SOUTHERN AFRICA GLOBAL COMPETITIVENESS HUB

# Rules of Origin, “Commercial Availability” and Trade Preferences: Denim and AGOA

**Advisor:**
**Frank Flatters, Economist**

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**The Services Group, Inc.**

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P.O. Box 602090 ▲Unit 4, Lot 40 ▲ Gaborone Commerce Park ▲ Gaborone, Botswana ▲ Phone (267) 390 0884 ▲ Fax (267) 390 1027

Email: info@satradehub.org

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### Summary of Main Findings and Recommendations

AGOA preferences for garments have been of great mutual benefit to US consumers, buyers and their contract manufacturers, and to workers and garment producers in some of southern Africa's poorest countries. A principal reason for this is the third country fabric clause that exempts less developed beneficiary countries (LDBCs) from the yarn forward rule of origin.

The commercial availability provision that was inserted into the most recent extension of AGOA threatens to undo many of its gains. The costs are likely to be aggravated by some key missteps in its implementation; but there are fundamental contradictions between the goals of provision and its likely impacts, regardless of how well it is implemented.

The new provision requires the USITC to consider and rule on petitions claiming that certain locally produced yarns or fabrics are "commercially available" to apparel producers in LDBCs. If it verifies such availability, it is required to determine the amount that is so available, and LDBC garment producers are then required to use at least these amounts in order to qualify for the third country fabric rule designed to assist LDBCs and their customers.

There are two fundamental problems with this provision.

- If a designated fabric truly is available in the quantities, product characteristics, according to all delivery and service requirements, and at a competitive cost—i.e. if it really is commercially available—buyers will not need any inducement or incentive to purchase it. All other things equal, buyers would always prefer to purchase from local suppliers. The evidence from the southern Africa region and from the rest of that world is that buyers and producers will go to considerable effort on their own to explore and foster local supply networks.
- However, if local supplies are not available, or are not of the right quality (a truly complex and multi-faceted issue in the case of apparel fabric), or if delivery schedules cannot be met, or prices are too high, then forcing local producers to buy locally will diminish if not destroy their ability to compete for production contracts.

In other words declaring a fabric to be commercially available and requiring its local use in certain quantities is at best redundant, in which case it is not necessary; or the declaration will be wrong, in which case it will be harmful.

It is in the nature of the global garment industry that a requirement to use "commercially available" local fabric, or even the threat of such a requirement, is unlikely to be simply redundant and hence benign. Designers and buyers require maximum flexibility in sourcing of fabrics; they need to adapt continuously to changing style, market and cost conditions. If producers are subject to actual or even possible restrictions on their sourcing decisions, they will rapidly become less preferred suppliers and will find it difficult to win out in global competition for orders and for long-term relationships with key buyers. Such long-term relationships are a key factor in development of a successful, sustainable and upwardly mobile garment industry.

Even if local fabric producers could meet local garment makers' needs at one point in time, there is no guarantee that they would be able to do so next month or next year. It would be dangerous for local fabric producers to tie their future primarily to local garment makers; and requiring garment makers to source fabric locally will reduce their global competitiveness, and possibly fatally so.

Local purchasing requirements are not in the long-term interest of either garment makers or of fabric and yarn producers. The recent decision of the Gap, one the largest buyers in Lesotho, to withdraw from that market because of uncertainties created by the commercial availability provision is an ominous sign for regional apparel and textile industries.

The new commercial availability clause could quickly undo many of AGOA's benefits. This is even more so if, as in the case of denim:

- the clause is imposed retroactively,
- amounts of commercially available fabric are not very carefully and conservatively determined, bearing in mind the need for flexibility on the part of buyers, the existence of alternative markets for locally produced fabrics and the potential costs of inadvertently granting monopolistic powers to local suppliers as a result of local content requirements,
- errors in determining commercially available amounts are amplified by carrying them forward into future year requirements,
- forms and procedures for monitoring shipments according to whether they contain locally sourced fabric are not up to the task, and
- methods for determining actual local fabric content are not realistic and agreed by all parties.

The first best solution, and the one that accords most closely to the goals of AGOA is to dispense with the commercial availability provision as inherently harmful to local and regional garment makers and inherently difficult to administer in a non-destructive manner.

The second best and far inferior, but possibly necessary in the short run, solution is to correct the errors in administration and implementation that are highlighted in the bullet points just above.

Does this ignore a major goal of the commercial availability provision—to help the development not only of local garment industries, but also yarn and fabric producers? No, as this report shows, the commercial availability provision is not a suitable instrument for this purpose. What are the alternatives?

Some of the blame for failure of regional textile industries to integrate into global production networks rests with domestic policies and domestic industries that have been inclined to focus on protected local and regional markets. However, longstanding distortions and especially high levels of protection in major developed country markets also bear a large share of responsibility.

The first best solution, at least from the perspective of a US government wishing to assist development of the local and regional industry, is the same as for garments—to grant African textile producers duty-free preferential access under AGOA, under a single stage transformation rule of origin as has been granted to LDBCs for garments. This would induce local yarn and fabric producers to shift their focus from protected domestic and regional markets to the global market where success depends of productivity, quality, innovation and cost rather than inefficiency derived from focus on small markets and directing entrepreneurial effort at maintaining protection.

While this is certainly the first best in terms of maximizing the opportunities for developing a competitive textile industry, some players that have become accustomed to a different game, might prefer to get US assistance in forcing successful local garment makers to buy from them. But this is not a viable or sustainable long-term strategy, for either the garment or the textile industry.

In response to AGOA opportunities, international garment buyers have and continue to give assistance to local yarn and fabric producers in a quest to develop local and even global supply networks based in the region. In addition to granting preferential access to the US market as recommended here, it might be wise to consult with buyers, producers and policy makers that have been involved to date in order to identify key constraints to competitiveness of regional textile industries and to develop other means of assistance and policy reform to deal with these constraints.

