

Exporting and Upgrading in South African Leather Industries

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Foreword

The Industrial Restructuring Project (IRP) was initiated at the beginning of 1996 as the KwaZulu-Natal Industrial Restructuring Project (KZN IRP). The project initially focused exclusively on KwaZulu-Natal, but is now aimed at supporting industrial policy in South Africa at the national, provincial and local levels. It is facilitated by international experts and is based at the School of Development Studies, University of Natal Durban. The project has two important features. Firstly, it focuses on critical issues that are impacting on the competitiveness of manufacturing sectors that are under threat from increased international competition and the liberalisation of the South African trade regime. Secondly, it is action-oriented in design. The findings that have been generated have, for example, been presented to numerous industry stakeholders, including government, business associations and trade unions. The project consequently has the support of various regional and national stakeholders.

This particular report/working paper has arisen out of both new research and the cumulative knowledge that has been generated from previous studies. These cover a number of IRP reports, working papers, journal articles and conference papers. Some of the themes covered include South Africa's manufacturing competitiveness, the automotive industry, the clothing and textiles sectors, footwear, middle-management capacity, human resource development, institutional support for industrial restructuring, and business services for manufacturing competitiveness.

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I would also like to thank the 20 firms along with key stakeholders that agreed to participate in this research.

The views expressed herein are, of course, solely mine and as a result all responsibility for its content lies with me alone.

Richard Ballard
15/11/2002

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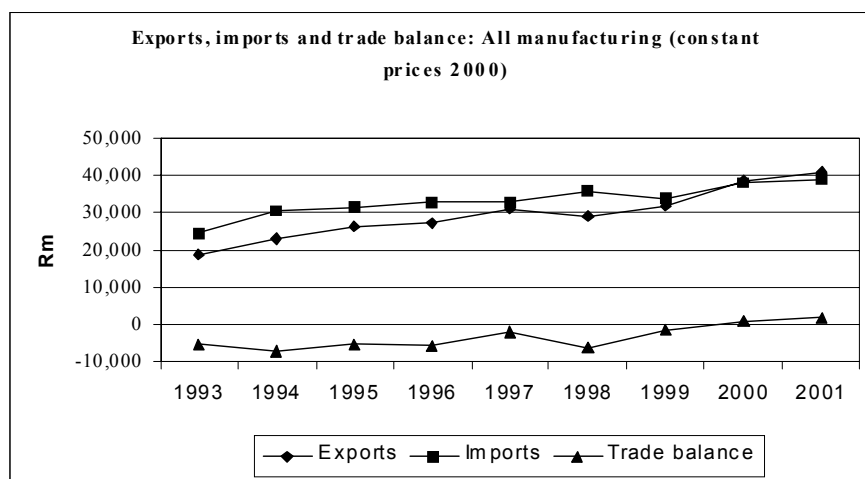
1 Preface: Introduction to the Research Programme

Raphie Kaplinsky & Mike Morris

The past two decades have seen a growing homogenisation of economic policy as the Washington Consensus has swept through the global economy. South Africa has not been immune to this shift in the policy agenda, particularly in the post apartheid era, manifested primarily through a new trade regime, with the gradual reduction in import tariffs,¹ and a reduction in the exceptionally large tariff dispersion.

There have been a number of important and related consequences to this changing trade regime. The increasing exposure of domestic firms to international competition (particularly in the industrial sector), has forced producers to face new and more intense forms of competition. “World Class Manufacturing” has forced itself onto the agenda and sets the standards for industrial restructuring. As a consequence of this restructuring, productivity has grown, albeit with a substantial fall in employment.² But, as domestic demand remained muted and as production competence grew, so South Africa’s manufacturing trade balance moved into the black on the back of rapid growth in manufactured exports. Significantly, for the first time in decades, exports exceed imports in 2001 (Figure 1), providing evidence of the growing exposure of South African producers to global standards of competitiveness, as well as to growing production competence. If sustained, this positive trade balance has the possibility of easing the foreign exchange gap constraining South Africa’s growth performance.

Figure 1



¹ Between 1994 and 1996 the weighted average of import tariffs halved from 14 to 7 percent, and then stabilised at 5 percent after 1998.

² Using the DTI data base, as a rough indicator of productivity growth, manufacturing sales per worker rose (in real terms) by 38 percent (1993 – 2001). Although an imperfect indicator (value added per worker would be better but the data is unavailable), it does suggest a significant rise in labour productivity. There is no equivalent useful data to measure either capital or total factor productivity. During the same period, employment fell by 11 percent.

From the policy perspective, the key challenge is to provide both a general policy framework and a range of specific inputs which consolidate this growth in competitive capabilities. This fourth phase of the Industrial Restructuring Research Project aims to assist the building of sectoral policy implementation capacity within DTI by providing insights into those factors promoting international competitiveness (and exporting) in manufacturing. We focus on four value chains – two consumer goods products (clothing, furniture) and two intermediate goods products (auto components and leather). Loosely, they respectively group into buyer driven value chains and producer driven value chains.

The specific focus of this research programme is *to better understand the dynamics of exporting firms*. By focusing on the most successful exporting firms in each of the four value chains, (and in nominated sub-sectors), the study hopes to determine:

- ❑ what the characteristics are of successful exporting firms and the value chains in which they participate;
- ❑ whether successful South African exporters are locked into virtuous or vicious circles of global specialisation;
- ❑ to what extent exporting firms are able to change their positions in their value chains by *upgrading* their operations through a greater input of knowledge-intensive activities.

1.1 The Virtues of Exporting

Based on the successful experience of both first- and second-tier newly industrialising economies, a new orthodoxy has grown on the virtue of exporting (see, for example, the World Bank's 1993 study of East Asian economic success). This posits benefits arising both for the economy as a whole, and for the corporate sector.

From the *economy-wide perspective*, it is argued that exporting provides the capacity to specialise in areas of comparative advantage. The previous import-substituting regime meant that economies were insufficiently focused on what they could do best with resources being put into activities which were unlikely to add to real GDP over time (or to do so at high opportunity cost). A second virtue of growing exports is a positive trade balance which provides the resources to promote rapid overall economic growth. And, thirdly, growing foreign demand (especially for labour-intensive products which are the comparative advantage of low-income economies) creates employment. This latter point is especially attractive for South Africa where the unemployment rate is so high that no conceivable increase in domestic demand would have much impact on reducing the rate of unemployment.

From the *firms-perspective*, growing exports offers a number of advantages. First, it allows the firm to specialise in those activities where it clearly holds a comparative advantage. Allied to this, the large volumes which can be sold on global markets makes it possible for the firm to reap economies of scale, not just in production but also possibly in design, marketing and logistics. Further, when exporting is accompanied by a competitive exchange rate, it may provide greater profits than when products are sold in the domestic market. And, finally, exposure to more demanding customers forces the

firm to upgrade its products and processes and is thus a transmission belt for enhanced learning.

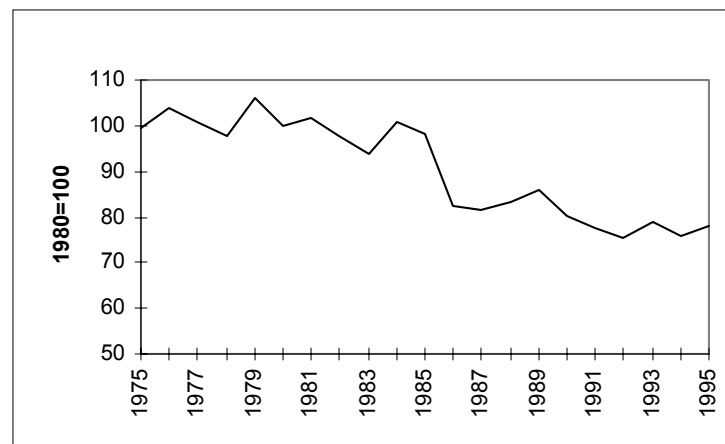
For all these reasons there is a growing orthodoxy on the benefits to be reaped from greater exporting.

1.2 Exporting and the conferring of benefits

But does exporting always confer benefits to producers? It is widely known that primary commodity prices as a whole have been characterised by falling terms of trade; as well as extreme price volatility. For this reason economic policy in many countries has concentrated on encouraging a transition from the production and export of primary products to the production and export of manufactures.

And yet, in recent decades this policy objective has become increasingly questionable. For it is no longer true that manufactured exports benefit from rising terms of trade. In particular, whilst the manufactured exports of the high income developed market economies have indeed continued to rise, those from developing countries have begun to fall. As can be seen from Figure 2, in the decade after the mid 1980s (when China becomes an increasingly active participant in global trade), the terms of trade of developing country manufactured exports fell consistently, and by more than 20 percent. This arises directly as a result of the competitive pressures which resulted from China's growing presence in manufacturing exports.

Figure 2: Price of developing country manufactured exports relative to developed market economy manufactured exports of machinery, transport equipment and services



Source: Wood 1997.

Beyond this aggregate picture, the scale of price decline was not limited to a global environment unrelated to the activities of South African firms. As Box 1 shows, many of the products produced and exported by South African manufacturers have shown an alarming fall in price. In the furniture sector, the only thing which has kept South African firms solvent has been the falling exchange rate (Box 2).

Exporting *per se* may not necessarily be a good thing; it all depends on the nature of what is being exported. In the worst case, when exports experience significant and sustained declining terms of trade, immiserising growth may occur. In other words, there

is an increase in the scale of economic activity – more resources are used – but this results in a decline in absolute living standards. A less severe, but still troubling outcome is when the resultant growth rate is positive, but at sub-optimal levels. In other words, had the resources being utilised to increase exports been used in a different manner, then the outcome would have been more beneficial to income growth.

Box 1: Falling prices in South African manufactured export sectors

Global manufactured export prices of products traded by apparel firms

- ❑ The global price of chinos (in US\$) fell by 25 percent between 1997 and 2000
- ❑ During 2000, the price paid by importers of men's dress suits into the UK fell from £60 to £53
- ❑ Poplin shirts imported from the Far East fell in price from \$2.30 to \$2.00 in the 18 months ending in May 2001.

South African manufactured unit export prices

- ❑ The unit price of tanned sheep leather fell from \$32.19/kg in 1995 to \$6.58/kg in 2000
- ❑ The unit price of car leather seats fell from \$60.19/kg in 1995 to \$28.72 in 2000
- ❑ The unit price of leather shoes fell from \$11.29/pair in 1995 to \$9.56/pair in 2000 and of non-leather shoes from \$4.49/pair in 1995 to \$3.02/pair in 2000

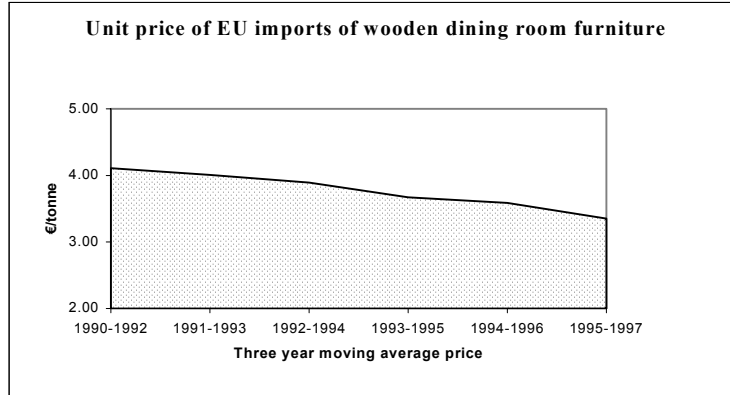
(Source: Kaplinsky, Morris and Readman (2001).)

The blunt policy prescription arising from this is that it is not so much a matter of whether South African manufacturers should be induced to export, but what they export. If they are locked into the production and export of products exhibiting a sustained and significant decline in prices (without a concomitant decline in production costs), then the outcome will be deleterious.

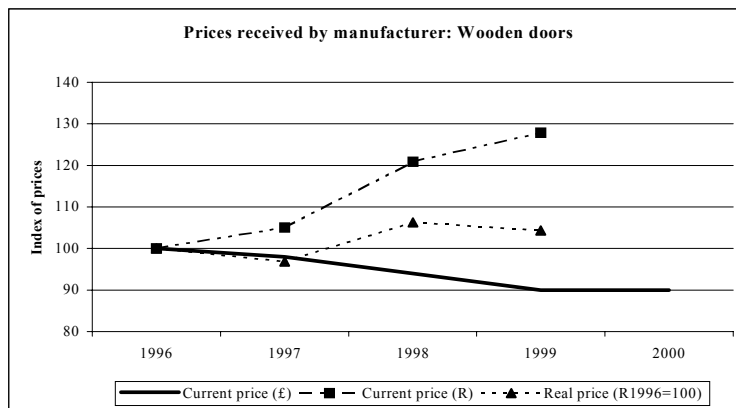
So, what determines whether firms are locked into these harmful export niches? The answer is the extent of competition which exists in each of these market segments. Unless firms find some way of escaping these competitive pressures – which, as we have seen, from the perspective of developing countries have been severely heightened by China's entry into global markets – they will not prosper. How do they avoid these competitive markets? By developing the capacity to upgrade. This is now increasingly recognised as the challenge facing industrial policy throughout the global economy, influencing not just national strategies, but corporate strategies as well.

Box 2: Falling global prices in the wooden furniture sector are extremely dangerous when producers are unable to upgrade

Growing competition in the wood furniture sector is having a major impact on the wood furniture industry. At an aggregate level, global prices are falling, as can be seen in the case of EU imports during the 1990s.



For some developing country producers who are locked into the commodity segments of this market (pine dining room furniture), the fall in prices can be very significant. For example, the Sterling prices of bunk beds and kitchen furniture received by two South African exporters of kitchen doors fell significantly, by more than 20% in four years. As can be seen, the only factor saving this manufacturer of doors was the falling exchange rate, which devalued by more than the rate of inflation in this sector. Although this may have saved the wooden furniture manufacturer, the upshot of devaluation for the economy as a whole is a fall in the international purchasing power of domestic value added.



Kaplinsky and Morris (2001)

1.3 A Value Chain Perspective on Upgrading

How would we know if firms had managed to upgrade their activities? Two schools of thought have addressed this issue in recent years. The first has focused on core

competences (Hamel and Prahalad, 1994). The thinking here is that firms need to examine their capabilities to determine those of its attributes which:

- provide value to the final customer
- are relatively unique in the sense that few competitors possess them
- are difficult to copy, that is where there are barriers to entry.

The capacity to innovate therefore arises from concentration in these competences and the concomitant outsourcing of those functions which do not meet these three criteria. A useful supplement to this line of thinking is that in a dynamic world, core competences can easily become core-rigidities (Leonard-Barton, 1995), and part of the task of upgrading is to relinquish areas of past expertise.

Closely related is a school of thought focusing on dynamic capabilities (Teece and Pisano, 1994). It argues that corporate profitability in the long run cannot be sustained by control over the market (for example, through using quasi-monopolistic practices), but through the development of dynamic capabilities which arise as a result of its:

- internal *processes* which facilitate learning, including the capacity to reconfigure what the firm has done in the past
- *position*, that is its access to specific competences either within its own activities, or those which are drawn from the regional or national system of innovation
- *path*, that is, its trajectory, because change is always path-dependent.

Both of these related concepts provide an important backdrop for understanding the phenomenon of upgrading. They are especially helpful in understanding the factors both driving and facilitating improvements in product and processes which arise from the activities of the firm itself. But they are also weak because they stop at the level of the firm, and fail to capture upgrading processes which are systemic in nature and which involves groups of firms linked together in value chains. This is particularly damaging for the core competences approach which explicitly neglects the chain through its normative conclusion that upgrading almost always involves outsourcing.

Consequently, we need to view the upgrading challenge in a wider perspective, capturing the central idea that it may involve changes in the nature and mix of activities, both within each link in the chain, and in the distribution of intra-chain activities. This relates both to the achievement of new product and process development, and in the functional reconfiguration of who does what in the chain as a whole. It is thus possible to identify four trajectories which firms can adopt in pursuing the objective of upgrading, namely:

- **Process upgrading:** increasing the efficiency of internal processes such that these are significantly better than those of rivals, both within individual links in the chain (for example, increased inventory turns, lower scrap), and between the links in the chain (for example, more frequent, smaller and on-time deliveries)
- **Product upgrading:** introducing new products or improving old products faster than rivals. This involves changing new product development processes both within individual links in the value chain and in the relationship between different chain links
- **Functional upgrading:** increasing value added by changing the mix of activities conducted within the firm (for example, taking responsibility for, or outsourcing

accounting, logistics and quality functions) or moving the locus of activities to different links in the value chain (for example from manufacturing to design)

- **Chain upgrading:** moving to a new value chain (for example, Taiwanese firms moved from the manufacture of transistor radios to calculators, to TVs, to computer monitors, to laptops and now to WAP phones)

1.4 General Methodological Issues

The four value chain/sectoral studies have adopted a broad common methodological approach combining macro and micro data, utilising quantitative and qualitative sources. This general methodology has been adapted in each of the sectoral studies to cover the specificity of conditions in each of the separate sectors, as well as the need to disaggregate each sector into the various sub-sectors which exhibit the greatest exporting propensity. Furthermore each study differs with respect to the number of exporting sub-sectors, as well as the number of firms interviewed.

The macro data covers two data sets. The first provides a birds-eye, sectoral view of production, value added, employment and factor productivities in each of the broad sectors in which the specific researched value chains operate. This provides a broad sectoral background in which to view the behaviour of the researched chains. This data is drawn from a variety of data-bases, including those held by the DTI, the IDC and TIPS.

The second set of macro data focuses on South African export performance in each of the researched chains, but at a high level of disaggregation. Specifically, it focuses on the nature of export performance in the three major buying markets, Europe, the USA and Japan. Three sets of detailed analysis have been undertaken:

- The growth of South African exports in each of these markets over the past decade
- The share of South African producers in each of these markets
- The performance of South African exports in relation to unit prices.

Unlike the sectoral data, where we have drawn on established data bases, we have undertaken detailed original analysis to produce this data, involving extensive analysis of import trends in each of these three major consuming markets.

In this respect the macro analysis is particularly useful for gaining a comparative perspective on export performance in regard to efficiency and upgrading trends in each of the sectors. The link as to whether exporting may be leading these sectors into an upgrading path or immiserising growth is investigated through broad unit price and market share movement. The following table provides a framework for understanding these relationships.

Table 1: A framework for understanding the analysis of South Africa's export performance

Unit Price	Market Share	Possible Interpretation
↑	↑	Good indication that sector is moving into more quality products for which customers are willing to pay more, and they are successfully managing to increase their shares in this higher value market
↑	↓	Unlikely that upgrading is occurring. More likely explanation is that our sector is unable to produce the product competitively and is thus likely to be on a downward path in terms of market share
↓	↑	Possibility that process upgrading may have occurred which has resulted in production costs reducing so that the product is able to be sold at a lower unit price while still reaping a profit, and this price reduction has led to an increase in the market share
↓	↓	The sector is likely to be on a 'race to the bottom' where unit prices are being bidded down by strong competition, profit is negligible and despite this market share is still being lost because other firms are offering even lower prices

However, useful as this macro analysis is, its primary function is to provide the framework for asking more detailed questions of process and trajectory, and this is the subject matter of the micro-level studies. They raise a number of issues and potential hypotheses which are investigated more fully through the firm level micro analysis.

The micro data analysis was based on firm level interviews with the most significant exporters in the most important exporting sub-sectors. In each case we aimed to interview the five leading exporters in each chain within each of the main exporting sub-sectors. The actual number of firms interviewed differs in each study depending on the characteristics of the disaggregation into various sub-sectors. Our rationale for this sampling procedure is that we are aiming to understand the upgrading benefits (if any) accruing to major exporting firms as a consequence of their export activity.

The micro level data collected from the firms was both quantitative and qualitative. Each firm was visited and key personnel were interviewed using a structured qualitative interview schedule. In addition a quantitative questionnaire was left behind for the firm to fill in and fax back to the researchers. Numerous follow up calls were made to attempt to elicit a reasonable response rate.

The firm level interviews and questionnaire were designed to allow the researchers to investigate some of the issues thrown up by the macro data analysis. The intention was to elicit responses in regard to exporting trends, whether learning from exporting was taking place, what the efficiency and skill levels were, how they were changing in response to export demands, how firms were responding to raised technical demands from foreign customers, and finally whether process, product and functional upgrading was occurring.

The micro data collection was also designed to lay the basis for understanding the various value chains operating in these sectors, and identify the driving forces governing these value chains. From the perspective of exporting firms it was important to identify the provision of access within these chains, how standards are set, how conformance to standards occurred, what room for manoeuvre exists with respect to changing roles and

function, and finally whether exporting firms were locked into value chains which were locked into immiserising trajectories.

In addition the firm level interviews were intended to yield rich qualitative information a host of issues acting as 'enablers' and 'blockers' for exporting firms, and hence feed into any policy recommendations for the DTI in its role of export facilitation.

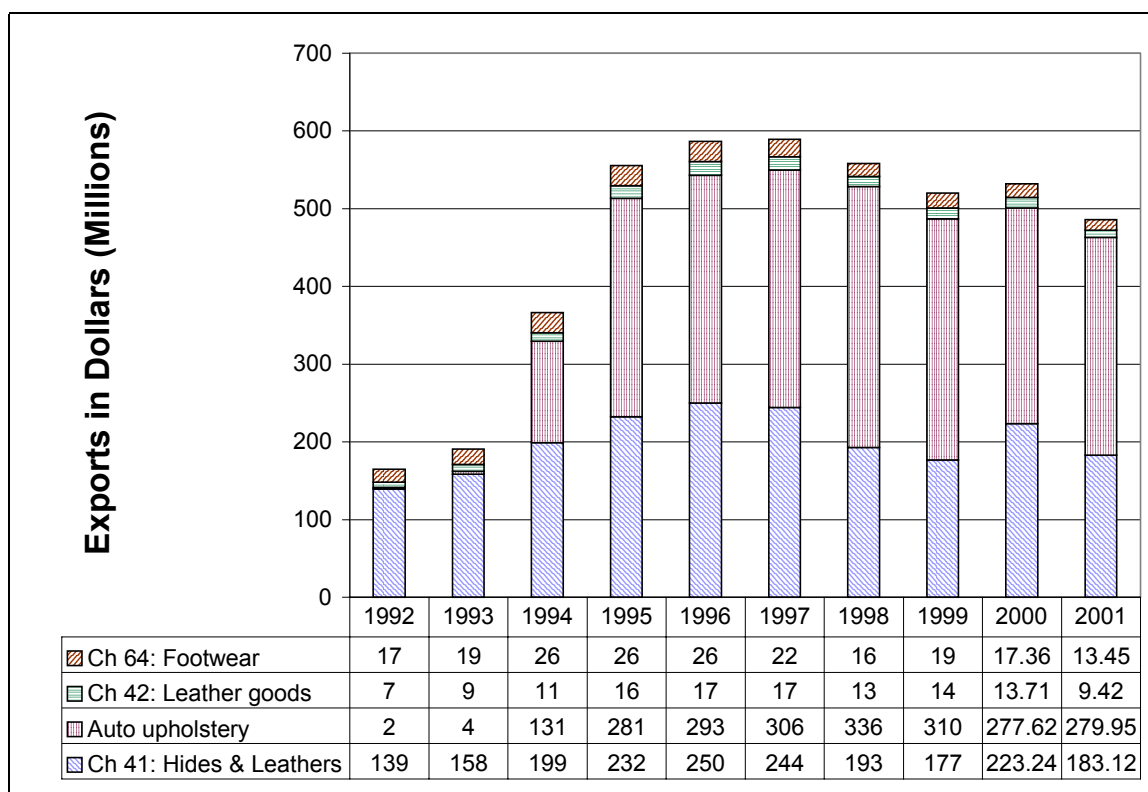
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2 Leather Value Chains: Raw Materials Issues

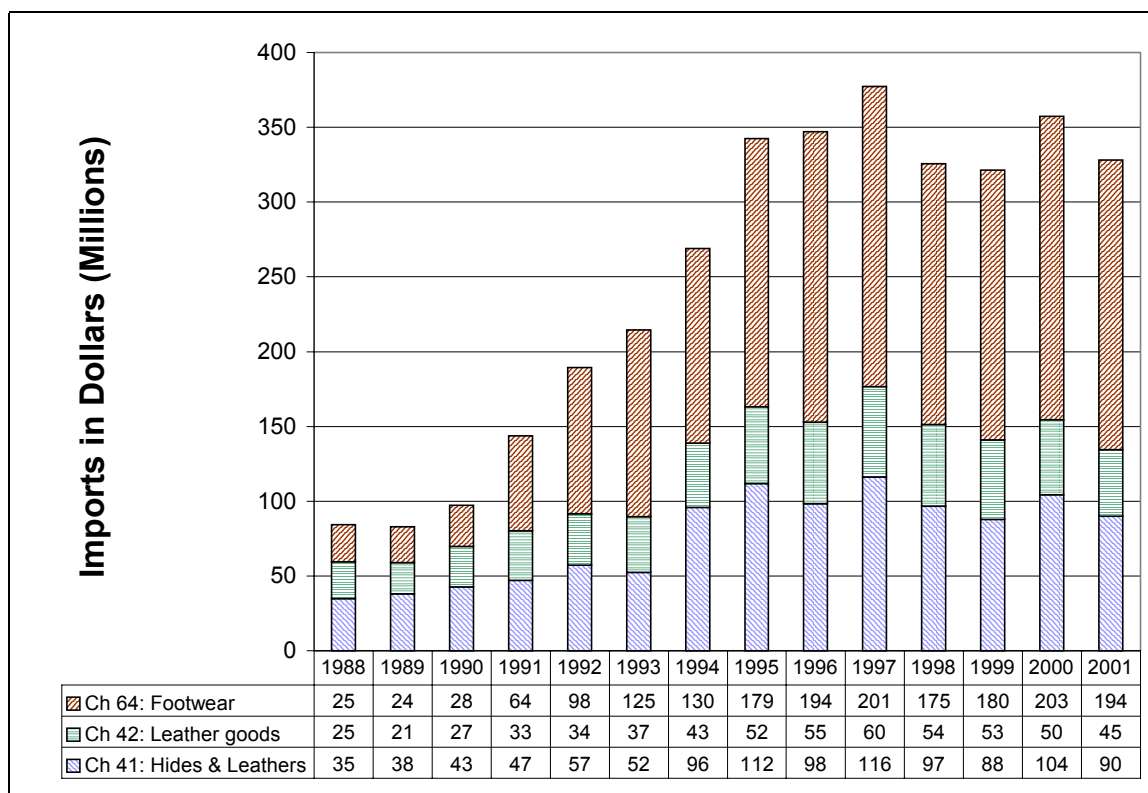
South African Leather value chains have undergone a substantial transformation over the last decade as a direct result of the effects of a more liberal economy. From being relatively untraded before liberalization – where each stage of the value chain was orientated to a domestic market or supply base – leather has become highly traded at various stages of beneficiation. South Africa now exports large values of automotive leather upholstery, exotic leather and bovine hides (Figure 3). Small levels of exporting of exotic leather handbags and other general items, along with some footwear, also take place. Taken together, exports total \$485.94m, of which auto upholstery makes up 58%, leathers, skins and hides make up 38% while general goods and footwear make up 2 and 3% respectively.

