COMPETITIVENESS IN CASHMERE INDUSTRY

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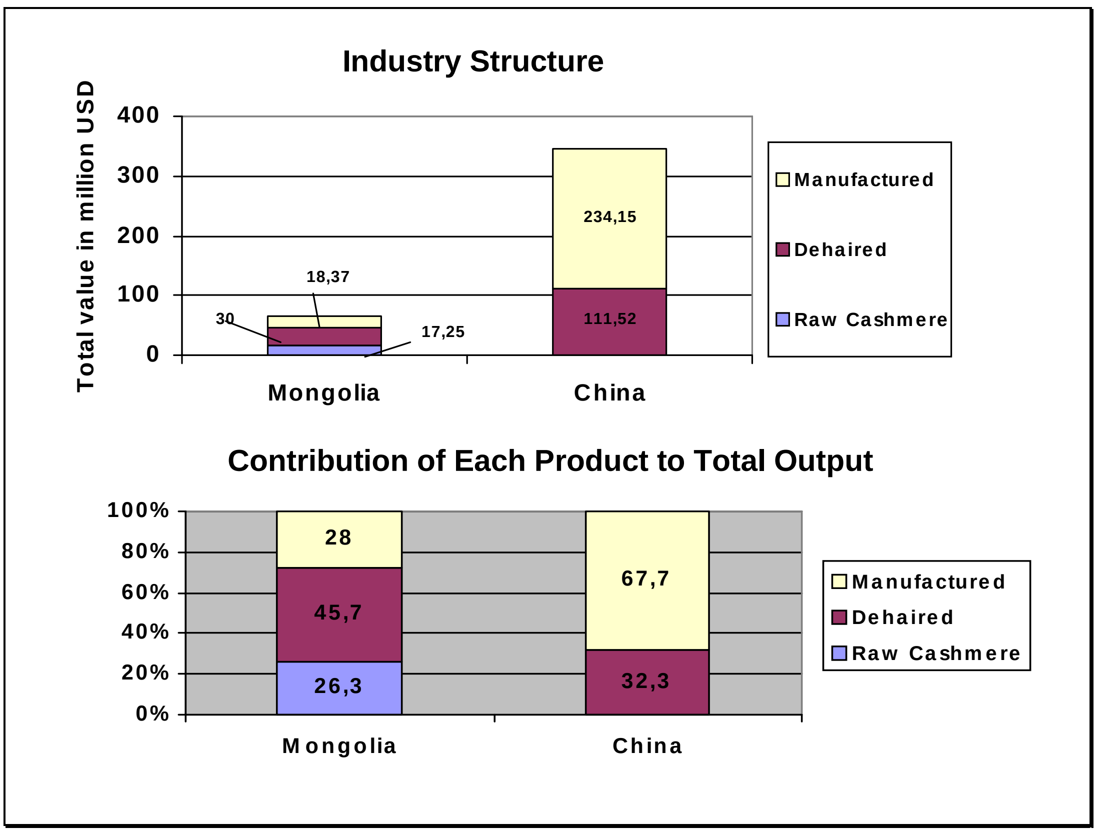
Ladies and Gentlemen

I would like to present today the results of our study on the Competitiveness in Cashmere Industry, in particular, of our study in Inner Mongolia, China. What we have found out there was surprising and at the same time very educational and therefore availing myself this opportunity I would like to share with you the experience.

During the tour we have interviewed officials both from central and rural divisions of Inner Mongolian Planning Commission, representatives of big and small processors and have done some site visits of their facilities.

It was very interesting to us not because we were there for the first time but because it allowed us to compare Chinese and Mongolian position in this competitive world.



Mongolian cashmere industry today has to compete against cashmere industry of China and other countries for raw materials and for market share. The first of graphs show size of the exported outputs from two countries in 1999 (Mongolian export in three categories has earned USD 65.62 million and China has earned USD 345.67 million in total) Last year China has earned 12.7 times more than Mongolia in exporting manufactured ready-made knitwear only.

The second shows contribution of each product to total value of the export earning. It also clearly shows who is focusing where: 67.7 percent of Chinese export targets high-end consumers of ready-made knitwear, whereas Mongolia exports only 26.3 percent of its cashmere products as final garments.

