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**Research Report**

## Assessing the Impact of Chinese Investment on Southeast Africa's Cotton: Moving up the Value Chain?

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# POLICY BRIEF

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## ASSESSING THE IMPACT OF CHINESE INVESTMENT ON SOUTHEAST AFRICA'S COTTON: MOVING UP THE VALUE CHAIN?

BY TANG XIAOYANG

An influx of Chinese and other Asian investment in Southeast Africa over the last decade has had a significant impact on the cotton-textile value chain in the region. Increased investment has changed the structure of the region's cotton market, increased competition in local markets, introduced new challenges for cotton producers, and affected relationships with local communities.

Meanwhile, although the textile sector remains relatively underdeveloped, it has the potential to add value to local cotton sectors if investment continues to increase. Based on extensive fieldwork, this research analyzes the impact Asian investment has had on Southeast Africa's cotton value chain, and identifies strategies for encouraging greater investment from Asian textile manufacturers.

The cotton-textile-garment value chain is integral to the economies of many developing countries, including Botswana, Lesotho, Malawi, Mozambique, South Africa, Swaziland, Tanzania, Zambia, and Zimbabwe. Cotton production provides income for smallholder farmers; textile (fabric) and clothing manufacturers are large employers and can contribute to a country's economic growth.

**Over the last decade, Chinese and other Asian investment has significantly increased in Southeast Africa, impacting the region's cotton value chain in four primary ways:**

- (1) International competition:** Southeast African countries used to have booming garment export sectors, stimulated in part by preferential trade arrangements with Europe and the United States. However, after the Multi-Fiber Arrangement (MFA) expired in 2005, Asian companies captured a large portion of the market in the United States and Europe because of their lower production and manufacturing costs.<sup>1</sup>
- (2) Imports:** Asian textile products have also flooded Africa's domestic market, threatening the existence of the remaining textile industries in the region. China is the largest source of textile and apparel imports to the region; India and Pakistan are second and third.
- (3) Raw material sourcing:** An increasing number of Asian buyers are entering Southeast Africa to directly engage in the production, purchase, and processing of cotton.

- (4) Investment:** Investment from Asian countries is shaping the structure and development of the entire cotton-textile-apparel value chain in Southeast Africa. Most of the textile manufacturers in the region are of Asian origin.

This research aims to evaluate the impact of Asian investment on Southeast Africa's cotton-textile-garment value chain, with a particular focus on the cotton and textile sectors.

## COTTON

### Market

**Asian investors entered the Southeast African cotton market in the mid-2000s, driven primarily by increasing demand from the Asian textile industries in general, and from China—the world's largest cotton consumer—in particular.** The Chinese-owned China-Africa Cotton (CAC) began to acquire cotton in the Chipata region of Zambia, and quickly expanded to Zimbabwe, Malawi, and Mozambique (see case study on next page). Several other Chinese companies have also recently arrived in Tanzania, Zambia, and Zimbabwe.

In addition, other Asian companies are also active in the region. From India, the Parrogate Group started in Zimbabwe and subsequently expanded to Zambia and Malawi. Seeing the Group's success, a number of other Indian ginners came to the region in 2011 and 2012. Olam, a Singapore-based global supply chain manager and processor of agricultural products, has an extensive presence in Tanzania, Zambia, and Zimbabwe.