Figure 3: Net exports of leather and leather products



As the value exports have grown with trade liberalisation, so the value of imports has also increased (Figure 4). Of the \$328 million imported, 59% of the value is footwear, 27% is skins, hides and leather and 14% is general leather goods. Although the leather industry imports two-thirds of the value of its exports and therefore runs a trade surplus, the traditional leather industries of general leather goods and footwear find themselves in trade deficits.

Figure 4: Net imports of leather and leather products



Given the shift from ‘parochialism’ to ‘porosity’, the industry has been extremely dynamic over the last decade. There have been massive job losses in traditional industries of footwear and general goods, while at the same time growth in new sectors, especially automotive upholstery. In order to understand these changes, it is useful to provide an outline of the leather industry in terms of the main stages between unprocessed hides/skins and the market of finished goods, to identify the key players in these stages, and to define the relationships between them. In so doing, this section will highlight some of the key raw materials issues confronting downstream users which are the subject of sections 3, 4 and 5.

2.1 Bovine Leather Value chain

It is inappropriate to speak of a singular ‘leather industry’ in South Africa. Rather, there are various manufacturers that use cattle ostrich and other hide/skin or leather as a raw material. Differentiation may be vertical (across various degrees of value adding) or horizontal (the same raw material put to different uses by different kinds of manufacturers).

Figure 5 attempts to map the key players in the bovine value chain and the way that they relate to one another. The two vertical dashed lines are intended to denote South Africa’s trade borders. Incoming red arrows crossing these lines therefore refer to imports while outgoing arrows are exports. Downward green arrows that do not cross these lines are trade between different South African users of bovine leather. Outward pointing blue arrows represent exports.

As can be seen from the diagram, today's dominant domestic user of South African leather is the Automotive Upholstery industry which produces almost exclusively for export. However this figure would have looked substantially different a decade ago when this industry barely existed and footwear was the primary user of bovine leather within South Africa. The different segments of the value chain are as follows:

Segment 1 - Hide supply: Due to the deregulation of the meat industry the accuracy on slaughter data has decreased and it is not possible to know for certain the number of hides produced in South Africa annually. The SA Meat Industry Company estimates that the meat industry slaughtered 2.8 million cattle in 1999 but that this would have decreased significantly in 2000 (<http://www.samic.co.za/>). This includes informal unrecorded slaughtering, but still amounts to less than 1% of the world's hide supply. Official statistics alone show total slaughterings in 2001 are similar to 1991 after having recovered from a decrease in the late 1990s (<http://www.samic.co.za/frmMI.htm> also see ITC 2001). The bulk of these hides go to wet blue tanneries for further beneficiation (arrow B). Around 10% of the original hide stock, however, is exported without further beneficiation (arrow A). These tend to be low grade hides produced in rural areas.

Segment 2 – Semi-processed hides: In segment two, hides undergo a preserving process and become 'wet blues'. Although this is called a tanning process, it does not produce what consumers understand as leather – this is the job of finishing tanneries (in segment 3). Although wet blue tanneries do add some value to the hide, their primary role is to distribute hides to finishing tanneries in segment 3 either domestically or abroad. They are therefore often referred to as 'hide merchants' or 'hide agents'. There are only around five such companies in South Africa and the channelling of hides through this small number of players therefore places them in an important position. Since they are selling what is in effect a global commodity, they respond to global market demands and are therefore exporting increasing volumes (arrow D). It is estimated that as much as 50% of the original hide stock is now exported.

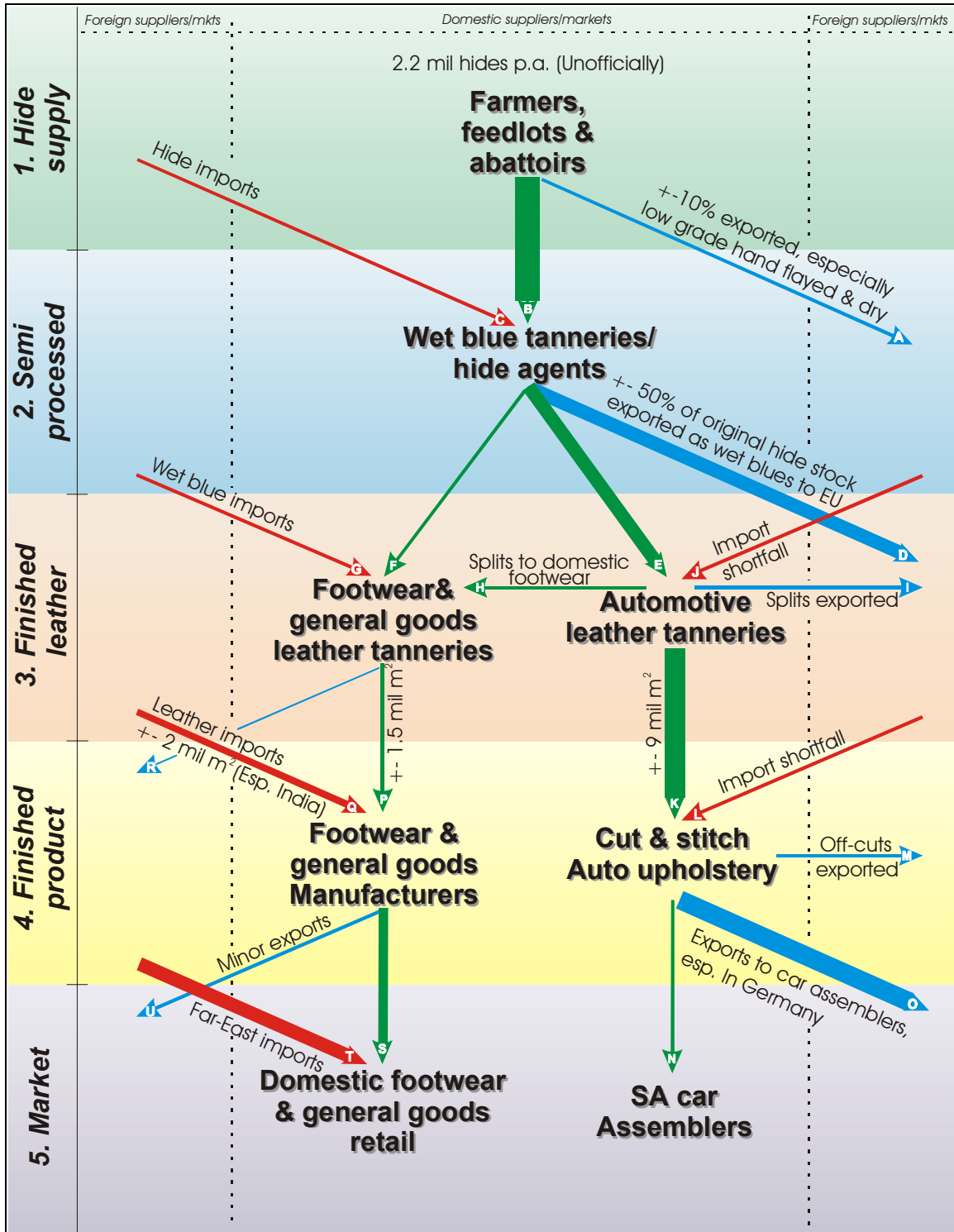
Despite the export of some hides, it is also necessary to import others (arrows C & G). According to the ITC, the bulk of all imports of leather by quantity (which is primarily bovine) come from Australia (55%) followed by Europe (15%) Asia (10%) and South America (7%) (2001: 31). The ITC report suggests that 0.5 million hides are imported into South Africa – presumably split between unprocessed (raw hides in arrow C) and semi-processed (wet blues in arrow D) (ITC 2001: section 1.4).

Segment 3: The tanneries in segment 3 are responsible for turning semi-processed hides into finished leather for use in specific industries. Most finishing tanneries were orientated towards producing for the footwear industry a decade ago. However, with the decline in footwear production and increased use of imported footwear leather, many of those tanneries either closed or switched to manufacturing leather for the auto upholstery industry. There is now only a residual footwear tanning industry of two firms. On the other hand, there are around 8 automotive oriented tanneries, many of which are now foreign owned. It should be noted that the latter only require certain parts of the hide (i.e. the grain) and the remainder is either exported (arrow I) or made available to the footwear tanning industry (arrow H).

Segment 4: There are 78 general leather goods manufacturers, 136 footwear manufacturers and 8 automotive upholstery manufacturers in South Africa. Former two have suffered shrinkage due to a failure to export (arrow U) and increasing imports

(arrow T). Auto upholstery manufacturers on the other hand have enjoyed growth as a result of MIDP-assisted exports (arrow O). Auto upholstery manufacturers, general leather goods manufacturers and footwear manufacturers are the subjects of sections 3,4 and 5 six of this report respectively.

Figure 5: Bovine Leather Value Chain 2001



2.1.1 Key raw material issues

Key debates in the industry refer to Arrows A and D – the export of raw and wet blue hides. The bulk of these hides are to Italy where tanneries use them for a variety of downstream uses including footwear, general goods and upholstery. According to Customs and Excise data (Figure 6) quantities in kilograms exported have not changed much from the mid-1990s to the present.

Figure 6: Quantity of Bovine and Equine hides and leather exported from SA³

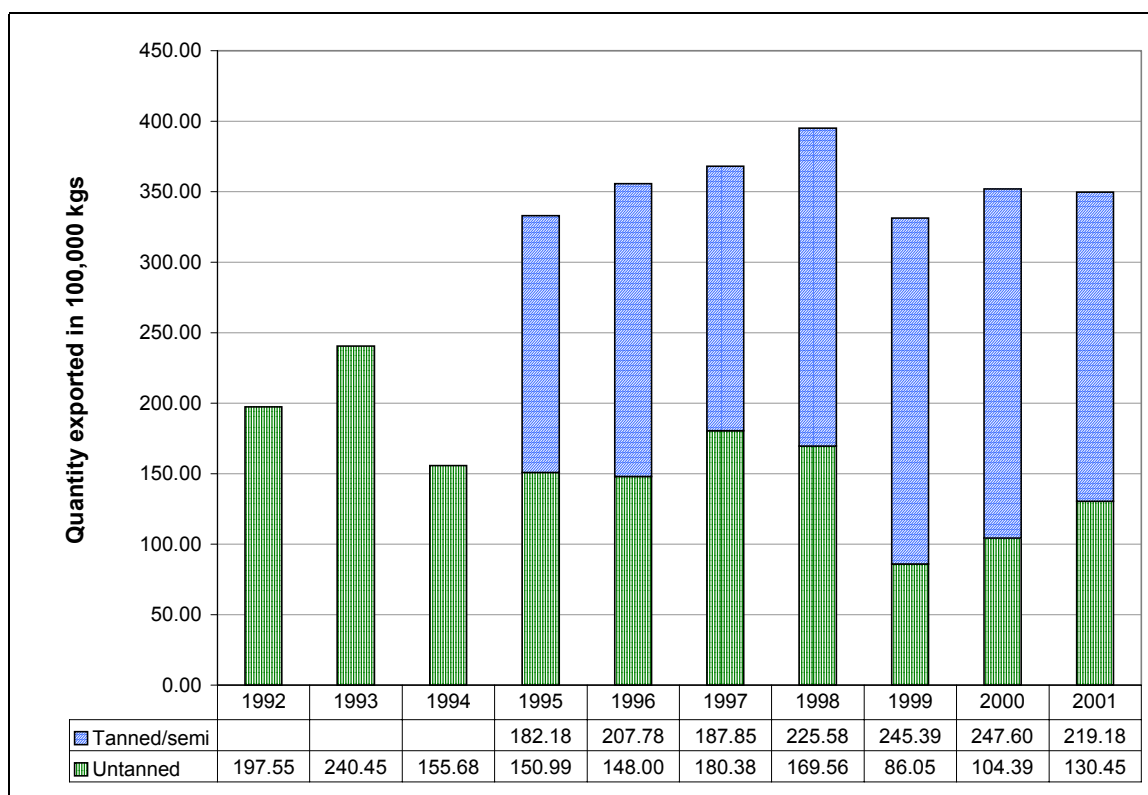


Table 2: Value and Unit Price of Bovine and Equine hides and leather exported from SA

		1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Value \$	Untanned	28.66	36.57	26.42	28.07	25.05	33.74	24.05	9.89	18.95	21.03
	Tanned	23.93	29.66	47.83	48.98	44.93	45.40	40.07	37.62	75.96	43.80
Price Per kg	Untanned	1.45	1.52	1.70	1.86	1.69	1.87	1.42	1.15	1.82	1.61
	Tanned	-	-	-	2.69	2.16	2.42	1.78	1.53	3.07	2.00

Downstream tanneries and manufacturers in segments 3 and 4 complain that they would like access to exported hides. It appears somewhat paradoxical that semi-processed hides destined for Italy sit at the dockside alongside hides coming into the country from

³ When reading Figure 6 note that: (1) The unit of measure changed from square metres to kgs in 1995 for tanned leather and a longer historical view is therefore not possible; (2) The Harmonised System trade classification is such that it is not possible to separate semi-tanned and finished leather. It is likely that most tanned bovine leather is, in fact, wet blue leather; (3) The classification groups bovine and equine together although it is likely that, in effect, these figures refer to bovine.

places such as South America to meet local demand. However, as Sweetnam comments, the simultaneous import and export of leather

is anomalous to the casual onlooker and, I fear, to government agencies who see a hide as a hide and do not understand the quality differences that exist. In the "good old days", South Africa had a "closed" market and it was possible to buy good hides at a cheap price which in turn permitted the footwear industry to buy leather at affordable prices. With the deregulation up of the market and the advent of auto tanning, prices for top quality hides soared beyond the prices footwear could afford, particularly in a market which was going the other way for them with the flood of cheap and illegal imports for the East. (Sweetnam 2001)

Before liberalisation in the early 1990s, the meat industry was regulated and industries that utilised leather enjoyed lower hide prices. When this changed in the mid-1990s, however, prices increased towards world parity (Sweetnam 2001). Traditional sectors were therefore adversely affected. Due to the price pressures being forced on footwear manufacturers as a result of cheap imports, footwear manufacturers themselves started importing cheap leather primarily from India. Footwear tanneries were therefore forced between the squeeze of increasing domestic hide costs and decreasing prices of imported leather. They were also no longer protected from the fluctuations of the world market, such as the price hike in 2000 as a result of global shortages (Table 2).

It needs to be recognised that wet blue hides are a relatively generic tradable commodity and the hide agents, by definition, can sell their product anywhere in the world. There is therefore little forward dependence by wet blue tanneries on the domestic industry and exporting has become increasingly attractive. There have been suggestions that the government should consider restricting the export of hides in order to allow downstream manufacturers access to domestic hides. Arguments for and against this approach are as follows:

Motivations in favour of the restriction of exports:

- The price of hides would become more affordable to finishing tanneries and manufacturers. Therefore they would become more competitive and more value adding would take place in South Africa thus providing more job opportunities.
- Other countries impose restrictions on the export of their hides. Van Niekerk states that 'South Africa vigorously complies with all WTO regulations, while trading with economic super powers i.e. China, India, etc. who don't comply with these regulations.' (van Niekerk 2001: 33). India notoriously is able to under-cut other leather producers through this policy.
- Hide merchants are practising "MIDP pricing" in which a premium is charged for hides going to the auto industry since the MIDP favours local content.

Arguments against restriction:

- There is a shortage of hides in South Africa and pricing is therefore price is set at import parity. If the export of hides were to be restricted, it would not change the price.
- Many low grade hides would be kept back for which there is currently no market in South Africa. A system to distinguish between different kinds of hides would be expensive.
- When Brazil attempted to restrict the export of hides, the hide merchants simply penalised sales to the local market to compensate for their loss of earnings.

- Restriction is punitive and against the spirit of competitiveness.

Wet blue tanneries are in a powerful position in the South African bovine value chain as a result of the fact that they channel a resource for which there is high global demand, and which is highly tradable due to its generic form. Yet one cannot reasonably argue that the South African downstream industries are at a competitive disadvantage in global terms if they are paying the same as all other manufacturers in the world. Indian producers might have an advantage as they have special circumstances that provide hides under world prices, but this is little justification for the same to be attempted in South Africa. The key consideration that South African policy makers have to face is whether South African manufacturers are, in fact, able to purchase raw material at world prices. As we have seen, MIDP pricing suggests that hide merchants might be charging more than global prices in order to get their piece of the MIDP. Hide merchants are more tempted to export than to sell domestically at the same price in a situation where the Rand is depreciating as there are advantages in earning foreign exchange and keeping it abroad as long as possible. These two problems place South African buyers of hides at a disadvantage as they are buying local raw material at higher than world prices.

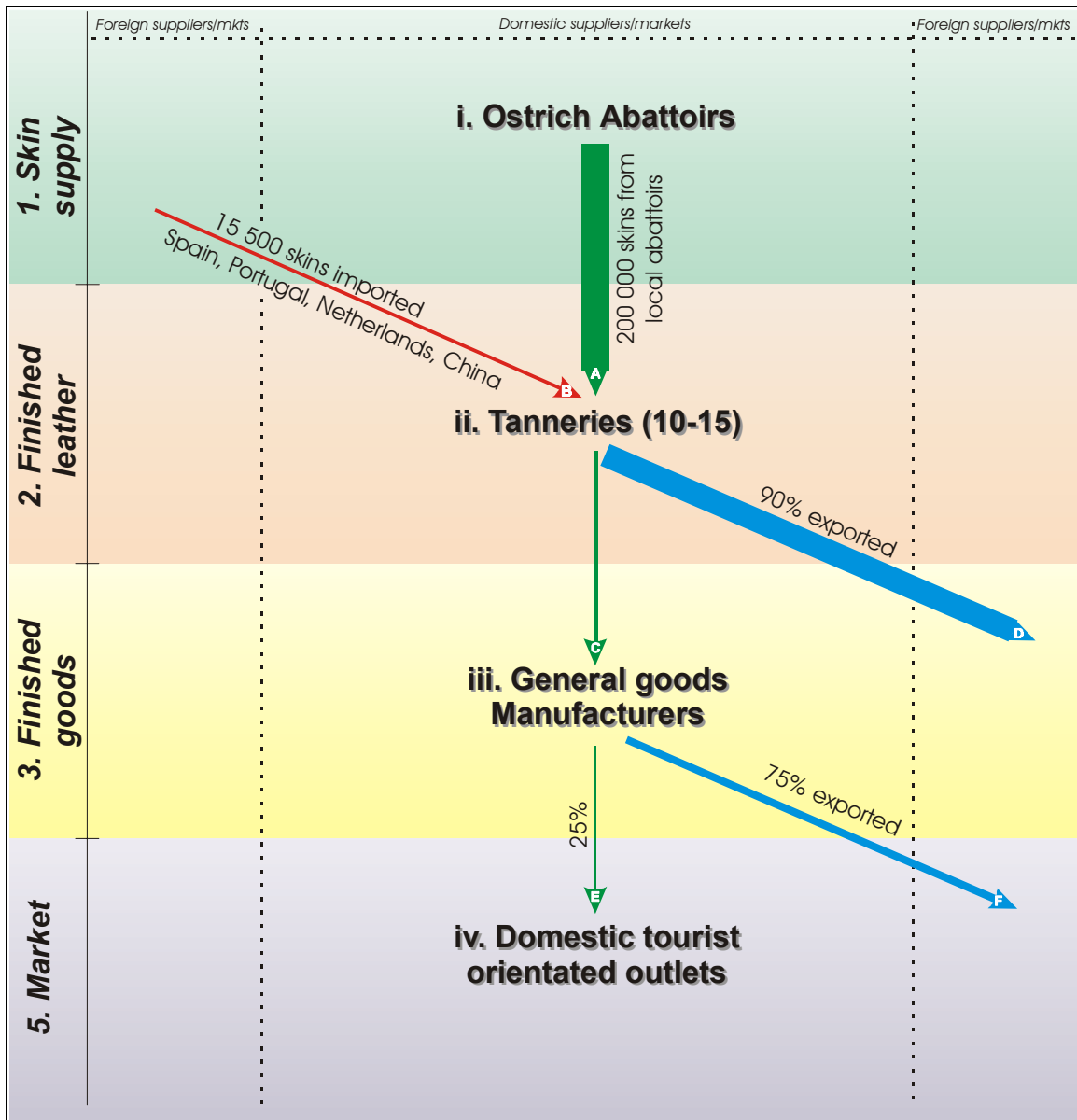
These issues are raised not on the basis of a definitive study but merely to outline the hide pricing debate and contextualise issues that are raised in subsequent sections.

2.2 Ostrich Value Chain

Although 'bovine' frequently gets conflated with 'the South African leather industry', ostrich leather is an extremely important component. According to Customs and Excise (see the Appendix Table 11, p 71), exports of exotic leather are valued at \$62m, compared to exports of bovine leather of \$ 43.8m. It is therefore the most important component of exports of raw materials by value, despite the fact that almost 14 times less volume of exotic leather are exported than tanned bovine leather.

The ostrich leather value chain (Figure 7) differs from the bovine chain in that it skips the separate semi-processed leather stage required in bovine tanning (with ostrich, raw skins are processed into finished leather within one factory). There are also fewer kinds of players and value adding beyond the production of tanned leather is minimal. As can be seen from Arrow D, the bulk of finished ostrich leather is exported from South Africa. One possible future change to this value chain is the possibility that it may be able to break into the automotive upholstery industry, which would result in the split value chain that we seen in the bovine leather industry. This has been identified as a strategic direction for leather producers and it seems they may be having initial successes in this regard.

Figure 7: Ostrich Leather Value Chain 2001



2.2.1 Key raw material issues with the Ostrich Value Chain

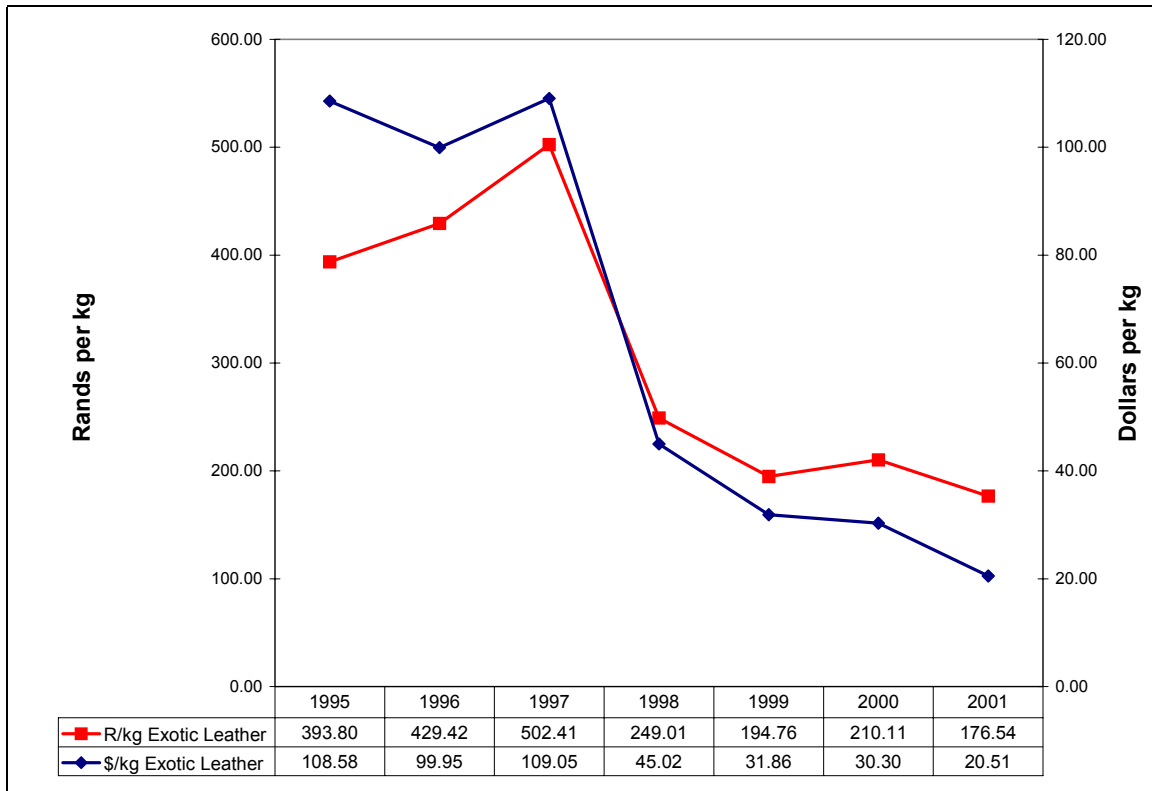
Once again, deregulation is a key dynamic resulting in changing prices of leather. Whereas in the past ostrich products were channelled through the Klein Karoo Co-operative, the deregulation of this industry has seen the emergence of around 10 tanneries and an increase in the skins tanned from 1500 a month in the early 1990s to a peak of 4500 later in the decade according to one tannery. The current figure is now 3000 a month.

