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PERSPECTIVE

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The EU's EBA Scheme and the Future of Cambodia's Garment Industry

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EXECUTIVE SUMMARY

- The European Union (EU) has become Cambodia's largest export market, with its share of Cambodian exports increasing from 16.9 per cent in 2000 to 39.4 per cent in 2017. A key driver of this increase are garment exports.

- The EU's Everything But Arms (EBA) scheme plays a crucial role by providing duty-free and quota-free access to Cambodian exports. Specifically, the EU's reform of its rules of origin (ROO) in 2011 resulted in a significant increase of Cambodian garment exports to the EU.

- The EU granted the EBA scheme to Cambodia with human rights and labour rights conditionality, but decided to partially withdraw it over concerns about Cambodia's violation of political rights, restrictive actions on civil society and trade unions, and economic land concessions in the sugar sector.

- The loss of EBA is likely to have a substantial negative impact on the Cambodian economy.

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A CAUTIOUS OUTLOOK FOR THE CAMBODIAN ECONOMY

The Cambodian economy has experienced rapid growth in recent decades, with its gross national income per capita increasing to US$1,119 in 2018 from US$ 337 in 1995.[1] A key driver of this remarkable economic growth is the substantial increase of garment exports to high-income markets such as the European Union (EU), the United States, Canada, and Japan. However, Cambodia's economic prospects are becoming increasingly uncertain after the EU announced in February 2019 its intention to launch a procedure to temporarily withdraw tariff preferences granted to Cambodia under the "Everything But Arms" (EBA) arrangement, over concerns related to serious human and labour rights violations in the country.[2] In response, the Cambodian Ministry of Economy and Finance said that the government has reserved around US$3 billion to cope with the possible suspension.[3] The possible withdrawal of the EBA has been recognised as a shock capable of triggering an economic crisis.

How important is the EU market for Cambodian exports? How did garment exports to the EU become so important to the Cambodian economy? What impact have exports to the EU had on trade, investment, and jobs in Cambodia? Why does the EU intend to suspend the EBA for Cambodia? Answers to these questions will shed light on the implications of the EBA withdrawal for Cambodia.

THE EU AS CAMBODIA'S LARGEST EXPORT MARKET

The Cambodian economy has experienced rapid growth in international trade in recent decades. Total exports increased from US$1.37 billion in 2000 to US$11 billion in 2017, while total imports jumped from US$1.42 billion in 2000 to US$14.2 billion in 2017.[4] As the volume of its international trade increased, the structure of Cambodia's trading partners also changed. In 2000, 54 per cent of Cambodia's total exports went to the United States, but this declined to 21.3 per cent in 2017. By contrast, 16.9 per cent of Cambodia's total exports in 2000 went to the EU, with this increasing to 39.4 per cent in 2017. The major importers in the EU are Germany, the United Kingdom, Spain, France, Belgium, the Netherlands, and Italy.

Garment products make up a substantial portion of Cambodian exports to the EU. In trade statistics, they are recorded as 'knitted garments' in Harmonized Code (HS) chapter 61 and 'woven garments' in HS chapter 62. Aggregating these garment products allows us to measure the relative importance of garment exports. For instance, garments made up 75.7 per cent of Cambodia's total exports to Germany in 2016, and 79.1 per cent for the UK in the same year.[5] Other major export goods include bicycles and cereals such as rice.

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EU'S GENERALIZED-SYSTEM-OF-PREFERENCES (GSP) SCHEMES

To understand the rapid growth of garment exports to the EU, it is crucial to discuss the EU's Generalized-System-of-Preferences (GSP) schemes. The EU has unilaterally granted developing countries with preferential access to EU markets under the GSP since 1971. The objective is to promote sustainable development and good governance in developing countries through international trade. To make the GSP consistent with multilateral trade agreements, the "Enabling Clause" allows for exceptions to the Most-Favoured Nation (MFN) principle in WTO rules.

