A PROPOSED MARKET FRAMEWORK
FOR THE BUYING AND SELLING OF SEED COTTON
IN MALAWI

Introduction

1. This proposal is motivated by the firm belief, confirmed by the Government of Malawi, that there is a big opportunity for developing a large, successful and profitable industry for cotton growing and lint production in Malawi. This is an industry that will deliver a potentially significant return to the farmers and ginners alike, contributing to the wealth of the community and delivering much needed foreign exchange to Malawi.

2. This proposal sets out a number of modest suggestions, which it is felt will provide a possible initial regulatory framework within which the industry can thrive and prosper.

3. This proposal is based upon the understanding that:

    - The Farmer is entitled to a price for his crop that is determined through a fair competitive process;

    - There continues to be a strong justification for the establishment for a floor or minimum price;

    - The Buyer should compete in the purchase of raw cotton and be prohibited from coordinating on price or quantities;

    - The more efficient the market structure is for buying and selling the more potential there is for the Farmer and, indeed, the Ginner, to increase his return;

    - The provision of inputs or the financing of the provision of inputs should be carried out by a commercial organisation or organisations that are independent of the Buyer;

    - There is a need to adopt a programme for enhancing the average yield of the Farmer’s cotton crop;

    - There is a developing security problem in Malawi that has led to numerous robberies in the last season and has materially increased the costs associated with the purchasing of cotton in rural markets.

    - There is a need both for the industry and the government to have better statistics in relation to the crop and the marketing process.

General Approach

4. There can be no industry, no activity and no wealth creation if there is not a good crop of cotton grown in Malawi. It is therefore essential that ginners and farmers and indeed the Government ensure that the interests of the industry are aligned on achieving the

objective of building a healthy robust and much expanded harvest of raw cotton in Malawi.

5. The regulatory framework should capture the benefits of the newly competitive environment, whilst providing for a mechanism to ensure that the overall and, indeed, shared objectives of ensuring that a good crop is grown with an attendant high yield.

Background

- ***The Market Participants***

6. The Growers comprise some ±2 million mainly subsistence Farmers, mostly farming plots of between half a hectare and five hectare. On the other hand, there are some five Ginners, Great Lakes, Malawi Cotton, Iponga, Toleza, Wogate, Nadi and Afrisian Cotton. Of these, Great Lakes has by far the largest ginning capacity and, certainly this year, buys at least 50% of the Malawi crop.

7. There are legal restrictions on the exports of raw cotton, as a result of which growers in Malawi have very little option but to sell cotton to the local ginners. On the other hand, the bigger ginners have established gins in some of the surrounding countries and are able to balance their purchases amongst different countries.

- ***The Customers for Cotton Lint and Seed***

8. The market for Malawian processed cotton is almost wholly to customers outside Malawi. There was historically an active spinning and weaving industry in Malawi, led by the largest facility, David Whitehead. Spinning and weaving is an industry that has been in decline in Malawi, and there is now only a very small market for cotton lint domestically.

9. The seed crushers in Malawi are also customers and they should be involved in the development of a market structure because they are also beneficiaries.

- ***Characteristics of the Market***

10. Each gin company, indeed, all gin companies, provide some seeds and inputs. When the harvest arrives, the growers either ask for woolsacks from the ginner to whom they propose to sell and these are then filled, weighed and paid for. Alternatively, some of the small holders will bring cotton in to the gin buying market in whatever bags the farmer has and the cotton is weighed and put into woolsacks. Very roughly a woolsack may be recycled 2 – 3 times in a season. This means that for a crop of around 50,000 tons a total of around 200,000 woolsacks are needed.

11. Actual purchases are made through:

    1) markets established by the gin companies in the rural areas where cotton is grown,
    2) mobile markets effectively ad hoc collection points in the rural areas; and
    3) through traders who buy often early and then resell to the ginners.

12. Each of these need to be considered in turn. The markets established by the gin companies comprise a buyer, appropriate premises where seed cotton may be bought, weighed and stored, security staff and weighing equipment. Apart from the season 2008/9, the trend has been for more and more competing markets with the attached duplication of security support and weighing scales.