Since supply is no longer restricted, prices are falling dramatically. According to Figure 8, 2001 prices are only a fifth of the 1997 pre-East Asian Crisis high. This accords with anecdotal information provided in interviews that ostrich leather fell from \$40 per square

foot to \$12 per squared foot over this period. One firm reported that ‘uncoordinated local competition’ did not benefit local industry but was exploited by Japanese buyers who were ‘particularly active in down-bidding local producers’.

The increase in leather supply is not only the result of domestic competition, but is compounded by an increasing number of tanning elsewhere in the world. Legislation preventing the export of ostriches was revoked in 1997 and live birds and tanning technology are no longer South Africa’s preserve (Borland 1998). One firm interviewed indicated that South Africa’s share of ostrich leather production has fallen from 99% to 60% since 1993 as other countries have gained competence in this craft.

Figure 8: Unit price of exotic leather exported from South Africa



With old state barriers to entry removed through deregulation, the industry was now open and faced the potential commodification of the product with unregulated supply. As a result, Klein Karoo needed to develop market-compatible barriers to entry and therefore developed a strategy to follow a branded ‘high road’ approach as ‘the world’s foremost supplier of ostrich products’. Down stream manufacturers could access the Klein Karoo brand which was supported by advertising and marketing to generate a brand presence. This was combined with a strategic focus on Research and Development to promote the quality and diversity of leather products in order retain leadership in the industry. Klein Karoo strives for a quick turn around time for enquiries for new colours and finishes in order to better service the market. Other tanneries argue that the state should support generic branding of South African ostrich leather in order to pursue a similar strategic path of achieving distinction from other producers in the world.

2.3 Approach and Methodology

Table 3: Interviews and Questionnaires completed

	Bovine tanning	Ostrich tanning	Auto upholstery	Footwear	General goods
Interview	3	3	5	5	3
Questionnaire	-	1	3	1	-
Total no. of exporting firms	6	15	8	6	5

In 2001, a preliminary overview study of the leather value chain was undertaken (Ballard 2001). While the intention of the last report was to descriptively map out the leather value chain, the purpose of the present report is more specific. As was explained in section 1, the purpose of the broad research project (also including automotive components, clothing, and furniture), was to survey the 'top five exporting firms in the top five exporting categories of each industry'. The intention was to examine the extent to which these successful exporting firms were learning from exporting and were upgrading in terms of their products, processes, functions, and even value chains. The data and discussion is therefore orientated around these fairly specific conceptual issues rather than a comprehensive review of all dynamics within the industry.

Structure of report: Given that the issues facing each sector of the leather industry varies considerably, it was decided to treat each sector on its own in order to draw out specific considerations. Section 3 deals with the auto upholstery sector, section 4 covers general leather goods and section 5 reviews footwear. One cautionary note is that given the low level of exporting from the latter two sectors, the discussion presented fairly tentative given the relative lack of export experience in these industries from which conclusion can be drawn.

3 Automotive Upholstery

Summary of key trends

- ❑ **Growth:** Although quantities of exports have grown, the Dollar value of exports has been essentially stagnant since 1995 compared to the rapid increases between 1993 and 1995.
- ❑ **Raw material unit prices:** Although bovine leather spiked in 2000 as a result of global shortages, there was an overall decline during the second part of the 1990s.
- ❑ **Reducing dependence on the MIDP:** Some firms consider South African leather to be over-priced as a result of the MIDP and have begun importing a significant part their leather requirements. They therefore do not gain much from the MIDP but are also not penalised by raw material providers inflating prices due to the need to access 'local content'.
- ❑ **Process upgrading:** Unit prices of leather upholstery have fallen faster than the decrease in the cost of leather suggesting process improvements by manufacturers.
- ❑ **Functional upgrading:** As OEMs have disengaged from close involvement with the running of seat manufacturing businesses, so these manufacturers have gained new opportunities for improving their manufacturing and logistics.
- ❑ **Value chain upgrading:** In order to hedge against possible loss of leather upholstery business from South Africa, some firms are diversifying in to the export of cloth seat covers.

3.1 Introduction

The leather automotive upholstery industry (also referred to here as leather seat cover manufacturing) has been a recent arrival on the South African manufacturing landscape. From having been of negligible size a decade ago, it now employs in the region of 3,000 people in the sewing industry alone, and is directly responsible for a substantial portion of the 3,749 people employed in the tanning industry. It is almost exclusively export-orientated, and even domestic sales tend ultimately to be exported as they are installed in cars that are built for export. It is responsible for almost two and a half billion Rand worth of direct exports – more than any other sector that is related to skins hides and leather.

The dazzling success of the auto upholstery industry, however, is not linked to any intrinsic advantages South Africa possessed in the production of these kinds of products, but rather the ability of any high value automotive component to generate duty rebates (Import Rebate Credit Certificates or IRCCs) which automotive OEMs could use to offset the duty on imports under the Motor Industry Development Programme (MIDP). Like the catalytic converter industry – which came to South Africa with similar suddenness – leather upholstery is characterised by an expensive raw material (Ballard 2001: 23). This is not a labour intensive industry, and the labour cost of sewing a seat is only around 3% of the final cost of the product.⁴ Since the MIDP rewards exports on the basis of their value, it favours the export of high value goods such as leather upholstery and catalytic converters. The leather upholstery industry, then, came to South Africa to

⁴ By comparison, the automotive components industry spent 11.03% of its costs on labour in 2001 according to the B&M Analysts database for the KwaZulu-Natal, Gauteng and Eastern Cape benchmarking clubs.

opportunistically take advantage of the MIDP. Now that the sector is firmly established, policy makers and manufacturers themselves are trying to confront the key question of whether the future of the industry depends on the continuance of the MIDP or whether it has used the shelter afforded by the MIDP to become competitive in its own right? This question becomes particularly important as

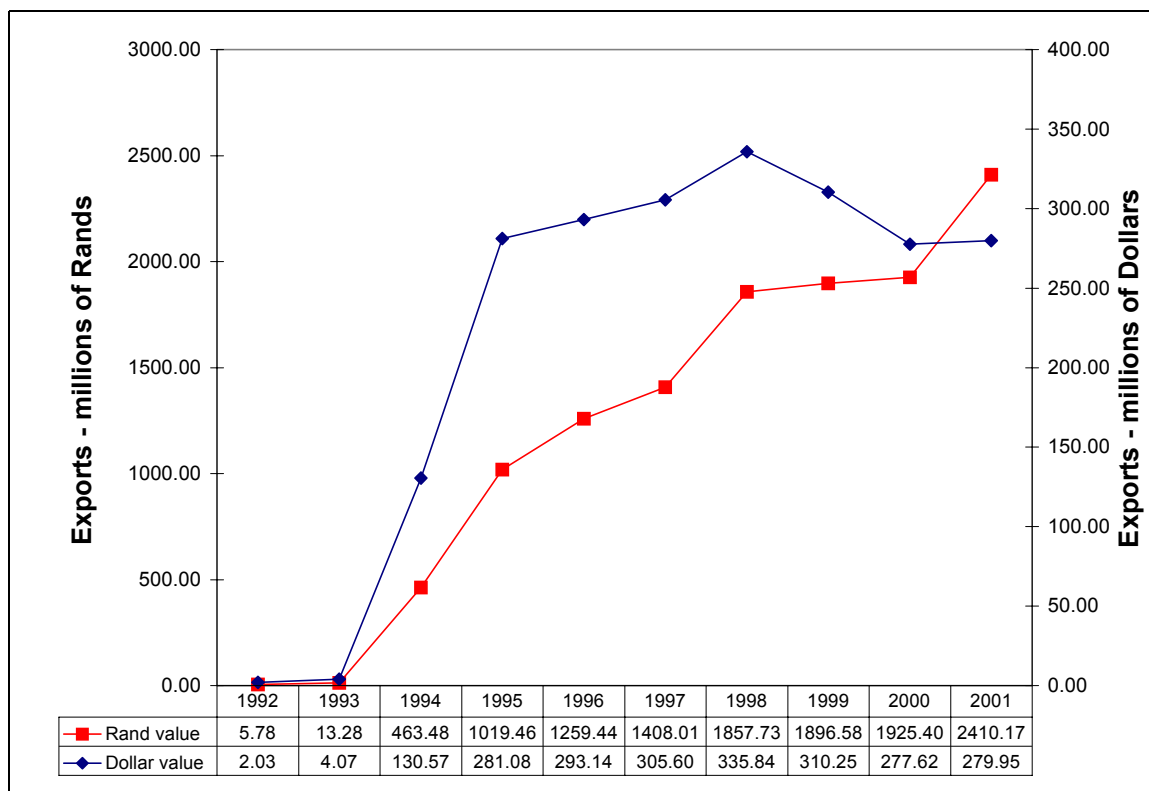
1. the benefits yielded by the MIDP are decreased year on year towards the end of the current programme in 2007 and extension to 2012.
2. the exporting base of the automotive industry grows so that dependence on the leather seat cover sector is reduced.
3. high domestic leather prices as a result of hide shortages, exports of hides, and “MIDP Pricing” by hide producers neutralise any benefits afforded by the MIDP route (IDC 2001: section 3.3).

Although the future of the sector cannot be determined here, the following section attempts to map out some of the key trends around exporting, unit prices, leather supply, and the allocation of value adding activities between different players.

3.2 Macro Data

3.2.1 Exporting data

Figure 9: Value of automotive upholstery exports from South Africa



Exporting data is an excellent proxy for the total production of this sector since the sector is almost exclusively export focused. According to customs and excise data (Figure 9),

the Rand value of covers exported (square marker read against the left axis) has grown year-on-year from negligible levels of R5.8 million in 1992 to almost two and a half billion Rand in 2001. However, when converted into Dollars (diamond marker read against the right axis), it becomes clear that the appearance of growth in the second half of the 1990s is misleading. The industry's major growth took place between 1993 and 1998 followed by a slump back to 1995 levels by 2001. If we ignore the 1998 high, it is clear that the industry has been stagnant since 1995, as 2001 levels are similar to those of 1995.

It is critical to note that during the period of year-on-year growth in Dollar terms, there was in fact a near-halving of unit price (\$ per kg) which means that dramatic growth took place despite the fact that manufacturers were making seat covers for lower and lower prices (Table 4). In other words, quantities of exports increased almost twice as fast as the value of exports. However, since 1999 quantities of exports have declined year-on-year, and as a result the value of exports decreased until 2000. Interestingly in 2001 there was an increase in Dollar value of exports even though quantities continued to fall. The increase in the price of auto upholstery – a likely affect of the increase in raw materials globally due to BSE and foot and mouth disease – was enough to increase the value of sales despite falling quantities (see Figure 12, page 28 below).

Table 4: Volume and Price of Exports of Automotive Upholstery

	1995	1996	1997	1998	1999	2000	2001
Kgs (mil)	4.7	6.1	8	10.4	11.4	9.7	9.1
\$ per kg price	60.2	47.9	38.3	32.2	27.2	28.7	30.8
R per kg price	218.32	205.71	176.43	177.92	166.44	199.22	264.97

(Source: Calculated from Customs & Excise data for HS 42.05 & 94.019)

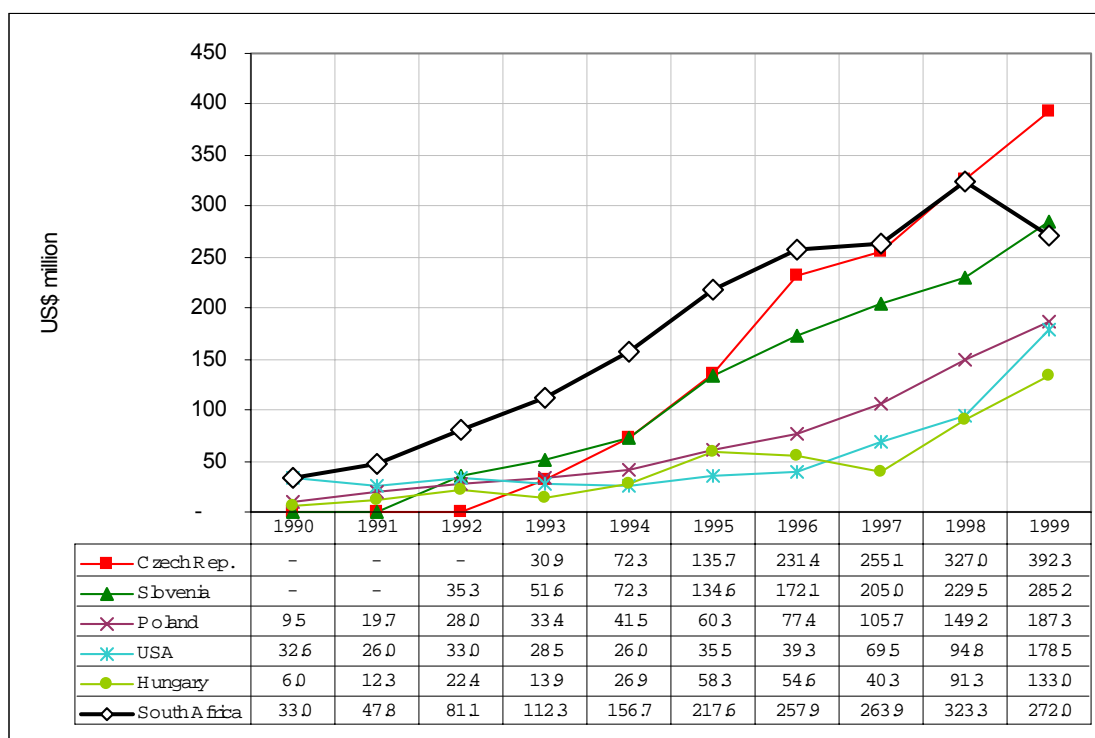
Sales to domestic assemblers: Although the level of exporting in 2001 in Dollar terms is the same level as it was in 1995, it should be noted that an increasing number of leather covers are being sold to local OEMs who then install them in cars they manufacture. According to the 2001 ITC report, 5% of leather upholstery goes to the local motor industry. Since then, this may have increased as a result of increasing exports of cars made in South Africa. According to S&V, BMW accounts for around 50% of the leather upholstery industry and installs 20% of its purchases in cars, most of which are exported (S&V 2002: 31). DCSA accounts for further exports of covers installed in CBUs. Together DCSA & BMW manufactured passenger 83,000 cars in 2001. Even if we assume each one of these had leather seat covers costing R3,000 or \$348.46 a set, it would only add \$28.9 million to the 2001 export values – still below the 1998 peak.

Raw material usage: Raw material usage may be another proxy for indicating change in production of seats. One respondent suggested that the auto upholstery industry was using 12,000 hides a week in 1999 but only 7,000 early in 2002. Once again, however, this is only suggestive and cannot be taken of clear proof of a reduction of seat manufacture since some manufacturers are making use of imported leather. What we can argue, given these proxies for growth, is that the industry has been stagnant at best in terms of Dollar value of output for the last few years in comparison to its rapid growth in the mid-1990s.

3.2.2 The European Market

The European Market: South Africa's exports of leather upholstery are almost exclusively to the European Union and it is therefore useful to examine South Africa's position in this market more closely. Imports of this category of products from all countries into the EU grew rapidly, increasing fivefold from \$318 million in 1990 to \$1,809 million in 1999. Figure 10 shows that until 1998, South Africa was the major supplier of these goods to the EU, but in 1999 was overtaken by the Czech Republic. While all other major suppliers continued to grow their sales in 1999, South Africa's sales declined. The figure demonstrates clearly that South Africa's major competition on seat cover manufacture is Eastern Europe, although the US also enjoyed a sharp improvement in 1999.

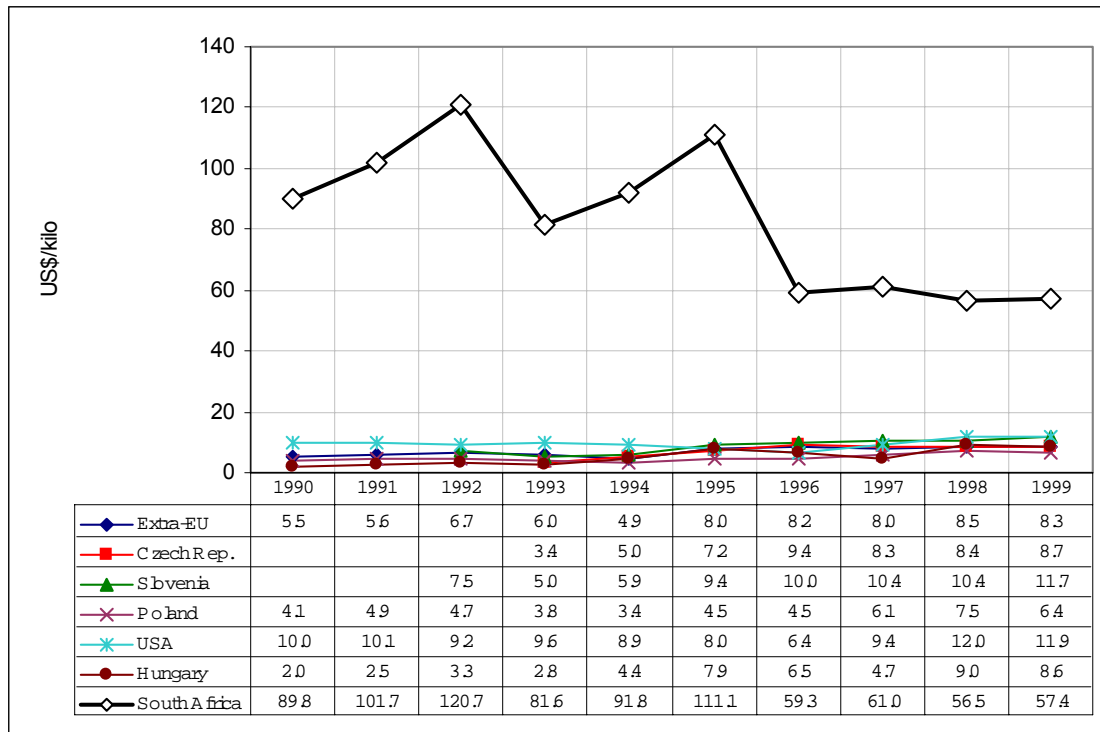
Figure 10: Value of Imports of seat covers into the EU by Country (includes textiles)



An analysis of unit prices (Figure 11) demonstrates that South Africa is supplying high-end goods under this trade category (HS 94.0190). The explanation for South Africa's outlier unit price of \$57.4 per kg, compared to an average of \$8.3 per kg is that South Africa is supplying exclusively leather seat covers whereas Eastern European countries are also supplying textile and cloth covers. Unfortunately the HS trade classification does not allow for the isolation of leather covers.

Focusing on South Africa's unit price – it is evident that South Africa reduced its price per set of covers rapidly after the establishment of the industry in the mid-1990s (this will be discussed further in Figure 12 below). Note that fluctuations in the early 1990s are relatively meaningless due to low volumes.

Figure 11: Unit value of Imports of seat covers into the EU by Country



3.2.3 Growth prospects

Globally there is a greater penetration of leather upholstery in cars sold. More people are now choosing leather and it is available in more models of cars. According to Intercontuft (2001), there has been a transition in the cars exhibited in the Frankfurt motor show from 63% cloth and 37% leather in 1997 to 49% cloth and 51% leather in 2001. This trend was strongest amongst German passenger cars. A key development observed was increased use of partial leather seat covers with combinations of textiles and leather in order to improve comfort and reduce cost.

While this seemingly robust global market clearly represents opportunities, South Africa's ability to make further inroads is uncertain. The SA Meat Industry Company argues that the auto leather industry is under threat as leather becomes less important to car manufacturers as a source of MIDP credits (S&V 2001: 30). As OEMs export increasing numbers of CBUs, they do not depend as heavily on the export of high cost goods such as leather covers and therefore do not ensure that this kind of product is made in South Africa. Although this is a rather gloomy picture, it is clear that the sole reason for the initial establishment of the industry was to generate local content for OEMs under phase six of the Local Content Programme and then duty rebates under the MIDP. Growth from negligible levels to \$ 281 million between 1993 and 1995 shows that rapid growth is clearly possible, yet its growth rate after 1995 was marginal despite a dramatic fall in unit prices. One can only deduce, therefore, that the level of exporting from South Africa is essentially a reflection of the industry's response to government policy rather than a result of South Africa's competitive advantage in the manufacture of these products.

3.3 Firm level feedback

3.3.1 Overview of firms

Six seat manufacturing firms were interviewed for the purposes of this research exercise out of a possible eight manufacturers in the industry. The following provides a broad descriptive overview of the firms:

Establishment: While one of the firms was established in the early part of the 1990s, most were established in the second half of the 1990s (three in 1996 and two in 1998). Therefore this industry is barely a decade old.

Ownership: All except one of the seat cover manufacturers are owned by multi-national companies specialising in automotive trim or leather production. The one exception is an independent South African-owned manufacturer.

Range of products: Products made in SA are primarily seat cover kits (including cushions, squabs, fold away arm rests and bolsters), but also include door panels, airbag covers, gearlever covers and headrest covers.

Customer Base: Seat covers are supplied for a variety of OEMs and car makes including Audi, VW, Ford, Mazda, Volvo, Fiat, BMW, Holden, DaimlerChrysler, Alfa, Daewoo, Nissan, Rover and future contracts for Mitsubishi and Toyota. These OEMs are located in South Africa, Germany, Italy and Australia.

Size: While three of the sewing operations interviewed only had one plant each, the remaining three had multiple plants of between two and four, sometimes located in different parts of the country. Firms' employee count specifically on leather seat manufacture ranged from 50 to 1,200. The average number of employees was 434 per firm or 217 per plant.

3.3.2 Leather supply issues

Three firms stated that they use leather manufactured from 70-75% local hides, with the remainder being imported (This is the proportion declared by hide traders themselves in the DA 190 form which is part of the MIDP). Some hides have to be imported as there are not enough available from South African hide suppliers. This situation is exacerbated by the increasing exports of up to half of the hides produced in South Africa. While many of these would never have been suitable for use by seat cover manufacturers, exports of raw material increasingly include better grade hides.

Reaction to this trend by the auto-upholstery industry varies. Given the importance of local content in the context of the MIDP, it is clearly in the interests of downstream seat manufacturers to avoid using imported hides. One set of firms is actively lobbying the DTI to impose an export duty of 10% on hides in order to ensure that more South African hides are available to local manufacturers for further beneficiation before they leave the country. They cite similar taxes imposed elsewhere as justification for a tax of this nature in South Africa. They also refer to hide producers in South Africa as 'monopolistic' saying they sometimes sell at higher prices domestically than they are able to sell for on the export market knowing that local buyers will pay a premium for 'local content'.

Another firm expresses concern about hides being exported from South Africa but does not see an export duty as a fail-safe option. They cite the Brazilian experience where a similar tax was imposed and hide sellers simply increased the price in order to compensate for this tax.

In contrast, other automotive upholstery firms do not see an export tax as fair on hide producers. Taking a global picture, they say that these firms should not be restricted from getting the best price they can for their product. Furthermore, an export tax may hold back low-grade hides that may not be useful to downstream manufacturers. If this is to be avoided through inspection systems, then these measures will themselves add cost to the price of hides. Therefore, while three of the firms interviewed stated that something needs to be done about hide exports, and two stated that they would support measures to restrict hide exports, this does not represent the view of all auto-upholstery firms.

Regarding price, firms seemed to believe that the situation had improved since the end of 2000 and beginning of 2001 when bovine leather prices globally peaked as a result of the multiple diseases. One firm reported that its input leather price only increased once a year and that this year it increased by 7% which is below inflation. Another stated that in the 6 month period leading up to March 2002 (when the interview was conducted) the cost of leather fell from \$23 per square metre to R21 per square metre.

3.3.3 Process upgrading

Process upgrading is the improvement of the efficiency of intra-firm or intra-firm processes in order to reduce cost, improve quality and improve service frequency and delivery. Process upgrading is the drive towards the optimal use of capital and human resources in terms of best manufacturing practise globally.

Competitiveness: Most of the firms stated that, while they aimed to be competitive without the MIDP, the industry would not survive without it. In comparison to sister plants throughout the world, South African seat cover manufacturers say that they are generally able to match or beat the ex-works price of any other plant. While South Africa does have some cost disadvantages (labour productivity and leather price were mentioned), the industry has other cost advantages which offset these (labour cost and overheads). Recent falls in the value of the Rand helped to accentuate these advantages although this has also had its own negative effects such as tempting hide producers to export more of their stock.

The most important barrier faced by South African firms is distance to market. Given the high value of the goods manufactured as a result of the high cost of leather, it is not viable to sea-freight these goods to Europe as it would tie up too much cash in stock holding. It is also necessary to fly these goods as they are a 'trim' part for which OEMs usually require flexible JIT deliveries. According to one firm, it was able to beat mainland European prices *including logistics* but that this was still not enough for them to win contracts from European producers since customers preferred nearby manufacturers who could be more responsive to their requirements. Furthermore, as Figure 10 demonstrated, this work increasingly being relocated out of Western Europe to Eastern Europe which has major labour cost and productivity advantages. Added to this, transport cost for Eastern European producers is, obviously, far lower than that of South African producers. One firm estimated that whereas it would cost R80 at most per seat

cover to fly the product from Eastern Europe, the same cost from SA was R310 which is around 7% of the value of the seat.

