

# **Pakistan's Textile and Clothing Sector: Its Future in the European Union**

Karin Astrid Siegmann

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Mailing Address: PO Box 2342, Islamabad, Pakistan.  
Telephone ++ (92-51) 278134, 278136, 277146, 270674-76  
Fax ++(92-51) 278135, URL: [www.sdpi.org](http://www.sdpi.org)

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1 As of 28June08.

# **Pakistan's Textile and Clothing Sector: Its Future in the European Union<sup>2</sup>**

Karin Astrid Siegmann

## **Abstract**

In 2005, Pakistan was the largest supplier of bed-linen to the European Union (EU). The EU is Pakistan's largest trading partner, with textiles and clothing (T&C) accounting for almost two thirds of its sales to the common market. In this paper, a closer look is taken at the anatomy of and prospects for the trade relationship between Pakistan and the EU, focusing on the T&C sector. It reveals a contested relationship between Pakistan and the EU. 'Carrots' from the side of the EU were granted in the form of trade preferences and catalysed export growth. It was slowed down by the 'stick' of anti-dumping duties. Given the strengthened position of competitors in the post-quota era combined with structural weaknesses in the Pakistani T&C sector, i.e. mainly the lack of investment in high value-added sub-sectors and in skill development, it is questionable how sustainable this development is.

In future, Pakistan's T&C industry will either specialise in yarn and cloth production and loose significant market shares in garments due to lack of competitiveness or it will climb up the value-added chain and further shift its export composition towards made-ups and, especially, garments. What would be the consequences of these scenarios? If Pakistan puts up with its role as a major yarn and cloth producer, and accepts that others do better - and cheaper - in garments manufacturing, this would imply high costs in terms of industrial and social development of the country. It is thus a highly undesirable future industrial pathway. Alternatively, a setting that ensures Pakistan does not lose its market shares in garment exports to the EU strengthens the trade-development bond. However, it requires a joint effort by the Government of Pakistan, the industry and its trading partner EU. The main challenge, therefore, is to promote skill development at all levels of the industry. In the garment sector, this does not only involve managerial and technical staff, but also staff at the level of operators.

## **1. EU-Pakistan Trade in Textiles and Clothing: A Love – Hate Relationship?**

European nights are intimately linked to Pakistan. A large number of the community's citizens spend their nights on Pakistani bed-sheets. In 2005, the South Asian economy was the largest supplier of bed-linen to the union (Aziz, 2006). Sufficient basis for an intimate trade relationship, one could assume. True. The European Union (EU) is Pakistan's largest trading partner, with textiles and clothing (T&C) accounting for almost two thirds of its sales to the union (EC's Delegation to Pakistan, 2004). As in many close relationships, however, the EU also is the cause of a lot of pain to its partner. One sore example was the imposition of a punitive import duty on

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2 The research underlying this paper was carried out for Mohammad Farooq Textile Mills Ltd. The author is grateful for helpful comments and suggestions by David Boyer and valuable research assistance by Hajira Hamid. All remaining shortcomings are solely my own.

Pakistani bed-linen in 2004, accusing the exporter to dump bed-linen below cost prices at the European market. Rumor has it, that this move was actually an act of jealousy, punishing Pakistan for upgrading its commercial air fleet with US-American Boeings rather than with European Airbuses.

In the following sections, a closer look is taken at the anatomy of, and prospects for, the trade relationship between Pakistan and the EU, focusing on the T&C sector. Features of both partners that have the potential to promote or constrain T&C exports from Pakistan to the EU are sketched in the next section. Therein, the focus is on EU's trade-related policies regarding Pakistan and on the structure of Pakistan's T&C industry. Section 3 provides an overview of the resulting exports to the common market. Section 4 outlines possible scenarios for the future of the contested relationship and their likely consequences in terms of industrial and overall development. Finally, measures that support a healthy trade partnership between Pakistan and the EU in T&C are described in the last section.

