SERBIA CONTINGENCY PLANNING AND ECONOMIC SECURITY PROGRAM

APPAREL INDUSTRY SUB-SECTOR REPORT

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MAIN REPORT

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for

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Executive Summary

Apparel firms in Novi Pazar developed under different conditions and have traditionally served different markets from firms in the rest of Serbia. Most production has been in creating low-cost knock offs and counterfeits of popular western brands and styles. Demand was greatest and most firms were established during sanctions and when regional markets were just opening and incomes and brand awareness were low. As these trends reverse, firms in Novi Pazar will see their traditional niches disappear and will be however subject to the same forces from the same markets as firms in the rest of Serbia. The traditional markets, though still significant, are under increasing pressure both in cost and volume.

Manufacturing is very important in Novi Pazar, comprising some 23 percent of recorded income in the municipality. Of that, apparel is far and away the most important of the manufacturing industries. The sector has traditionally provided jobs to many unskilled workers, many of whom are women. A failure to adapt to new market conditions and find new niches as older markets decline will mean additional poverty and unemployment in Novi Pazar.

Increasing economic security in the sector and building resilience to change will largely revolve around diversifying away from the traditional markets. Firms in other parts of Serbia continue to successfully transition away from shrinking markets so some avenues for diversification are open and known. Whether or not the firms in Novi Pazar do or should follow those same paths or not is not important. What matters is that the skills required for accessing any new markets in a globalizing economy are largely the same. These include marketing, quality control, ability to use and access market knowledge, logistics, financial control, and sourcing.

As with other reports in this series, this study covers the sector at the level of broad trends, rather than extreme detail. One reason for this is that data is too poor to be certain that the details are correct. Data is Serbia overall is poor, and data in Novi Pazar is nearly non-existent. Firms regularly operate partially or wholly in the informal economy, evading taxes and keeping activities secret. As such, the analysis in this report is largely based on interviews with firms and those with knowledge of the sector in the region.

These second is that data at the micro-level is changing rapidly. The specifics of costs, capabilities, markets, and supply chains are in constant flux. However, they are in flux within the context of broader trends. It is more important to understand and be able to respond to those broader trends than to get involved in minute details on costs and linkages at any given point in time. Having a clear understanding of the trends allows program responses to be accurate in concept, and flexible in implementation.

As per the above and the analysis herein, the recommendations of this report are largely related to improving Novi Pazar firms' ability to access and service new markets. Firms that are not doing so will not invest and will not hire new employees. While some of those markets can be identified currently, others will evolve over time.

I. Introduction

SCOPES is a multi-year project to improve economic security in Southern Serbia. The Project is funded by the United States Agency for International Development (USAID). The objective of this sub-sector study is to determine and recommend specific actions that the SCOPES project can undertake to improve economic security in the Novi Pazar area.

Project management and the USAID Mission have identified “light manufacturing” as a targeted sub-sector in Novi Pazar, with a particular emphasis on apparel production. Novi Pazar has many apparel companies and numerous families’ livelihoods depend on the sector. The recommendations in this report are to be based on a sound understanding of the region, the sector, its potential, and constraints to success. Particular attention is paid to the sub-sector value chain and areas where this could be strengthened by SCOPES program activities.

At the inception of SCOPES, an extensive assessment was undertaken in order to select the areas in which the project would work. The Novi Pazar municipality was selected on the basis of analysis of a range of indicators. A high concentration of Muslims (71 percent), geographic isolation, large number of youth many of which are unemployed or face unemployment, and potential rising tension with the resolution of issues in nearby Kosovo, all contributed to the municipality’s selection in the program.