#### The influx of Asian investment has led to:

- (1) INCREASING COMPETITION IN LOCAL MARKETS.** Previously, for instance, cotton buyers in Zambia did not pay farmers in cash; instead, they wrote the farmers receipts and paid the money the following year. In response to greater competition, ginners have begun to offer farmers more attractive prices and manners of payment, and have also started providing them with inputs and technical assistance.
- (2) CHANGES IN THE STRUCTURE OF MARKET COMPETITION.** As Asian investment in Southeast African cotton markets has increased, some traditional gineries have been forced out of the market. For example, CAC bought a ginnery from the U.S. firm Cargill in Malawi. Ginners' profitability is closely related to scale economies; only when a company acquires enough cotton can it recover its pre-investment in seeds, inputs, and technical assistance. Small ginners may encounter greater difficulties in the future.
- (3) SIDE BUYING.** "Side buying" is when new companies buy cotton from farmers who have already contracted with other companies. Under contract farming, ginners provide seeds, inputs, and technical assistance to farmers and deduct the costs when they buy the farmer's cotton at harvest. New companies without those sunk costs sometimes lure farmers away from established contracts by offering higher buying prices. In Zambia, ginners have formed an association to regulate side buying, to enforce penalties on side buyers, and to maintain a healthy market order. Nine out of eleven ginning companies in Zambia—including the major Chinese players—are members of the

## RESEARCH METHODS

The researcher conducted fieldwork in Malawi in January 2013, and in Botswana, South Africa, Tanzania, and Zambia in July and August 2013. Semi-structured interviews were carried out with over 150 officials, entrepreneurs, specialists, workers, farmers, and scholars.

association. Similar organizations have also been organized in Malawi and Zimbabwe.

Although the cooperative associations cannot completely prevent side buying, they have kept the markets functioning and progressing. Thus far, the companies that have been found to violate side buying rules are usually small newcomers from Asia.

**(4) NEW CHALLENGES BECAUSE OF THE STRUCTURE OF THE CHINESE MARKET.** The Chinese government has implemented an import quota for cotton in order to encourage domestic cotton plantations and to protect Chinese farmers. Even state-owned Chinese ginners operating in Africa, such as China-Africa Cotton, are subject to the quota regulations, making it difficult for them to bring their cotton into the Chinese market. One method CAC has employed is processing imported cotton lint into yarn in a mill set up in the Qingdao Free Trade Zone since yarn imports are not restricted by the quota. However, the mill in Qingdao is only able to process 30 percent of CAC's imports. In order to increase its cotton processing capacity, CAC decided to invest in a spinning mill in Mozambique. This presents a promising opportunity to develop spinning capacity in Southeast Africa.

At the same time, this opportunity may be fleeting because the cotton quota is widely criticized in China for distorting the market. The Chinese government may abandon the practice of maintaining high cotton purchase prices, and instead adopt a subsidy for farmers, liberalizing the cotton market. **If the cotton price in China is allowed to equalize with the international market price, will spinning mills in Africa be able to compete with those in China? Will Chinese and Asian companies still be willing to invest in cotton processing mills in Africa?**

## CASE STUDY: CHINA-AFRICA COTTON

*China-Africa Cotton (CAC) was established in 2008, but its history can be traced back to 2003. Mr. Ju Wenbin, from Qingdao city, was the manager of Mulungushi Textile—a former Chinese aid project—in Zambia. Sensing opportunity in the burgeoning cotton market, he partnered with several investors to set up a cotton buying and ginning company in Chipata, Zambia. This firm grew modestly until 2010, when they received capital from the China Africa Development Fund (CADF), an equity investment fund of the China Development Bank. With this influx of capital, the amount of cotton purchased jumped from an average of 3,000 tons per year to over 10,000 tons in 2010. The company has since become a major player in Malawi, Mozambique, and Zambia, and in 2013 it also entered Zimbabwe and Mali.*

*CAC is now a joint venture between CADF, Qingdao Ruichang Cotton, and Qingdao Huifu Textile. CADF owns 65 percent of the total share, but does not participate in CAC's daily operations. The other two are private companies, of which Mr. Ju is a shareholder.*

*By 2013, CAC had invested over US\$60 million. It has set up six ginneries and two cotton seed oil extraction plants in five countries. On average it purchases over 100,000 tons of seed cotton, employs 3,300 local workers, and works with over 200,000 local contract farmers.*

*In the fierce scramble for cotton, the availability of capital plays a decisive role in winning contracts with farmers. CADF's investment not only brought in large amounts of capital, but it also helped the company obtain short-term loans from the China Development Bank, giving it a significant advantage. CAC is required to export all of its cotton to China as a condition of lending by the China Development Bank, yet it is constrained in doing so by the strict Chinese cotton import quota.*

