Report for the Institute for Global Dialogue

Report on Government Responses to New post-MFA realities in Lesotho

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Executive Summary

In the short space of five years, Lesotho's clothing industry grew from six factories to 40, from exporting $140 million worth of garments in 2000 to $391 million in 2005. The duty-free privileges, and at the time the quota-free privileges as well, offered under the United States' AGOA regime attracted investors from Asia and South Africa and sparked the dramatic rise in garment factories, employment in those factories, and exports. However, a change in the international conditions in the garment industry and a significant appreciation of the currency have caused the industry to contract.

The major shift in international condition occurred in January 2005. The Multifibre Arrangement (MFA) and its successor the Agreement and Textiles and Clothing (ATC), the international agreements that governed the apparel quota system for 50 years, expired 31 December 2004. The MFA was one Lesotho's attractions; the country had unfilled quota. Quotas no longer restrain China, India, and Vietnam from manufacturing unlimited garments. These countries have lower costs than sub-Saharan African (SSA) countries; buyers and retailers are leaving SSA to place orders in Asia.

Besides quota-free access, Lesotho was able to attract foreign investment due to its advantageous exchange rate with the US dollar, duty-free access to the United States granted under the African Growth and Opportunity Act (AGOA), low wages, access to South Africa's transportation system, and relatively stable political environment. These advantages are rapidly disappearing. Since 2003, the Maloti, pegged to the Rand, has since appreciated in value against the dollar. Thus, wage costs, in dollars, have almost doubled (nominally) over the past three years. At the same time, worker productivity, as reported by factory managers, has not significantly increased despite the 10-year presence of the industry in Lesotho.

Lesotho, as a lesser-developed country (LDC), is able to import fabric from Asia under the third country fabric provision of AGOA to be used in the manufacturing of garments exported to the US. This provision, which allows Lesotho duty-free access to its major market, expires in September 2007. After September 2007, factories in Lesotho must use fabric made in SSA or the United States to receive duty-free entry.

Lesotho exports almost entirely to the US, making it heavily dependent on one market. The EU market also offers an opportunity, but duty-free access to Lesotho is blocked by stringent rules of origin, which requires that garments eligible for duty-free entry must be made from fabric made in Lesotho. Although Lesotho currently has a denim fabric mill that supplies jeans manufacturers, the majority of Lesotho's factories use knit fabric, for which there is no mill in Lesotho. The introduction of a knit fabric mill is key for the industry in Lesotho, not only to access the European markets, but also to shorten lead times importing fabric from Asia, and to continue to access the US market should the third country fabric provision expire.

Keeping factories in Lesotho is proving a difficult task due to these changing conditions. Eight factories have already left Lesotho, finding it too difficult to compete with China, Vietnam, and Cambodia given the current conditions. Approximately 10,000 workers have been laid off as factories close or lay-off workers. Protected from the international market by quotas and tariff preferences, producers in Lesotho never upgraded their operations to face the new post-MFA competition. Now they are facing the consequences.

The government of Lesotho has instituted several policies to assist firms in staying in Lesotho. The Lesotho National Development Corporation (LNDC) assists existing industrialists with bureaucratic and infrastructural problems as well as attracts new investment. The government led a delegation of ministries and industrialists to the US to encourage the US government to extend AGOA as well as speak to major buyers like Gap and Levi Strauss. To assist factories with their bottom lines, the government instituted a duty-credit certificate scheme (DCCS) to rebate import duties on raw materials. Firms interviewed for this project have confirmed that this is one of the major reasons why the clothing firms have been able to stay in Lesotho.

Several key conclusions can be drawn from this project:

1. The significance of China's global economic expansion cannot be underestimated in terms of its impact on Lesotho's clothing and textile industry.

2. The major competitive threats to the industry therefore lie in the developing world and not in the industrialised world.

3. Given the rapid growth of the garment sector in Lesotho and its importance to output, balance of payments, job creation, and income distribution, any changes will have significant repercussions with respect to high unemployment and serious poverty observed in the country.

4. Without duty free access through AGOA to Lesotho's major market, the United States, the clothing industry is likely to suffer severely.

5. The sustainability of the industry requires firms in the industry becoming more internationally competitive to compete effectively with Asian producers. Government proposals to assist firms should include firm learning, clustering, and worker training.

6. Improvement of the physical infrastructure, in particular the water system, is essential for attracting knit fabric mill investors and thus the creation of an integrated value chain within Lesotho.

7. An integrated value chain (e.g. a knit fabric mill) would allow Lesotho to enhance its competitiveness against its Asian rivals in terms of lead times and access to the US market should the third country fabric provision expire in September 2007.

8. Bureaucratic infrastructure needs to be improved to smooth customs clearances, company registration, and visa and residency permit applications.

9. The existing exchange rate tied to the South African Rand does not assist the clothing exporters in Lesotho who find it very difficult to compete without high degrees of preferences in global markets.

We have not yet seen the full impact of China on Lesotho. Firms in Lesotho need to prepare themselves for tremendous international pressure and competition.

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Abbreviations

AGOA	African Growth and Opportunity Act
CMT	cut, make, and trim
EBA	Everything but Arms
EPA	Economic Partnership Agreement
EU	European Union
FOB	free-on-board
GDP	Gross Domestic Product
GSP	Generalized System of Preferences
IMF	International Monetary Fund
LRA	Lesotho Revenue Authority
LNDC	Lesotho National Development Corporation
MFA	Multifibre Arrangement
MFAF	Multifibre Alliance Forum
MTICM	Ministry of Trade, Industry and Cooperatives and Marketing
SACU	Southern Africa Customs Union
SSA	sub-Saharan Africa
UNCTAD	United Nations Conference on Trade and Development
US	United States of America
USITC	United States International Trade Commission
WTO	World Trade Organization

1 Introduction

Since 2000, Lesotho along with Kenya, Madagascar and Swaziland, has seen year-to-year doubling of clothing exports to the United States under the AGOA program. These SSA countries have experienced tremendous growth in the clothing industry mainly because of AGOA duty-free benefits, but also due to advantageous exchange rates with the US dollar. However, on 31 December 2004, the Multifibre Arrangement (MFA), the quota system that restricted Chinese exports to developed countries ended, freeing China and other large producers from binding quotas. Dire predictions were made about the end of the clothing industry in SSA, which accounted for 3% of global garment exports in 2004. The winners would be China, Vietnam, and Cambodia, where global garment production would concentrate. Indeed, eight factories in Lesotho have closed, leaving 5,800 unemployed. Their closure has been attributed to a lack of orders as retailers source their garments elsewhere and to the appreciation of the Rand against the dollar. With layoffs at other factories, the total number of jobs lost is 10,700.

The objectives of this study are to investigate and analyse policy and other responses of the Lesotho government to the liberalisation of the clothing and textile industry, with a focus on the end of the Multi-Fibre Arrangement. Included should be an examination of whether the utilisation of preferential measures (AGOA, 'Everything but Arms', Cotonou) will have any ameliorating effects."

The primary focus therefore of the paper is addressing the policy issue of what can be done to assist the firms remaining in Lesotho. This project investigates what the government in Lesotho has done in the build up to the end of the MFA as well as what strategies are available to the government to cement the industry in Lesotho for the future. In order to do this we conducted a number of interviews with firms, stakeholders and government officials in Lesotho.

1.1 Methodology

In January 2006, interviews in Lesotho were conducted for this project. A total of seven manufacturers, two government officials, one industry association, one sourcing agent, and one key industry informant were interviewed (Table 1). The seven manufacturers interviewed represent 51% of the employment in the industry. One jean and six knit manufacturers were interviewed.

Table 1: Firms Interviewed in January 2006

	No. Interviewed	No. of Firms in Lesotho	Total Employment of Firms Interviewed	Total Industry Employment
Knit Firms	6	30	13,350	20,924
Woven Firms	1	9	6,000	14,754
Total	7	39	18,350	35,678

Source for total Lesotho data: LNDC

2 The Context: The Global Clothing and Textiles Industry

The clothing and textile industry has increasingly become globalised. In 2004, clothing and textiles were one of the world's most traded products, with total exports being valued at $453 billion. The textile and clothing industry is particularly suited to global production networks because the clothing value chain is compartmentalized: most apparel products can be exported at each separate stage along the apparel value chain, making the sector highly trade intensive and sensitive to a country's trade regime (Gereffi and Memedovic 2003). Furthermore, clothing production is mostly labour-intensive yet requiring low skill levels, making the industry suited to developing economies. In contrast, textiles production is far more capital-intensive; developing countries, which lack capital investment, have encountered difficulties in creating backward linkages in the textiles supply chain (Morris *et al,* 2005).

The garment value chain is buyer-driven, meaning that the final retailer or buyer determines the product it will sell in stores, rather than the producers or manufacturer dictating product design and characteristics. Buyers and retailers have control of the chain. But they are affected by constant change in business processes and consumer demand. There have been several major changes, identified by McCormick and Schmitz (2002). First, no longer do retailers keep huge stocks, practising 'just-in-case' retailing, but instead find it cheaper to keep low inventories and practise 'just-in-time' ordering. Thus, time to market is key as stock is no longer held in warehouses, but sent directly to stores. Manufacturers must be able to deliver on time.