Serbia has a very extensive apparel sector, mainly conducting both cut-make-trim (CMT) and “full package” contract work for a variety of foreign brands and retailers. These range from low cost and lower quality production, to production for the top brands in the world. Current trends among Serbian firms overall are toward small, fast, high quality production runs for mid to upper tier fashion companies. The manufacturers in the Novi Pazar area have historically operated in a somewhat different niche. The focus has been on jeans and knits, usually of average quality and low cost. A significant amount of production has traditionally been in creating “knock-offs” of foreign brands for sale in Serbia and regionally. Both own brands emulating the styles of foreign brands and full forgeries of popular foreign brands were produced. During the sanctions against Serbia when the country was cut off from international markets and when Albania was opening to foreign trade, these firms did particularly well.

This sub-sector mapping is focused mainly on jeans and to a lesser extent manufacturers of knitwear. These constitute the bulk of the industry in Novi Pazar. They also are most at risk in the current environment. As trade has become increasingly open and as the holders of trademarks begin to more aggressively prosecute abuses, the firms have come under pressure. Novi Pazar also has a number of manufacturers that more fit the description given above for the Serbian industry as a whole. They will not be part of this study, except to give examples of how firms can diversify out of their traditional markets. Given the nature of the firms and the informality of the Novi Pazar economy, there is very little reliable official data available. As such, this analysis relied largely on interviews.

II. End Markets and Consumer Demand

In principle, the apparel business is one without a large amount of asset specificity. An, especially small, production facility could be used to manufacture a reasonably wide range of products. That said, as noted above there is currently considerable specialization in both product and end markets among Novi Pazar manufacturers. The main end markets and some comments on their current state and trends are discussed briefly in the following:

1. Local and regional, mainly ex-Yugoslavia, markets for own-brand jeans and other twill production

   These markets grew largely in response to a combination of sanctions that limited foreign imports, and a demand for low cost alternatives to popular foreign styles. Consumers are mainly at the lower to middle end. The first blow to production for this market came as international markets opened after the removal of sanctions and alternatives became available. The second blow is happening over the longer term, but is no less problematic. As incomes rise in former Yugoslavia, consumers prefer to buy real imported and brand name items. That said, though the market size is hard to estimate, many firms in Novi Pazar at this time still seem to be able to produce profitably here.

2. Local and regional, mainly ex-Yugoslavia, markets for counterfeit jeans and other twill production.

   Under sanctions, this was a key market. As former Yugoslavia is increasingly integrated into global markets, producers of counterfeit goods are coming under pressure. This trend is likely to continue, with both an decrease in markets, and an increase in the cost of continuing to produce counterfeits. That said, indications are that this is still a significant market. It should be noted that production in this areas is also not appropriate for USAID support.

3. Global, mainly EU, of small, fast turnaround production runs for major fashion brands.

   European fashion brands and retailers are switching from large, very low cost production runs where Asian factories have an advantage, to smaller runs that allow them to control inventory and respond very quickly to shifting consumer demands. Much of the Serbian apparel industry is already making the transition to this market, away from large scale runs. Some firms in Novi Pazar have followed, but many do not appear to have done so. This market segment appears to be profitable and likely to remain so for some time.

The firms will and should continue to produce for markets where they feel they are able to sell. Regardless of longer term trends (which change and reverse direction in any case), there are still opportunities in the shrinking markets. However, diversification and increasing the range of markets that the firms are both fully aware of and able to produce for can help increase economic security in the region.

III. Supply Channels

Serbia has a very limited textile industry. For the materials, mainly denim and other twills, that are used in Novi Pazar, nearly all materials are imported. The main sources are Turkey, Italy, Greece, Pakistan, Brazil, Argentina, China, Indonesia and Belgium. Importation of raw materials on its own does not indicate weakness in the sector. Since there is considerable commonality in materials usage across the sector, materials can be purchased and imported in bulk, saving on both purchase and transportation costs. For the smaller firms, orders are pooled through third party importers, while the larger ones arrange conduct much of their own ordering.

On the other hand, while Novi Pazar was reasonably well positioned geographically to service the primary markets of the 1990s, it may be less well positioned for diversification into other international markets. Difficult transport conditions to and from major trunk roads and ports will increase costs. That said, producers in Novi Pazar may not be in a significantly worse situation than other producers in Western Serbia which have so far been successful.