One silver-lining in this apparent MIDP dependence is the case of a firm that has been able to ignore MIDP benefits in its planning for an export contract to a new customer and was able to beat a Chinese producer *on price alone*. Having become frustrated with what it saw as excessively high hide prices it took the strategic decision to import all of its leather. It therefore foregoes local content for the leather content of the product which is a major part of costs. The advantage it gained by avoiding expensively priced local leather clearly outweighed the disadvantage of gaining duty rebates (IRCCs). Indeed, it stated that OEMs are less becoming less interested in IRCCs anyway as they access them from other sources such as catalytic converts, and it is therefore forced to plan without them.

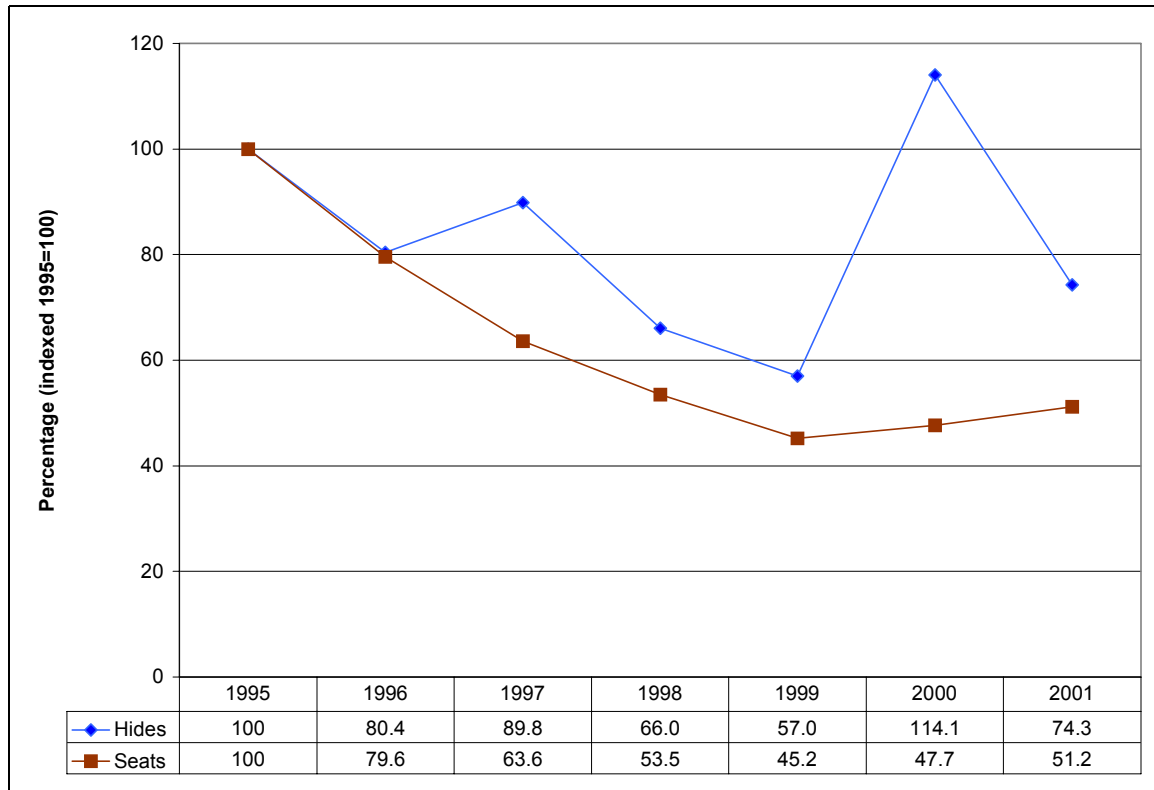
Raw material and auto upholstery unit price changes: Figure 12 plots relative change in unit price of hides⁵, and auto upholstery (see Table 4, p 22). As unit price change in upholstery demonstrates, South African manufacturers managed to reduce the unit price of their product by 54.8% between 1995 and 1999. While this may seem impressive, this was achieved on the back of a 43.1% reduction of the price of leather – the primary cost of the seat – over the same period. Given that prices of the end product fell 11.7% further than the price of the raw material we can suggest that savings were also achieved in the manufacturing process.

Since 1999, increases in unit prices of seat covers are far shallower than the increase in semi-tanned and tanned leather prices over the same period. The widening gap suggests further process improvements that ‘cushioned’ raw material price increases from the seat cover buyers through efficiency gains in the manufacturing environment.

Although this is a crude measure – the hide price line does not reflect what seat cover manufacturers actually paid for their leather – it is possible to suggest that the divergence between these two lines represents increasing productivity and efficiency by seat manufacturers. In general, seat cover manufacturers seem to hold similar production philosophies to other automotive manufacturers most notably increasing adherence to World Class Manufacturing and Lean Production. They hold accreditations such as ISO 9001, ISO 9002, QS 9000 and VDA 6.1. They are therefore driving towards ‘quality at source’, low inventories, low absenteeism, and so on. Anecdotally, respondents indicated massive improvements in a short space of time for these key measures. For example, it was noted by one firm that it now took one employee to make the same output that previously took two employees.

⁵ Export unit price of tanned and semi-tanned hides in Table 2, p. 14 are taken as a proxy for the price of hides automotive upholstery tanneries would pay. Import parity of the import price of wet blues may have been a better indicator of this, but HS trade classification does not allow this to be separated from finished footwear leather. Since this is largely water buffalo leather from India it is not the same kind of leather that automotive tanneries would be buying and is subject to different pricing mechanisms.

Figure 12: Relative change in unit price of hides and seat covers



Quality: While sewing defects are an important source of quality problems, general consensus is that an equal or greater number of quality problems arise from raw materials (colour, thickness, stretchiness, etc). Further problems also arise as a result of the design of the seat, which manufacturers lobby to change. The main source of quality problems within seat cover manufacturer's control is sewing. Sewing mistakes are unfixable as it is not possible to correct a bad seam with leather. As a result, scrap rates with leather are higher than with textiles. According to one firm, scrap rates are around 2% at the start of a products' life and 1% by the end. Another firm stated that sewing defects were a constant target for improvement and it was aiming to reduce such problems to a third of their current levels. Most firms, therefore, indicated that they could be globally competitive with regards to quality.

Automation: Employees are highly skilled in terms of operating sewing machines and training may take from 3 to 6 months. This is important as there is little scope for automation and it therefore remains a labour intensive industry.

Inventory and Logistics: One firm stated that it had reduced its finished stock in transit to Europe. The firm stated that it used to allow for 15 days of finished goods (5 days at the South African warehouse, 5 days in transit and 5 days in Europe) even though it has always been flown to the market. Now this has been reduced to a total of 9 days, taking better advantage of the rapid actual transport time. A certain amount of buffering is required due to the fact that airlines have discretionary (therefore random) power to offload a shipment of leather even though it has been reserved in advance. Another firm stated that this was the factor preventing it moving from a three week inventory holding system to one where it needed only two weeks of stock.

Localisation of B Parts: Whereas many “B Parts” (i.e. non-leather parts such as foils) have, until now, been imported, localisation of these materials is due to happen with some new contracts won by manufacturers. Cover manufacturers see localisation as an important strategic move as they represent 8% of costs. Suppliers located in close proximity will also improve value chain flexibility, allowing for stock reduction, just in time supply and rapid responses from suppliers. The lead time on imported B Parts is around six weeks transport plus two weeks manufacture. This places South African firms at a serious disadvantage compared to, for example, Polish manufacturers who would have a transport lead time of just two or three days.

Absenteeism: Absenteeism was highlighted as being relatively low amongst those firms that disclosed this measure. One firm stated that it was 1% and another that it was 2.5%. This compares favourably with the average 4.32% amongst South African automotive component manufacturers (Data from the B&M Analysts database on the automotive benchmarking clubs). However, firms stated they were expecting this to increase as a result of the new legislation on absenteeism, and as a result of HIV/AIDS.

3.3.4 Product upgrading

Product upgrading refers to the improvements of products in a way that better positions firms within the value chain. Higher rents can be generated if firms are manufacturing a product that other firms are not producing or cannot produce. Downgrading, therefore, is the manufacture of products that have low barriers to entry (e.g. mass-market cost driven production).

Most of the product-related innovations that have taken place since the industry have related to leather. Beyond this, actual designs are prescribed by the automotive assembler who, given that this is one of the key aesthetic components of their car, are extremely stringent and prescriptive about the way their seat covers are made. The scope for product innovation by South African seat cover manufacturer is, therefore, minimal. Changes and upgrading at the level of raw material production are as follows:

Solvent free tanning: The switch from a market of footwear manufacturers to a market of automotive upholstery manufacturers has seen vast improvements in tanneries' products. Many of these tanneries are on a trajectory towards getting ISO 14000 certification which is likely to be a universal requirement in the automotive industry soon. Tanneries make use of 'solvent free' techniques which is not usually the case in footwear tanning.

‘The standards now demanded by automotive manufacturers are extremely high indeed, and are constantly changing, and the tanners and chemical suppliers have, so far, met these demands.’ (S&V 2001c: 32)

Chrome-free tanning: Recently, some car assemblers have begun stipulating that upholstery be made using ‘wet whites’ rather than ‘wet blues’. This means that the leather has been tanned without residues of chrome or other metal (S&V 2001c: 32). Although the process is more expensive, it has the advantage of avoiding the need to dispose of chrome shavings which have a high environmental cost. With the use of wet whites, the tanning process does not have this kind of residual and becomes a ‘completely recycled’ product.

Some tanneries in SA are set up to manufacture wet whites while others are not. Some tanneries do not believe that this is going to become a dominant requirement in the short term.

Full vs Corrected Grain: Another leather-related change is the way in which some OEMs are more stringent with their requirements for leather. DCSA and BMW require 'full grain leather' which is the outer few millimetres of the hide embossed with a pattern in order to ensure consistency. By contrast, OEMs such as Fiat (and this also characterises much of the leather upholstery market in the US) allow for 'corrected grain' leather. Although the same part of the hide is used, it is sanded, painted and then embossed with the pattern. Whereas in the former method the colour comes from a dye in the leather itself, the second method uses a superficial paint as an outer layer on the leather. The second method, of course, is less expensive as it is more accommodating of marks on the leather (tick bites, scratches, etc). At least one tannery in South Africa is manufacturing this kind of auto upholstery.

To the extent that it allows South African manufacturers to access *additional* markets this may represent an opportunity for the industry. However, it also represents a movement from a relatively exclusive high-end product to a more accessible kind of product closer to the mass market. If the barriers to entry are lower and, therefore, competition is higher, this would be classified as 'product downgrading'. This may be too strong a conclusion, though, and would only apply if the entire industry were to switch from full to corrected grain. Furthermore, corrected grain leather remains a relatively expensive product. Although those who require full grain leather believe it to be stronger, it is unclear whether the second method produces an aesthetically inferior product or whether this sense of inferiority is a largely perception based one.

3.3.5 Functional upgrading

Functional upgrading refers to a set of firms taking on more or different 'functions' in a way that improves their position within the value chain. There are a variety of value adding activities that take place in the production of the leather seat covers, including: tanning hides into wet blues, finishing leather, cutting leather, sewing covers and pulling covers onto seats. Furthermore, there are two key logistics-related functions, namely procuring leather for sewing and shipping sewn covers to customers. These value adding activities are divided between the main players namely, wet blue tanneries, finishing tanneries, sewing operations (seat cover manufacturer), SA OEMs (car assemblers) and Foreign First Tier Customers or sister companies. Plotting various permutations of the distribution of these main activities between the main players provides some insight into functional change and also governance issues. It would be an oversimplification to claim that the objective of each player is to accumulate as many of the value adding activities as it can. A number of factors come into play around this decision including perceptions of risk and perceptions of 'core competence'. However, retention of key activities by some parties does restrict paths for upgrading open to others. In this regard, three scenarios can be proposed to describe the auto upholstery industry in SA..

The first scenario below describes the situation whereby BMW owned two sewing operations called SA TRIM and Midlands Trim. BMW, then, was directly responsible for the bulk of the key value adding activities including procuring leather, sewing the covers, shipping the covers and, of course, accumulating the IRCCs. A slightly modified variant of this 'involved OEM' scenario is the outsourcing of the actual sewing of covers to

another firm but the retention of key activities such as procuring leather and shipping covers. In essence the sewing operation is undertaken on a sub-contracting basis with no other value adding activities housed within the sewing manufacturer.

Scenario 1: OEMs in control of key links	Wet blue tanneries	Finishing tanneries	Sewing	SA OEM	Foreign 1st tier
Tanning wet blues	X				
Finishing leather		X			
Cutting Leather		X			
Procuring leather				X	
Sewing Seat Covers			X	X	
Freighting Covers				X	
Accumulating IRCCs				X	
Pulling Covers Onto Seats					X

Scenario 2 describes a situation where tanneries accumulated a variety of activities. The Kolosus group has substantial vertical integration as African Hide Trading provides wet blues to Kolosus Automotive Leather (previously Ladysmith Leathers) (ITC 2001 section 3.1). A second example of vertical integration was Bader Bop whose activities, at one stage, began with raw hides and ended with completed seat covers. While most auto tanneries bought in their wet blues from hide agents, Bader Bop continued through the 1990s to buy in raw hides and tan the wet blues themselves. In 2001, however, it was announced that the wet blue tanning activities would cease (S&V 2001b). It argued that it was not downscaling but that since there was surplus wet blue tanning capacity in South Africa it was not necessary to retain this activity in-house. Therefore Bader Bop continues to see finishing and cutting leather as its main focus.

Scenario 2: Finishing tanneries in control of a number of activities	Wet blue tanneries	Finishing tanneries	Sewing	SA OEM	Foreign 1st tier
Tanning wet blues		X			
Finishing leather		X			
Cutting Leather		X			
Procuring leather		X			
Sewing Seat Covers		X			
Freighting Covers		X			
Accumulating IRCCs				X	
Pulling Covers Onto Seats					X

While these two examples are possibly more unusual instances of vertical integration, the key strategic activity for tanneries beyond their traditional domain of producing finished leather is the cutting of the leather in preparation for sewing. One of the multi-nationally owned sewing operations stated that the allocation of this work to tanneries is a peculiarity of the South African industry as it is one of the key rent-generating activities generally monopolised by sewing operations internationally. Another firm estimated that sewing covers only constitutes 30% of the value adding to finished leather, whereas

cutting accounts for 70%. Importantly, whoever cuts panels from the tanned leather is in a position to manipulate the 'yield' of the leather. If they are able to cut a higher yield than they actually declare to the buyer of the leather they are able to make more money.

Scenario 3 is a more recent development. With effect from 1 March 2002, BMW sold its leather manufacturing operations to other manufacturers already making this kind of product (i.e. its former competitors). BMW's operations were called SA Trim and consisted of a Gauteng operation, sold to the Automotive Leather Company, and Midlands Trim in Pinetown, sold to Aunde in Durban. The reasons given for the sale of these operations were to create "synergies in the leather component industry" in order to ensure post MIDP competitiveness (S&V 2002, p.31). BMW also stated that it did not consider sewing of leather components a core business. It stressed that there was "no intention to reduced the BMW leather business in South Africa ... the devaluation of the Rand makes the export of components more attractive, not less."

Scenario 3: Sewing firm in control of a number of activities	Wet blue tanneries	Finishing tanneries	Sewing	SA OEM	Foreign 1st tier
Tanning wet blues	X				
Finishing leather			X		
Cutting Leather			X		
Procuring leather			X		
Sewing Seat Covers			X		
Freighting Covers			X		
Accumulating IRCCs				X	
Pulling Covers Onto Seats			X		

As BMW sold off SA Trim and Midlands Trim, the key activity of sewing was transferred to first tier sewing firms. It also transferred responsibility for procuring leather and freighting finished covers to the sewing firms. Its involvement in the industry, then, was reduced to the simple accumulation of IRCCs and the usual regimen of controls associated with OEMs who procure parts from suppliers (Barnes 2002). Sewing firms thus accumulated more activities and began turning their attention to cutting. More recently, one seat manufacture has initiated a joint venture with a finishing tannery, which would be relocating itself to be nearer to the sewing plant.

Crucially, sewing operations are now in charge of their own incoming and outgoing logistics. In the past their money was made purely on the conversion process of sewing the covers which gave little opportunity for value chain improvements. In contrast to Scenario 1 where OEMs retained control over purchasing of leather and shipping of finishing covers, the seat sewing operations in Scenario 3 are in charge of both.

- **Materials handling:** One sewing operation saw this as a great opportunity since, according to the spokesperson, success in this sub sector is based on efficient materials handling. Since the raw material is so expensive, it was possible to gain a competitive edge if it was possible to hold less stock in inventory. When OEMs were in charge of freighting finished seat covers to Europe they held *three weeks* of finished goods inventory whereas some of the sewing operations have reduced this to 36 hours.

- **Own procurement:** A further advantage of own-procurement is that sewing operations now have the choice as to whether to buy cut leather or to bring cutting operations within their own functions. If, as one seat cover manufacturer believes, cutting is a key rent-generating activity due to the declaration of 'yield', this is an important strategic direction for sewing operations.
- **New customers:** This disengagement by the OEM has also freed the seat cover manufacturers to explore new markets. Whereas they previously existed to cut and assemble covers on behalf of an OEM, they are now given responsibility of running all aspects of the business, on the condition that IRCCs will continue to be available to the OEM. The original OEM gains nothing from the monopolisation of the output from a set of firms and encourages these manufacturers to find other markets as this will reduce overheads for the manufacture of their products.

The down-side of this, however, is that the sewing operations are more directly exposed to fluctuations in hide and leather price. They become the buffer between a fixed price contract for the end product (i.e. the seat cover) and the price fluctuation of hides which are a globally priced commodity. Furthermore, the disengagement of OEMs from key activities places them in an easier position to withdraw support for the seat cover manufacturers; although it should be stressed that they have expressed their commitment to the leather seat industry. Despite these reassurances, firms do not take for granted that their business is guaranteed. One firm is therefore aggressively diversifying its market and is even branching into the manufacture of non-leather covers (see 'Value chain upgrading' below).

It should be stressed that 'Scenario 3' only describes a portion of seat cover manufacturers. Some have chosen not to pursue acquisition of cutting business or vertical integration with tanneries. Although they say they can see the logic in this strategy they would not be supported by their multi-national parent company in acquiring a tannery, for example, as they see their core business as seat cover sewing.

3.3.6 Value chain upgrading

Value chain upgrading is defined as the movement of firms into different value chains in order to escape the limitations of their old value chain. The obvious limitation of the leather upholstery value chain is that business may not be secure. In response to the shift away from the 'involved OEM' in Scenario 1 towards the disengaged OEM in Scenario 3, one of the seat cover manufacturers has recognised that this frees the OEM to source this product from anywhere it chooses, as it no longer has to give preference to local manufacturers. The usefulness of the upholstery industry was not because of its special abilities in upholstery manufacture, but its ability to generate duty rebate credits (IRCCs) under the MIDP. As exports across the automotive industry increase, both of other kinds of parts and of whole cars, OEMs have an increasingly diverse IRCC base and the leather upholstery business in South Africa may have decreasing importance in terms of the MIDP. Some manufacturers, therefore, treat this business as having a finite horizon and one firm even argued that there might not be a leather upholstery business in five years time.

In order to hedge against this, one sewing operation is diversifying away from an exclusive focus on leather covers into textile covers. It has acquired a major contract to supply these covers to an OEM which has, until now, not been a customer of the sewing operation. Therefore this move has enabled the cover manufacturer to find new customers that it might not have otherwise had. The firm argues that it is only possible to

be competitive if the seat manufacturer has its own supply of textiles. Fortunately for this firm, textiles is a core business of the multinational parent company globally, and it is also core competence of a sister plant in South Africa. Furthermore, the firm's sound competence in manufacturing leather car seat covers means that it is well placed to embark on the easier process of textile seat manufacture (whereas a leather seat may take 4.5 hours to sew, textile covers take as little as 45 minutes). The firm believes that once this business is launched it should be able to rapidly reduce scrap which is a key determinant of the viability of seat cover manufacturers. Such a shift would be encouraging in as much as it move the South African industry towards a more normal product profile which – elsewhere in the world – is composed primarily of textile covers.

3.3.7 Governance, Coordination and Lead Firms

Governance refers to the 'co-ordination of economic activities through non-market activities' (Humphrey & Schmitz 2002: 3). Value chain analysis 'views the *coordination* of the entire chain as a key source of competitive advantage that requires using networks as a strategic asset' (Gereffi 1999: 3). It is important, therefore, to identify *lead firms* that occupy a position of power in the value chain by coordinating the activities of others. More specifically, do suppliers have a degree of autonomy in the way they meet their customer's requirements, or do customers become actively involved in the running of their supplier's business?

Relationships between customers and suppliers can thus be plotted on a continuum from hierarchical governance (vertical integration) to arm's length trade-based relationships. The position on this continuum, according to Humphrey and Schmitz (2002: 3) can have a critical impact on a firm's scope for upgrading. In particular, customers can be motivated to restrict suppliers from acquiring competence or undertaking value adding activities which customers considers to be their domain (Humphrey & Schmitz 2002: 6). This is a particularly important factor when the relationship between customer and supplier errs towards vertical-integration. Where the arrangement stops short of direct investment in one party by another, but is still characterised by an asymmetry of power and competence, Humphrey and Schmitz describe it as a quasi-hierarchy (2002: 2). The motivation to 'manage' suppliers may be that

- there are high transaction costs caused by specialised products that require more active coordination between buyer and seller (2002: 7) or
- there are 'doubts about the competence' of suppliers and therefore wish to eliminate risks associated with supplier failure (2002: 10).

However there is a disincentive to invest because

- the customer does not see the set of activities as their 'core competence'
- the customer wishes to outsource risk.

Therefore, where there is a need for the customer to be heavily involved in supplier's operations, but there are reasons why it is rational to avoid investing in the supplier, the relationship can be classified as quasi-hierarchical. This term is useful for understanding scenario 1 (above) where an automotive assembler outsourced sewing operations to a seat cover specialist but did not allow it to buy its own leather or ship the finished product. The firm was therefore constrained around the extent to which it could improve its processes.

Under what circumstances can a customer-supplier relationship become more equal? Relationships may become less hierarchical as lead firms gain trust in their suppliers' ability to perform as required. 'As capabilities in the supplying cluster increase, local firms may find that the lead firms vacate certain spaces'. (Humphrey and Schmitz 2002: 12). This neatly describes the situation in which automotive assemblers switched to a more laissez faire position *only after* the nascent seat manufacturing industry had proved itself capable of performing as required. Disinvestment from seat cover manufacturing factories and the hand over of greater autonomy in inbound procurement and outgoing logistics allows these firms more scope to upgrade their processes.

3.4 Discussion

Upgrading: The first broad comment that can be made on the basis of the above discussion is that the auto upholstery sector is a constantly learning and improving sector in terms of the four areas of 'upgrading'.

- Firstly its continuous drive towards lean production techniques has seen a number of shifts in its intra and inter firm process, or its ability to make products efficiently. The constant drive towards better quality and lower inventory through logistics are indicative of this.
- While product upgrading is arguably not as significant as process upgrading, the tanning sector is fulfilling a crucial function in being able to adapt towards new demands for environmental rigour.
- In terms of function upgrading, we have seen the improved position of seat manufacturers in the value chain which has allowed them greater flexibility in their path towards embeddedness. From having been simply CNT type operations they are now fully fledged autonomous businesses in charge of procurement and outgoing logistics.
- Finally, value chain upgrading is taking place amongst some firms diversifying into textile seat covers in order to overcome the inherent precariousness of the business.

Security of business & future growth: Despite vast improvements in productivity, the rapid improvements in efficiency are inadequate to ensure future growth or retention of current business due to the nature of work allocation between global MNCs and the importance of the MIDP. Most seat cover manufacturers are part of global multinational corporations that have similar capacities in a number of sites around the world. Some of these sites have labour productivity or cost advantages. Some also have advantages of being close to the primary market (e.g. East European firms supplying Western Europe). This work should be seen as 'easy-come-easy-go' business for South Africa. It came here not because of any core advantage to do with the manufacturing of seat covers, but rather to generate IRCCs. Very often it was not new business to the seat cover manufacturers globally, but rather a re-allocation of work in response to demands from their OEM customers. If the impetus to locate that work in South Africa is lost, the 'barriers to departure' are far lower and multinationals can very rapidly re-allocate business to sister plants elsewhere in the world. Future growth and decline of the industry will therefore be an interplay between:

- Change in the global demand for leather seat covers in cars.
- The need for duty rebate credits (IRCCs) by assemblers wishing to import.

- The growth of a broader IRCC-generating base of a variety of exporting automotive sub-sectors.
- The dependence of the leather seat industry on IRCCs to offset competitive disadvantages.

Clearly, independence from the MIDP is critical and will be achieved through process upgrading of manufacturing and the value chain that will allow South African producers to compete globally. Paradoxically, one of the key inhibitors to greater competitiveness (and therefore independence from the MIDP) is, in fact, caused by the MIDP. The high cost of raw materials to South African producers results from the premium charged for local content. If the industry remains dependent on the MIDP benefits of exporting, local content continues to be paramount. This may result in 'MIDP' pricing of local hides by those who control the hide supply (wet blue manufacturers). However, if the industry is able to compete without MIDP benefits, there will be no special preference for local hides and prices will be set at import parity.

Once this kind of independence is achieved, the 'plateau' of exporting identified in Figure 9, which was defined as the level of exporting required to generate duty rebate credits for OEMs, may be broken and further growth could take place. Of course, relationships with domestic OEMs remain paramount as they increasingly re-focus their own operations towards exports thus providing opportunities for increasing domestic sales of leather seat covers for cars locally assembled for export.