## **2. Character matters: structural features of T&C trade**

*Relationships depend on the partners' personal traits. Applied to T&C trade between Pakistan and the EU these key attributes are basically the EU's trade policy and the structure and competitiveness of Pakistan's T&C industry.*

An influential step to bring Pakistan closer to the EU was the decision to provide duty-free access for Pakistani clothing products to its market under the Generalised System of Preferences (GSP) in 2001. The stated reason for this measure was to reward Pakistan's efforts to combat drug production and trafficking (EC's Delegation to Pakistan, 2001). However, in 2004, the European Commission (EC) announced the simplification of its GSP scheme, waving goodbye to the special scheme to combat drug production and trafficking. It expired on 31 December 2005 (EC, 2004). Import duties of 12% were to be paid since January 2005. However, Pakistan's Ministry of Commerce courted heavily and as a result Pakistan receives 9.6% GSP rates of import duty for a number of product categories, including T&C sales, since January 2006 (JCCC, 2005). Yet, the reduction is not substantial and the situation of the Pakistani industry compares unfavourably with other countries in the region. Bangladesh, for example, obtains zero duty access to the European market due to its least developed country status. Sri Lanka equally does not pay import duties due to specific incentives for countries having ratified certain conventions on sustainable development and good governance.

The EU's development policy is intended to flank its trade policy vis-à-vis developing countries. Support for trade-development linkages is one of the six core areas of the EU's development policy. This involves amongst others improved market access, removal of competitive constraints, enhanced cooperation in trade-linked areas, technology transfers, private sector development (European Council, no date). The EU intends to support reforms in developing countries' trade policies of that also serve gender equality (EC, 2001). This is an important point for the T&C industry that Pakistan is the largest formal employer of women in an environment with strong cultural constraints to women's participation in the paid labour market. As a practical

consequence, the EU and Pakistan signed an agreement in February 2004 for trade-related technical assistance for Pakistan (EU, 2004). It involves measures to enhance the competitiveness of key sectors of the Pakistani economy, including T&C.

While the GSP inclusion drew Pakistan closer to the EU, haggling over the alleged dumping of bed-sheets on the community's market has greatly disturbed the trade relationship. The EU imposed an anti-dumping duty of 13.1% on bed-linen exports from Pakistan effective from March 2004 arguing that cheap imports from Pakistan were causing an injury to the European textile industry<sup>3</sup>. While review investigations about the basis of this claim are ongoing since January 2005, no conclusions have been drawn so far, to the detriment of Pakistan's industry.

Apart from these bilateral issues, the global trade environment for T&C goods has a considerable impact on the trade relation between Pakistan and the EU. Or – in our relational terms – one should never underestimate the role of rivals on a partnership! World-wide, competition in T&C trade made a quantum leap in 2005. In January 2005, the Agreement on Textiles and Clothing (ATC) expired. An agreement under the World Trade Organisation (WTO), it was aimed at gradually phasing out the quota system that had governed trade in T&C for more than 30 years. Since January 2005, buyers and sellers of T&C products no longer rely on quotas in the main markets. Established trade relations can be abandoned for newcomers who offer the same or better quality at equal or lower price. This basically means that both price and quality competition amongst T&C producers increases. Especially, China's entry into the WTO in 2001 signalled that from then on a great number of T&C manufacturers across Asia, Latin America, and Africa would have to compete with one huge, cost-efficient producer.

The rise in Chinese T&C – and other - imports was anticipated in China's accession protocol to the WTO. The Textile Specific Safeguard Clause stipulated that other WTO members could implement protective measures in case of a sudden surge in Chinese imports crossing 7.5% annual import growth (WTO, 2001). That is what the EU resorted to after Chinese imports of nine product categories, including T-shirts, pullovers, blouses, stockings and socks, rose between 51% to 534% between January and May 2005 (EC's delegation to China, 2005). The agreement the EU signed with China in June and amended in September 2005 constrains the rise in Chinese imports in sensitive product categories until the end of 2007 and provides breathing space to other trading partners like Pakistan (EC, 2005).

