

## **RISK MANAGEMENT and CONTRACTUAL ISSUES IN SINO-AUSTRALIAN WOOL TRADE IN THE WTO ERA<sup>1</sup>**

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*China's WTO accession is not a commitment to guarantee contractual obligations – it is not a guarantee to pay!* (White, 2001)

Much has been made of the impact of the WTO on trade with China as it further integrates into global economy and as it interacts with foreign markets. Using an industry case study, this paper seeks to investigate whether these institutions can really affect everyday transactions as intended. Many observers, inside and outside China, subscribe to the sentiment that WTO accession will act as further stimulant to economic reforms and growth. China is widely acknowledged as the dominant force in the world textile sector. Australia has been supplying China's wool textile sector with raw material for

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over two decades with China now Australia's largest wool export market<sup>3</sup>. However, the Sino-Australian wool trade has not been without its problems. Both sides complain of opportunistic behaviour by the other, especially in times of market volatility. Whilst the WTO and other legal instruments do not mean more stable prices, they are designed to ensure clearer, more enforceable trading rules and lessen the risk of opportunistic behaviour by the participants.

This paper addresses the question of: does WTO accession change the operation of the Sino-Australian wool trade? By removing or decreasing bureaucratic factors external to the contract such as tariff and non-tariff barriers, does WTO accession make it easier for Chinese mills to access Australian wool? And with contractual difficulties still being endemic within the trade why have institutional remedies such as the Sino-Australian-New Zealand Standard Wool Contract (*Zhong-Ao-Xin Biaozhun Hetong*) (SWC)<sup>4</sup>, in spite of high-level bilateral support, not been more widely adopted to guard against defaults?<sup>5</sup>

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<sup>3</sup> For many years China's wool textile industry has relied on imports for around 75% of its raw material, importing around 300,000 tonnes annually for the last four years. China imported 193,465 greasy equivalent tonnes of Australian wool worth AUD \$1.4 billion for the 12 months up to May 2003, equivalent to 39% of Australia's total wool production (The Woolmark Company, 2003). Reducing the cost of relatively expensive raw wool to Chinese processors and end users is seen as a major task by the Australian industry over the next decade (AWI, 2001).

<sup>4</sup> The terms Standard Wool Contract and Model Wool Contract can be used interchangeably. The Chinese term *biaozhun hetong* (literally "accurate contract") and to a lesser extent *moxing hetong* (model contract) are used in Chinese industry vernacular. This paper adopts Standard Wool Contract throughout.

<sup>5</sup> Sino-International wool trade difficulties have been well documented and stretch back to the early 1990s. The Australian Council for Wool Exporters claimed that in 1992 alone around AUD 25 million worth of contracts were broken, accounting for around 6 per cent of Australia's wool trade with China. Contract defaults are linked to Chinese buyers - trading houses or the mills themselves - dishonouring or re-negotiating contracts following a fall in auction prices. Re-negotiations are a common occurrence when the market moves (i.e. down) against Chinese importers, conversely Australian exporters can be known to delay or deliver lower quality wool when markets move up. See Power (1993) in Brown, C. G., & Longworth, J.W (1994). The tone of a recent International Wool Industry conference also exhibited signs of dissatisfaction with China's commitment to renegotiated contracts citing China's absence from a meeting in Nice, France in 2001 the chairman is quoted in the minutes: "Concern was expressed about the current volatility in the price of wool at auction and, in particular, the fundamental obligation for IWTO member organisations to respect the sanctity of contracts. Whereas it was stressed by several delegates that their comments were not directed at any specific country it was NOTED that China's admission to IWTO membership had been conditional upon its undertaking to adopt the IWTO Arbitration Rules, upon its accession to the WTO. In this regard, the committee AGREED to recommend to the Assembly that this matter should be pursued by the IWTO Executive Committee...it was noted with regret that the Chinese

In July 2003, a former Australian wool industry representative to China reported “more and more exporters were now reporting renegeing of contracts and despite the industry’s previous efforts to develop a standard wool contract to police such trade disputes with China, it’s ability to smooth over such problems was now eroded” (Queensland Country Life, 2003). Why hasn’t the standard wool contract been adopted? This research takes a close look at the wool trade transaction. When wool markets move against the Chinese importer as can be seen with the huge increase in trade disputes coinciding with a large drop in wool prices post-Easter 2003 the number of renegeed and renegotiated contracts increases<sup>6</sup>. Conversely, when the market moves up radically, as it did in September 2002, Chinese importers complain of delayed consignments, or opportunistic *ex ante* behavior by Australian exporters. Wool is proving a volatile commodity and with a lack of price and quality risk management options available to Chinese importers, defaults and the like will inevitably continue.