**Rules of Origin, "Commercial Availability" and Trade Preferences: Denim and AGOA**

## 1 Introduction and Overview

Rapidly rising garment exports have been among the most important outcomes of the Africa Growth and Opportunity Act (AGOA), with large employment benefits concentrated in some of Africa's poorest countries.[1]

A considerable part of this success has been attributed to the decision to exempt a designated group of Less Developed Beneficiary Countries (LDBCs) from what is commonly known as AGOA's yarn-forward rule of origin for garment exports. Under this rule, apparel is not eligible for AGOA preferences unless it is made from fabric woven in the US or in beneficiary African countries from yarn that is also produced in the US or in beneficiary African countries. It was widely recognized that very poor countries would find it difficult to meeting this demanding requirement.

In view of the weak industrial structures associated with their low levels of economic development, therefore, the designated LDBCs were granted a temporary exemption from this rule and were permitted to source yarn and fabric globally, much more closely mimicking what has been a standard pattern in complex global production networks, not only in garments and textiles, but also in most other industrial goods.

The temporary nature of the LDBC provision, however, created significant uncertainty for apparel buyers and producers, as well as for potential investors in upstream yarn and fabric production. The waiver of this rule of origin was originally scheduled to last for only four years, from October 2000 until September 2004. Subsequent amendments (AGOA III in 1994 and AGOA IV in late 2006) have extended the provision twice, and it is currently scheduled to expire in 2012.

At the same time as AGOA IV extended the date of the third country fabric provision, however, it also introduced a potential restriction on LDBC access to third country materials. In the event of a petition to this effect, the US International Trade Commission (USITC) is required to determine whether certain locally produced yarns or fabrics are "commercially available" for use by LDBC garment producers. If such local supplies are determined to exist, the USITC must determine the precise amount that is available to LDBC apparel producers. In order to benefit from the third country fabric provision, LDBC producers then will be required to use such quantities of local fabrics. If they do not do so, the yarn-forward rule of origin will apply and any garments using third country fabric will not be eligible for AGOA preferences.

A principal justification for the new abundant supply provision is that it will help support the development of upstream yarn and fabric industries in AGOA beneficiary countries, an argument supported by firms that have or are interested in investing in yarn and garment production. Garment producers and buyers on the other hand refer to the potentially damaging impacts of this measure on their costs, quality and supply chain management.

The mere existence of this clause has created commercial uncertainty for buyers and for producers of both fabric and apparel. Details of its substance and implementation have raised additional difficulties and concerns.

A further clause included in the AGOA IV legislation deemed denim (HTS code 5209.42.00) to be in abundant supply in the amount of 30,000,000 square meter equivalents (SMEs) for the year beginning 1 October 2006. This is an exception to the legislation's requirement for such determinations to be reached as a result of a petition to the USITC and of its

[1] See recent papers by Paul Brenton and colleagues; details provided in References below.

examination of the evidence as to the existence and quantities of such commercially available fabric,

The USITC, however, is still required to rule on commercial availability of denim on an annual basis until 2012 and to issue reports on actual utilization of such amounts. Its initial report on the matter, issued in September, includes findings that are unsettling for the apparel industry in key LDBCs, and at least one major US buyer has already indicated that it has decided to leave the region.

The purpose of this briefing is to discuss the underlying economics and implementation of the textile and garment rules of origin and the new abundant supply provisions as illustrated by the case of denim.

## 2 AGOA: A Brief Textile- and Garment-Centric Overview

The Africa Growth and Opportunity Act of 2000 (AGOA I, known also as the Trade and Development Act) provided duty-free, quota-free access to the US market for a wide range of products exported from qualifying African countries. The Act and its provisions reflected the interests of a number of different groups. From the perspective of the textiles and garment sectors these included, as promoters of AGOA

- An Africa lobby with genuine humanitarian, strategic and/or other interests in assisting and promoting the development of poor African countries,
- American garment buyers that had been running into quota and capacity constraints in sourcing in Asia and had identified several African countries as potential substitutes,
- Asian and African garment producers with a desire to and/or a history of supplying major US buyers and who shared the buyers' interest in sourcing from Africa,

and, on the other hand, with some resistance to AGOA from

- US textile and garment producers and associated unions that had no particular interest in further competition from African production granted duty-free access to the domestic market.

It is important to observe that AGOA emerged in large part as a means to assist shifts in garment sourcing from traditional Asian suppliers to newer producers in Africa. This was a logical response to binding quota constraints and rising costs in key supplier countries, and capacity constraints in alternative Asian supply sources such as Cambodia. The shift of garment manufacturing to several centres in southern Africa was a sign of confidence in the capacity of the region to compete in global markets; and AGOA was a useful means of providing an increased competitive edge to African production.

Conflicts among the key US interest groups led to a number of compromises and ongoing uncertainties over the long run future of the program. Among the most important issues were treatment of yarn and textiles (not generally eligible for AGOA preferences), rules of origin and special LDC provisions in respect thereof, and sunset clauses for the overall program and for the LDBC provisions. The recently enacted "commercial availability" clause and its retroactive application to denim is the most recent manifestation of such conflicts, although this might be the first time that the principal instigator of a key AGOA provision was a non-US interest group.

AGOA I was designed to last for eight years, from 1 October 2000 to 30 September 2008. Garments were covered, but subject to certain safeguard provisions and to a "yarn forward" rule of origin, requiring that garments must be made cloth manufactured in the US or in a beneficiary country, from yarn also made in the US or a beneficiary country. Certain less developed beneficiary countries were exempted from the yarn forward rule of origin and were permitted to source cloth from third countries. This LDBC provision was scheduled

initially to expire after only four years, after which the yarn forward rule would apply. The set of LDBCs benefiting from this provision initially excluded Botswana and Namibia, but they were later included by an amendment passed in 2002 (AGOA II). A number of other countries have been added to the LDBC list subsequently.

The AGOA Acceleration Act of 13 July 2004 (AGOA III) moved the end date of AGOA preferences from September 2008 to September 2015, and extended the termination date of the LDC third party fabric provisions on apparel from September 2004 to September 2007.

The most recent AGOA amendments (AGOA IV) were passed on 20 December 2006. The main purpose was to extend the LDBC garment provisions from 2007 to 2012.