*Due to its success in Zambia, the Malawian government invited CAC to invest in Malawi. It hoped that in addition to facilitating cotton exports, CAC would also provide training for local technicians, and would increase the value added of locally grown cotton by setting up seed oil extraction plants and textile mills. When the Chinese government agreed to build an agro-technology demonstration center in Malawi in 2011, CAC was assigned to carry out the task, offering training to local farmers and technicians, and setting up a seed company to reduce Malawi's dependence on imported seeds. In both 2011 and 2012, CAC was the leading cotton purchaser in Malawi.*

## Government and Policy

In almost every cotton growing country in Southeast Africa, the government emphasizes the **value added** of cotton processing; countries do not want to continue to merely provide natural resources to Asia. Yet, the only cotton-growing country in Southeast Africa that also has a significant textile sector is Tanzania. Almost all spinning mills in Zambia and Malawi have been closed down; Zimbabwe's once flourishing textile sector collapsed during its economic crisis.

## Technology and Productivity

Asian ginners have brought **new production and management approaches** to the African cotton industry, as well as inputs and technical assistance. In countries with decentralized systems, such as Malawi, Zambia, and Zimbabwe, each ginner develops its own cotton seeds and introduces different technologies to the region. For example, in 2013, CAC built a new acid treatment plant in Zambia that will significantly raise the germination rate of cotton.

African officials, professionals, and ordinary farmers also frequently visit Asian countries to learn cotton production techniques. In interviews, the farmers who participated in these trips said that the experience "opened their eyes"; for the first time, these farmers were able to witness the entire cotton value chain of the international market.

## Society and Environment

**Asian investment in the African cotton industry has also impacted local communities and the environment by:**

- (1) INTRODUCING RECYCLING PRACTICES.** Asian companies have demonstrated how complete recycling can almost entirely eliminate waste from cotton processing. CAC turns used cotton seeds into cakes for animal feed, or fuel for boilers. The grease produced by the extraction process can be used as soap.
- (2) OFFERING EMPLOYMENT OPPORTUNITIES.** The workers employed by ginneries are mainly male as the plants require heavy labor. However, the increasing number of ginners provides more employment opportunities and alternatives for women who decide to work in the sector. For instance, the Zambia Cotton Farmers Association sent fifteen Zambian women to Ethiopia to learn handloom techniques. They will produce items that require intensive labor, but little capital, such as tablecloths and hand towels.
- (3) COMMUNICATION.** For Asian investors, especially the Chinese, communicating with local communities used to be a serious challenge. However, they are quickly learning and adapting to local contexts. CAC did not previously attend the meetings of the ginners' association. Yet, since 2010, CAC's General Manager has recognized the importance of these meetings for information sharing among companies. CAC management also actively promotes local employees to managerial positions with the belief that employees who see potential for promotion will be more loyal and motivated workers, and more effective managers. CAC has awarded two local managers with trips to China, and the company is planning to have at least one local employee become vice general manager.

## TEXTILES

### Market

Textiles (fabrics) are the weakest component of the cotton-textile-garment value chain in Southeast Africa. The majority of ginned cotton produced in the region is exported to Asia, and the African garment industry imports almost all of its fabrics back from Asia.

**Southeast Africa used to have an established textile sector, but increased competition from Asian textile industries has driven many of the African textile companies out of business.** In 1997, Zambia had six spinning mills; none are operational today. Many of the textile companies that remain in the region do not produce fabrics for garments, but instead make seat belts and other special high-value fabrics.

The only exception is Tanzania, where a vibrant textile sector is still functioning. This is partly due to (1) the Tanzanian government's heavy investment in its textile sector from the 1960s to 1980s, and (2) the successful privatization of the textile industry since the 1990s. As of August 2013, there were 16 operational textile mills in Tanzania.