In addition, consumers are demanding cheaper products, but shopping more frequently and buying more clothes (Nordas, 2004). To accommodate this change in demand, retailers now have more seasons and shorter runs in those seasons (McCormick and Schmitz 2002). For manufacturers, this means that they are forced to compete on price, and must get more orders from buyers as orders are smaller than in the past. It is typically in developing economies that we find garment manufacturing facilities as costs are generally lower there, in particular labour costs. To be able to compete in a world where price pressures determine orders, manufacturers typically absorb the lower prices by reducing their margins or by increasing worker productivity.

It is important to understand the three major factors that have spread garment production to so many different countries, including countries in SSA. The first is the increasing concentration of buyers with consequences for global governance. The garment value chain has been characterised by a concentration of retailers and buyers, particularly in the US in the last few years. Walmart alone represents 20% of demand in the US retail market (Frontline, 2004). The five major US retailers, Walmart, Sears', Kmart, Dayton Hudson Corp, and JC Penny's, combined control 68% of apparel sales (Gereffi and Memedovic, 2003). By 2010, the top 10 retailers are expected to control 25 – 30% of world textile and clothing trade (KSA Associates as quoted in Manchester Trade Team 2005). Buyer concentration results in orders of large volumes and, of course, low prices. This makes it difficult for small scale suppliers to meet the requirements of large global buyers within time period demanded. This has advantaged countries such as China with large volume plants, and transnational companies (often based in Hong Kong or Taiwan) who have a competitive advantage in organising large scale production runs. Consequently the concentration of power in the hands of a few retailers gives them considerable control over manufacturers within the garment value chain and leaves manufacturers with little clout to obtain high prices (Morris *et al* 2005).

The second major explanation for the structure of global production has been costs and efficiency. Although the clothing industry has become increasingly characterised by the requirement for shorter lead times, greater inter- and intra-seasonal variety and tighter logistics (USITC, 2004; Kaplinsky, 2005), cost has been king in this industry. In 2004, a US International Trade Commission (USITC) enquiry into competitiveness in the global textiles and clothing industry provided a comprehensive overview of emerging trends based in part on a series of country case studies conducted by industry experts. It concluded that China is "expected to become the 'supplier of choice' for most U.S. importers (the large apparel companies and retailers) because of its ability to make almost any type of textile and apparel product at any quality level at a competitive price". The USITC concluded that China's low unit labour costs were due to a combination of low wages and high productivity. As for quality, it is "considered by industry [to be] among the best in making most garments and made-up textile articles at any quality or price level" (USITC 2004: xi and xiii).

The third and most important factor is the Multifibre Arrangement (MFA) and its successor, the Agreement on Clothing and Textiles (ATC). The MFA was a system of quota restrictions placed on all countries by the US and European countries to try to limit imports to protect their own industries. Instead of halting the production power of Asian countries as intended, manufacturers in Japan, Korea and Taiwan over time spread out their production networks to other countries in the region to take advantage of other countries' unfilled quotas (Kaplinsky, 2005).

This quota-based preferential trade access meant that production spread to an ever-increasing number of countries. This was largely because firms in quota-full economies organised garment production in under-utilised quota producer countries. Thus, during the 1990s, a rapid process of third party organising and supply sourcing functions spread throughout the developing world to provide access to established markets. Hong Kong garment producers opened factories in Mauritius and elsewhere, and Korean and Taiwanese producers spread their operations to the Caribbean and to sub-Saharan Africa. In turn, as they matured in their operations and established their own footholds, Mauritian garment producers also spread their operations to Madagascar. In more recent years, large Asian producers, especially in Hong Kong and Taiwan, developed the capacity to mobilise and coordinate full-package manufacture (i.e. all the manufacturing stages) in the global textile and clothing value chain, leading to what Gereffi (1999) termed "triangular production networks." In other words, production in one country (usually least developed) was organised and coordinated by firms in another (mostly middle-income) country, with products produced sold on to final buyers in yet a third (usually industrialised) economy.

Competition between countries arose as labour and transportation costs as well as proximity to market increasingly played an important part. Manufacturers could easily shut down a factory in one country to open again in another, forever seeking cheaper wages and better access to markets. This resulted in manufacturers in developing countries competing against each other and in particular against China, bidding down wages and production costs. Meanwhile, clothing production in Northern countries decreased as wages there made them uncompetitive; this shift was particularly marked in the 1990s. In 1992, 49% of apparel sold in the US was made there; by 1999, just 12% was 'Made in the USA' (Gereffi and Memedovic, 2003).

China is substantially the world's largest clothing exporter, increasing the value of its clothing exports by 540% from $9.7 billion in 1990 to $61.9 billion in 2004 (Table 2). In 1990, China accounted for only 9% of the world's total clothing exports, but by 2004, its share had increased to 24%, and if Hong Kong (10%) is included, China effectively accounted for one third of world clothing exports. Although Italy grew clothing exports by 51% between 1990 and 2004, its share of world exports declined from 11% to only 7%. Mexico and India are the only other countries among the top 10 exporters that have been able to increase their world share. India's clothing exports grew by 162% (from $2.5 billion to $6.6 billion) between 1990 and 2004, increasing its share of world total exports from 2% to 3%.

Table 2: World trade in clothing by top 10 countries (US$ million)

Exports Clothing										**1990-2004 % change**	**% World Total**	
Country	1980	1985	1990	1995	2000	2001	2002	2003	2004		1990	2004
China	1,625	2,450	9,669	24,049	36,071	36,650	41,302	52,061	61,856	540%	9%	24%
Hong Kong	4,976	6,718	15,406	21,297	24,214	23,446	22,343	23,152	25,097	63%	14%	10%
Italy	4,584	5,320	11,839	14,424	13,384	14,220	14,643	16,191	17,925	51%	11%	7%
Germany	2,882		7,882	7,530	7,320	7,444	8,338	9,749	11,221	42%	7%	4%
Turkey	131	1,208	3,331	6,119	6,533	6,661	8,057	9,937	11,193	236%	3%	4%
France	2,294	1,935	4,671	5,659	5,414	5,469	5,882	6,935	7,865	68%	4%	3%
Mexico	2		587	2,731	8,631	8,012	7,751	7,343	7,197	1126%	1%	3%
India	673	930	2,530	4,110	6,179	5,484	6,037	6,459	6,620	162%	2%	3%
Belgium					3,941	4,206	4,649	5,353	6,235		0%	2%
USA	1,263	785	2,565	6,651	8,629	7,012	6,032	5,537	5,059	97%	2%	2%
World	40,590		108,129	158,353	197,498	194,490	202,310	225,940	258,097	139%	100%	100%
Imports Clothing												
USA	6,943	16,202	26,977	41,367	67,115	66,391	66,731	71,277	75,731	181%	24%	28%
Germany	8,326		20,411	24,550	20,183	19,330	19,647	22,219	24,076	18%	18%	9%
Japan	1,537	2,012	8,737	18,758	19,709	19,186	17,602	19,485	21,687	148%	8%	8%
UK	2,858	2,694	6,961	8,002	12,995	13,169	14,657	16,551	19,245	176%	6%	7%
Hong Kong	695	1,671	6,913	12,654	16,008	16,098	15,640	15,946	17,129	148%	6%	6%
France	2,637	2,707	8,381	10,639	11,412	11,769	12,402	14,771	16,791	100%	7%	6%
Italy	797	779	2,580	4,703	6,139	6,697	7,576	9,342	11,130	331%	2%	4%
Spain	152	121	1,649	2,492	3,847	4,279	4,965	6,559	7,732	369%	1%	3%
Belgium					4,828	5,013	5,272	6,249	7,156	0%	0%	3%
Netherlands	2,875	2,045	4,768	5,132	5,371	5,220	5,250	5,943	6,644	39%	4%	2%
World	42,271	50,822	112,236	162,871	207,093	203,820	211,765	236,035	269,473	140%	100%	100%

Source: Morris, Barnes and Esselaar (2006, forthcoming)

The quota system was essential to the global spread of industry. The MFA had the consequence of fostering garment and textile industries in countries with limited comparative advantage, including some SSA countries. SSA is only a small participant on this global stage. Its share of global textile exports was only 2.6% in 2004, and 3.7% for clothing (WTO 2005). Most of these exports are destined for the USA and the largest SSA clothing and textile exporter is Lesotho, followed by Madagascar, Kenya, Mauritius, Swaziland and South Africa. (Table 3 below)

The nature of competition in the apparel industry has also changed. No longer does a factory compete with one that is down the road, but with one that is across an ocean. Developing countries producing textiles and clothing are competing against other developing countries, like China and India. China's exports of clothing have already increased to approximately a quarter of the world total since it joined the WTO in 2001 (de Jonquieres, 2004). Asian countries have a number of advantages in clothing and textiles. China and other Asian countries have available at easy reach cheap, high-quality fabric, produced in Asia (Robbins *et al*, 2004). China has the ability to produce a growing range of items, and has improved its capacity in order to overcome barriers of international quality standards. Unfortunately for producers in SSA countries, prices of Asian-produced garments are declining, while Asian clothing exports are growing. China's share of the US textiles and apparel market, which was about 22% in 2003, is expected to increase to between 65% and 75% after quotas are removed (ATMI, 2003). Developing countries such as Lesotho must keep in mind such competition when preparing a strategy for the future.

