The Mongolian and Chinese Cashmere Industries

International Competition and Domestic Cooperation

Mercy Corps International
Susan A. Hahn

Table of Contents

Abbreviations

Approx.	Approximately
CEO	Chief Executive Officer
CJV	Contractual Joint Venture
CSP	Cashmere Sub-Program
Cm	Centimeters
EJV	Equity Joint Venture
FEC	Foreign Export Company
FESCO	Foreign Enterprise Service Organization
FMV	Fair Market Value
FOB	Free On Board
GAAP	Generally Accepted Accounting Principles
GI	Gobi Regional Economic Growth Initiative
HPC	Hubei Planning Committee
IA	Institute of Agriculture
IAH	Institute of Animal Husbandry
IMPC	Inner Mongolian Planning Committee
JSC	Joint Stock Company
Kg	Kilogram
LLC	Limited Liability Company
MAI	Ministry of Agriculture and Industry
MF	Ministry of Finance
Mc	Micron
QC	Quality Control
RO	Representative Office
RGP	Regional Growth Plan
RR	Resident Representative
SOE	State Owned Enterprise
RMB	Chinese Yuan
RPC	Regional Planning Committee
TDB	Trade and Development Bank
TOG	Mongolian Togrog
UB	Ulaanbaatar, Mongolia
USD	U.S. Dollar
WTO	World Trade Organization
YTD	Year To Date

The Mongolian and Chinese Cashmere Industries

Executive Summary

The Mongolian cashmere industry faces two opportunities:
1. improve its domestic operating environment,
2. and improve its international competitiveness.

The best step towards improving Mongolia's domestic operating environment is for the government and the industry to create a common vision, and to support the vision by allocating resources towards its implementation.

To compete internationally, the Mongolian cashmere vision will have to identify and implement a goat-to-garment strategy based on high-end luxury and value, not price. Mongolia needs to develop and market its own niche market, one where China is unable to compete. China is and will continue to be the low cost cashmere supplier to the world. Mongolia will destroy its own cashmere market if it tries to compete with China on a low cost basis.

Chinese Cashmere Industry Overview

China's cashmere industry is heavily concentrated around Hohhot, Inner Mongolia and Qinghe, Hubei. It is estimated that well over 80% of China's cashmere is either processed or traded through these two regions. Inner Mongolia is the center for cashmere production, processing and finished knitwear production. Hubei is the center for cashmere scouring, dehairing, combing, and raw material trading.

In 1992 the Inner Mongolian Planning Committee (IMPC) targeted cashmere as a strategic industry. By 1996 large, integrated processing facilities such as King Deer and Erdos were operational and ready to export mass produced finished knitwear. The downturn in the Asian economy greatly reduced Korean and Japanese demand, leaving the industry with massive processing overcapacity (30-40%). To rectify this, the IMPC has not allowed new construction in the cashmere industry since 1998. Facility expansion has been encouraged in other industries, such as the mining of coal.

China's land reform allows farmers to own and manage their own acreage. Farmers are free to determine which commodity to produce. However, they are not free to sell or rent land for non-agricultural production, severely limiting land available for industrial expansion. In 1999 the Hubei Planning Commission (HPC) helped the cashmere industry acquire agricultural land for a new industrial park in the cashmere trading center of Qinghe. The park will provide cashmere companies with low cost rent and upgraded utilities. A new, state-of-the-art cashmere technical institute, slated for completion in 2004, will be built close to the industrial site. The technical institute will concentrate on processing and marketing cashmere fiber, and enterprise management.

Regional Planning Committees

The role of Regional Planning Committees and Regional Growth Plans must be understood to evaluate China's governmental incentive system. Every year Regional Planning Committees (RPC) create regional growth plans (RGP). RGPs are development strategies that identify a set of strategic industries unique to each geographic region, and a set of broad government incentives. Government and industry leaders cooperate to create the greatest synergy between industries and incentives. The result is measurable, strategic economic growth.

The RGP reflects the unique agricultural and industrial base of each region. RGPs in Inner Mongolia and Hubei typically include a healthy mix of cashmere, beef, mutton, dairy, timber and coal industries.

Once the RGP is approved, The Light Manufacturing and The Agricultural and Husbandry Sections of the Regional Planning Commission (RPC) oversee agricultural production and processing, and ensure implementation of the plan. The Light Manufacturing Section has authority to determine and license the location of new manufacturing sites, set maximum production capacities, and manage state financing. The Agricultural and Husbandry Section promotes agricultural improvement programs and environmental protection policies.

Transparency of Benefits

It is important to note that these benefits are available to all strategic agricultural and industrial sectors included in the RGP. However, within each sector government incentives do not benefit all firms equally, as discussed in the next section. (See Access to International Buyers.) In the case of cashmere, the IMPC supports large processors and is intent on consolidating small processors. They openly discourage small independent processors. The reason for this is clear: large processors generate more profit and provide a larger tax base for the government. Moreover, their size makes them easy to identify and monitor, making tax collection expedient.

Box 1: The IMPC extends government incentives to large processors and to a much lesser extent, small companies willing to cooperate and consolidate production. Cooperation can take many forms. For example, two independent companies manufacturing different sections of sweaters (body versus arms) can agree to finish the final seams at a third facility. Independent companies not willing to consolidate or cooperate with other facilities do not have access to these benefits. At the same time, they are not negatively affected more than any other non-strategic business in the area. It is up to the individual owner to evaluate whether he will align with the industry and receive the industry benefits, or go it alone. It is estimated that a majority of China's 2,600 independent cashmere firms generate a healthy profit, **without** the benefit of government incentives.

Government Incentives

Recent and current RGPs in Inner Mongolia and Hubei have included the following six government incentives:

1. Streamlined Access to Loans
2. Tax Rebates

3. Regional Development Spending

4. Access to International Buyers

5. Public Tender of Company Shares on the National Stock Exchange

6. Construction Approval and License

1. Streamlined Access to Loans

RPCs have the ability to expedite bank loans through the Central Bank of China. Loan approvals can take up to one year for firms in non-strategic industries. Firms in strategic industries can access credit within 2-3 months of application. This is conducted much in the same way that large Fortune 500 firms, in comparison to new enterprises, have quicker access to loan capital in the United States.

Note: As of 2/2000, all companies in Inner Mongolia, regardless of strategic importance, had access to loans with 0.5% - 1% per month interest rate, depending on the term length.

2. Tax Rebates

China's central government provides incentives to strategic industries because they provide the state with a rich source of tax revenue. China's tax policy reflects its economic development strategy. To encourage the expansion of business start-ups, very few taxes are levied on raw material procurement or on production. This allows new enterprises time to organize their operations into a profitable position before facing cumbersome tax structures. Once companies generate revenue, profit taxes are levied.

For cashmere, high profit taxes are levied on the export value of finished knitwear. Approximately 75% of the collected tax goes to the central government, and 25% goes to the RPC. Both the RPC and the central government can choose to refund a portion or the entire sum of the collected tax back to the individual firm.

3. Regional Development Spending

Instead of a direct tax refund, the central government and/or the RPC can use the tax revenue to improve the region as a whole, benefiting all industries equally. Infrastructure improvement, which increases market accessibility, is an example of a preferred regional support activity. According to *Contact China*, a business periodical published by the US & Foreign Commercial Service, China has used such funds to build approximately 3900 km of expressways during the last 3 years, with total spending reaching $26.2 Billion USD in 1998.

4. Access to International Buyers

The RPC uses firms' annual sales figures to determine which firms (within a specific strategic industry) have permission to contract with and export directly to international buyers. Smaller companies are required to market their products through Foreign Export Companies (FEC).

FECs are state-owned companies that receive international orders and distribute them to small companies to fill. In the Inner Mongolian cashmere industry, FECs have no objective criteria for selecting the recipient company. Influence, respect to the IMPC, and "cooperative spirit" help secure orders. The RPCs prioritize companies that agree to cooperate with the FECs. (See Box 1, page 2) Securing international orders can mean the difference between survival and bankruptcy for small firms.

Note: There are rumors that if international buyers contact small companies directly, they can fill the order and contact one of the Foreign Export Companies to levy the appropriate export tax. It is imperative, however, that the international buyer and not the Chinese company initiate that communication. According to the US Commercial Section of the United States Embassy in Beijing, the role of the FEC will continue to decline in upcoming years.