See Table 1 below:

**Table 1: Eastern Market Indicator Wool Prices 9 April 2002 to 25 September 2003**



**Source:** BWK-Elders web site: <http://wool.elders.com.au/>

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delegation did not attend!” [emphasis in original]. Quote taken from the IWTO minutes for its Annual general meeting at Nice, France November 2001, available at [www.iwto.org](http://www.iwto.org), accessed on 25<sup>th</sup> July 2003. Contractual difficulties involve China across many industries particularly in commodities and industrial products trade. For further literature on the topic see Dickson (1997).

<sup>6</sup> On the first sale day after Easter in 2003 Australian Raw Wool prices on the Eastern Market Indicator (EMI) 114 cents per kilogram.

## Hypothesis

This research paper tests the hypothesis that institutions such as the Standard Wool Contract — a substantially more comprehensive contractual form which specifies in advance or *ex ante* the required terms of trade and conditions — are put in place to decrease transaction costs (information, negotiation and monitoring) and the risk of opportunistic behaviour, have not been widely adopted. It is argued here that these institutions have not been effective due to the nature of the international wool trade, and China's textile industry structure coming out of the plan. For example, limited exposure to foreign markets and best practice in purchasing raw material sees an absence of risk management options available to Chinese mills. This research finds that Chinese mills and importers are averse to using the SWC for a variety of reasons, some of which have been noted by others such as Quirk (2002) but here non-adoption is taken further. This paper implies that tightly specified contracts reduces the Chinese mills' alternatives to renegotiation and price risk management in the advent of markets moving against them. Fuzziness in contractual forms grants Chinese firms leeway in interpretation and possible arbitration proceedings (all carried out in China) and this 'looseness' has been and continues to be exploited by Chinese wool importers as a means to reduce market risk.

There is a large amount of anecdotal and reported evidence that sees large increases in the numbers of disputes and renege contracts reported by Australian exporters, where the quality of the wool consignment is contested, when the market has moved against Chinese, *ex post*, and while the Chinese purchaser awaits delivery. Such claims often rely on test results issued by Chinese Customs Inspection and Quarantine sampling, and often disregard the International Wool Testing Organisation (IWTO) approved certificates that the SWC would indicate as the relevant and objective quality assurance measurement. It is hard to point the finger either way at wrongdoing, in many ways the Sino-Australian wool trade can be described as another version of "The Great Game", where participants of both sides utilise information asymmetries of the other. For example, contracts normally use the broad Chinese typing system to specify the wool required in the import contract and Australian traders acting opportunistically *ex ante* take advantage of this by

putting together lots that stretch the upper limits of these already loose, or broad grading categories to their legal limit.

The SWC was implemented specifically to reduce problems the trade was experiencing with regards wool description, specification, fibre testing, and arbitration procedures, in order to reduce the mutual need for higher information, re-negotiation, and monitoring costs<sup>7</sup>.

## **Methodology**

In a move away from traditional wool supply chain studies or the “wool pipeline” as it is known, my focus has been on looking at the dimensions of the Sino-Australian wool transaction. Previous wool pipeline or supply chain studies could have been mimicked in this analysis but this would really only temporarily update what has been said before about the wool pipeline and the industry in general<sup>8</sup>. To identify the different participants a series of semi-structured interviews of various enterprises, regulators, testing facilities and government bodies in China over a three-year period were carried out. In addition, participants of the Australian industry were also surveyed. Traders and representatives of various Australian industry organisations such the Australian Wool Testing Authority (AWTA); and former Woolmark Company employees responsible for China and,

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<sup>7</sup> Market anomalies like the SARS outbreak in Feb- March April in 2003 also highlight the difficulties that can arise in the trade. Australian exporters complained of Chinese buyers enacting a *force majeure* clause in the standard wool contract claiming SARS as an ‘act of god’. (*bu ke kangli*) This was quite a furore among the Australian trade as this clause was a bone of contention amongst Australian negotiators, who required the clause in SWC negotiations, and their Chinese counterparts, who argued that *force majeure* was not a part of Chinese business or legal culture. As an example of Chinese buyer behaviour when faced with sudden price drops, such as the huge ten per cent drop in March 2003. A number of contracts signed before the Easter break were reported to have been broken and headed for arbitration. There were reports that Chinese buyers were applying a *force majeure* due to SARs, claiming that many mills were pulling out due to overseas orders being cancelled and mills shutting their doors due to SARs. Much of China was closed down due to the viral epidemic, however, the timing that this occurred at, being the week that there was a record drop in price movements against Chinese importers met with strong suspicion from the Australian exporters.