There are three preferential trade schemes as of December 2015.[6] First, the standard GSP grants low or lower-middle income countries with duty reductions for 66 per cent of all EU tariff lines. Second, the special incentive arrangement for sustainable development and good governance (the so-called 'GSP+') grants duty-free access in the same 66 per cent of tariff lines as the standard GSP for countries with vulnerable economic structures. Beneficiary countries are in return required to follow international conventions such as human and labour rights, environmental protection, and good governance. Third, the EBA arrangement grants least developing countries (LDCs) with duty-free and quota-free access for all tariff lines except for arms and ammunition.

After obtaining GSP status from the EU in 1997, Cambodia has been a beneficiary under the EBA arrangement since 2001.

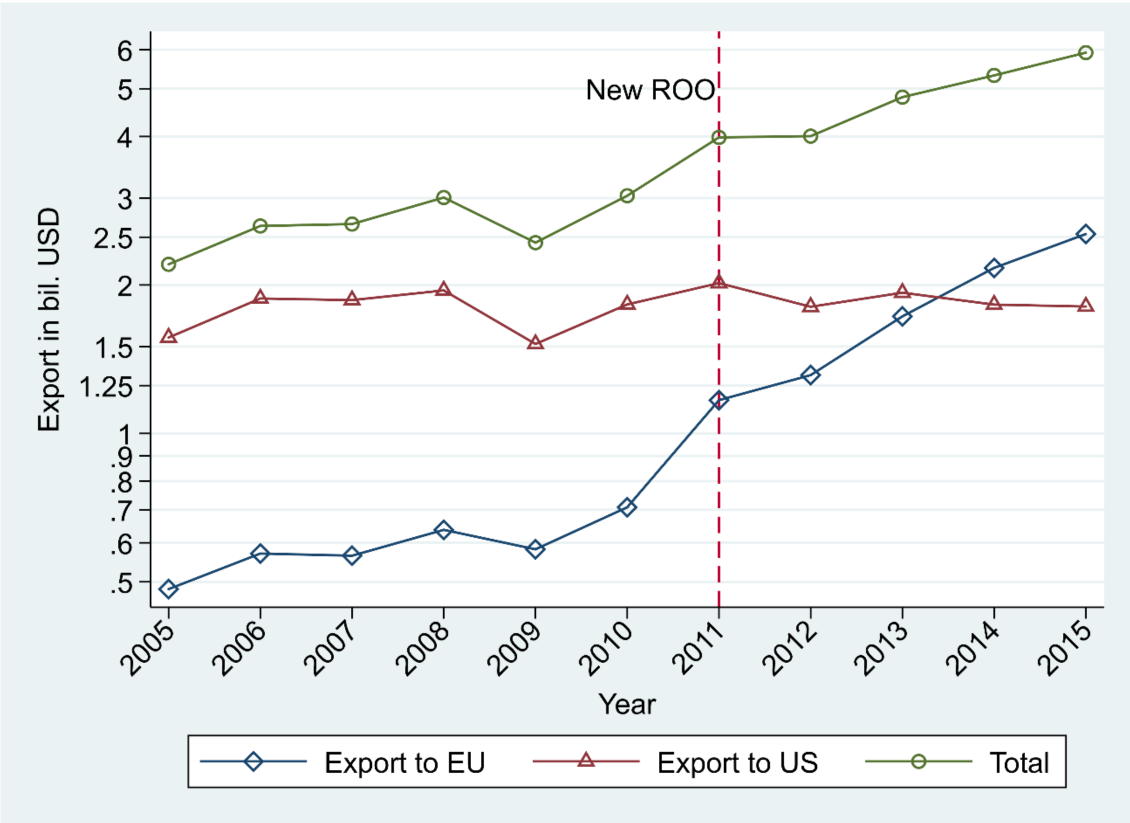
EU'S REFORM OF RULES OF ORIGIN AS A KEY TO EXPORT GROWTH

To qualify for preferential access to the EU market, exporters in beneficiary countries must follow the GSP's rules of origin (ROO) and submit a certificate of origin for each shipment entering the EU. Without such ROO ascertainment, traders would be able to transship export goods through beneficiary countries to avoid paying higher tariffs on products originating from non-beneficiary countries. Preventing transshipped exports is a legitimate reason for stipulating ROO in preferential trading arrangements.

