Submission to the House of Representative Standing Committee on Industry, Science and Resources Inquiring Into

Increasing Value-Adding to Australia's Raw Materials

Cotton Australia, July 1999

Introduction

Cotton Australia, as the peak representative of the Australian cotton growing community is committed to furthering investment opportunities that will expand and refine domestic and overseas markets for the industry.

In the local context, we believe that significant gains can be made in manufacturing and marketing textiles derived from Australian raw cotton, although the limiting factors discussed in this paper must first be addressed.

These limitations tend to restrain value adding in the high-volume, low-margin sector of the market which accounts for 90 per cent of sales volume and is subject to the most competitive pressure. Conversely, the specialist fashion market, which accounts for only 10 per cent of domestic volume and is traditionally characterised by higher mark-up, lends itself more readily to value adding improvements. Several Australian growers are already winning ground in this niche area, and their successes suggest that there is room for more widespread expansion.

These issues and opportunities will be discussed further on.

Marketplace description

The opportunities for on-shore value adding of Australian cotton are to some extent limited by the size of the domestic market, and to a larger extent by offshore factors resulting from our competitors' highly developed manufacturing industry and the government support it enjoys.

While the opportunity does exist for Australian consumers to be serviced from a broader onshore value-adding base, competitive factors suggest that we are unlikely to ever satisfy our entire consumptive requirement from domestic manufacturing sources.

Currently, Australian raw cotton production exceeds consumptive use by up to 15-fold, with up to 3 million bales grown annually, and a manufacturing demand of only 180,000 to 200,000 bales. However, in evaluating this disparity, it is important to note that Australia's entire manufactured cotton consumption is only in the order of between 400,000 and 490,000 bales, based on an individual consumption level of 5–6 kg/person (1 bale = 227 kilograms = 500lbs) and a population of 18.5 million. When cotton input used in blends (with polyester, wool, viscose etc) is allowed for, our potential domestic consumption rises to about 7kg/person, or about 600,000 bales. Imported, finished produce therefore accounts for about 60 per cent of consumption.

Put another way, the difference between raw cotton production and gross domestic consumption means our growing community must export more than 90 per cent of its raw product. Of the world's 70 cotton-producing nations, only Chad and Benin, which have no manufacturing base whatsoever, add less value to their product.

Our consumption compares with a United States level of 15kg/person/year, which based on a population of 270 million amounts to about 18 million bales. Significantly,

this figure is approximately equal to total US annual raw cotton production, although this year American mills are geared to process only 11 million bales into yarn, with the remainder going to overseas manufacturers.

From these figures it is evident that any increase in domestic manufacturing would have to target exports, and some discussion of how this could best be effected will occur later in this paper, along with an evaluation of impediments to a "level playing field" and how and whether these can be overcome.

The manufacturing characteristics of our competitors

Australia's ability to consume only a fraction of its raw cotton production is largely offset by its ability to supply offshore manufacturing clients with reliable supplies of high-quality lint. Generally, our reputation for excellence has seen our product earn a premium at the higher end of the fashion market. However, there are occasions when quality can be compromised by climatic factors, as was the case in the past season when both quality and prices were depressed. Our traditional raw cotton export destinations have been Indonesia, South Korea, Japan, and Western European countries notably, Germany and Italy.

In evaluating future directions for value adding and determining the structures that best suit our needs, an appraisal of our competitors' structuring would be timely. As will be seen, these present the single-most important barrier to broadening our own.

As has been seen, world cotton growing and manufacturing has traditionally been dominated by the United States. The growth of the US cotton industry was symbiotic with the English industrial revolution, but it is worth noting that the foundations of American domination in manufacturing were laid in the latter quarter of the 19th Century. This has been followed by frequent and extensive technological improvements and investment programs, particularly in the past 20 years that have ensured maintenance of American supremacy.