<sup>8</sup> Over the last twenty or more years there have been numerous studies into China’s wool textile industry and institutions conducted by the Australian and International wool industry organisations. This paper and subsequent research has surveyed literature involving trade missions to China see (Australian Department of Trade and Australian Trade Commission, 1986), (International Wool Secretariat, 1995), (Longworth & Brown, 1995, 1997), (Findlay & Lu, 1996), (Findlay et al, 1992).

specifically, the development of the Sino-Australian-New Zealand Standard Wool Contract (SWC). Relevant industry-related literature produced by Australian research organisations was augmented by surveys of literature originating from Chinese sources (such as the Nanjing Wool Market, an organisation responsible for relevant industry news and price data dissemination in China).

The paper is organised thus. To highlight the problems faced along the wool pipeline to China, a case study involving a disputed consignment quality between an Australian exporter and a Chinese mill will be analysed. The majority of the issues and elements to this case are the same problems that the SWC and WTO accession hoped to resolve. The case study highlights where these institutions basically fail and why similar disputes still occur on a regular basis. In analysing the case study the dimensions of the transaction loom large, the timeliness, the frequency of the interaction, Chinese Customs re-testing, and most importantly the superimposing of all these issues with the core issue, the market movement of wool over the transaction time frame.

### **Case study of a Sino-Australian wool transaction gone wrong**

#### *Changzhou Topmaking Claim 1995-1998*

In April 1995, Changzhou Wool Top mill entrusted a Chinese Import-Export company to sign a contract to purchase 228 tonnes of greasy wool from an Australian wool trading company. In August 1998, after the wool consignment landed in Shanghai, Changzhou topmaking applied to the Changzhou Commodity Inspection Bureau (*Changzhou shangjian ju*) for an inspection. Upon completing the inspection it was discovered that the staple length of the wool in the consignment did not meet the specifications set out in the contract, in addition the wool consignment exhibited signs of insect damage and this was duly recorded on the test result issued.

In December 1995, the Chinese company put a claim for compensation to the Australian company, faxing the Commodity Inspection Bureau's inspection certificate to the supplier

and the wool trader in Australia. However, there was no reply from either of the above two companies. The Chinese company then applied to the China International Economic Trade Arbitration Committee (*Zhongguo guoji maoyi zhongcai weiyuan hui*) for arbitration.

The Australian company argued was that this contract was signed under laws that the Australian government did not allow direct sales of stockpile wool to foreign customers. In line with these regulations the company can only provides services and support to the Chinese purchaser during the carrying out of the contract, it definitely cannot act as the vendor in the contract, and thus cannot undertake any responsibility. Therefore, the Chinese plaintiff should bring the claim against the real selling party in the contract, at the same time claimed that there was no problem with the consignment of wool in question.

The selling party also stressed that sampling was very important in the testing for staple length, often needing 100 per cent sampling (direct translation), and that the Commodity Inspection Bureau sampling and testing does not represent the standard test [actual wording "true scale of sampling" author's translation note].

This means that owing to the sampling be inadequate, the results were not a true representation, as a result, the staple length test results cannot be relied upon as a problem [with the consignment]. As for the insect damage, the selling side believed that only one lot in the consignment had significant damage, the remaining lots although having some damage on one side to a depth of 1 cm this would not have any effect on processing performance.

The China International Economic Trade Arbitration Committee (CIETAC) [Chinese name – *Zhongguo guoji jingji maoyi zhongcai weiyuan hui* ] according to the shipment consignment quality and quantity certificates issued from a notarised IWTO standards institution prior to shipping, after the consignment reached its destination harbour, and the customs re-inspection had been carried out, if a quality, quantity or packaging

contractual non-conformance was discovered, the purchaser has six months from the consignment reaching port to lodge a claim for compensation. Negating that the Australian company has the intention to shirk its responsibility, clearly it has a legal responsibility. Responsibility reverts clearly, the below decision in arbitration's core problem is that the vendor's consignment has a quality problem. The purchaser claim that the consignment does not conform to the contract conditions under the certificate issued by the Changzhou Commodity inspection Bureau certificate, issued after the consignment had reached their destination harbour. Obviously, the Commodity Inspection Bureau certificate is the crucial document in proving there exists a quality problem.