On 31 December 2004, the MFA ended and with it, all quotas on textiles and clothing trade between member states of the WTO. Although the phasing down of the quotas had been planned as a gradual process spanning five years, importing countries back-loaded what products they would remove from quotas. Most chose to remove items in the first few years of the phase-out which were of little significance in their imports. The removal of quotas did not mean a "level playing field" since global trade in clothing and textiles is still regulated by tariffs. It is important to note here that the Generalised System of Preference by which the US and 26 other developed countries provides duty-free tariff preferences to over 100 beneficiary countries notably exclude clothing and textiles. In the case of the US, in 2001 the average weighted tariff for clothing was 15.5%, but ranged from 13% to 17% for cotton products and 25% to 35% for synthetic products.

2.1 Preferential Trade Access: African Growth and Opportunity Act

Preferential trade access is the other major contributing factor to the spread of the garment industry. The African Growth and Opportunities Act (AGOA) was signed into USA law on 18 May 2000, aiming to assist SSA by using trade as a means of generating investment and employment. Thirty-six SSA countries, including Lesotho, are eligible for duty-free access to the United States under AGOA. AGOA covers an additional 1,800 tariff lines beyond the traditional US Generalized System of Preferences (GSP) for special selected countries. To be eligible for AGOA preferences, countries must meet certain eligibility criteria; countries must not engage in activities that undermine US national security or foreign policy interests especially in the areas of human rights and terrorism, for example (UNCTAD 2003). AGOA's major difference was the inclusion of clothing and textiles for duty-free access to the US; Lesotho and other SSA countries already had duty-free access under the US GSP for most other products.

Table 3: Clothing exports from selected SSA countries to the US and EU (US$m)

	Kenya		Lesotho		Madagascar		Mauritius		South Africa		Swaziland	
	US	**EU**	**US**	**EU**	**US**	**EU**	**US**	**EU**	**US**	**EU**	**US**	**EU**
1990	2.5	2.5	24.5	5.6	0.4	10.8	121.2	522.7	0.0	32.3	3.4	
1995	34.0	6.3	61.7	12.6	6.7	122.0	190.3	573.3	55.7	66.9	11.7	
2000	43.9	1.7	140.1	1.6	109.5	234.6	244.7	638.5	140.9	78.6	31.9	1.1
2001	64.4	1.7	216.7	3.2	178.2	233.3	238.3	591.2	173.4	69.0	48.1	0.8
2002	125.9	1.1	321.0	2.1	89.4	145.6	254.4	642.3	180.6	68.7	89.1	0.2
2003	187.8	1.4	392.4	1.2	195.9	127.9	269.0	616.2	231.8	78.0	140.5	0.2
2004	277.2	3.2	455.9	1.0	323.3	196	226.4	635.7	141.3	70.3	178.6	1.1
2005	271		390.7		277		166		86.5		160.9	

Source: Gibbon (2002). 2003-2005 data from USITC, US Department of Commerce, Otexa, and Eurostat
Note: US $ exchange rates based on rates for 31 December in the relevant year

Table 3 shows the marked increase in clothing exports from AGOA beneficiaries. Lesotho, Kenya, Madagascar and Swaziland all saw exports overall increase significantly in the period of 2000 through 2005. South Africa and Mauritius, due to the fact that they are not considered LDC countries and thus do not have access to third country fabric, did not see as significant a rise in exports. Mauritius petitioned the US government to have access to third country fabric and was granted permission in 2004, but only through 2005.

2.1.1 Rules of Origin and Third Country Fabric

AGOA has strict rules of origin. Garments must be made of 85% US-made yarn and fabric to enter the US duty-free or alternatively, from fabrics and yarns made in other AGOA beneficiary countries, but limited to a maximum of 3.5% of all US apparel imports (UNCTAD 2003). For countries with a per capita gross domestic product (GDP) of less than $1,500 in 1998 (i.e. LDC countries), the rules of origin requirement is relaxed even further: LDCs can import fabric for production from anywhere in the world (Olarreaga and Ozden 2005). This provision is called the third country fabric provision. The third country fabric provision was originally set to expire in September 2004, but in August 2004, the provision was renewed until 30 September 2007. This provision has been key to the rise of the industry in Lesotho. In 2003, of all the apparel products shipped under AGOA to the US from eligible countries, 76% were exported using third country fabrics; only 19% of AGOA exports used local and regional fabrics, mostly SA producers (TRALAC 2004).

Error! Reference source not found. Table 4 shows that since 2002, more than 90% of all clothing exports from Lesotho to the United States receive duty-free treatment. Exports qualify mainly because of the exception granted under the third country fabric provision. South Africa and Mauritius (**Error! Reference source not found.**) have lower qualifying shares of exports due to the fact that they do not or did not have access to third country fabric. Mauritius currently has a special derogation for third country fabric for a period of one year, set to expire at the end of 2005.

Table 4: AGOA qualifying as share of total clothing exports to US, 2001 – 2003 (US$m)

Country	2001	%	2002	%	2003	%	2004	%
Lesotho	129.2	60.1	317.7	98.9	372.6	94.9	447.6	98.2
Madagascar	92.1	51.8	75.4	84.4	186.3	94.9	314.5	97.3
Kenya	51.7	80.0	121.3	96.6	176.2	93.9	271.5	97.9
Mauritius	38.9	16.3	106.5	41.8	135.0	50.2	147.8	65.3
Swaziland	8.2	17.1	73.7	82.7	126.9	90.2	175.6	98.3
South Africa	30.4	17.4	85	46.9	126.6	54.5	114.7	81.2

Source: Morris *et al* (forthcoming). Data: US Department of Commerce, Otexa

The third country fabric position is crucial for countries exporting to the US; it not be renewed in 2007, there could be significant consequences for manufacturers in AGOA countries. To access AGOA benefits, sub-Saharan African countries would need to increase fabric production for SSA garment manufacturers exporting to the United States. US fabric is prohibitively expensive, and African fabric is not of a high enough quality for export. Although South Africa and Mauritius could expand their textile capacity, production would need to increase to meet demand (Coughlin *et al*, 2001). Large investments would be needed in the textile industry to update it enough to meet the lead times and product variety garment manufacturers need (Coughlin *et al*, 2001). According to manufacturers interviewed in Lesotho, fabric mills in sub-Saharan Africa do not provide the wide variety of fabric necessary to meet manufacturers' needs.

Production and export of clothing and textiles is concentrated in five SSA countries: Kenya, Lesotho, Mauritius, Madagascar, South Africa, and to a lesser extent Swaziland. These six countries account for over 90% of African clothing exports (Gibbon 2002, 2003). AGOA has provided SSA countries with a valuable opportunity to industrialize as they have been shielded from open competition (Minor *et al*, 2002), and sub-Saharan African countries have taken advantage of this opportunity. Exports from the region are mainly formerly quota-restricted low-price basic items such as trousers (typically jeans), t-shirts and sweaters that usually have long production runs, low labour value-added and few styling changes (USITC, 2004).

2.2 Preferential Trade Access: EU's Cotonou Agreement and EBA

Under the Cotonou Agreement, exports from Lesotho have duty-free access to European Union markets but must meet strict rules of origin. The Cotonou Agreement is currently being phased out. Under current EU proposals, Lesotho and other lesser-developed countries must choose between entering into an economic partnership agreement (EPA) with the EU, which is negotiated separately between a country and the European Union, or revert to preferences available under the Everything but Arms (EBA) initiative, which is part of the European Union's GSP (Brenton, 2003). The current rules of origin for the EBA are the same as under the Cotonou Agreement; it is difficult for Lesotho to export garments to the EU due to the stringent rules of origin.

2.2.1 EU Rules of Origin

Duty-free access to the EU is contingent upon a garment meeting the stringent rules of origin. Under general preferential rules of origin, non-originating materials (i.e. imported yarn or fabric) must undergo "sufficient working or processing to confer unto the article a new origin of the product obtained" (Euratex, 1998). A garment is subject to the principles of 'cumulation,' i.e. the garment must undergo two or more manufacturing or transformational processes to qualify for duty-free access. In other words the garment must be made from fabric made in Lesotho. The European Union publishes a list of the different processes that qualify a garment of duty-free access (Euratex, 1998).

However, in the late 1980s Lesotho applied for and received a derogation of the rules of origin, which lasted for eight years (Salm *et al* 2002). The derogation attracted investors to Lesotho. Unfortunately, in 1997, the derogation from the EU expired and was not renewed. As a result, some firms closed, while others switched to producing for the US market.

