soms) depending on the popularity of the model and difficulty of the work.

Characteristics of Kyrgyz Garments

Most respondents and experts claim that clothing produced in Kyrgyzstan is well-made and that the quality of goods has improved over time. All surveyed industry workers asserted that the quality of Kyrgyz clothing has improved. “*They are so well done that they can be passed off as Turkish garments,*” one small enterprise owner said.¹⁴ Reasons cited for improved quality are the fact that sewers have more training and have become more experienced, and the reality that wholesale customers are more demanding regarding quality.

However, the fabric used in the production of clothing in Kyrgyzstan is not the best quality. The majority of fabric used in production is imported from China and is synthetic, including fabric used for children’s clothing. Summer clothing is usually sewn from semi-natural materials, consisting of about 50 percent staple cotton and synthetic fibres.

A small proportion of clothing is produced with more expensive, better quality fabric imported from Korea, Turkey and the United Arab Emirates. However, for most wholesale customers who order the fabric and sell the clothes, it is unreasonable to import more expensive natural fabric, because it will raise production costs and prices. Fabric from Uzbekistan and

¹³ Property rights are weakly enforced in the country, including in the garment production sector.

¹⁴ This is based on the perception of the high quality of Turkish goods (see footnote 17).

Tajikistan is not imported to Kyrgyzstan because of its relatively low quality and higher cost. Most fabric used in clothing production is bought at the Madina bazaar in Bishkek.¹⁵

Sales and Marketing

The final products are sold in internal markets, mainly Dordoi and Kara-Suu¹⁶ bazaars, and exported to Kazakhstan and Russia, and, to a lesser extent, to Tajikistan and Uzbekistan. Russian and Kazakhstani consumers seem to have similar taste in clothing, which differs from that of Tajik and Uzbek consumers. Industry representatives claim that the majority of clothing is exported to Russia and Kazakhstan, because wholesale sellers know their markets, through the presence of relatively large Kyrgyz diasporas in these countries. This gives them an advantage in selecting styles that will be in demand. Kyrgyz garment output is therefore primarily aimed at middle-class consumers in Russia and Kazakhstan.

All the clothing products produced in Kyrgyzstan and exported to Russia and Kazakhstan are required to have a label specifying “Made in Kyrgyzstan” to be exempt from excessive import duties. However, domestic producers also attach another label that resembles labels on Turkish clothing. Kazakhstan retailers remove the “Made in Kyrgyzstan” label and Kyrgyz clothing is sold with the “Turkish” label.¹⁷ In Russia, retailers remove the Turkish label, preferring to sell the clothing under the “Made in Kyrgyzstan” brand.

2.5 Recent Policy Changes and Export Markets

Change in Import Tariffs

On 17 August 2012, the Government of Kyrgyzstan issued decree N573 introducing changes into international trade regulations and import tariffs for specific types of goods were raised. This directly affected the apparel industry. Tariffs for imported fabric substantially increased from \$0.20 to \$0.35 per one kilogram for on-land transportation.¹⁸ In this regard, it would be interesting to see both macro and microeconomic impact of this policy change on the apparel industry. The increased import tariff on fabrics increased the cost of production in the apparel sector and made final products more expensive. See Table 2 for statistics on imported Chinese fabrics before and after the increase in tariffs, as reported by the Chinese Customs Office.

Table 2. Chinese Fabric Imports to Kyrgyzstan

| Man-made staple fibres (HS2002 code 55) | Quantity (kg) | Value (US\$) | Change in quantity (%) | Change in value (%) |
|---|---------------|--------------|------------------------|---------------------|
| January-October, 2012 | 96,097,437 | 102,382,427 | -38.15 | -34.65 |
| January-October, 2013 | 59,433,316 | 66,908,274 | | |

Source: Customs Office of China, www.customs-info.com

¹⁵ Madina is the second largest bazaar in Bishkek, where Chinese goods are traded. The bulk of imported Chinese fabrics are traded at Madina.

¹⁶ Kara-Suu is the largest wholesale market in the southern part of the country.

¹⁷ This may be a result of the fact that in the 1990s, Central Asia and Kazakhstan were mostly importing Chinese and Turkish garments. The former were cheaper and of lower quality. Turkish apparel was more expensive and considered to be of higher quality.