5. Public Tender of Company Shares on the National Stock Exchange

The RPC selects firms that are able to sell stock on the national exchange. Timely, non-interest bearing capital is a great advantage to firms. Often, non-cooperating firms in strategic sectors do not have the right to sell stock on the exchange, and must deal with a cumbersome loan application system. Small, independent firms often raise capital from friends and family, offering a share of ownership in return.

6. Construction Approval and License to Build or Expand Production Facilities

The Light Manufacturing Section has authority to determine and license the location of new manufacturing sites, maximum production capacities, and state financing. The ability to expand is managed across industries identified in the RGP. In the case of cashmere, this has constricted industry expansion in Inner Mongolia, and fostered expansion in Qinghe, Hubei. (See Overview.)

Market Data Collection

Market data collected from Chinese processors was used to compare Mongolian and Chinese operating environments. In the cost analysis, four processors were compared using the same set of assumptions.

In the exercise, the processors all engage in the washing and dehairing of cashmere, and included the following company examples. They are ranked in order of net profit. The first being the company with the greatest net profit return:

1. A Chinese processor in UB who had just established primary processing in UB and who exported washed, dehaired cashmere to China for spinning,
2. A Qinghe processor who buys cashmere from Mongolia for processing domestically in China, and takes advantage of every possible loophole,
3. A small Qinghe processors who buys cashmere from Mongolia for processing domestically in China,
4. A large, well-established, international processor whose operations had already exceed the six year tax holiday opportunity.

The cost analysis shows that if the processors use the same Mongolian fiber, at the same cost, and attain the same processing yield, then the Chinese processors have a 1% cost advantage over the Mongolian processors (see page 26). In reality, the dehairing yields for indigenous cashmere fibers are 51% in Mongolia and 35-45% in China. Chinese processors' cost of production is approximately 5% more expensive than Mongolian processors' when the cost model is completed with indigenous fibers and their relative domestic prices.

China's production costs are not significantly lower than Mongolia's costs. Using the raw, greasy cashmere price of $40 USD/Kg, similar yields and production costs, Chinese processors are able to market dehaired cashmere at $95-105 USD/Kg while Mongolian processors market fiber at $110 USD/Kg. It is the seemingly unexplainable nature of China's low cost selling strategy that fuels Mongolia based proponents of an aggressive Chinese cashmere theory. If not low cost processing, then what allows China's low-cost strategy?

China's Operating Environment

1.	Inter-Firm Cooperation
2.	Comparatively Lower Margin Expectations
3.	3-4 Year Profit Cycles
4.	Trader Volume
5.	Raw Material Blending Technology
6.	Customer Satisfaction
7.	Emergence of Mom-and-Pop Processors

1. Inter-Firm Cooperation Cashmere production is highly concentrated in poorer regions of China. In most cases, cashmere companies are the major employer in the town or district that they occupy. As such, cashmere companies assume responsibility for guaranteeing the town's livelihood. With so many livelihoods at stake, companies have developed great inter-firm cooperation. For example, Qinghe has no fully-integrated processors. Companies have divided the numerous processing steps among more than 40 small mom-and-pop companies. Firms engage in only one of the following processing steps: trading, scouring, combing and dehairing, spinning, finished knitwear, machinery repair, utility repair, or labor recruitment. Firms exchange reduced individual margins for increased volume throughputs. Each firm makes less profit, but the community as a whole benefits from lower unemployment and greater social services. In addition, as cashmere's regional importance grows, the RPC will continue to include cashmere in its RGP. This qualifies the cashmere industry's inclusion in tax rebates, regional funding, and other benefits described earlier.

2. Comparatively Lower Margin Expectations Chinese investors have a lower target margin than their Mongolian counterparts. Small Chinese companies target 6-7% margin for washed, dehaired cashmere while Mongolian companies target 20%. Western entrepreneurs invest money in order to optimize their return. They are interested in profit, and evaluate many markets simultaneously. In China, large processors are either wholly or partially state-owned enterprises. The state becomes the greatest stake holder, controlling between 49-100% of ownership. The state sees the cashmere processor as a source of tax revenue, not as part of an investment portfolio. This makes lower margins acceptable.

3. 3-4 Year Profit Cycles On average, most traders and processors make enough profit once every three years to continue doing business. This means that 67% of the time they are operating at a loss. In 1999 traders and small processors quoted 100% profit margins. If they stick to their target 6-5% annual margin, they could operate at a loss for the next two years, if not longer.

4. Trader Volume A greater number of international traders keeps domestic Chinese prices below stated market levels. Afghanistan and Iranian traders travel to Qinghe with cashmere to trade with local processors. Afghanistan cashmere is a courser cashmere than either

Mongolian or Chinese cashmere, which trades at a significant discount to Chinese cashmere.

5. Raw Material Blending Technology Raw material blending reduces raw material costs. This could be done legally or illegally, depending on the individual entrepreneur. Chinese processing technology can blend Chinese cashmere with wool, merino wool, angora, pashmina, silk, plant silk, and cashmere from Iran, Afghanistan and Mongolia.

6. Customer Satisfaction Advanced, flexible blending technology allows Chinese processors to meet buyer price points. International buyers can create cashmere blends to satisfy final consumer quality and cost requirements.

7. Emergence of Mom-and-Pop Processors The emergence of small, efficient, mom-and-pop processors are putting downward cost pressure on large integrated firms in both Mongolia and in China. Large firms are forced to compete by reducing margins. The large companies are able to compete in the short-term due to their knowledge of the international buyer base, advanced technology, and developed infrastructure. During this period they hope that their deep pockets and state alignment will insure their continued success, and drive mom-and-pop processors out of business.

Mongolia's Operating Environment

This section compares the Mongolian operating environment to the Chinese operating environment. The Chinese operating system's strength lies in the existence of a concise vision, and government/industry cooperation. These are summarized below. Remaining sections of this report expand on each of the three items in more detail.

Enablers of an Effective Operating Environment	Mongolia	China
A clear and concise industry vision is mutually agreed upon by State and Industry	Cashmere Sub-Program	RGP
The State allocates resources to create an incentive system which supports the industry vision.	MAI has identified individual events, but no vision guides the activities.	RPC aligns resources and incentives with vision. (Page 2)
The industry participates in government programs benefiting the cashmere industry. Individual companies and entrepreneurs allocate resources with the long term vision.	Industry participation limited to two State Owned Companies (SOE): The Gobi Company (100%) Mon Amical (45%)	Over 1,200 large firms and small cooperating firms participate.

A Clear Industry Strategy, Mutually Agreed Upon by State and Industry.

Equivalent to China's RGP and RPC, is Mongolia's Cashmere Sub-Program (CSP) created by the Ministry of Agriculture and Industry (MAI) in March 2000.

The CSP's goal is to "enhance the production of raw cashmere and cashmere products which meet the standard requirement, and promote its competitiveness in the world market."

This goal will be achieved by:
1. Improving goat breeds and cashmere quality (12 action steps)
2. Upgrading raw material processing standards in order to improve the quality and design of finished goods, and to increase the number of products sold (eight action steps)
3. Improving market management (6 action steps)

The CSP relies almost exclusively on the government to accomplish all activities. The key implementers of the CSP include the MAI, the Ministry of Finance (MF), the Institute of Agriculture (IA) and the Institute of Animal Husbandry (IAH), the Gobi Cashmere Company (100% SOE), the Mon Amical Cashmere Company (51% SOE). Two non-governmental organizations, The Gobi Regional Economic Growth Initiative and ACDI/Voca, are mentioned.

Evaluation:

The CSP is a very good first step towards a cashmere industry strategy. It shows government commitment, and willingness to dedicate resources. However, several decisions regarding program implementation may limit the long term effectiveness of the CSP.

First, the MAI has assumed a paternalistic role, independently identifying critical steps and actions necessary to accomplish the CSP's goal. Only four out of 21 action steps involve any outside participation. If successful, the CSP's implied paternalism may encourage long-term dependence of the cashmere industry on the government. This would reduce industry initiative and substantially burden the government budget in the long-term.

Second, the MAI excluded privately held companies from participating in the CSP design and implementation, creating a suspicious rift between Industry and Government. Left unchecked, this may undermine cooperation and limit the long term effectiveness of the CSP.