This advantage was clearly the result of three striking features we have witnessed while we were there:

- ***long-term vision and strategy*** of the industry leaders to reach international markets and consumers;
- and once the goal is achieved ***to commit themselves to keep serving those markets and consumers***;
- ***to be flexible to respond*** to the market and consumer's ever changing tests and demands.

These three features can be summarized into one concept **"customer service"**. We all know that the concept is well accepted and appreciated in the West and serves as guiding principles for all companies doing legal business. But as we saw, Chinese companies are also serious about adopting the concept. However, instead of seeking the most attractive segments of international market, companies and industries from developing countries miss many opportunities by focusing their attention on elsewhere.

There are ***seven common ways***[1] emerging economies usually miss the opportunity:

- They think they will succeed by default because they have a plethora of cheap resources (it is called overreliance on their basic factors of advantage);
- "We are doing our best but they do not like it, what is wrong with them?" - they poorly understand their customers;
- "How come Chinese are ahead of us, and how did Europeans manage to survive?" - they ignore their relative competitive position;
- "We are done as long as we have sent to the wholesaler our shipment, if something wrong with the product it is the wholesaler's problem" - they fail to forward integrate;
- "I would rather let the order to expire than give it to my competitor" or "If it does not benefit me then it should not benefit any one" - poor interfirm cooperation
- "We are doing OK, our lack of business is due to outside influence, therefore we should take every measure to not allow this happen to us." - they like to take defensive position)
- "They should protect us, they should help us, and they should create environment for us" they like paternalism.

We often say "we have vast land, lasting resources" and, in terms of cashmere production, we like to repeat "because Mongolia is cold, goats grow fine cashmere, and our fiber is the best quality". But 98 percent of all goats grow white cashmere in Inner Mongolia, whereas only 5 percent of Mongolian goats grow white cashmere. Besides, Inner Mongolia has branded their cashmere and now has educated consumers about their "Diamond Fiber", which has earned a worldwide reputation and following.

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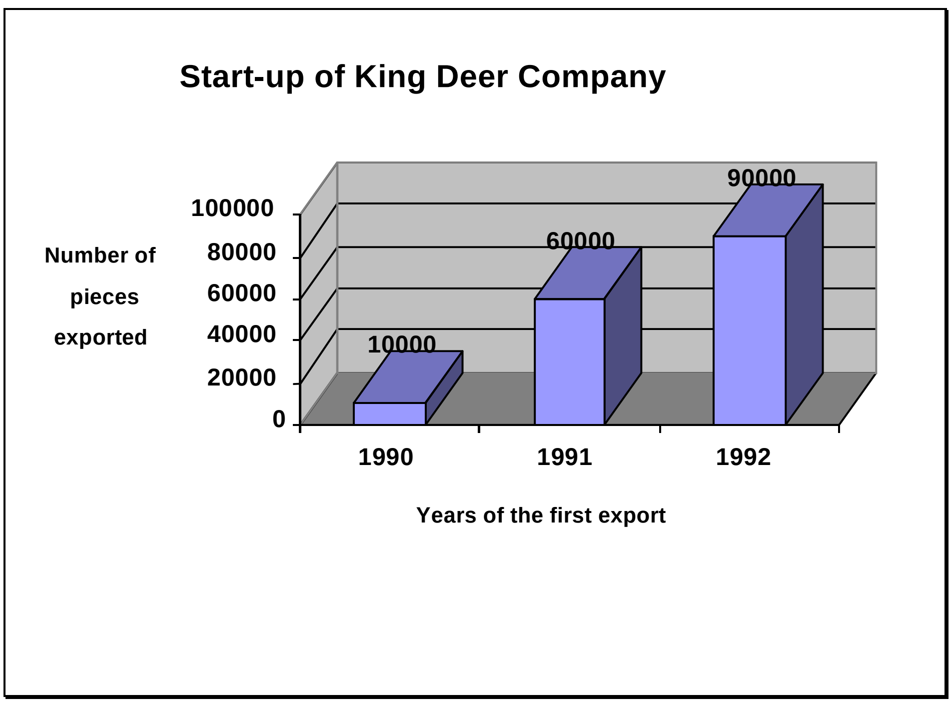
[1] Lindsay & Fairbanks, Plowing the Sea, 1997, Harvard Business School Press