Firms in Novi Pazar by many indications cooperate adequately in areas where this is beneficial. As noted, inputs are consolidated to lower costs. Whether this is being done to the fullest extent is an area that can be further explored during the SCOPES project. There may be additional gains to be made through better information and coordination. Given the small size of the firms, it is also common to consolidate production capacity to meet large orders. This implies that the small size of the firms is not likely as relevant a statistic as it otherwise would be, and that scales can be reached. This may not put buyers' minds fully to rest. In a previous USAID project, a group of buyers was introduced to several Novi Pazar firms. When asked about the production capacity, the manager of one firm replied "how much do you want?" This was an honest answer reflecting the order sharing tradition, but the buyer was not convinced of the reliability of the arrangements. According to the interviews, limits to efficiently consolidating orders appear to be on the managerial side.

One advantage to across-firm order consolidation is that is speeds the rate of learning across firms. On the one hand, this may create a lemming like path dependence that has led to the extreme product homogeneity across producers. The downside comes when markets shift, and resilience across the sub-economy is low due to a lack of diversification. On the positive side, new ideas and technologies can be rapidly adopted across firms. This may be extended to information sharing and in particular understanding and accessing new markets, a hypothesis that the SCOPES project is recommended to test. Given the standard, off-the-shelf technologies and the commodity nature of the business, there is little true innovation that is likely to take place or be needed outside of meeting the needs of new customers. As such, horizontal linkages between firms are likely to continue to be used mainly for spreading market and basic production information.