In addition, however, the amendments included a new rule requiring the use of "commercially available" locally produced fabric. Under this provision, the USITC can be petitioned to rule on whether any material used by LDBCs under the third country sourcing privilege is "commercially available" from producers in an AGOA beneficiary country. If such supplies are determined to exist, the USITC must then determine the quantities of commercially available local material and LDBCs are then required to use these amounts in order to qualify for AGOA preferences. For such products, apparel producers wishing to use the third country fabric waiver can do so only if USITC-determined amounts of locally available fabrics are utilized. Otherwise, LDBC producers are subject to the yarn-forward rule of origin and any apparel containing third country yarn or fabric will not qualify.

A successful determination of local commercial availability will result in the setting of usage requirements for the following year, and, on an annual basis, for every subsequent year until 2012 when the third country fabric provision is currently scheduled to end.

The USITC is also charged with verifying, also on an annual basis, whether LDBC apparel producers actually meet the requirements to use local commercially available fabric. Failure to meet the requirement in any year will result in the addition of the deemed shortfall to the purchase requirements determined for the following year. In other words, a shortfall in use of local fabric results in the requirement the following year to use not only the full amount of that is determined to be commercially available in that year, but also an additional amount equal to the shortfall in the previous year.

A single failure to meet the local purchase requirement authorizes the President to withdraw the third country fabric rule for the apparel in question; but he is not required to do so. A second consecutive failure results in compulsory withdrawal of third country provision, making any apparel using third country yarn or fabric ineligible for AGOA preferences.

Although the legislation requires that an abundant supply action be triggered by a petition to the USITC, it also included a determination that denim (of HTS code 5209.42.00) was in abundant supply at 30,000,000 Square Meter Equivalents (SMEs) per annum as of October 2006. This means that LDBC denim apparel exports for the period 1 October 2006 to 30 September 2007 are expected to utilize at least that amount of local fabric. It also means that the USITC will be required to determine the amounts of commercially available local denim for AGOA exports in every subsequent year until the end of AGOA in 2012.

The USITC held hearings in June 2007 and delivered a report in September. Its determination was that for 2007-2008 the amount of commercially available denim would be slightly more than 21 million SMEs. Although it had not concluded its investigation of actual usage in 2006-2007, it indicated that it expected to find a substantial shortfall in usage relative to the 30 million SMEs that the Congress had determined to be available for this purpose. If this prediction turns out to be correct,

- the President will be required to decide whether to make denim apparel ineligible for AGOA's LDBC provision, and

- if he does not do so, the amount of local denim they will be required to use next year in order to qualify after that will be greater than what the USITC has deemed will actually be available.

## 3 Rules of Origin and Trade Preferences—Implementation Issues

Rules of origin are necessary in any trade preference scheme as a means of ensuring that preferences are granted only to products originating in the countries for which the preferences are intended. They do so by requiring that the production of any good include sufficient manufacturing activity or local content to ensure that it really did originate in the indicated location and is not merely being transhipped from elsewhere in order to take advantage of tariff preferences (trade deflection).

Unfortunately implementation of these rules can impose serious economic costs on the very activities that trade preferences are meant to promote. These costs can arise both from the way in which the rules are implemented and from unintended consequences of their use to achieve broader economic goals, beyond prevention of simple trade deflection. As a result, they have the potential to cause serious disruptions in global production patterns and on which all countries—poor, middle income and rich—rely as a key element in their continuing economic progress.

This section deals more with implementation issues. A discussion of broader economic impacts of rules designed to achieve additional economic goals is presented in the following section.

The mere existence of rules of origin increases the complexity and costs of trade. The visa system that needs to be implemented by any AGOA-participating country is extremely demanding, and its implementation, in some countries at least, has led to the growth of a whole new industry of customs brokers that specialize in AGOA shipments. These new service providers have displaced experienced freight forwarding companies, increased shipping costs on US-bound exports from the region, and weakened the customs services of countries in which agents have found it more lucrative to move out of the public sector and into the private brokerage industry. By and large, however, the system appears to be operating relatively smoothly now, and the costs have been absorbed by and are now part of the AGOA regime. (Do we have any estimates of these costs? Or any examples of AGOA trade opportunities foregone as a result of these complexities and costs?)

Adding further to the costs of participating in AGOA and complying with its rules of origin on garments has been ongoing uncertainty about the details of and time periods for which its various provisions are valid. The most recent commercial availability clause is a significant new addition to these uncertainty costs.

### 3.1 Uncertainty: Basic AGOA Provisions

***End-Date of AGOA Preferences:***

AGOA preferences were originally intended to apply for eight years, until 2008. Half way through this period, in 2004, the end-date was extended to 2015, providing greater certainty to producers and investors about the longer-term preferences available from producing in Africa.

As mentioned earlier, AGOA imposes two different rules of origin for apparel. The standard rule is the yarn forward rule—apparel is eligible for AGOA preferences only if it is made from yarn and fabric produced in eligible African countries or in the US, utilizing yarn that is also produced in eligible African countries or the US. The second rule, a waiver from the standard one, allows certain eligible countries, so-called LDBCs, to source fabric from anywhere, and regardless of the source of the yarn used in making the fabric.

***End-Date of LDBC Third Country Fabric Provision:***

There has been much greater uncertainty about this waiver of the yarn forward rule for LDBCs. The LDBC waiver for third party fabric was originally designed to last four years. Botswana and Namibia were added to the list of LDBCs after two years (i.e. with only two years remaining in the original waiver period). Three months before the planned expiry date, the third party fabric provision was extended for another three-year period. And then in December 2006, less than nine months before its next expiry, the provision was extended for another four years.

The two extensions of the LDBC provision were not complete surprises. But it was far from certain that they would occur and, if so, for how long. This uncertainty creates real costs for investors, producers, workers and buyers.

For those in the apparel business, investments include land, buildings, machinery, logistical systems, worker training and development of buyer networks. If access to third party fabric is necessary for the financial viability of such investments, it makes a great deal of difference whether this is going to be available for only four years, seven years, or eleven years. The possibility of expiry of third country fabric access after four or seven years would serve as a serious deterrent to investment, and would bias investors in favour of short-term projects. Costly investments in machines and worker training necessary for product and skill upgrading would be very risky in such circumstances, and investors would be inclined to set up only to produce basic products and not engage in longer term plans to improve the long-run competitiveness of local garment production.