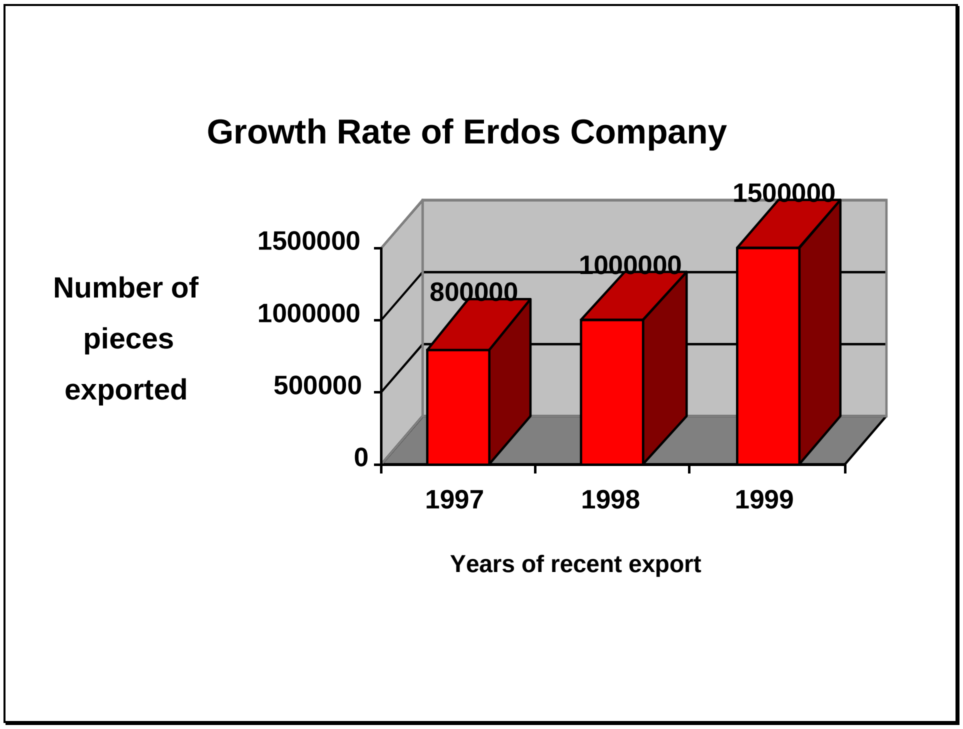
It turns out advantages such as cheap labor, cheap and abundant raw material, and good geographic location are not always sustainable because ***they are all can be easily imitated***. The Chinese have proven that. They have a competitive advantage in all three categories.

"Global customers are increasingly blind to the origin of products they buy." For them it is no longer important if the product has the "1st world" or the "3rd World" origin. The only important thing for them is quality and service. It is not sufficient to know who is your potential customer, the most important aspect is ***to understand what they need and then to deliver the product and services that best meets that need***. Chinese companies are doing well in this regard, from the beginning they chose the precise segment of the international market they would serve. They are always alert to changes and differences in the consumers demand and they seek the most attractive customers.

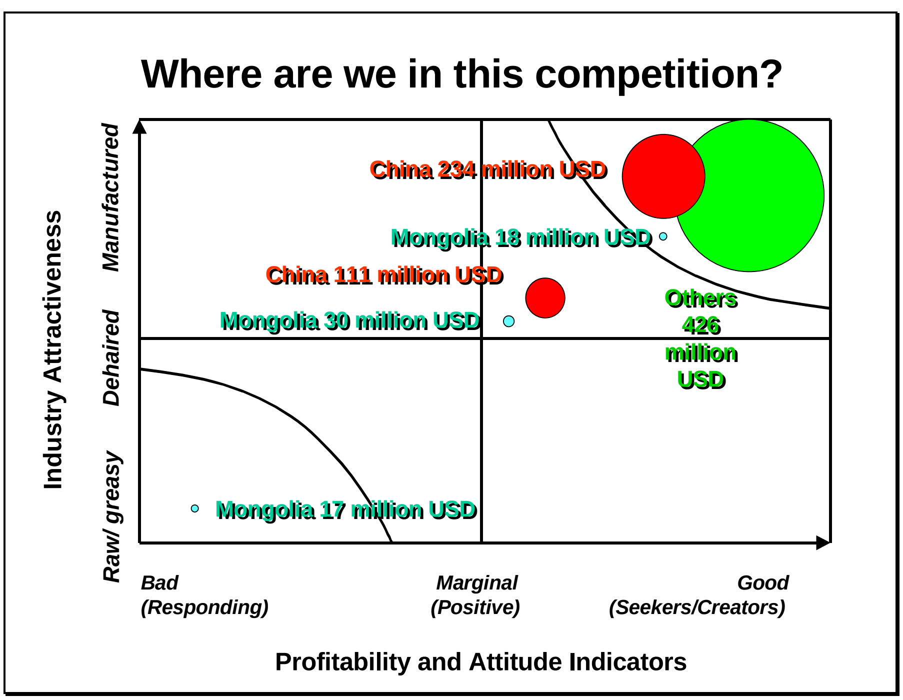
An example of this is the King Deer Cashmere Company, the headquarter of which we can see at the background. The graph shows how Kind Deer expanded it production during its first three years of export operation. During startup they were solely oriented to the international market, and only last year in 1999 they started to offer their products to the domestic market.



