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The Role of Foreign Investment in Ethiopia's Leather Value Chain: Lessons for Ghana

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INTRODUCTION

In this policy brief, we report on work by Brautigam, McMillan and Tang (2012) who study the impact of foreign investment on Ethiopia's leather value chain. The goal is to draw policy lessons for Ghana and other African countries. While it is true that Ghana is comparatively more developed than Ethiopia, it is also true that like Ethiopia, Ghana's manufacturing sector is underdeveloped. And in both countries (as in much of Africa), there is significant potential for developing agribusiness through foreign investment.

In Ethiopia, significant potential lies in the leather value chain. Ethiopia is home to one of the largest livestock populations in the world and Ethiopian goat and sheepskins are known for their superior quality. Yet Ethiopia's share in world trade of leather and leather products is tiny. For example, in 2010, Chinese exports of leather products were estimated at US$8.3 billion while Ethiopian exports were estimated at only US$3.7 million. Formal Chinese firms employed almost 3 million workers, while Ethiopia's formal firms employed a mere 7,600 workers. It is not surprising that the Ethiopian government has been actively involved in the promotion of industrialization in the leather value chain.

To promote indigenous manufacturing, the Ethiopian government has generally not allowed foreign investment in tanneries (up to crust level) or in the marketing of hides and skins. However, because local tanneries were not advanced enough to process up to the crust level, the government suspended the ban on new foreign investment in tanneries for several years. As a result of relaxing these controls, Ethiopia has seen a significant increase in foreign investment in leather processing and manufacturing since 2004. At the same time, the government initiated a series of programs to support informal shoemakers. Finally, past and current regimes have implemented a series of trade policies such as export bans and taxes targeted at keeping raw hides in the country for processing. Notably, government policy to date has focused almost exclusively on leather processing. Very little attention has been paid to upgrading and commercializing the livestock sector.

In order to better understand the impact of foreign investment in Ethiopia's leather industry, we conducted a census of all formal firms currently active in the leather value chain. The last significant surveys of firms in the Ethiopian leather industry of Ethiopia took place, as far as we can tell, took place in 2005, but did not include firms established after 2003 (Sonobe et al. 2009). We began with Asian-owned firms. Using snowball techniques, we moved from the Asian firms to their Ethiopian (and non-Ethiopian) contacts in the leather cluster, which included subcontractors, suppliers, buyers, and trainers. We also interviewed all foreign-owned firms, asking about their Asian linkages. Subsequently, through semi-structured interviews and focus groups with Ethiopian officials and industry associations, we asked about proactive efforts, if any, by Ethiopians to engage Asian factory owners and learn from Asian practices through field visits and investment promotion tours. We were able to interview all of the foreign firms in the leather industry and 20 of the 26 domestic firms. We did not survey livestock owners or small shoemakers because, for the first portion of the study, the focus was on firms in the formal sector.

RESULTS: LEATHER PROCESSING

As a whole, the Ethiopian leather processing industry (by which we primarily mean tanneries) experienced substantial investment by foreigners. As opposed to the manufacturing sector, foreign investment in the tanning sector produced complaints about foreign competition and its crowding-out effect, which was linked to familiar problems like limited access to credit, lower-grade technology, and inferior resulting quality. Firms also criticized Ethiopian government policy for hampering their ability to export unprocessed leather.

All four of the Chinese tanneries surveyed—as well as two Indian tanneries—that decided to invest in Ethiopia had bought leather from local Ethiopian tanneries for between 7 to 14 years prior to investing. Each Asian firm reported that their primary reason for investing in Ethiopia was to secure their leather supply. Chinese companies also mentioned that the leather supply short age in China had driven them to invest overseas, whereas Indian investors did not feel such a pressing domestic supply shortage. There were differences between Chinese and Indian firms in implementation. Chinese companies were quick in setting up working factories: the period between their investment decision and the beginning of operations was on average between 2 and 3 years. By contrast, even though one Indian company had planned to invest 5 years ago, it increased buying and then began construction only 18 months ago and will not start full operations until 2013, a full 7 years after it began plans to invest. Another major Indian buyer, the gargantuan Tata Group, delayed its investment plan due to uncertainty over Ethiopian government policy.