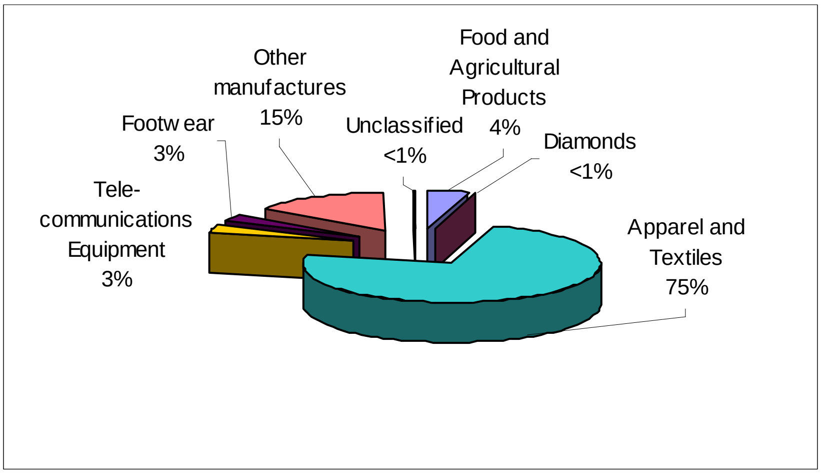
Lesotho currently could export denim products to the EU as there is a denim fabric mill in Maseru. It does not appear, however, that jeans manufacturers are taking advantage of this opportunity. Knit manufacturers, due to the lack of a knit fabric mill, currently are unable to access the EU market duty-free.

3 The Country: An Economic Overview of Lesotho

Lesotho is a small, land-locked country in Southern Africa, completely surrounded by South Africa. Lesotho's population is 1.8 million (2003), but has negative population growth due to the HIV/AIDS epidemic (USITC 2005). Lesotho in general has few natural resources; the country lies at a high elevation with little arable land. In 2003, GDP was $1.1 billion, with an annual growth rate of 2.5%.

Lesotho has relatively few exports. Clothing was the major export in 2004, accounting for Lesotho's major export in 2004 was clothing, accounting for 75% of total exports (Figure 1).

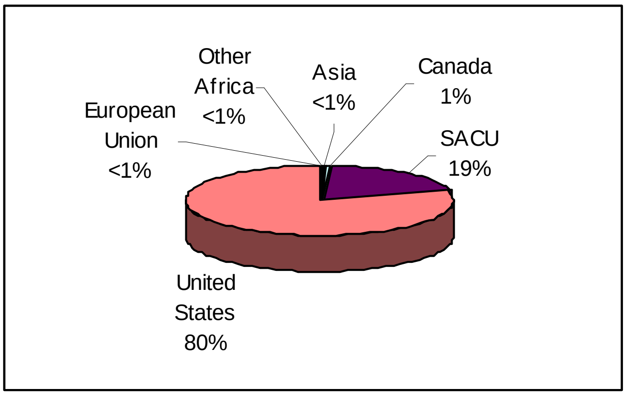
Figure 1: Lesotho's Exports to the world (2004)



Source: IMF (2005)

Besides a concentration in exports, Lesotho has few trading partners. The United States alone is the destination of 80% of Lesotho's exports; 98% of which is clothing and textiles (Figure 2). The next largest destination market is the South African Customs Union (SACU), of which South Africa, Namibia, Botswana and Swaziland are members. In 2002 (the last year that figures are available), 18% of Lesotho's GDP came from clothing and textiles (USITC 2004).

Figure 2: Lesotho's Export Partner Countries (2004)



Source: IMF (2005)

Unemployment in Lesotho is high, estimated at 40-45% (USITC, 2005). For years, people in Lesotho relied on remissions from male relatives who worked in the South African mines. But as the mines closed or down-sized, workers have returned home and have not been able to find employment; the clothing industry mainly employs women.

3.1 History of the Garment Industry in Lesotho

Lesotho in the late 1980s and early 1990s had competitive wages and production costs, attracting foreign investment from Asian firms who were seeking unfilled quotas as well as firms, both South African and Taiwanese, who left South Africa to avoid the restrictions placed on South Africa due to its apartheid regime. Lesotho is the leading recipient (per capita) of FDI in the clothing industry among AGOA beneficiaries (Lall 2005). The majority of this investment comes from Taiwan. Initial industrial garment production investment in Lesotho occurred in Maputsoe, the closest area of Lesotho to Durban and the port and also around Maseru, the capital.

Table 5: Number of LNDC Assisted Garment Factories in Lesotho (1994-2004)

	1994	1999	2004	2005
Number of Factories	6	21	47	39
Number of Workers	8600 (est.)	19,000	41,000	35,678

Source: Ruicon 2004, LNDC documents, Interviews

The garment industry has grown steadily since the 1980s, from 21 firms in 1999 to 47 in 2004 (**Error! Reference source not found.**). More than 80% of clothing investors are Taiwanese – the rest are South African. Although the industry grew steadily, eight factories closed between June 2004 and December 2005, leaving 5,800 workers unemployed (USITC, 2005). Reasons for closures include volatility of the rand and the loss of orders due to increased competition and the end of textile and apparel quotas in 2005. An additional 6,150 were laid off as factories reduced their number of employees. The net loss of jobs is only 10,700 however, as ten factories increased their employees by a total of 1,250.

In the last survey of the industry undertaken by the Lesotho National Development Corporation in July 2005, Lesotho currently has 39 clothing firms employing 35,678 people (Table 6).

Table 6: Total Firms and Employment in the Garment industry in Lesotho (as of July 2005)

	No of Firms	Employment
Woven Firms	9	14,914
Knit Firms	30	20,924
Total	39	35,678

Source: LNDC, Interviews

Table 6 also illustrates the importance of knit firms to the industry in Lesotho. Knit firms comprise 77% of firms in the clothing industry and 60% of employment. These firms are also the most vulnerable to the end of the third country fabric provision in September 2007 as they will no longer be able to import cheap fabric from Asian countries. Nine woven firms are in a much more secure position for 2007 as they have access to the Formosa denim mill, a $100 million investment built in 2004 by the Nien-Hsing group.

The government currently offers various forms of assistance to the industry, which are discussed in further detail below.

3.2 Lesotho's Destination Markets

Lesotho currently exports mostly to the US. As discussed above, the rules of origin of the EU prevent Lesotho from taking advantage of duty-free access to the EU. However, it would benefit Lesotho to diversify its export markets. Lesotho was able to negotiate a derogation of the rules of origin of the EU, and the government might be able to negotiate a similar agreement in the future. The EU market has several general characteristics that make it attractive to garment manufacturers. Orders are generally smaller and more flexible than orders for the US market, allowing producers to fill in empty production capacity. EU buyers also tend to be more flexible in case there is a problem with a shipment (Gibbon, 2003). As an example, manufacturers in Madagascar have been able to access the EU duty-free and those who export to some extent to both markets are able to better balance their production capacity (Sedowski, 2006). It is important to remember that the EU market is not as unified as the US market. Each country in the European Union has its own national retail chains, with few large, cross-border retailers. Thus, orders destined for the EU are smaller than orders to the US; manufacturers would need more orders to fill the same production capacity. Manufacturers indicated in interviews that they are exploring exporting to the European Union. Denim manufacturers, due to the presence of a denim fabric mill would be able to access the duty-free benefits offered by the EU. Knit manufacturers, however, are disadvantaged as there is no local knit fabric mill, and any garments they export to the EU would be subject to duties.

4 Changes since 1 January 2005

Now that a full year has passed since the end of the MFA, the effects of the removal of quotas should be evident. Overall AGOA exports fell by 16%, Madagascar's by 6%

and Swaziland's by 2%. The major casualty of quota removal was South Africa, whose AGOA exports collapsed, virtually halving. By contrast, comparing similar product groupings, China's exports to the US increased very rapidly during the same time period (Kaplinsky and Morris 2006).

Total exports from Lesotho have gone down by 14%, decreasing from $456 million in 2004 to $391 million in 2005 (Table 7).

Table 7: Exports of Apparel from Lesotho to the United States (in US$)

	2004	2005	% decrease
Total Exports of Apparel to the US	455,753,000	390,712,000	-14%
Total Exports of Apparel under AGOA	446,487,000	388,344,000	-13%

Source: AGOA.info

However, not only has total value of exports gone down, but the unit price received has also gone down. Table 8 gives a comparison for the top five products in 2004 and 2005. For the top ten products that Lesotho produces, unit price received has gone down an average of 3.2%. The top ten products has also decreased by 7.4%, while total exports have gone down by 14%, leading to the conclusion that exports in Lesotho are being concentrated into a few product categories.