The second graph shows the growth rate of Erdos Company for last three years. They achieved this remarkable success thanks to their flexibility and customer service. Last year they managed to keep their price flat for customers despite the fluctuations in the price of raw cashmere. Customers were coming back with more orders because of the service they were receiving.



Previously I mentioned about the importance of knowing your competitive position in the international market.
We say that Mongolia is the second biggest player in the cashmere market. But what does that mean? Which market are we talking about? There are many things to analyze in order to understand your competitive position.



Here is a graph we have attempted to show where Mongolia is positioned in the all segments of the industry. At the onset, you must know which market you compete in and how your specific product compares with that of your competitors. It is clear that there is huge potential for both and Mongolia and China to increase their market share and profit, and China is obviously well along in fulfilling this goal.

Not To Choose Is To Choose: The Example Of Colombian Leather

On a sunny day in May 1993, 100 of the most important members of the Colombian leather industry gathered in a meeting room in Bogota to plot their escape. There were no locks on the doors, no bars on the windows, and no guards in the halls outside, but these ranchers, tanners, manufacturers, distributors, exporters, and advertisers felt themselves to be caught in a very real trap with no clear way out. As one delegate after another outlined the dimensions of the dilemma, emotions rose and tempers flared. Occasional moans of desperation made the mood in the room almost unbearable.

Things had not always been so bad for the Colombian leather industry. From 1986 to 1991, exports of leather manufactured goods had grown by an average of almost 19 percent each year. Foreign sales of shoes, handbags, and other products had more than doubled the size of the industry in that time and had brought revenues of $140 million to the men and women in that Bogota meeting room. Industry leaders were proud of their ability to compete in North America, Europe, and Asia; in 1991, Colombia was a "net exporter"exporting more leather goods to the United States than it imported.

But in 1992, exports of leather products began to fall. When this happened again in 1993, fear of economic stagnation began to spread in the industry, and people wondered: Could the future of Colombian leather be in jeopardy? The Colombians' strategy had been to offer what was until then an attractive combination of threshold-level quality and moderate price. The strategy was grounded in their basic advantages, such as inexpensive labor, low-cost, locally produced hides, and a favorable exchange rate. Relying on these basic factor advantages, manufacturers had compensated for the somewhat poorer quality of their products with lower prices. This strategy proved successful until other manufacturers, largely from China, taking advantage of labor rates far below those in Bogota, offered similar quality along with much lower prices. The Colombians had advantages such as inexpensive wage rates, but they also had the disadvantages of expensive internal transportation and rising labor costs.

China and Korea pushed Colombian brands out of one retail and mass-market channel after another. At the same time, the higher-end markets dominated by Italian leather products were out of reach. The inconsistent quality and peculiar designs of Colombian leather bags represented little threat to the dominance of Gucci or Devecchi. Moreover, what the Colombians had heard about the Italian leather industry's strength in design, manufacturing, and interfirm cooperation led them to believe that their own industry was years away from presenting any kind of a challenge to the Italians. Squeezed out of the international markets above and below them, the Colombians seemed to have nowhere to go.