3.4.1 Policy considerations

- Engage with the industry over ways of avoiding 'MIDP pricing' by hide manufacturers. Restrictions of the exports of hides is the most frequently cited route but this should be fully investigated before implementation. Independence from the MIDP through international competitiveness would be ideal since it would remove the necessity to purchase local hides and enable manufacturers to import raw material thereby empowering them to bargain for competitive prices with domestic suppliers.
- The MIDP is critical to the future of the industry. Although manufacturers have gone a long way towards competitiveness, logistics continue to be a barrier given South Africa's distance to market. Reductions in benefits derived from the MIDP should be carefully balanced with further improvements in competitiveness by the industry.
- Promote the diversification of manufacturers into products other than leather seat manufacture in order to avoid complete dependence on the leather industry.

4 General Leather Goods

Summary of key trends

- ❑ **Growth:** Exports of general leather goods increased to moderate levels of \$17.4million in 1996 but subsequently declined to just above half of that level by 2001.
- ❑ **Export markets:** While Japan has been a declining market of destination for SA leather goods exporters, sales to the EU have been increasing. The latter has, therefore, eclipsed Japan as the most important market for South African general leather goods.
- ❑ **Raw material unit prices:** The value of ostrich leather has collapsed since the industry was deregulated in the early 1990s.
- ❑ **Pricing strategy:** The unit prices of exports have been falling partially as a result of the fall in ostrich leather, but also because some producers have attempted to enter the discount market. Some of these firms have now closed and it is important for South African exporters to continue a high end focus.
- ❑ **Own branding vs manufacture under licence:** While some producers are manufacturing under their own brands, others are doing so under licence of a global buyer. Both routes appear to yield good market opportunities for producers.

4.1 Introduction

The general leather goods industry encompasses a variety of manufacturers producing clothing, gloves, travel goods, handbags, wallets and other leather accessories. Aside from the variety of products made, the key cleavages dividing firms revolve around:

- ❑ **Raw materials:** Firms that work with exotic leather (primarily ostrich, but also including game and reptile) tend to be distinct from those that work with bovine leather and synthetics primarily because they are focused on high-end goods.
- ❑ **Export orientation:** As the following will show this sector is a net importer and production for exporting amongst the 78 registered firms that manufacture general leather goods is rarely undertaken. However, where it does happen, exporting appears not to occur in 'degrees'. Firms that export tend to be almost exclusively export focused.

These cleavages overlap to a large extent. Firms using ostrich and other exotic leather tend to be more likely to be export-focused firms due to the fact that their products are extremely expensive and the domestic market would not be able to support the industry. They specialise in hand bags, wallets and other small items.

This is not to say that there are no exporting bovine leather goods manufacturers. Indeed one firm has been awarded a contract to supply portable computer cases to a global computer brand. The firm has appointed a marketing person who will solely concentrate on exports, thereby showing a strong commitment to re-focusing on exports. Typically, however, the bovine leather general goods industry does not operate on these terms, having failed to re-orientate away from its dependence on the domestic market. Exporting firms commenting on other firms in the industry describe them as "unprogressive", having failed to keep up to date with capital and technology and refused to participate in the industry association. They continue to rest their hopes on protection

from external competition and failed to commit to exporting. The size of firms is might be a barrier to exporting, with each having an average of just 26 employees.

4.2 Macro data

4.2.1 Employment levels

The number of employers registered with the National Bargaining Council of the Leather Industry has fallen by a third since 1995 (Table 5). The number of employees decreased even more sharply, and 2001 levels were just three-fifths of their 1995 levels. As a result, average firm size decreased from 28.7 employees to 26.2 employees. Although there was no decrease in the number of firms between 2001 and 2002, the sector continued to shed jobs.

Table 5: Number of Employers and Employees in the General Leather Goods Industry

	Employers	Employees	Avg. frm size
1995	119	3410	28.7
1996	116	3183	27.4
1997	108	3040	28.1
1998	108	3167	29.3
1999	97	2716	28
2000	87	2458	28.3
2001	78	2287	29.3
2002	78	2042	26.2
2002 as % of 95	65.5%	59.9%	91.2%
% change	-34.5%	-40.1%	-8.8%

(Source: National Bargaining Council of the Leather Industry)

4.2.2 Imports and Exports

Imports: Taken as a whole, the general goods industry is a net importer. However, this is nothing new, and given the relaxation in import controls in the first part of the 1990s, it is somewhat surprising that the deficit only increased marginally from its 1990 level of \$23.7m to reach \$35.3m in 2001 (Table 6). Imports increased from \$27.1m in 1990 to \$60.3m in 1997, after which they decreased year-on-year to \$44.8m in 2001. Ignoring the 1997 peak, then, imports only grew by 39.5% between 1990 and 2001. Table 7 indicates that more than half of the imports in 2002 were made up of travel goods. Clothing and handbags were the other significant categories of general goods imports. The distribution of value of imports between different product categories changed very little during the course of the decade.

Table 6: Imports and Exports of General Leather Goods (Customs & Excise data for HS 42)

CH42	Exports		Imports		Deficit
	Rands (Mil)	Dollars (Mil)	Rands (Mil)	Dollars (Mil)	Dollars (Mil)
1988	7.0	3.1	55.9	24.6	-21.5
1989	9.0	3.4	54.9	20.9	-17.5
1990	8.9	3.4	70.2	27.1	-23.7
1991	11.5	4.2	91.7	33.2	-29.0
1992	19.6	6.9	98.2	34.5	-27.6
1993	28.3	8.7	121.7	37.3	-28.6
1994	39.3	11.1	151.9	42.8	-31.7
1995	59.1	16.3	186.8	51.5	-35.2
1996	74.9	17.4	234.4	54.6	-37.1
1997	80.2	17.4	278.0	60.3	-42.9
1998	72.0	13.0	301.3	54.5	-41.5
1999	85.1	13.9	324.3	53.0	-39.1
2000	95.1	13.7	348.3	50.2	-36.5
2001	81.1	9.4	385.3	44.8	-35.3

Domestic market: Unfortunately, due to the way in which goods are classified under SIC, it is not possible to comment on domestic sales of general leather goods in the same way as for footwear (below). It may be the case that the general leather goods market in South Africa has shrunk (for example the market may now prefer synthetic products for price or fashion reasons). It is also likely that a portion of the domestic market has been lost to illegal imports which would not be represented in Table 6.

Table 7: Comparison between 1992 & 2001 of relative value of trade in general goods sectors

		Saddlery	Travel	Handbags	Small items	Clothing	Gloves	Other	
Exports	1992	1.7%	21.3%	38.6%	9.5%	14.7%	0.1%	14.1%	100%
	2001	6.1%	20.3%	36.9%	9.1%	14.0%	0.1%	13.5%	100%
Imports	1992	1.1%	55.6%	19.2%	5.8%	11.5%	2.3%	4.6%	100%
	2001	0.3%	53.7%	14.9%	7.0%	20.2%	3.1%	0.9%	100%

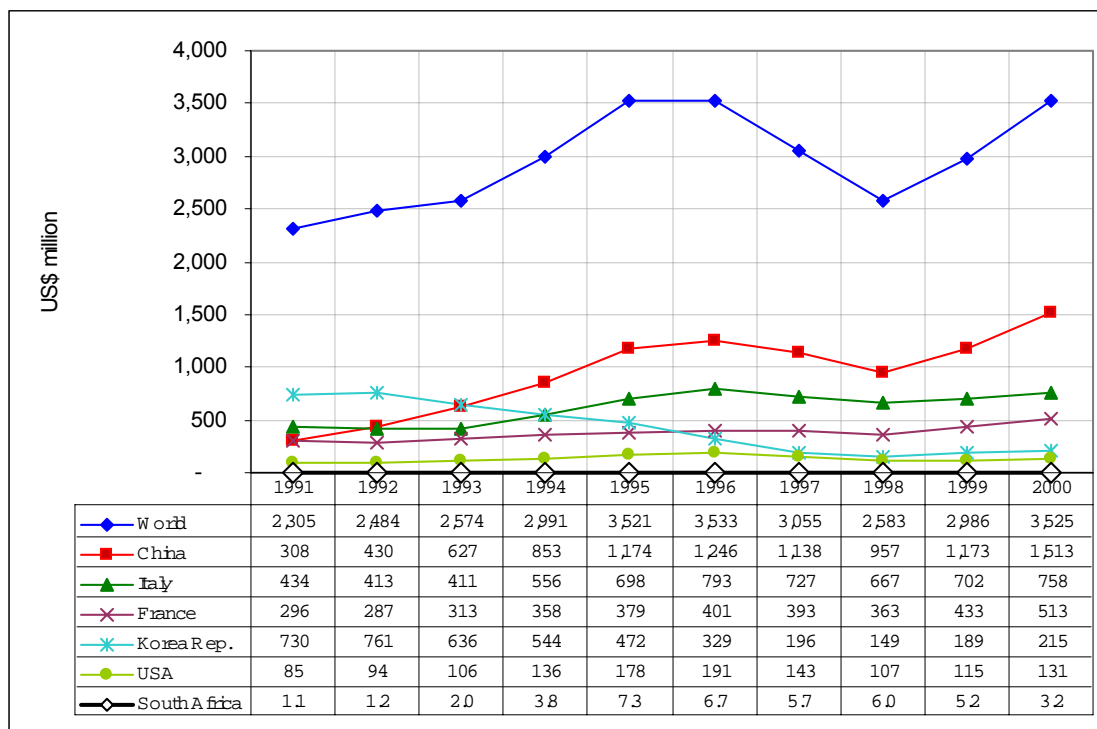
(Source: Derived from Customs & Excise Data calculated in Table 12 on page 72 below)

Exports: Although starting from a small base, exports grew impressively until 1995 from \$3.4m at the start of the decade to reach \$17.4m in 1995. Thereafter they decreased to \$9.4 in 2001. Table 7 shows that the most important category of exports was Handbags (at \$3.37 m), followed by Travel goods and Clothing. Comparison between 1992 and 2001 shows that exports of saddlery grew from 1.7% to 6.1% of leather goods exports.

4.2.3 Foreign Markets: Japan

Japan is frequently cited as a key market for South African general leather goods. It is important to assess South Africa's market share in Japan, trajectories of growth relative to other suppliers to Japan and trends in unit prices.

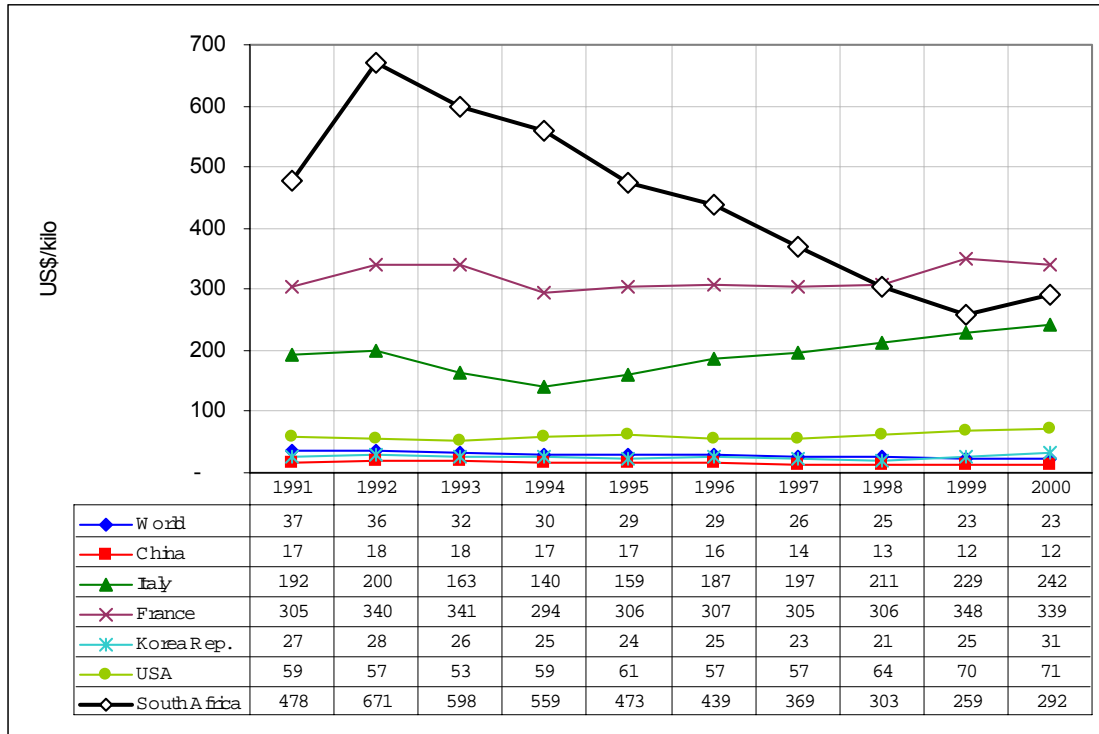
Figure 13: Value of Imports of General Leather Goods into Japan by Country



Total sales to Japan: Figure 13 shows Japan's importation of general leather goods (HS Ch 42). Total imports (depicted on the 'world' line) clearly show the effect of the East Asian crisis in 1998, with total imports having fallen by a quarter of their 1996 levels. By 2000, this had recovered to pre-crisis levels of \$ 3,525 m, of which China supplies the greatest value followed by Italy and France. Interestingly, Korea – frequently cited as a major competitor to South Africa in the Japanese market – experienced declining sales to Japan in the 1990s, with its trend from 1992 to 1996 going against the trend of an overall expansion of general goods purchase by Japan.

SA's position in the Japanese market: Although South Africa considers Japan to be a major market for its finished leather goods, it is clear that it is a very small player in relation to other countries supplying Japan. In fact, South Africa's rank in terms of sales to Japan was only 20th, having improved from 23rd position in 1991. South Africa's sales to Japan improved in the first half of the 1990s, with 1995 levels being almost 7 times larger than their 1991 levels. However, it then declined slightly year-on-year from until 1999 followed by a major decline in 2000. Unlike other countries' sales into Japan which experienced their worst year in 1998, South Africa's collapse happened in the years following the crisis, when other countries' sales to Japan picked up again. During this period several exporting South African manufacturers of general leather goods closed down.

Figure 14: Unit price of Imports of General Leather Goods into Japan by Country



Unit prices: Figure 14 shows that South Africa, Italy and France are supplying high value products well above the average unit price of \$23 per kg in 2000. China, on the other hand, is supplying goods at below the average unit price. In other words, although China makes up almost half of the sales going into Japan, these sales are generated from large quantities of low value goods. Italy, which supplies around half the value China's of imports of general goods into Japan (Figure 13) does so off one-fortieth of the China's quantity.

This split in the market between mass market and exclusive fashion items is, to some extent, related to the difference between bovine leather products and exotic leather products including ostrich and reptile. South Africa's sales to Japan would almost exclusively contain ostrich leather. According to one general goods firm interviewed in March 2002, bovine was their cheapest material at R1.70 per square decimetre, while ostrich was around R15.4 and crocodile R140. Exotic leather goods, then, are extremely expensive with an ostrich handbag possibly costing R7,000 (there was even a crocodile leather case on sale for R72,000).

The 2000 data on its own suggests that South Africa's products were of a similar nature to those of Italy and France. However, a longer term view shows that South Africa's unit values declined markedly throughout the decade from \$671 per kg to \$242 per kg in 2000. The reversal of this trend from 1999 to 2000 may indicate that the firms that closed in the late 1990s were those attempting to sell to a middle level market in Japan with the unit value of the surviving firms being higher. The major reason behind the decline in unit prices is, however, not a price war between South African producers, but a massive reduction in the cost of ostrich leather – their primary raw material (see Figure 8 on p. 18)

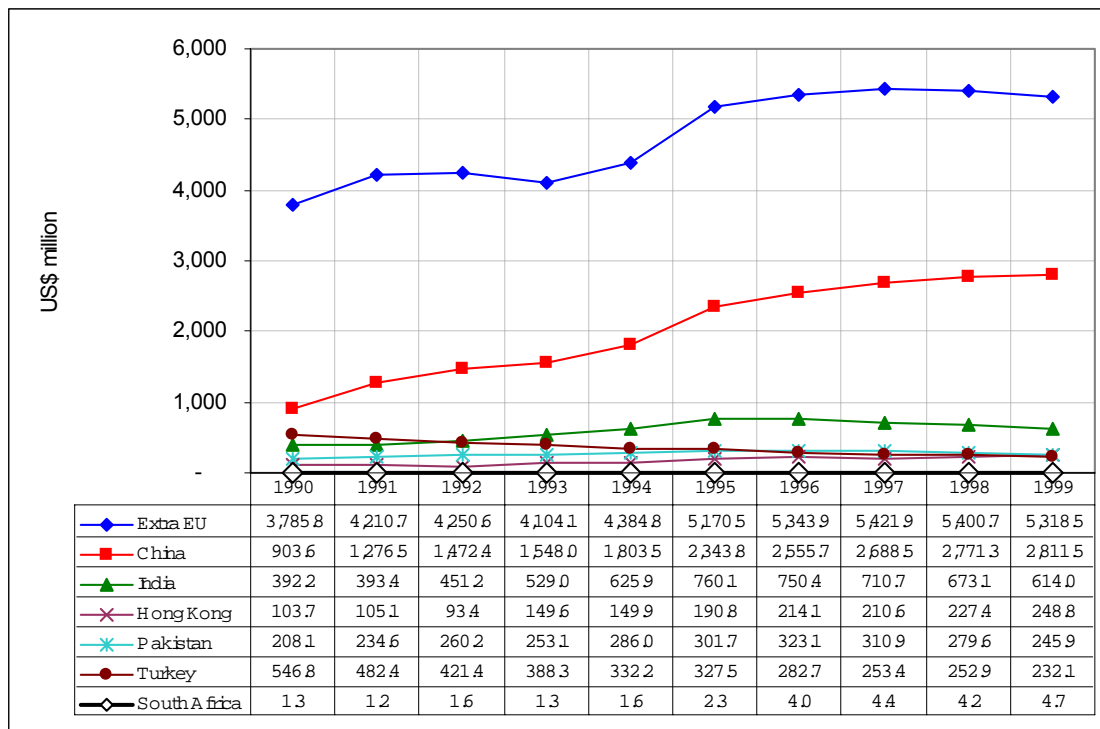
4.2.4 Foreign Markets: the EU

Total sales to the EU: Sales to the EU of general leather goods were \$ 5,381.5 m (the 'Extra EU line'). The value of general goods sales to the EU was stable before 1993, and after 1995 the market seems to have expanded between 1993 and 1995 (the unit price was constant during this time as can be seen in Figure 16).

Other suppliers to the EU: This is a market dominated by Far Eastern countries. The major single supplier of general leather goods to the EU is China, which supplied 52.8% of total sales in 1999, representing an increase in market share from just 23.8% in 1990. It is interesting to note the way in which Turkey lost market share, with sales halving during the 1990s it moved from supplying 14.4% of the EU market in 1990 to just 4.4% in 1999.

SA change over time: Although Japan was a more important market than the EU in 1995, when \$7.5m went to Japan and only \$2.3m to the EU, this pattern has now altered with the EU becoming a more important market than Japan for South African general leather goods (Figure 15). Encouragingly, although South Africa is a minor supplier of these goods to the EU in comparison to Far Eastern suppliers, SA's sales have grown year-on-year in Dollar terms since 1993.

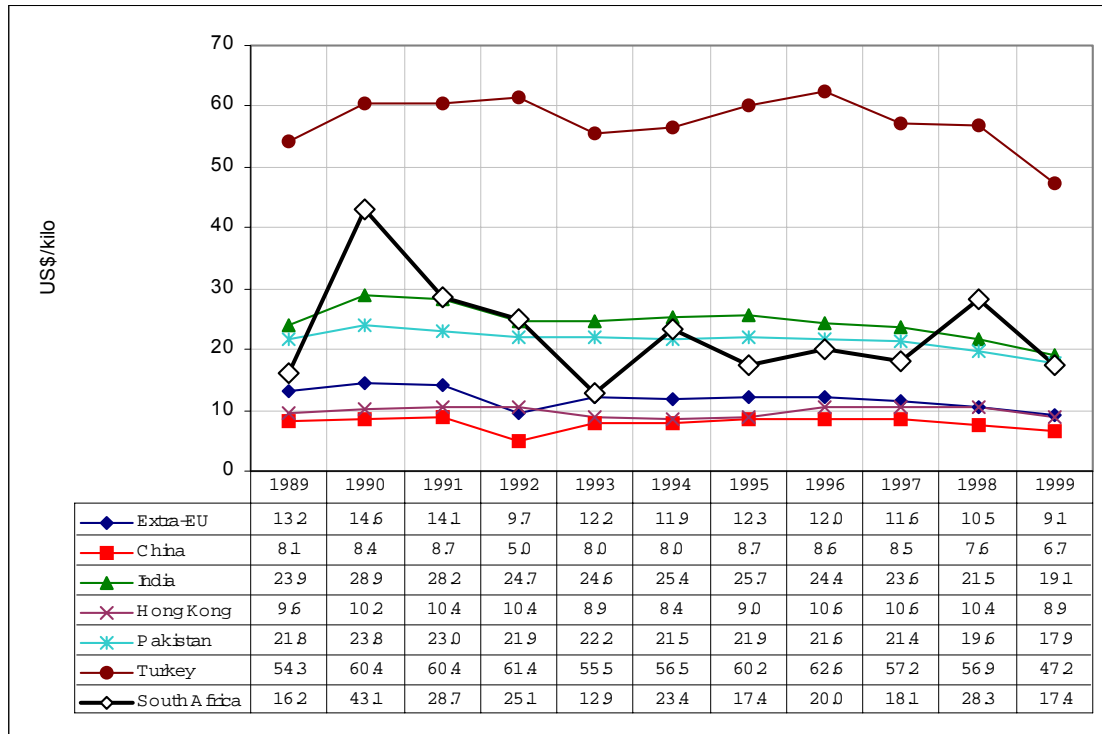
Figure 15: Value of Imports of General Leather Goods into the EU by Country



Although South Africa's unit price of general goods sold into the EU has fluctuated (a likely result of the small volumes) these fluctuations have kept above the average unit price ('extra EU'), putting it in the same category as India and Pakistan, but well above China and Hong Kong. It also appears that general goods going into the EU are not as

high end as those going into Japan (compare this with Figure 14 where unit price is \$292 per kg). Possibly supply to Japan is predominantly ostrich leather whereas there is a higher proportion of bovine leather products in the mix of goods supplied into the EU.

Figure 16: Unit price of Imports of General Leather Goods into Japan by Country



4.3 Firm-level feedback

4.3.1 Profile of Firms Interviewed

Selection of firms: The selection criterion for firms – which according to the methodology were to examine the most successful exporters of the sector – necessarily force the selection of unusual firms from the broader population of general leather goods firms. As explained in the introduction, most firms in this sector are users of bovine leather supplying the domestic market. Exotic leather goods producers are far fewer but tend to be the export-focused manufacturers of the sector. Three exporting general goods firms were interviewed. Two of these were manufacturers of exotic leather products, while one manufactured bovine and textile goods. The two exotic leather firms primarily manufacture handbags, small items and larger bags for the fashion boutique market.

The bovine leather goods manufacturer is operating in a different market. It has received a contract to manufacture computer cases for a major foreign computer manufacturer. Although the volumes initially would only allow marginal profitability, the starting orders only account for five percent of the customer’s total needs and could therefore increase to more significant volumes. Interestingly this contract has been brokered through an automotive upholstery manufacturer. The computer case manufacturer will make use of

AGOA benefits and will therefore need to use local leather in order to boost local content.

Export intensity: The two exotic leather goods manufacturers were largely export oriented (averaging an 80% export intensity between them). One of these firms indicated that at the beginning of the 1990s, its sales were primarily domestic with only 10% exported. As this firm was able to grow its exports throughout the decade it has grown the size of the firm in terms of number of employees and now has changed premises in order to accommodate its expanded activities.

The bovine leather goods manufacturer was primarily producing for the domestic market and its new export contract will introduce an export focus to the firm.

Firm size: The two exotic leather goods manufacturers averaged 66.5 employees. Although this appears to be small, it is more than twice the size of the average firm in the industry (see Table 5 above). While one firm stated it did not intend to grow further, the other had actively recruited for the last two years. The non-exotic leather goods manufacturer also expected growth of 40 employees as a result of its new export contract.

Export regions and domestic markets: Exports were destined for the EU, Japan, Australia, and the US. The Japanese market was seen as the traditional mainstay of this industry and therefore the 1998 crisis in the Far East was catastrophic. For one firm it resulted in an actual loss of all business to Japan for during 1997 and 1998, with orders only coming back in 1999. The market remains sluggish in the sense that ongoing *deflation* in Japan, means not only that consumers' buying power is decreasing, but that people who can afford the product will wait as long as possible in order to get a lower price.

For those exotic goods manufacturers selling to South African retail chains, these outlets are not orientated to a local clientele but rather to tourists from abroad, many from Europe and the US but increasingly from Japan and even from Malaysia. A recent windfall has been the avoidance of the Suez Canal by cruise liners who now dock in South African ports bringing wealthy buyers. Therefore the suggestion that the firms sell 20% locally needs to be qualified by the fact that most of these are indirect exports via tourists.

Understandings of growth and opportunities: Producers believed the fashionability of ostrich is improving, with younger people becoming interested in buying these products. In the past it was associated with older buyers who were buying for exclusivity but not necessarily 'chick' or 'trendy' reasons. Bright colours are thus increasingly important.

Regarding bovine leather products, the firm interviewed believed that opportunities exist around South African producers' special competence in relatively ad hoc flexible work such as corporate promotional work. Unlike many Far Eastern producers, who specialise in mass production, South African manufacturers are able to make money off smaller jobs and this may offer opportunities for exports.