An issue so far largely independent of official policies is the increased demand for social and environmental compliance in T&C production. Its labour-intensiveness of and its toll on the environment in terms of heavy use of water and energy as well as hazardous substances, such as dyes and bleaches, has catalysed consumer demand for "cleaner clothes"<sup>4</sup> in terms of the social and environmental conditions of their production (Banuri, 1998). It is passed on to retailers and buyers who increasingly demand social and environmental certification of T&C producers according to international or their own standards. Both the Government of Pakistan (GoP) and

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3 Previously, dumping-related duties were imposed by the EU on Pakistani bed-linen from 1997-2002.

4 The largest European consumer organisation lobbying for better working conditions in the global T&C industry is the "Clean Clothes Campaign".

industry have mostly rejected these demands as a new form of protectionism that is a burden for the industry's competitiveness. Research has shown, though, that it cannot only be expedient, but also profitable for exporters to comply with the increasingly complex demands of international clients (Khan and Haider, 2004).

Turning to key features of the other trading partner, Pakistan's T&C industry is the country's most important industrial sector. It caters for 9% of gross domestic product (GDP), about 60% of the country's exports and employs 35% of industrial sector workers (Ministry of Finance, 2005b), about 30% of whom are female (Siegmann, 2006).

Broadly, the Pakistani T&C sector has two very dissimilar faces. Historically, the focus of Pakistan's T&C sector has been on early stages of processing, i.e. ginning, spinning, and weaving, due to the domestic availability of cotton. One in eight bales of the global cotton production is harvested in Pakistan. It is becoming the third largest cotton consumer world-wide (ICAC, 2006). For many years, Pakistani cotton and yarn exporters remained competitive due to the availability of subsidised cotton prices and very low labour costs for the hand-picked cotton. Their economic importance is paralleled by the political influence they exert. Pakistan's share of world trade in cotton yarn and cloth is about 30 and 8 per cent, respectively (Ministry of Finance, 2004). However, during the past ten years the production and export of higher value-added items such as made-ups and knitwear has picked up. In fiscal year (FY) 2004/5, bed-linen and hosiery alone accounted for 22% and 21% of Pakistan's exports to EU, respectively (EPB, 2006). During the past years, a major effort has been undertaken to modernise the textile sub-sector in particular. The impressive amount of USD 5 billion has been invested in the T&C industry from 1999 to 2004. Almost half of the investment went into spinning, a fourth in weaving and a meagre 8% in made-up textiles (Ministry of Finance, 2005b).

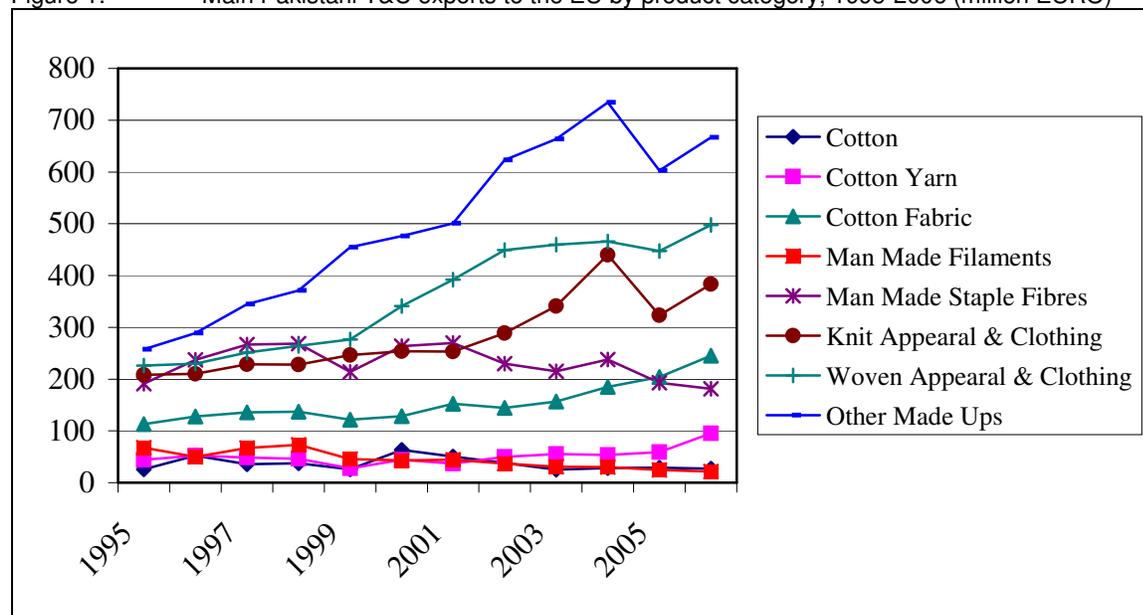
The woven and knit garment sectors represent the darker side of the industry. Whereas the textile sector is characterised by large units and high capital-intensity, clothing production takes places in smaller establishments, roughly 80% of them in the informal sector (USITC, 2004). Labour-intensity and the employment of women workers is high, standards regarding working conditions poorer than in the textile sector. Of the investment volume quoted above, it obtained less than 5% of the total (Ministry of Finance, 2005), i.e. about one third of the investment targeted in the "Textile Vision 2005" (Ministry of Finance, 2003).