Opportunity:

The MAI can build upon the CSP to create a more competitive operating environment for Mongolian cashmere processors. The Government of Mongolia and the MAI can encourage a mutually agreed upon (state and industry), long-term, industry vision. This vision can be accomplished through the design of two complementing government and industry action plans. Responsibility for vision implementation should be actively shared and supported by all integral parties: herders, processors, traders and government.

Action steps towards creating a mutually agreed upon, long-term vision.

- Hold an Open Forum to discuss the CSP (See page 14). Allow industry leaders to understand and contribute to the development of the CSP. Encourage the sharing of ideas, which allow government leaders to fully realize the ramifications of the CSP on the cashmere sector.
- Increase industry participation to ensure future policy buy-in. The CSP currently excludes all privately held companies from participating. This exclusive list must be expanded to more closely reflect the a representative, industry mix.
- Work with the cashmere industry to identify a mutually agreed upon long-term vision. Insist that industry leaders actively participate in the development of CSP, and develop a separate industrial program that complements the CSP's activities.

- Set responsibilities, identify key implementers, state objective outcomes and their date of completion. Monitor program progress and completion by prearranging follow-up meetings and revaluation dates.

Results:
1. An industry wide vision that is mutually agreed upon by industry and government leaders.
2. Resources are allocated to support the vision.
3. Increased efficiency of resource allocation results in quicker program implementation .
4. Future policy and legislation supports the vision, is well understood and supported.
5. The CSP adopts quantifiable, objective outputs which support the vision and the industry action plan.
6. The creation of an industry action plan, designed to support the vision and compliment the CSP, ensures that both government and industry equally share responsibility for attaining the vision.
7. Increased communication brings leaders together periodically to monitor and reevaluate program effectiveness.
8. An improved internal operating environment fosters a healthy cashmere industry.

State-Allocated Resources Support the Vision.

An industry vision for the cashmere sector allows the government to effectively allocate its resources to create an incentive system which supports the vision. The cashmere industry in Mongolia is currently operating without such a vision. Past government leaders executed decisions, which affected the cashmere industry, in isolation.

The following government actions, initiated without the benefit of a guiding vision, created incentives and barriers to conducting business in Mongolia's cashmere sector that the new government will have to address. In most cases, the ability to change or enhance past actions are under the direct control of the Mongolian government. This action list represents the most expedient opportunities for government to improve the operating environment in Mongolia.

Summary of decisions and policies affecting Mongolia's cashmere industry.

Decision/Policy	Page	Intended Result	Current Reality
CSP Mandate	6	Goal: Enhance cashmere production and promote international competitiveness.	Private companies' non-inclusion in the CSP discourages industry cooperation. CSP actions lack guiding vision. Government paternalism encourages industry dependence.
Credit Access	9	Industry interest rates were greatly reduced in 2000.	Interest rates are still 10% higher than Chinese market rates.
Tax Holiday	10	Encourages international investment.	Discourages 100% wholly owned Mongolian cashmere processing facilities.
Tax Enforcement	10	Equal enforcement supports government and industry objectives.	Unequal enforcement creates an advantageous environment for small illegal processors over large, responsible processors.
QC Inspections	11	A CSP action step.	Small firms are more likely to be

		Inspect facilities for labor law compliance, and rank facilities according to technical capability.	culprits of labor law violations than large, international firms, yet 24 small firms were not inspected. Processors question its benefit to the industry. Action seen as an individual event, not as part of a larger vision.
Cashmere Specifications	11	A CSP action step. Specifications will define cashmere for export purposes.	Non-standard specifications hinders international negotiations and casts doubt on Mongolian cashmere quality in general. Reclassifying poor fiber as cashmere misdirects attention away from increasing micron problems.
Business Entry in Requirements	12	Low barriers to entry are meant to facilitate business development.	Barriers are too low to discourage less than honest businesses from entry.
Export Valuation	12	Tax revenue generation.	Non-representative FMV values overstate company profits and increase profit tax burdens.
Animal Tax	12	Tax revenue generation.	Tax is not calibrated to encourage healthy, productive flocks, or to prevent overgrazing.
Goat Skin Tax	12	Tax to protect natural resource (cashmere) for future production needs.	Tax discouraged the culling of old, non-productive animals from herds.
Government Production Awards	12	1,000 Head Herder Award nationally recognizes successful herders.	Award is based on the quantity, not the quality, of animals. This encourages overgrazing, putting increased pressure on rangelands.
Zud Relief Programs	13	Emergency relief aid for zud stricken areas.	If not monitored, may encourage marginal herders to continue operations, and may restock animal levels beyond rangeland carrying capacities.
Veterinary Services Fee Schedules	13	A transition tool to assist veterinarians during privatization.	Preset fees do not allow vets to charge market prices for services, creating a barrier between them and the free market.
Hoof & Mouth Disease	13	Border quarantine containment necessary for a 21-day period.	Prolonged containment increases delivery costs for Mongolian processors, making them uncompetitive to Chinese processors. Increased transportation costs come directly out of company profit, negatively affecting state tax revenue.
Statistical Data Collection	13	Provides accurate information to decision makers.	No incentive for accurate reporting creates misrepresentative data. Decision makers aren't able to make sound decisions.
Border Cooperation Agreement	14	Fosters cooperation between China and Mongolia.	New agreement is being signed, giving Mongolia a chance to negotiate new terms.

Pursuit of WTO arbitration	14	WTO provides trademark protection and arbitrage service at no cost to members.	Non-pursuit of arbitration in unfair trade cases makes illegal business, in comparison to legitimate business, quite "cheap".

1. Credit Access

The most improved industry incentive is the new, lower-interest loans available through the Trade and Development Bank (TDB). In the past, processors access to domestic credit resources was severely limited due to the dearth of bank loans from the struggling bank sector. This changed recently when the Trade and Development Bank, in cooperation with KFW of Germany, made lower interest loans available to the cashmere industry. Cashmere loans are subsidized in comparison to other industries in Mongolia, yet higher than domestic loans available to Chinese cashmere processors.

Loan Availability and Interest Rates

	To all Industries	To the Cashmere Industry	To all Industries	To the Cashmere Industry
	1999	1999	2000	2000
Mongolia Short-term Loan Value	 42.0% N/A	 42.0% 1,036,000 USD	 24.0-34.8% N/A	 21.6% 5,863,300 USD
Mongolia Long-term Loan Value	 7.75% 5,000,000 DM	 7.75% 3,062,077 DM	 7.75% Under Negotiation	 7.75% Under Negotiation
China	6-12%	6-12%	6-12%	6-12%

For loan portfolio details, see Appendix.

Result

- Working capital availability is greatly improved since last year. Processors are able to get short-term working capital to buy raw materials.
- Interest rates still remain uncompetitive to China, making credit and expansion plans comparatively more expensive.

2. Tax Holiday

A generous six-year profit tax holiday is extended to all new and establishing cashmere companies with foreign investment. There are two subsequent tax holidays: a 100% holiday for the first three years, and a 50% holiday for the last three years. Wholly-owned Mongolian enterprises opening a new company do not qualify for this incentive.

Result

- Wholly-owned Mongolian enterprises aren't able to compete on cost with foreign investment companies receiving the tax holiday benefit. To remain competitive, many enterprises seek joint-venture partners in China, the country of closest proximity with cashmere interests. As of 7/2000, Buyan is the only wholly-owned Mongolian dehairing facility.

3. Tax Enforcement

Taxes are a daily part of conducting business. If enforced evenly, they support government and industry objectives. If not, they create an unfair operating environment between cashmere companies operating within Mongolia's own borders. At present, taxes are not equally enforced. The large, easy to find processors are targeted more often for audits and tax collection.