Table 8: Lesotho vs China; Top 5 Lesotho clothing exports to US, 2004 and 2005

Item	Lesotho exports 2005 ($)	Value change (%) 05/04		Unit price change (%) 05/04		Lesotho market share (%)			China market share (%)	
		Lesotho	China	Lesotho	China	2001	2004	2005	2004	2005
Total	390,600,000	-14	112			0.53	1.0	0.8	8	16
1	59,300,000	-9.3	215.3	-9.2	-57.5	1.42	1.7	1.5	1.8	5.5
2	43,900,000	-16.7	82.5	12.8	-67.7	0.95	2.4	1.8	2.3	3.8
3	39,300,000	36.1	138.2	-8.5	-45.1	1.58	1.8	2.2	1.7	3.5
4	30,800,000	34.0	534.7	-4.6	-52.8	2.76	6.9	8.2	0.7	4.0
5	12,000,000	-41.0	442.0	-9.9	-34.1	1.39	1.1	0.6	1.5	7.1
Avg Top 10*	24,500,000	-7.4	151.6	-3.2	-46.2	1.2	1.8	1.5	3.2	7.7

Item	
1	Women's Or Girls' Other Pullovers, And Similar Garments, Of Cotton, Knitted Or Crocheted, Containing Less Than 36 Percent By Weight Of Flax Fibers
2	Men's Or Boys' Other Pullovers, And Similar Garments, Of Cotton, Knitted Or Crocheted, Containing Less Than 36 Percent By Weight Of Flax Fibers
3	Men's Trousers And Breeches, Not Knitted, Of Cotton, Blue Denim
4	Boys' Trousers And Breeches, Not Knitted, Of Cotton, Not Imported As Parts Of Playsuits, Blue Denim
5	Women's Trousers And Breeches, Of Cotton, Not Knitted, Blue Denim

* weighted average

Source: Kaplinsky and Morris (2006). Data: http://www.usitc.gov. Accessed November 2005.

Lesotho mainly manufactures low cost, low value-added basic garments, mainly t-shirts and jeans. I Lesotho exports just 11 different categories of clothing, while South African manufacturers export in 38 different categories (GDS 2004). It is these specific groups of products that have faced increased competition from low-cost manufacturers in Asia after the expiration of the MFA quotas (MFAF 2005), putting Lesotho in a precarious position.

Although production and exports have been affected, this has not been as critical as the impact on employment. The effects of the end of the MFA on firm-mortality and employment loss have been much more severe and indeed have bordered on the catastrophic, particularly Lesotho and Swaziland (Table 9).

Table 9: Employment decline in clothing sector, 2004-05

	2004	2005	% decline
Kenya	34,614	31,745	9.3
Lesotho	50,217	35,678	28.9
South Africa	98,000	86,000	12.2
Swaziland	32,000	14,000	56.2

Source: Kaplinsky and Morris 2006

The scale of job losses between 2004 and 2005 is alarming. It is not just the degree of job loss which is of concern, but the nature of the jobs which have gone. It mostly involves women, and the impact on their families is severe. For Lesotho, a country without alternative sources of employment, this employment decline has major poverty implications. But we also know from global experience that rapid economic growth can be a significant factor in reducing poverty levels, and the loss to both GDP and exports arising from a sharp contraction of the clothing sector will have a further negative impact on poverty levels.

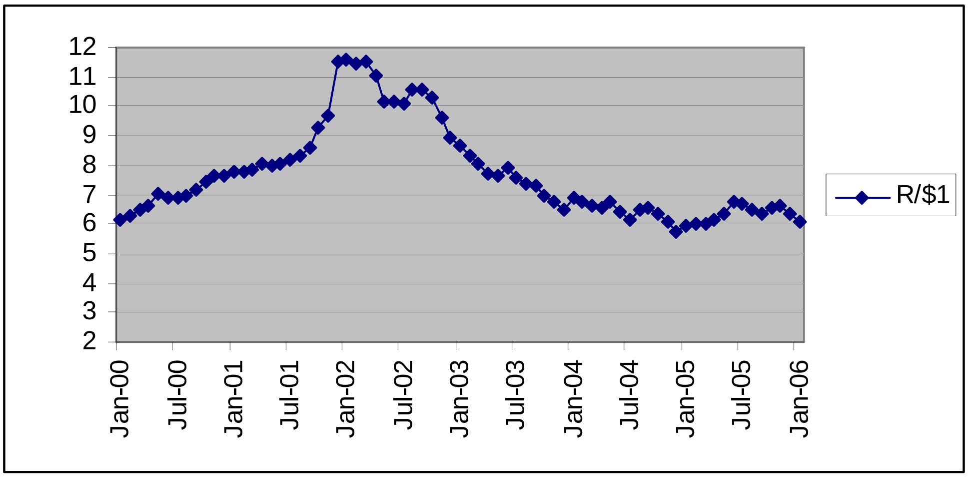
However, it would be misleading to blame the end of the MFA solely for the decrease in exports. To what extent the end of the MFA is to blame and to what extent the appreciation of the Maloti/Rand is to blame for the decrease in exports is difficult to determine. What is certain is that the appreciation of the currency has played a larger role in the decrease in exports for Lesotho than mentioned in other reports and generally accepted.

5 Constraints and Coping Strategies of Manufacturers

5.1 Constraints specific to Lesotho

The major constraint that manufacturers face at this time is the exchange rate. Lesotho's currency, the Maloti, is pegged 1:1 with the South African Rand. Between 2000 and 2002, when most of the manufacturers arrived in Lesotho, the exchange rate between the US dollar and the Maloti/Rand was at its most advantageous. However, in mid-2003, the Maloti/Rand started appreciating against the dollar, rising from R12 per $1 to R7.5 per $1 in 2004 to its current position in January 2006 at R6 to $1. Figure 3 illustrates this point. According to the IMF, "the maloti's sharp rise vis-a-vis the U.S. dollar resulted in a 23 percent real effective appreciation from end-2001 to mid-2005" (IMF 2005, 15). The appreciating exchange rate has made it particularly difficult to remain competitive in the garment industry.

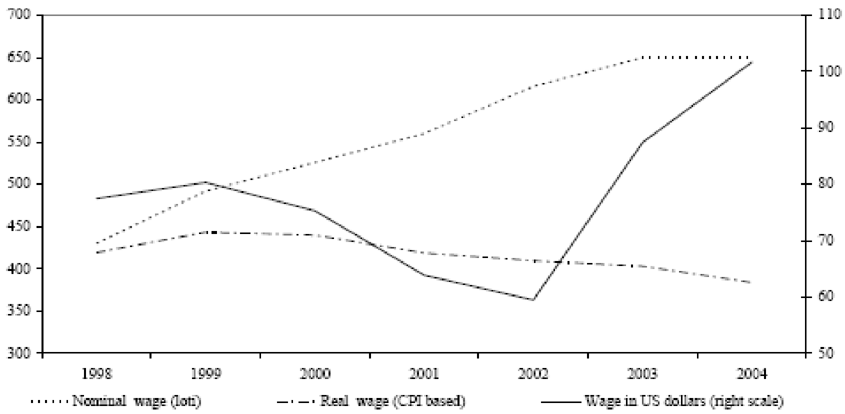
Figure 3: Nominal Exchange Rate (USD-Rand), 2000-2006



Source: www.reservebank.co.za. Data accessed 5/5/2006

Manufacturers have felt the appreciation in the Maloti/Rand most in the monthly wage bill. As manufacturers are paid in dollars, the exchange rate plays an important part when manufacturers convert dollars to Maloti to pay local costs, including wages. Labour costs constitute the largest cost for manufacturers in Lesotho, but they also must pay for utilities, taxes, etc. Manufacturers must now change twice as much dollars in maloti as they did in 2002, despite the fact that wages have not increased in real terms in the time period from 2000 to 2004 (Figure 4).

Figure 4: Monthly Wages, 1998-2004



Source : Lesotho authorities and Fund staff estimates.
1/ Minimum wage for a trained weaver (1998-2003) or a trained manufacturing worker (2004).

Source: IMF (2005)

As firm managers reported,

> "Our breakdown of costs is very unhealthy right now – our labour costs are too high, given our output" (Key Informant F).
>
> "Wages aren't high, but they just look that way because of the currency. It's the currency that causes problems" (Key Informant G).

The currency threshold for 'breaking even' is generally accepted as being R8 to $1:

> "Currency is the problem. We were fine at R12-13 per $1, even R8 per $1. That was fine, but now there is a problem, with R6 per $1" (Key Informant F).

> "If the currency drops back to 12-13 per $1, we can still compete with China, even without the third country fabric provision (Key Informant G).

One factory manager made the point that at R12 to $1, minimum monthly wages of R643 in Lesotho are just $54, making Lesotho cheaper than China, which is reported to have wages around $60 per month. Even at R8 per $1, monthly wages of R600 comes to $80, which is still acceptable. But wages are approximately $107 per month, pricing them above the competition, mainly China and Vietnam.

The USITC speculates that the exchange rate is one of the reasons that in 2004 investors for a knit fabric mill decided to drop their plans (USITC, 2005).

5.2 Wages and Productivity

Wages in Lesotho are set nationally by the government. Wages in Lesotho are cheaper than wages in South Africa and equivalent for those in Swaziland. Workers, by law, have vacation time and sick leave. Anecdotal evidence from interviews indicates that wages in Lesotho are higher than in China, Vietnam and Cambodia, giving anecdotal evidence to support this. Table 10 gives the monthly and hourly wage costs in rand and dollars.