Similar considerations apply to apparel buyers. Most international buyers make purchases on the basis of long-term relationships with apparel producers. Development of these relationships requires investment in quality certification and in ongoing verification, development of confidence in the suppliers' ability to meet stringent process and end-product requirements, to meet tight production and delivery schedules, and to have the flexibility to meet ever changing and always demanding requirements on the sourcing of fabric and other inputs. Uncertainties about any producer's ability to source raw materials according to the buyer's requirements on cost, quality and technical specifications make investments in the development of a long-term purchasing relationship much more risky. Uncertainties about the availability of the third country fabric waiver from one year to the next or, worse, from one season to the next reduce the returns from investments in a long term purchasing relationship. At best, as in the case of producers, it will bias any investments in favour of short run relationships in basic commodities where fabric requirements are less demanding and important.

### 3.2 New Uncertainty: The Commercial Availability Clause

The "abundant supply" or "commercial availability" clause included as part of the most recent extension of the LDBC provision adds a major new source of uncertainty facing any buyer or producer about the long run flexibility of supply of fabrics for apparel produced in African LDBCs. The uncertainty applies at several levels.

***Timing and Coverage:***

For any producer or buyer there is the general uncertainty from one year to the next that some critical fabric will be deemed to be "commercially available" in the region and restrictions placed on the ability to source it internationally. How can the US Congress or USITC officials know better than apparel buyers and producers whether a particular fabric is "commercially available" in Africa and if so in what quantities? More importantly, how can any producer or buyer predict what the Congress or the USITC will decide from one year to the next?

If such a determination is made, what will be the implications for buyers and producers in terms of price, quality and delivery? How is it possible for buyers and producers to establish long term commercial relationships for particular products and producers with this kind of fundamental uncertainly hanging over any long-term decisions? If garment producers and buyers are not closely and carefully consulted in advance of any decisions are made (they were not in the case of denim), the problems will be even worse.

The economic implications of local purchase requirements such as this are dealt with in more detail in Section 4 below.

***Implementation Details:***

There are several aspects of the precise specification of the commercial availability provision that substantially increase the uncertainty facing firms whose products are subject to its provision.

- Whether the local purchase requirements set under the provision are satisfied, and hence whether the products of any firm are eligible for AGOA preferences depend, not on the actions of any individual firm, but rather on the aggregate purchasing decisions of all producers; in other words, a firm's fate depends on aggregate outcomes over which it has no control. Even if a particular producer sources all its fabric requirements locally, if no other producers do so, or if the aggregate amount of local sourcing does not meet the provision's requirements, their products might become ineligible for AGOA preferences under the LDBC third country fabric provision. On the other hand, even if a company sources no fabric locally, but other companies do so, and in amounts sufficient to meet the provision, their products will remain eligible. This creates not only great uncertainty for buyers and producers, but also some very strange incentives—under the circumstances just described, firms might have very little incentive to source locally, despite the existence of the commercial availability clause. The only solutions are either collusion among a sufficiently large set of suppliers, or coordination by governments, both of which are likely to be costly in their own right, and unlikely to succeed anyway, taking account of the multi-country applicability of the commercial availability provision.
- The commercial availability provision specifies a certain amount of fabric that is deemed to be available and hence that needs to be used in a given year in order for particular garments to qualify for AGOA preferences. If this condition is not met, any unused amount is carried forward and added to the amount of local fabric that will need to be used in the following year. In other words, if the original estimate of commercially available amounts is too large, the error is multiplied and increased even more in future years. This increases uncertainty and makes it virtually impossible for garment producers and buyers to know what flexibility they will have in third country fabric sourcing, even one year ahead.
- Implementation of the denim rule has revealed a flaw in the coding systems necessary to monitor adherence to the local content requirements. Among the categories for classifying garment exports under AGOA is one for "garments regardless of origin of fabric" and another for "garments made of fabric made in the US or the region from yarn also made in the US or the region." The first of these categories is the one that was routinely used by garment exporters from LDBCs, since the origin of the fabrics and yarns in such garments has been irrelevant under the third party fabric rule for LDBCs. Since the denim requirement was applied retroactively and since producers had no foreknowledge of the need to track local fabric usage, large amounts of garments went out without any indication of whether and how much local fabric they contained. Furthermore, since the" regardless of origin of fabric used" category continues to exist and since using the category for use of local fabrics involves, at least potentially, considerable additional effort in verifying such claims, producers might be continuing to use the "regardless of origin" category. This will be a continuing problem for denim and

almost certainly will arise in the event that other fabrics are declared to be "commercially available" in the region.

- The standard (non-LDBC) rule of origin for garments simply requires that AGOA shipments are made from qualifying fabrics and yarns, but does not specify or monitor the amounts of such qualifying fabrics. Implementation of the commercial availability requires a system for determining the amounts of these fabrics as well. The system that has been chosen is one that relies on "standard coefficients" of square meter equivalents (SMEs) per typical garment exported. The ITC hearings have revealed considerable discrepancies between the coefficients that are being used and those that local producers claim to apply to the garments they are actually producing and exporting.

These implementation problems and issues are exactly what might be expected when bureaucratic processes are imposed on market transactions. The discussions are reminiscent of old Soviet planning debates in which regulators tried to replace markets with quantitative performance indicators.

## 4 Rules of Origin and the Economics of Global Production Networks

The main function of rules of origin is to prevent "trade deflection" or the transhipment of goods from third countries in order to take advantage of preferences granted to other countries. However, international experience shows that rules of origin also can be used for a variety of other trade and industrial policy purposes, with consequences that often differ from and are contrary to their stated goals. It is for this reason that rules of origin have come to be viewed as one of the principal inherent weaknesses of preferential trade arrangements. (See Erasmus, Flatters and Kirk 2006 for more on this in the SADC context.)

The yarn forward rule of origin for apparel is a classic example. The rule appears not only in AGOA, but also in many other US and EU trade agreements and has also been adopted in the Trade Protocol of the Southern African Development Community (SADC).

The yarn forward rule is certainly not necessary to prevent trade deflection. The processes involved in cutting, making and trimming garments from fabric are real production operations and are easily verified though on-site inspections of factories and workshops and through examination and auditing of sales, purchase and inventory records. The same is true of knitting, weaving, printing and dying. The yarn forward rule of origin is clearly far more restrictive than necessary to prevent trade deflection.