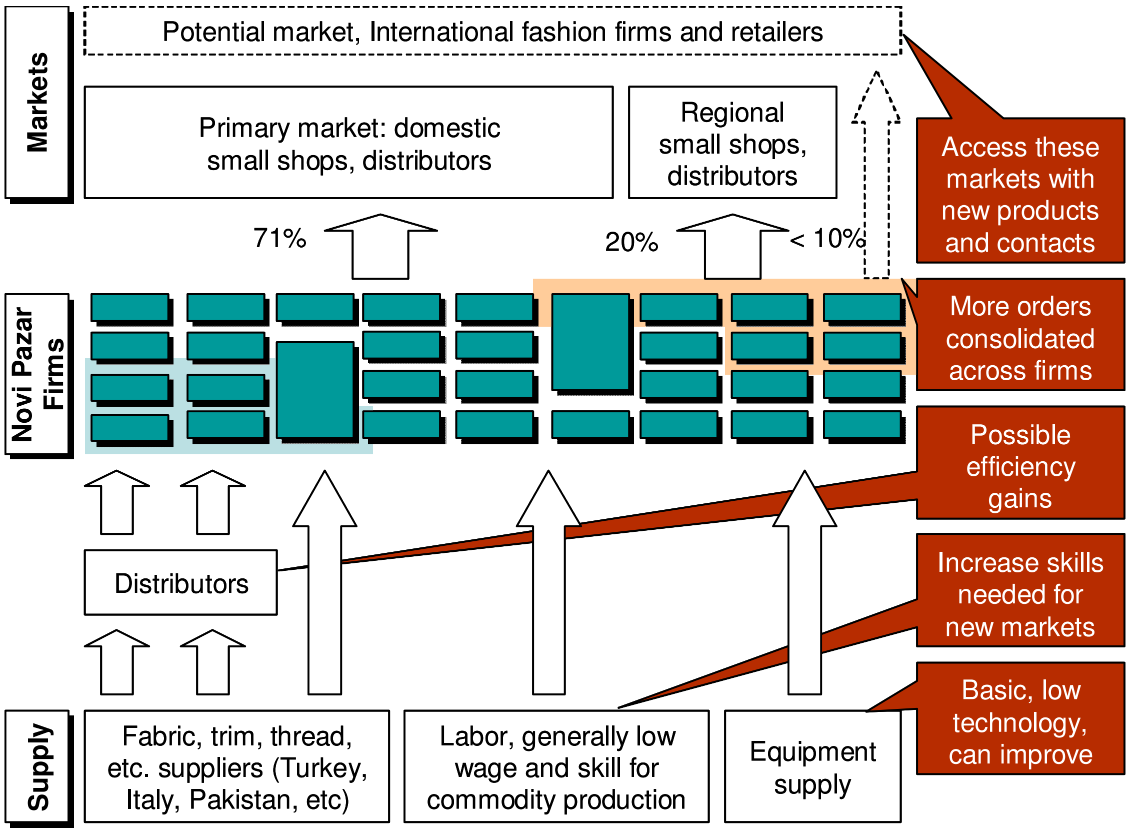
IV. Structure of the Sub-Sector

The particular sub-sector under analysis in Novi Pazar is distinct from that of the rest of Serbia. Whereas Serbia overall historically had a thriving apparel sector that was hurt during the crisis years, much of the industry in Novo Pazar developed in response to the crisis. Firms were established to take advantage of the gaps in imports and in non-enforcement of intellectual property laws. With the demise of the state firms in the 1990s, equipment and expertise were available to spawn the growth the sub-sector.

There are some 250 firms in the sub-sector, only ten of which employ more than 100 people. As noted previously, the boundaries of these firms are somewhat in flux, with production shifted freely between firms as needed to fulfill orders. Total employment is estimated to be between 8,000 and 10,000, a very significant number for a region the size of Novi Pazar. Production is almost entirely in twills, mainly jeans and skirts (over 85 percent). There is also some production of knitwear (less than 10 percent). Production is heavily domestically biased, with an estimated

71 percent still sold in Serbia (including Kosovo), and with most of the rest in the immediate region. Very little is in the third category discussed in Section II above.

A high level mapping of the Novi Pazar apparel sub-sector is given below.



In order to understand the strengths and weaknesses of the current structure, the mapping must work backwards from the target markets. As the first two are well served, but shrinking, the demands of the third are the main focus of this discussion. The mapping reveals some characteristics in the operations of the sub-sector, as well as some areas that may be improved:

1. There is a very heavy reliance on markets that are increasingly under threat, for the reasons discussed in Section II above. Whereas much of the Serbian apparel industry has been able to diversify into additional, mainly foreign, markets, this is less the case for the firms in Novi Pazar. These firms have instead diversified into branded products, as almost all have a trademark. However, in the commodity type markets (i.e. jeans) in which they operate, few have gained sufficient brand recognition for that to be of any value.

2. Indications are that orders are regularly consolidated across firms. This helps to compensate for small firms size. This may not be in an organized a manner as possible nor in a secure enough way to allow foreign firms with very tight schedules to feel comfortable about delivery.

3. Some larger firms source directly, whereas most smaller firms work through suppliers which serve multiple firms. There are a large number of suppliers, which may indicate that scales

and so efficiencies are not as high as they could be. Lessons from the Macedonia apparel industry indicate that significant cost improvements can be made through great logistic and sourcing consolidation.

4. Though labor supply and quality appears to be adequate for the lower levels and types of production, this is not the case for serving more sophisticate markets. Firms regularly remarked on the lack of skills in certain key areas such as management, CAD/CAM and other sophisticated manufacturing technologies, and pattern making.

   The workforce as a whole is mainly women of minority (Moslem) status. Their vulnerability to the shifting and decreasing markets is very high. Any efforts toward market diversification or maintaining competitiveness in current markets will require a coordinated effort on the part of management, marketing departments, and staff. All trainings have to be in response to markets demands, and a clear understanding of those by owners/managers.

5. Equipment in the plants in generally new, even relative to the main competitors in Serbia. It can also be used flexibly to adapt production to the product and quality demands of different markets. However, at the same time equipment is mainly sewing machines and cutting equipment. There is little more sophisticated or digitally controlled production equipment. Some of this may be necessary for working with more demanding clients.