In reality, the Changzhou Commodity Inspection Bureau after receiving the test report, spent large amounts of time, and proceeded to test all lots of wool, and moreover maintained a detailed report, and kept very accurate records of figures and information.

In March 1998, the China International Economic Trade Arbitration Committee's final decision came through. None of the Australian company's consignment sold met the quality requirements of the contracted specifications, making it a serious legal breach [of contractual duty].

After the vendor's consignment reached port, and undergoing the China Changzhou Import Export Commodity Inspection Bureau re-inspection/testing, it was discovered that the staple length did not conform to the contract specifications, and the wool showed signs of insect damage, and this changed the basic use-ability of the wool, and in no way could be used in the way originally intended by the purchaser, the vendor's actions seriously violated standard legal practice and must take full legal responsibility of the losses incurred by the purchaser.

According to this decision, the Australian company had to pay USD 433.80 to the Chinese Import-Export Company; and to the Changzhou topmaking mill for losses from insect damage, and for the consignment's staple length not conforming to specification, losses of USD 260,000. The vendor also had to pay the testing and arbitration costs. After

three years this contractual dispute finally came to end and the claim for compensation on a shipment of imported wool was successful.

Source: Ding Lijie et al (1998) *Jinkou yangmao zhiliang wenti lijing san nian zhonghuo suopei* [Quality problem with imported wool takes three years for damages claim] (in Chinese) *Zhongguo Shangjian* [China Commodity Inspection Journal] Issue No. 12. p.32

The next section will identify and expand on three key areas that surface in this case study and cross-align them with the WTO accession obligations and the SWC's adoption that sought to avoid these disputes re-occurring.

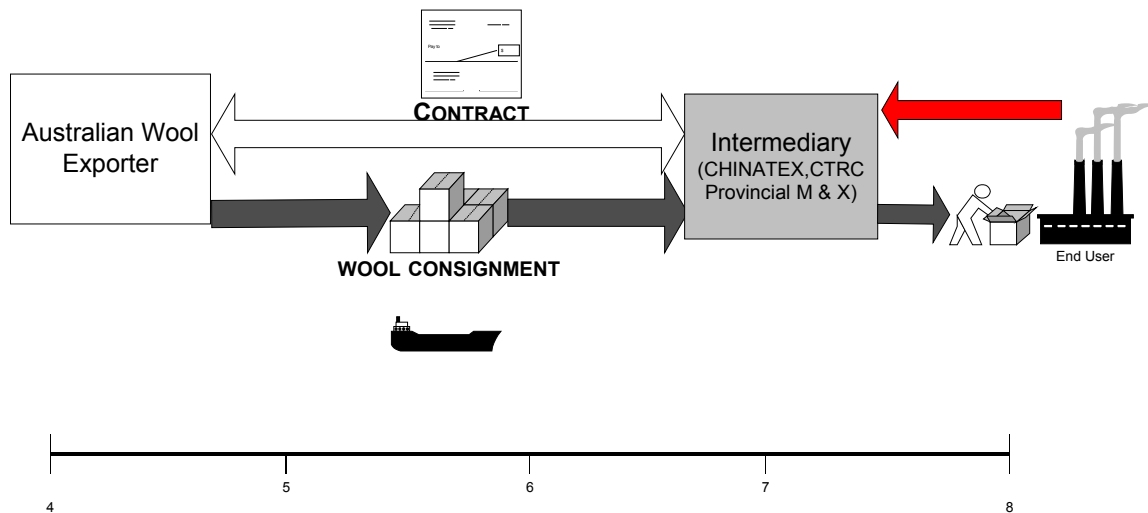
The three areas are:

1. The dominance of Intermediaries ('Piggy back' contracting: products of the plan)
2. The importance of specifications used in the wool contract
3. Risks faced by Chinese mills: Contract Price and Consignment Quality

### **1. Intermediaries and 'Piggy back' contracting: products of the plan**

As China has grown to be the largest destination for Australian wool in many ways the Sino-Australian wool trade can be described as the *land* of the middle man meets the *industry* of the middle man. Intermediaries, hardly a novel feature of the international trade, are important actors in the Wool Textile Industry (Champion, 2001). The role of an intermediary in the Chinese trade regime has its origins in the planned economy and the subsequent reforms to this system over the last twenty years. One of the most noticeable developments in Sino-Australian wool trade as China transformed its importing control from the highly bureaucratic, MOFTEC/CHINATEX era, pre-1985 and the relaxation of import controls to allow more trading companies and mills direct licences to import in 1992, is the issue of decreasing quality. This transaction can be seen in figure 1 below.