Cashmere Specific Taxes	Comments
A 5% duty of in-bound raw materials.	Limits foreign fibers entering Mongolia, and prevents processors from accessing cheaper cashmere from Afghanistan and Iran.
A 13% VAT is levied on all in-bound materials, it is refundable if re-exported.	Customs officials assign a Fair Market Value (FMV) that overstates the companies' year-end profit. Trading companies shipping small volumes are less effected.
A 3% fiber surtax is levied on the herder.	With no way to collect the surtax from herders, tax collectors ask large companies to pay the tax on the herder's behalf. This tax is not collected at Tsaiz, where market trading is not recorded or monitored.
A 4,000 tog tax on every Kg of raw, greasy cashmere exported.	Customs officials do not often probe fiber bales at the border. Traders can hide cashmere in wool bales to avoid the tax.
A 1-2% handling fee is payable to the State Bank, where all foreign exchange must be cleared according to the banking laws of Mongolia.	Individual traders are not checked at the border and can bring in large amounts of cash to exchange in the informal market, thereby avoiding the State Bank fees.
A tax equal to 3% of the transaction value is payable by cashmere buyers to the tax department according to the Income Tax Law of Mongolia.	This tax is not collected at Tsaiz, where market trading is not recorded or monitored.
A 19-40% of employees salary is paid as payroll tax by large processors on behalf of their employees. (19% to income tax and 22% to social insurance.)	Individual traders have "undeterminable income" and pay 5,000 tog/year income tax. This tax is not collected at Tsaiz, where market trading is not recorded or monitored. Large processors do not pay payroll tax for
A 40% corporate income tax	This tax is high enough to encourage companies to hide profit and avoid taxes. Small companies may move frequently to avoid paying formal income taxes.

Note: Traders can enter the country on a tourist visa and conduct business operations, directly violating the terms and conditions of their visa, and allowing them to avoid all taxes.

Result

- If not taxes are not enforced evenly, large processors will carry a disproportionate percentage of the industry's tax burden. Left unchecked, this may discourage future investment in the cashmere industry.
- An unequal operating environment between Mongolian cashmere processors hinders inter-firm cooperation, making industry cooperation almost impossible.

4. Quality Control (QC) inspection of processing facilities

In May 2000, the MF, MAI, IAH, IA, and the Chamber of Commerce completed quality control inspections of dehairing and finished knitwear facilities, as outlined in the CSP. Government objectives for the inspections, and the quality criteria, were not shared in advance with processors. Only 24 out of 56 registered cashmere companies were inspected. The half which were not be located effectively escaped the QC inspection, fines, and other penalties which would discourage them from non-standard operations in the future.

Result

- Processors viewed the inspection as an individual event, and not part of a larger, well-defined strategy. As such, processors felt that the government inspections created a new opportunity for graft.
- The unequal enforcement, reflected by the inspection of easy-to-find international companies and the non-pursuit of small, illegal firms, created a rift between the large profitable processors and the government.
- It can only be assumed that the "missing" companies would fair worse in QC inspections than the large processors. If the government meant to ensure Labor Law issues such as a safe work environment, then the government needs to pursue and inspect "missing" companies and levy appropriate fines and penalties.

5. Cashmere Specifications

It has been well recognized that Mongolia needed to create and enforce a material specification for cashmere. In May 2000, new cashmere specifications were published by the MAI as outlined in the CSP. The new Mongolian cashmere specification defines cashmere as any goat fiber with micron at or under 19.0 microns. This micron criteria exceeds cashmere's international standard of 17.5 microns.

Result

- Reclassifying poor quality fiber as cashmere misdirects industry (especially herder) attention away from the real problem of increasing micron.
- A unique specification causes international buyers to question and doubt the overall quality of Mongolian fiber. In addition, a unique specification hinders and delays international negotiations.
- A unique specification that creates a broader, not narrower, definition of cashmere undermines any "Quality Label" initiatives that would be used by a promotion board to differentiate Mongolian from Chinese fiber.

6. Business Entry Requirements

Barriers to opening a Representative Office (RO) and registering processing facilities are more lenient in Mongolia than in China, see page 16. A RO in Mongolia is legally able to represent its foreign headquarters and to negotiate and execute contracts. If so desired, foreign companies can open and close ROs quickly and inexpensively, avoiding government regulations that effect the rest of Mongolia's cashmere industry.

Result:

- Barriers to entry are favorable enough to encourage foreign investment.
- Barriers to entry may not be high enough to discourage marginal entrepreneurs and companies from entering business.

7. Export Valuation by Customs

Valuation of exports should be made at Fair Market Value (FMV). It is standard practice for customs officials to assign a FMV using the contracted transaction price which accompanies the bill of lading. If the customs officials doubt the document or the transaction price, they have the right to assign a new FMV. It is standard practice to use historical importation/exportation values to revalue the product and assign a new FMV. If the owner of the product doesn't agree with the new FMV, it can be pursued in arbitration.

In Mongolia, customs officials assign FMV using the highest year-to-date sales contract. Protocol does not allow customs officials to use the highest negotiated annual contract price to determine FMV, according to Dale Wisely, Deputy Attaché at the American Embassy in Beijing. In 2000, Gobi Cashmere Company sold dehaired cashmere at a high of $120 USD/Kg. Since then, customs officials have assigned a FMV of $120 USD/Kg to all cashmere exports. The cashmere market price in 2000 has averaged $110 USD/Kg.

Result

- Inaccurate FMVs overstate revenues and profit, resulting in higher company profit taxes. Actual profit taxes paid by processors exceed 40% if this occurs, creating a barrier to profit, and wedging an even greater margin between Chinese and Mongolia profit taxes.

8. Animal Tax

The national animal tax is based on a two tiered tax system, which assigns a higher flat tax to herders with more than 250 animals. Herders with a larger portion of large to small animals (cows, horses and camel versus sheep and goats), pay an additional fee. In general, animal taxes for large herders in Dundgovi averaged $300 USD in 1999.

Result

- The graduated tax encourages underestimating herd size, negatively affecting tax revenue and national statistics collection. In addition, the tax is not calibrated to encourage a healthy, productive flock, or an appropriate number of animals per grazing area, etc.

9. Goat Skin Tax

On December 12, 1999, the government levied a 6,000 tog/skin tax of all goat skins in order to slow down the volume of goat skins traded, and to protect Mongolia's spring cashmere clip for processors. By January 10, 2000, the tax was lowered 4,500 tog/skin to 1,500 tog/skin.

Result

- The tax significantly slowed down the volume of skins traded.
- Experts estimate that old, unproductive male goats make up 35% of the Mongolian goat herd composition. High market prices for goat skins provided herders an incentive to cull their larger, older unproductive animals. The tax decreased herder profits, effectively eliminating the incentive to cull.

10. Government Production Awards

The Thousand Head Herder award is a prestigious, nationally recognized award given to herders with over 1,000 head of animals.

Result

- The award is based on the quantity, not the quality, of animals or animal products. The quantity based incentive encourages herders to expand flock size, putting increased pressure on already stressed grasslands.

11. Zud Relief Programs

Many of the Zud relief programs incorporate restocking of animals and livelihood regeneration into their plans, without taking into consideration the 2.7 fold increase in the number of herders and 2.3 fold increase in the number of goats since 1989. During the last 10 years, a lack of job opportunities forced many marginal herders to remain in the industry. Their flocks often include the most unproductive animals, pressuring already strained grasslands.

Result

- Relief programs that do not closely monitor the restocking goats in zud disaster areas can increase the number of marginal herders (and the number of goats) past sustainable levels. Programs that allow marginal herders to pursue interests other than herding will allow the number of herders to recalibrate to a more sustainable level.

12. Veterinary Services

The government determines veterinarian fee schedules.

Result

- Preset fee schedules prevent veterinarians from setting their own prices for services and medications. If liberalized, successful vets can charge prices that reflect their quality and contribution to animal improvement.

13. Hoof and Mouth Disease

China and Russia are both known to have hoof and mouth disease. With the outbreak of hoof and mouth disease in Mongolia, China has imposed quarantine containment of all animal products at the border. According to veterinarian David Sherman, washed and dehaired fiber poses no contamination risk after processing. Chinese customs intends to enforce quarantine procedures until November, a period of more than three months. Processors currently return fiber to UB and airfreight it to customers to meet contract delivery requirements. The additional airfreight is substantial at $2.60/kg.

Result

- The cost of delivering against contract is much higher in comparison to Chinese processors.
- Mongolian cashmere processors profit level decreases, and their need for working capital increases. This lowers profit tax revenues.

14. Statistical Data Collection

Processors, herders and traders have little incentive to accurately report their activities.