The most frequently stated reasons for imposing such a restrictive rule of origin are to support the development of local (African in the case of AGOA) spinning and weaving industries or to protect or create business for spinning and weaving industries in the preference-granting country (the US in this case). A more subtle extension of the argument is that encouraging the development of local spinning and weaving industries in AGOA beneficiary countries will also increase the competitiveness and long-term development of their apparel industries. Apparel producers and buyers, on the other hand, argue that imposing artificial restrictions on fabric and yarn sourcing increases costs, reduces product quality and harms the competitiveness of apparel producers in AGOA beneficiary countries.

It should be noted at the outset that such performance requirements are generally forbidden trade policy instruments under WTO rules and it is a bit of an anomaly to see them used, without apparent recognition of the contradiction, in many preferential trading arrangements.

### 4.1 Structure of Global Production Networks

The economic impacts of restrictive rules of origin are understood best against the backdrop and in the context of the structure of global production networks.

Globalization as we know it today is characterized by the "fragmentation" of international production networks. This has been made possible by drastic cost reductions and efficiency improvements in logistics, communications and finance. It has enabled not only just-in-time supply chain management and flexible customization of design and production, but also the division of production across the globe, regardless of the final destination of the goods being produced. Design can take place in one set of locations, production of components and sub-components in others using raw materials from yet other sources, while assembly takes place in other locations, and marketing, inventory control and customer service are scattered elsewhere. In today's global economy, production activities can be much more efficiently parcelled out to different locations according to the relative costs and quality standards available at each.

This is very different from the days when the location of production was governed and constrained primarily by the location of basic industrial raw materials and of major markets. In this new environment flexibility in sourcing, production methods and in adapting to changing market circumstances is central to economic success. The reverse is also true—arbitrary requirements on any parts of the process, whether in marketing channels or raw material and intermediate input sourcing can seriously jeopardize international competitiveness of the industries or activities to which they apply.

This is not to deny the existence of agglomeration economies in the development of industrial clusters and networks of related supply chains. But these clusters are themselves in constant evolution, and tend to develop in response to market forces as investors in upstream and/or downstream industries adapt to changing market conditions. See some examples in the following box.

**Fragmentation of Global Production in Different Industries**

Producers in Mauritius are involved in various parts of the manufacture of wristwatches, including movements, wristbands and final watch assembly. But each of these is for a quite different category of watch, with the wristbands going into high-end watches assembled in Switzerland and the locally assembled watches using mid-range movements from east Asia. While many different components are made in Mauritius, they do not and should not be expected to "fit together." Regulations that required greater self-sufficiency along the local supply chain would kill all parts of the chain. The set of components and final products made in Mauritius has and will continue to evolve in response to changing cost conditions, and it is the ability of firms to adapt that makes the industry viable and competitive there.

The production of electrical and electronic goods in east and southeast Asia follows a similar pattern. When high quality television receivers were first produced for export from Indonesia, Japanese and Korean investors focused on assembly, with few components sourced locally. As expertise improved, the investors actively sought out local and international partners to expand the range of locally produced components, lowering costs in the process. Meanwhile, displaced components producers in countries that had originally supplied Indonesian assemblers moved to more sophisticated products, both components and final goods. And Indonesian product composition continues to evolve in a similar manner.

These examples show the importance of fragmented global production networks in enabling poor developing countries to get a foothold on the international industrial development ladder. Countries do not have to be competitive at all stages of a product value chain in order to compete. They can fit in at any stage in these value chains, and, with the support of a flexible investment and business environment can develop capabilities and continue to upgrade across and within value chains. But there is no fixed or ideal pattern to which it is

necessary to conform. In particular, it certainly is not necessary to develop fully vertically integrated production networks in any country or region.

The main role of governments in these processes is to create a low cost business environment and especially to ensure that all parts of the necessary logistical networks, particularly tax, customs and port procedures operate as smoothly as possible. To try to second-guess investors and producers by imposing arbitrary restrictions on sourcing and marketing decisions (such as local content requirements and similar regulations that were a common practice under old import substitution regimes) would almost certainly impede rather than promote international competitiveness of local production in global production networks.

### 4.2 Implications for Textiles and Apparel

The global textiles and apparel industry is similar. Textiles and especially garments have been among the most important platforms for early industrial development in many developing countries. As in electronics, the world markets for textiles and garments involve a complex set of closely interconnected international production networks. Items at almost all parts of the value chain, from yarn to garments, are made almost everywhere in the world, coordinated through market networks of buyers (largely from the world's richest markets) and contract manufacturers.

The spinning, knitting or weaving, and dying or printing of the materials that go into most garments take place at many different locations around the world. Production of intermediate inputs and the cutting and making of garments might all take place in any country. As with Mauritian wristwatches, large and sometimes subtle cost and quality differences mean that the each component is used in very different final or intermediate products that are in turn produced in many different locations. National or even regional self-sufficiency in the whole or even a significant part of the value chain for any product is exceptional rather than the norm. Furthermore, these production networks are continuously evolving, with ongoing shifts in production patterns in response to changing consumer requirements and relative production costs.

These production networks have provided enormous benefits to workers in poor developing countries and to buyers, designers and consumers in rich countries, as particular operations in the value chain, and especially the labour intensive activities of cutting, stitching and trimming have gravitated to labor abundant countries. Being able to participate in global value chains does not require abundance of particular raw materials or existence of more skill and capital intensive local weaving, printing and dying industries. Far more important than the physical proximity of related upstream or downstream industries are efficient communications and logistical networks.

To impose arbitrary regulatory requirements on global sourcing decisions would be highly constraining and detrimental to competitiveness in global markets. Flexibility in sourcing is important both for technical reasons (cost and quality) and as a means of reducing market risks arising from changing cost and supply conditions and from excessive dependence on particular suppliers. Indeed the recent increases in Asian investments in places such as Lesotho and Madagascar arose in large part as a means of dealing with supply constraints in east and southeast Asia. (And as we will argue further below this is one of the primary initial motivations for pursuing the special trade preferences that emerged under AGOA.)

The importance of flexibility in raw material sourcing, even for a "simple" and "basic" fabric such as denim was described well in the USITC hearings on denim and AGOA.