In terms of actual operations, there were episodes of discord between Asian and Ethiopian firms. For example, Ethiopian firms blamed two Chinese tanneries for aggressive purchasing of Ethiopian raw sheep skins that led to substantial price increases—the local market price of sheepskins skyrocketed by 430 percent from 20 to 106 birr per piece. However, the extent to which this can be blamed on Chinese purchases is not clear. Many believe that Ethiopian traders control the market for raw hides. The extent to which they manipulate prices is unclear. Chinese firms may have been more able to afford the higher prices. Though such claims have yet to be substantiated by more formal proof, they are emblematic of the rocky relationship foreign leather processors have had with local Ethiopian competitors.

Overall personnel movement between Ethiopian and Asian rivals was modest. In the private sector, there was some evidence of training—through trading relationships, 4 of the 11 Ethiopian companies had hired Indian experts or had received technical assistance from Indian partners. While several European investors in Ethiopia had brought in Chinese experts, not one Ethiopian firm had done so, for as of yet unknown reasons. Yet one prominent Ethiopian executive commented that although his main competition was Chinese (both tanneries and shoe manufacturers), these firms had brought skilled and experienced workers into the industry. “Eventually we will be the beneficiaries as that expertise will come to us,” he said, “but that will take time.”

Each of the three Indian companies interviewed reported that they had sent technicians to local tanneries to provide long-term technical support. No Chinese company had done likewise. On the government side, Ethiopia’s Leather Industry Development Institute (LIDI) partnered in 2011 with the Central Leather Research Institute (CLRI) and the Footwear Design and Development Institute (FDDI), two Indian government institutions, to improve its technological knowledge of the leather industry. In this exchange, each of 11 Ethiopian tanneries hosted three or four Indian leather experts for 1 year to help improve industrial practices. However, the overall results of this initiative were mixed—although several companies considered the experience very positive, some tanneries viewed the time period as too short, and others reported that the Indian experts imparted only abstract management techniques rather than the sought-after technical knowledge that could be applied to future practices.

There is also evidence of technology transfer. European firms in Ethiopia are getting substantial technology transfer via China; this is being transferred to Ethiopia, even if it is not Ethiopian-owned firms. In addition, all the trainers from India constitute substantial technology transfer. At least one Ethiopian firm we interviewed told us that he took a team to China to visit factories there, and will be sending personnel to China for training (in Tata’s plant in Ghangzhou). In addition, Friendship Tannery was also planning to bring raw leather and wet blue from other parts of Africa for processing in their tannery. They have six tanneries producing up to wet blue in Somaliland, Sudan, Mali, Algeria and Côte d’Ivoire). They have interns from the Ethiopian Leather Institute, and they have sent Ethiopian Engineers, operators, and production managers to their operations in Somaliland and Sudan, which is transferring technology from China and Ethiopia to elsewhere in Africa.

Though some Ethiopians imported a small number of machines from India or China, the local companies by and large imported their machinery mainly from Italy, Germany, and the United Kingdom, as they questioned the quality and reliability of the Asian machines. The tanneries sourced the basic processing chemicals locally and imported most of the specialty chemicals from Europe, as the target European leather market has strict environmental standards and requirements regarding the origin of leather production.

Ethiopian government policies to encourage value-added processing pushed companies to upgrade from wet blue to crust by 2008 and from crust to finished leather by 2011. Larger foreign companies—two Chinese, one Sino-Italian, and one British—responded quickly by directly upgrading their machinery to export finished leather. Small-and medium-size local tanneries were the most affected by the policies: 45 percent (5 of 11) of the interviewed local tanneries stopped exporting or greatly reduced their export due to the new policy. Such tanneries then started selling semi-processed leather to other tanneries in order to survive, but they sought to buy machinery (mainly from Italy) to upgrade, as they did not want to be dependent on local partners. However, buyers reported that the standard of finished leather in Ethiopia was still low due to the lack of adequate facilities, worker skills, and suppliers. The exported skins needed to undergo further processing in China, India, and the United Kingdom to meet customer requirements.

Even though trade patterns have reflected the weight of growing Asian countries (primarily China), Italy is still by far the largest importer of Ethiopian leather. Even though China's total imports from Ethiopia rose 120 percent over the course of 6 years from US$12.5 million in 2005 to US$27.5 million in 2011—Italy's rose by 82 percent in the same period from US$21.7 million in 2005 to US$39.4 million in 2011. (The United Kingdom and India ranked third and fourth, respectively, as destinations for Ethiopian processed leather).

