Private Enterprise Development in Low-Income Countries

The Role of Foreign Investment in Ethiopia's Leather Value Chain

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A census of formal firms in the Ethiopian leather industry reveals that the change in government policy was successful in attracting foreign direct investment in the processing of raw hides and in the manufacturing of leather products. This has led to some degree of technology transfer, albeit limited so far. Policies to encourage value-added local processing have been more successful with the large foreign tanneries than the smaller Ethiopian ones.

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

Because local tanneries were not advanced enough to process up to the crust level, the government suspended the ban on new foreign investment in tanneries for several years. As a result of relaxing these controls, Ethiopia has seen a significant increase in foreign investment in leather processing and manufacturing since 2004. At the same time, the government initiated a series of programs to support informal shoemakers and implemented a series of trade policies such as export bans and taxes targeted at keeping raw hides in the country for processing.

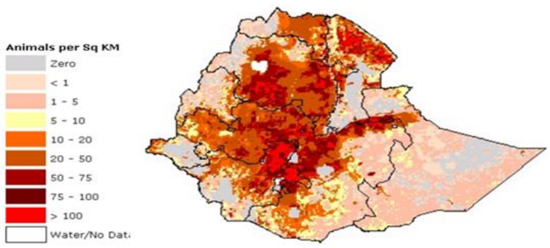

Figure 1 – Ethiopia's livestock population

These measures aim to incite foreign firms to relocate more of the leather transformation process to Ethiopia, in the hope that spill-overs from their operations will improve local technology and knowledge all along the value chain. However, foreign investors could also harm the Ethiopian leather sector if they compete with local tanneries while operating in isolation or capture the markets presently served by informal businesses. Foreign firms, particularly those from China and other parts of Asia, have been investing in Ethiopia's leather sector, but very little information about their operations has been officially recorded so far.

A census of foreign-owned and local firms involved in the leather value chain

In order to better understand the impact of foreign, and, in particular, Asian investment on Ethiopia's leather industry, we conducted a census of all formal firms currently active in the leather value chain. We began with Asian-owned firms and, using snowball techniques, moved to their Ethiopian (and non-Ethiopian) contacts in the leather cluster, which included subcontractors, suppliers, buyers, and trainers. We also interviewed all foreign-owned firms, asking about their Asian linkages. Subsequently, through semi-structured interviews and focus groups with Ethiopian officials and industry associations, we asked about proactive efforts, if any, by Ethiopians to engage Asian factory owners and learn from Asian practices through field visits and investment promotion tours. We were able to interview all of the foreign firms in the leather industry and 20 of the 26 domestic firms.

Foreign investment in the leather processing sector

As a whole, the Ethiopian leather processing industry (by which we primarily mean tanneries) experienced substantial investment by foreigners. All four of the Chinese tanneries surveyed—as well as two Indian tanneries—that decided to invest in Ethiopia had bought leather from local Ethiopian tanneries for between 7 to 14 years prior to investing. Each Asian firm reported that their primary reason for investing in Ethiopia was to secure their leather supply.

Overall personnel movement between Ethiopian and Asian rivals was modest. In the private sector, there was some evidence of training --4 of the 11 Ethiopian companies had hired Indian experts or had received technical assistance from Indian partners. While several European investors in Ethiopia had brought in Chinese experts, not one Ethiopian firm had done so, for as of yet unknown reasons. Each of the three Indian companies interviewed reported that they had sent technicians to local tanneries to provide long-term technical support. No Chinese company had done likewise. On the government side, Ethiopia's Leather Industry Development Institute (LIDI) partnered in 2011 with the Central Leather Research Institute (CLRI) and the Footwear Design and Development Institute (FDDI), two Indian government institutions, to improve its technological knowledge of the leather industry. In this exchange, each of 11 Ethiopian tanneries hosted three or four Indian leather experts for one year to help improve industrial practices. However, the overall results of this initiative were mixed: although several companies considered the experience very positive, some tanneries viewed the time period as too short, and others reported that the Indian experts imparted only abstract management techniques rather than the sought-after technical knowledge that could be applied to future practices.

Our data shows evidence of some degree of technology transfer. European firms in Ethiopia are getting substantial technology transfer via China. In addition, all the trainers from India constitute substantial technology transfer. At least one Ethiopian firm we interviewed told us that he had taken a team to China to visit factories there, and will be sending personnel to China for training.

In terms of actual operations, there were episodes of discord between Asian and Ethiopian firms. For example, Ethiopian firms blamed two Chinese tanneries for aggressive purchasing of Ethiopian raw sheep skins that led to substantial price increases—the local market price of sheepskins skyrocketed by 430 percent, from 20 to 106 birr per piece. Though such claims have yet to be substantiated by more formal proof, they are emblematic of the rocky relationship foreign leather processors have had with local Ethiopian competitors. As opposed to the manufacturing sector, foreign investment in the tanning sector produced complaints about crowding-out effects from foreign competition – due to limited access to credit, lower-grade technology, and inferior resulting quality.