The US industry has also benefited from a cultural mainframe that is far-removed from the Australian experience. This is characterised chiefly by:

- Full integration of growing, manufacturing and marketing (primary, secondary and tertiary) of cotton.
- An interventionist Federal Government that responds rapidly to any external competitive advantages.
- Robust quota and tariff regulations on imported produce, that endure despite WTO Uruguay Round requirements.

Domestic support within the US comprises two programs:

- The US Department of Agriculture's Export Credit Guarantee Program, administered by the Commodity Credit Corporation, which guarantees payments due from banks in 34 foreign countries and regions that have "high market development potential". Indonesia, our chief export destination is among them. In effect, the program conferred an inordinate advantage on US exports to Indonesia following last year's Indonesian crash, forcing Australian growers to develop an exports insurance program to maintain a competitive position.

- The Step II program, a government subsidy paid to exporters and domestic consumers of US-grown cotton. The value of Step II is “the difference between the least expensive US quote and the A Index quote plus 125 points/lb”. In 1997/98, the Step II subsidy was worth 4.90 cents/lb, or $24.50 per bale.

It is important to note that the majority of cotton producing countries apply protectionist measures in some form or other, although this may not always take the form of direct subsidy to the manufactured product.

Pakistan, for instance, which produces more than 6 million bales, has in the past supported its raw cotton market though agricultural subsidy, bringing a corresponding advantage to the secondary and tertiary sectors. Until the designated demand for domestic manufacture is satisfied, exports are not allowed. Elsewhere, other manufacturing sectors are supported through tax holidays, restrictions on imported produce and export incentives.

By contrast, the marginal benefits enjoyed by Australian exporters under the Import Credit Scheme are to be withdrawn by July 2000, and replaced with the far less attractive Strategic Investment Program. The former allows exporters to import produce to an equal value exempt of tariffs, and credits can be traded, while the latter allows a 20 per cent retrospective payment on investment, subject to proof of local production.

The world’s second most significant cotton producer is the People’s Republic of China, which rivals American raw production at about 20 million bales/year. Because the Chinese manufacturing base has suffered from a technological lag, and has not been positioned to process this volume, a stockpile (of unknown size) has developed, and in the past year some of this surplus has been released onto world markets. China also imports cotton, largely to manufacture premium produce for re-export. Despite these limitations, the Chinese impact on the global market, particularly on prices, is significant.

Consideration must also be made of the Indonesian manufacturing base because of its significance to the Australian industry. While Indonesia does not grow cotton, it is the export destination for about a third of the Australian crop, thus occupying a unique position for the local industry. Its total The strength of the Indonesian manufacturing base has arisen because of substantial investment from overseas, notably from China, Hong Kong and other regional sources.

To a large extent, these investors were themselves quarantined from last year’s collapse of the Indonesian economy, and in many instances were able to gain considerable advantage from the meltdown. This arose because, as offshore import-exporters, this group was trading in non-Indonesian exchange, principally the US dollar, and was buying raw cotton and selling the finished product in these currencies.

Furthermore, on devaluation of the Rupee, manufacturing costs (labour) were substantially reduced, resulting in an in increase on gross margins. These factors essentially allowed Indonesia to remain a viable manufacturing base for Australian

cotton, and exports to that country have remained stable in a climate of extreme political and economic uncertainty.

However, from a practical and cost viewpoint, the degree of investment in the Indonesian industry was not entirely prudent. This is so because of the extremely high start-up costs of spinning and weaving, which are in the order of $AUD1000 per bale of usage.

To put this figure in perspective, it is worth noting that if Australia were to process an entire 3 million bale crop, an investment of $3 billion would be required. Note that this level of investment would generate more than 8000 jobs. In addition, a return of assets would not be expected within 10 years. Consequently, investment certainty is prerequisite, and with it a climate of political and economic stability. In this regard, Australia meets the necessary criteria, and the offshore competitive advantage is then reduced to labour costs.

Since modern spinning and weaving operations are highly automated, labour costs are minimal, and this in itself cannot be seen as an impediment to capital investment in new Australian mills. Furthermore, in garment production the most intensive human inputs are in stitching and finishing, and it is in this latter area that the greatest advantage can be achieved by locating activities offshore. For instance, Australian sewers are paid in the order of $20/hour, compared with $2/hour in China.