13. A mobile market is effectively a location not manned on a full time basis to which the gin company concerned will arrange to come at a determined time each day/week to buy cotton.

14. Finally, there are the traders. Traders are not regulated in any way. They are middlemen who buy seed cotton for as low a price as they can and then sell on to the ginners. In the past their services were an institutional part of the buying programme for some gin companies. Traders put in jeopardy the minimum price requirements since they are not committed to it. One concern for the farmers is that by using self employed traders it is possible for the ginners to undermine the spirit of the minimum price requirement which is to drive a maximum return in favour of the farmer.

15. On the other hand, traders fulfil some competitively desirable objectives. They are competing customers for the farmers' seed cotton, they provide transport often from areas forgotten by the ginners, and they provide a form of arbitrage between the ginners as they try to get the best price by negotiating with the various gin companies. Some traders have formal arrangements with ginners to sell inputs and seed to the farmers.

16. The disastrous 2008/9 season helps to illustrate the interaction of some of these factors. In 2008/9 a minimum price was set at 75 kwatcha – a price that gave the raw material a value that exceeded the value of the products (seed and lint) made from it. As a result, although markets were opened, nothing was bought and after a few months, when it became clear that the government would not reduce the price, the markets were withdrawn. Indeed, Cargill not only withdrew their markets, they withdrew from the market completely and closed their Malawian operations.

17. Farmers had nowhere to sell and for many months could only get traders to buy. In the desperate time immediately after harvest when farmers needed money for food, soap, household and school expenses, prices to traders were as low as 18 Kwatcha per kilo, but generally between 20 and 25 Kwatcha, well below the costs of production.

18. Once sales were possible farmers relied upon traders and some worked collectively to hire lorries to bring their cotton in to the gins. Those that relied upon traders, and these were the majority, unquestionably ended the season getting a much lower price for their seed cotton. Although the rains in the 2009/10 season were not good, undoubtedly the major cause of the dramatic fall in the size of the national crop was the very low prices that the farmers were able to get for their seed cotton.

- ***Operation of the Market***

19. Raw Cotton (seed cotton) is bulky and expensive to transport and, as a result, a practice has developed of establishing local markets in the communities where cotton is growing. With the new competitive environment, there has been a proliferation of market stalls in

which each of the competing gin companies established their presence, their own buyer, security staff and weighing equipment.

20. Market entry is very easy for Farmers and their ability to switch from one crop to another produces some very volatile swings in the size of the annual crop. Thus, the swing from the estimated 70,000 plus ton crop of 2008/2009 to the 15,000 minus crop of 2009/2010 reflects very directly the disenchantment of the Farmers with the prices they were able to obtain as a result of the regulatory and market conditions of 2009.

21. For ginners, there are financial barriers to entry owing to the costs of processing, the necessary ginning equipment and the need to have access to sufficient money to fund the buying markets and the purchase of seed cotton. However, there are very little regulatory obstacles and the government encourages new entrants. At present there is a significant over-capacity in the ginning sector.

22. The relationship between the cotton grower and the gin company has changed over the years. Initially, the cotton gin companies introduced cotton farming to smallholders and provided all the equipment and all inputs. In return, the growers were required to sell to the supplying gin companies so that the cost of these inputs could be recovered. In practice, there was often no separation between the price even per kilo and the amount allocated for the recovery of the input costs.

23. This scheme made the grower dependent on the discretion of the gin company for a fair return for his labours. This paternalistic relationship was very dependent upon the fairness of executives in charge of the gin companies and the economic objectives of their companies. In the modern environment, and with the outrageous example of the behaviour of the tobacco buyers, farmers are reluctant to rely on the good faith of the old paternalistic approach. They would prefer to have the essential issue of price settled on a competitive basis in the marketplace upon the balance of supply and demand.

24. The level of competition has intensified over the last three years with the entry of Toleza cotton onto the market. This has led to the proliferation of buying markets opened by each gin company. Although Cargill exited the market last year, its place has been taken by Malawi cotton, a Chinese owned venture. As a consequence, there has been real price competition. In the last season (2009/10), this drove prices in some places to as high as 120K levels, achieved because of competition, but also because of the high international demand and a small Malawian crop. For once, the gin companies were up against the wall rather then the farmers!