Foreign investment in the leather manufacturing industry

Two important examples of Asian manufacturing investment in Ethiopia showcase different approaches that Asian firms have taken as regards investing in Ethiopia. These firms are China's Huajian Group and Hong Kong's New Wing Group. Both shoemakers worked on fulfilling American and European Original Equipment Manufacturing (OEM) orders, so 100 percent of their Ethiopian-made products will be exported. Moreover, these firms produce only women's shoes, while local firms focus almost exclusively on men's shoes.

There are clear differences between the two firms. Cheap labor was discovered to be the main reason for Huajian's investment, as average Ethiopian salaries are only US$35 per month, which is about ten times as low as those of the firm's Chinese workers. Huajian entered Ethiopia at a relatively large scale, and quite rapidly, at a time when local supplies of quality skins and hides were already tight. They were unable to source all of their raw materials locally, and thus at the time of our research, six months after they had started production, they were importing 70 percent of their leather supply. The Chinese managers trained Ethiopian staff, most of who were newly graduated college and high school students, and sent 86 Ethiopians to China for 2 months of training in November 2011. They view this as an investment in the future of a skilled Ethiopian staff. Further, their location 35km from Addis Ababa, along with their plan to build a leather products focused industrial zone close to Ethiopia's principal leather-making cluster, will create opportunities for technology spill-overs to local firms. Huajian has signed a memorandum of understanding with the China-Africa Development Fund (CADF) to invest $2 billion to build a shoe production base in Addis Ababa over the next 5 years.

Figure 2 - Huajian Shoe Factory Assembly Line

New Wing, on the other hand, is a smaller firm, and is able to source most of its leather from inside Ethiopia, and the company planned to establish its own tannery for refining processing. (Existing Chinese tanneries in Ethiopia do not supply leather to local leather product factories because the government assesses their tax incentives based on the proportion of processed leather exports.) Rather than hiring unskilled workers and training them in China, New Wing "poached" some of its skilled workers from other firms; this was a source of some resentment locally. Though some New Wing workers shared Chinese industrial techniques with colleagues from previous jobs, New Wing, like Huajian, has so far had little impact on the productivity of existing Ethiopian leather manufacturing companies.

International non-Asian players are also working to develop the Ethiopian leather manufacturing industry. A British tannery with factories in China and a tannery in Ethiopia established a glove-making factory in Ethiopia and used a team of Chinese trainers supplied by their Chinese agent to teach advanced production skills to Ethiopian workers.

Government policies have had mixed effects on local firms' upgrading so far

While the industry is still in its nascent stages, it is clear that the change in government policy was successful in attracting foreign direct investment in the processing of raw hides and in the manufacturing of leather products. The majority of investors in leather processing are from China and India, while the majority of foreign firms in shoe manufacturing are from Europe. However, the two largest shoe manufacturers are from China. These findings are important because manufacturing firms have the potential to provide well-paid employment for large numbers of people with minimal training. At this stage, jobs have already been created, exports have increased, and there is some evidence of technology upgrading in the leather sector overall.

Information collected in interviews with tanneries suggests that the Ethiopian government's policies targeted at fostering value-added local processing have met with some success albeit at the expense of Ethiopian tanneries. Larger foreign tanneries -two Chinese, one Sino-Italian, and one British- responded quickly by directly upgrading their machinery to export finished leather. On the other hand, 5 of 11 of the smaller local tanneries that were interviewed stopped exporting or greatly reduced their exports due to the new policy. Such tanneries then started selling semi-processed leather to other tanneries in order to survive, while planning to buy machinery to upgrade, as they did not want to be dependent on local partners. However, buyers reported that the standard of finished leather in Ethiopia was still low due to the lack of adequate facilities, worker skills, and suppliers. The exported skins needed to undergo further processing in China, India, and the UK to meet customer requirements.

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

Moving forward…

Because foreign firms' projects in the leather sector are in their infancy and investors are planning for expansion, the government of Ethiopia has a unique opportunity to track these firms over time.

While the training and skills offered by Chinese firms can be highly relevant for Ethiopian conditions, our data shows that there has been little integration between Chinese and local firms so far. No local firms have hired Chinese advisors or employees, although European-owned firms have done so. An important research question for the medium term will thus be the extent to which Asian (Chinese) knowhow—the raw technical and industrial knowledge that powered Chinese firms to be among the most competitive leather manufacturing and processing companies in the world—will be diffused to Ethiopian-owned companies.