4.3.2 Comments on government support

There seemed to be mixed response to the importance of Trade Fairs. One firm stated that it has not been 'using government incentives lately' and although it went to a fair two

years ago, it did not see this as central to marketing. However, the other firms stated that fairs are *critical* and the DTI's assistance in this regard is key to securing new work for firms. The firm said that it had made recent use of government assistance to attend fairs and was very complementary of the service it received. However, it commented that there was 'a lot of paperwork' and that 'pre-requisites were onerous'. Furthermore, the money available does not go as far as it used to. Whereas in the past, the money allocated would cover the cost of the stand and the cost of one person's flight to the fair, it now does not even cover the cost of the stand. The cost of the booth is \$6,000 and they budget R1,200 a night for accommodation. Furthermore, the firm has to pay for around R120,000 in samples. All together these expenses make such trips expensive undertakings.

Generally firms felt that they did not have an adequate understanding of the schemes available and would like to know more about facilities available. In other words, the DTI did not advertise available resources adequately. For example, one firm had applied for an expansion subsidy to help pay for a recent move but it did not know this was possible until they were told as much by a consultant.

4.3.3 Process upgrading

Exotic leather goods manufacturers have very high-level production environments. Both firms' exposure to the international market for some time means that their quality levels are extremely high. Pressure for optimal manufacturing also comes from the fact that the producers use their factories as part of their marketing. Both have retailing outlets at the factory and frequently show potential buyers around the production areas in order to demonstrate the high level of skill and quality. In other words, these factories are at the opposite end of the spectrum to unrepresentable sweatshops.

Skilling: Manufacturing depends on the 'craft' of employees and in-house training is therefore paramount. Multi-skilling is high and individual workers are responsible for making most of the product rather than just a small part of it. One firm did comment that it was increasingly difficult to bring skilled craftspeople from Europe and elsewhere and this did not occur as frequently as it did in the past. Immigration laws were cited as a key barrier.

Absenteeism: According to one of the firms, absenteeism was not a problem as they felt their workforce motivation was high. This was also deduced from the fact that turnover was low.

Inventory: Inventory holding is a problem for this industry as a result of the need to strike a balance between holding as little as possible of extremely expensive stock and responding responsively to customer orders. One firm stated it was holding three to four weeks of finished stock in order to be able to supply customers and in-house retail outlets.

4.3.4 Product upgrading

Unit prices: There is a split within the industry between those firms attempting to retain a high-end product niche, and those seeking to supply a larger market with more affordable products. The latter tend to be smaller operators who are able to undercut the larger manufacturers with more expensive products. According to the analysis of one of the larger firms, this is only because they are supplying an inferior product.

The fact that South African firms concentrate on high-end goods is critical for all of the export markets supplied. South African producers supplying to the high-end market in the US believe they have an advantage as this market ‘has an aversion to anything that says “Made in China/Korea”’. In the Japanese market, according to one informant, it is important for South African producers to avoid the middle market as Korean producers cater for this group. Therefore, although Korean producers have cost advantages, they are not necessarily a threat as long as South African producers specialise, i.e. keep producing for more expensive/high quality ranges. Indeed, when asked for an explanation as to why some exporting South African firms had recently closed, the informant suggested that it was because they went ‘down market’ trying to supply the discount market.

Raw material prices: Importantly, ostrich goods manufacturers complained that ostrich leather producers are not adequately regulating the quantity of their product released onto the world market. This results in massive price fluctuations and instability. The manufacturer argued that ostrich leather has been ‘prostituted’ implying that South Africa’s good name as an ostrich leather producer was being compromised. Another firm stated that whereas before 1994 the price of ostrich leather was around \$35 per square foot, it was now \$24 per square foot as a result of the deregulation of the market. Given that ostrich leather is likely to have a similar price around the world, the reduction in price is unlikely to place South African firms at any particular disadvantage. However, the lowering of input costs would change the dynamics of the industry. In particular, barriers to entry may be lower and South African producers may find themselves facing increasing competition.

4.3.5 Functional upgrading

The variety of functions that can be assumed by general ostrich goods producers includes the following:

- Design
- Branding
- Manufacture
- Marketing & Distribution
- Retail

The combination of these determines what kinds of markets they can access and whether they are in a position of relative strength in relation to their customers.

Design: Own design is very important. Firms maintain that although they keep up to date with products being released around the world, they are not ‘copying’ designs but developing bags and small items themselves from scratch.

Branding vs. producing for other labels: Own-design is obviously critically important where a manufacturer is attempting to support an own-brand/label. Both exotic leather goods manufacturers visited have one or more brands of their own.

However, one manufacturer also produces under licence for brands such as Calvin Klein. Although this reduces the manufacturers control over various functions on the above list, it provides the opportunity to supply into markets that would not otherwise be accessible. Furthermore, these global buyers are high fashion labels, a situation which is somewhat different to supplying to a low-cost oriented discount buyer.

Manufacturing: As long as these firms wish to remain producers they will retain manufacturing as a core competence. If they were to see themselves as primarily 'branders' they would outsource manufacture to other factories in South Africa or elsewhere in the world. While we have seen this amongst some general leather goods firms selling to the local market, who have switched from being manufacturers to importing wholesalers, we have not seen this kind of conversion for exotic leather producers orientated to the export market. Given that this kind of outsourcing is often motivated to find low cost production, such a transition would probably be undesirable for South African firms who do not want to compete in the lower cost markets.

Indeed in one case, we have seen the opposite process where an exotic leather goods manufacturer has brought the production of certain add-on parts in-house. The firm has acquired machine shop where it is manufacturing its own brass fittings such as buckles in order to avoid having to import them and to ensure a high quality product and control over the design.

Marketing & Distribution: Regarding marketing, one general goods manufacturer has sales offices in New York where a sample range is kept. This office is also responsible for delivering and servicing the stores that stock their goods. Rather than relying on agents to fulfil this function, then, it has taken control of this key link into the market and as a result has enjoyed growth of sales into this region.

Retail: As indicated above, both firms sell products directly from their factories, usually to visitors from overseas. One firm also has three of its own retail outlets in South Africa which are oriented to tourists. The vertical integration of manufacturers towards the retail end of the value chain shows attempts by producers to secure a market for themselves. Strategically this makes sense since independent retailers may chose to stock ostrich leather products made in low cost regions of the world rather than South African made goods.

4.4 Discussion

Analysing exports from South Africa's general goods sector is difficult since there are very few successful exporters. However, the few firms that are exporting seem on a 'virtuous' upgrading path in terms of three categories of upgrading:

- **Process:** Manufacturing processes are organised around highly skilled employees who understand the craft of making handbags and other items. As such, it is a 'learning' and 'knowledge intensive' environment which relies heavily on employees' abilities.
- **Product:** Products tend to be high-end, high quality luxury items rather than mass-market products where competition is greater. Experience of firms that have closed suggests that it is difficult to succeed in the 'discount' market.
- **Function:** Firm's strategies for relating to markets appear to be attempts to ensure the retention of key functions such as branding, design, distribution and retail. Firms also recognise that refusing to relinquish control over these functions may lock them out of markets and therefore do also supply to agents, and manufacture under licence (i.e. another brand).

It appears that the biggest challenge confronting the sector as a whole from a 'learning' point of view is isolation on three counts:

- **Little learning from each other:** Firstly, the 78 firms manufacturing general leather goods are often isolated from each other as a result of their failure to participate in and support employers associations. The opportunities for synergies or cluster-type engagement within the sector are, therefore, limited. This is unfortunate since the small size of firms prevents economies of scale in isolation and great opportunities could come from cooperation (e.g. see McCormick 1999: 1531, Pike 1992: 2).
- **Little learning from exporting:** Learning from exporting is not taking place amongst the vast majority of general goods manufactures, who are not engaging in exporting at all.
- **Little learning from international expertise:** Even firms who are exporting seldom benefit from international skills in their craft. Firms complained that they no longer bring specialists from Europe or elsewhere in order to refresh their skills base as a result of difficulties around immigration regulations and the cost of doing so. Furthermore, unless firms sell to other manufacturers, their 'learning from exporting' is likely to be limited to quality control demanded by customers. While the retention of design and branding functions is laudable, this may also restrict learning from manufacturing other firm's designs.

4.4.1 Policy considerations

- Key policy objectives should be to promote export orientation and to improve competitiveness. This might seem very general and obvious, but commitment to exporting is clearly very low in the sector as a whole and needs to be promoted as a desirable objective for a wider group of firms. In particular, education about the opportunities offered by AGOA and the EU should be targeted at this group of firms.
- There is a need for inter-firm collaboration or clustering since there is very little communication between firms. This has been undertaken fairly successfully in the footwear sector and should therefore be extended to general goods. At present there is little commitment by firms to the employers association. The clustering process will therefore have to overcome pervasive resistance to collaboration.
- Trade fairs remain a critical method for acquiring new business. Support in this regard is therefore valuable and should be promoted or expanded if possible.

5 Footwear

Summary of key trends

- ❑ **Domestic sales:** The footwear market in South Africa has decreased in terms of value of sales of around 42.1% during the course of the decade.
- ❑ **Imports:** As well as the domestic market shrinking by two-fifths, it is being increasingly lost to imports. Import penetration is now 63.4%.
- ❑ **Exports:** The industry has utterly failed to perform in terms of exports. Although it grew promisingly until 1996, it subsequently declined year-on-year to half of its 1996 high over the very period when depreciation in the exchange rate should have yielded labour cost advantages.
- ❑ **Production:** As a result of shrinking sales, increasing imports and lacklustre exports production has collapsed to little more than a quarter of its 1990 level in real price terms.
- ❑ **Exporting intensity of exporters low:** Even amongst exporting firms, exporting comes second to the domestic market. Export intensity is less than a quarter of output in most cases. While some firms are seeking to expand exports, other appear to treat exporting as supplementary.
- ❑ **Process upgrading:** Declining capital and labour productivity, declining value added and declining market share in export markets all suggest South African footwear manufacturers have not yet sufficiently restructured their manufacturing processes in order to meet their market's requirements as well as their competitors do.
- ❑ **Functional upgrading:** South African exporters engage in various additional functions such as retail, logistics and warehousing, own design and branding. While these suggest they are pursuing the exporting 'high road', the failure to grow exporting indicates the need for a more flexible approach to forms of exporting in order to increase exposure to international markets.

5.1 Introduction

The footwear sector in South Africa has been a glaringly weak performer over the last decade. Massive job losses and firm closures resulted from the loss of the domestic market to imports and the failure to significantly grow exports. The sector's inability to compete is illustrated by falling capital and labour productivity, decreasing levels of value adding and declining profits which, according to the NPI, fell from 5.2% in 1991 to 1.1% in 1999.

While many producers feel aggrieved that the government surrendered 'their' domestic market to imports, South Africa would have been unusual in global terms to have retained a self-contained producer-market relationship. In fact, over the last few decades the major markets such as the US have become net importers. The collapse of the industry, then, is not unusual in global terms and arguable its occurrence was an inevitability whose timing was simply the result of the end of years of protection. Lall (1993) argued that footwear was typical of stagnant sectors that had little dynamism as a result of over-protection under the industrial strategy of Import Substitution Industrialisation. He argued that high import tariffs were used not as a policy measure with a finite horizon underpinned by a strategy to overcome inefficiency, but simply a mechanism to protect jobs in otherwise uncompetitive sectors.

'At the narrower industrial level, the most highly protected activities are textiles, apparel and footwear: these are all mature, labour-intensive activities that are clearly not undergoing learning, and are being protected to preserve employment. The more dynamic areas of South Africa's future comparative advantage, say in electronics or equipment, receive far less protection. This confirms the suggestion that the protective structure is geared to maintaining obsolete and inefficient patterns of specialisation rather than to promoting a shift to a more dynamic pattern.' (Lall 1993: 61)

In the light of Lall's assessment at the cusp of the transition between a protected to an open economy, the subsequent collapse of the footwear and other labour-intensive industries would seem to be the consequence of the worst effects of protectionism, namely the failure of industry to learn and upgrade. If inefficiency was the cause of collapse of these industries, then this loss should be read as a necessary – if painful – correction in the economy. Of course the removal of tariffs should not have been treated as a Darwinist 'test' to see if footwear was competitive (accompanied with the self-satisfied notion that if they perished, they didn't deserve to survive anyway), but rather treated as an opportunity to motivate a stagnant industry towards dynamic learning. A more gradual programme of tariff reduction accompanied with a strategy to re-structure the industry might have taken the frequently fatal effects out of the government's rather stark challenge to 'sink or swim'. Indeed, the demise of any sector should be seen as problematic Tewari cautions 'against a growing view in the literature that policy makers should let dying sectors die, and instead switch freed-up regional and sectoral resources toward more modern, technology intensive uses' (2001: 3). She argues that since a strongly diversified industrial base is key to a 'robust region' from which high tech industries can grow, it is necessary to view the successful response of traditional labour intensive industries to global pressures as complementary to the conditions for the success of newer industries.

The challenge for the footwear sector, then, is the twin need to substantially restructure to generate greater productivity, and to engage with global value chains as a way of ensuring production stabilisation and possibly growth. Despite the enthusiasm generated at the 'Footwear Strategy Workshop' on 7 March 2002, the following will suggest that it is difficult to prove that the industry has yet 'turned the corner'. The most positive development is an apparent shift in mindset away from blaming labour, the government and imports for the collapse in the industry and a simple recognition of the need to export. As this objective becomes the norm within the industry, it may be possible for it to transcend its current impasse.

5.2 Macro data

5.2.1 Employment data

According to the National Bargaining Council of the Leather Industry, the number of registered footwear firms declined from 214 to 135 between 1995 and 2002 (Table 8). The total number of employees declined at a faster rate and is now little more than a third of its 1995 level. As a result, average firm size also decreased by 40%.

These figures may exaggerate losses because a number of firms and employees are not registered at the bargaining council. Increasing use of the COFESA-type model results in a number of un-registered employees producing components or whole shoes, possibly numbering as many as 10,000 (Ballard 2001: 47).

Table 8: Number of Employers and Employees in the Footwear Industry

	Employers	Employees	Avg. frm size
1995	214	28,351	132.5
1996	203	24,878	122.6
1997	197	22,841	115.9
1998	200	19,990	100.0
1999	183	17,537	95.8
2000	140	15,742	112.4
2001	111	11,972	107.9
2002	136	10,803	79.4
2002 as % of 95	63.6%	38.1%	60.0%
% change	-36.4%	-61.9%	-40.0%

(Source: National Bargaining Council of the Leather Industry)

5.2.2 Trade and sales data

Increasing imports: Table 9 summarises the trade status of the South African footwear industry. South Africa's footwear imports have increased dramatically throughout the course of the 1990s as South Africa's tariffs began reducing 5% a year from their 60% (non leather) level in 1994 to reach GATT levels of 30% in 2000. In Dollar terms, imports increased sevenfold from 1990 to 2001. Customs data indicates, however, that for the first time in 2001, the Dollar value of imports actually decreased. Optimistic interpretations of this as an indication that domestic producers are stemming the tide by competing in the domestic market should be balanced with the more likely explanation that the depreciation of the Rand acted as a deterrent for imports. Furthermore, increasing illegal imports are not captured in these figures.

Table 9: Imports and Exports of Footwear (Customs & Excise data for HS 64)

CH64	Exports (X)			Imports (M)			Surplus/Def x-m (\$)
	Rands (Mil)	Dollars (Mil)	X intensity	Rands (Mil)	Dollars (Mil)	M penetratn	
1988	4.6	2.0	-	56.4	24.8	-	-22.8
1989	8.2	3.1	-	62.5	23.8	-	-20.7
1990	6.6	2.6	1.0%	71.2	27.5	9.7%	-24.9
1991	14.7	5.3	1.2%	175.3	63.5	13.4%	-58.2
1992	47.7	16.7	2.2%	278.2	97.5	14.0%	-80.8
1993	63.7	19.5	2.5%	407.5	124.8	19.3%	-105.3
1994	91.5	25.8	4.7%	462.0	130.1	19.9%	-104.4
1995	94.0	25.9	4.5%	650.1	179.2	24.4%	-153.3
1996	111.9	26.0	6.3%	834.8	194.3	33.4%	-168.2
1997	101.4	22.0	5.6%	924.8	200.7	35.0%	-178.7
1998	90.8	16.4	5.9%	965.7	174.6	39.9%	-158.2
1999	115.7	18.9	8.3%	1,102.3	180.3	46.3%	-161.4
2000	120.4	17.4	13.0%	1,407.0	202.9	63.4%	-185.5
2001	115.8	13.4	-	1,666.5	193.6	-	-180.1

Table 10: Comparison between 1992 & 2001 of relative value of trade in footwear

		Leather	Non-leather	
Exports	1992	73.9%	26.1%	100%
	2001	39.0%	61.0%	100%
Imports	1992	40.2%	59.8%	100%
	2001	36.0%	64.0%	100%

(Source: Derived from Customs & Excise Data calculated in Table 12 on page 72 below)

As can be seen in Table 10, the value of imports of non-leather footwear has, throughout the 1990s been higher in value than imports of leather footwear accounting for 59.9% in 1992 of imports and 63.9% in 2001. Of course, non-leather footwear has a lower price per pair than leather – the average price from 1992 to 2001 being \$7.93 and \$3.00 respectively. In terms of quantity, non-leather footwear accounts for 77.1% of pairs imported (Table 12).

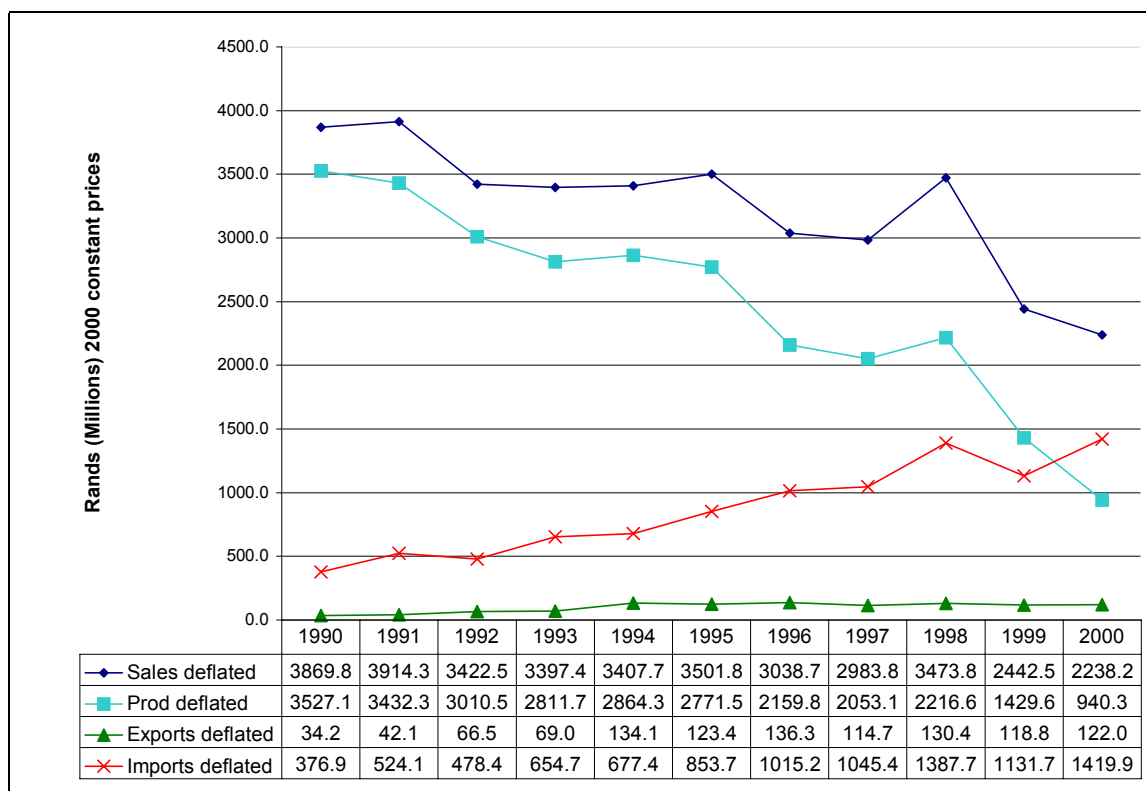
Decreasing domestic market: According to the IDC, sales of footwear in the domestic market have increased in Rand terms from R1,806.70 million in 1990 to R2,238.18 million in 2000 in real prices. However, when a producer price index deflator is applied, it is clear that this does not represent real growth but rather a decline of 42.1% throughout the decade (Figure 17). Therefore the domestic market has shrunk in real terms. Part of the explanation for this may be with a declining unit price of shoes sold on the domestic market as a result of competition from low cost regions. It is unlikely to reflect decreases in the volume sold. However, changing consumer spending towards new products such as cell phones and the national lottery are widely understood to have affected disposable cash available for purchase of long established products such as footwear (ITC 2001: section 1.1.5.2).

It also needs to be pointed out that these sales figures only represent formal sector sales. It would not include footwear sold on the informal market. It is unfortunately not possible to determine the extent to which losses in the formal market coincide with gains in the informal market.

Import penetration: The combination of a decreasing domestic market (in terms of value) and increasing imports conspired to place domestic producers under extreme pressure. Indeed these two trends need to be seen as related, since the advent of imported shoes was based on their cheapness. Therefore the domestic market may not have shrunk in terms of pairs sold but the average price per pair would have decreased. Import penetration, then, increased from 9.7% in 1990 to 63.4% in 2000.⁶ In other words, only 36.6% of the domestic market is now being supplied by domestic producers.

⁶ This accords with the independently calculated figure suggested by the ITC (2001: section 1.1.5.2) which estimates that more than 60% of footwear sales are from imported stock.

Figure 17: Imports, Exports and Trade Deficit for Footwear in SA



(Based on IDC Data with a producer price index deflator applied to indicate real change at 2000 prices)

Exporting: Under these circumstances, the only salvation for the industry would have been a significant reorientation to exports. The trade data tells us that this failed to take place. In Dollar terms, exports began the decade promisingly, with an increase from \$2.6 million in 1990 to a peak of \$26 million in 1996. They subsequently slumped to half that in 2001. According to the breakdown displayed in Table 10, exports are dominated by non-leather footwear which accounts for 61.2% of the \$13.4 million exported. Until 1999, however, leather footwear had been the strongest export sub-sector. The reversal of fortunes has less to do with any increase in non-leather footwear imports – which have fluctuated between \$7 and \$11 million since 1995 – but rather the year-on-year falls in exports of leather footwear from a high of \$15.8 million in 1995 to \$5.24 million in 2001. The fall-off of leather footwear exports may primarily be to the closure of Richleigh in Pietermaritzburg (which was part of the Conshu Group). This firm had significant leather export contracts but these dried up in 1996 resulting in the firm's closure.

Production: Production is calculated in Rand as sales minus imports plus exports (i.e. the value of production by local firms for the domestic and international markets). Given the decrease in sales, the increase in imports and the minimal contribution of exports, production has decreased to little more than a quarter of its 1990 level in constant price terms (Figure 17).

Export penetration: Despite the failure of exports to grow consistently throughout the decade, export intensity (i.e. the portion of footwear made in SA that is exported) actually increased as a result of shrinking domestic production (Table 9). Export intensity increased from 1% in 1990 to 13% in 2000. It should be stressed that while this appears

to show a greater export orientation this is more as a result of shrinking domestic sales than increasing exports.

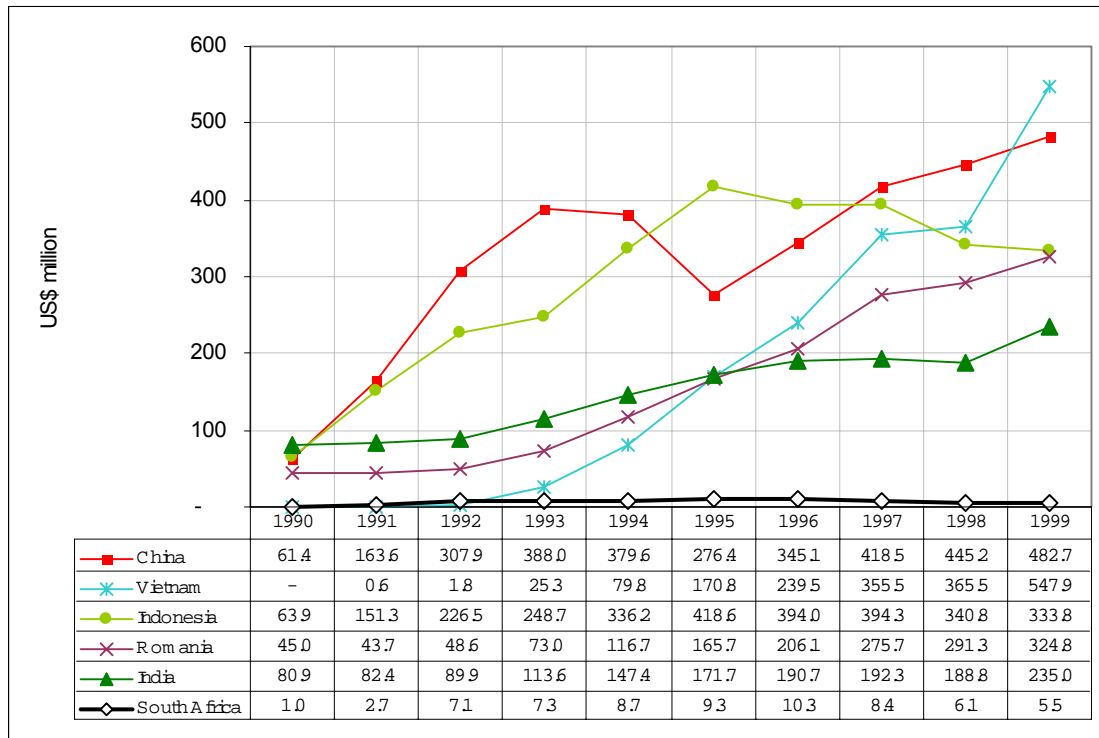
5.2.3 Foreign markets: the EU

An analysis was conducted on a selection of trade codes for footwear into the EU only. A comparison was made between footwear with leather uppers (HS 64.03) and with textile uppers (HS 64.04). The latter proved to be relatively insignificant, although sales in 1999 had risen to half a million dollars. Not included, however, are rubber boots/gumboots (HS 6401) which are likely to have yielded higher sales if considered part of the synthetic footwear category.