**Figure 1: Basic Actors involved in Sino-Australian wool trade**



Historically, China’s wool import regime has been dominated by the large trading companies such as CHINATEX (*Zhongfang yuan liao jinchukou gongsi*) — a textiles foreign trade specialist whose origins are in the Foreign Trade Ministry and groups borne out of the former Ministry of Textile Industry (MOTI), the China Textiles Resources Company (*Zhongguo fangzhi wuzi gongsi*) (CTRC). These origins are indicative of many participants involved in China’s wool imports — the mills have traditionally been removed from the trade interface. The trade interface the Chinese importers deal with in Australia is not a government marketing organisation but private traders and trading companies, some of whom have their own processing arms and can sell raw or semi-processed wool. Many Australian traders have extensive purchasing arms and networks in Australia and specialise in trading wool (as opposed to the majority of the Chinese trading companies where the wool desk is a small component of the overall operation. CHINATEX, for example, deals in cotton and man-made fibres with wool being a comparatively small segment of over all operations.)

The fragmented nature of the wool industry and the wool pipeline is well documented and the above case exhibits elements of this fragmentation. The processor of the wool in the Changzhou case has to use an intermediary Import and Export Company to purchase the wool. The intermediary is acting as an agent under a type of ‘piggyback’ contracting

arrangement and is never physically involved with the wool consignment but is more a conduit to the external, international wool market. They act on instructions from the mill and carry out the necessary logistics involved in clearing a cross border transaction, opening a letter of credit, conveying necessary documentation for both domestic and international authorities. Question: *It is unclear who takes title of the consignment and when, under Western legal frameworks it is the intermediary and this is often a point of confusion in any arbitration case.*

This use of 'piggy back' contracting can lead to many problems. Especially on the Western side as the contract may not actually be with the purchaser of the wool but the company who represented them. Chinese mills are also disadvantaged by the old system as mills maybe unaware of the terms and conditions under which the intermediary purchased the greasy wool. In the past, this designated trading system has caused problems for Australian wool traders and Chinese end users.

Supply chain studies recognise that intermediaries can add value to a product and with such heterogeneous commodity such as wool, intermediaries play a vital role in the transfer of small wool lines from wool growers to larger raw material consignments for processors (Casson, 1997, p.157; Popp, 2000; Quirk, 2002) <sup>9</sup>. However, in the China import regime case intermediaries are decreasing the value of the consignment by the

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<sup>9</sup> Wool is a highly heterogeneous commodity, a natural fibre affected by environmental conditions more so than other natural fibres like cotton see (Champion and Fearn, 2001). The variation of fibre diameter – the main value component of wool- occurs widely within the same sheep that produces between 4 and 5 kilograms of wool. By nature the small size of woolgrower production ('clips') leads to a general lack of critical mass in providing for wool processors hence the need for a middle man who puts together farm lots into consignments for processor use. Australian wool growers producing anywhere from on average of one to hundreds of tonnes of wool, from vastly different climatic conditions, put raw wool lots up for auction in three main centres, Melbourne, Sydney and Fremantle. Post auction is where traders combine these different wool lots and consignments for the overseas orders (98 per cent of Australian wool is exported and an increasing amount of this is in an unprocessed, raw or greasy form) for more the Australian wool trade system go to the Australian Wool Exchange web site [www.awex.com.au](http://www.awex.com.au). Much like the *impannatori* in Prato in Northern Italy and the nineteenth century disintegrated textile industry of Lancashire were dependent on a dense web of merchants, brokers and factors for its dominance of global markets, so to do Australian based traders rely on their knowledge of production in Australia, what is available, and what their customers needs are, who it can be sold to. Quirk (2002) highlighted the many difficulties growers groups face by further integrating up the supply chain and forming alliances with processors.

obfuscation of test certificates, buying in large economy-of-scale motivated lots that are then broken down into smaller mill packages.

Chinese intermediaries do fulfil an important role and without some of the services they provide mills would not be able to access Australian wool. But they can also retard the information flow between the end users and the suppliers. In any international commodity trade paradigm information is a key component of success for the participants, Chinese intermediaries in the wool textile sector have incentives to keep commercially sensitive information, which could be in the form of consignment objective information/quality, from end users. WTO and the SWC are both aimed at removing 'market interference' and these information barriers.

### **WTO reforms**

Notionally, WTO accession will bring about many administrative external changes aimed at opening the way for Chinese mills to participate directly with the Australian trade. China's WTO accession provides reforms that are designed to allow mills easier access to imported wool.