¹⁸ The HS2002 codes of the products affected by the policy change are 41, 42, 50-56, 58-65, 67.

The volume of imported man-made fabric in the first ten months of 2012 and corresponding period in 2013 decreased by 38%. This is a substantial decline and might have been caused by the increase in import tariff rates, and by changes in demand for Kyrgyz apparel industry products and a consequent change in demand for Chinese fabric.

There is also some evidence of the microeconomic effects of tariff changes. Industry representatives claim that in 2013 the number of orders significantly decreased; for some by as much as 30 and 40 percent. One entrepreneur said, *“Wholesale customers are now afraid to give big orders, as they might not be able to sell the clothing at a higher price”*. Wholesalers have decreased the per unit payments for sewing companies, claiming that the fabric has become more expensive. They are trying to pass on some burden of increased tariffs to sewers.

Industry workers also report changes in demand for Kyrgyz garments. They report that Russian customers have ordered fewer Kyrgyz clothes in the last two years. This may be due to increased instances of counterfeit “Made in Kyrgyzstan” clothing exported to Russia from China (through Kyrgyzstan), which is of lower quality and undermines the demand for Kyrgyz products; intensified competition in the Russian garment market by Belarusian garment manufacturers, and an increase in income of the Russian middle class, enabling them to spend on more expensive items.

Recent unrest in Birulovo, Moscow, may further decrease number of orders (mainly from Russia). The unrest affected the immigration policy of the Russian Federation. Mass victimisation of immigrants from Central Asia and Caucasus started in October 2013, following the murder of Russian resident by an Azerbaijani migrant. As a result, the biggest wholesale clothing markets Liublino and Strogino were closed. In Strogino, around 30 percent of all sellers, and in Liublino at least 10 percent of all sellers are Kyrgyz selling clothes produced in Kyrgyzstan.

3. Competition from Belarus

Clothing produced in Belarus is the main competitor of Kyrgyz apparel in Russia and Kazakhstan. While Kyrgyz producers promote the “Made in Kyrgyzstan” brand, Belarusian clothing is exported under the common brand “Belarus Jersey”¹⁹. Like Kyrgyz clothing, Belarusian clothing is aimed at middle-class consumers. Vietnamese, Bangladeshi and Chinese clothes sold in Russian markets are cheaper, of lower quality and marketed to less affluent consumers. Conversely, Turkish garments are much more expensive than Kyrgyz clothing and do not compete for the same market.

The biggest advantage that Belarusian clothing producers have over Kyrgyz enterprises is that they mostly use domestic fabric. Manufacturing of fibres for textile and technical yarns dates back to the Soviet era, when over 50 percent of man-made fibre and yarn production was concentrated in Belarus.²⁰ Belarus has produced viscose fibres since 1930 and polyester and polyamide since 1965. It is also the fourth-largest producer of linen in the world, exporting more than half its output.

¹⁹ Belarus Jersey is an English translation of “Belorusskiy Trikotaj” (Белорусский трикотаж).

²⁰ *Rieter Spun Yarn Systems*. 22, no . 54 (January 2010).

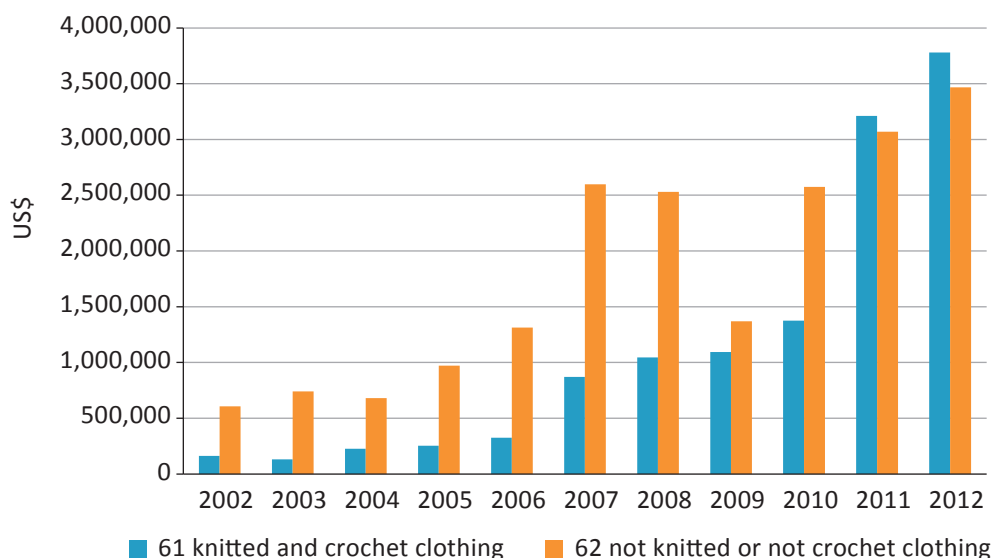
Moreover, the highly export-oriented textile industry in Belarus has been actively developing a very wide range of products, including clothing, fur and leather goods and shoes, knitted products, sportswear and lingerie.