### **Government and Policy**

Textile mills require significant **investment and steady supplies of electricity**. Zambia is an advantageous location to establish large regional mills since it is geographically located in the center of Southeast Africa, has a strong cotton sector, and is peaceful and democratic. As noted above, China used to support a large integrated textile mill in Zambia called Mulungushi. Although the mill was closed in 2006, many Zambian officials hope that they can reopen the mill.

### **Technology and Productivity**

**The ratio of Asian managers and trainers to local African workers can vary significantly among the textile companies in Southeast Africa.**

- Taiyuan Textile, a Taiwanese firm in South Africa, employs 500 to 600 people in its spinning section, and has four to five managers from Taiwan and 20 to 30 technicians from mainland China. The technicians are responsible for training, machinery adjustment, and maintenance.
- In Tanzania, the Chinese-aided Urafiki Textile has been operational for over 40 years. Many local employees have worked there for their entire lives and are thus already skilled in operation and maintenance. As a result, the number of Chinese workers in the mill has been reduced from about 60 to 18, all in management positions.

### **Society and Environment**

Textile mills, like garment factories, are **labor intensive**. On the one hand, Asian mills can create thousands of jobs for local communities; on the other hand, the companies often operate with low margins and thus fix workers' wages at low levels. This can cause conflicts with local workers' unions and labor authorities.

## **POLICY IMPLICATIONS AND RECOMMENDATIONS**

Reviving and developing the cotton-textile-garment value chain can create employment and promote profitable economic activity in Southeast Africa. Continuously rising costs of labor and production in Asia are forcing manufacturers to consider relocating. At first they primarily moved from China to Vietnam and Cambodia, but the wages in Southeast Asia have also begun to rapidly increase. Thus, they have begun exploring the possibility of expanding into Southeast Africa.

**The region offers unique advantages for Asian textile and garment investors:**

- Compared to Asia, Africa is closer to European and American markets.
- Africa also enjoys more favorable trade policies from the European Union and from the United States; the textile products made in Africa can enter these markets at lower costs and with fewer tariffs.

- Many African countries have ample land for factories, low labor costs, and raw material inputs, such as cotton.

**At the same time, a number of factors discourage investment in the region, including:**

- Political instability and tenuous security environments.
- Compared to Southeast Asia, the lack of economic integration between African countries makes the regional markets in Africa more fragmented.
- A lack of physical and human resources severely reduces productivity, mitigating the advantage offered by abundant natural resources and low labor costs.
- Finally, the cultural barriers between Asia and Africa are also daunting for many Asian investors.

**In order to attract and encourage more investment from Asian textile manufacturers, African governments should consider the following measures:**

- (1) **Subsidies and incentives** for investment can successfully attract small- and medium-sized Asian garment enterprises for a short period. The short term investment can, in turn, stimulate the manufacturing sector. In order to increase the competitiveness of small- and medium-sized enterprises, governments can facilitate the formation of clusters, which offer the benefits of economies of scale, and can attract suppliers and buyers to new area.
- (2) For countries that aim to foster long-term development, temporary tax holidays and incentives will not be effective. In this case, governments should focus on **improving political, economic, and institutional structures**, including security environments, logistics, labor regulations, and openness to foreign investment.
- (3) **Proactive governmental support** for factories plays a big role in attracting new Asian investors. Investors are drawn toward governments that are clearly committed to fostering manufacturing.
- (4) African governments should pay special attention to **labor relations**, as this is an important consideration for garment enterprises. The potential for cultural and regulatory clashes exists. For example, Chinese investors are used to so-called “responsibility systems” where workers produce a daily quota and earn bonuses for above-quota production instead of daily or hourly wages.
- (5) If Southeast African countries can establish **efficient textile mills**, they will be able to eliminate the timely and costly process of exporting cotton to Asia for processing, only to later import Asian fabrics to produce African garments. By promoting coordination of the upstream and downstream producers, African governments can help strengthen textile processing industries.

1. The Multi-Fiber Arrangement is an international trade agreement on textile and clothing that was active from 1974 until 2004. The agreement imposed quotas on the amount of yarn, fabric, and clothing that developing countries could export to developed countries.

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