The key changes are:

- Guaranteed import quota volumes;
- The elimination of mandatory re-inspection of wool consignments;
- The phasing out of designated trade status, removing the need for licences to import wool;
- Inclusion in the Agreement on Textiles and Clothing (ATC);
- Ability to influence trading rules via WTO protocols (which has led to the increased presence of foreign specialist wool textile experts and arbitrators on the panel of the China International and Economic Trade Arbitration Committee (CIETAC))

## Quota reforms

At the time of contract purchase, 1995, the Changzhou Mill would have been allocated a wool import quota by the Jiangsu Provincial Textile Bureau. This quota was normally based on historical usage, such as previous performance in exports. The development of a black market from time to time would indicate that quota was allocated inefficiently and inequitably<sup>10</sup>. If mills had no quota or had used up the quota already allocated they may buy unused quota from other mills, the price of which varied year to year but could be as high as 10,000 Rmb per tonne in some years when quota quantities was ‘tight’ against demand. In recent years quota has become much less the issue it was around 1997-1998<sup>11</sup>

The idea is that mills can now directly apply for an import licence and not have to negotiate with Provincial governments for quota or alternatively look for quota on the black market. Prior to WTO quota was allocated twice yearly and this could hold up mills’ purchasing wool<sup>12</sup>. Presently, there is a “first come first served” (*xian lai xian*

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<sup>10</sup> In 2001, the Changzhou wool topmaking mill has an annual processing capacity of around 5000 tonnes, 90 per cent of this is Australian or imported wool, the other ten per cent is purchased domestically from Xinjiang or IMAR and costs around USD 1 per kilogram less. In 2000/2001 this mill was allocated 1000 tonnes of import quota, the remainder of their imported wool requirements needed to be purchased through secondary markets either by buying unused quota off other mills and enterprises (Author Interview, 2001). For more on quota and black market quota see International Wool Secretariat report (1995), Longworth and Brown (1995).

<sup>11</sup> Under WTO wool import quotas are to increase yearly to around 287,000 tonnes (greasy equivalent) by 2005. In 2002 the raw wool import quota was 264, 500 tonnes and wool top quota was 72, 500 tonnes. According to Chinese Customs statistic for the first eight months of 2002, imports totalled 141,952 tonnes a decrease of 38, 576 tonnes on the previous year or 21.37 per cent overall (raw wool imports were down 28.7 per cent to 87,380 tonnes for the same period) Early estimates put the 2002 import volume at around 200,000 tonnes well below the quota limits. Mills no longer complain of needing to enter the black market to access quota, which at one stage added a significant premium to wool costs. However, the administration of quotas can be a problem, i.e. the timing of the quota release, previously it was twice yearly and this would cause delays, mills would have to wait long periods for allocation or buy quota on the black market. Again, this was a problem five or so years ago, however it does not exist to any great extent any more. (Nanjing Wool Market News, November 8, 2002)

<sup>12</sup> From January 1 2002, China put an automated application for import rights procedure replacing the former quota managed import licence system for wool, acrylic, polyester and polyester chips, moreover procedures were simplified somewhat, importing units/entities only had to apply in writing to relevant unit under the State Economic Commission (*jingmao wei jiequan*) Strategic Industrial Products Import Management Body using a special application form and with 30 to 40 days are able to receive a import licence, (NWMN, 2002).

*ling*), which requires mills to apply for quota at “point of contract”, which still means mills have to apply *ex ante* for quota<sup>13</sup>.

## **Designated Trading**

Under the new WTO environment the Changzhou mill may apply for an import licence after three years of China’s WTO accession – i.e. 2005. This system has been seen by the global wool producing countries as a ‘significant barrier to entry’. To help understand the structure of the Chinese Wool Textile Industry the different types of Chinese wool processors can be loosely arranged into three tiers based on volume and thus mode or channel of procurement. The first tier would see the largest traders and mills, such as CTRC, Chinatex, The Sunshine group, Tianyu Topmaking Zhangjiagang, Lanzhou Sanmao and around twenty others. They would buy mostly via an Australian wool buyer, with US dollars and open their own Letters of Credit or TTs (direct account transfers). These would buy for themselves and others charging a commission fee when acting for the latter. They would also buy speculatively and resell on to the domestic market. In the past, when quota and demand were quite tight they would also make handy business selling and buying quota to those mills and traders below them without allocated quota. The second tier would be the smaller scale wool users who do not have any expertise in international trade and procure wool via an intermediary such as CTRC, these purchases are in RMB and the intermediary organises the transaction for them. The mill in this case would have a contract with the Australian trader and would be in contact with the Australian side. However, the shipping document, bill of loading and LC would all carry the intermediary name (as it did in the Changzhou Topmaking Case). These wool users would be fairly familiar with raw wool quality issues, are small SOEs about to or have recently undergone ownership transfer in the form of a shareholding arrangement, or they