However, specific requirements for origin of goods may be too stringent, restricting the use of imported input from the lowest-cost third country and requiring a submission of complicated documents to prove origin. For these reasons, exporters in beneficiary countries may not fully utilise the preferential market access available to them. Instead, they may simply choose to export their products without duty-free treatment and pay a standard import duty. To address these concerns, the European Commission adopted a new regulation on the GSP's ROO on 18 November 2010. This regulation came into effect on 1 January 2011.[7]

Under the GSP's new ROO, garment exporters in Cambodia can use imported fabric produced anywhere and still enjoy preferential access to the EU. Because locally manufactured fabrics are not required, the origin requirement is relaxed from two-stage processing to one-stage processing. Simplifying origin requirements for garment exports appears to have had a substantial impact on the garment industry in Cambodia.[8] For example, Figure 1 shows garment export trends based on the UN COMTRADE database, with the nominal value of total exports in HS Chapters 61 and 62 in log scale for the period 2005-2015. The United States had been Cambodia's largest export market previously, but after 2011, garment exports to the EU have increased sharply. Exports to the EU increased so rapidly after 2011 that they went from being only 38.8 per cent of US-bound exports in 2010 to exceeding US-bound exports by 40.2 per cent in 2015.

Figure 1. Garment Exports in Cambodia



Notes: Exports include the commodities in HS Chapters 61 and 62; the nominal value of exports is shown in log scale.
Source: UN COMTRADE

CHINA'S GROWING ROLE IN CAMBODIA'S GARMENT INDUSTRY

Simplifying restrictive origin requirements for garment products in the GSP has had a substantial positive impact on garment exports. A key result is the flexible use of intermediate inputs imported from any market, which should reduce the cost of garment manufacturing in Cambodia. Consequently, the EU's reform of the GSP's ROO has also affected international sourcing patterns of intermediate inputs for garment manufacturing. Garment manufacturing uses inputs such as textiles, and since the level of domestic textile production is severely limited in Cambodia, garment producers there have used mainly

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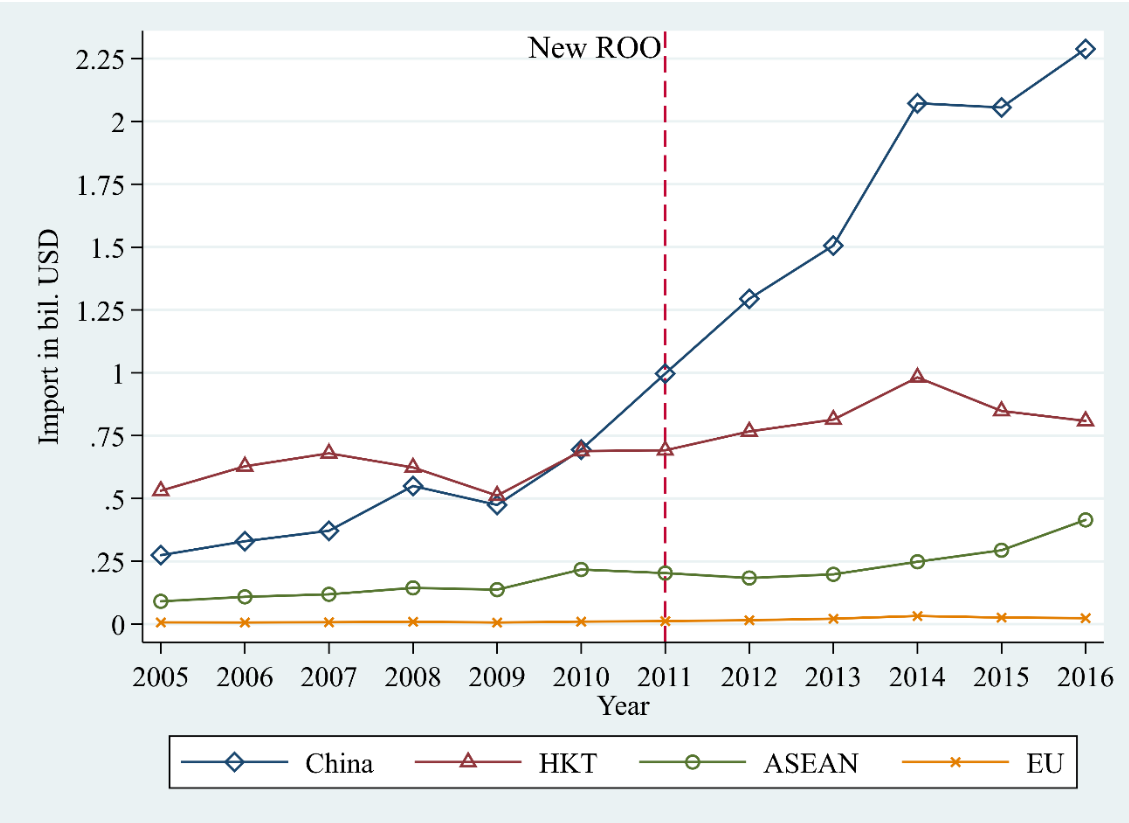
imported fabric from China, Hong Kong, Taiwan, and South Korea. In particular, China was Cambodia's largest source of textile imports even before the ROO reform in 2011.

