

REVIEW OF WOOL TRADE RELATIONS WITH JAPAN

A REPORT BY THE AUSTRALIA-JAPAN RESEARCH CENTRE
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FOREWORD

The Australia-Japan Research Centre (AJRC) at the Australian National University was pleased to have had the opportunity to prepare this report on Australia's wool trade relations with Japan at the request of Australian Wool Innovation Limited.

The Centre research group was led by Professor Christopher Findlay with support in Australia from Greg McGuire and Jong-Soon Kang. Professor Motoshige Itoh from the University of Tokyo led the research group in Japan, with support from Naoki Shimoi. Professor Peter Drysdale acted as an adviser to the project. Suggestions from other colleagues in the AJRC were also of great benefit to the research team and Centre staff provided further research support.

Extensive fieldwork was conducted in Japan for the purpose of preparing this report, and the research group is grateful for the time and for the interest of those who were interviewed.

Professor Findlay is responsible for the material in this report. Further information can be obtained, or comments provided, through email at christopher.findlay@anu.edu.au.

1. EXECUTIVE SUMMARY

THE CRISIS IN THE MARKET IN JAPAN

The direct trade in wool between Australia and Japan is dead. The relationship between production of wool in Australia and its consumption in Japan remains alive, but the link is now based on third parties.

Although the link remains alive, it is suffering. Consumption of wool fibre per head in Japan has dropped by 40 per cent since the middle of the 1990s. Its current level is 0.74 kg per head for apparel, compared to 1.13 kg per head in 1995.

Achieving the goal of increasing the sales of Australian wool in Japan now depends on a more complex set of factors that determine the sales of products containing wool, the share of wool in the fibres used in those products and the share of Australian wool in that wool material.

In this report, proposals are presented to Australian Wool¹ for working on all these dimensions of a strategy for rebuilding wool trade relations with Japan.

THE ORIGINS OF THE PROBLEM

The problem in the market in Japan has its origins in a number of factors, including a revolution in retailing and a hollowing out of local production in the context of a policy of industry protection.

¹ The term ‘Australian Wool’ is used here to denote all the Australian interests associated with wool use and consumption in Japan, including woolgrowers and their organisations such as AWI and Woolmark.

RETAILING AND DISTRIBUTION

The first factor is the revolution in retailing and distribution in Japan.

The management of the domestic links in the chain has been turned on its head. Previously the upstream processors would push wool products down to the department stores using sophisticated systems for quality control and risk management. The new retailers now pull in product, but not necessarily from within Japan. This change to a wider view of sourcing options at the same time as the shift by consumers to casual wear has challenged wool's share of fibre consumption. The emergence of a new set of retailers was prompted by regulatory changes in Japan which removed the constraints previously applying to the establishment of new large stores.

HOLLOWING OUT

The second factor is the change in the costs of processing at all stages in Japan compared to the rest of the world.

Generally, Japan has been losing competitiveness in the textiles and clothing business. There has been a rapid relocation of these activities offshore, especially to China. The import penetration of the industry at all stages has risen.

Even without the retail revolution, the product-making stages would have moved offshore, but the retail revolution has been linked to a shift in the management of the supply chain, which in turn has helped break down wool's share of the market.

One qualification to the hollowing out of the Japanese textiles and clothing industry is the experience of the fabric makers. Their net exports have actually increased. The origins of their competitiveness are in their technology, their innovation and their quality control systems. But their survival may also have as much to do with policy on protection as it does with their ability to compete in global terms.

THE STRUCTURE OF PROTECTION

Conditioning this adjustment in the industry has been the structure of tariffs in Japan. Tariffs on wool products are relatively high overall and tariffs rise as the degree of processing increases. There is relief available to some stages of the production process which is provided by a re-import scheme. Under this scheme, products exported from Japan for further processing offshore can be reimported duty free. This scheme has been especially important for the fabric makers.

The relocation of the Japanese industry has been supported by foreign direct investment (FAI), but offshore production is also organised by contracting arrangements. This linkage is more footloose than production based on FDI. China is currently the major supplier into Japan. Production bases in China might move further inland, as costs rise on the coast. But if opportunities for cutting costs are exhausted, processing contracts could shift to other countries, such as Vietnam.

A WOOL TRADE RELATIONS STRATEGY

The strategy proposed to respond to the challenges in the market in Japan has two components. One concentrates on trade policy, and another focuses on relationships in the industry.

The trade policy component is designed to remove impediments associated with the international transactions at various points along the supply chain that reduce demand for Australian wool.

