PRICING DISTORTIONS AS A CONSTRAINT TO SMOOTH VALUE CHAIN OPERATIONS:
THE CASE OF COTTON LINT IN ZIMBABWE

CZI
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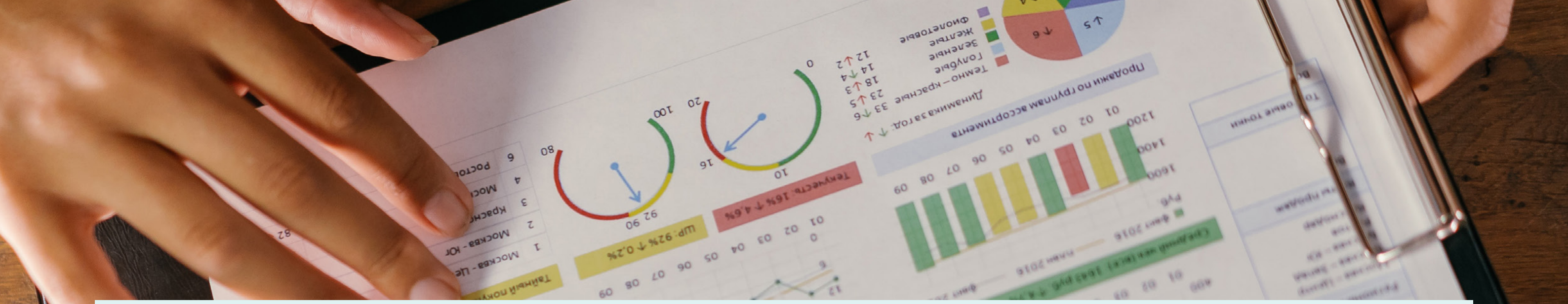

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The CZI ZimIndustry Analysis, Trends and Insights focusing on Value Chains Sectors and Products is a publication of CZI. These are publications aimed at informing the market and policy makers on **industrial development, technology, emergence of new sectors or products, performance in value chains, emerging trends and highlight both business and policy opportunities.**

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Quick Summary

There is an outcry of lint shortages to local spinning factories and this has led to problems in the downstream industries. The pricing issue, which can be traced to the general exchange rate distortions in the country, remain at the core of having enough cotton lint for the well-functioning of the cotton to clothing value chain. While the resolution of the exchange rate remains a priority for both monetary and fiscal policy, there is an urgent need for an interim mechanism that is intended to bail out both the ginners and spinners by cushioning them against the effects of the parallel market premium.

1.0 Value chains are central in NDS1

The strategic vision of the industrialisation agenda under National Development Strategy 1 (NDS 1) (2021 – 2025) is to contribute to economic structural transformation by moving Zimbabwe's economy up the value chain through industrial transformation. Under the NDS1 running from 2020-2025, each major sector of the Zimbabwean economy should be developed based on a recognised value chain. These value chains operate from the primary producers to the sale of finished goods locally or in the export market. There are six prioritised value chains in the NDS 1, namely:

- soya bean,
- cotton,
- leather,
- fertiliser,
- pharmaceutical; and
- bus and trucks assembly value chains.

The cotton value chain provides economic and livelihood synergies through vertical and horizontal linkages with the textile, apparels, yarn, fabric, oil processing, and stock feed among other industries. Cotton production supports the livelihoods of over 500,000 families directly and is principally grown in marginal low rainfall areas of Natural Region 4 (UNCTAD, 2017). Cotton is also one of the cash crops in Zimbabwe that bring foreign currency and support job creation at different nodes in the value chain. Cotton and yarn exports from Zimbabwe increased from US$30.1 million in 2020 to US$85.7 million in 2021[1].