Result

- Inaccurate business information is collected by tax authorities and/or the National Statistics Bureau. Policy makers are devoid of accurate information on which to base their decisions. Example: if the cashmere clip is inaccurate, border enforcement statistics can be misleading.

15. Signing of the Mongolian/Chinese Border Cooperation Agreement

The 1996 Mongolian/Chinese border cooperation agreement is still in effect while the new cooperation agreement is being negotiated. Once signed the agreement will be in effect for an estimated four years, making attention to detail, and industry insight, very important.

Result

- Attention to details will ensure that Mongolia and China work out a mutually beneficial border agreement, which protects both countries from businessmen engaged in illegal trade.

16. Pursuit of WTO Support and Arbitration

WTO provides trademark protection and arbitrage service at little or no cost to its members.

Result

- In most cases when unfair Chinese trade is suspected, no industry or government leader has ever went to the WTO for arbitration.
- Non-pursuit of arbitration in unfair trade cases makes illegal business quite "cheap" in comparison to legitimate business.

Government – Industry Cooperation

For the CSP to be effective, the MAI must integrate it's activities with the industry vision and the industry's action plan. Cashmere industry leaders are eager to participate and contribute to their own success and well-being, as demonstrated by the industry turnout at the Gobi Initiative's Cashmere Summit in February 2000. The government and the MAI can utilize public notice and open hearings to improve communication, cooperation and coordination between industry and government initiatives.

Notice and Hearings

Public notice and open hearings solicit constructive comments from knowledgeable persons, which allow the drafters of legislation to fully understand the impact that proposed legislation may have on the cashmere industry, and/or effects that the legislation may have in other sectors of the economy, such as skins, hides, veterinary services, etc.

Public Notice and open hearings encourage industry buy-in. All interested parties affected by the new policy or legislation are better able to accept constraints or requirements imposed by new legislation when they are able to participate in the process themselves.

Drafters of legislation can better construct and apply legislation to attain the desired economic or political affect, when they have access to industry insight and knowledge. This will help prevent frequent legislative changes.

> Example: In April 1999, foreign investors, domestic investors, academia, international experts and donors were not given advance notice of the proposed cashmere ban. In the period of three weeks, the ban was introduced onto the floor of the parliament, where it was narrowly defeated. The speed at which the proposed ban moved through parliament suggested that legislators did not fully analyze the ban's ramifications in the cashmere and other related sectors.

With public notice and open hearings, the government can call on resources from qualified experts to assist in policy impact analysis. "Effect of a Cashmere Ban on the Cashmere Sector" by Dr. Vernon Ronigen, summarizes the effect of nine different policy tools on the Mongolian economy. The report was written to facilitate understanding and encourage deliberate analysis of policy decisions by government. With prior communications, the report could have been made available prior to the proposed legislation's entry into parliament.

Changes in law that are frequent, or that are not consolidated with changes in other relevant laws, indicate an ineffectiveness of government and reflect a lack of due diligence. Government instability encourages borderline business people to pursue illegal activates. Stability and consistent enforcement of government legislation is needed to encourage responsible business people to invest in Mongolia's cashmere sector.

Result

- Public notice and open hearings are critical prior to passing proposed legislation, and can be used to facilitate improved communication leading to a mutually agreed upon industry vision.

Border Enforcement

Current negotiation of the new Mongolian/Chinese Border Cooperation Agreement hands Mongolian government leaders' the best and most immediate opportunity to curb illegal transportation of cashmere across the Mongolian/Chinese border.

Increased control will greatly benefit the Mongolian cashmere industry. With improved border control, traders would pay Mongolian cashmere export taxes when leaving the country, creating a more desirable playing field for the Mongolian processors. According to Mr. Dale Wisely, the Deputy Attaché of the United States Embassy in China, dialogue initiated between Mongolian/ Chinese border agencies in 1996 resulted in the 1997 Border Cooperation Agreement.

Starting from 1996, improved communications benefited the Mongolian cashmere industry.

- 1998 - increased communications led to greater accuracy in collecting Mongolian production data, crucial for identifying the quantity of cashmere crossing the border.
- 1998 - Heightened border presence, reduced tariffs, and the low market value of cashmere reduced the incentive to smuggle cashmere.
- 1999 - Considerable improvement in border enforcement during cashmere combing season was provided by Mon-Amical, who donated fiber probes to help detect cashmere hidden in sheep wool bales.
- 2000 - Cashmere prices collected on both sides of the border indicate improved export tax collection. More than 75% of the prices reflect the $3.75 export tax between April 10-20 at the South Gobi border.

Fiber Color	April 10		April 17		April 20	
	Mongolian Side	Chinese Side	Mongolian Side	Chinese Side	Mongolian Side	Chinese Side
Gray	39.49-40.72	40.72-44.5	42.26-43.52	44.48-49.13	42.23-43.69	46.90-48.54
Dark	37.35-38.45	40.72-41.67	33.68-41.10	42.26-45.45	38.83-41.26	45.63-46.41

Data collected by Market Watch, a Gobi Initiative program. Prices in $ USD /Kg for raw, greasy cashmere, 16 micron.

Future benefits from improved communication among border enforcement agencies include: improved enforcement, better statistics, and sharing of violator information. One way to improve cross border relations is to increase effective communications between the two countries. Weekly informational exchanges between border employees and Chief Inspectors from both countries, held right at the border where the action occurs, facilitates the sharing of information and addresses problems and misunderstandings before they escalate.

> Similar meetings improved communications and improved cooperation between border enforcement agencies at the Mexican/U.S border near Brownsville, Texas. Increased communications, in attempt to curb illegal immigrant and drug smuggling, allowed both agencies to quickly realize that criminals have no geographic loyalty. An illegal export on one side translated into an illegal import to the other side. Sharing criminal activity records of frequent offenders resulted in increased apprehension rates, which reinforced the working relationship between the two border enforcement agencies.

Another way to increase criminal activity is for both enforcement agencies to track and monitor capital flight. It is illegal to export large values of Chinese currency. Chinese criminals create complicated capital flight schemes to offset volatile fluctuations in RMB value and/or to avoid frequent, inconsistent changes in government legislation. Capital flight may partially explain why almost half of Mongolia's 52 registered cashmere firms could not be located for the CSP's QC inspections held this past May.

> Chinese criminals use Mongolian agents to register a business in Mongolia, such as a cashmere washing and dehairing company. Registration costs are minimal at USD $1,000. The agents use false names and documents to establish the paper companies, making the criminals untraceable once the scheme is found. Then a country with stable currency valuation, such as the U.S., is selected. RMB funds are wire transferred to a bank in that country to procure capital equipment for use in the Mongolian company. Once the funds are out of the country, China cannot monitor how the funds are spent.

Business Entry

In Mongolia, most Chinese cashmere companies are registered to operate as Limited Liability Companies (LLC) and Joint Stock Companies (JSC). Foreigners starting business in China usually register as an Equity Joint Venture (EJV), a Contractual Joint Venture (CJV), or a Representative Office (RO).

Common Legal Forms and Capital Requirements

Mongolian LLC	Mongolian JSC	Mongolian RO	Chinese EJV, CJV	Chinese RO
Minimum of one person.	Minimum of 50 shareholders.	Minimum of one person.	Unknown.	Minimum of one person.
Can manufacture and process.	Can manufacture and process.	Makes contacts and can negotiate contracts	Can manufacture and process.	Makes contacts, but not negotiate contracts or take fees for service.
Approx. $10,000, 30% paid at the outset.	Approx. $30,000 in cash or capital.	None	33% of total investment.	None

While visiting Chinese cashmere companies, many stated that they had ROs in Mongolia. The reason is clear, ROs are able to negotiate contracts on behalf of their headquarters and take fees for services. King Deer has a RO and two agents that are hired to locate, contract, and export fine fiber. As an RO operating in China, these activities would be illegal and subject to penalty. In China, the foreign-based headquarters would have to negotiate and sign a contract. The RO would only execute the contract. The end effect will look the same, but the time and efficiency of contract execution is more costly in terms of time and capital resources.

In addition, although the Chinese RO is not able to contract or take fees for services, they are taxed on the value of transactions passing through their offices at 33% (30% national tax and 3% regional tax). It is unclear from preliminary research, whether the Mongolian RO is subject to tax. If falling under the standard profit tax of Mongolia, it would be subject to a 40% tax.