The "Textile Vision 2005", a strategy paper for the Pakistani T&C sector developed as early as in 2000 by the Small & Medium Enterprise Development Authority (SMEDA), identified amongst other things the following weaknesses of the sector (SMEDA, 2000): a narrow export product base, with a focus on low value added yarns and fabrics rather than made-ups and garments, and a lack of focus on a trained workforce in high-value added industries, such as clothing. Increased attention for garments and made-up articles as well as improved quality throughout the textile chain was advocated as a response to these challenges. This implied technology upgrading at all stages of textile processing, human resources development, and improved marketing. These sound ideas have not been implemented so far. On the contrary, a lack of qualified workforce becomes apparent in both sub-sectors.

### 3. Anatomy of textiles and clothing trade between Pakistan and the EU

As can be gauged from Figure 1, during the past ten years, Pakistani made-up and knitwear exports play an increasingly important role in T&C sales to the EU, whereas less processed cotton products, such as yarn and fabrics, fetch less and a declining share of export income from the EU. As indicated above, bed-linen is the most important component of made-up exports.

Figure 1: Main Pakistani T&C exports to the EU by product category, 1995-2006 (million EURO)



Source: Eurostat (no date), see Table A1 in the Annex

Pakistan's exports of bed-linen to the world market came a close second to China's (USITC, 2004). The EU's decision to grant Pakistani T&C products duty free access to its market under the GSP in 2001 triggered this surge in exports as visible in the steep increase in made-ups and knitwear sales after 2001. The imposition of 12% import duties on Pakistani bed-linen together with the anti-dumping imposed in March 2004 led to reduction in its sales' growth, though, and catalysed the increase in China and Turkey's market share in the EU (Aziz, 2006).

According to Figure 1, the rise in international T&C trade after the expiry of the quota system in January 2005 has not provided a push to Pakistani exports to the EU. Official statistics show that overall, exports have increased slightly after the quota expiry. T&C exports July to March 2004/5 were 2.1% higher than in the previous FY (Ministry of Finance, 2005b). Made up textiles sustained their strong growth performance despite the significantly higher costs the industry incurred in terms of anti-dumping duties in addition to the lapse of the previous GSP scheme. In the second half of the year, however, both woven and knit apparel sales display a downward trend. This trend is mirrored in a study conducted by the Sustainable Development Policy Institute (SDPI). It casts doubts on the sustainability of export growth. A majority of cotton, yarn, fabric, made-up, and woven as well as knit apparel exporters faced lower product prices after the quota expiry. Most companies exporting fabric and garments have realized reduced

profits<sup>5</sup>. Several respondents explained that increasing sales are a strategy to deal with these reduced margins. The majority of Pakistani fabric, knitwear, and made-up textiles exports went to the EU both in FY2003/4 and 2004/5. The question thus remains for how long companies can survive these harsher business terms. More than one third of the surveyed exporters (38.5%), especially those of garments and made-ups, are aware of manufacturers that have gone out of business.