In addition to the common “Belarus Jersey” brand, some companies promote their own brands such as Slavyanka, Milavitsa and Kamvol. Milavitsa, one of the largest lingerie producers in Europe, produces and exports lingerie to CIS countries, including Kyrgyzstan.

The majority of Belarusian clothing is aimed at the same customer group as Kyrgyz clothing. Belarusian garments are high quality and produced from both synthetic and natural domestic fabric. Currently, the price of Kyrgyz garments is lower than that of Belarusian clothing. For example, similar dresses made in Kyrgyzstan and Belarus cost \$25 and \$45 respectively.

Belarusian garments have been gaining popularity in Russia and Kazakhstan. Exports of clothes from Belarus to Kazakhstan increased steadily between 2002 and 2012 (see Figure 2). Belarus exported knitted and crocheted (mostly “Belarus Jersey”) clothing worth \$163,000 in 2002. Ten years later in 2012, the volume had increased to clothing worth \$3.8 million. The sharpest increase was observed between 2010 and 2011, when Belarus and Kazakhstan joined the CU. Exports of knitted and crochet clothing increased by 133 percent, from \$1.38 million to \$3.21 million. Exports of not knitted/not crocheted clothes rose from \$607,000 in 2002 to \$3.5 million in 2012. While the dynamics of Belarusian exports to Kazakhstan are impressive, in terms of absolute values, they remain small compared to Kyrgyz exports of apparel to Kazakhstan.

Figure 2. Belarusian Clothing Exports to Kazakhstan

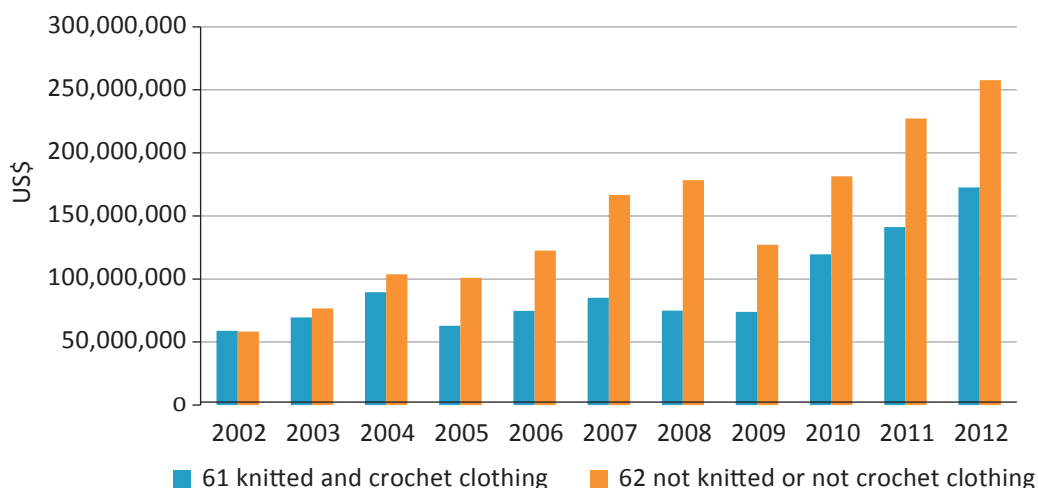


Source: UN Comtrade

While not as dramatic as those in Kazakhstan, exports of Belarusian garments to Russia have also increased since 2002. The volume of knitted and crocheted clothes exports increased

from \$59 million in 2002 to \$173 million in 2012, while exports of not knitted and crocheted clothing increased from \$58 million to \$258 million within the same time period.²¹