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<sup>13</sup> Tariff-Rate Quotas (TRQs) were introduced in the Uruguay Round to support market access following the tariffication of non-tariff barriers to trade in agriculture. In the view of Gervais (2000) TRQs created an administrative mess in which governments often discretionarily allocate import licenses to private and/or public firms. Numerous papers describe the arbitrarily chosen procedures used to allocate licenses in different countries and the resulting distorted trade patterns due to significant spreads between domestic and world prices, the administration of import licenses can have important strategic effects under imperfect competition.

are large, successful Township and Village enterprises. The third group are the much smaller mills, that may buy wool from varying Chinese sources, are usually consuming less than one hundred tonnes of wool per month and make low quality generic wool tops. These mills, due to the expense of Australian wool are usually the first to substitute into other sources of wool (Ireland, South Africa, Chinese, Kazakstan, Norway, Turkey, Russia to name a few) if prices rise too high. In theory, all these groups could buy direct from Australian wool auctions if they so wished after 2005 however it is unlikely that they will.

### **Re-testing by China Customs**

Re-testing by Chinese customs is another area regarded as a barrier to trade by the Australian and international wool textile industry. The general view being that the responsible testing authority in China, the China Inspection and Quarantine (CIQ) are ignoring accepted IWTO certificates and are merely carrying out a revenue raising exercise (White, 2001)<sup>14</sup>. (The issue of quality inspections is becoming an increasing area of concern for exporters to China across a number of industries<sup>15</sup>.) In speaking to another industry conference in Shanghai an Australian representative raised this issue stating:

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<sup>14</sup> Mandatory re-testing adds a cost to the consignment both in terms of transaction cost and time for delivery. Based on the value of the consignments and testing fees are 0.25% of the value of the consignment. So if the wool consignment was worth \$500,000 the test fee would be a modest \$1250. The issue here is the neglect of the IWTO test certificates in arbitration and the time factor.

<sup>15</sup> Cotton has also run in to problems in fibre testing in China although Australia's cotton shippers have taken some of the credit for China's reversal of a proposal to introduce short fibre and neps count changes into Chinese cotton standards. The initial changes, which were meant to take place on April 1 2003, have now been suspended while Chinese government officials develop an entirely new inspection system based on state-of-the-art instrument testing. Chairman of the Australian Cotton Shippers Association (ACSA) Dorcen Walters said during their visit to China in February they voiced their concern over the move. "In my opening address I was very strong on this issue and urged the Chinese not to move down this track," he said. China announced that it would postpone plans to incorporate short fibre content and neps counts into its cotton standards. The new quality test rules were expected to impact on cotton supplies from the United States and Australia which both viewed the tougher standards as nothing but trade barriers. The Australian and US cotton crop is harvested by machines making it more prone to neps and short fibre whereas China has less machine use in harvesting cotton (McAulay, 2003); A recent article in the *Australian Financial Review* quotes the solicitor who was in charge of the Sino-Australian-New Zealand model wool contract compares China's Quality Inspection Corporation (QIC) to Japanese inspectors of decades past where the aim is to find something wrong with it and earn inspection fees (Lawson, 2003).

“Membership of WTO also means that stronger international pressure will be applied to China to revise the current practice whereby all imported wool is subjected to compulsory inspection and testing. In this regard, it is accepted that China must institute appropriate health and quarantine safeguards relating to imported wool. However, the refusal of the relevant authority in the past to recognise and accept IWTO certified wool test results produced in accordance with international standards has added unnecessary cost to the wool importation process in China. Your authorities and importers must have the right to query any suspect certified test results but this should be done in accordance with the established IWTO review process. Usually, Chinese wool contracts require the seller to provide IWTO test certificates but, under current arrangements, the Chinese inspection and testing authority can simply ignore these certificates.” (Quirk, 2002)

## **2. Importance of Specifications in Wool Trade Contract**

Wool is a very difficult and complex commodity to trade — it is often argued that it is an industrial product more so than a commodity (Champion and Fearne, 2001)<sup>16</sup>. The common problems that appear in Sino-Australian wool contract disputes are often to do with consignment quality. This is common in all wool transactions and trades:

