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Kazakhstan's cotton sector reforms since independence

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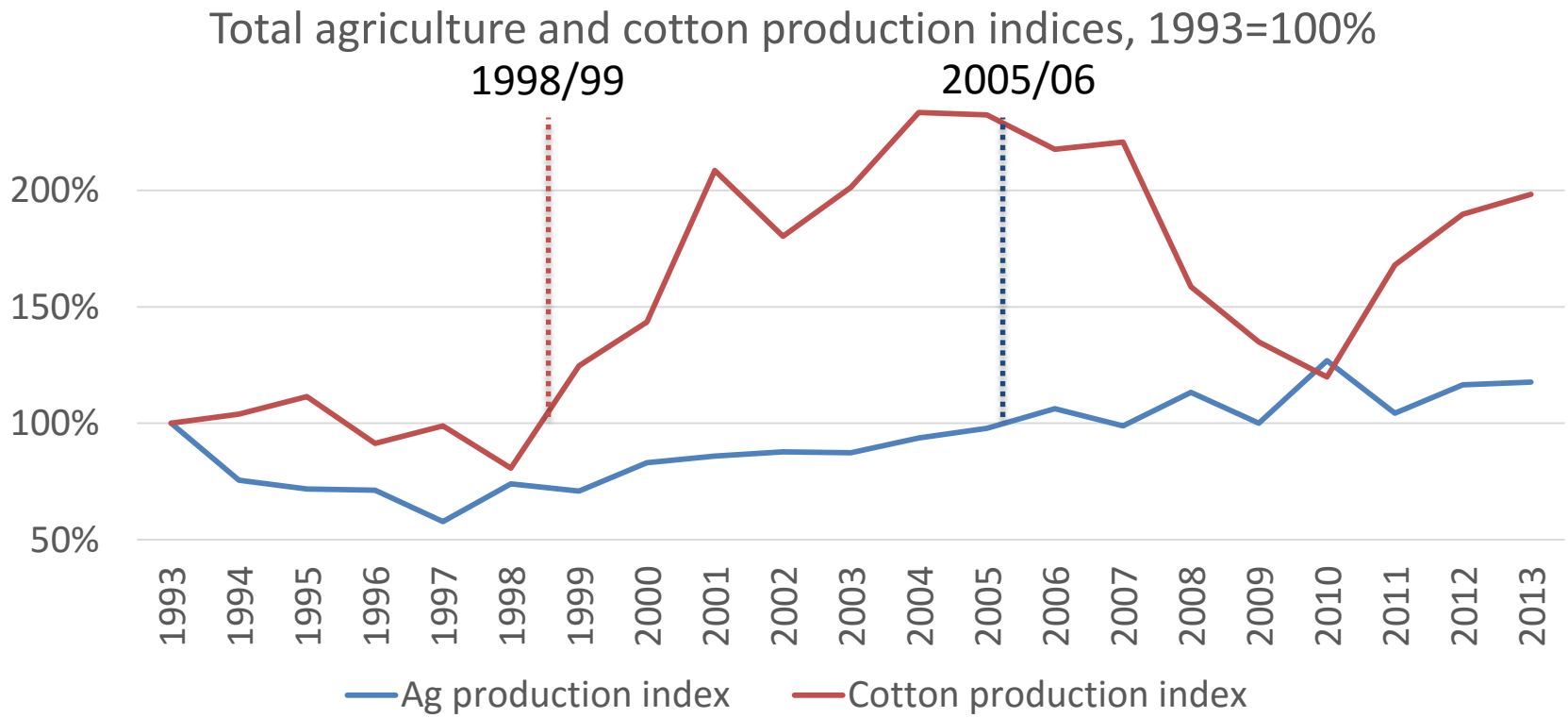
November 2, 2016

Samarkand, Uzbekistan

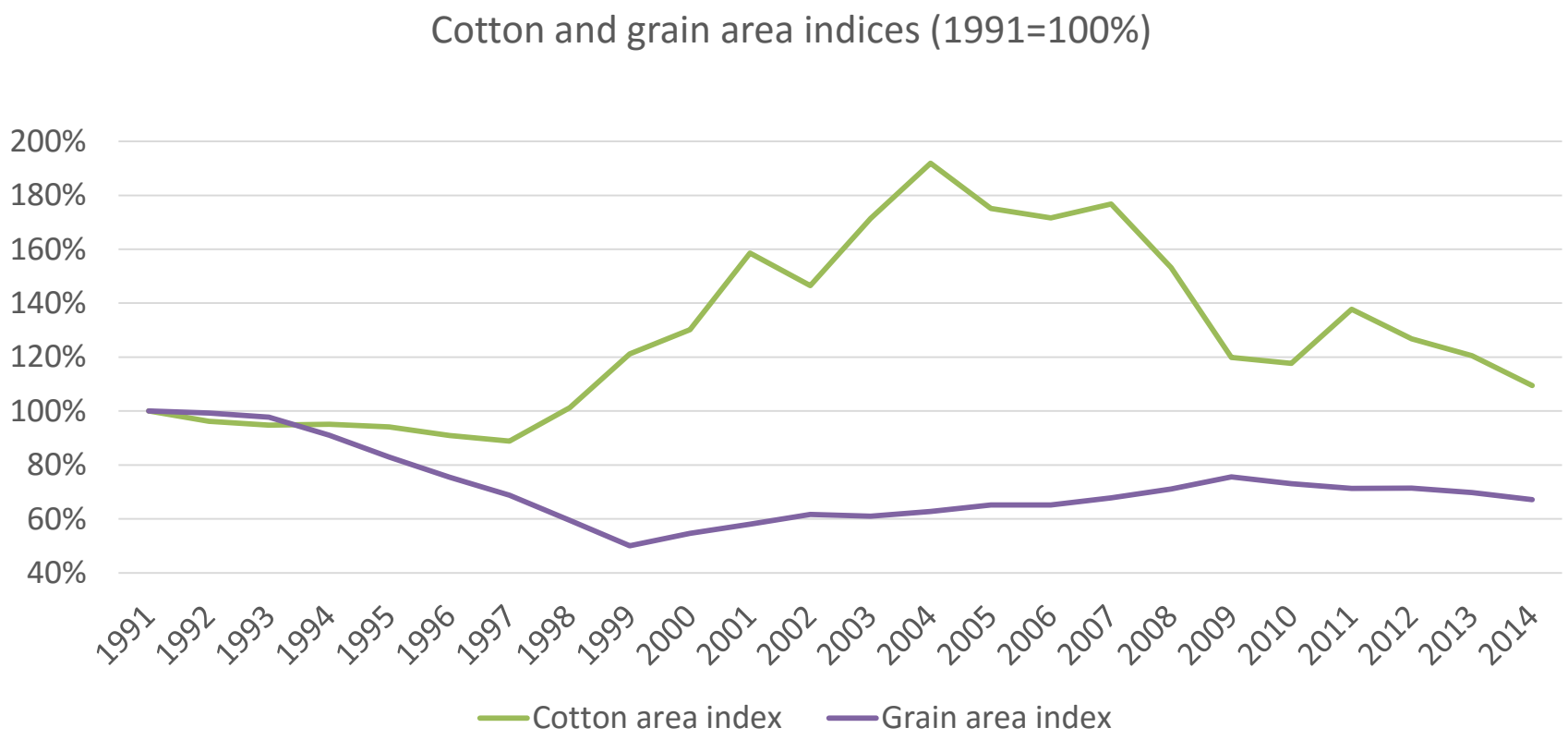
Cotton sector was the first to recover after crises in 1990s