Levi Strauss & Co is one of the world's largest players in markets for denim fabric and apparel. It has considerable experience in dealing with vertically integrated supply situations and has found that this "limits our ability to be flexible in product offerings, drives costs up, and ultimately does not meet the overall requirements of the business." As a result they

have tended to avoid mandated vertical integration programs "due to the limitations they put on us as buyers." As a result, Levi Strauss experience has shown that "a quest for vertical integration can actually inhibit rather than promote new investment in the apparel sector…. For LS&Co, vertical integration is far less important when choosing our suppliers than access to a wide variety of raw material and an ability to provide top quality finishing of these fabrics." (LS&Co written testimony, USITC Public Hearing, 5 June 2007.)

In the same hearings even a local contract manufacturer with substantial denim milling capacity referred to the necessity for garment makers to be able to source globally and flexibly in order to respond to ever-changing buyer preferences and requirements. In response to rapidly changing fashion trends, "every two or three months the buyer might change the look of the denim." (CGM USITC testimony p. 35.) A garment maker that is constrained to source from particular denim suppliers might be unable to respond and soon would lose the interest of international buyers.

While denim might appear to be a rather simple and homogeneous fabric, it is far from being so. Even with the same yarn and construction specifications, fabrics from different mills will have very different look and feel; and the colour shadings will differ in different applications. The problem becomes much more complex when different types of fabric (stretch fabrics for instance) are included in the mix. Fashion designers and buyers have very well-defined specifications and require high levels of predictability in ordering new lines.

Once again, according to the USITC testimony of a regional producer of both fabric and jeans, designers (and hence their buyers) are very particular about the precise look and feel of fabric, and even the hint of controls over their fabric sourcing decisions is enough to drive them away from the region. "As a matter of fact, Gap two years ago wanted to pull out of the region. …[with the likely end of the third country fabric provision] they don't see the flexibility there. They're scared." (CGM USITC testimony pp. 62-3.)

This is not peculiar to denim products, of course. South Africa's own recent attempt to promote the local textile industry by restricting imports of certain fabrics from China—all of which were deemed to be commercially available in South Africa—provides some sobering insights into the impact of any interference in fabric sourcing decisions. Within months of implementation of these regulations some of the strongest South African garment producers are in deep trouble. According to one of these producers "three production lines are standing empty because orders have dried up due to the unavailability of certain quota-affected fabric; and … [our] intimate wear factory has shrunk to half its size." (Financial Mail, 17 August 2007.) While such garment makers would prefer for many reasons to source fabric and other inputs locally, the capacity to do so according to necessary quality, delivery and price requirements simply does not exist.

South African garment producers are constantly striving to develop local fabric sources. AGOA garment buyers and contract manufacturers have devoted similar efforts to seeking out, fostering and mentoring regional fabric suppliers. But forcing them to source locally through arbitrary rules or abrupt changes in trade regulations adds no value to this process.

In response to the new China quotas, one South African producer recently placed large orders with six local textile mills. However, the fabric had such severe quality defects that the firm was forced to cancel manufacturing orders. The company owner says it stands to lose millions of rand in turnover. "The local textile industry can't give us what we need in terms of quality, delivery and service," says the company's Managing Director. In response to the China quotas, "we're battling to get fabric and our CMT suppliers suffer because we can't give them the work flow. They're sitting without work so their efficiency goes out of the window." (Financial Mail, 17 August 2007.)

According to another producer, "the Chinese quotas have taught us CMTs two things. We're absolutely reliant on fabric delivered consistently and on time; and if you don't have a flexible

factory you are dead in the water. Most of our competitors have had to shed jobs because they haven't been able to adapt." (Financial Mail, 17 August 2007.)

These problems are occurring despite the fact that:

- Buyers are not prohibited from buying from other sources in Asia or anywhere else; they can buy from Bangladesh, India, Indonesia, Lithuania, Pakistan, Thailand—anywhere in the world as long as it is not China;
- The quota system has clearly been leaking, as fabrics supposedly sourced in places like Malawi and Myanmar have grown by leaps and bounds after imposition of the China quota; most of these products are clearly round tripping to avoid the quotas; and
- The majority of the South African apparel products affected here sell primarily in the domestic market, protected from serious import competition by tariffs of about 40 percent as well as by similar import quotas on Chinese garments.

Imagine the impact of an absolute requirement that a certain amount of fabric had to be sourced solely in the region (and nowhere else), that there was no room for leakage in application of the rule, and that the garment producers had to compete, not in a heavily protected local market, but rather in the US market against global competitors. This is the reality of measures such as the AGOA commercial availability provision that is now facing LDBCs.

As mentioned earlier, a witness at the USITC's hearings in June described the Gap's concerns two years ago about uncertainties surrounding continuation of the third country fabric rule for LDBC producers. AGOA IV should have allayed these concerns by extending this provision until 2012. However the accompanying commercial availability requirement, its application to denim, at the heart of one of the Gap's key product lines, and the USITC's first report on its implementation have nullified any beneficial impacts of this extension, and the Gap has announced that it now plans to discontinue sourcing in Lesotho where, until now, it has been the single largest AGOA garment exporter.

The withdrawal of a major buyer from the region is not good for the fabric producers that the commercial availability provision was intended to assist. It sends an unfortunate signal was well to other apparel buyers. The concerns go well beyond denim, since the commercial availability clause leaves open the possibility of its application to any fabric or yarn that a petitioner can argue to be available in the region.

It is ironic that a measure intended to assist fabric producers hurts them as well as their downstream clients in the apparel business, just as regional suppliers are coming on stream and apparel producers are beginning to patronize them. But it would be surprising if a measure that holds buyers' most critical supply chain management decisions hostage to USITC decisions and to regional fabric suppliers had any other effect.

### 4.3 Key Issues

There are some very clear lessons here.

- Imposing restrictions on fabric and other raw material sourcing activities of garment producers will not help them to become internationally competitive; on the contrary, it can only harm them.
- Since artificial local sourcing requirements weaken the competitiveness of garment producers, they will also harm the fabric producers they are intended to help, since they will jeopardize the viability of the very local demand on which such measures are predicated.
- To the extent that a local fabric industry is going to rely for its survival on sales to local garment producers, the fabric industry's success depends on the health and

competitiveness of these garment producers. This requires that the fabric industry also be able to compete on its own merits against global competition.