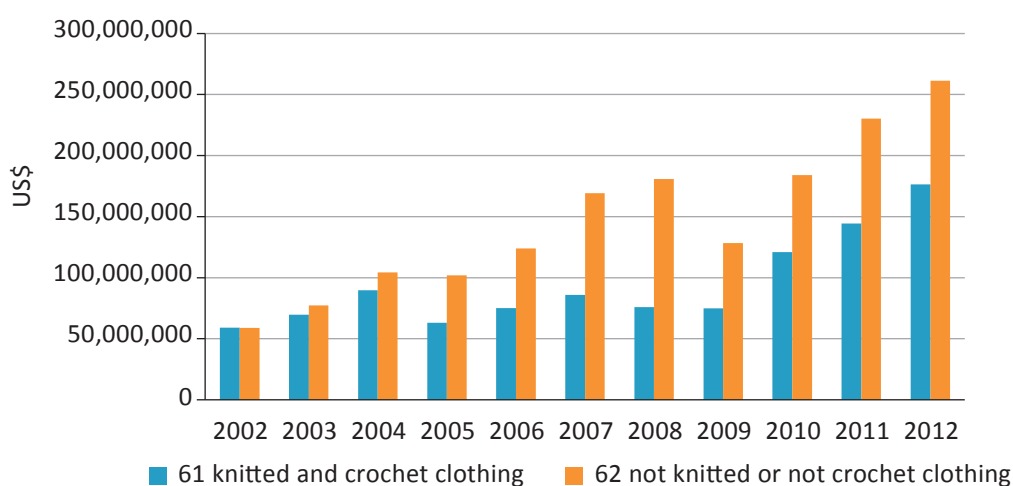
Figure 3. Belarusian Clothing Exports to Russia



Source: UN Comtrade

To summarise, Belarusian garment exports to CU countries increased almost threefold from 2002 to 2012, from \$118 million to \$438 million (see Figure 4). However, when compared to Kyrgyzstan, which recorded an impressive ten-fold increase from under \$15 million to \$155 million in the same period (Figure 1), Belarusian growth is less remarkable.

Figure 4. Belarusian Clothing Exports to Customs Union Countries



Source: UN Comtrade

²¹ Taking into account devaluation of the dollar, this increase may be less impressive than it seems. For a more complete picture, it would be useful to analyse dynamics of Belarusian exports in physical units. Unfortunately, this information is not available at UN Comtrade.

In addition to the domestic production of fabric, Belarus has another key competitive advantage; state support. This is reflected in the State programme on innovative development of the Republic of Belarus in 2011 – 2015. In particular, the Belarusian government has implemented the following:

- Subsidising interest payments on loans of textile industry representatives for their re-equipment in 2006-2010;
- Certification of Belarusian products, funded by government under the “Quality” programme in 2007-2010;
- Agriculture tax exemption for producers of natural fabrics since August 2006;
- Procurement of equipment by state for linen production factories;
- Financial support in the form of soft loans to textile companies. For instance, a 366.8 billion of Belarusian ruble loan²² was provided to 30 companies to modernise equipment;
- Funding research and development activities. For instance, 529.2 billion Belarusian rubles were provided in 2010 to develop a new fabric similar to denim; and
- Providing the textile industry with skilled labour under an agreement with universities and vocational schools.

In terms of direct government support, Belarusian producers are better off compared to their Kyrgyz counterparts. However, while the Kyrgyz government has not provided direct support to the sector, it has extended indirect assistance by introducing the patent system for sewing enterprises and introducing a simplified weight-based customs clearance procedure.

Kyrgyz producers have other advantages over Belarusian producers:

- Kazakh customers have specific tastes and prefer Turkish clothing. Kyrgyz entrepreneurs are familiar with the tastes and preferences of buyers from Kazakhstan, and produce clothing styles that resemble Turkish garments;
- Kyrgyz entrepreneurs produce clothes for the Kazakh market in different (and more appropriate) sizes than the clothes they produce for the Russian market. Specifically, they produce smaller garments with Asian measurements for Kazakh customers and larger garments with European measurements for the Russian market;
- “Made in Kyrgyzstan” clothes are cheaper than those from Belarus by 30 to 70 percent, which makes them more attractive to lower middle class buyers.