Cotton outpaced other sectors in agriculture by 7 years

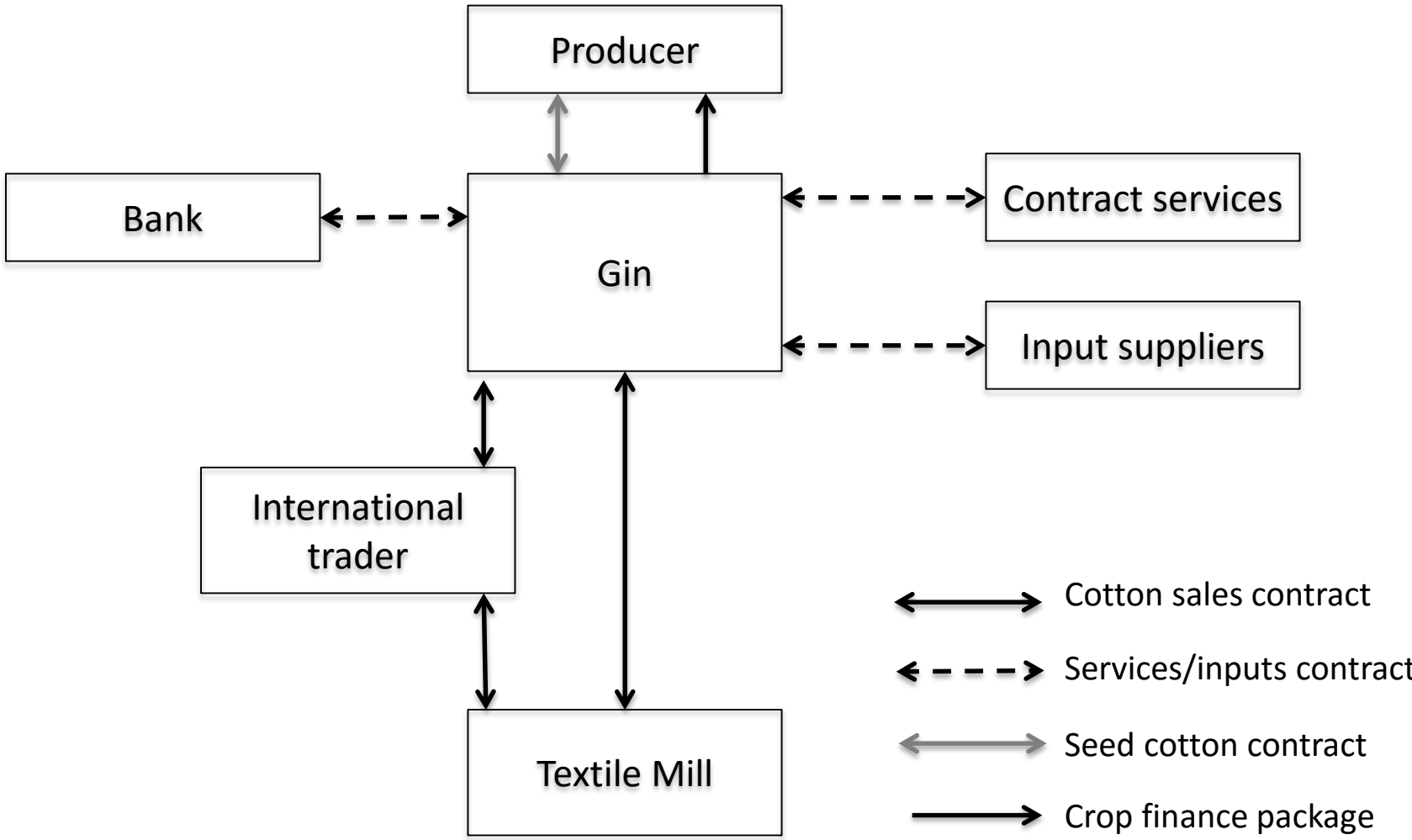


.. and performed even better than the grain sector

- planted area under cotton is higher than in soviet times – which is not true for grains



Cotton industry used to be the only example of vertical coordination use in Kazakhstan.