Penalties and Fines

From the information researched, the Chinese document clearly listed the penalties of not meeting business requirements and the enforcing agencies. The Mongolian documents did not list penalties.

- For operating without a Registration Certificate a company can be fined up to $1,300 and banned from doing future business.
- For failure to submit accurate Letter Of Activity with Registration Renewals a company will be fined $650.
- If a company fails to submit the Sponsor's approval documents to the SAID within 30 days of approval, the documents are null and void and the registration application fee of $75 is lost. The company will have to start the process over.
- For businesses dealing in "State secrets" it's representatives are personally subject to China's Criminal Code and face criminal trial. Collecting national consumer and market data can and is often investigated for State secret violations.

RO Registration Process

	Mongolia	China
Sponsorship Requirement	None. Foreign companies may solicit consulting firms to represent and assist in the procedure.	The RO must be sponsored by a Chinese company. The sponsor receives a fee to help organize and complete application process.
Sponsor's Approval Document (Pizhunshe)	None.	Application Letter, Notarized copy of a business license, Letter of creditworthiness from a bank, Personal resumes of proposed resident representatives (RR), Notarized letter of appointment to act as RR, Company's annual report.
Documents to File	Application, Company Profile, Company's bank certificate, Certified copy of permission granted by competent authorities of the foreign state (if required by laws of that	Pizhunshe and all above documents, Another letter of registration and application from the CEO, Registration application form (triplicate in English and Chinese), Registration fee of $75.

	country), Main activities, organization structure and staffing of the RO.	(Pizhunshe is null and void if not submitted within 30 days.)
Speed of Decision	10 days from receipt of application.	3-9 months from start of process.
Registration	Registration expires after 3 years, with a subsequent 2-year renewal period.	Registration expires after 3 years with a subsequent 3-year renewal period. Registration and RR certificates must be renewed annually.
Employment	RO can hire international or national staff as necessary.	RO can hire international staff as necessary. Local professionals must be hired through a government monopoly agency in charge of supplying Chinese employees to RO offices of foreign corporations. Registration of local employees with FESCO is mandatory.

FESCO: Foreign Enterprise Service Organization.

Note: Information explaining requirements of Chinese investors starting cashmere production facilities in China was not available through the US & Foreign Commercial Service in Beijing during the consultant period. This information is critical in understanding barriers to entry facing Chinese entrepreneurs as they evaluate new business opportunities in China and Mongolia. It can assist the Government of Mongolia in redesigning appropriate business entry requirements, if necessary.

Access to Credit

KFW of Germany

In 1999, the KFW of Germany extended 5 MM DM each to the Trade & Development Bank (TDB) and the IT Bank for long-term loan extension. In 1999, The TDB lent 1.6 DM to the cashmere industry, and the rest was evenly split between the manufacturing of meat (carcass/slaughter), construction/furniture (Ochin), beverages, sausage/ham, and a printing house. The IT Bank went under conservatership, and the loans were not extended.

Long term loans of 8-year maturity are lent to encourage capital investment. KFW loans money to two industries per industrial sector per year. In 1999, over 1 MM DM was lent to the Buyan and Mana companies. Although not a formal requirement, all long term financing in 1999 involved the procurement of German technical equipment. Conversations are underway to determine the feasibility of loan capital for the Year 2000. Loan capital is negotiated annually between the KFW & TDB, and implemented by the TDB. KFW reserves the right of final approval before capital is extended.

Trade & Development Bank

TDB is dedicated to supporting the cashmere industry, and is able to extend short-term loans to individual firms at values that are equal to or less than 20% of its capital portfolio.

In 1999 loans were set at market rates, approx. 3.5% per mo. According to the TDB, the cashmere industry is known for it's poor management, and late repayment. In 2000, loans were set at 1.8% per month, roughly are 0.2% - 1.1% per mo. below market rates, to encourage on-time repayment. The TDB said it is too early to know if subsidized interest rates will encourage on-time repayment.

Cashmere Loan Portfolio, *according to B. Medree, CEO of Trade & Development Bank*

	Short Term - TDB 12 mo. loans @ 3.5% per mo. 42% per year Loans at market rate	Long Term - KFW of Germany 8 yr. loans @ 0.646% per mo. 7.75 % per year
1999	1,036,000,000 Tog	3,062,077 DM

	Short Term Trade & Development Bank 12 mo. loans @ 1.8% per mo. 21.6% per year Loan Market rates: 2.0% for hard currency 2.9% for tog loans	Long Term KFW Bank (German) 8 yr. loans @ 0.646% per mo. 7.75% per year Discussions TBD Fall 2000
2000	5,863,300,000 Tog	To Be Determined

TDB has loan capital available for additional loans in 2000. No applications under review as of 7/7/00.
In 2000, almost all short-term loans went to fund raw fiber procurement.

Appendix

Topic 1.
Factors negatively affecting (Chinese) investor satisfaction in Mongolia:

- Poor and unstable workforce.
- Contract promises not kept (time, quantity, quality, price).
- Inefficient output of workers. Workers do not work efficiently and are not reliable. Although paid more than Chinese and Madagascar employees, output was lower.
- Unprofessional and unaccountable local management. Drinking on the job is common.
- Workers and managers were unappreciative of their jobs and salaries. King Deer's Madagascar workers outperformed Mongolian workers for diligence, quality output and timeliness.
- Lack of customer service to interested investors, on all fronts.
- Mongolian government regulation was acceptable, but more bureaucratic than necessary.

Topic 2.
Evaluation criteria of foreign investors:

- Inexpensive labor.
- A system to avoid Chinese quotas.
- Tax incentives.
- Transit: less than 30 days to a major export port.
- Acceptable cashmere supply available. Mongolian cashmere has an undesirable purple hue. There is not enough true white.
- Cheap raw material prices.

Topic 3.
How to improve Mongolia's cashmere industry
Advice from government and industry leaders.

- Turn a raw material advantage into an economic advantage.
- Mongolia owes its success to raw cashmere availability. Mongolian cashmere is finer than Iran's cashmere. This benefit is lost if cashmere micron exceeds 16 microns.
- Invest a lot of money, time and training into technology. Trade technology for training with valued partners.
- Protect designs by creating value-added, ready make knitwear that is technically difficult to copy.
- Brand name labeling creates product popularity and drives growth. A successful brand name must have high, guaranteed quality and satisfaction and be advertised in international markets overseas.
- Control your raw material quality and watch costs.
- Never allow uncontrolled growth. Solid leadership and clear long-term vision creates pragmatic expansion of business resulting in success.
- Concentrate on the segment of the market that determines values for the entire supply chain: finished ready-made knitwear.
- Obtain the highest technology in the world and train workers to operate it.
- Understand your buyers' requirements and exceed them.
- Understand and provide good service and a high quality product. Guarantee work and product quality.

- Expand consumer market share every year. (Erdos anticipates 5% annual increase over the next 3 years.)
- To develop the cashmere sector, the industry must develop state-of-the-art-processing technology and keep it in-country.
- The raw material is a natural advantage, but the most profitable market is the international ready-made knitwear market.

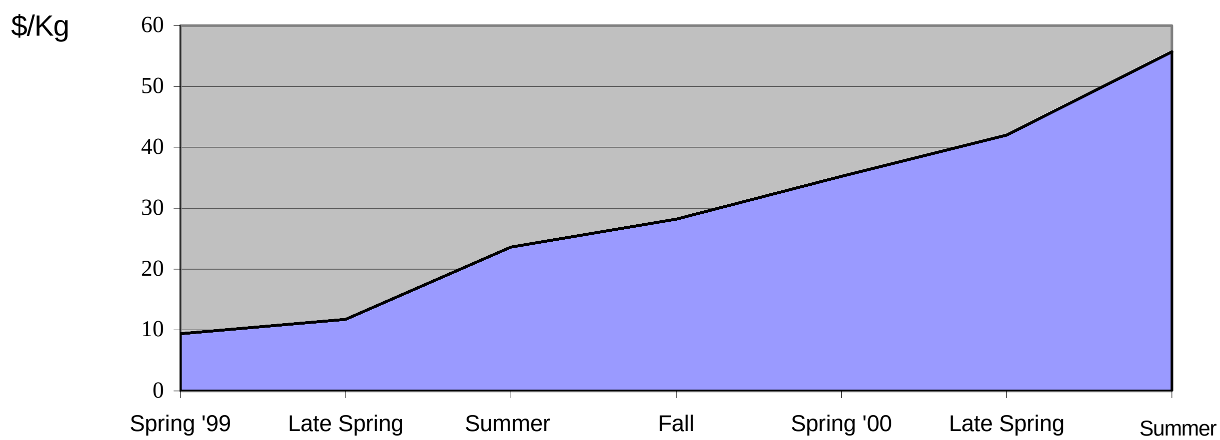
Market Values

All prices quoted in U.S. Dollars, fob Qinghe as of 6/2000, unless otherwise noted.