At the Bogota meeting, one delegate expressed his pessimism regarding the Colombian industry: "It is clear that we must beat the Chinese or the Italians to stay in business. But my friends, I cannot use chop sticks and my tastes are not for pasta, so bankruptcy appears the only choice available to me." In his expression of ultimate frustration, this delegate had unwittingly introduced an idea that would ultimately show the Colombians the solution to their problem. This revolutionary idea? The notion of choice. Let's revisit the strategies of the Colombians, the Italians, and the Chinese and ask two questions about *strategic choices.* First, what kind of competitive advantage did firms in each of the countries pursue? Second, what approach to technology and innovation did those firms take? The answers to these questions uncover the root of the Colombians' problem.

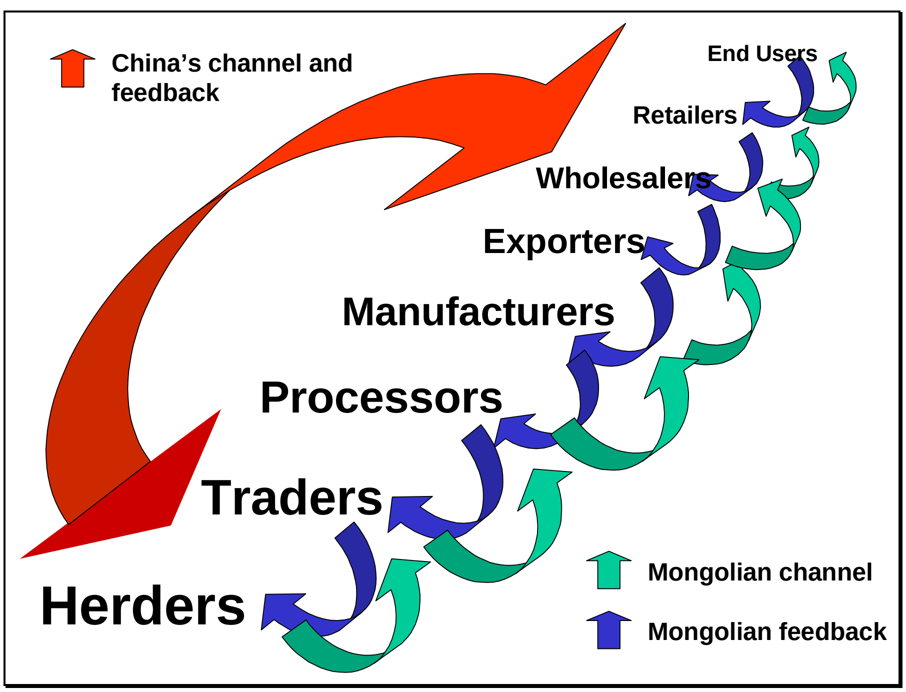
Consider first the Italians. Italian leather manufacturers benefit from two strengths in their local environment: very demanding consumers of fashion and very competent designers. Those strengths have enabled the manufacturers to develop sophisticated, high-end products that can satisfy the most demanding customers in the world. And it is these customers that they have chosen to serve.

Now consider the Chinese. With a wage rate of about one-sixth that of the Colombians (at the time of the Colombian leather sector's meeting), they hold a tremendous comparative advantage in the leather industry, and they have *chosen* to pursue a low-cost strategy while maintaining just enough design and manufacturing capability to remain at an average level of quality for the world industry. This enables them to compete very effectively for price-conscious consumers world-wide.

Now consider the Colombians again. They had made no clear choices regarding for whom they wished to compete or how best to compete. Other than relying on a historically devalued currency and inexpensive labor, they had not pursued strategies to maintain a low-cost position nor had they invested enough in design, manufacturing, or marketing technology to achieve high-quality, differentiated products. What they had done, in fact, was to cede the strategic battlefield to others like the Chinese and Italians and had thus lost their ability to determine their own market position.

Quality deterioration of Mongolian goat fiber is due to ***"failure to join forces in order to target high end market"*** and ***"poor interfirm cooperation.***

Also it looks like that bigger companies in Mongolia do not care relaying small orders to smaller companies. It my view the important thing is that the order should be kept in Mongolia so that smaller Mongolian companies get benefits out of the business.There is positive competition, and there is cut throat competition. Positive competition, as found in forward integration, means mutually beneficial cooperation. Firms that integrate and join forces to inform one another about market forces allow them to optimize their overall position, without additional investment. In China big firms such as Erdos are wholly integrated, but most are not. It is all about cooperation within the industry to help the industry to survive. And as the industry grows, so do individual firms.