Source: Sadler, 2006

Contracts

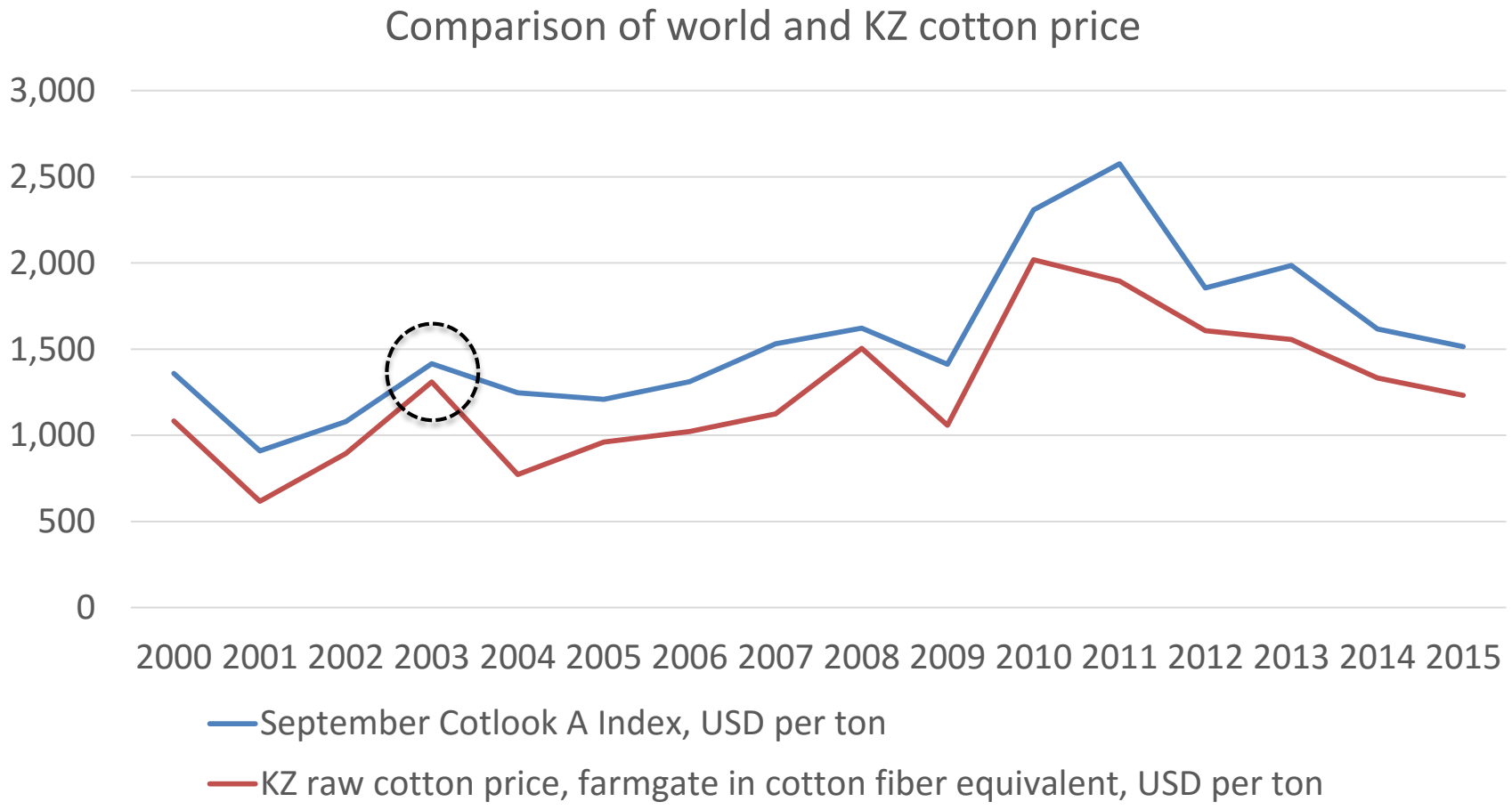
- Cotton traders introduced forward contract scheme
- To avoid market risks, price was linked to world price:

$$Price = ((P_L – 26\%) – P_P * Q$$

Price	– price per 1 ton of raw cotton
P_L	– Liverpool Cotton Association price
26%	– delivery discount
P_P	– processing services price
Q	– cotton fiber conversion coefficient (quality)

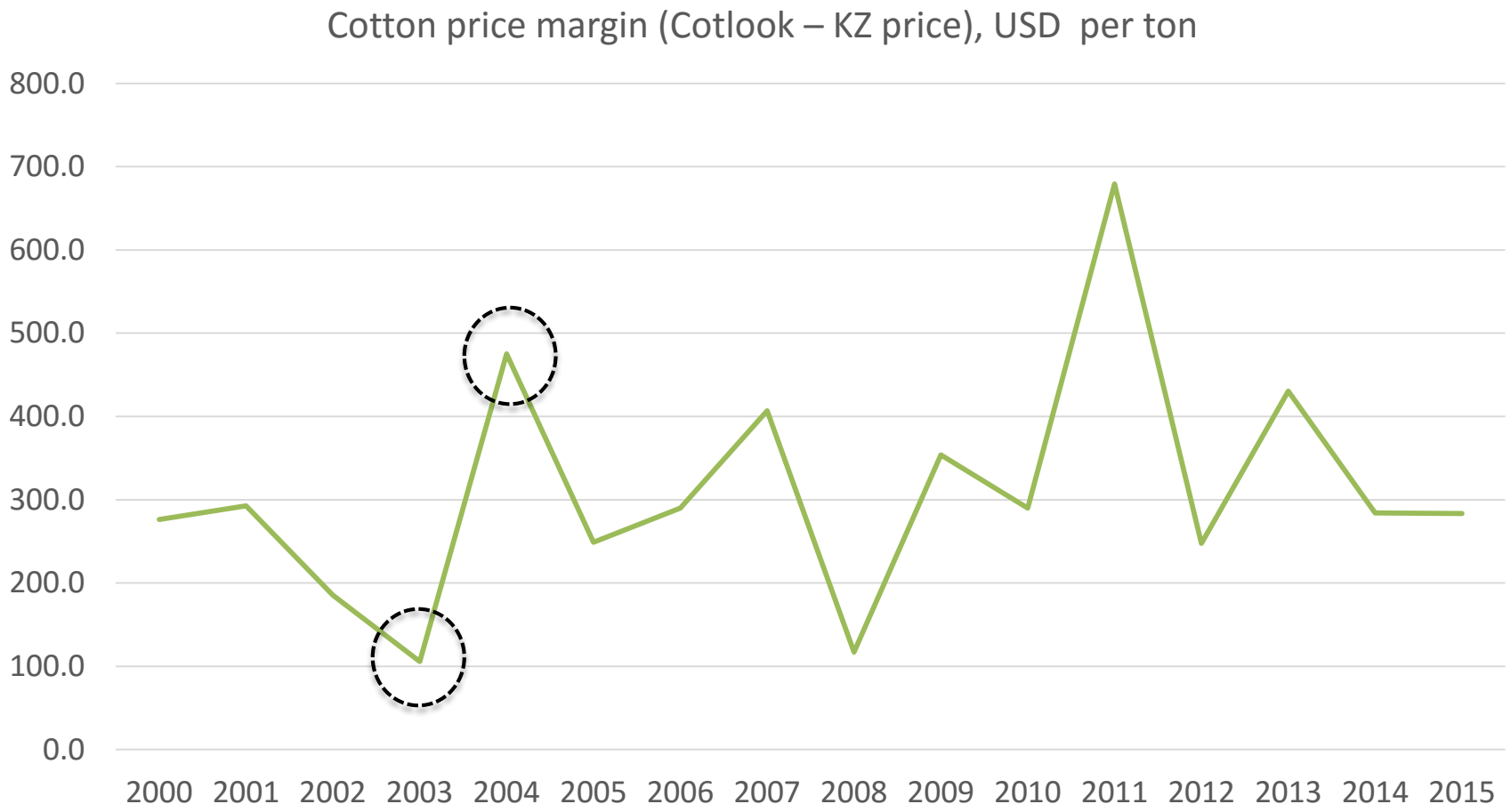
Source: Formation and development of cotton market. Sh. Zhukabayeva. 2005