Raw, Greasy Cashmere
Spring 1999 prices opened between $9.41/Kg and $11.76/Kg. In autumn the price flattened out to $23.53/Kg, peaking at $28.23/Kg for a short 2-week period. Prices opened at $35.25/kg during new crop, March 2000. Chinese and Mongolian cashmere traded parallel, both reaching $42/kg early May, 2000. Prices diverged at the end of May, as the outbreak of hoof and mouth disease in Mongolia and China restricted imports of animal products, including cashmere. Chinese prices escalated to approximately $55.69/kg for fine white (15 mc 36 cm) cashmere and $42/kg (white, 15 mc, 26cm) as of the middle of June, 2000. Processors expect these prices to hold until autumn. (Exchange at $1USD=8.08 RMB)

All large Chinese processors stated that the high raw material prices wouldn't prevent them from securing raw product. All agreed that the international, ready-made knitwear market drives the price for all intermediate cashmere sectors, and that most raw material cost increases can be passed on in new finished knitwear contracts.

Chinese Cashmere Prices
1999-2000 YTD



Finished Knitwear Market
Consumer price sensitivity provides the only upper limit to escalating cashmere prices. Today's raw cashmere market puts knitwear production costs at the upper end of consumer acceptability. International demand drops sharply when finished knitwear exceeds $0.17/gram. The increasing cost of raw cashmere leads China's oldest cashmere processing facility, Snow Lotus, to expect prices to increase and consumer demand to soften in autumn 2000. Large processors in both

countries meet among themselves in the autumn to discuss prices for the next fashion year production.

Priced in standard industry units.

Buyer demand	Finished knitwear, cents/gram	China's internal production cost for average women's sweater, 350 grams
Orders increase in volume	13-15	$49.00
Orders hold constant	16-17	$57.75
Orders decrease significantly in volume	18-20	$66.50

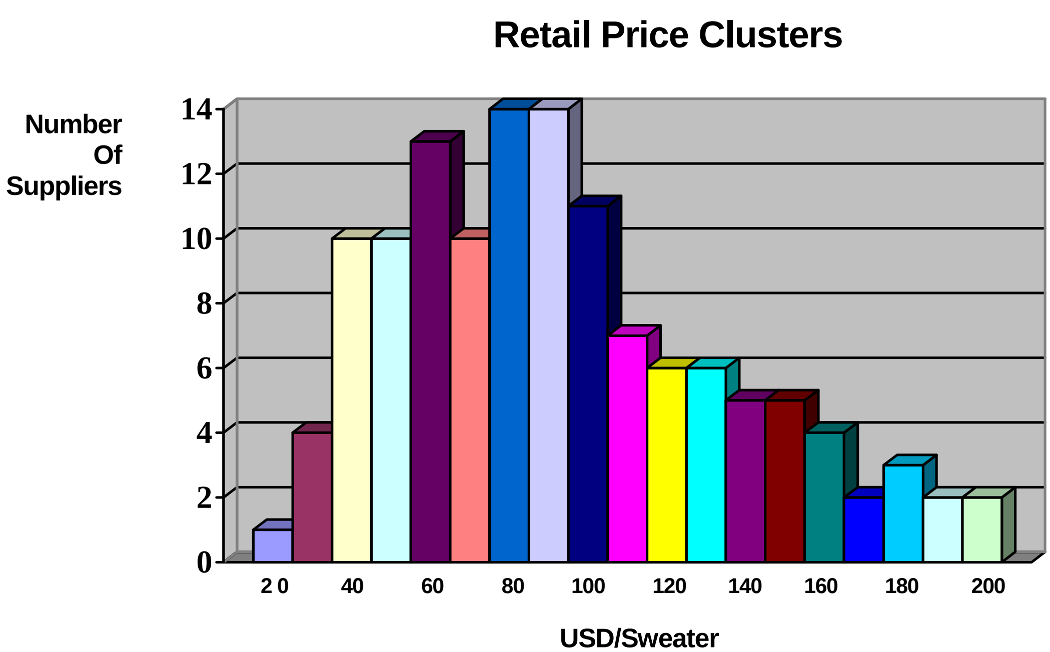
- Current Chinese knitwear production averages $0.14 +$0.03 (quota) = $0.17/gram.
- Chinese processors estimate Madagascar and Mongolian production at $0.13-0.15/gram (YR2000).

Values differ, due to raw material costs, overhead and technology. Values range from $0.14-$0.15 gram for large state owned companies like Snow Lotus (Beijing), and from $0.13-$0.15 for small mom-and-pop firms (Qinghe and Beijing). A $0.03/gram quota is added for U.S. orders.

Retail Price Clusters

Twenty-two of the largest finished knitwear processors were surveyed in two retail markets in Hohhot and Beijing. Prices were collected in February and June, 2000. Prices did not appear to increase during that period.

Domestic sales prices are most heavily concentrated between $80-90 USD per sweater. If international retail margins apply, processors' manufacturing sales costs to retailers is 50% of the final sales price of the product, or about $40-45 USD/sweater. If sold at 13% margin, processor average profit ranges from $4-5 USD/sweater. Large department stores and knitwear processors have state ownership, making it difficult to determine if preferential pricing occurs. Promotional price discounts ranged between 30%-51% on higher-end cashmere sweaters. Low end retail prices were not discounted. All labels clearly listed cashmere blends.



Retail department store prices of the 17 largest processors.

Prices in USD/unit.

Hohhot, Inner Mongolia, February 2000

Company	Sweater	Scarf	Pant	Skirt
Erdos	82 – 106	28		
King Deer	82 – 106	28		
Mongol King	45 – 101	8-9		
Merguan Yangrong Jingin	56 – 68	19 – 34		
Brgal	82 – 94			
Zhao Jun	106 – 139		35 – 94	38
Zhao Xing	106 – 125			
Alpas	86-208			
Viction	84 – 162			
Meng Sheng	41 – 104			
Aerjili	39 – 151			
Elite	24 – 32			
Yslanya	47 – 94			
King Warrior	62 – 73		56	
Pangu	35 – 94			
Bixuerong Cashmere Co	80 – 82			
Rong Ba	NA – sells through private outlets only			

- *Erdos blankets were $353 - $494 each.*
- *Department store sales prices were discounted between 30% - 47% of the original value for Mongol King and 48% - 51% for King Warrior.*

RMB- Friendship Store, Beijing, June 2000

Company	Sweater	Shawl	Pant	Vest	Coat
Erdos	47-86	107			
King Deer	39	159			
Jyoyn	48-115	110			
Pringle	183				
Zhenbei	97;134-245		56	78	347;531-642
Tujuang	67:97-161		85	94	
Digao	66				
Silk Market	5-74	22;100;161			

- *Blends listed on all labels. Each label had its distinct retail area in the state Friendship Store.*
- *All clerks agreed that King/Deer/Pringle had the highest quality.*
- *Erdos retail stores now sell Erdos labeled cotton, silk, silk/cashmere and pure cashmere products.*
- *Silk Market shawls are discounted between 45-65%, depending on individual negotiation skills.*

Cashmere Production
10,000 tons of cashmere is produced in China. 8,000 tons comes from the Inner Mongolian region. 2,000 tons comes from other Chinese regions.