V. Environment

The main trends negatively impacting the apparel firms in Novi Pazar, are generally considered to be positive for Serbia and the region as a whole. Better protection of intellectual property rights, increased integration into global trade networks, better tax enforcement, and rising incomes, all work to undermine the environment in which the firms in Novi Pazar were established and thrive. It is, however, widely believed in the rest of Serbia that Novi Pazar firms still generally do not pay the, especially employment and income, taxes that other Serbian firms are increasingly subject to. This is entirely plausible. The isolated and informal nature of the production allows this to occur.

Nationally, there is little in the way of a concerted apparel strategy or set of policies in Serbia. The Government's approach is fairly laissez faire, with few supports of hindrances. The increase in the value of the currency is perhaps one of the largest policy issues that affects both exporters and those producing for the domestic markets.

Novi Pazar firms are subject to the same aspects of the global regulatory environment as other apparel firms in Serbia. On the positive side, there is good access to EU markets. On the negative is the removal of quotas on Chinese production. In commodity clothing markets, of which twills/jeans are generally considered to be part, low-cost Asian production has significant advantages in the marketplace. Firms in Novi Pazar have been more slow at taking advantage of new trends in EU markets (as discussed above) to make up for the decline in the profitability of mass production.

As a location for accessing new international markets Novi Pazar is not ideal, but not hugely disadvantageous relative to other Serbian firms. Access to main roads and other centers of production (and so everything from spare parts to supplies) is somewhat more problematic than from other apparel producing regions in Serbia. Basic infrastructure exists, but is not as reliable as more central parts of the country. Some respondents in the surveys noted that industrial zones with reliable and redundant infrastructure would help.

Firms in Novi Pazar technically face many of the same constraints to obtaining financing as other Serbian apparel firms. However, given the informal nature of many of these firms and the more limited reach of the banking system in the municipality, financing is an even more critical issue. This will likely hinder the undertaking of some of the investments that may be needed to make the transition to new markets. However, these firms also have a long tradition of self-financing and managed to make the initial investments for establishment under much more difficult circumstances. Nonetheless, lack of access to competitive financing is likely to put the firms at a disadvantage *vis a vis* competitors in the highly competitive international marketplace. Internal financing is not generally considered to be as low cost and market based financing when it is available.

The Novi Pazar region also lacks some business support services. Logistics, supply, repair and other operational areas seem to be well covered. However, strong capabilities in accounting and financial control may not be as well represented. Whether this matters will depend on the relative costs and benefits of formalizing operations, and is tied into the relative cost of financing and of increased reporting costs. Close coordination of production between firms does seem to facilitate learning and the transference of techniques through the sub-sector.

There are also areas related to markets and technology adoption where all firms are lacking. Most notably, this is in access to and dissemination of information about new markets. Many if not most of the marketing departments of firms do not speak European languages and do not have contacts outside of the region. There are no central organizations, associations or marketing entities that are able to quickly and accurately bring this information to Novi Pazar firms. Similarly, even some buyers who have visited the firms have come away perplexed about how best to go about doing business. Firms in Novi Pazar are largely unfamiliar with the expectations of foreign firms. When a representative of Levi Strauss visited, one of the firms inquired whether they would be expected to use the patterns provided by Levis, or whether they should use their own that they had been creating counterfeits from for years.

VI. Sub-Sector Trends and Dynamics

Market trends reflect the discussion in Section II above. The primary markets are under pressure, and the secondary and potential markets will require a concerted effort to access successfully. It is likely that these trends will continue and the firms of Novi Pazar will need to continue to diversify to protect themselves. These trends obviously have significance for the workforce and overall levels of employment. Though rough estimates of employees range from 8,000 to 10,000, the importance of the sector means that many other jobs are closely tied to the fate of the sector. Without an overall diversified economy, much of Novi Pazar's economy is endangered by the loss of apparel markets.