Traders used their market power to increase margins



Source: own calculation based on Statistics Committee and National Cotton Council of America data

Traders used their market power to increase margins (continued)



Source: own calculation based on Statistics Committee and National Cotton Council of America data

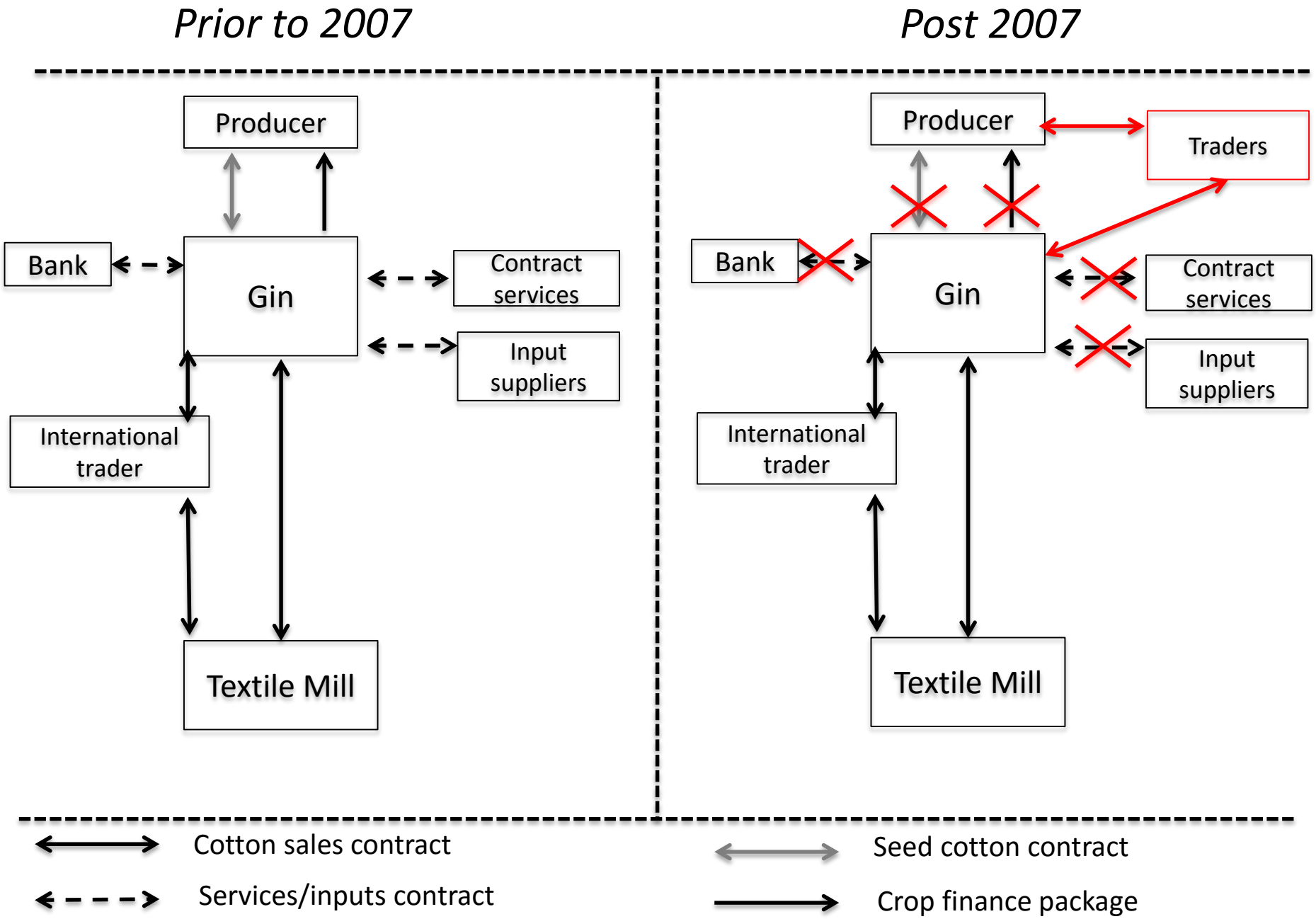
Legislation reasoning

- Following 46% price growth in 2003, producers extended area under crop
- In 2004, world price dropped by 12% and by 41% - Kazakhstan, i.e. ginneries increased their margin
- It led to farmers complaints on fairness of ginneries
- Government decided to put in order in cotton market and developed Law on Cotton sector development
- New law introduced the idea of cotton warehouse receipts, which showed good results in grain market
- Law was in line with overall political imperative to establish state-mandated industry clusters