- Whatever the intended market of local fabric producers, therefore, their success and sustainability depends on their own global competitiveness; this cannot be improved by hobbling others.

All other things equal, of course, garment producers would prefer to have access to local fabric suppliers. This would permit greater coordination, better service and, above all else faster and less costly delivery. This is especially true in southern Africa, with its relatively isolated location in relation to Asian fabric suppliers. It is for this reason that garment makers have a natural inclination and have always been willing to make efforts to develop local supply sources. As mentioned earlier, AGOA buyers and contract manufacturers are devoting considerable effort to achieving this.

What does this all mean for requirements that producers use certain amounts of locally produced fabrics that are deemed to be “commercially available?”

- First, if the fabric truly is commercially available in the sense that it meets all the buyer’s requirements, the producer will be happy to buy it without any external prodding.
- Second, if the fabric does not meet all the buyer’s requirements, and/or if substitute products are better at doing so, the imposition of any requirement that forced garment makers to make an inferior choice would, of necessity, jeopardize the commercial success of the garment makers.
- Together, this means that the only useful measure of “commercial availability” is the market test—the amount of any fabric that is commercially available to any group of buyers at any point in time is the amount that these producers are actually purchasing. The closer any technical, political or bureaucratic process comes to approximating this measure of commercial availability, the less harmful will the requirement be.

Of course, if the process manages to get the amount right, or at least not to overestimate the deemed amount of commercially available fabric, then the local purchase requirement is unnecessary. But if the process overestimates the amounts that are commercially available, the consequences for buyers and producers of garments can be large.

While the market test described here might sound relatively simple, there is a real problem, both conceptually and practically in making even rough and meaningful estimates of the amounts that are actually commercially available for use in making denim products to be sold under AGOA preferences, and for determining, *ex post*, the amounts that actually have been used. Some of these issues were raised and discussed in the USITC hearings, with no apparent resolution. For the moment we concentrate on the underlying conceptual and economic issues, to demonstrate that the problems are not likely to be resolved through some simple “practical” or technical analysis.

- How much is actually produced in the region (on a forward-looking basis since the quantities are determined in advance), taking account of all kinds of possible quality and specification differences? At the moment the aggregate amount of production for the commercial availability provision is specified at the 6-digit HS level. This actually includes many different products from a commercial and technical perspective. Even moving to the 10-digit HS level would leave room for a wide variety of fabric types. More importantly, the denim producing situation in southern Africa is in a state of flux, with some mills closing, new ones opening, and others changing hands. This makes it very difficult to make predictions of even rough aggregate amounts of supply capacity and of actual production into even the immediate future.

- How much of this is or will be available for AGOA-destined products, bearing in mind that regional denim products are also sold locally and regionally as well as in other developed country markets, and especially the EU, which has similar yarn-forward rule of origin? The mix of regional and third country fabric used for all markets can change substantially in response to fashion trends and cost developments, which means that the residual that might be "commercially available" for AGOA products could also be highly variable.
- Another critical quantity for non-vertically-integrated garment producers is the amount of fabric that is not used internally by integrated producers. Amounts that integrated producers use for their own purposes are clearly not "commercially available" to others. Once again, even for relatively fixed and predictable amounts of total production, this can change dramatically in response to shifts in fashion and market conditions, and can be used as a strategic variable by the fabric producers in order to gain commercial and competitive advantages in both the fabric and garment markets.
- How can the amount of "commercially available" fabric that is actually used by determined after the fact? This requires first a system for determining which denim product exports included designated local fabrics and which did not. And second, it requires an agreed system for determining the physical fabric amounts used. Both of these have already turned out to be technically difficult and administratively complex tasks. The method used for classifying garments according to sources of fabric used, especially for LDBCs, has turned out to be inadequate to the task. And the "standard coefficients" used to convert garment volumes into "square meter equivalent" fabric amounts have been the source of considerable dispute and controversy.

A further problem arises from the fact that, even if the amount of commercially available fabric is "correctly" determined, imposing the rule might still cause considerable harm by reducing competition in the local fabric market. The exact nature and extent of this harm depends on how the requirement is actually implemented. But the main point is that the imposition of a local sourcing rule might give considerable monopolistic power to fabric producers, and especially to those who have their own or related downstream apparel manufacturing businesses.

Under a regime of significant and/or uncertain local sourcing requirements integrated manufacturers by being able to choose whether and how much fabric to keep for their own use and how much to release to the local market gain market power over non-integrated CMT producers, and the exercise of this power might be unrelated to relative costs or other competitive characteristics of different producers. A strict local sourcing rule could provide integrated producers with life and death control over garment makers that might be dependent on them. In the absence of such rules, garment makers can source fabric wherever they wish and would be more than happy, of course, to buy locally as long as quality, delivery and competitive price requirements could be met. These are the essential ingredients of a competitive market environment.

### 4.4 Summary

Restrictive rules of origin and similar kinds of local content requirements are antithetical to the way in which global supply networks operate. They distort commercial investment and production decisions, and are especially harmful to lesser-developed countries, the very ones that have the most to gain from trade preferences that give them an opportunity to participate in niches of global supply chains in which they truly have the potential to compete.

Greater integration of local and regional production networks is potentially helpful and is a natural part of the evolution of production as development proceeds. However, trying to force the development of these supply chains by coercing garment makers to buy locally and

regionally is almost certainly harmful to both upstream and downstream industries. This is illustrated already by the Gap's recent decision to withdraw from Lesotho. Just as garment producers need to compete on world markets in order to be sustainable, so must yarn and fabric producers be able to compete if they are to survive and if they are expected to assist the development of local garment industries. Supplying relatively small local markets to take advantage of distorted incentives is not a particularly sensible way for local and regional yarn and fabric producers to become internationally competitive.

Even if textile and garment sectors co-exist in a country or region, a much more viable and sustainable pattern is one in which all depend much more on sales and purchases in global networks rather than among themselves.

Forcing local garment producers to source fabric and yarn locally or regionally is not a sensible way to try to help them.