Table 10: Monthly and Hourly Wages in Lesotho January 2006

	Trainee	Trained
Monthly Wages	R643 ($107)	R686 ($114)
Hourly Wages	R3.31 ($0.55)*	R3.53 ($0.59)*

*Based on a monthly, full-time salary. Benefits are not included. Exchange Rate: R6/$1

Source: LNDC

Wages are only one component of unit labour costs. The other components are the degree of automation involved, the skills possessed by the labour force and the effectiveness of management. A detailed investigation of efficiency in Lesotho observed low levels of skill and efficiency (Salm *et al*, 2002). Middle management was particularly weak and was largely made up of Chinese workers with shop floor experience, but little management experience and largely unable to communicate with the labour force. They concluded that "operator productivity within the industry was generally low. This is principally due to deficient recruitment policies, inadequately trained operators, poor supervisory management, communication difficulties and cross-cultural misunderstanding" (Salm *et al* 2002, 51). Poor labour relations are part of this. A detailed survey of worker attitudes found that 51.3% of workers felt "very negative" towards their employers, and a further 14.3% felt "quite negative." Only 1% felt "very positive." Fifty-four percent felt that their lives had not improved at all since joining their factories, and a further 37% said that it had improved "only a little." The overwhelming majority see Asian investors (their factory managers) in an extremely negative light" (Salm *et al* 2002, Annex 3, 21).

Factory managers do not see workers and their productivity in a positive light either. Factory managers are generally negative regarding workers and their skill levels. Low productivity was cited by firm managers interviewed as one of their major problems.

All manufacturers interviewed report worker productivity as being low in comparison to other countries like China, Cambodia, and Vietnam.

> "Workers aren't motivated. We've introduced training problems that have workers, but the improvements weren't enough. It's hours that matter – workers produce less in the afternoon and at the end of the month" (Key Informant F).

> "If workers aren't skilled enough, buyers won't come. Yes, we do have training, skills have improved a lot in the last year. But there are a lot of things [styles, techniques] that workers can't do – the learning curve is very slow and many things [accessories] are so expensive (Key Informant B).

Despite the fact that Lesotho has had a robust clothing industry for more than 10 years now, worker productivity is reported as still being low. There are currently no training institutions in Lesotho, so firms must train workers when they are hired. There is a pool of skilled workers who have been laid off from other factories. However, as AIDS-related deaths increase as predicted, the pool of skilled workers will shrink while the demand will be grow as people become too sick to work.

For Lall (2005) what is most worrying, is that productivity problems can no longer be considered 'teething' problems, faced by an industry at the beginning stages. Factories have been in Lesotho long enough to have realised all possible economies in sewing, and the lack of productivity improvements is indicative of communication barriers between managers and factory workers, nonexistent training facilities, low worker skills, and a non-piece rate wage system (Lall 2005).

5.3 Lack of Fabric Mills in sub-Saharan Africa

Although the lack of fabric mills is a constraint that will play a larger role come 2007 when AGOA's third country fabric provision expires, the current lack of a knit fabric mill is hindering access to the EU market as well as timely delivery to the US market. At present, Lesotho has a denim woven fabric mill, Formosa, in the Nien Hsing group, which produces for Nien Hsing's factories in Lesotho. However, 77% of the garment manufacturers in Lesotho require knit fabric. Knit manufacturers must import fabric, waiting four to six weeks for the fabric to arrive from Asia. The presence of a knit fabric mill in Lesotho would allow manufacturers to expand their product range into more time-dependent garments as their lead time would be much shorter. Lesotho currently exports basic garments – jeans, t-shirts – as these products are not as time-dependent.

Although Southern Africa does have knit fabric mills, their annual production would not be enough to also fill the orders of factories in Lesotho, besides those of other Southern African countries (Coughlin *et al*, 2001). Firms interviewed in Lesotho reported that knit fabric mills in South Africa have slow lead times, low quality levels, and high prices. South African knit fabric mills take six weeks to deliver an order of fabric, just as long as it takes a knit fabric mill in China to make and deliver the same order (Source: Interviews). South African mills at this time are not feasible options, nor do they have the capacity to produce for all of Lesotho's needs.

Come 2007, the lack of a knit fabric mill Lesotho to meet the industry's needs will have dire consequences. No longer able to import fabric from Asia, firms will either lose duty-free access to the US and with it their 16% average tariff advantage, or they will be forced to buy costly fabric from African or US producers.

> "Without AGOA, the 17% tariff (on cotton goods), we would not have other advantages" (Key Informant C).

Most manufacturers interviewed indicated that they would leave in 2007 should no knit fabric mill be built in Lesotho in the next year. However, manufacturers are optimistic that the third country fabric provision will be extended. Should the provision be extended, however, there will be even less of a chance that a knit fabric mill will be built.

5.4 Transport Infrastructure: Implications for Lead times

After the exchange rate and lack of local fabric, the next major problem faced by manufacturers is transport to and from ports. Manufacturers in Lesotho have two options for transporting a container to the port. The most used option is transport by road from Maseru or Maputsoe to Durban, the closest port. Although this is the more expensive option, it is the fastest. Rail is the second and cheaper option for transport to the port. Containers leave from the Maseru Container Terminal and go via Bloemfontein to Port Elizabeth. However, it can take nine to 20 days to transport a container by rail to the port (Table 11**Error! Reference source not found.**).

Table 11: In-land Transport Options between Maseru and Port Elizabeth and Durban

	Rail (Port Elizabeth)	Road (Durban)
Days	9-20 days	1-2 days
Cost (40 ft container)	R7,125	R9,500-12,500

Source: World Bank (2004)

Manufacturers also report delays at the border caused by South African Revenue Services taking longer than necessary to process a container. The harbour at Durban is reported as being inefficient and overburdened, given the level of traffic. "There are bottle necks at the harbour and the Lesotho border. It can take 7-10 days to get a container through customs" (Key Informant D).

These infrastructural problems take a heavy toll on firm lead times as Table 12 demonstrates. Although Lesotho is no more disadvantaged relative to other SSA countries the length of these lead times severely penalises Lesotho as it competes with more productive firms in Asia. Asian firms have a 30 day advantage as fabric mills are closer, and Asian firms are approximately only 14 days away from the ports on the west coast of the United States.

> "Our lead time is a minimum of 75-100 days. In Cambodia, it's 45-60 days. Buyers must plan ahead to order from us. They are taking a high market risk if what they order [so far in advance] from us doesn't sell well" (Key Informant F).

Table 12: Determinants of lead time – Kenya, Lesotho and Swaziland

DELIVERY TYPE	KENYA	LESOTHO	SWAZILAND
Delivery of fabric from Asia (Taiwan or China)	30 days	30 days	30 days
From port to factory	7 days (Nairobi)	3 days	3~10 days
Production lead-time	30 days	25 - 30 days	25~30 days
Factory gate to port	3 days	3 day	2 days
Port to U.S.A. Port (NY)	40 days Mombassa to NY	28 days Durban to NY	28 days Durban to NY
Total delivery time	110 days	90 – 100 days	90~100 days

Source: Kaplinsky and Morris 2006

The most important issue regarding transport is that transport itself is not the problem, but that importing the fabric from China causes a delay of a minimum of 30 days, a delay that construction of a knit fabric mill would decrease.

5.5 Infrastructural Constraints: Water

The industry is hampered by a lack of water. Low water pressure and unacceptable water quality were reported as problems experienced by manufacturers. One manufacturer reported not having enough water for even the employees' toilets. The government's Inter-ministerial Task Team has been trying to address these problems since 2004. However, three firms reported continuing problems with water costs and service. One of the clothing firms in Lesotho had to close 13 out of 23 lines in 2004 due to water shortages and another Lesotho firm also observed poor water supplies as a handicap to production, along with power outages.

Water availability and service must be improved to attract knit fabric mill investment. If water availability is a major constraint now, the situation will only deteriorate should a knit mill be built, as vast quantities of water are necessary for washing and dying.

5.6 International Constraints: Falling Prices

One of the most pronounced effects of the end of the MFA is the global decrease in prices received by manufacturers for garments. All firms in Lesotho reported receiving lower prices for the same garment in 2005 than in 2004. Firms reported price drops of between 5-20%. Table 13 shows two items for which exact prices were reported.

Table 13: Firm-reported price drops 2004-2005

	Price received 2004	Price received 2005	% decrease
Item: t-shirt	$3.00 per dozen	$2.20-2.40 per dozen	20-26%
Item: synthetic pants	$21.00 per dozen	$9.50 per dozen	55%

When prices drop, it is difficult for manufacturers to turn a profit as bottom line costs have not changed. Indeed, one of the largest costs manufacturers face in Lesotho is labour costs, which increase each year. The increase in costs combined with the decrease in prices received, places manufacturers in a difficult position, making them more likely to close down or lay off workers.