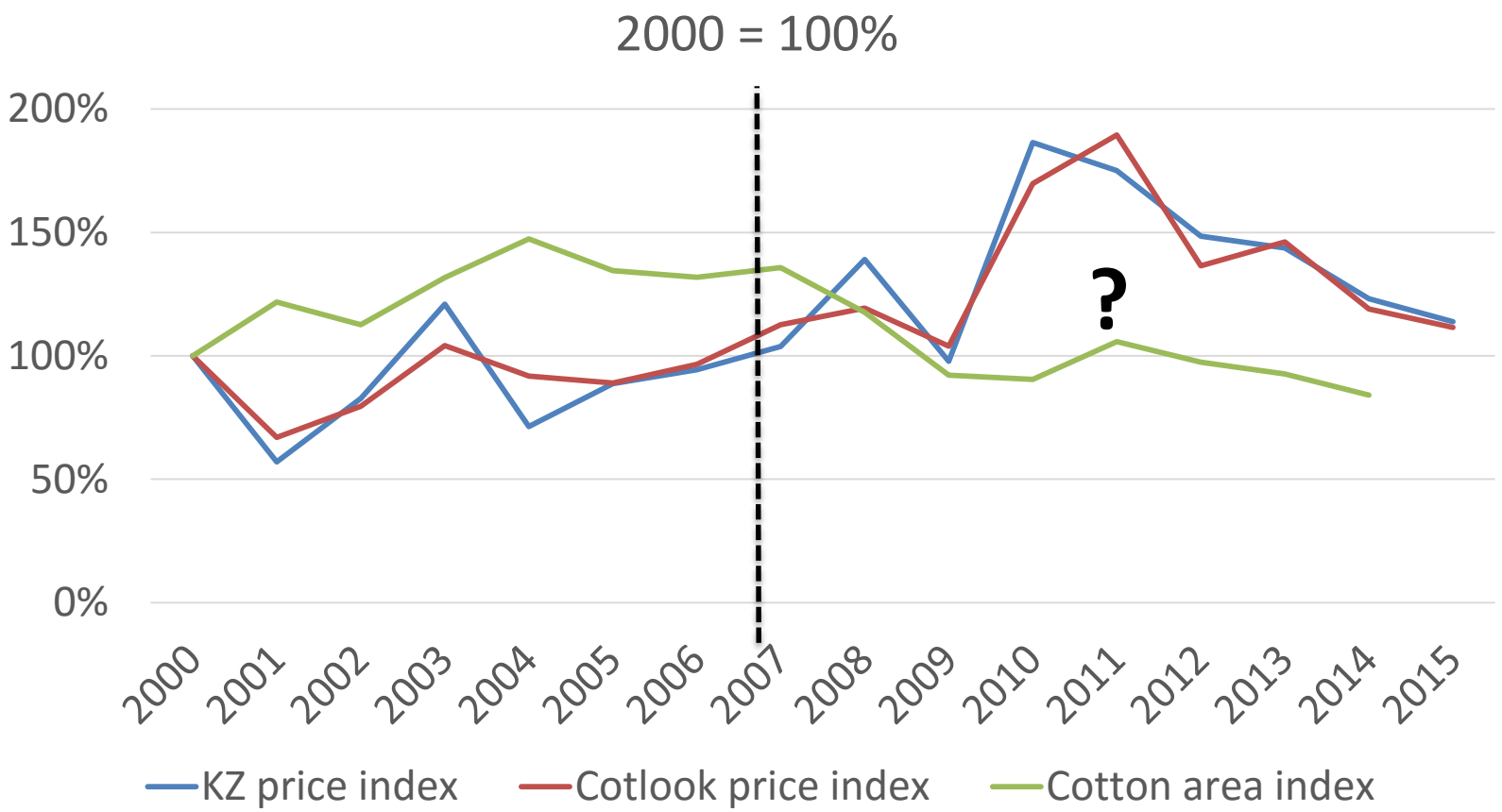
Key features of the Law on Cotton sector development (July 21, 2007)

- Ginners were prohibited from engaging in business activities which were not related to warehouse services (*removed in 2015*);
- Ginners were prohibited from issuing guarantees and using their property as collateral under loan agreements with third parties;
- Cotton receipts were introduced;
- All ginners must participate in a guarantee scheme - cotton receipts guarantee scheme.