4. Implications of Customs Union Accession for the Kyrgyz Garment Sector

To assess the implications of Kyrgyz accession to the CU for the apparel sector, an analysis of the cost of production was done. Respondents, including enterprise owners and wholesale order customers provided cost calculations for different types of clothing they currently produce and distribute (see Annex A1). Based on this information and using the common external tariff (CET) of the CU,²³ the cost of production of the same garments under the CU was calculated.

²² As of December 2013, it is equivalent to about 1.26 billion Russian rubles. The exchange rate used for calculation is 10,000 Belarusian rubles=34.24 Russian rubles.

²³ Information on CU CET rates can be found at http://online.zakon.kz/Document/?doc_id=31234212

Annex A2 provides these calculations for three types of clothing: men's winter jackets, women's dresses and men's shirts. It should be noted that in the calculation of production costs under in the CU scenario the cost of labour remained unchanged. Of course, this is an unrealistic assumption (and will be relaxed below) as overall price levels are expected to increase substantially after the country enters the CU. The cost of production for the three types of clothing increases by 1.6 and 4 percent, when the CET is applied and the cost of labour is unchanged. The increased cost of fabric following higher import tariff rates under the CU will not dramatically increase the cost of clothing. However, accession to the CU is going to result in significant increase in overall price levels and hence the cost of labour. Under the assumption that aggregate price level goes up by 15 percent when in the CU, one can add an additional 10 to 15 percent to the production costs of clothing due to increased labour costs.²⁴ One can expect that the cost of garment production would increase by between 10 and 20 percent, depending on the complexity of clothing style, and the amount and quality of fabric required.

To summarise, based on pure calculations, Kyrgyz garments would still be cheaper than Belarusian products after joining the CU. However, given the rising popularity of Belarusian clothes in Russia, Kazakhstan and even Kyrgyzstan, and recent positive developments in the Belarusian textile industry, projections are not that optimistic. With state support, sewing factories are being modernized in Belarus. This will positively impact productivity and decrease production costs and prices. This might bring Belarusian clothes into price alignment with Kyrgyz garments, shrinking the current 30 to 70 percent price differential. As a result, Kyrgyz products may not withstand the competition of Belarusian textile products, and may lose their current market niche of the middle class in Russia and Kazakhstan, and instead serve the lower class customer market.²⁵

5. Conclusions and Policy Implications

In the last decade, the Kyrgyz garment sector has demonstrated remarkable export-driven growth. The export volume of Kyrgyz clothing to the Russian Federation and Kazakhstan increased ten-fold from 2002 to 2012. The main reasons for this growth include WTO membership and simplified weight-based customs clearance which allowed for relatively cheap acquisition of fabrics; favourable patent-based tax treatment; and the solid entrepreneurial skills of Kyrgyz entrepreneurs.

²⁴ According to standard trade theory, when a small economy, Kyrgyzstan, integrates with a much larger one (Russia in this case), the price level of the integrated economy would be dictated by the larger economy. Given the tremendous size difference, it is logical that the overall price level in Russia would prevail, and overall price level in Kyrgyzstan would be pulled up after integration. Specifically, in the factor market, labor especially (relatively) "unskilled labor" – in this case, garment workers – which Kyrgyzstan is abundant of, and which Russia is short of – would enjoy a wage pull-up from Russia. This is indicated strongly by wages of garment worker wages, which are a lot higher than most other sectors in Kyrgyzstan (see earlier section).

²⁵ One may argue that when Kyrgyzstan joins the CU the volume of Chinese re-exports going through Kyrgyzstan to Russia and Kazakhstan would further decline thus benefiting Kyrgyz clothing producers – with fewer (re-exported) Chinese goods there may be more demand for Kyrgyz clothing. However, magnitude of this effect is not expected to be significant as the re-exports of Chinese goods have already substantially shrunk following tightened administration at the external borders of the CU, including Kyrgyz-Kazakh border.

This paper examined recent developments in the apparel production sector in Kyrgyzstan. In particular, it attempted to assess the impact of recent policy changes, namely, the increase of import tariffs on fabrics and other clothing accessories, and it analysed the possible implications of the Customs Union accession by Kyrgyzstan on its garment production sector. To this end, a number of in-depth interviews with both garment producers and wholesale order customers were conducted.