To shed light on input sourcing, Figure 2 shows the value of Cambodia's textile imports from major exporters, including China, Hong Kong, South Korea, Taiwan, ASEAN, and the EU. It is evident that textile imports from China increased the most sharply. Specifically, the value of fabric imports from China increased from US$695 million in 2010 to US$2.28 billion in 2016. The share of fabric imports from China increased from 42.3 per cent in 2010 to 63.5 per cent in 2016.

Figure 2. Fabric Imports in Cambodia



Notes: Fabric indicates the commodities in HS 5208-12, 5309-11, 5407-08, 5512-16, 56, 57, 58, 59, and 60; HKT indicates the total fabric imports from Hong Kong, South Korea, and Taiwan.
Source: UN COMTRADE

The EU's reform helps to reduce restrictions on intermediate input sourcing for garment production in Cambodia since garment manufacturers can now exploit a wide range of intermediate inputs produced in the most efficient markets, and still enjoy duty-free access to the EU. Consequently, the investment climate in Cambodia has improved for foreign investors in the garment industry, and there has been a sharp increase in inward FDI flows for Cambodian garment production after 2011. Disaggregating the nationality of foreign investors in the garment industry, Figure 3 shows a trend in FDI inflows from major parent countries. It is evident that garment FDI inflows from China increased the most sharply after 2011. This finding suggests that the pronounced increase in textile imports from China was

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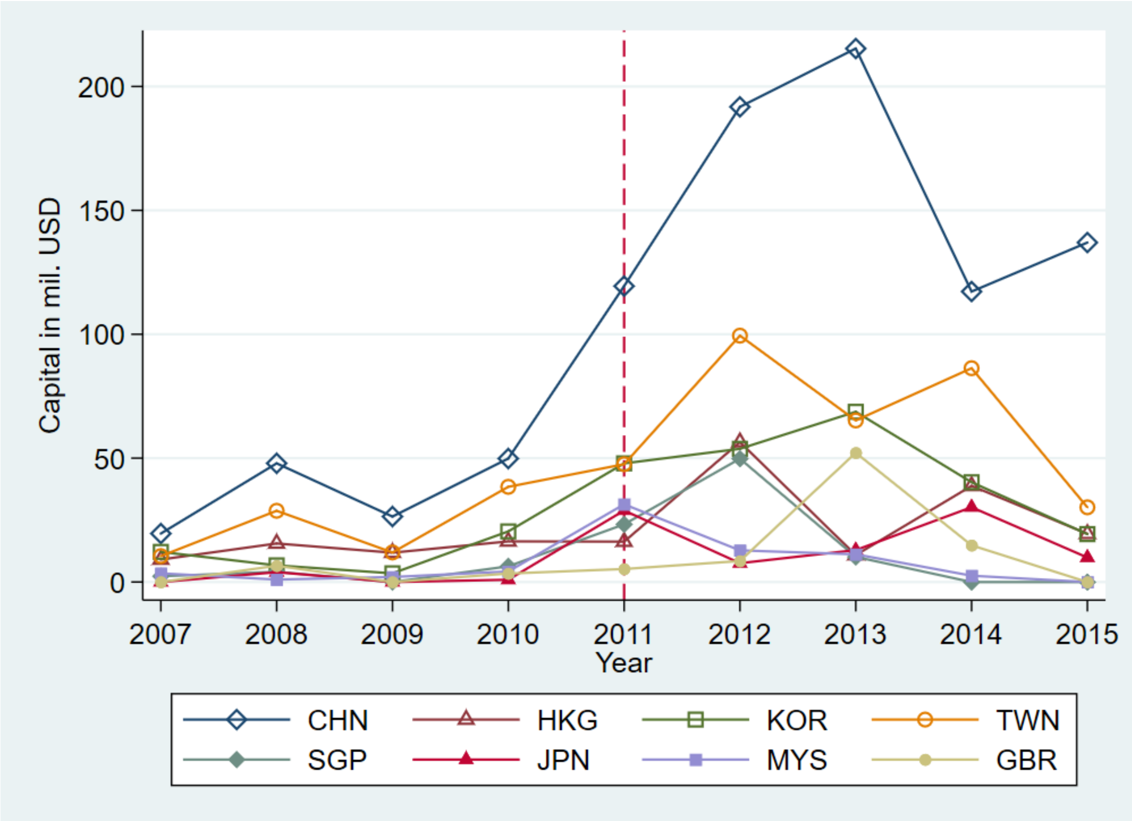
brought about not only by existing garment factories before 2011, but by a surge of new Chinese investors after 2011.