1 https://www.trademap.org/Country_SelProductCountry_TS.aspx?nvpm=1%7c716%7c%7c%7c%7c52%7c%7c%7c2%7c1%7c1%7c2%7c2%7c1%7c2%7c1%7c1%7c1

2.0 The cotton to lint value chain

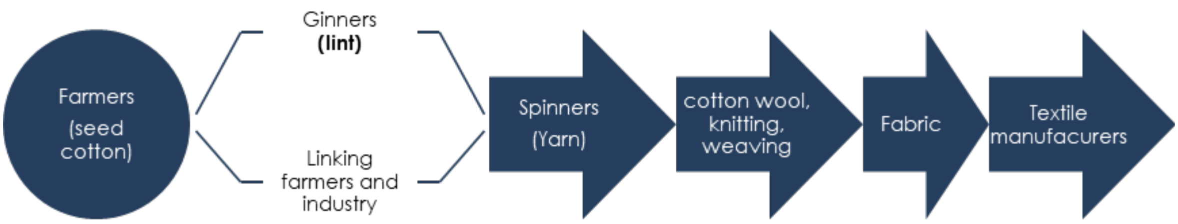
The cotton-to-clothing value chain in Zimbabwe comprises the following processes:

- Farming
- Ginning
- Spinning
- Weaving
- Clothing
- Dyeing
- Designing

The sector's product range is quite diverse ranging from seed cotton, lint, yarn, vegetable oil, fabrics to clothes. The Zimbabwean story of the cotton value chain starts with production of seed cotton by farmers followed by the separation of seed from fibre which is done at the ginneries. This then triggers the beginning of the lint spinning and other value addition processes.

The ginning segment is very important in the cotton-to-clothing value chain. It is linked both to the farmers on one hand and to the textiles and clothing industry on the other through the spinning mills (Figure 1). Thus ideally ginners should be the ones having contracts with farmers for seed cotton while spinners rely on ginners for lint for the value chain to be well functioning.

Figure 1: Ginners linking farmers and the textiles industry



Lint is the major ingredient of the downstream value addition manufacturing processes in the textile industry. Spinning is the first process of the textile value chain and involves the conversion of cotton lint (produced at ginning), into spun yarn. Zimbabwe has a ginning capacity of up to 700,000 metric tons per year against the yearly production of 195 991 metric tons and 101,000 metric tons in 2020/21 and 2019/20 season respectively (MoLAFWRD, 2021).

3.0 Local availability of lint for value addition becoming a concern

CZI engagements with different players in the value chain has shown that there is a discourse and dialogue between spinners and ginners on the marketing of lint and the pricing model to be used. Spinners cited that about 90% of the lint is exported leaving them with about 10% in a season (from May to September) which is insufficient to keep them spinning all year round. For example, during the 2020 season 45,000 metric tonnes (MT) of lint was exported and 4,500 MT was left for local spinners. In the 2021 season, 56,000MT of lint were exported and 6,000 MT was left for local spinners (Masenda, 2022).

The need to balance between quantities that can be exported and what can be left for local value addition was anticipated by policy. According to literature as well as players in the cotton value chain, there is a policy requirement that about 30% of the lint should be reserved for local players, while the remaining 70% can be exported by the ginners. Cotton lint had to be controlled to avoid the collapse of the textile industry. This means that the current practice goes against what policy had anticipated, calling for the need to interrogate the main reasons for this development. It is surprising, however, despite the general acknowledgement that there is a 70:30 ratio for exports and local usage of lint, all efforts to locate the policy statement or the regulations which specifically provide for this were not successful. In addition, engagements with spinners, ginners, the Ministry of Industry and Commerce and the Agriculture Marketing Authority to get reference to the specific policy document or regulations through which this could be enforced were not successful. It therefore remains unclear whether this was a policy pronouncement which was not later followed by legislation and whether it was a temporary or permnent measure. This absence of the legal provisions could be what is emboldening ginners to disregard the provision.

4. Pricing of lint becoming an issue of contention

Lint prices are generally determined in the international market, including the Liverpool Cotton Index Price. Thus the local ginners are price takers and they usually stick to the Liverpool Cotton Index Price as a benchmark for what they would expect. Currently, both ginners and spinners are agreeing on using the Liverpool Cotton Index price discounted for transport and insurance costs. However, due to the exchange rate distortions, the main challenge is on the mode of payment.