To demonstrate interfirm cooperation, I have included a story concerning the Italian textile industry, in which they used this to their advantage to successfully compete against the Chinese textile industry.

Successful interfirm cooperation story from Italy

In the 1970s, the Italians faced strong competition with China, which was shifting the terms of the competition in the low-cost segments oflong-run textiles and mass-produced garments. The Italians foresaw nosustainable competitive advantage for themselves. Instead of exiting, however, the large, core textile firms redefined strategies around three elements: fashion, high quality, and flexibility. Their customers, which included the fashion houses of Milan, were some of the most sophisticated consumers of textiles in the world. The large, core manufacturers decided to make it a priority to understand those customers' needs and serve them with innovative designs, quality, consistency, and rapid delivery to market. To do that, the firms increasingly began to outsource discrete activities to smaller suppliers while maintaining coordinating functions for themselves. As a result, the small firms profited, the large firms resolved their problem, and the entire set-up worked to build needed flexibility into the industry. Moreover, the suppliers began learning about such issues as quality from the large firms. Soon those large "mother firms' became focused solely on coordinating and out-sourcing the production of garments, advertising, monitoring quality, and transferring learning. Eventually, the manufacturers' use of clusters led the Italian fashion industry to reinvent itself from being a "seeker" of demand segments to a "creator" of demand.

A popular conspiracy exists today in Mongolia's cashmere industry. "China, in its determined grab for world domination of the cashmere industry, unfairly supports its cashmere processors with Government subsidized loans and incentives. Therefore they have greater flexibility to meet market rates for raw cashmere, and increase their competitive advantage in the international readymade knitwear arena".

Developing countries like to be ***defensive*** and ***paternalistic.*** Defensiveness is usually related to a lack of information, cooperation and trust. It is the final method one would use, when there is seemingly no other choice or hope. With lack of precise information people usually make wrong conclusion based on partial inferences and inaccurate premises. I think today we witness exactly the same situation with this Chinese conspiracy.

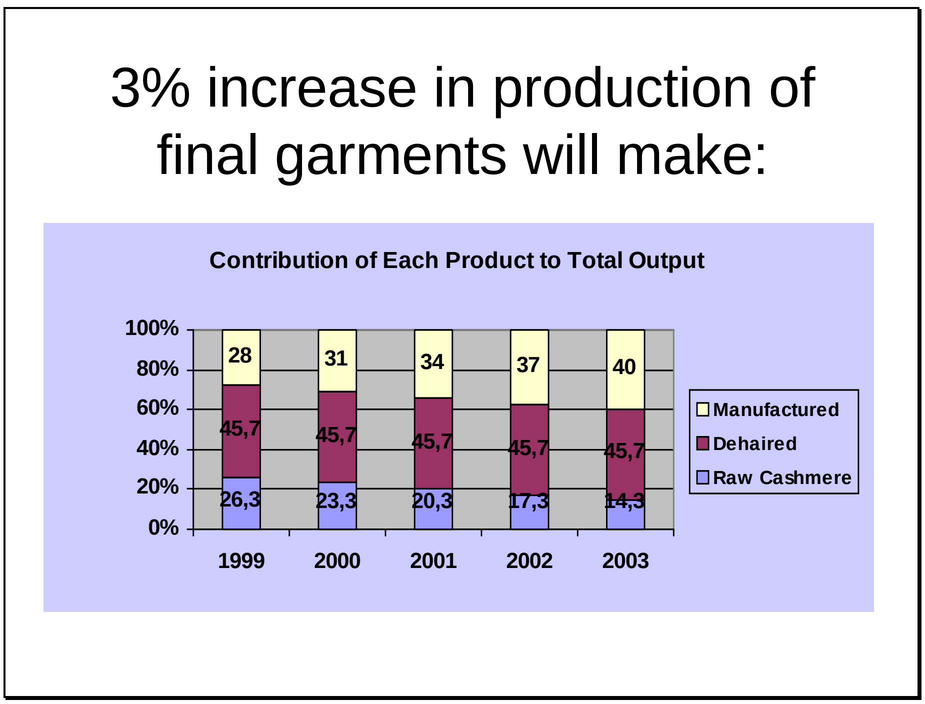
After traveling to Inner Mongolia and interviewing governmental officials and business entrepreneurs, it became clear. There is little motivation for a conspiracy theory in Inner Mongolia.

