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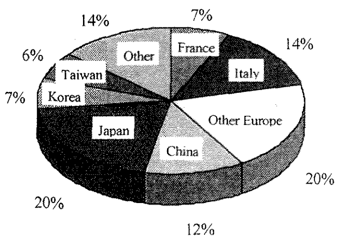
China's Wool Market: Strategic Trade and Investment Issues*

The emergence of China as Australia's single most important wool export destination

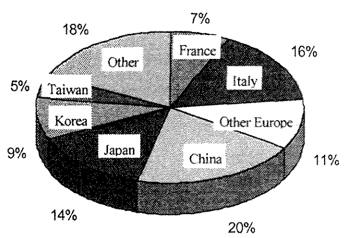
China has recently become the largest importer of Australian wool. In the 1994-5 selling year, China's share of Australia's total value of wool exports rose to 20 per cent, compared with a 16 per cent share for Italy and a 14 per cent share for Japan (Figure 1). Wool now ranks as Australia's top export commodity to China, worth nearly A$700 million in 1994-95. The emergence of China as Australia's single most important customer has led to much attention being paid to the Sino-Australian wool trade not only because of the size of trade but also because of its volatility (a volatility illustrated by the current downturn in imports from Australia since the end of the last selling year).

Figure 1 Australian wool exports by destination (% in value terms)

1991-92



1994-95



The growth of the Chinese wool textile industry

During 1980-94, the real value of output of the Chinese wool textile industry recorded an average annual growth rate of over 10 per cent. The main contributing factor was the rapid increase in domestic demand for wool textile products as a result of strong increases in household incomes, but more recently, with increasing foreign direct investment, exports have become an additional driving force. Now nearly a quarter of all wool processed in China (domestic production plus imports) is exported compared with only 10 per cent in 1987.

The rapid growth of the Chinese wool textile sector has caused increasing demand for wool. China's apparent consumption of wool (domestic production plus imports minus exports) grew from 85,800 tonnes ('clean equivalent') in 1980 to 331,500 tonnes in 1994. Given the limitation of domestic supply, most of this growth had to be met by imports. During 1980-94, wool imports into China increased at an annual average growth rate of 17.8 per cent.

Constraints on further growth

There are two major constraints on the further growth of the Chinese wool textile industry. The first is the restriction created by the Multifibre Arrangement (MFA), the international agreement which has governed trade in textiles and clothing since 1974. MFA will undergo major reforms in the next ten years, but China may be discriminated against in terms of access to reform benefits, as it is not yet a WTO (World Trade Organisation) member. For that reason, China's early accession to the WTO is important for the growth prospects for China's exports of finished wool products.

The second constraint is China's restrictive domestic trade policy with respect to wool imports. Currently, China imposes both tariffs and quotas on wool imports. Given the limited potential for the domestic supply to grow due to production, organisational and financial constraints, an open system for wool imports is vital to the development of an internationally competitive wool textile industry in China.

The main issue in Sino-Australian bilateral trade negotiations

The choice of trade policy regime for wool also has important implications for raw material supplying countries. Australia, being a major supplier of wool to China, has a strong interest in seeking an open system for wool imports into China. Negotiations between the two countries over the market access issue have been going on for some time, but have proved to be difficult. The Chinese government has proposed a tariff-quota regime for wool imports on the ground that domestic wool producers need to be protected for political reasons. This scheme raises domestic prices, decreases demand and also imposes an automatic quantitative upper limit to imports from the world market.

The main issue that has arisen in the recent bilateral negotiations between China and Australia is how to set the quota base. Despite the rapid increase in wool imports in the past two years, China is still seeking a quota base for wool imports based either on the three year average of imports for 1991-93 or five year average between 1990-94. These periods include some years of relatively low imports which means that a substantial portion of the current import demand would be unmet. If this eventuates, the proposed tariff-quota arrangement for wool imports would be more restrictive than the current arrangement and the Australian wool industry would be left worse-off than before Sino-Australian negotiations began.

Strategic options for Australia

In order to encourage the Chinese to open their market for wool imports, incentives need to be provided. Chinese officials have argued on many occasions that if other countries want to have the Chinese market opened, they should open their market too. While it is difficult to achieve this among all other countries given the structure of world textile and clothing trade, Australia should be in a position to commit itself to an accelerated import liberalisation for textile and clothing products, in return for an open raw wool import market in China.

The Australian textile and clothing industries have been the most highly protected part of the manufacturing sector. Although Australia is not a member of the MFA, its tariffs for textile and clothing imports are the highest among the developed countries. Australia has committed to a program of reduction in the effective rate of assistance for textiles from the existing 41 per cent to 17 per cent in 2000-01 and for clothing from 66 per cent to 33 per cent over the same period. Even with these reductions, textiles and clothing will still be the most heavily protected sector in Australia as the effective rate of assistance for all manufacturing will be only 5 per cent by 2001. Clearly there is scope for the Australian textile and clothing industries to accelerate trade liberalisation.

The process of liberalisation made in both processed products and the associated raw materials may be pursued not only in negotiations concerning China's entry into the WTO but also by using mechanisms such as the APEC where a package to support Chinese accession to WTO can be developed and where member economies are being asked to commit themselves to programs of liberalisation.

Aid can be also used as an incentive for opening up the Chinese wool import market. A concern of Chinese policy makers about liberalisation is that cuts in protection would reduce greatly the real incomes of growers in pastoral areas of China who have fewer substitution possibilities. While the situation may be exaggerated in view of the limited substitutability between domestic and imported wool, aid programs to the wool growers in pastoral areas can facilitate structural adjustment in these areas caused by trade liberalisation and consequently will ease political discontent arising therefrom. Relevant aid projects include those which develop the infrastructure of the region, facilitate changes in the structure of production and contribute to human resource development.

The acceleration of import liberalisation for the textile and clothing market will pose a big challenge to major political parties in Australia which need to make a decision on whether to lend stronger support to a highly competitive raw wool industry by seeking an open market in China or continue to support a domestic industry that has already lost its comparative advantage.

The acceleration of import liberalisation would require faster adjustments of Australia's textile and clothing industries. Relevant responses by Australia to a more rapid trade liberalisation could include:

- accelerate the rationalisation of production by shifting economic activities into more capital-intensive product lines, such as production of wool tops;
- shift to quick-response, hot-fashion and high-value product markets, where skilled labour in designing and marketing high quality products is required;
- relocate textile production activities offshore by means of foreign direct investment.

In sum, there is a significant prospect of forming a coalition between Australia, the largest world wool producer, and China, potentially the largest world wool processor, provided that an active and innovative approach is taken by Australia in relation to the Chinese market. If the initiative of simultaneous liberalisation within China's raw wool sector and Australian textile and clothing sector can be realised, this will provide an excellent example for APEC countries on the handling of the so-called 'sensitive' sectors.

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