25. This has given rise to some disputes between competing gin companies over the extent of their respective contributions to inputs. These disputes reflect a notion of defined market share and are anti-pathetical to a competitive market. Accordingly, the time has come for a new approach that can encompass the broader issue of financing inputs as well as encouraging a stronger cotton market and higher yields.

The Financing of Seed and Inputs

26. In business everything comes at a cost. If the ginners provide the inputs themselves, or finance the inputs, it will be a cost for them and either the costs incurred will be taken back or the price to the grower reduced and the surplus set off against the costs. In either case, it is part of the relationship between the gin company and the farmer to whom it gives inputs.

27. As we have explained above, the farmer prefers to be able to quantify the costs of the inputs and would rather sell his cotton on a competitive market.

28. This requires that the Farmer is given the freedom to buy his own inputs without being tied to any gin company. Accordingly, the Farmer should not have to look for a gin company for the financing or sourcing of those inputs but rather to an independent micro financing company or companies or possibly directly to a seed company or companies that will sell to them directly or on credit. This will leave the Farmer free to sell to the gin that makes the most competitive offer.

29. Accordingly, we recommend that inputs should in principle be financed by loans made directly to Farmers by an independent finance or micro-financing organisation or organisations. In the first year, there will have to be a special procedure because there is insufficient time to put into place a more detailed framework. In the first year, each gin will have the following responsibilities:

    (1) to make an initial payment of 15% of the costs of the inputs needed for the share of the national crop that he anticipates he will buy, either as recorded in the meeting last month at Toleza or, alternatively, one based on the general statistics of the 2008/09 season. Thus if a ginning company was expected to get 10% of the national crop, it would be anticipated that he would pay US$ 325,000 towards inputs and seed (10% of the Great Lakes estimated cost). The down-payment would therefore be US$ 48,750. This would entitle the ginner concerned to withdraw from some central location the seed and inputs appropriate for his 10%.

    (2) to make an agreed 4 kwacha payment with respect to each kg of seed cotton purchased by the ginner or indirectly by any trader he may use. These payments should be made within 10 days of the end of each month in which the purchase was made.

    (3) an undertaking would have to be made by the ginner concerned that he would repay the financing institution the total of the amount owed, in the example above US$ 325,000, either through the operation of the 4 kwacha levies or, if these are insufficient, by a top-up payment at the end of the season.

    (4) in the event that the ginner was to purchase more cotton than the amount for which he had bought an allocation of seed and input money, he would continue to pay the 4 kwacha levy.

30. During the course of the 2010/11 year, each ginner will compile a register of all growers together with details of monies borrowed (where appropriate). This register

will then become part of a national register and will enable a financing institution to undertake to make available loans in succeeding years.

31. It is anticipated that this structure will facilitate a transitional phase advancing towards an empowering of the grower enabling him to take responsibility for the choice and method of payment for seeds and inputs in the coming years.

32. It will be for the ginner to assist both the financing institution and the farmer in ensuring a smooth and secure lending process. The ginner will continue to support the farmer in every other way.

33. Clearly there will need to be some framework and agreed common paperwork in support. Some elements of a framework are considered under the heading of the "Cotton Markets".

Cotton Markets

34. For reasons discussed above in 15 to 25 locations all of the major cotton gin companies have markets in close proximity to each other. Each has its own security, own set of scales and own buyers, and independent transport arrangements. This emerging feature of the market gives rise to a number of potential opportunities.

35. These "cotton buying centres" provide an opportunity to rationalise security provisions and provide a focal point for the industry. Any unnecessary duplication of costs reduces the efficiency of the market and, therefore, cash available for purchasing cotton. In addition, in the area of security, it gives rise to a nightmare for the police. In the 2009/10 season, the police were particularly concerned by the amount of money being carried around to the markets to replenish the buyers requirements.

36. A first step in a rationalisation of the market structure might be the establishment of agreed "cotton buying clusters" in locations spread as evenly as possible around the major cotton producing areas.

37. The location of these cotton buying clusters ("CBCs") would be agreed upon by the ginners and representatives of the farmers. At these CBCs, each ginner would agree to take premises adjacent to each other or close by so that security costs can be shared. Once the industry had agreed the CBC centres, these centres would provide the best most secure location for the lending institution.