Chinese cashmere production is heavily concentrated in one region. Over 80% of Chinese cashmere is grown in the Inner Mongolian region. Therefore, the Inner Mongolian Planning Committee (IMPC) has prioritized cashmere and has provided large cashmere processors with cohesive vision, streamlined financing and governmental support to identified, strategic industries. While the cashmere industry is strategic industry, benefits are not distributed equally. According to the IMPC, only the 10 largest cashmere processors benefit from government support.

Small, independent cashmere companies in Inner Mongolia and China receive NO benefits. However, this is the standard operating condition accepted by small processors every day in China. It is encouraging to know that even without government support, small companies are healthy and thriving in China. ***In 1999 alone, approximately 2,600 small companies successfully competed with state supported large processors.***

In summary, China has no conspiracy theory targeting the demise of Mongolia's cashmere industry, and no motivation to create one. The Inner Mongolian Regional government promotes and supports industries and a handful of industry leaders that generate economic growth in their rural regions.

We estimated Mongolia's benefit of increasing raw material allocation from the export of raw, greasy cashmere to the finished ready made knit wear industry increasing ready made knitwear exports 3% a year for five years, holding the export value for semi-processed cashmere constant (washed and dehaired cashmere currently represents 45.7% of export value)[2].



This assumes that Mongolia's cashmere industry grows 10 percent a year (in line with the last three years, when annual growth rate was 14% in 1997, 10.8% in 1998, and 13% in 1999). With this Mongolia's export earnings can increase by more than USD 5 million after five years.

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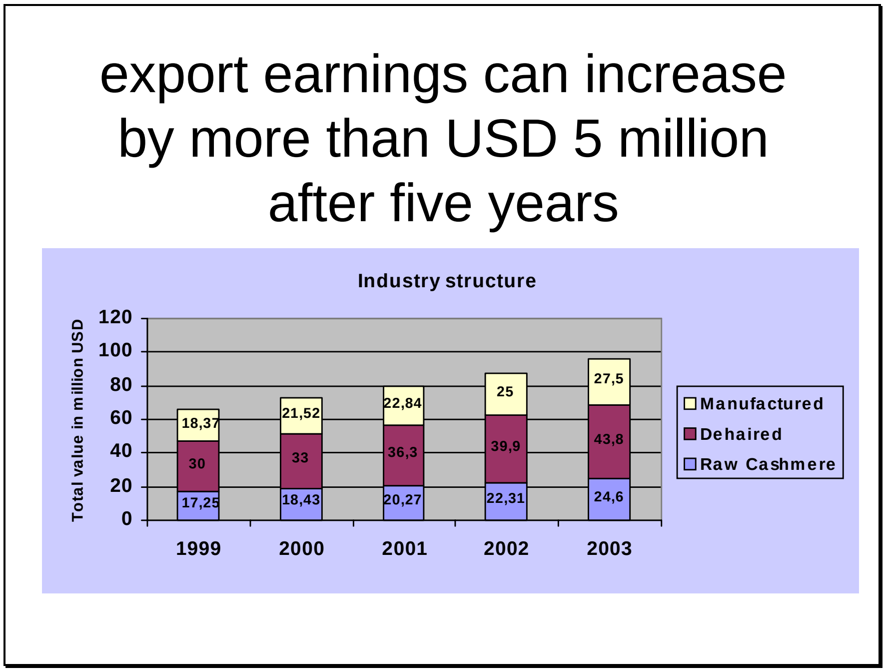
[2] Data is based on Dr. Roningen report.



With this said it is apparent that it is time for Mongolian cashmere industry, every one including herders, traders, processors and manufacturers to look beyond the local and national boundary, to exchange information, to cooperate and to commit themselves to pursue the USD 758.6 million market as opposed to current USD 18.3 million export.

Now is the time for Mongolian processors and government leaders to determine the best strategy for successfully competing against 10 state supported large processors and over 2,600 small processors that make up the cashmere's competitive set in China.

It is clear: if Mongolia continues to concentrate only on the cashmere situation within its own borders, other international players will make decisions without regard to Mongolia's future.

It is up to you now to think about the future and decide what is the best way to grab the opportunities we still may have in this competition.