6 Government Action

"Without government, Lesotho can't survive. It would be a disaster without government. Without government support, we wouldn't be here otherwise." (Key Informant C)

"Government is very supportive of the industry. We have monthly meetings with the government; they are very easy to talk to. There is the Inter-ministerial Task Force that we talk to." (Key Informant A)

In comparison to other SSA countries assistance to garment industrialists, Lesotho's government has been and is the most proactive in supporting the vital clothing and textile industry of the other AGOA beneficiary countries. Government can play an important role in supporting an industry and encouraging factories to stay. One of the primary competitive benefits of Chinese industry is the efficiency with which the infrastructure functions. This includes not just physical infrastructure such as roads, water and power, but also bureaucratic infrastructure such as port clearance, enterprise set-up and the delivery of appropriate certification. Many of the AGOA economies are fully aware of this. Yet in most cases policy response is cumbersome, and action is slow. Amongst the countries in SSA with garment industries, research undertaken has found that manufacturers in Lesotho were most favourably disposed towards the government support which they received. They felt that they had ready access and an open ear in government. Although not all of their problems were solved (for example, water shortages), the general response from government was conducive to enhanced investments, such as the new $100 million denim fabric mill. Below the important strategies undertaken by the government are discussed.

6.1 Lesotho National Development Corporation

The major government vehicle for support of the clothing and textile industry is the Lesotho National Development Corporation (LNDC). The LNDC is considered to be the driving force behind the growth of the garment industry. The LNDC manages the industrial estates as well as the investment process of investors considering investing in Lesotho. Two industrial estates are located north of Maseru in Maputsoe and Ha Nyenye, and two in Maseru (Thetsane and Maseru West Industrial Estate).

According to the 2002 DFID report, the LNDC has attracted investors to Lesotho as well as "reassured them through difficult times and assisted them in expanding their businesses." The LNDC offers as services company registration, assistance in acquiring the proper licenses and permits, investor counselling, and assistance in industrial (union-firm) relations (LNDC 2006). The LNDC has attracted investors using the incentives of relatively cheap and well-educated labour, and a 15% tax rate compared to 35% that most businesses pay, and subsidized wages during a designated training period (Source: Interviews, Salm *et al*, 2002). Firm owners report that the LNDC is helpful and responsive when assisting firms with any problems. The LNDC interacts on a frequent basis with industrialists to ensure that problems industrialists have are being addressed to the fullest extent possible, though capacity and funding within the LNDC is a problem.

When there is a problem on a LNDC industrial estate, it appears from interviews with firms that the LNDC is relatively quick in solving the problem. There is a shortage of factory shells however. Firms that chose to occupy factory shells not built by the LNDC have found it difficult in getting the LNDC to assist them when they face problems, particularly with utility problems like water and electricity availability and cost. As an example, however, firms reported financial problems due to the appreciation of the Maloti/Rand, and the LNDC responded by decreasing rents in LNDC-owned factory shells by 10% (Key Informant I).

6.2 Taking Care of Bureaucracy: Inter-ministerial Task Team

In 2004, the Ministry of Industry, Trade, Marketing and Cooperatives encouraged the creation of an inter-ministerial committee to discuss the needs and problems garment manufacturers were facing, given that 2005 would be a difficult year due to the end of the MFA. The Inter-ministerial Task Team was created in July 2004, with the final report adopted in September 2004. The ministries involved in the task team included the ministries of Employment and Labour; Finance and Development Planning; Home Affaires and Public Safety; Local Government; Natural Resources; Public Works and Transport; and Trade and Industry, Marketing and Cooperatives. Other government representatives were involved, including the Central Bank of Lesotho, the Lesotho National Development Corporation and Lesotho's national utility companies, among others. Industry was represented by selected firms and industry organizations. It is important to note also that government was in dialogue with the industrialists in Lesotho before the Inter-ministerial Task Team was established (Key Informant I), although now procedures for solving problems have been formalised.

6.3 Increasing Productivity: Training

The government of Lesotho offers a tax rebate for industrialists on their training costs: 100% of staff training costs are tax deductible. Industrialists interviewed stated that this was a helpful government program. Additional assistance for training costs is also available via ComMark Trust, a non-governmental organization working with the LNDC. ComMark Trust provides up to three years of subsidies for training costs. The first year, ComMark Trust provides a 50% training subsidy, decreasing to 45% in the second year and 40% the third year. ComMark Trust provides a list of approved training companies, who can train industrialists in production processes, productivity, human resources and cultural assimilation (ComMark Trust, no date).

Factory managers interviewed reported taking advantage of the training programs offered by the ComMark Trust. One firm of the seven interviewed reported important productivity gains after the training; two firms, however, stated that although high levels of productivity were achieved during the training program, once the training program was completed, productivity dropped again (although to a level somewhat better than before the training program).

In addition, to receive duty-credit benefits, manufacturers must invest in a minimum amount in training, depending on the category the company falls into. The amount spent must either be 5% of the annual wage bill or 10% of the value of the duty-credit certificate when training the workforce of CMT operations (ComMark Trust 2003).

6.4 Attracting buyers: Government lobbying for the industry

The government has also assisted firms by lobbying for the industry. A delegation of government officials and industry representatives went to the United States in January and February 2005 to visit the US Congress and the Bush Administration to impress upon them the importance of the AGOA program to the industry in Lesotho. In addition, the government officials met with representatives of the major brands that source from Lesotho, including Gap and Levi Strauss to impress upon them their importance to the industry.

The government is also currently involved in the industry by taking industrialists with them whenever they visit buyers or attend trade shows in other countries. The government is working with the industrialists to expand their product lines (Key Informant I). Knit fabric producers have been invited by government to tour Lesotho so as to see the opportunity that knit manufacturers offer (Key Informant I).

The Government of Lesotho is also involved with Angola, Tanzania and other African countries in renegotiating the rules of origin for garments for access to the European Union (Key Informant I). It is unknown at this time the outcome or progress of the negotiations.

6.5 Duty Credit Certificate Scheme (DCCS)

All the firms interviewed cited the Duty Credit Certificate Scheme (DCCS) as the major reason why they had not relocated after the appreciation of the rand and the end of the MFA.

> "We would have left already if it hadn't been for the DCCS" (Key Informant E).
>
> "Factories have only been able to survive because of the DCCS. They changed from CMT to FOB so they would increase the value-added" (Key Informant G).

The DCCS is a rebate of the duty to be paid on the importation of clothing and textile products. "The duty credit is the value by which import duty can be reduced and is based on the value of goods exported which have been manufactured in Lesotho during a specified period" (ComMark Trust 2005).

FOB versus CMT

- FOB (Free-on-board): the manufacturer must buy all the fabric and trims itself from suppliers. The manufacturer takes ownership of the raw materials.
- CMT (cut, make trim): indicates that all the raw materials needed (fabric and trims) arrive in the container, and manufacturer in Lesotho assembles the final product. The goods still belong to the supplier, not the manufacturer.

The DCCS was introduced in March 2003 to run until March 2005, but it was renewed for an additional four years. DCCS was conceptualised by the government to encourage exporters to upgrade from being a CMT firm to a FOB firm (see box). Currently, most of the manufacturers in Lesotho are CMT firms, meaning that they only assemble the fabric and trims that arrive in a container from the client. CMT firms receive less of a benefit than FOB firms. By becoming FOB, firms can get 4.5-6% extra revenue on their turnover versus 3.4-4.5% for CMT firms (Maloney 2006). This is a valuable advantage when profit margins are sinking in the face of international downward price pressures. Three firms interviewed mentioned switching from CMT status to FOB status to take advantage of the higher duty-credit benefit. However, at the same time, these firms took on more risk, as now they must have the lines of credit available to purchase the necessary fabric and trims, as well as liaise frequently with the buyer on acceptable fabric and trim suppliers (Key Informant H).

Although the DCC benefit that Lesotho pays out comes from Lesotho's share of the SACU revenue pool, government feels that the increase in economic growth attributable to the clothing industry more than makes up for the decrease in revenues (Inter-ministerial Task Team 2004).

However, one must keep in mind that the DCCS is just a temporary support measure that provides little incentive to upgrade. Firms do not seem to be using the breathing space provided by the DCCS to train their workers or upgrade their

6.6 Government Financial Supports: Corporate Tax Rate and (Proposed) Wage Subsidy

In February 2006, the Minister of Finance and Development Planning, Timothy Thahane, announced the lowering of the company tax on clothing firms from 15% to 0% to "to help support the recovery in our textile and clothing industry and to encourage diversification of exports" (Thahane 2006). It is unknown what effect this late stage effort will have, if for example it will attract new factories or encourage current ones to expand. But this does show that the government of Lesotho is aware of the problems the industry is facing and is trying different support mechanisms to see which are the most effective.

The Inter-ministerial Task Team also has considered granting a wage subsidy for exporters, tied to the exchange rate. If the Maloti/Rand falls below R7.5 per US dollar, the government would provide a subsidy for as long as the rate stays below the base rate (Inter-ministerial Task Team, 2004). However, since it was first proposed in 2004, no further action has been taken.