Distortion of supply chain

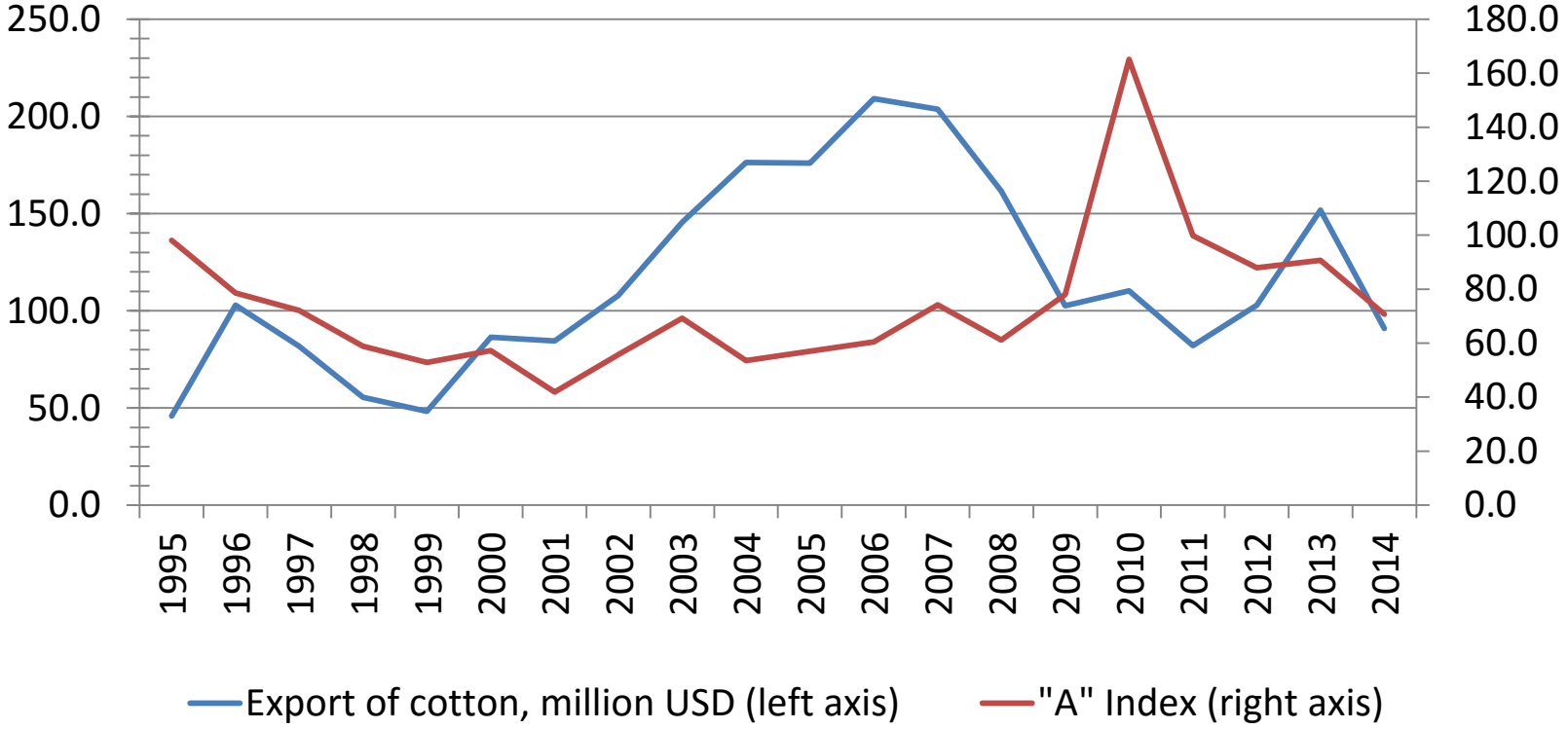


Area has been shrinking despite positive market context



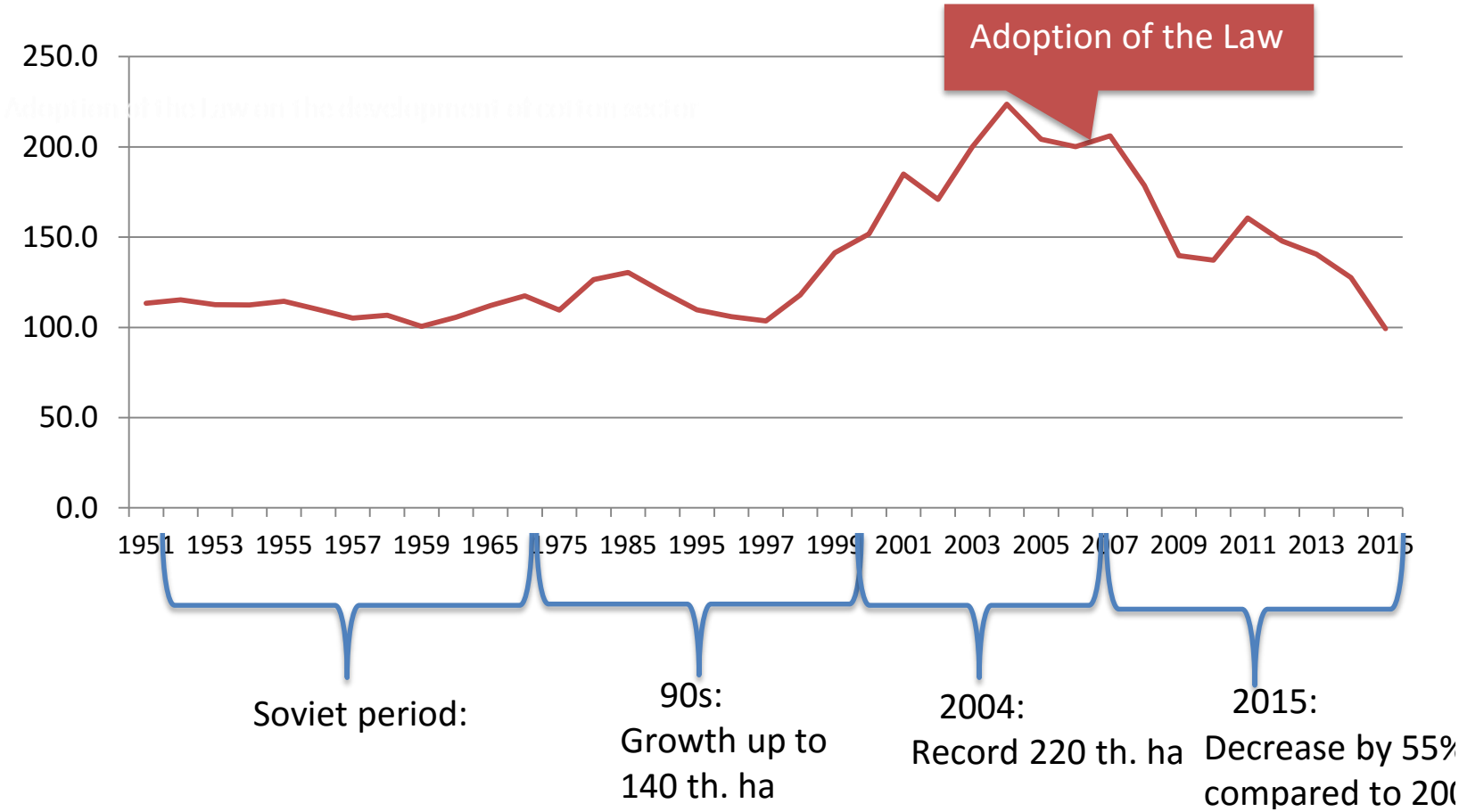
Source: own calculation based on Statistics Committee and National Cotton Council of America data

Export of cotton has been decreasing since 2007 and has become less responsive to world market signals