By comparison with spinning and weaving, capital costs in finishing, principally in sewing-machines, are also low, bringing another benefit to the Australian manufacturer.

In this regard, many existing Australian-based manufacturers now spin, weave, dye and cut garments, relying on high local capital investment and low labour costs, and export their cut produce for finishing offshore prior to its return for sale in Australia.

While this system allows domestic manufacturers to produce competitively in the home market, it should be remembered that maximum domestic consumption amounts only to about a third of Australian raw cotton production, and any capacity in excess of this would have to be geared to exports. However, because the global playing field is far from level, domestic spinners and weavers caution that under existing conditions an enhanced manufactured export market would generate only marginal returns. In the world market, a real differential of 50 cents/kg translates to a competitive advantage of $1.50/kg.

From this it can be inferred that for an enlarged domestic value-adding base to succeed, our competitors must remove trade barriers and support structures in line with our own program, or Government support for domestic manufacturing must be improved.

The bulk versus the specialised markets

Cotton textile production falls principally into two key areas: the bulk, or industrial sector, and the specialist, or fashion sector. The former comprises with high-volume,

low-margin product such as toweling and sheeting, casual clothing and underwear and accounts for about 90 per cent of volume; the latter is at the fashion end of the market, and is low-turnover, high-margin, and accounts for 10 per cent of volume.

There is a logical belief that the best opportunity for onshore value adding exists in the specialist market because the returns are high, and the investment requirements are correspondingly low.

Australian cotton is generally regarded as among the world's best in terms of consistency and quality. However, the manufacturing advantages flowing from this are not easily apparent in the raw-cotton trading market; they become more evident in the finished product, and in this Australian produce does have a competitive edge that arguably could be further developed.

This is so because there is room for the sector to capture a more significant share of the market both at home and overseas. Australian produce is already prized by overseas brands such as Marks and Spencer. If there the market were to be developed along the lines illustrated above (spinning, weaving, dying and cutting at home; finishing offshore), considerable benefit could be derived for our export revenue.

Already some cotton growers are engaging in this model of their own volition and cornering important niche markets. Brands include Tandou, Southern Star, and the Goondiwindi Cotton Company. This reflects the growers' recognition and appreciation of market opportunities and their reputation for being self-starters who are not reliant on Government intervention.

However, it requires little imagination to realise that if this model were embraced within a comprehensive Government package, the market could be significantly developed, resulting in a raised profile for Australian excellence, while generating new jobs.

Conclusion

It is plain that while WTO tariff reduction targets are not being met by our competitors, any opportunity for onshore value-adding will be compromised. Washington's recent decision to bar Australian lamb from its markets indicates that despite an attested intent to the contrary, governments are for domestic political reasons reluctant to open markets to competitors.

Therefore, in the absence of an Australian Government commitment to supporting domestic manufacturers, any productive increase would result only in marginal returns.

Our existing manufacturers have demonstrated that competition is possible by correctly allocating the productive processes to their best cost base (ie. high capitalisation and low labour costs in spinning and weaving onshore; low capitalisation and low labour costs in offshore finishing).

An expansion of our manufacturing base could be geared to bringing new development to regional cotton-growing centres, thus bolstering economies that

already enjoy considerable stability flowing from the growing industry. Such a manufacturing base would offer new opportunities for the regions, while giving manufacturers access to the infrastructural advantages that these centres enjoy (eg. power and transport).

However, it is clear that returns from the high-volume sector of the market would be of a lower order than those of the low-volume niche markets discussed above. Given the nature of the Australian domestic market, and the inequities of the global market, it is apparent that the greatest short-term gains are to be made in the latter sector.

With this in mind, it is recommended that government:

- Considers means of supporting the industry to allow us to retain our competitive edge against producers who show little commitment to reaching Uruguay Round targets.
- Considers developing a program that would allow producers to take full advantage of our ability to develop and expand into the fashion niche market.