This is because Italy is still in many ways the heavyweight in the world leather industry. Italy excels at adding value to the leather chain. Its production, for example, is dominated by expensive handbags, worth €1.8 billion (US$2.33 billion). Along with a distant second-place France, Italy accounts for 77% of the leather production value of the entire European Union. And because Italy does not produce enough hides domestically and has strict environmental regulations that prohibitively raise domestic tanning costs, it is a large worldwide importer of cheap raw or processed hides, to which Ethiopia's growing leather processing industry contributes.[1]

In the future, however, there are plans for continued expansion of foreign leather processing firms in the Ethiopian industrial landscape. The PHISS Company of China, an international leather trading and production giant, invested US$8.3 million in Ethiopia in its Friendship Tannery project. The Friendship Tannery is primarily a 40,000 square meter regional processing center 83km from Addis Ababa that will process leather for export from Mali, Sudan, Côte d'Ivoire, Somaliland, and other African countries where it already operates goatskin and sheepskin facilities.[2] It also includes a local tannery with a soaking capacity of 15,000 hides and skins per day. Friendship Tannery has announced that it will create 600 permanent and high-paying jobs.[3]

Three other Chinese firms and two other Indian tanneries have also explored building facilities in Ethiopia, but these plans have not yet materialized, as these investors had concerns about the Ethiopian investment environment and the ability of Ethiopian factories and workers to produce leather that conforms to international quality standards.

MANUFACTURING OF LEATHER PRODUCTS

Two important examples of Asian manufacturing investment in Ethiopia showcase different approaches Asian firms have taken as regards investing in Ethiopia. These firms are China's Huajian Group and Hong Kong's New Wing Group. Both shoemakers worked on fulfilling American and European Original Equipment Manufacturing (OEM) orders, so 100 percent of their Ethiopian-made products will be exported. Moreover, these firms produce only women's shoes, while local firms focus almost exclusively on men's shoes. New Wing's leather sourcing depended more on local supply, and the company planned to establish its own tannery for refining processing. While Huajian also planned to build a tannery, it imported 70 percent of its leather supply. Existing Chinese tanneries in Ethiopia do not supply leather to leather product factories in Ethiopia because the Ethiopian government assesses their tax incentives based on the proportion of processed leather exports.

China's Huajian Group built a factory 35km from Addis Ababa (and the city's associated manufacturing knowledge base) in the Sino-Ethiopia Economic Cooperation Zone and began operations only 4 months after its president visited Ethiopia for the first time in September 2011. The Chinese managers trained Ethiopian staff, most of whom were newly graduated college and high school students, and sent 86 Ethiopians to China for 2 months of training in November 2011. By July 2012, Huajian was employing over 1,000 workers, of whom 800 were locals and 200 were Chinese, mainly in supervisory positions. It has signed a memorandum of understanding with the China-Africa Development Fund (CADF) to invest US$2 billion to build a shoe production base in Addis Ababa over the next 5 years. Huajian also plans to send another 300 workers from outside the company to China for training and to teach shoemaking skills as part of its Corporate Social Responsibility program.

On the other hand, New Wing, which is based in Hong Kong but has two production bases in mainland China, bought an Ethiopian tanning factory in May 2011 and began operations in September 2011 after having previously outsourced this part of operations to Anbessa, a local firm. It hired its workers from nearby factories and did not bring outside instructors (except an Italian technician to help install machinery) to train workers. By July 2012, New Wing employed 300 Ethiopians. Though some New Wing workers shared Chinese industrial techniques with colleagues from previous jobs, New Wing had so far had little impact on the productivity of existing Ethiopian leather manufacturing companies.

There are thus clear differences between the two firms. Cheap labor was discovered to be the main reason for Huajian's investment, as the company's 24,000 workers in China earn on average US$300–450 per month, while average Ethiopian salaries are only US$35 per month. Huajian entered Ethiopia at a relatively large scale, and quite rapidly, at a time when local supplies of quality skins and hides were already tight. They were unable to source all of their raw materials locally, and thus at the time of our research, 6 months after they had started production, they were still importing70 percent of their leather supply. Their deci-

[1] www.cbi.nl/?pag=85&doc=585&typ=mid_document
[2] www.phiss.com/?page_id=156
[3] www.leathermag.com/news/fullstory.php/aid/14672/Friendship_Tannery_to_open_in_April_.html

sion to hire graduates of LIDI and to undertake the expense of bringing them to China for further training was an investment in the future of a skilled Ethiopian staff. Their location 35 km from Addis Ababa and plan to build a leather products focused industrial zone close to Ethiopia's principal leather-making cluster will create opportunities for technology spillovers to local firms.

New Wing, on the other hand, is a smaller firm, and is able to source most of its leather from inside Ethiopia. Rather than hiring unskilled workers and training them in China, New Wing "poached" some of its skilled workers from other firms; this was a source of some resentment locally.