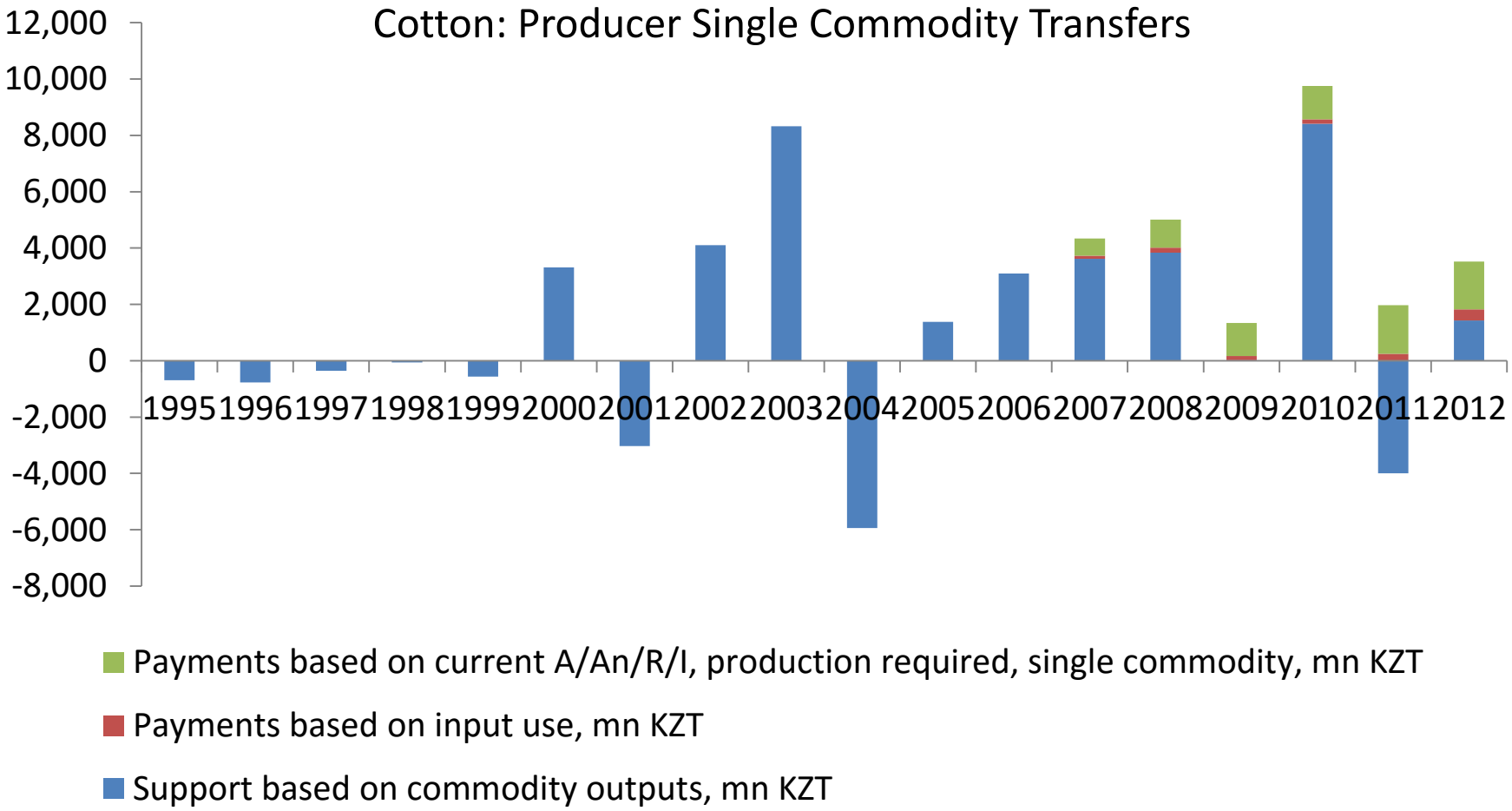
Source: Committee of Statistics

by 2015, total sown area decreased by more than a half compared to 2004



Source: Committee of Statistics

.. and even subsidies did not help



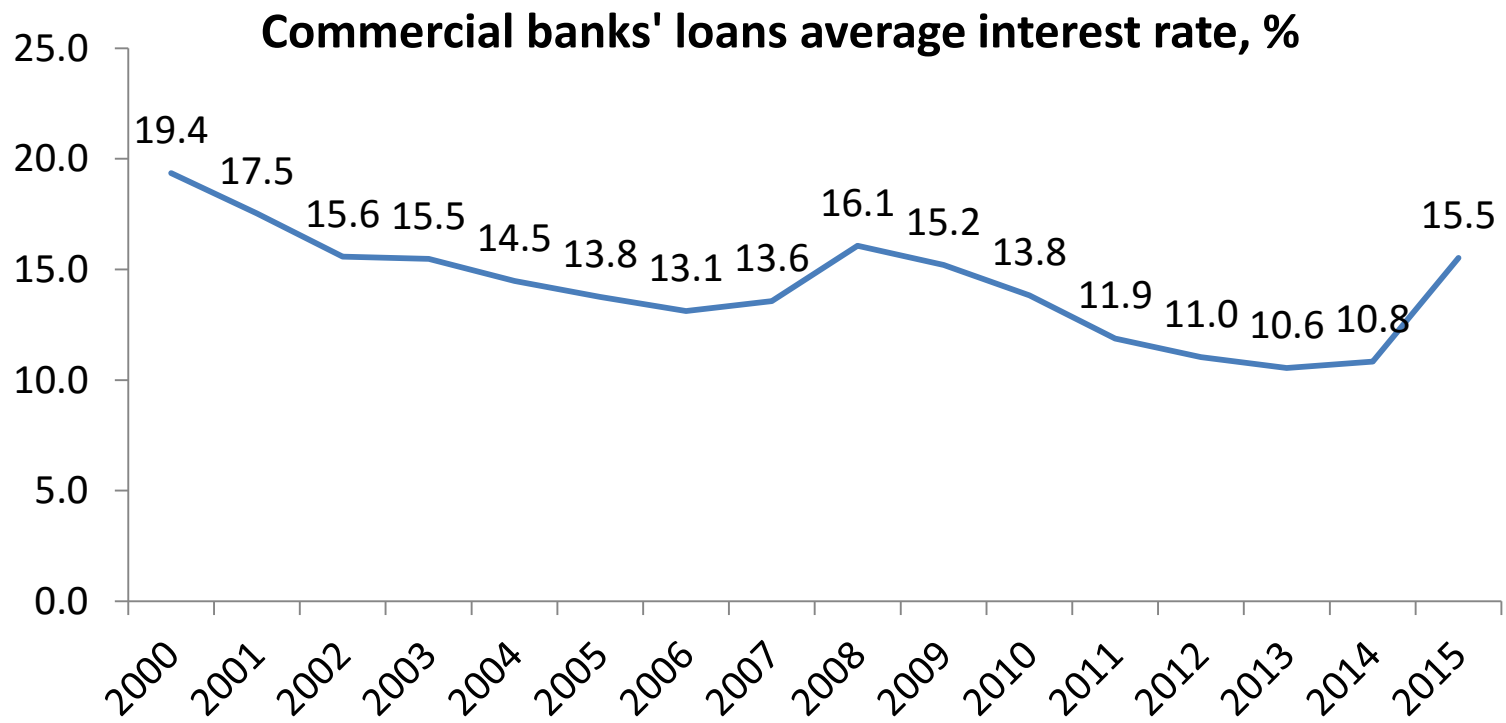
Source: OECD PSE database

Government intervention continued

2005	legislation on creation of SEZ Ontustik, specialized on textile industry. SEZ was expected to become a core of “textile cluster”, following M. Porters’ ideology. Plan was to attract US $1bn of investments, build 15 factories in three years,
2007	creation of KazMakhta, subsidiary of state-owned Food Contract Corporation. Company was procuring, processing cotton and producing seeds. Intention was to intervene the market and provide “fair price” for farmers.
2011	First factory “Khlopkoprom-Tsellulosa” started operations in SEZ Ontustik
2015	Kazmakhta was sold to private investor
	Change in cotton processing regulation

other factors <u>could have influenced</u>

- due to financial crises, interest rates have increased in 2008, that could have limited financing of producers
- but afterwards, rates dropped, which did not lead to restoration of the cotton industry