Building increased resilience in the sector will focus on a three sided strategy:

1. Maintaining to the extent possible declining markets in lower-end jeans sales in the country. The firms of Novi Pazar are very closely connected to these markets and are well positioned to adapt. In the face, however, of changing consumer tastes and increased imports, this will continue to be increasingly difficult. That said, this market is expected to remain significant

for some time. The production of counterfeits is hardly an activity that can be advocated by a USAID project. However, it is likely that this will continue as long as it is lucrative and provides some additional market channels.

Few changes in the sector need to happen for success to be maximized in these markets. This is the strong point for these firms.

2. Diversifying into greater exports of core products. Fewer than 30 percent of all products are exported, yet tastes are similar across the region. There are no other major regional areas of jeans production that can obtain the scale in purchases and exports that Novi Pazar firms can. At some level, this puts them up against the large scale Asian and Turkish producers, which are a major threat. New potential markets include Russian and the CIS, the former of which Serbia has a free trade agreement with, though there are some restrictions related to apparel.

   Accessing and successfully selling into these markets will be a challenge, but should be possible. Lower costs, knowledge of localized tastes, and better market contacts are critical, whereas increased quality will also be an issue in some markets.

3. Moving into new markets and product lines as needed. Almost all of the firms in Novi Pazar have responded to this need by creating their own brands. Though they may be proud of these trademarks, outside of Serbia (if even there in the current environment) these labels have little to no value. They may even be a liability. The firms of Novi Pazar can diversify by moving more toward the type of contract manufacturing that other firms in Serbia have done over the past few years. This involves moving away from own brands and large scale production, toward contract production for EU based fashion companies in small production runs with fast turnaround.

   Doing so will not be easy. A number of barriers exist that need to be overcome:

   a. May firms will see it as a step back from own label or even counterfeit production.
   b. Quality will need to be improved.
   c. Financing is required to carry the inventory and production costs, and transactions are not on a cash basis.
   d. Market information and contacts are poor.
   e. Language skills and an understanding of how to deal with EU buyers are lacking.
   f. Costs are not highly competitive, though are believed to be close.
   g. Input markets need to be adapted to EU tastes, or firms need to expand their input markets to include suppliers in other parts of Serbia or the region.
   h. Some equipment will need to be upgraded, or changed

These barriers may seem formidable, but they have been overcome both by many firms in Serbia to date, including some in the Novi Pazar sub-sector area. The current markets are becoming increasing tenuous, leaving little choice but to diversify if there is to be growth and increased stability. It is a simple fact that the apparel industry is highly competitive at the production level. There is little choice but to continue to adapt.

VI. Strategic Analysis

Strengths	Weaknesses
• Long experience in production of jeans and twill fabrics • Large number of flexible companies • Fairly close to EU markets • Strong supply network to imported raw materials • Reasonable quality products • New equipment, especially for sewing • Strong links to local and regional wholesale and retail networks • Low price of labor	• All imported materials, can lead to higher costs and disruptions • Lack of skilled labor, especially specialty • Lack of most modern technologies required by markets • Few good designers • Poor information flow and transference of market information between producers and buyers • Poor quality and work safety management • Shifting demands and low purchasing power of local consumers • Near impossibility of creating own brand outside of Serbia
Opportunities	**Threats**
• Proximity to EU markets and experience elsewhere in Serbia indicates that markets can be diversified • Equipment and skills are not highly specific, allowing a diversification away from only jeans and twills • Suppliers of all needed equipment and all knowledge exists in Serbia	• Pressure from imported goods and shifting market demands • Higher competition in the commodity products from Asian and Turkish producers • Difficult attitude toward change can keep new markets from being accessed • Low skill levels of workers not conducive to more demanding markets • High labor content and low level of buyer loyalty in current markets leads to high risk of market loss should costs shift even slightly

VIII. Proposed Recommended Activities for SCOPES

Most recommendations are focused on the firm or sector level. There are no effective associations with which to work at this time. The possibility of supporting and existing or starting a new association should be looked at. However, doing so should be approached with extreme caution. All options of existing institutions, whether public or private, should be looked at closely first.