Figure 3. FDI Inflows in the Garment Sector from Major Parent Countries



Notes: Capital is measured in millions of US dollars; major parent countries for inward FDI in garment sector accounted for 97.9 per cent of the total capital investment during the period 1994-2015.
Source: Cambodian Ministry of Industry and Handicraft.

CONSEQUENCES ON JOBS

The impact of the EU's GSP ROO reform is not limited to just trade and investment, but can also be seen in other aspects of garment production, such as employment.[9] Table 1 outlines the number of workers in the garment and textile industries for 2009, 2011, and 2014. In the garment industry, the total number of workers in formally registered firms increased from 256,867 in 2011 to 276,169 in 2014 – an increase of 19,302 jobs. This pattern is consistent with the positive trade shock brought about by the EU's reform on employment in the formal garment industry, supporting the important role of formal garment factories in fuelling aggregate employment growth in the Cambodian economy. In the textile industry, the total number of workers in formally registered firms decreased from 19,966 in 2011 to 4,954 in 2014. The estimated loss of 15,012 jobs in the formal textile industry is consistent with the negative trade shock on the textile industry brought about by import competition.

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My analysis shows large positive employment effects on formal establishments in the garment industry, and large negative employment effects on formal establishments in the textile industry. There have been little employment effects on informal establishments in these industries following the trade shock. Additionally, the large employment expansion in the formal garment industry is accounted for by existing firms rather than new entrants, and domestic-owned rather than foreign-owned firms. The positive employment effects predominantly involve female workers while the negative effects are significant only for male workers.

Table 1. Total Number of Workers in Garment and Textile Industries

Industry	Garment		Textile	
Registration	Informal	Formal	Informal	Formal
Year 2009	31,457	234,390	27,554	16,247
Year 2011	37,566	256,867	19,075	19,966
Year 2014 [a]	28,350	276,169	14,437	4,954

Notes: Formal and informal sectors indicate formally registered and unregistered establishments under the Ministry of Commerce or provincial department of commerce, respectively; (a) the total number of workers in 2014 is estimated by multiplying the establishment-level number of workers by corresponding sampling weights.
Source: Establishment Listing 2009, Economic Census 2011, and Inter-censal Economic Survey 2014

CONSEQUENCES ON PRODUCTIVITY

The ROO reform also has productivity improvement effects, seen through an expansion of garment production.[10] Specifically, simplifying ROO should reduce the costs of garment production through a better mix of inputs and lower documentation costs of proving origin. As a result, a reduction in production costs should translate into an improvement in garment production efficiency. My empirical assessment shows that labour productivity increased significantly for the garment industry during the post-reform period, but did not change significantly for the textile industry. Additionally, my analysis shows productivity improvements for both formal and informal establishments in the garment industry.