Main consequences of adoption of the Law: post-2007 trends in cotton industry

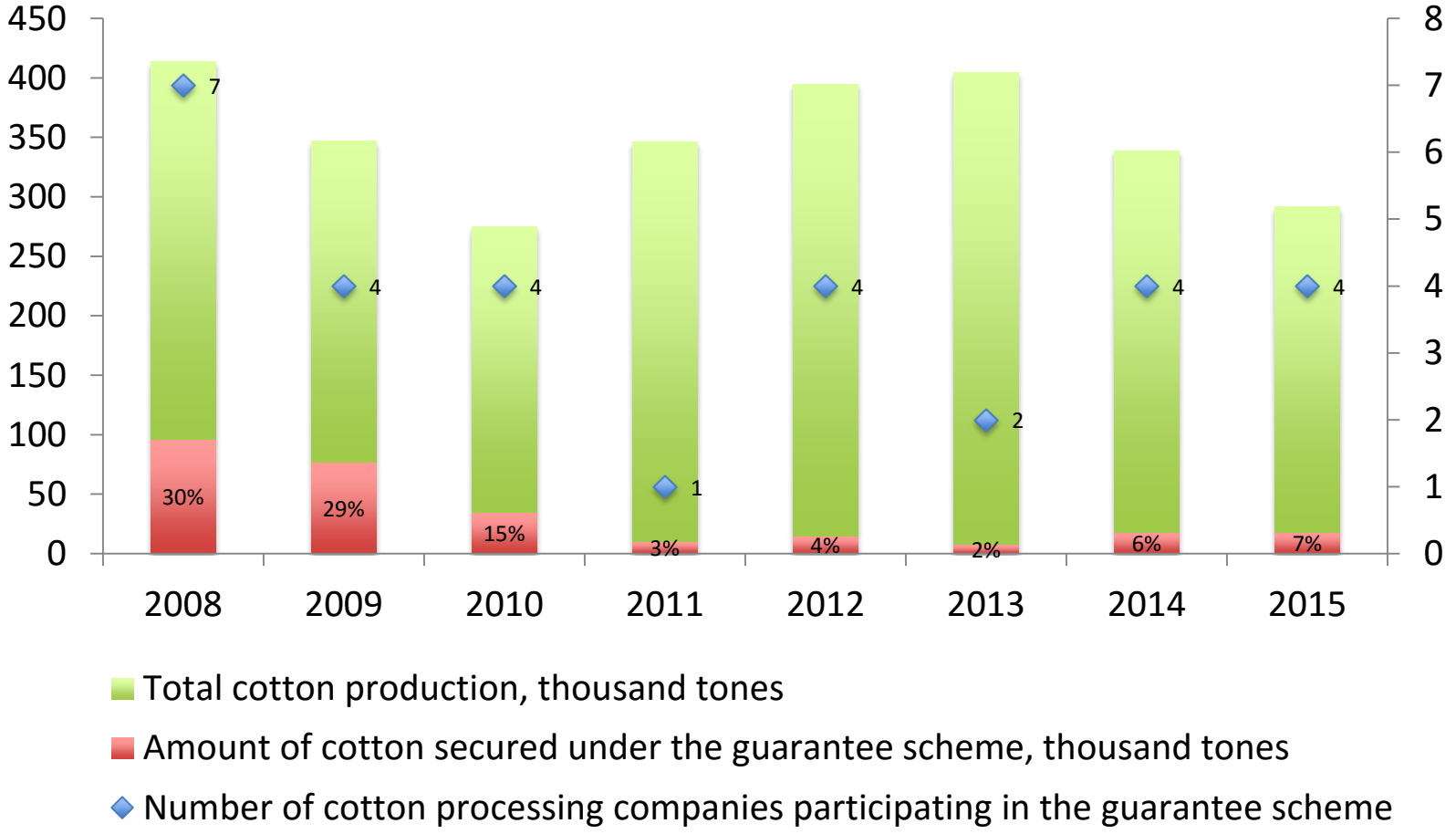
- Distortion of supply chain and financing system;
- Shrinking sown area and decreasing cotton output;
- Decreased processing capacity;
- Falling exports;
- Increase of government spending;
- Inefficiency of cotton receipts;
- Decrease of private investments in the sector.

Processing plants are operating at 33% of their total capacity - 12 out of 23 plants were operating in 2015

	Total number	Total capacity th. tons	Number of those who applied for working in 2015	Total capacity of those who applied for working in 2015, th. tons	Licensed ginners and CCC
Ginners	23	**841**	12	**274,5**	12
Cotton collecting centers (CCC)	345	-	144	-	144

Source: Akimat of Southern Kazakhstan oblast

Cotton receipts which should have provided cotton growers with the opportunities to obtain finance are ineffective in reality



Source: KazAgroGarant

SEZ Ontustik performance

- Created in 2005, SEZ Ontustik was expected to become a core of “textile cluster”, following M. Porters’ ideology. Plan was to attract US $1bn of investments, build 15 factories in three years and process 100’000 tons of cotton annually.
- By 2011, Government invested ~US $65 mio in infrastructure construction. First company “Khlopkoprom-Tsellulosa” has started.
- By 2015, 8 factories operational, worth US $144 mio investments, mostly backed by semi-government loans.
- In 2014 114 tons of local cotton was processed. SEZ management argue limitation on textile sector specialization.

Source: http://otyrar.kz/2012/06/zabytoe-slovo-klaster-pochemu-v-yuko-ne-rabotayut-klastery/
http://expertonline.kz/a13647/

Conclusions

- government pro-development regulation could be devastating for industry development
- the quality of regulatory measures turns out to be more important than the availability of massive state funding for production lines that were hand-picked by the cabinet of ministers
- liberal reform of the cotton law that relaxes the constraints on processor funding might restore the vibrancy of the cotton sector