Cashmere Margin Targets, generic
Dehaired 6-7%
Yarn 12-13%
Middle men trade finished knitwear for a 1-2 cent margin for every 15-17 cent per gram sold.
Retail 100%+

Machinery
New Wool Carding Machine: 50,000 RMB (Approx. $6,200 USD)
Old Wool Carding Machine: 20,000-30,000 RMB (Approx. $2,500- 3,700 USD)
New Processing Plant, est. (Yarn and Finished knitwear) 40 MM RMB (Approx. $5MM USD)
New Processing Plant, est. (carding machines + capital to buy cashmere) $300,000 USD

Processing Yields
Raw, greasy to washed, dehaired: 35-45%
Dehaired to yarn: 98%

Wages
$55.70/mo, unskilled labor
$75.00/mo textile skilled labor
Textile Wages can range from $61.00-$100/mo elsewhere in China.

Camel Hair
The market for female camel hair, dehaired, has remained flat for the past three years at $22.30/kg. There is no value for camel hair waste.

Cost Analysis

Author's Note: Prices used in the cost analysis were provided by processors and traders in Inner Mongolia and Hubei. There is no objective, third party publication of cost data for comparison. It is difficult to confirm if Chinese processors use Generally Accepted Accounting Principles (GAAP). If they don't, they could eliminate standard costs from their pricing structure. (E.g.: No recognition of insurance, inventory carrying-cost, time-value of money, sales cost, etc.) If GAAP standards are not recognized, their processing costs could be lower than indicated in the analysis.

Assumptions: All processors use the same yield Mongolian cashmere fiber for processing washed and dehaired fiber. The UB Processor in column one, page 26, has been in operations more than one, year and no longer has the tax holiday. They are forced to airfreight product to their clients (Hoof & Mouth). All other freight is by a 13-ton container. Interest rates are averaged at 6% a year for companies with access to Chinese credit, and 12% for companies with access to international credit.

Washed, Dehaired Cashmere USD/Kg	UB Processor Foreign Investment No Tax holiday	Qinghe Processor	UB Processor Chinese New Company	Qinghe Processor Non law abiding
Procured Cost	40.00	40.00	40.00	40.00
Greasy fiber Tax @ 3%	1.20			
Insurance & Misc @ 1%	0.40	0.40	0.40	0.40
Procurement & Sorting Expenses	1.00	0.50	0.50	0.50
Freight to Mongolian Border		0.20		0.20
Fiber Export Tax @4000 tg		3.81		
Freight to Qinghe		0.20		0.20
Greasy Fiber Sub Total	42.60	45.11	40.90	41.30
Sorting Yield	99%	99%	99%	99%
Sorted Cost	43.03	45.57	41.31	41.72
Scouring Cost per greasy kg	0.60	0.60	0.60	0.60
Scouring Yield	75%	75%	75%	75%
Scoured Cost	58.17	61.55	55.88	56.42
dehairing Yield	67%	67%	67%	67%
Dehaired Material Cost	86.83	91.87	83.41	84.21
Manufacturing Overhead per Kg	5.00	3.00	3.00	2.50
Subsidized Occupancy		-0.56		-0.56
Dehaired Cost	91.83	94.31	86.41	86.15
Less Waste Credit	-0.35	-0.35	-0.35	-0.35
Net Cost of 1 Kg dh cashmere	91.48	93.96	86.06	85.80
Interest	5.51	2.35	2.15	2.15
dehaired Cost, Incl. interest	96.99	96.31	88.21	87.95
Sales Price Europe	110.00	105.00	105.00	105.00
Marketing Fees @ 2%	2.20	2.10	2.10	2.10
Freight to Customer	2.60	0.53	0.53	0.53
Sales Financing - 60 day terms	2.20	0.88	0.88	0.88
Cost of Sales	96.99	96.31	88.21	87.95
Income Before Taxes	6.01	5.18	13.28	13.54
Taxes	40%	30%	0%	10%
After Tax Profit	3.61	3.63	13.28	12.19
Tax Rebate - 50%		0.71		
Net Profit, per dehaired Kg	3.61	4.34	13.28	12.19
After Tax Return on Investment	3.28%	4.13%	12.65%	11.61%

Contacts, Resources and Site Visits

B. Medree, CEO Trade & Developmnet Bank, Ulaanbaatar, Mongolia

Z. Purevnyam – Assistant President, Erdos Mongolia Cashmere Products Co., Ltd, Ulaanbaatar, Mongolia

E. Tuul - General Manager, Tevkhen Co. Ltd, Ulaanbaatar, Mongolia

Ch. Gantsetseg – Director, Rong Ba, Ulaanbaatar, Mongolia

John Napoleoni - CFO, Forte Cashmere Company, Ulaanbaatar, Mongolia

Ronnie Lamb - President, Mon Amical, Ulaanbaatar, Mongolia

Li Chun He – Chairman, Agricultural and Husbandry Section of Inner Mongolian Planning Commission

Mr. Mun Chun Lee – Administrative Officer, the Chancellery of Inner Mongolian Planning Commission Gao Jin Hu – Department Head of Light Manufacturing, Agricultural and Husbandry Section of Inner Mongolian Planning Commission

Soyolt – Department Head of Agriculture and Animal Husbandry, Agricultural and Husbandry Section of Inner Mongolian Planning Commission

Wang Ping – The Office of the Inner Mongolian People's Association for Friendship with Foreign Countries, The Division of Sister City of the Inner Mongolia Foreign Affairs Office

Mr. Gao, Director of Operations, Erdos Cashmere Group, Dong Sheng, Inner Mongolia

Mrs. Lucy Xin Shing – Public Relations Coordinator, Erdos Cashmere Group, Dong Sheng, Inner Mongolia

Ms. Z. Purevnyam - Assistant President, Erdos Cashmere Group, Ulaanbaatar, Mongolia

Mr. Nasanmonkh - Import/Export Manager, Erdos Cashmere Group, Ulaanbaatar, Mongolia

Ms. Maijargal, Operations Manager, Chono Trade, Ulaanbaatar, Mongolia

E. Tuul - General Manager, Edelweis Cashmere Company, Ulaanbaatar, Mongolia

Chi. Gantsetseg – General Manager, Rong Ba Cashmere Company, Ulaanbaatar, Mongolia

Enkhsaikhan – Private Entrepreneur. Ulaanbaatar, Mongolia

Tsogt - Inner Mongolian Entrepreneur. Hohhot, Inner Mongolia

Liu Hong – Manager Director of Opreations and Senior Engineer, King Deer Cashmere Group Company, Baotou, Inner Mongolia.

Si Qin Da Lai (Tsetsendalai) – Assistant to the Manager Director, King Deer Cashmere Group Company, Baotou, Inner Mongolia.

Yan Shou Zhi – Vice General Manager and Senior Economist, King Deer Cashmere Group Company, Baotou, Inner Mongolia.

Mrs. Li Shu Fang - Operations Manager, Jin Da De, Hohhot, Inner Mongolia

Liu Li Zhong - General Manager, Forte Cashmere Company, Inc. Beijing, China

Zhou Guo Jiang - Secretary, Qinghe County Committee of the Communist Party of China, Qinghe, China

Liu Li-xiang - Owner and General Manager, Huixing Cashmere Products Co, Ltd, Quinghe, China

Feng Zi Hong - Owner and Manager, Qinghe Animal-By Products Ltd. Shenzhen Hongxia Trade Co. Quinghe, China

Xu Po - Engineer in Chief, Snow Lotus Cashmere Co. Ltd, Beijing, China

Cari Enar - Economic Section, American Embassy, Beijing, China

Dale Wisely - Deputy Attache, American Embassy, Beijing, China

Resources

Doing Business in Mongolia, Mongolian Business Developmnet Agency, 1999

Special Topic Report: Establishment of a Representative Office, US & Foreign Commercial Service, Beijing, China.

Cashmere "Sub-Program", Ministry of Agriculture, May 2000

Cashmere Industry Outlook, Trade and Development Bank, June 2000

Obstacles to Doing Business, Chairman of the Working Group to the AMBG headed by Maurice Lynch, March 1998, December 1998, August 1999,

Cashmere Summit, Gobi Regional Economic Growth Initiative, April 2000

The Impact of a Mongolian Ban on the Exports of Raw Cashmere, Dr. Vernon Roningen, Gobi Regional Economic Growth Initiative, August 1999

Recommended Action to Improve Cashmere, Stephen D. Vance and Susan Hahn, Gobi Regional Economic Growth Initiative, January 2000

Consultant Site Visits

Inner Mongolia, China	March-April 2000
Qinghe, China	June 2000