Sales to the EU: Total sales from all countries of footwear with leather uppers (HS 6403) amounted to \$3,911.8 m in 1999, of which 40.9% is met by the Far Eastern countries of Vietnam, China, Indonesia and India. In 1991, these countries were only supplying 13.2% of sales and their current dominance is therefore relatively recent. Vietnam’s growth in sales of this product have been spectacular, from selling less than South Africa in 1992, it surpassed China’s sales in 1999 to become the major supplier to the EU.

SA change over time: In 1999, South Africa ranked 43rd in terms of the value of sales to the EU, which is the same rank it had in 1990. South Africa’s sales did grow tenfold from 1990 to 1996 to \$10.3m but by 1999 had halved the 1996 peak.

Figure 18: Value of Imports of Footwear (leather uppers) into the EU by Country

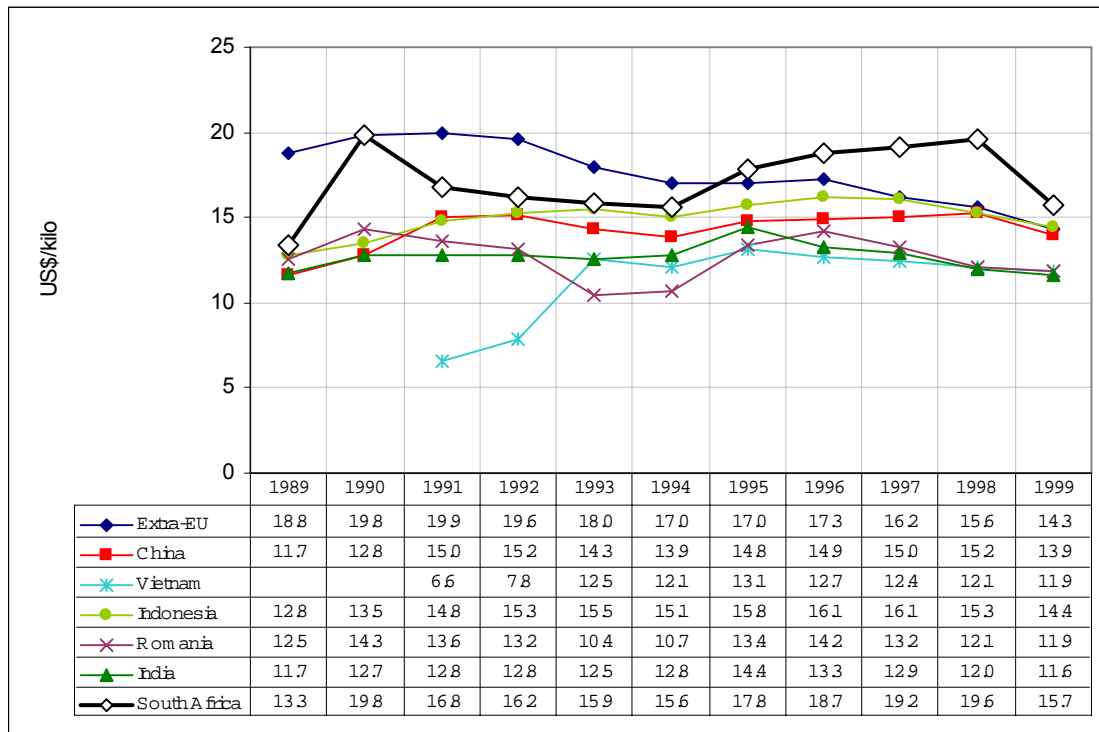


The price of leather upper shoes sold into the EU has declined throughout the 1990s by more than a quarter (27.7%) as countries like China and Vietnam gained dominance as

low cost producers. South Africa's prices, however, have moved from being below the world average price in the first half of the 1990s to above the world average price in the second half. Tellingly, the growth in Dollar value of exports occurred when South Africa's products were priced below the average import price, and they shrank when they became more expensive.

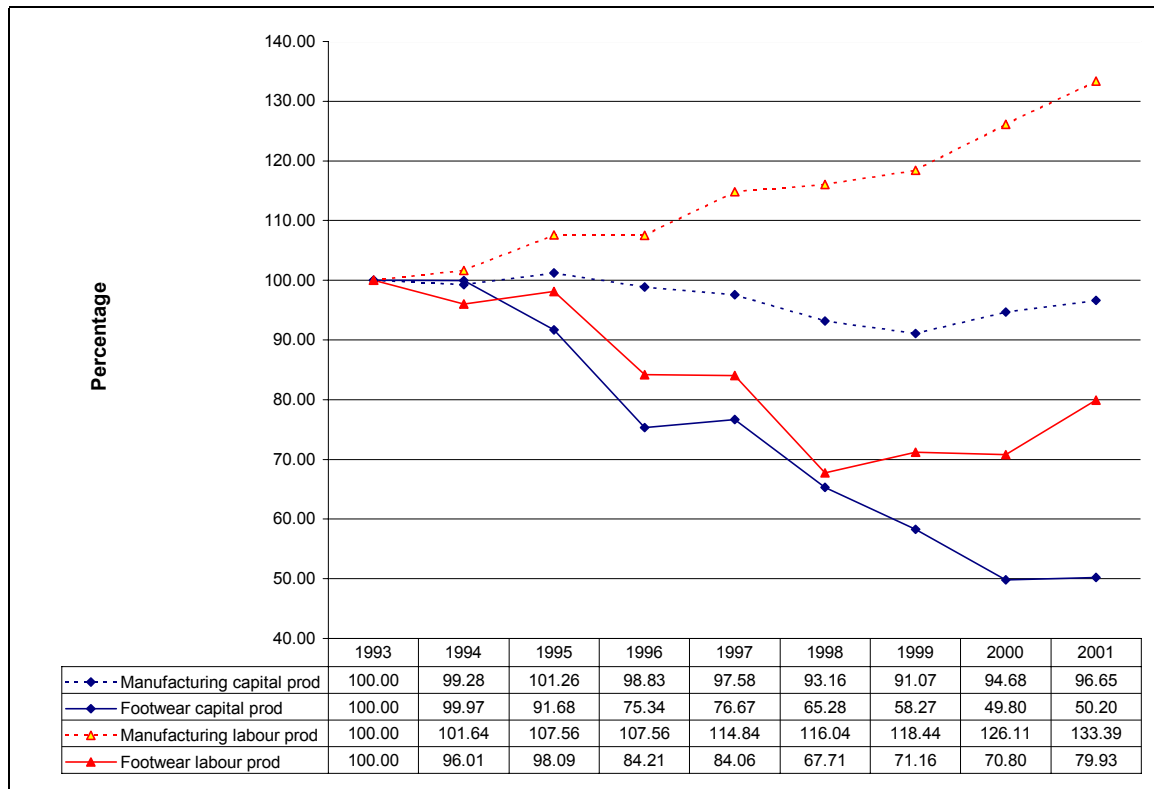
Although South Africa's prices are not competitive with Far Eastern prices, it should be pointed out that the countries represented on this graph do not account for three-fifths of supply into the EU. There has been substantial convergence of the world price on Far Eastern prices, but there will be suppliers other than South Africa who are not represented on the graph that do supply a more expensive product. The positive interpretation of this figure, then, is that South African producers are not competing purely on the basis of cost and are therefore competing in a different category to Far Eastern producers. In other words, high unit prices need not be a problem if a producer is not competing with low cost producers. Given South Africa's falling market share, however, its high unit prices do not appear to be offering substantial advantages.

Figure 19: Unit price of Imports of Footwear (leather uppers) into the EU by Country



5.2.4 Productivity and Value added

Figure 20: Indexed labour and capital productivity in footwear compared to the average



The bleak position of the footwear industry is further emphasised with the examination of productivity figures (Figure 20). By way of context, the NPI calculates that materials are 51.2% of costs, direct labour is 18.5% and other costs are 29.2% (Möller 2002). According to the survey completed by one firm, which manufactured leather footwear, materials counted for 57% of the cost of sales, direct labour was 22%, indirect labour was 14% and logistics was 7%.

Labour productivity: Labour productivity is defined as value added at factor costs per employee. Whereas labour productivity in South African industry increased to 33.9% above its 1993 level by 2000, labour productivity in footwear collapsed to 67.7% of the 1993 level by 1998 (see Figure 20). Since then, encouragingly, it has improved to 79.9% of its 1993 level. The stabilisation and slight improvement since 1998 would suggest that there have been improvements in the way employees interact with production.

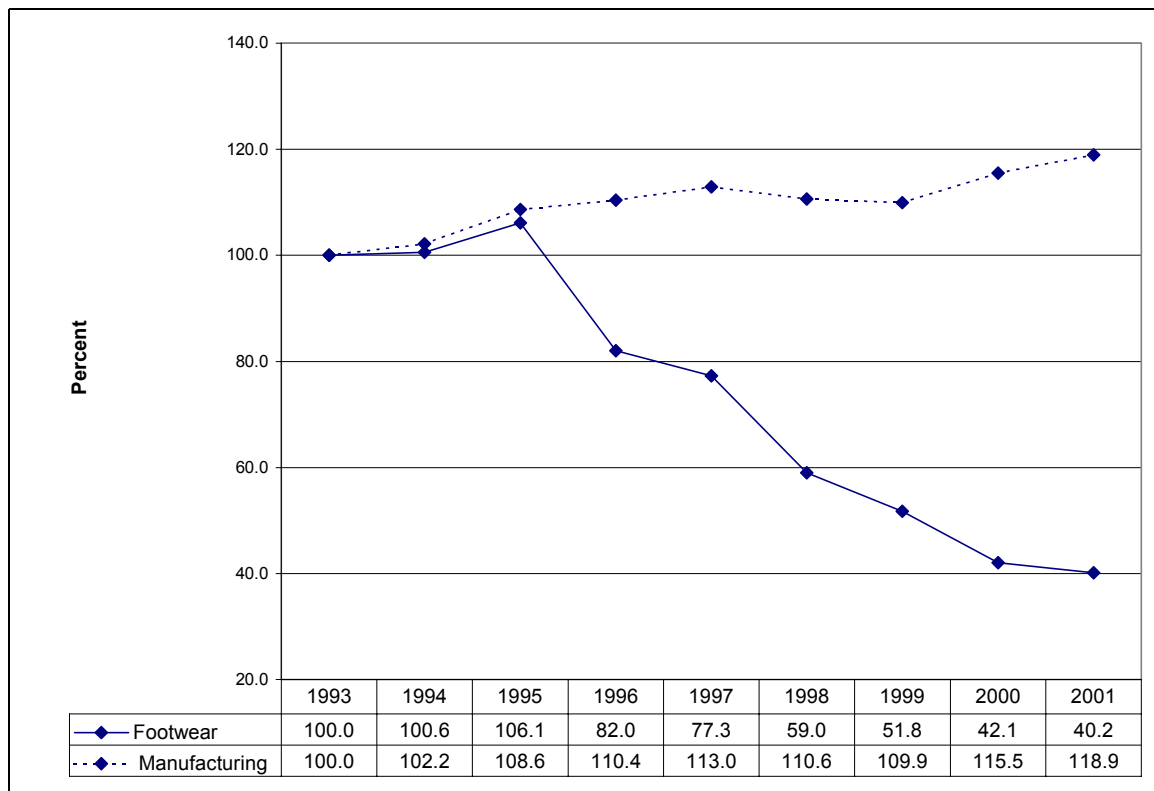
Capital productivity: Capital productivity in footwear is also under-performing. The manufacturing average by the end of the decade was slightly below its 1993 level and is therefore broadly stagnant. Footwear, on the other hand, slid to half of its 1993 capital productivity level by 2000, although capital productivity then stabilised.

Value adding: On value adding indices, footwear also diverges dramatically from industry averages (Figure 21). Whereas South African manufacturers are now adding an average of 18.9% more value than they were in 1993, footwear manufactures are only adding two-fifths of their value adding level in 1993. Firms are getting decreasing returns for the conversion (i.e. value adding) activities they are undertaking with factors of

production. For instance, in order to have the footwear labour productivity decline observed, value added is falling faster than the decline in number of employees.

Analysis: The three indices discussed above demonstrate that the footwear industry is in crisis. The crisis appeared in 1995 but there is a degree of stabilisation toward the end of the period. These findings are verified by the analysis of TIPS data (van Seventer 2002) which ranks footwear as one of the worst three performing of 46 economic subsectors. According to van Seventer (2002: 39) multi-factor productivity has also declined by 6.2% between 1996 and 2000.

Figure 21: Value adding index



5.3 Firm-level feedback

5.3.1 Firm Profiles

Selection of firms: The number of firms exporting footwear is very small and is probably less than 10. Six large footwear firms were interviewed although two of these were not, at this stage, exporting. One had been exporting until recently and another was looking to start soon.

Products: Products of footwear firms interviewed included ladies and men’s fashion shoes, men’s formal wear, industrial safety shoes and rubber boots.

Number of employees: Exporting footwear firms were larger firms, averaging around 400 employees. The industry average is 79 employees per firm according to Table 8.

Export intensity: In no case was exporting the dominant focus of the firm's output. Export intensity ranged from 8.3% to 22%. One firm stated that it was aiming to be one-third export orientated. Change in export intensity varied for different firms. Some firms were experiencing increases, one had constant exporting levels and one even had decreases in the proportion of outputs being exported.

Start of export contracts: While export contracts began relatively recently in two cases (2000 and 1999), others were established in the mid-1990s and even, in one case, the 1970s.

Export Markets: Export markets were identified as the UK, France, Switzerland, the US, Mexico, Kenya, Japan, Singapore and Australia.

Market types and distribution: Market types included independent retailers, catalogues and wholesalers. Distribution was undertaken both by agents in the export country and by firms themselves who set up their own warehousing abroad.

5.3.2 Constraints on exporting

A number of constraints to exporting, other than price competitiveness, were identified during discussions with firms:

Distance to market is a key challenge to South African firms seeking to export. One firm manager stated 'Even if manufacturing is competitive, distribution is prohibitive.' Supplying into the US is particularly difficult where agents and retailers operate off very quick lead times. This requires one of two expensive solutions:

1. The establishment of a warehouse from which shoes could be distributed. The storage not only costs money for warehousing, but also means producers need to be prepared to hold finished goods stock.
2. Alternatively, it is possible for firms to air-freight their footwear to their markets. This, however, is costly and one firm calculated that this costs \$4 per pair to the US as opposed to \$1.30 via sea freight.

One firm reported that it spent more than R1.3 million to establish an exporting link into the US and argues that most other firms would not have been in a position to raise this capital (S&V 2001 d).

Volume: Foreign markets often require extremely big volumes. South African firms, which evolved to serve a fragmented domestic market with relatively short runs are not geared to supply the volumes required for the US and other markets.

Paying gatekeepers: A further barrier to entry identified is the increasing trend of US agents to charge up-front fees before they will distribute the product, rather than the traditional method of commission 30 days after sales. Such up front fees may be extensive and it may cost be necessary to pay 10 agents a total of R330 000 in order to sell a range.

Insurance: For safety critical shoes which protect employees from hazardous activities, the US is a difficult market in which to compete. Several firms investigated this, but found that they would be required to take insurance against litigation in the case of a failure of the product to perform its protective function.

5.3.3 Raw materials

Importation of raw materials: Exporting firms that make use of leather import the bulk of their raw materials. The levels of importation ranged from 100% to 80%. This was not always the case and the transition from domestic to imported sourcing took place during the 1990s as import duties on leather fell and domestic sources became more expensive. Firms repeatedly cited the differential hide supply arrangements in different countries as a factor in raw material affordability. The cheapness of Indian leather is explained by Indian government regulations inhibiting the export of raw or semi-processed hides. Therefore Indian finished leather tanneries have a large supply of hides available domestically. One firm stated that all of its leather was imported from India on account of the above factors.

Promotion of domestic leather production: Regarding the possibility of preventing the loss of South African hides to the world market, there was a mixed response. Footwear tanneries themselves were obviously keen to promote an export tax on hides in line with other hide exporting countries in the world. Other firms suggested that it would not make sense to inhibit the export of hides since most tanneries were now closed and there would be no one to tan the hides. Instead of promoting local leather production, some manufacturers would like importing to be easier. Controversially, the South African Footwear and Leather Industries Association (SAFLIA) has applied to the Board of Trade and Tariffs to have the remaining 10% import duty on finished footwear leather removed in order to make imports cheaper.

The need for domestic leather: The tendency to by-pass local manufacturers in order to achieve lower raw material costs may, however, backfire on footwear manufacturers. One firm stated that although they had not made much use of local producers of leather until now, they would start doing so if they were to secure contracts under the EU agreement since this required high local content levels. Should SAFLIA succeed in removing import duties this may result in the further reduction of remaining domestic footwear tanning and therefore eliminate the local source for inputs required in terms of trade agreements.

Furthermore, while imported leather might be cheaper in terms of purchase price, this results in other costs. One firm stated that it had to order leather 3 months in advance of need for the raw materials (the Indian tanneries require 6 weeks to make the leather and it may take another 6 weeks to get to SA). At any one time, the firm is committed to four months of stock. Therefore the firm is disadvantaged both in terms of flexibility and in terms of high inventory holding.

5.3.4 Government support

Awareness: Many respondents commented that they were inadequately informed about available schemes and programmes. In the blunt words of one manager, 'It is no good having incentives if no one is using them.' It was indicated that as firms run increasingly lean operations they have less time to spend investigating possible programmes for which they qualify.

Competitiveness fund: One firm stated that it had made use of the competitiveness fund to support its R&D activities. The amount awarded was only 16.6 % of the amount the firm spent on product development. Therefore, while the amount was welcome, it did not make a fundamental difference to the firm's ability to undertake this kind of activity.

Trade fairs: Along with the use of South Africans living abroad, trade fairs appear to be a critical method of finding buyers for export contracts. The Dusseldorf and Manchester Fairs have both been responsible for a number of contacts which lead to exports. Some complaints were made about the slow payment required to attend these events. A firm that went to South America in August 2001 as part of the DTI stand still had not been paid the agreed amount by March 2002.

Export promotion: Several firms suggested that a duty credit certificate type scheme would be worth investigating. In an industry magazine, van Niekerk commented: 'Our Government gives one sector of the tanning industry (the MIDP) and another not. This seems constitutionally unfair' (van Niekerk 2001: 33). This issue was raised at the footwear strategy workshop in Cape Town on 7 March to a positive reception by the representatives of the industry. Elsewhere firms indicated that it would be a concrete contribution that the government could make to the sector.

Comments on trade deals: Only one firm was exporting to the US and stated that while AGOA was a useful assistance, it was not the key factor behind being able to export there. A different firm exporting to the EU said that this arrangement gave crucial benefits to South African exporters. Several other firms also argued the EU trade deal offered much potential even if they were not yet taking full advantage of it.

5.3.5 Process upgrading

There is little evidence of a wholesale shift in firms' processes towards a radically different way of manufacturing. There was ad hoc awareness of the need for lower inventory, improved quality and a well trained multi-skilled workforce. There was isolated evidence of strong commitment to these ideals was, and encouragingly an indication that firms were 'learning from exporting'.

Labour costs: Unlike the bulk of the footwear industry which is fixated on what are perceived as high labour costs, one of the characteristics that distinguishes exporting firms is their belief that a successful enterprise will be based on more than just low cost. One manager, when asked about competitiveness, stated "price is not an important issue, but marketing and accessing markets is". He substantiated this by saying that if labour in China costs half of what it does in SA, it may only make a small difference to the end price. Whereas the labour might cost \$2.17 for the SA shoe, it is \$1.06 for the Chinese shoe. In the overall context of a \$22 shoe, this is not a make or break difference.

Another firm argued that as a result of the devaluation of the Rand in the last part of 1999, South African footwear producers can now compete on price. Still another manager stated "efficiency is a management problem" and not a labour problem. South Africa has a cost advantage compared to many parts of the world in terms of labour and overheads. Furthermore, he argued, South Africa's skills are as good as they are overseas.

Inventory: One non-leather footwear manufacturer believed that they are 'about as lean as you can get', living from hand to mouth with 24 stock turns a year.

Quality: Exporting is having a direct impact on the way South African producers make shoes, and manufacturers explained that foreign buyers tend to be more demanding than South African buyers. One manufacturer explained how they began supplying a

shoe to South African retailers which had a tack in the back of the shoe, which resulted in a visible hole. The firm then began supplying the same shoe to a foreign buyer who rejected it as a result of this hole. The firm then developed a way of inserting the tack without making a hole. As a result, the domestic market also benefited from this innovation. This is a small example of a larger pattern of 'learning from exporting' whereby South African manufacturers alter the way they operate in response to more demanding overseas buyers.

Multi-skilling and training: Firms had embarked on programmes such as ABET and the "6m" course on how a business works. While most of the firms identified training as a key need for their business, they generally conceded that they were not doing enough training. One firm that provided data indicated that the training budget was 1% of remuneration. Rather depressingly, another manufacturer stated that he doesn't know what kind of training to give his workforce. He said that he had tried green areas but they never took off.

5.3.6 Product upgrading

Product upgrading is the manufacture of different kinds of products that give firms advantages in the market place. Once again, evidence of these kinds of product advances is anecdotal and ad-hoc. For example, one firm has designed a kind of moccasin that uses much less leather because of the way it is attached to the sole. Instead of wrapping around underneath the foot where it is not seen, the unit is attached to the leather where it meets the unit, thus allowing the manufacturer to produce far more shoes for the same amount of leather. Other firms indicated that they were responding to greater demand for choice in colours. Finally, firms were adapting to new technologies such as the manufacture of soles with two densities.

At a more conceptual level, one of the key concerns of 'product upgrading' is whether the firm's pricing strategy is to go 'down market' (cheap low quality products) or 'up market' (expensive high quality products). The unit price of leather footwear being sold into Europe (Figure 19) appears to indicate that South Africa is not competing at the discount end of the market. This is further verified by the one firm that completed a questionnaire and stated that unit prices of their product had increased by 63.6% in Rand terms. However South Africa's failure to grow sales of this category of product to the EU indicates that although manufacturers are strategically exporting the right kind of product, they have not yet offered any advantage to buyers. In other words, by competing in an above average price category they need to be offering impeccable quality and service. The decline in exports to the EU over the last few years suggests that this is not happening.

More worryingly, intrinsically higher value leather footwear has moved from a position of dominance in 1992 to marginalisation in 2001 compared to the importance of non-leather footwear (Table 10). This has happened since non-leather footwear (of which a significant portion is likely to be rubber boots) has held its position whereas leather has declined. South African manufacturers, then, are proving themselves incapable of competing in more expensive kinds of leather footwear.

5.3.7 Functional upgrading

Functional upgrading refers to changes in a firm or sector's mix of activities so that they are in a more secure position generating higher rents. In the case of footwear exporters

in South Africa, there were four different functions which firms may chose to bring in-house in order to achieve specific advantages:

- Coordinating function: Out-sourcing of manufacturing to another part of the world.
- Retail functions
- Logistics and warehousing
- Design & Branding

Coordination function: In an attempt to benefit from cost advantages of manufacturing elsewhere in the world, one firm established a joint venture with a tannery in India to make components of shoes as well as whole leather shoes. At a smaller scale, then, this attempting to take on the kind of non-manufacturing coordinating function undertaken by big global buyers. While the plant in India is a low cost producer of shoes, the South African offices are responsible for what are arguably more important and lucrative functions of design, branding and distribution. The firm reports that it is too soon to indicate whether this venture has been a success or not.

Retail: A different firm is engaging with vertical integration in the opposite direction of the value chain, i.e. retail. Specifically, one of the firms interviewed has established joint ownership with a footwear retail chain in Europe. This is not uncommon for labour intensive industries, with Tewari identifying this trend amongst high-end garment manufacturers in India (2001: 8). The advantage, of course, was establishing “captive distribution channels in European markets” (ibid). It also provides further cost cutting opportunities for manufacturers as they now control their own logistics systems.

Logistics, distribution and warehousing: While distribution is conventionally the responsibility of agents in the market country, several firms interviewed had established in-house warehouses and distribution functions in the US and Europe. As was explained above, the long distance (and time) to market is a substantial barrier for South African exporters and having finished goods stock in the market country enables flexible supply of goods and therefore better service to buyers. In some cases, the lead time that would be available were manufacturers to ‘make to order’ and then ship their goods would be too long for many buyers. Nike’s lead times are now less than a month – which is about how long it takes to ship goods from South Africa to the US.

Branding: Several exporting firms were manufacturing and marketing under their own brands. Simpson distinguishes between major brands, minor brands and mini-brands. Major Brands are no longer manufacturers but rather out source their production to what are effectively CMTs in low cost regions. They require massive advertising budgets. Mini-brands, by contrast, offer niche products with unique themes. Simpson points out that a niche product in the US is a large volume for a South African producer (Simpson 2002). The following is a case study of one firm attempting to export under an own mini-brand:

Case study of own branding:

One firm, recognising the need to re-orientate to a greater export focus, has realised that there are different exporting paths. It has carefully analysed its choices for exporting and decided that there were three scenarios:

1. Making footwear according to the buyer’s design or sample.

2. Designing own footwear and finding a buyer.
3. Designing own footwear and building a brand.

The firm has opted to pursue the third option recognising the vulnerability of options one and two, and the strength given by owning a successful brand. Option one was seen as vulnerable on the grounds that there is no security for competing on cost. Even if it were possible to offer brand owners such as Nike low cost, they will switch away from you for a matter of 10 cents per shoe savings. Option two was seen to be equally vulnerable. If the firm designed and manufactured a successful range of shoes, they would be emulated by low cost producers within months. Therefore, it is necessary to protect own design with own branding. The owners of large brands pay the producers of their shoes around a quarter of their final selling price, suggesting that brand-owning is the key rent taking link in the value chain. The firm also believes that South Africa has an advantage in that the high managerial and professional costs of running a brand in places such as the US are substantially less in South Africa. It is here that South African producers can find a place in the global footwear industry since low cost producers specialising in scenario one (i.e. India and China) do not attempt any own branding.