38. If a network of lending institutions could be established at the rural cotton buying centres, this could facilitate a further important opportunity. None of the gin companies like to operate a system whereby their supervisors have to carry around large amounts of money. In any given season the amount of money at risk will vary between 2-3 billion Kwacha all carried for the most part in cars and motorcycles around the rural cotton growing areas. One way of avoiding this would be for the buyers to establish an account with the lending institution in the local CBCs and instead of handing out money at the individual markets the gin companies would hand out a voucher. This voucher could be redeemed at the lending institution at the CBC. This lending institution could deduct the borrowed amount before handing the money over to the

farmer. This would at one step put all the cash into one place and avoid the need for daily delivery to the cotton buying markets.

39. To better ensure that appropriate buying details are recorded, the CBCs could be used as buying registration points. Thus any purchases in the allocated territory of a buying centre would have to be registered to ensure the appropriate deduction had been made before it could be transported out. The police could reinforce this by checking that cotton transporters had obtained their appropriate registration for their seed cotton. This would have the added benefit of acting as a control mechanism over the traders.

40. It would be necessary to establish a framework for both mobile buying and for markets established in areas away from the CBCs. It may be that this would be subject merely to a requirement to register these transactions at the local CBC. However, the issue needs further thought.

41. In conclusion, the ginners would act as a collection point for the money that had been loaned for inputs. It would be the responsibility of the National Farmers Union / lending institution to deduct the monies against the loans and to refund the money where either no loans had been incurred or where loans had already been refunded.

Need to Increase Size and Yield of the Natural Cotton Crop

42. We believe that a market structure along the lines discussed above would incentivise the farmer to achieve better crops and yields. However, the transition for the farmer to a position of self reliance and independence may need some support, accordingly there is a third opportunity arising from the establishment of the CBCs. This would be to use them as a focal point for a field worker/extension worker initiative.

43. This might be an initiative whose cost could be shouldered by an NGO or government initially but then gradually handed over as a cost to the local farmers. The principle here being that if the farmer believes he is getting some value from the use of the services of the extension workers he will be prepared to pay for it, if not it probably is not worth continuing.

Need for Industry Statistics

44. There is an absence of information and statistics, which make it very difficult to develop a strategy for the market. The most obvious need for statistics was illustrated this year. It was thought we had a national crop of 28,000 tons right up to the date the harvest began and it turned out that the crop was less than 15,000 tons. The development of CBCs would facilitate the tracking of statistics for both the crop and the marketing processes.

Implementation

45. Without question, there needs to be a review of the regulatory framework for the operation of the cotton market in Malawi. However, despite this year’s disastrous crop, there are certain obvious opportunities for enhancing the competitive conditions and better securing a more robust, larger, higher yield and sustainable crop. This paper

provides the ideas upon which with some relatively simple adjustments – all within the current framework – some very useful progress can be made this year towards the establishment of Malawi as a premium and major supplier of cotton in the region.

46. These adjustments can be brought about through the adoption by the Ministry of Agriculture of certain carefully drafted conditions for the issuing of seed cotton buying licences.

47. The license would include new conditions requiring that the applicant would:

1) avoid any collusion with other ginners on prices or quantities or any activities intended to restrict competition on the cotton market;

2) in conjunction with other ginners, have established a ginners association with a code of conduct and a constitution that provides rules and regulations for marketing

   The constitution of the ginners association would require that agreement was reached in conjunction with the farmers on the location of between 15 and 25 local CBCs evenly spread around the cotton growing areas.

3) In agreement with other ginners, would have developed a scheme for the payment of shared security costs for the CBCs and have made the necessary payments to support those security costs.

4) have arranged in conjunction with a lending establishment a scheme whereby the lending establishment made loans to farmers. The scheme would involve the ginners assisting in the process of recovering loans for the financing institution through a process of deducting monies from the purchase price of seed cotton.

48. The ginners would arrange to ensure that all cotton transactions both at the CBCs and mobile and other centres would be registered with a representative of a joint ginners/farmers liaison group at each cotton buying centre.

49. These details would be collated and provided to the government and interested parties every two weeks.

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