#### **4. Future scenarios for a contested relationship**

The preceding sections sketch a contested relationship between Pakistan and the EU in terms of their trade in T&C. 'Carrots' from the side of the EU in the form of trade preferences granted and catalysed export growth. It was slowed down by the 'stick' of anti-dumping duties. Given the strengthened position of competitors in the post-quota era combined with structural weaknesses in the Pakistani T&C sector, i.e. mainly the lack of investment in high value-added sub-sectors and in skill development, it is questionable how sustainable this development is.

Depending on the industry, the government, and buyers' strategies, Pakistan's T&C industry will either specialise in yarn and cloth production and loose significant market shares in garments due to lack of competitiveness or it will climb up the value-added chain and further shift its export composition towards made-ups and, especially, garments (Siegmann, 2006).

What would be the consequences of these scenarios? If Pakistan puts up with its role as a major yarn and cloth producer, and accepts that others do better - and cheaper - in garments manufacturing, this would imply high costs in terms of industrial and social development of the country. The garment sub-sector fetches higher value-added as compared to the textiles sub-sector. As clothing items have almost become 'perishable' goods in terms of their demand structure (Altaf, 2006), it also is the part of the global T&C market that grows more rapidly and thus provides prospects for expansion. As mentioned above, it also is labour- and female-intensive. It thus guarantees trickle down effects to a larger share of the population as well as a contribution to women's economic empowerment. A future trade scenario that accepts a shrinking role of this aspect of the trade relationship with the EU weakens the link between trade and Pakistan's industrial and overall development. It is thus a highly undesirable future industrial pathway.

Alternatively, a setting that ensures Pakistan does not lose its market shares in garment exports to the EU strengthens the trade-development bond. However, it requires a joint effort by the GoP, the industry and its trading partner EU. Pakistan is far from its main market, which has increasingly become a factor determining the geography of global T&C production. The chunk of global clothing demand that is less dependant on proximity, namely high end clothing items, needs a talented workforce (Altaf, 2006). The main challenge therefore is to promote skill development at all levels of the industry. In the garment sector, this does not only involve managerial and technical staff, but also staff at the level of operators.

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5 Given the respondents' hesitance to report profit data (29% missing answers), it is likely that the survey data carry a positive bias with valid profit averages being overly optimistic.

## 5. Measures supporting a healthy trade partnership<sup>6</sup>

For the GoP, this would involve a paradigm shift. So far, policies have implicitly and explicitly supported the marketing of Pakistan as a cheap rather than a skilled trade partner. As the above discussion has shown, though, trade does not automatically translate into sustainable development. Legislation has provided disincentives to unionisation, made the implementation of minimum wages flexible and supported labour market institutions in cotton cultivation that accepted cotton contamination by keeping cotton pickers wages low. Overall, spending on schooling has been pathetically low in Pakistan. In the 2005-06 budget, this area accounted for a meagre 1.5% of public expenditures (Ministry of Finance, 2005a). The result is that less than a third of women and girls and not even half of all males have access to formal education (Federal Bureau of Statistics, 2004). Although the GoP has set up training institutes to support its industrial engine, with few exceptions, they are dysfunctional due to lack of skilled faculty and adequate curricula. For an important sub-sector such as knit garment production, no training institute exists (Khan, 2005).

Increased quality demands in an environment of harsher competition for market shares in the EU have to be translated into a more skilled and motivated workforce. As stated above, if the GoP would face these challenges it would not only increase the prospects for sustained exports from the garments sub-sector but also crucially contribute to Pakistan's overall industrial and human development. Apart from the direct provision of and support for skill development in technical, managerial skills, marketing and design, improvement of working conditions is therefore necessary. The government and employers need to implement existing labour laws, extend them to contract and informal sector workers, and to workers in export-processing zones, as well as sanction their violation.

Apart from contributing to skill development, the GoP should also join hands with industry in implementing measures that help mitigating structural change in the T&C sector. Job losses in unskilled categories are likely in either scenario. In particular, targeted social safety nets for workers who are dismissed should be set up. They may include counselling, skill upgrading, entrepreneurship programmes, access to loans etc. A special effort should be made to reach vulnerable female workers due to the significantly lower chances for alternative employment they face.