Domestic matters within the market in Japan are the focus of the relationship component of the strategy and its targets are to support sales of wool products especially those involving wool from Australia.

TRADE POLICY

The trade policy component of the strategy includes work in the WTO, APEC and at a bilateral level. It also requires careful monitoring of other developments in the region.

WORLD TRADE ORGANISATION

The current Doha Development Round of negotiations in the WTO provides important opportunities for Australian Wool.

Australian Wool has a strong interest in the negotiations on industrial tariffs. Its main interests are not in the agricultural sector issues but in the industry sector issues. It must define its positions on the negotiations of reductions in industrial tariffs and put its views to Australian negotiators and to allied sectors located in other WTO economies.

TARIFFS IN JAPAN

The first interest is to reduce tariffs on wool product imports into Japan. Higher tariffs on final wool products increase prices to consumers and reduce the quantity of wool fibre consumed.

A formula should be used to cut final product tariffs and to reduce the degree of escalation in Japan's tariffs. There are various proposals on the table in the WTO negotiations about which formula might be used. One is a proposal from the United States to cut all industrial tariffs to zero by 2015. Negotiation on the formula should be monitored closely and the Bogor commitments of APEC (which cut tariffs faster in industrial countries than does the US formula) are a good benchmark.

The tariff rates on textile and clothing products based on various fibres are similar. From the perspective of the consuming country there is no basis for wool to make a case for special treatment. Nor is it a sensible strategy, since it could incite a response by other fibre suppliers who have substantial bargaining power at the table with Japan. Wool product tariffs would fall as part of a package in which tariffs on all textiles and clothing products are cut.

Of more concern is the avoidance of any special treatment of any other fibre. This could occur as a result of special requests made by Japan's other trading partners as part of the WTO negotiations. There is risk for example that if the US had special interests in cotton it might seek to achieve faster cuts in cotton product tariffs than those applying to other products. An advantage of the formula approach is that it avoids this type of bargaining.

To be effective with respect to tariffs on clothing and textiles, a position will also have to be established on the implementation of the Agreement on Textiles and Clothing (ATC). While Japan does not apply quotas to its imports, other countries do. A formula applying to textiles and clothing will also apply to ATC members, and the additional issues that arise as a result of the interaction of the tariffs and quotas should be considered.

TARIFFS ALONG THE CHAIN

The second target is to make sure there are no impediments along the supply chain into Japan. Not only Japan's tariffs but also those along the chain are important.

Many of the countries apply tariffs to the intermediate products that are used in wool products. All of the economies now part of the supply chain also provide ways for exporters to have tariffs refunded (or to not pay them at all) on such products, so the effect of those tariffs on intermediate products is generally neutralised. But it is important to monitor those policies, and the best way to remove any risk of an impediment emerging is to cut the protection altogether.

IMPLEMENTATION

Active participation in the provision of policy advice to the Australian government on its WTO agenda is one element of the implementation of the trade strategy. That includes putting positions through the various committees that advise the Australian Trade Minister on these issues.

Implementation of the strategy also requires a preparedness to participate actively in the protection debate in Australia, particularly with respect to textiles and clothing. Australia will be arguing for less protection in the rest of the world on textiles and clothing. Its argument will not be effective unless it too makes the same commitment. A forum for that debate is the current Productivity Commission inquiry into the textiles and clothing industry.

The next major milestone in the WTO process will be a Ministerial meeting in Mexico in September 2003. A position paper on WTO issues for consideration by Australian officials as they prepare for that meeting will be useful.

APEC

APEC continues to be an important institution for the implementation of the trade strategy.

One source of APEC's value is its complementarity with the WTO process. APEC and its committees of officials provide important venues where arguments can be rehearsed and positions explained outside a formal negotiating environment.

It will be useful, for example, to present a paper on aspects of the liberalisation of textiles and clothing trade to APEC officials. Material can not only be delivered to APEC directly via Australian officials, but can also be delivered through Australian members of the APEC Business Advisory Council and also via second track mechanisms such as the Pacific Economic Cooperation Council.

APEC also provides a forum for discussion of the risks in the use of preferential trading arrangements.

OTHER REGIONAL ARRANGEMENTS

The region through which Australia's wool travels to Japan is now awash with negotiations on free trade agreements (FTA).

The wool industry in Australia benefits from its wool being processed by the lowest cost processors. The location of further processing should shift with changes in relative costs.

A series of preferential trading arrangements does not facilitate this process of adjustment. Preferential arrangements put particular suppliers into preferred positions.