However, for Zimbabwe the pricing issue has become subjected to some complexities. Government has initiated efforts to hedge farmers against depressed producer prices and loss of value due to inflation through announcing a minimum price of seed cotton. The announced prices comprise of both USD and ZWL components post-production. This means that ginners have to pay some component to the farmers in USD. This also implies that the ginners would be expecting to receive USD for the sale of lint.

However spinners are citing that they are not able to pay for the lint in USD (US0.30 per kg of lint), since they also make local sales in ZWL$ from the lint. According to them, paying for lint in USD would erode into their margins. However, the failure by spinners to pay in foreign currency creates an incentive for ginners to export more lint (more than the prescribed 70%) as a way of sourcing foreign currency to cover their costs for procurement of raw materials as well as to maximise on returns since the local currency is overvalued at the official rate. Ginners thus require spinners to pay for lint in foreign currency in line with New York or Liverpool Index Prices after deducting transport and insurance.

COTTCO, a key player in the ginning of cotton and the main exporter of cotton lint has currently proposed that it can only release the lint to local spinners at the 60:40 ratio in USD and ZWL price respectively. On the other hand it is alleged that private ginners are demanding payment in USD only. Spinners cited that if they pay in USD prices, their production costs will be very high such that they will compromise the whole value chain on the import substitution agenda. Their customers will be forced to import yarn rather than sourcing it from local spinners.

One proposal that has been put forward is for spinners to have own contract farming arrangements with farmers so that they do not put pressure on the ginners. Having spinners competing with ginners for seed cotton when they have not invested in, and perfected their ginning capacities will only add complexities to the value chain with serious implications on costs and competitiveness.

5.0 Possible pathway in solving the lint problem and in reviving a vibrant cotton to clothing value chain

From the engagements with ginners and spinners, there are a number of options to explore so as to remove the current constraints. These include the following[2]:

5.1 Pricing

A viable cotton lint pricing model would need to be set with the input from both ginners and spinners. Ideally, the price of lint which the spinners get from ginners should leave ginners indifferent between exporting and selling their lint locally. Selling lint locally at lower prices than the international market would be seen as a form of subsidy to spinners. This means that the exchange rate distortions that manifest themselves in a high parallel market margin is an issue which need to be resolved.

While the official exchange rate is still adjusting to a more realistic level, an interim arrangement where spinners can buy foreign currency at the existing formal exchange trading platforms (auction market or the willing buyer willing seller platform) remains the only ideal way of ensuring that lint is purchased at a price that does not create incentives for violating the existing local reservation policy.

Once the pricing issue is settled sustainably, both players (spinners and ginners) can work together in regular price adjustments where necessary. This limits problems of ginners exporting all the lint at the expense of the local industry. This brings the importance of working as a team rather than in silos.

5.2 Co-ordination

There is need for a common shared vision with well integrated value chain associations aspiring to improve cotton production at the farm level as well as enhancing local value addition. Players in the value chain as represented by their associations should continue to regularly meet with the objective being to address value chain bottlenecks.

5.3 Policy

The 30:70 requirements is a noble policy initiative that is designed to safeguard the interest of both ginners and spinners. Ginners and spinners also cited that there has been no timely feedback from Ministry of Industry and Commerce and Ministry of Agriculture on their issues with regards to shortage of cotton lint locally. This also calls for improved collaborations between industry and the responsible ministries to give timely feedback on critical issue which enhance the value chain efficiencies.

2 The information was obtained in the Association of Cotton Value Adders of Zimbabwe (ACVAZ) meeting minutes.

6.0 Conclusion

The status quo has led to the need to export more lint produced in order to generate foreign currency to continue operations. This has led to a situation where the supply to local spinning factories has been reduced. This has led to problems in the downstream industries. Thus the pricing issue, which can be traced to the general exchange rate distortions in the country, remain at the core of having enough cotton lint for the well-functioning of this value chain. While the resolution of the exchange rate remains a priority for both monetary and fiscal policy, there is an urgent need for an interim mechanism that is intended to bail out both the ginners and spinners by cushioning them against the effects of the parallel market premium.

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