While in particular the GoP needs to do its homework, the EU can flank its efforts to sustain a healthy trade relationship for mutual benefit. The inclusion of Pakistan in the new GSP is a helpful step for guaranteeing Pakistan's access to the common market. However, more investment in the relationship is possible. The anti-dumping duty on bed-sheets is a major obstacle for Pakistan's most successful export item. It is high time to withdraw the duty since, in the last two years, the claims of dumping could not be substantiated.

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6 The suggestions are partially based on the proceedings of a regional workshop "What comes after the quota went? Human development effects of the ATC expiry?" organised by SDPI and the UN Trade Initiatives from a Human Development Perspective (UN-TIHP) that took place in Islamabad from November 21-22, 2005. Representatives from the T&C industry, government, trade unions, donors, and academia participated (SDPI-UN-TIHP, 2005).

Support for skill development can be part of development assistance for Pakistan, in terms of financial support but also through training of faculty, and help in curriculum development. As the implementation of labour standards will support investment in the skills of the workforce as well as labour productivity, the EU's assistance will be useful in this area as well. The EU can support the transition toward social and environmental compliance, a short-term investment, that brings long term benefit for industrial and overall sustainable development. At the international level, the stance the EU as one of its most influential members takes in the WTO regarding a social clause, linking trade flows with minimum labour standards has an important role to play. Globally, sanctioning the ILO core conventions at the level of the WTO provides a more level playing field for competition, supports skill-based industrial development, and benefits millions of workers.

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## Annex

Table A1: Main Pakistani T&amp;C exports to the EU by product category, 1995-2006 (million EURO)

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Cotton	26.06	52.51	35.80	37.75	26.06	63.00	50.28	37.81	25.21	27.99	28.60	27.10
Cotton Yarn	44.01	52.13	48.73	46.08	27.53	44.33	36.84	49.52	55.08	53.53	58.80	95.36
Cotton Fabric	113.09	127.76	135.79	136.89	121.74	128.15	152.65	144.42	156.41	185.05	203.89	245.03
Man Made Filaments	67.73	49.64	66.84	73.24	45.43	42.97	44.03	36.81	31.00	30.04	24.53	21.80
Man Made Staple Fibres	190.91	237.09	266.92	268.43	213.65	263.45	269.57	230.10	215.32	237.78	193.04	181.39
Knit Apparel & Clothing	208.19	210.12	228.30	227.90	246.14	253.48	253.31	288.51	341.26	439.80	323.07	383.47
Woven Apparel & Clothing	226.23	229.88	251.53	264.50	276.42	341.16	392.20	449.04	459.65	465.98	447.38	497.99
Other Made Ups	257.52	288.76	344.93	370.97	454.80	476.10	500.79	622.74	663.60	734.35	602.86	666.78

Source: Eurostat (no date)

Table A2: Main Pakistani T&amp;C exports to the EU by product category, January-October 2005 (mio. EURO)

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct
Cotton	2.76	2.50	2.89	2.97	3.12	2.45	2.62	1.33	2.58	1.45
Cotton yarn	5.02	5.24	6.30	4.75	5.05	4.81	4.33	3.49	5.18	4.33
Cotton fabric	10.97	18.71	20.04	16.08	18.01	16.01	17.78	12.27	20.27	16.79
Man-made filaments	1.83	1.74	1.90	1.77	3.03	2.55	1.83	1.61	2.26	2.46
Man-made staple fibres	20.85	14.74	19.42	18.63	18.06	13.73	14.85	11.61	16.97	14.08
Knit apparel&clothing	21.44	23.26	28.48	21.99	23.81	23.62	35.19	31.85	33.34	25.25
Woven apparel&cloth.	41.84	35.04	38.17	36.85	34.19	35.13	41.69	39.94	44.76	33.95
Other made-ups	38.36	38.77	50.35	48.51	50.02	48.52	53.27	51.57	58.01	53.02

Source: Eurostat (no date)