The findings suggest that the volume of Chinese fabric imports declined by 30 percent in the first 10 months of 2013 relative to the same period in 2012. This may be due to the recent import tariff increase which has resulted in increased costs of imported fabric. While these increases did not substantially increase the final cost of clothing, wholesale customers are being cautious about placing large orders. Another reason behind the decline of Chinese fabric imports may be the shift in preferences of Russian customers who are now earning higher incomes. The Russian middle class can now afford more expensive clothing, and Belarusian garments are becoming popular in the Russian Federation and Kazakhstan. Finally, with Kyrgyzstan joining the CU, its clothing products would be still cheaper compared to Belarusian clothes but the current price differential would shrink. This, combined with the enormous support provided by Belarusian government to its garment sector, may result in Kyrgyz producers losing some share of its middle class customers in CU countries.²⁶

In light of expected developments associated with the planned accession to the Customs Union, the Kyrgyz government, given the shortage of financial resources to support the sector, should at least maintain a status quo in terms of the taxation system and retain the amount of tax payments under the patent and social fund contribution.

²⁶ Leaving CU membership issue aside, the import tariff increase does not add much to the cost of garment production. Competition from Belarus, based on the loss of export market niches, poses a more serious challenge. There is no way for the Kyrgyz government to match the support provided by the Belarusian government to its garment sector. The question is what would this mean to the future of the Kyrgyz garment industry? At a theoretical level, the industry should strive to be more efficient and cost effective to be more competitive. How can this be achieved? This is a potential area for future research.

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Annexes

Annex 1. Calculation of current production costs of garments

1. Jacket

| | |
|--|-------------|
| Fabric and accessories, including transportation | 170 KGS |
| Production | 128 KGS |
| Total cost | 300-350 KGS |
| Wholesale price | 400-450 KGS |

2. Winter jacket/Parka

| | |
|------------------------|---------------|
| Fabric and accessories | 680 KGS |
| Transportation | 20 KGS |
| Production | 220 KGS |
| Total cost | 900 KGS |
| Wholesale price | 1200-1250 KGS |

3. Blouse

| | |
|------------------------|---------|
| Fabric and accessories | 120 KGS |
| Production | 100 KGS |
| Total cost | 220 KGS |
| Wholesale price | 350 KGS |

4. Dress

| | |
|---------------------------------------|---------------------------------|
| Fabric (expensive, US\$4.5/metre (m)) | 284 KGS |
| | (average fabric is \$2 - \$3/m) |
| Accessories | 30 KGS |
| Transportation | 15 KGS |
| Production | 135 KGS |
| Total cost | 450 KGS |
| Wholesale price | 550-600 KGS |

5. Men's shirt

| | |
|--|---------|
| Fabric (0.95m* \$2/m*49KGS/ \$) | 93 KGS |
| Vlieseline (0.2m*20 soms/m) | 4 KGS |
| Accessories (buttons, 10 items * 0.2 soms) | 2 KGS |
| Thread, package | 3 KGS |
| Production | 95 KGS |
| Total cost | 197 KGS |

6. Dress "Kacheli"

| | |
|--|---------|
| Fabric: 1.8 m (amount of fabric needed) * \$3.6 (price of fabric per metre) * 49 (approximate exchange rate) | 317 KGS |
| Accessories | 22 KGS |
| Thread | 5 KGS |
| Glue | 8 KGS |

| | |
|-------------------------|----------------|
| Package | 2 KGS |
| Costs of materials used | 54 KGS |
| Work: cutting | 13 KGS |
| Sewing | 70 KGS |
| Ironing | 13 KGS |
| Packaging | 4 KGS |
| Costs of labor | 100 KGS |
| Total cost | 454 KGS |

7. Men's winter jacket – another model

Materials:

| | |
|--|---------|
| Fabric: 1.9 metre (amount of fabric needed) * \$1.8 (price of fabric per metre) * 49 (approximate exchange rate) | 168 KGS |
| Polyester batting (sintepon): 2 m * 93 KGS (price per metre) | 186 KGS |
| Lining fur: 1.9 m * \$2.4/m * 49 | 224 KGS |
| Lining for sleeves: 0.5 m * 50 KGS/m | 25 KGS |
| Accessories: Buttons | 18 KGS |
| Zippers | 15 KGS |
| Pockets | 5 KGS |
| Thread | 5 KGS |
| Package | 3 KGS |
| Cost of materials used | 649 KGS |