There are some risks for wool in the proliferation of the FTA route. For example, there is a possibility of an arrangement involving China and Japan. The tariff rates in Japan are relatively high and under an agreement with full coverage, China would have preferential access to the Japanese market. Without an agreement, China would lose market share in Japan much more quickly as other suppliers took over. This transition is retarded by a preferential agreement.

There is a further and significant risk in this situation. China is also a raw wool producer, so supplies of raw wool inputs into its export products bound for Japan may also be diverted to its domestic sources. This is more likely to happen because of requirements that will be present in any agreement to achieve a certain level of local content in order to have access to the preferential tariffs.

There is considerable uncertainty about how the process of FTA negotiations will evolve. Dynamic political economy effects created by FTAs and complexities in their architecture mean that a series of agreements need not build up to non-discriminatory free trade.

Australia is an active participant in the FTA game. Its position in this respect, including its focus on the US in its own negotiating agenda, has limited its ability to respond to initiatives in East Asia. Uncertainties also remain on the question of exercising the provisions of earlier treaties with Japan which provide for the extension to each other of privileges granted to third parties.

Overall, the set of East Asian FTA initiatives needs to be monitored and the risks of discrimination highlighted for presentation to Australian officials for reference in their own dialogue with our East Asian trading partners.

APEC too has on its agenda a discussion about principles for the development of preferential arrangements, and a contribution to that discussion as part of this overall strategy package would be worthwhile.

BILATERAL DISCUSSIONS

Australia and Japan are in the process of bilateral discussion about reinvigorating the economic relationship.

In terms of the application of this strategy suggestions of talking points for the bilateral discussions are ‘all of the above’, namely

- ❑ dealing with industrial tariffs in the WTO;
- ❑ managing the risks associated with the use of FTAs, including the distortions to the wool product supply chain and the risks of diversion of trade away from wool from Australia; and
- ❑ implementing the APEC commitments.

A free trade agreement with Japan will not provide substantial benefits to the wool industry. To try to adopt an FTA will in fact reinforce a tendency towards preferential arrangements, and this tendency contains severe risks for this industry which has such a complicated supply chain between itself and its final consumers.

RELATIONSHIPS IN JAPAN

For some decades, there was a direct link between wool production in Australia and consumption of wool products in Japan. But that direct link has now transformed into a chain of connections.

There is value in establishing an Australian Wool Circle in Japan that provides a vehicle for representing Australian Wool’s policy interests in Japan and that delivers information so as to ‘close the loop’ between wool production in Australia and consumption of clothing and other wool products in Japan.

While the information flow component is valuable to the long term planning of wool producers in Australia, the immediate value in the information will more likely be linked to the design of research and development strategies in the processing and application of wool.

Specific roles for this network include, but are not restricted to,

- ❑ being a vehicle for representing the commercial and policy-related interests of Australian Wool in Japan
- ❑ working together with counterparts in Japan on
 - anticipating and sharing views on changes in the volume and composition of final wool product demand in Japan

- anticipating, but also leading, the delivery of new products in the consumer market
- understanding trends in retailing in Japan and understanding the contribution of wool products to the business development strategies of the new retailers
- becoming more aware of the risks in the business due to processing in third countries, eg questions of quality
- facilitating the coordination of activities between Japanese processors and Australian suppliers of raw materials and technology in third countries
- building channels of communication back to the basic research processes in Australia and in other wool processing countries

The challenge specified here is to represent Australian Wool's interests in Japan more directly to its counterparts there, including its policy interests. The activities and interactions within Wool Circle will also support and add value to the commercial activities of Woolmark in Japan.

The Japanese fashion industry is also now looking for partners to pursue business opportunities within the global market place. The Australian Wool Circle will be well placed to become an important ally of the Japanese fashion industry.

The detail of the Wool Circle will evolve over time but included in this report are proposals for participation from discount stores, designers, industry press, fashion companies, including foreign brands, department stores, trading companies, manufacturers, and industry associations.

The first step in establishing such a Wool Circle is for a delegation, led by Australian Wool Innovation (AWI) to visit Japan to participate in discussions with each type of potential participant, one-on-one or in the form of a CEO-level conference. The conference can be used as a one-off event in order to contribute to the specification and establishment of the Wool Circle. But the first AWI delegation would also evaluate whether to continue the conference as a regular event.

Once established, the Wool Circle in Japan will require continuing support in the form of administration and communication as well as inputs from research. It will also require work to continue to represent the interests of Australian Wool to other Wool Circle members and to policy makers in Japan. This work can be organised in a collaborative manner between researchers in both Australia and Japan, in cooperation with input from key Wool Circle members.