There are also international non-Asian players working to develop the Ethiopian leather manufacturing industry. A British tannery with factories in China and a tannery in Ethiopia established a glove-making factory in Ethiopia and used a team of Chinese trainers supplied by their Chinese agent to teach advanced production skills to Ethiopian workers. The Chinese agent was making plans to shift his own Chinese glove factories to Ethiopia in order to take advantage of Ethiopia's low labor cost. In addition, a German glove maker brought technicians from its branch in China to train Ethiopians in their factory in Gondar.

In all cases, these investments are very new. At present, there is little integration between Chinese and local firms. There are no examples of local firms that hired Chinese advisors or employees. An Ethiopian government program supplied Indian advisers to domestic formal sector firms, and some domestic firms have solicited technical assistance from Indian experts on their own. An important research question for the medium term will be the extent to which Asian (Chinese)knowhow—the raw technical and industrial knowledge that powered Chinese firms to be among the most competitive leather manufacturing and processing companies in the world—will be diffused to Ethiopian-owned companies.

European companies in Ethiopia are already availing themselves of this Chinese knowledge through their own agency, made easier because, with agents and factories in China already, their search costs are very low. Their experience and that of Huajian illustrate that the training and skills offered by Chinese firms can be highly relevant for Ethiopian conditions. At present, Ethiopian firms appear to prefer familiar partners from Europe. They clearly value the quality of machinery and skills from Italy, for example. As Chinese firms are extremely new investors, the future trajectory of their technology spillovers is not yet known.

At present, the market for leather products is sharply segmented, with large foreign firms focused solely on exports, large Ethiopian firms focused on a mixture of exports and the local market, and small Ethiopian firms focused solely on the local market. These three types of firms meet in the market for Ethiopian skins and hides. Smaller Ethiopian shoe factories lacking modern skills and technology are likely to be challenged by larger firms, including foreigners, increasingly set up new productive branches and compete more intensely for Ethiopian hides.

WHAT HAVE WE LEARNED?

Government policy can attract foreign direct investment in manufacturing in Africa

While the industry is still in its nascent stages, it is clear that the change in government policy was successful in attracting foreign direct investment in the processing of raw hides and in the manufacturing of leather products. The majority of investors in leather processing are from China and India, while the majority of firms in shoe manufacturing are from Europe. However, the two largest shoe manufacturers are from China. These findings are important because manufacturing firms have the potential to provide well-paid employment for large numbers of people with minimal training. They are also important because they illustrate the diversity of Chinese investment in Africa, not simply natural resources and infrastructure, but manufacturing.

Like trade, FDI often entails winners and losers

Information collected in interviews with firms suggests that the Ethiopian government's policies targeted at fostering local processing have met with some success albeit at the expense of Ethiopian firms. In particular, foreign firms with better access to capital and machinery have been able to respond more quickly than local firms to the government's attempts to upgrade the value of leather exports. At the same time, investment and exports have increased, jobs have been created, and there is some evidence of technology upgrading. There are also benefits that have so far not been documented. For example, the increase in the price of raw hides is a benefit to sellers of raw hides. As noted, the leather sector is in a nascent stage, and to fully evaluate the impact of foreign investment, it will be important to follow these firms over time. However, by anticipating such impacts, governments can decide whether or not it makes sense to compensate losers. For example, the government of Ethiopia liberalized the market for foreign investment and simultaneously put in place a number of programs to support small-scale shoe manufacturing.

Surveys are essential

Foreign investment has already had some impact on local firms and the Ethiopian economy as a whole. But if planned investments are realized, the future impact of foreign firms is likely to be much greater. However, very little information about the operations of these firms has been officially recorded. Because the projects are in their infancy and because of plans for expansion by foreign investors, the government of Ethiopia has a unique opportunity to track these firms over time in order to monitor their engagement with the local economy. To identify the impact of foreign firms on local firms in the industry, it will also be important to simultaneously collect information about local firms. This type of information could be used to target industrial policy and dispel myths. If this is not done, the risk is that Ethiopians become discouraged and outright hostile to foreign investors. Ultimately this could reduce the attractiveness of Ethiopia as a destination for foreign investment.

At the same time, the importance of the raw material suppliers must not be overlooked. There is evidence that at least one large Chinese shoe manufacturer had to import 70 percent of its raw hides to manufacture shoes. There is also anecdotal evidence that traders have monopsony power in the raw hide market. There is almost no official information about these actors in the leather value chain. To assess the full impact of foreign investment, this side of the market must be taken into account.

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