Work:

| | |
|-------------------|----------------|
| Cutting | 25 KGS |
| Sewing | 210 KGS |
| Ironing | 5 KGS |
| Packaging | 3 KGS |
| Technologist | 12-15 KGS |
| Buttons sewer | 3 KGS |
| Costs of labor | 260 KGS |
| Total cost | 909 KGS |

Annex 2. Calculations of production costs after joining the Customs Union

The calculations in this section are made under assumption that labour costs remain the same after CU accession. On average, each fabric bolt weights between 20 and 25 kilograms (kg) and includes between 30 and 50 metres of fabric.

Calculations for men winter jacket:

Nylon/polyester jacket fabric costs \$1.6/meter in China (www.made-in-china.com)

Weight = 0.225kg/m², width = 1.5 m

Weight of one linear meter of fabric = 0.225 * 1.5 = 0.3375 kg/m²

0.3375 kg/m²*50 meters in one bolt + 0.9 kg package = 17.775 kg

With the current tariff system, importing tariffs will make 17.775 kg * \$0.35/kg = \$6.22 per fabric bolt, or \$0.1244 per meter

With the common external tariff (CET) of Customs Union, for the same fabric bolt it will be paid 9% (tariff rate) * \$1.6/m * 50 m + 12% VAT * customs value= \$7.9, or \$0.16128 per meter

Table A1. Cost of fabric before (current tariff) and after (CET) joining Customs Union: Men's winter jacket

| | Current tariff | CET |
|---------------------------|----------------|---------|
| Fabric/unit of jacket | 1.9m | 1.9m |
| price of fabric per meter | 1.8 | 1.85 |
| exchange rate | 49 | 49 |
| | 167.58 | 172.235 |
| increase | | 3% |

The cost of fabric needed to produce one jacket increases by almost five soms or 3%.

Table A2. Costs of production before (current tariff) and after (CET) joining Customs Union

Winter Jacket

| | current tariff | CET |
|-------------------------------|----------------|------------|
| Fabric (\$1.8/m) | 167.58 | 172 |
| Sintepon (\$1.9/m) | 186 | 200 |
| lining fur (\$2.4/m) | 224 | 238 |
| lining for sleeves (\$1.02/m) | 25 | 26 |
| accessories | 38 | 38,5 |
| thread and package | 8 | 8,5 |
| cost of materials used | 649 | 684 |
| cost of labor | 260 | 260 |
| total costs | 909 | 944 |
| increase | | 4% |

Dress "Kacheli"

| | current tariff | CET |
|------------------------|----------------|------------|
| Fabric (\$3.6/m) | 318 | 320 |
| accessories | 22 | 23.0 |
| thread, glue, package | 15 | 15.7 |
| cost of materials used | 355 | 369 |
| cost of labor | 100 | 100 |
| total costs | 455 | 469 |
| increase | | 3.1% |

Men's Shirt

| | current tariff | CET |
|-----------------------|----------------|-----|
| Fabric (\$2/m) | 93 | 95 |
| Vlieseline (\$0.41/m) | 4 | 4,5 |
| thread, glue, package | 5 | 5,6 |

| | current tariff | CET |
|------------------------|----------------|------------|
| cost of materials used | 102 | 105 |
| cost of labor | 100 | 100 |
| total costs | 202 | 205 |
| increase | 1.6% | |

The biggest changes in total costs are seen in clothing items that use a lot of fabric, like a winter jacket, or use expensive fabric, like a dress “Kacheli”.

In the case of a winter jacket the total cost increased by 35 soms per unit. For 1000 units, a wholesale customer will pay 35,000 soms more with the common external tariff (CET).

The total cost for each dress increased by 14 soms. Wholesale customers will pay 14,000 soms more per 1000 units with (CET).

The cost of each shirt increases by 1.6% or 3 soms per unit. Wholesale customers will pay 3,000 more per 1000 units with the CET.

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