HUMAN RIGHTS AND LABOUR RIGHTS CONDITIONALITY IN EBA

Preferential trading arrangements such as the EBA confers favourable tariff treatment on developing countries with special economic needs. Because preferential tariffs are not applied to exports from other industrial countries, such preferential tariff schemes discriminate against non-beneficiary countries and thus violate a non-discrimination principle (MFN treatment) in WTO rules. However, the “Enabling Clause” enacted by the WTO provides a legal basis for the GSP, making preferential tariffs in favour of developing countries legally consistent with the WTO system. Consequently, countries can introduce GSP regimes at their discretion. Preference-granting countries can choose beneficiary countries and eligible products for development purposes. Granting countries can also change and withdraw GSP schemes at any time, and require preference-receiving countries to follow certain conditions, such as good governance, in return.

The EU's GSP has explicit human rights and labour rights conditionality.[11] If preference-receiving countries systematically violate these rights, the EU can withdraw trade preferences to any extent. A full removal of preferences means that preferential tariffs for all products are removed, whereas a partial removal would see preferential tariffs being dropped for some products, but remaining for other eligible products. The removal of preferential tariffs may be only temporary, and the trade preferences can be reinstated later. Nevertheless, the withdrawal of trade preferences does not imply an economic sanction of trade access to the EU market. If beneficiary countries are WTO members, they can still export to the EU at MFN tariff rates. For instance, if Cambodia loses duty-free EBA access, Cambodian garment producers can still export to the EU and pay an MFN tariff rate, which is around 12 per cent for garment products.

In February 2019, the EU started the process to withdraw EBA preferences from Cambodia over concerns about the denial of political rights, restrictive actions on civil society and trade unions, and economic land concessions in the sugar sector.[12] On 12 February 2020, the EU decided to partially withdraw trade preferences for Cambodia.[13] Specifically, the EU's standard tariffs will be imposed on the following goods.

- Selected garment products
- Selected footwear products
- Travel goods
- Sugar

The withdrawal of the tariff preferences amounts to around one-fifth (around 1 billion euros) of total yearly imports in the EU from Cambodia. This will become effective on 12 August 2020 if the European Parliament and the Council do not object. Explaining the EU's latest move, the High Representative for Foreign Affairs and Security Policy/Vice-President of the European Commission Josep Borrell said:

> "*The duration, scale, and impact of Cambodia's violations of the rights to political participation and to the freedoms of expression and association left the European Union with no other choice than to partially withdraw trade preferences. The European Union will not stand and watch as democracy is eroded, human rights curtailed, and free debate silenced. Today's decision reflects our strong commitment to the Cambodian people, their rights, and the country's sustainable development. For the trade preferences to be reinstated, the Cambodian authorities need to take the necessary measures.*"

As stated above, this latest move does not indicate that the EU has decided to remove tariff preferences for Cambodia. It is a gradual process that allows Cambodia to respond to concerns about violations of human and labour rights. Thus, the Cambodian government can still take positive and conclusive steps to meet the human and labour rights conditionality, which is explicitly stipulated in the GSP.

LOSING EBA BENEFITS: A LESSON FROM MYANMAR

The potential impact of EBA suspension on the Cambodian economy is of great interest to policy makers and academics. For example, how much will the EBA suspension reduce garment exports? While there are a number of economic approaches to predict the potential impact, the precise magnitude often crucially depends on underlying assumptions in economic models such as an elasticity of substitution, import demand elasticity, and so on.[14] Thus, the predicted impact can vary, casting doubts on the credibility of economic forecasts.

An alternative but unexplored approach is to draw from the recent experience of Myanmar. The EU suspended trade preferences for Myanmar in 1997 for forced labour, and re-established EBA preferences in 2013. While Cambodia's recent economic environment is quite different from late-1990s Myanmar, it is reasonable to assume similar economic environments in these countries for the 2010s. From the re-establishment of EBA preferences for Myanmar, possible lessons can be drawn by looking at how much Myanmar's garment exports increased after 2013.