The main purpose of the recommendations is to allow firms and the sector to improve management and diversify markets. Firms are already well placed to service their existing markets. It is believed that the marginal benefits to more support here will be much lower than that of diversification. As economic security is a primary goal of the SCOPES project, the stability in employment that will come from diversification is also a consideration. The primary new target markets are small-run, contractor markets in the EU and CIS. Recommendations are given in the chart on the following page. All of these activities are within the scope and capacity of the SCOPES project to deliver.

A number of activities were requested by the firms, but are not recommended in this report. The main reason was the cost and risk of low sustainability and impact. For some of these areas, the activities themselves are considered, but the institutionalization is left for further study. Some of these recommended, but rejected, activities are given in the table after the table of recommendations.

Recommended Activities

Activity	Reason for Rejection	Sub-Activities	Participants	Impact
Access to new markets in the EU and CIS	Will help diversify customer base to increase ability to adapt to instability in current markets	1. Customer expectations and service training 2. Buyer familiarity trips 3. Trade show attendance and trade trips to target markets	Firms and SCOPES team	Access to new markets is non-reversible on a firm level basis. Ideally an association would play a role.
Improve technical and managerial skills	Servicing new markets requires new techniques in production, quality control, and sales	1. Train firms in quality control, CAD/CAM techniques, operations, sourcing, financing, and efficiency 2. Support foreign language training 3. Provide trainings in sales and customer service 4. Imbed trainings in permanent institution: technical school, association, university, etc.	Firms, SCOPES team, and local institution	Allow firms to be able to meet the demands of new target markets, and develop curriculum and consulting capacity local to spread impact across firms
Improve overall market information, especially about new markets	Give firms the information they need to make strategic decisions	1. Translate key articles on trends and requirements in new markets 2. Develop and outsourcing directory with Novi Pazar firms and their capabilities and distribute and make available for download 3. If feasible, create information center to continue		Information about target markets will allow firms to prioritize and organize production in a way to service those markets. Currently only local markets are know.
Create sustainability for all above activities	Ensure that all and future firms have access to the above	1. Canvass all possible institutions in the region: existing associations, technical schools, employment centers, Chamber of Commerce offices, etc. to find an appropriate institution 2. Help develop protocols and training programs to imbed programs in the appropriate institution		

Logistics audit and action plan	Determine and obtain additional efficiencies from supply and distribution networks	1. Conduct a full audit of full and partial load costs and potential for additional consolidation 2. Recommend and implement technical, infrastructure and managerial solutions to improve logistics efficiency	SCOPES, Government of Serbia, logistics firms, suppliers	Better supply and distribution logistics will help overcome regional disadvantages and distances from newer target markets
Order consolidation management training	Order consolidation is critical for meeting larger orders, yet is carried out on an ad hoc basis	1. Assess the current practices for managing order consolidation across firms, including areas where reliability and efficiency are lacking 2. Develop a set of information sharing tools and processes to decrease the transaction costs of order consolidation	SCOPES, firms, technical schools	Improved efficiency and lower transactions costs in order consolidation will help ensure that small firms size is not a liability

Activities Requested, but not Recommended in Full

Activity	Reason for Rejection or Revision
Assistance in design and own-label branding	It is not believed that the benefits of developing new designs and recognized trademarks will be greater than the costs. There is already a huge surplus of own brands among Novi Pazar firms, with almost all of the estimated 250 companies having one. Building a brand to the point where the product commands a premium is a very expensive activity that has a very large risk of little to know return.
Development of industrial training center or institute	Having an industrial training center in Novi Pazar with a well trained staff would undoubtedly benefit the industry. However, it is not believed that it is realistic that one could be established, staffed and made sustainable without significant public sector support. At this time, the trainings and capabilities noted above will be housed in existing institutions and with existing capacity to the extent possible. During the course of the Project, SCOPES staff will seek to obtain support for a more permanent and dedicated facility. However, it will not be assumed that one can be established. Previous precedent has not be strong.