6.7 Trade and Investment Facilitation Centre: the 'one-stop shop'

The Trade and Investment Facilitation Centre, currently being set up by the Inter-ministerial Task Team, involves the MTICM, the Lesotho Revenue Authority (LRA), and the LNDC, with the support of the banks. The Centre is supposed to "seamlessly manage the issuance of import and rebate permits by the MTICM, and the clearance of goods by the LRA" (Inter-ministerial Task Team 2004). In addition, the Centre would assist factory management in obtaining residence permits and visas for required personnel; a problem that industrialists have said has hindered their efficiency. The Centre is also expected to reduce the time that it takes to register a new business in Lesotho from 90 days to 25 days with expedited processing. Although factories mentioned in interviews that the situation with visas and residence permits has improved, the Centre is not yet fully operational, despite the fact that it is highly demanded and relatively easy to set up.

7 Future Challenges for Manufacturers in Lesotho

The world does not hold constant. Not only must manufacturers in Lesotho contend with current changes in the global value chain such as increased importance of lead times and the end of the quota system, but there are changes on the horizon that will again affect the industry as a whole.

Countries benefiting from the AGOA regime have special access to the American market, but they are not the only poorer, garment-producing countries to have privileges. Currently, Israel, Jordan and Mexico benefit from similar agreements. There is no guarantee that these benefits will remain unique. For example, after the tsunami in December 2004, duty-free trade benefits were extended to tsunami-affected countries, although not for garments. The US Central America Free Trade Agreement also extended duty-free benefits to countries in Central America, but the rules of origin for garments are quite strict. However, this trend of duty-free access as an economic incentive for poor countries points to trade erosion.

Not only is trade erosion a problem on a trade agreement basis, but also on the international level. The World Trade Organization (WTO) has a schedule to regularly reduce tariffs internationally amongst its members. For example, AGOA exporters currently have the average tariff advantage of 16% on garments. However, if the WTO requires its members to reduce tariffs on all products, this advantage will erode, decreasing the advantage that AGOA exporters have over others.

The government of Lesotho appears to be realistic about its situation. It understands that without the clothing industry and the money it pumps into the local economy, the only alternative would be for the government to pay unemployment benefits (Adbelal *et al*, 2006). This strategy will buy time until Lesotho can diversify its exports by attracting investors in horticulture, sandstone and tourism (Abdelal *et al*, 2006).

7.1 Market Opportunities: The European Union

The European Union is a market that is largely untapped by manufacturers in Lesotho. Lesotho has duty-free access to the EU market, although stringent rules of origin must be met. European countries used to represent a large portion of Lesotho's garment exports; however, since the mid-1990s and the expiration of the special derogation of the EU's rules of origin, manufacturers have not exported to the EU in large quantities.

The main reason that manufacturers have not taken advantage of the EU market is due to the EU rules of origin. Products must undergo a certain amount of value-added within the country, but is usually described as a double transformation rule, as two transformation (from yarn to fabric, and fabric to garment) must be done in country to ensure enough value-added to receive duty-free access.

The current trade regime, the Cotonou Agreement, is about to expire. The Lesotho government must choose to be considered under the Everything but Arms (EBA) initiative, which has the same rules of origin as the Cotonou Agreement, or alternatively, negotiate with the EU bilaterally for an Economic Partnership Agreement

(EPA). Lesotho at one time was able to negotiate a derogation of the rules of origin and may possibly be able to do the same in the future. However, it must be understood that the EU does not represent a unified market like the United States, with one or two large, dominant retailers. The EU market is divided by country, with few pan-European retail chains.

The government, although it understands that the garment industry is important for Lesotho in terms of employment and exports, also realizes that it is dangerous to rely entirely on one industry. Although the government is pursuing a fairly active strategy in assisting the clothing and textile industry, it must also devote energies to diversifying the export base of Lesotho.

7.2 Vertical Integration: A Knit Fabric Mill

The key to securing Lesotho's future would be the presence of a knit fabric mill in Lesotho. However, the obstacles to the set up of a knit fabric mill in Lesotho are many. First, few investors would be willing to take the risk of investing in a knit fabric mill in Lesotho. Fabric mills are capital-intensive enterprises; Formosa, the denim fabric mill in Lesotho, for example, is a $100 million investment. The investment required for a knit fabric mill would be along similar lines.

Lesotho at this time would be hard-pressed to attract a knit fabric mill. Water availability, pressure and treatment are important for fabric dying and washing. Lesotho is barely equipped to handle the needs of its current factories. A water treatment plant would need to be built in order to attract a knit fabric mill. Even with a knit fabric mill, there is no guarantee that it would provide the more than 60 different types of fabric that producers need (USAID 2005).

Finally, AGOA's third country fabric provision might be renewed in 2007, thereby negating the need for a knit fabric mill in Lesotho. The only benefit a knit mill would provide (in the third country fabric provision is renewed) is shorter lead times; no longer would firms need to source from China, causing a delay of eight weeks.

It is important to note that the government is not inclined to have the AGOA third country fabric provision set to expire in September 2007 renewed. It sees the expiry as an opportunity to bring in knit mill investment. However, due to the precarious situation that most knit manufacturers find themselves, it appears that government, investors and manufacturers are looking to see who will make the first move.

7.3 Market 'Lesotho: the Brand'

Buyers and retailers are very sensitive to image and the importance of corporate social responsibility. Because of the labour, environmental and social laws in place, the working conditions in Lesotho are not nearly as exploitative as conditions found in Asian countries. The government of Lesotho should do more to promote Lesotho as a destination of choice for buyers and retailers concerned about labour and environmental standards. Workers in Lesotho do not experience the same sweatshop conditions as reported to exist in Asian countries. A campaign that offers Lesotho as an alternative to sweatshop conditions in other countries could benefit Lesotho. Investment promotion agencies are standard practise for newly industrialising countries and Lesotho could use further development in this area (Lall 2005).

8 Conclusions

A number of conclusions can be drawn from Lesotho's experience:

1. The significance of China's global economic expansion cannot be underestimated in terms of its impact on Lesotho's clothing and textile industry

2. The major competitive threats to the industry therefore lie in the developing world and not in the industrialised world. In other words, a levelling of the playing fields, i.e. extending trade advantages to all developing countries, is not to Lesotho's advantage. Besides Asia, Lesotho is competing to some extent with Latin American countries that also manufacture garments, and that may receive the similar benefits to those that Lesotho receives under AGOA.

3. Given the rapid growth of the garment sector in Lesotho and its importance to output, balance of payments, job creation, and income distribution, any changes will have significant repercussions with respect to high unemployment and serious poverty observed in the country.

4. The existence of preferential access granted to Lesotho to the United States market via AGOA, including the third country fabric provision is a necessary condition for Lesotho's clothing and textile industry. Without duty free access to Lesotho's major market, the United States, the clothing industry is likely to suffer severely. Lall (2005) predicts that the other problems Lesotho faces are minor in comparison to the potential loss of tariff advantages.

5. Foreign investment in Lesotho remains shallow (Lall 2005). Taiwanese investors are relatively mobile and can leave. Few if any backward linkages have been created, i.e. Basotho start-up firms supporting the clothing industry by providing cardboard boxes or dying facilities. Government could act by supporting training institutions, small enterprises, and encouraging foreign investors to create local linkages.

6. The sustainability of the industry however requires a major improvement in the production capabilities of firms in the industry. Without a major upgrading program which assists clothing firms to become more internationally competitive the industry will not be able to compete effectively with Asian producers. It is essential that firms start adopting world class manufacturing standards and processes. Government proposals to assist firms should include firm learning, worker training, and clustering. A cluster approach would allow firms to learn better techniques from each other and help the industry develop further. Firms must adopt a more active role to cement their position in Lesotho and in the global apparel value chain.

7. However, the adoption of world class manufacturing standards is not the only requirement. Such action must be complemented by the improvement in infrastructure, both physical and bureaucratic. The improvement of the physical infrastructure, in particular the water system and a water treatment plant, is essential for attracting knit fabric mill investors and thus the creation of an integrated value chain within Lesotho.

8. An integrated value chain would allow Lesotho to enhance its competitiveness against its Asian rivals. Integration, specifically the introduction of a knit fabric mill to Lesotho, will give the country an extra advantage in terms of lead times and access to the US market should the third country fabric provision expire in September 2007.

9. Bureaucratic infrastructure needs to be improved to smooth customs clearances, company registration, and visa and residency permit applications. This will hopefully disappear with the introduction of the Trade and Investment Facilitation Centre. The specific conditions in Lesotho play an important role in determining whether or not firms are able to remain competitive in the global apparel market.

10. The existing exchange rate tied to the South African Rand does not assist the Lesotho exporters of clothing who will find it very difficult to compete without high degrees of preferences in global markets.

11. We have not yet seen the full impact of China on Lesotho. The effects we observe are still at a nascent stage of China's expansion post MFA. It may well be that as China's expansion continues and other factors intersect with the above, there may be even greater impacts. The best that the firms in Lesotho can do is to prepare themselves for tremendous international pressure and competition.

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