Figure 4 shows a trend in garment imports in the EU from Myanmar. When Myanmar did not have EU trade preferences, garment producers could not export to the EU on a duty-free basis until 2013, thus exporting under MFN tariff rates instead. After the re-establishment of EBA preferences in 2013, there was a sharp increase in the value of duty-free garment imports from Myanmar in the EU. The value of duty-free imports increased from zero to 1.56 billion euros in just six years. Thus, garment factories are quite footloose and tariffs in high-income markets, such as the EU, affect their location sharply. While the negative impact of losing EBA benefits may not be strictly symmetric, we can draw insights from the Myanmar example for Cambodia.

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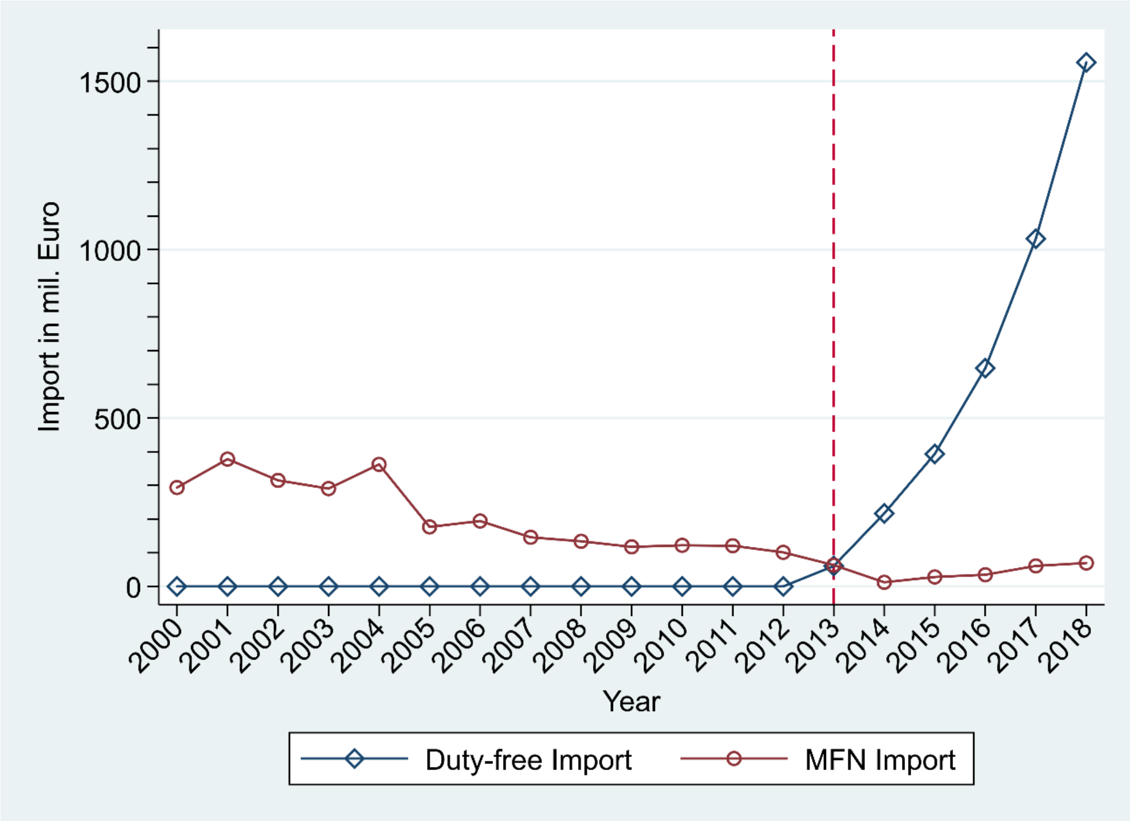
Figure 4. Garment Imports in EU from Myanmar



Notes: The nominal value of garment imports in HS Chapters 61 and 62 eligible for duty-free access from Myanmar in the EU markets is shown; diamond and circle markers indicate the imports that entered under duty-free and MFN rates, respectively.
Source: EUROSTAT.