Clearly the firm does not intend to take on Nike or other major brands – they spend 10% of their vast turnover on advertising – something with South African firms would never be able to afford in foreign markets. With mass advertising ruled out as an option, the only possibility for brand building is strategic marketing around a niche product.

The firm is adamant that it will not surrender its brand in order to allow a buyer to re-label for themselves. They received an offer from an up-market retailer for an order which would require the retailer's own brand to appear. The manufacturer chose to decline the order so that they could protect the products they make.

This firm's exporting path is laudable indeed in terms of the need to avoid the kind of exporting that cannot be sustained or does not make any money for the producer. Kaplinsky (2000) argues that intangible competencies such as R&D, design, branding and marketing are the means to create high barriers to entry unlike tangible production activities which have low barriers to entry and are therefore exposed to the pressure of global competition. There is therefore a great deal of sense in the logic of South African footwear manufacturers who are attempting to go the own design and branding route.

It should be pointed out, however, that this route does not provide an escape from cost pressures and process upgrading needs to take place in conjunction with this kind of functional upgrading. Möller (2002) cautioned that niche markets tend only to work in the short term. While they provide an opportunity to establish a market, it is then necessary to follow up with reductions in prices and improvements in quality (i.e. process upgrading).

Furthermore, while this strategy may work for well resourced firms, it is unlikely to offer the bulk of South African producers an avenue for exporting. The problem is that the more lucrative 'knowledge intensive' activities are usually hoarded by developed countries while low cost production activities are the only available role for developing countries. South African producers, then, are in the difficult position of attempting to break into markets via the powerful gatekeepers (i.e. buyers) while retaining control over key activities such as branding and design. These gate keepers are becoming

increasingly important as there has been an increasing concentration in retailing in the US, UK and other markets (Humphrey 2001: 26). Local producers face obstacles because such upgrading encroaches on their buyers' core competence. (Humphrey & Schmitz 2002: 6). In other words, functions such as branding, design and distribution might not secure a more 'powerful' position for firms so much as *stem from* a firm's position of power. South African manufacturer's scope to engage with foreign markets on their own terms may be severely limited, and it might be necessary to concede to the terms of powerful buyers.

5.4 Discussion

While the loss of domestic market to imports is frequently blamed for the footwear sector's demise over the last decade, it is clear from the discussion presented above that an equally important factor behind this process has been the sector's failure to integrate itself into global value chains. The sector as a whole has a low export intensity of 13%. Even the handful of firms that are engaged in exporting have not succeeded in making it their primary focus. The anti-exporting sentiment is captured in the following suggestion that most footwear manufacturers

'view export as well nigh impossible, blaming suppliers, the state of the domestic market, government and labour. Said one ... "I'm waiting for the world to beat a path to my door." He was joking. But clearly, he's also not hungry enough for the rough-and-tumble export world.' (S&V 2001d: 5)

As a result of this failure to find ways of exporting footwear, South African producers have not only lost out on the opportunity for market growth, but have also not benefited from the 'learning' dimension of exporting. Manufacturing for foreign buyers introduces previously sheltered producers from global standards of product design and production itself. Thus we see in the data presented above alarming falls in capital and labour productivity and value adding. Fundamentally, South African footwear manufacturers have not undergone necessary restructuring of reorganising production, upgrading employees, and improving productivity. As such, the biggest affliction of the footwear industry has been its failure to embark on what this research project defines as 'process upgrading' of the way firms organise their internal and external functions around efficient high-quality and high-service production.

South African footwear's failure in export markets offers some clues as to why they have failed to retain market share at home: they do not meet the requirements of their market. While cost is a key element of these requirements, it should be stressed that good service and high quality products are equally important.

'Established importers didn't get where they are today just because the Chinese make cheap shoes – most of the time they promise and deliver clean shoes at a good price with commercial styling and on time. Put it another way – the retailers, and especially the chains, trust them more than they do the local factories.' (Dickson 2002)

Footwear manufacturers see increased tariff protection as 'their first (and usually only)' remedy (S&V 2001e: 14). Yet AGOA and the EU trade deals offer excellent opportunities for those willing to look beyond South Africa's borders for markets. Having stressed the importance of exporting, though, it is important for South African producers to be

discerning about the kind of exporting they embark upon. Some firms have demonstrated an awareness of the dangers of exporting under buyer's labels and conditions and have attempted to pursue a 'high road' of own design and branding. To the extent that this leads to growth in sales with sustainable margins this should be encouraged and pursued.

Unfortunately, however, this is not always going to be an exporting option for firms. It requires, if nothing else, vast capital outlays in establishing distribution facilities in market countries. Less well resourced smaller firms wishing to engage with global value chains, therefore, need to consider approaching powerful gatekeepers such as retail chain buyers and major brand owners. It is difficult to see how the bulk of South African producers can break into export markets as 'own designers' and 'own branders' since 'access to developed country markets has become increasingly dependent on entering into the global production networks of lead firms situated in developed countries' (Humphrey & Schmitz 2002: 19).

Embarking on such a form of exporting contains great risks since buyer-driven value chains, by definition, are characterised by arm's length relationships with suppliers driven by the need for low cost production. Despite these risks, the advantages of exporting even for a powerful buyer will be the exposure to global standards of footwear production.

5.4.1 Policy considerations

- ❑ Competitiveness drive: It is clear that the industry needs to embark on a 'process upgrading path' and the footwear cluster may be the best forum in which to do this. This may take the form of best practise seminars on shop floor layout, stock control, human resources development, quality, design and other key areas of manufacturing.
- ❑ As with general leather goods, it is important for the government to educate the sector on the need for exporting. A recognition of the need for exporting cannot be taken for granted and it is therefore important to promote this path. Not only is this crucial from the point of view of providing opportunities for growth, but it also essential for the industry's ability to learn about international footwear manufacturing techniques. AGOA is only available for a finite period and therefore needs to be exploited as soon as possible. Notwithstanding the cautions about exporting under other labels or under relatively powerless conditions it might not be possible for all manufacturers to export along a more knowledge intensive route of own branding and design. Functional upgrading in these terms can come with time, but the immediate priority is to establish some level of export intensity.
- ❑ Trade fairs, once again, play a critical work in securing export work. The efficient functioning of this programme needs to be ensured, and the DTI should consider ways of expanding the value of such benefits.
- ❑ Given that logistics is a key barrier to exporting, it is important for firms to consider collaborating on warehousing and distribution in regions such as the US. This is something which the DTI should consider promoting.

6 Conclusion

Each sector has a full discussion on key challenges facing the industry. The following, therefore, is a summary and a repeat of policy considerations.

6.1 State policies & change in the leather industries

Dramatic changes in the leather industry over the last decade such as increases in hide prices, decreases in ostrich leather, the success of the automotive upholstery industry and the collapse of footwear and general leather goods, need to be seen in the context of changes in state policy:

1. **The end of Import Substitution Industrialisation and the liberalisation of trade:** In many ways the painful experience of footwear can be traced to the distorting effects of Import Substitution Industrialisation prior to the 1990s, when industrial policy promoted uncompetitive labour intensive sectors. When these sectors were exposed to the world market they were unable to retain domestic market share.
2. **Deregulation of bovine industry:** As the bovine industry was deregulated, hide prices moved upwards towards world parity and prices were therefore set at whatever hide agents could get on international markets. Further distortions continue as a result of the fact that other governments have not yet deregulated their industries and continue to restrict imports of raw material. Therefore South African hides are particularly attractive to world buyers since they are freely traded on the open market.
3. **Deregulation of the ostrich industry:** As the ostrich industry was deregulated, the industry lost ability to restrict supply and prices therefore collapsed.
4. **MIDP:** Under the Motor Industry development programme, the new industry of automotive upholstery established itself. This clearly had many positive effects of introducing new high-tech activities and improved tanning standards and, of course, the generation of tanning business which footwear would otherwise have been unable to support. It also had negative effects such as 'MIDP pricing' by hide merchants who charge a premium for local content required by seat manufacturers.

There have been further changes in government policy that were intended to influence the footwear and general leather goods industries (amongst a wider set of sectors) but have not yet had any major impact. These are the trade agreements with the EU and the US (AGOA) which give preferential tariffs to South African manufacturers attempting to sell into these markets. As we have seen, however, footwear and general leather goods have failed to grow their exports on the back of these opportunities.

6.2 Policy considerations

Auto upholstery

- Engage with the industry over ways of avoiding 'MIDP pricing' by hide manufacturers. Restrictions of the exports of hides is the most frequently cited route but this should be fully investigated before implementation. Independence from the MIDP through international competitiveness would be ideal since it would remove the necessity to purchase local hides and enable manufacturers to import raw material thereby empowering them to bargain for competitive prices with domestic suppliers.
- The MIDP is critical to the future of the industry. Although manufacturers have gone a long way towards competitiveness, logistics continue to be a barrier given South Africa's distance to market. Reductions in benefits derived from the MIDP should be carefully balanced with further improvements in competitiveness by the industry.
- Promote the diversification of manufacturers into products other than leather seat manufacture in order to avoid complete dependence on the leather industry.

General leather goods

- Key policy objectives should be to promote export orientation and to improve competitiveness. This might seem very general and obvious, but commitment to exporting is clearly very low in the sector as a whole and needs to be promoted as a desirable objective for a wider group of firms. In particular, education about the opportunities offered by AGOA and the EU should be targeted at this group of firms.
- There is a need for inter-firm collaboration or clustering since there is very little communication between firms. This has been undertaken fairly successfully in the footwear sector and should therefore be extended to general goods. At present there is little commitment by firms to the employers association. The clustering process will therefore have to overcome pervasive resistance to collaboration.
- Trade fairs remain a critical method for acquiring new business. Support in this regard is therefore valuable and should be promoted or expanded if possible.

Footwear

- Competitiveness drive: It is clear that the industry needs to embark on a 'process upgrading path' and the footwear cluster may be the best forum in which to do this. This may take the form of best practise seminars on shop floor layout, stock control, human resources development, quality, design and other key areas of manufacturing.
- As with general leather goods, it is important for the government to educate the sector on the need for exporting. A recognition of the need for exporting cannot be taken for granted and it is therefore important to promote this path. Not only is this crucial from the point of view of providing opportunities for growth, but it also essential for the industry's ability to learn about international footwear manufacturing techniques. AGOA is only available for a finite period and therefore needs to be exploited as soon as possible. Notwithstanding the cautions about exporting under other labels or under relatively powerless

conditions it might not be possible for all manufacturers to export along a more knowledge intensive route of own branding and design. Functional upgrading in these terms can come with time, but the immediate priority is to establish some level of export intensity.

- Trade fairs, once again, play a critical work in securing export work. The efficient functioning of this programme needs to be ensured, and the DTI should consider ways of expanding the value of such benefits.
- Given that logistics is a key barrier to exporting, it is important for firms to consider collaborating on warehousing and distribution in regions such as the US. This is something which the DTI should consider promoting.

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8 Appendix

Table 11: Breakdown of Customs and Excise Trade data of Hides and Skins

			1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Untanned Bovine & Equine (HS 4101)	Exp	Value (\$ mil)	28.7	36.6	26.4	28.1	25.1	33.7	24.0	9.9	19.0	21.0
		Qty (100,000 kg)	197.5	240.4	155.7	151.0	148.0	180.4	169.6	86.1	104.4	130.5
		Price (\$/kg)	1.45	1.52	1.70	1.86	1.69	1.87	1.42	1.15	1.82	1.61
	Imp	Value (\$ mil)	1.2	1.1	4.0	15.2	9.9	26.2	22.9	19.6	25.0	24.8
		Qty (100,000 kg)	9.4	9.0	22.1	71.9	75.6	151.4	135.2	141.4	144.9	119.4
		Price (\$/kg)	1.3	1.2	1.8	2.1	1.3	1.7	1.7	1.4	1.7	2.1
Net trade (X-M)		27.5	35.5	22.4	12.9	15.2	7.5	1.1	-9.7	-6	-3.8	
Untanned Sheep (HS 4102)	Exp	Value (\$ mil)	42.7	40.5	46.7	63.1	70.4	55.4	36.6	27.0	26.0	34.1
		Qty (100,000 kg)	191.1	153.1	134.9	116.5	148.2	143.4	124.1	118.5	137.6	154.2
		Price (\$/kg)	2.23	2.65	3.46	5.41	4.75	3.86	2.95	2.28	1.89	2.21
	Imp	Value (\$ mil)	0.3	0.3	0.2	1.2	0.2	0.5	0.4	0.6	0.0	0.5
		Qty (100,000 kg)	3.6	5.2	3.1	1.3	0.2	0.8	1.4	1.9	0.0	2.7
		Price (\$/kg)	0.7	0.7	0.7	9.2	7.0	6.4	2.4	3.3	24.2	1.8
Net trade (X-M)		42.4	40.2	46.5	61.9	70.2	54.9	36.2	26.4	26	33.6	
Untanned Ostrich, Goat, Rep (HS 4103)	Exp	Value (\$ mil)	2.2	2.4	3.4	4.9	8.1	7.9	3.9	4.8	10.4	10.0
		Qty (100,000 kg)	15.5	15.6	12.2	17.5	24.1	27.4	21.4	30.8	45.6	48.5
		Price (\$/kg)	1.42	1.55	2.82	2.79	3.37	2.88	1.81	1.55	2.29	2.05
	Imp	Value (\$ mil)	0.1	0.2	0.4	0.3	0.4	0.2	0.3	1.3	2.8	1.4
		Qty (100,000 kg)	0.4	1.1	1.9	1.9	1.0	0.9	0.9	1.4	2.3	1.7
		Price (\$/kg)	2.7	1.5	1.8	1.8	4.3	2.4	3.0	9.5	12.0	8.5
Net trade (X-M)		2.1	2.2	3	4.6	7.7	7.7	3.6	3.5	7.6	8.6	
Tanned Bovine & Equine (HS 4104)	Exp	Value (\$ mil)	23.9	29.7	47.8	49.0	44.9	45.4	40.1	37.6	76.0	43.8
		Qty (100,000 kg)	-	-	-	182.2	207.8	187.8	225.6	245.4	247.6	219.2
		Price (\$/kg)	-	-	-	2.69	2.16	2.42	1.78	1.53	3.07	2.00
	Imp	Value (\$ mil)	41.7	40.3	76.6	78.2	71.7	77.1	63.3	57.4	64.4	54.7
		Qty (100,000 kg)	-	-	-	102.6	94.2	89.9	78.4	86.1	86.3	66.4
		Price (\$/kg)	-	-	-	7.6	7.6	8.6	8.1	6.7	7.5	8.2
Net trade (X-M)		-17.8	-10.6	-28.8	-29.2	-26.8	-31.7	-23.2	-19.8	11.6	-10.9	
Tanned Sheep (HS 4105)	Exp	Value (\$ mil)	1.0	1.3	2.0	2.5	6.0	12.3	10.0	11.6	11.1	12.2
		Qty (100,000 kg)	-	-	-	2.69	2.16	2.42	1.78	1.53	3.07	2.00
		Price (\$/kg)	-	-	-	32.19	13.76	11.79	7.35	6.90	6.58	7.30
	Imp	Value (\$ mil)	1.9	0.8	0.6	0.7	0.4	0.3	0.1	0.1	0.1	0.1
		Qty (100,000 kg)	-	-	-	0.46	0.10	0.08	0.03	0.07	0.05	0.01
		Price (\$/kg)	-	-	-	14.2	36.4	40.2	36.4	10.8	43.6	46.4
Net trade (X-M)		-0.9	0.5	1.4	1.8	5.6	12	9.9	11.5	11	12.1	
Tanned Ostrich, Goat, Rep (HS 4106-41011)	Exp	Value (\$ mil)	39.5	46.4	72.0	88.0	86.6	82.2	60.1	84.5	80.8	62.0
		Qty (100,000 kg)	-	-	-	8.1	8.7	7.5	13.4	26.5	26.7	30.2
		Price (\$/kg)	-	-	-	108.58	99.95	109.05	45.02	31.86	30.30	20.51
	Imp	Value (\$ mil)	12.1	9.7	14.4	16.1	14.7	11.8	9.8	8.7	11.9	8.3
		Qty (100,000 kg)	-	-	-	18.1	6.1	4.9	5.3	6.3	6.3	4.3
		Price (\$/kg)	-	-	-	8.9	23.9	24.1	18.6	13.8	19.1	19.6
Net trade (X-M)		27.4	36.7	57.6	71.9	71.9	70.4	50.3	75.8	68.9	53.7	

Table 12: Breakdown of Customs and Excise Trade data of General Leather Goods

			1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Saddlery (kg) 42.01	Exp	Value (\$ mil)	0.15	0.10	0.06	0.11	0.19	0.14	0.23	0.26	0.34	0.56
		Qty (1,000 kg)	10.4	7.3	2.3	5.8	12.8	10.4	14.9	32.7	28.3	38.6
		Price (\$/kg)	14.18	13.44	25.81	19.02	14.94	13.02	15.48	7.82	12.11	14.41
	Imp	Value (\$ mil)	0.37	0.30	0.35	0.52	0.70	0.76	0.74	0.95	1.07	0.12
		Qty (1,000 kg)	21.89	16.26	23.31	30.34	44.97	55.77	61.61	71.88	94.54	86.36
		Price (\$/kg)	16.84	18.32	15.19	17.20	15.62	13.68	12.05	13.23	11.36	1.41
		Net trade (X-M)	-0.22	-0.2	-0.29	-0.41	-0.51	-0.62	-0.51	-0.69	-0.73	0.44
Travel (no) 42.021&029	Exp	Value (\$ mil)	1.86	2.35	3.24	4.18	3.07	2.62	2.59	2.36	2.51	1.86
		Qty (1,000 units)	504.0	255.9	493.3	429.3	3,368.5	3,794.2	5,879.5	2,419.5	2,056.0	15,575.8
		Price (\$/unit)	3.27	7.27	4.76	7.54	1.24	0.81	0.44	1.07	1.15	0.16
	Imp	Value (\$ mil)	18.93	21.53	23.43	28.20	28.70	32.12	29.28	28.72	27.82	24.02
		Qty (1,000 units)	11,415.36	13,088.54	14,760.87	18,296.91	18,302.07	21,635.60	21,321.91	26,150.93	28,220.98	26,220.68
		Price (\$/unit)	1.66	1.65	1.59	1.54	1.57	1.48	1.37	1.10	0.99	0.92
		Net trade (X-M)	-17.07	-19.18	-20.19	-24.02	-25.63	-29.5	-26.69	-26.36	-25.31	-22.16
Handbags (no) 42.022	Exp	Value (\$ mil)	3.37	4.73	8.43	9.03	5.64	7.87	6.95	3.27	2.65	3.37
		Qty (1,000 units)	83.4	71.4	125.8	355.4	618.8	391.8	618.7	585.9	385.2	300.3
		Price (\$/unit)	26.06	47.20	37.58	23.72	14.60	14.40	12.72	11.86	8.48	8.81
	Imp	Value (\$ mil)	6.52	6.35	7.27	8.36	8.96	9.66	8.75	8.25	7.72	6.65
		Qty (1,000 units)	2,998.14	3,726.30	6,218.59	6,330.01	8,287.83	7,931.71	7,195.04	7,265.03	8,581.44	8,333.61
		Price (\$/unit)	2.18	1.70	1.17	1.32	1.08	1.22	1.22	1.14	0.90	0.80
		Net trade (X-M)	-3.15	-1.62	1.16	0.67	-3.32	-1.79	-1.8	-4.98	-5.07	-3.28
Small items (no) 42.023	Exp	Value (\$ mil)	0.83	1.03	1.25	1.21	0.96	0.82	0.62	0.68	1.17	0.83
		Qty (1,000 units)	70.0	631.8	269.4	39.4	39.9	43.6	132.3	305.8	67.6	81.0
		Price (\$/unit)	8.68	1.31	3.81	31.82	30.36	22.01	6.17	2.02	10.07	14.50
	Imp	Value (\$ mil)	1.97	2.15	2.55	2.46	3.18	3.34	4.05	5.15	4.01	3.14
		Qty (1,000 units)	6,813.97	6,326.07	8,721.85	3,465.69	4,217.24	2,842.69	3,055.46	2,214.13	2,084.98	1,556.45
		Price (\$/unit)	0.29	0.34	0.29	0.71	0.75	1.17	1.33	2.33	1.92	2.02
		Net trade (X-M)	-1.14	-1.12	-1.3	-1.25	-2.22	-2.52	-3.43	-4.47	-2.84	-2.31
Clothing (kg) 42.031 42.033	Exp	Value (\$ mil)	1.28	1.80	1.57	0.96	3.91	1.31	1.88	2.02	1.87	1.28
		Qty (1,000 kg)						334.7	131.0	206.0	244.8	242.9
		Price (\$/kg)						11.67	10.03	9.11	8.26	7.70
	Imp	Value (\$ mil)	3.91	3.28	4.89	6.69	7.97	9.41	7.52	6.09	7.56	9.04
		Qty (1,000 kg)						1,787.28	1,640.06	1,289.03	1,373.29	1,729.73
		Price (\$/kg)						5.26	4.58	4.73	5.50	5.23
		Net trade (X-M)	-2.63	-1.48	-3.32	-5.73	-4.06	-8.1	-5.64	-4.07	-5.69	-7.76
Gloves 42.032 (pr)	Exp	Value (\$ mil)	0.011	0.033	0.035	0.054	0.030	0.029	0.025	0.020	0.043	0.011
		Qty (1,000 pr)	6.3	0.4	3.0	58.4	5.6	5.7	4.1	3.2	1.8	131.6
		Price (\$/pr)	5.50	30.72	10.93	0.59	9.57	5.29	7.04	7.96	10.90	0.33
	Imp	Value (\$ mil)	0.77	0.99	1.16	1.44	1.65	1.59	1.54	1.54	1.43	1.39
		Qty (1,000 pr)	145.02	218.00	250.81	316.63	305.71	296.54	279.29	359.95	347.41	372.22
		Price (\$/pr)	5.30	4.53	4.64	4.55	5.40	5.35	5.51	4.26	4.12	3.74
		Net trade (X-M)	-0.759	-0.957	-1.125	-1.386	-1.62	-1.561	-1.515	-1.52	-1.387	-1.379
Other (kg) 42.04 & 06	Exp	Value (\$ mil)	1.23	1.07	1.65	1.80	3.66	0.13	1.60	5.02	0.61	1.23
		Qty (1,000 kg)	43.5	3.1	33.3	54.6	54.5	20.0	87.5	30.8	41.8	38.8
		Price (\$/kg)	22.90	395.71	32.26	30.26	32.98	183.23	1.53	52.08	120.00	15.79
	Imp	Value (\$ mil)	1.57	1.08	1.19	1.51	0.84	0.73	0.63	0.63	0.60	0.39
		Qty (1,000 kg)	17.48	17.30	19.56	21.11	13.93	12.09	18.31	9.03	16.99	58.19
		Price (\$/kg)	90.01	62.27	61.03	71.36	60.52	60.09	34.49	69.25	35.41	6.68
		Net trade (X-M)	-0.34	-0.01	0.46	0.29	2.82	-0.6	0.97	4.39	0.01	0.84

Table 13: Breakdown of Customs and Excise Trade data of Footwear

			1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	
Leather Footwear	Exp	Value (\$ mil)	11.42	12.32	16.00	15.81	15.88	12.41	9.30	10.22	6.70	5.24	
		Qty (1,000,000 prs)	1.17	0.91	1.16	1.40	1.34	1.12	0.70	0.91	0.70	0.66	
		Price (\$/pr)	9.79	13.51	13.84	11.29	11.82	11.09	13.33	11.29	9.56	8.00	
	Imp	Value (\$ mil)	39.27	48.56	58.62	88.54	98.00	109.12	90.34	80.31	82.83	69.77	
		Qty (1,000,000 prs)	4.49	7.31	8.35	10.75	10.15	11.63	9.74	10.26	11.37	13.41	
		Price (\$/pr)	8.75	6.65	7.02	8.24	9.66	9.38	9.27	7.83	7.29	5.20	
		Net trade (X-M)	-27.85	-36.24	-42.62	-72.73	-82.12	-96.71	-81.04	-70.09	-76.13	-64.53	
	Non-leather footwear	Exp	Value (\$ mil)	4.04	4.79	6.68	8.65	10.15	9.73	7.36	8.71	10.66	8.21
			Qty (1,000,000 prs)	0.55	1.12	1.80	1.93	2.07	2.14	1.90	2.43	2.72	2.50
Price (\$/pr)			7.35	4.29	3.71	4.49	4.91	4.55	3.88	3.58	3.92	3.29	
Imp		Value (\$ mil)	58.45	76.69	71.91	90.83	94.29	89.64	79.98	93.11	120.04	123.80	
		Qty (1,000,000 prs)	15.66	25.38	24.03	55.42	40.54	25.81	21.06	26.79	43.02	44.34	
		Price (\$/pr)	3.73	3.02	2.99	1.64	2.33	3.47	3.80	3.47	2.79	2.79	
		Net trade (X-M)	-54.41	-71.90	-65.23	-82.18	-84.14	-79.91	-72.62	-84.40	-109.38	-115.59	