## 5 Conclusions and Recommendations

Despite uncertainties about their duration and some of their key eligibility provisions, AGOA preferences for garments have been of great mutual benefit to US consumers, buyers and their contract manufacturers, and to workers and garment producers in some of southern Africa's poorest countries. A principal reason for this is the third country fabric clause that exempts less developed beneficiary countries (LDBCs) from the yarn forward rule of origin, a rule that forces local or regional self-sufficiency and thus fails to recognize a key feature of normal global production relations in this and almost all other manufacturing sectors, and that is particularly harmful to poorer and less developed economies struggling to gain a foothold in the world economy.

The commercial availability provision that was inserted into the most recent extension of AGOA threatens to undo many of its gains. The costs are likely to be aggravated by some key missteps in its implementation; but there are fundamental contradictions between the goals of provision and its likely impacts, regardless of how well it is implemented.

The new provision requires the USITC to consider and rule on petitions claiming that certain locally produced yarns or fabrics are "commercially available" to apparel producers in LDBCs. If it verifies such availability, it is required to determine the amount that is so available, and LDBC garment producers are then required to use at least these amounts in order to qualify for the third country fabric rule designed to assist LDBCs and their customers.

There are two fundamental problems with this provision.

- If a designated fabric truly is available in the quantities, product characteristics, according to all delivery and service requirements, and at a competitive cost—i.e. if it really is commercially available—buyers will not need any inducement or incentive to purchase it. All other things equal, buyers would always prefer to purchase from local suppliers. The evidence from the southern Africa region and from the rest of that world is that buyers and producers will go to considerable effort on their own to explore and foster local supply networks.
- However, if local supplies are not available, or are not of the right quality (a truly complex and multi-faceted issue in the case of apparel fabric), or if delivery schedules cannot be met, or prices are too high, then forcing local producers to buy locally will diminish if not destroy their ability to compete for production contracts.

In other words declaring a fabric to be commercially available and requiring its local use in certain quantities is at best redundant, in which case it is not necessary; or the declaration will be wrong, in which case it will be harmful.

It is in the nature of the global garment industry that a requirement to use "commercially available" local fabric, or even the threat of such a requirement, is unlikely to be simply redundant and hence benign. Designers and buyers require maximum flexibility in sourcing of fabrics; they need to adapt continuously to changing style, market and cost conditions. If producers are subject to actual or even possible restrictions on their sourcing decisions, they will rapidly become less preferred suppliers and will find it difficult to win out in global competition for orders and for long-term relationships with key buyers. Such long-term relationships are a key factor in development of a successful, sustainable and upwardly mobile garment industry.

Even if local fabric producers could meet local garment makers' needs at one point in time, there is no guarantee that they would be able to do so next month or next year. It would be dangerous for local fabric producers to tie their future primarily to local garment makers; and requiring garment makers to source fabric locally will reduce their global competitiveness, and possibly fatally so.

Local purchasing requirements are not in the long-term interest of either garment makers or of fabric and yarn producers. The recent decision of the Gap, one the largest buyers in Lesotho, to withdraw from that market because of uncertainties created by the commercial availability provision is an ominous sign for regional apparel and textile industries.

Duty-free access to the US market under AGOA, together with exemption from the burdensome and unrealistic yarn-forward rule of origin for LDBCs, has been very successful in providing opportunities for garment makers in some of southern Africa's poorest countries to gain access to the US market.

The local purchasing requirements arising from the new commercial availability clause could quickly undo many of these benefits. This is even more so if, as in the case of denim:

- the clause is imposed retroactively,
- amounts of commercially available fabric are not very carefully and conservatively determined, bearing in mind the need for flexibility on the part of buyers, the existence of alternative markets for locally produced fabrics and the potential costs of inadvertently granting monopolistic powers to local suppliers as a result of local content requirements,
- errors in determining commercially available amounts are amplified by carrying them forward into future year requirements,
- forms and procedures for monitoring shipments according to whether they contain locally sourced fabric are not up to the task, and
- methods for determining actual local fabric content are not realistic and agreed by all parties.

The first best solution, and the one that accords most closely to the goals of AGOA is to dispense with the commercial availability provision as inherently harmful to local and regional garment makers and inherently difficult to administer in a non-destructive manner.

The second best and far inferior, but possibly necessary in the short run, solution is to correct the errors in administration and implementation that have been highlighted here. Commercial availability decisions certainly should not be announced retroactively. Determinations of commercial availability should be made very conservatively, bearing in mind the crucial importance of flexibility in raw material sourcing for producers to remain competitive in meeting buyer and market requirements. Inability to meet one year's requirements should be reviewed to determine whether the initial requirements were in fact realistic rather than simply being added on to the following year's requirements. And

methods must be found to ensure that use of local fabric is being properly measured and recognized.

Does the main recommendation ignore a major goal of the commercial availability provision—to help the development not only of local garment industries, but also yarn and fabric producers? No, as this analysis shows the commercial availability provision is not a suitable instrument for this purpose. What are the alternatives?

Some of the blame for failure of regional textile industries to integrate into global production networks rests with domestic policies and domestic industries that have been inclined to focus on protected local and regional markets. However, longstanding distortions and especially high levels of protection in major developed country markets also bear a large share of responsibility, as in the case of garments.

The first best solution here, at least from the perspective of a US government wishing to assist development of the local and regional industry is the same as for garments—to grant African textile producers duty-free preferential access under AGOA, under a single stage transformation rule of origin as has been granted to LDBCs for garments. This would induce local yarn and fabric producers to shift their focus from protected domestic and regional markets to the global market where success depends of productivity, quality, innovation and cost rather than inefficiency derived from focus on small markets and directing entrepreneurial effort at maintaining protection.

While this is certainly the first best in terms of maximizing the opportunities for developing a competitive textile industry, some players that have become accustomed to a different game, might prefer to get US assistance in forcing successful local garment makers to buy from them. But this is not a viable or sustainable long-term strategy, for either the garment or the textile industry.

In response to AGOA opportunities, international garment buyers have given and continue to provide assistance to local yarn and fabric producers in a quest to develop local and even global supply networks based in the region. In addition to granting preferential access to the US market as recommended here, it might be wise to consult with buyers, producers and policy makers that have been involved to date in order to identify key constraints to competitiveness of regional textile industries and to develop other means of assistance and policy reform to deal with these constraints.

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