The loss of EBA preferences is likely to produce a substantial negative impact on the Cambodian economy, such as the closure of garment factories and job cuts for garment workers. Since female workers account for the majority of garment employment, this would particularly affect poor female workers from rural regions.[15] A very rough estimate suggests that at least 60,000 jobs in garment factories would be lost.[16]

Given the negative repercussions, Cambodia would certainly want to be able to continue to benefit from EBA preferences. However, recent efforts by the Cambodian authorities and the EU to address this issue have not made headway. At this juncture, it appears that Cambodia is not prepared to accede to the EU's recommendations on human rights and good governance as a way to preserve the country's status under the EBA programme.

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[1] Data on gross national income per capita (constant 2010 US$) come from the World Development Indicators by the World Bank.
[2] See the press release by the European Commission on February 11, 2019, "EU triggers procedure to temporarily suspend trade preferences for Cambodia".
[3] See *The Phnom Penh Post* on November 28, 2019, "$3 billion in reserve ahead of possible EBA withdrawal".
[4] Trade statistics come from the Cambodian Ministry of Commerce.
[5] Data come from UN COMTRADE database.
[6] European Commission, 2016, "Report on the Generalised Scheme of Preferences covering the period 2014-2015.
[7] For details, see Commission Regulation (EU) No. 1063/2010 of 18 November 2010 amending Regulation (EEC) No. 2454/93 laying down provisions for the implementation of Council Regulation (EEC) No. 2913/92 establishing the Community Customs Code.
[8] A formal empirical analysis is found in Kiyoyasu Tanaka, 2019, "The EU's reform in rules of origin and international trade: evidence from Cambodia", Institute of Developing Economies, Japan External Trade Organisation, mimeograph.
[9] A formal empirical investigation is found in Kiyoyasu Tanaka and Theresa M. Greaney, 2019, "Trade and employment in the formal and informal sectors: a natural experiment from Cambodia", Institute of Developing Economies, Japan External Trade Organisation, mimeograph.
[10] A formal empirical investigation is found in Kiyoyasu Tanaka, 2019, "Trade and productivity in formal and informal firms: panel data evidence from Cambodia", Institute of Developing Economies, Japan External Trade Organisation, mimeograph.
[11] See Ionel Zamfir, 2018, "Human rights in EU trade policy". Retrieved from http://www.europarl.europa.eu/RegData/etudes/BRIE/2018/621905/EPRS_BRI(2018)621905_EN.pdf
[12] See the press release by the European Commission on February 11, 2019, "EU triggers procedure to temporarily suspend trade preferences for Cambodia".
[13] See press release by the European Commission on 12 February 12, 2020, "Trade/Human Rights: Commission decides to partially withdraw Cambodia's preferential access to the EU market".
[14] See the economic forecast in World Bank, 2019, "Cambodia Economic Update". Retrieved from http://documents.worldbank.org/curated/en/843251556908260855/pdf/Cambodia-Economic-Update-Recent-Economic-Developments-and-Outlook.pdf. Another forecast is provided in Krungsri Research, 2019, "Economic impact of the EU's suspension of its trade preferences on Cambodia". Retrieved from https://www.krungsri.com/bank/getmedia/2d30b1c8-a47b-4d42-96d4-a2d59e62f86c/RI_Economic_Impact_EBA_Suspension_on_Cambodia_190628_EN.aspx
[15] See Kiyoyasu Tanaka and Theresa M. Greaney, 2019, "Trade and employment in the formal and informal sectors: a natural experiment from Cambodia", Institute of Developing Economies, Japan External Trade Organisation, mimeograph.
[16] Around 635,000 jobs were provided in garment and footwear sectors in the first half of 2017 according to the ILO, 2018, "Cambodian Garment and Footwear Sector Bulletin". Thus, I estimate that garment factories account for 600,000 jobs. World Bank (2019) and Krungsri Research (2019) predict that garment exports to the EU would decline by around 10 per cent. If a linear relationship between employment and exports is assumed, a decline in exports would lead to a 10% decrease in employment, suggesting that 60,000 jobs would be lost.

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