“The specification of greasy wool contracts that is one of the most parts of the contract between buyer and seller. Over-specification, that is, the setting of limits that are too restrictive, results in a reduction in potential supply and increased price due to the sellers needs to cover the risks. Under-specification, having limits that are too broad, increases

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<sup>16</sup> Champion and Fearne (2001) ask the fundamental question of whether wool is a commodity or an industrial product as the implications for decisions in the supply chain can depend on the distinction. A ‘commodity can be defined as a material in its natural state, while a product is a “bundle of physical, service and symbolic attributes that satisfies consumers’ wants and needs”, the basic and important difference is that a product is directed towards an end user and that traditional commodity markets do not allow the efficient communication of different commodity attributes. Wool is unique in this argument over product vs Commodity as it is treated as a commodity, without recognition of its diversity. Champion and Fearne (2001) argue that this under appreciation leads to the poor communication and weak connection between segments along the wool pipeline.

supply but also reduces control of overall quality of the material delivered. This can result in processing a sub-standard product, variability between batches and processing inefficiency” (Curtis and Stanton, 2003)

Specification issues in contracts where two different legal systems are in place and two very different wool textile processing cultures, China, a relative newcomer but fast becoming the most important textile processing country in the world trade, and Australia, the largest wool producer and traditional leader in global wool marketing and exporting. China is not steeped in traditions of wool trade. Its modern trade system remains somewhat dominated by large trading corporations in CHINATEX and CTRC, who combined still account for around 50 to 60 per cent of China’s wool imports<sup>17</sup>. Even given Australian efforts to educate and upgrade the Chinese industry on modern best practice methods, for a variety of reasons China still relies on broad typing systems not micron or other more ‘specific’ objective measurements. In Australia, older typing systems have been gradually replaced by objective measurements in response to increasing technology, and the thirty year old idea that wool moving to an e-commerce model to reduce transaction costs would thus need a workable grading systems that provided a smooth, complete flow of information from sellers to buyers guaranteeing quality. The difference between the two industry cultures in regards use of typing and specification can be seen in the table below:

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<sup>17</sup> It is difficult to get an accurate picture of the proportion of the imports still undertaken by Chinatex and CTRC and these figures are from general discussions with employees of the two companies and Australian trade interviews.

**Table 2: Comparison of Chinese and Australian Wool Specifications**

Australian specifications		Chinese Specifications		Product Spec. and diameter relationship	
Type	Micron Range	Yarn count <sup>1</sup>	Upper limit	Product yarn count	Micron range
T55	19.6-20.5	66 (T55)	21.0	66	20.1-21.5
T56	20.6-21.5	64 (T56)	22.6	64	21.6- 23
T58	22.6-23.5	60 (T58)	24.1	60	23.1-25

Source: Nanjing Wool Market (1999)

<sup>1</sup> Yarn Count (or linear density) is defined as the mass per unit length, with the recommended unit in Australia and New Zealand being the tex (=grams per kilometre). This type of specification is out of date when talking raw wool and is a throwback to another era. Australian traders and wool growers do not talk in yarn count terms but rather micron, the measurement of fibre diameter.

From the above table it can be seen that the upper limit for fibre diameter (represented by micron) in the Chinese typing system is higher than the Australian system.

Contract disputes between processor and supplier or importer and supplier can arise in any number of areas. In the case of wool, quality attributes such as fibre diameter, fibre length, strength, vegetable matter content, moisture regain rate, colour are all contractually specified. Diameter is the largest determinant of value in wool's processing potential, although this varies from season to season<sup>18</sup>. Strength and length are both the attributes at question in the above case study. In the case study involved it is stated that

<sup>18</sup> For example, in years of drought there may be shortages of stronger or higher tensile wools, ('sound' wools which are nominally 34 newtons) and large quantities of wools exhibiting weak tensile strength ('tender' wools). An example can be seen in the difference in prices received by one woolgrower in 2003, a severely drought affected year, for two lots of 18.9 micron wool, one lot tested for 31 newtons (slightly tender) and the other 17 newtons (very tender) was 172 cents per kilogram (Queensland Country Life, 2003).

Changzhou Customs discover that there is a problem with the wool consignment not meeting the contracted specifications specifically with regard length and strength. The Australian exporter contends that the Chinese re-test was not adequate or to IWTO standards, which is a fair response when considering that testing procedures and technology in China, whilst improving are still not at the same standard of Australia. In this case, the strength and length test is the primary evidence used in the purchaser's claim but the test result is contested by the Australian side as below the commercially accepted level <sup>19</sup>.

In concluding this segment it should be pointed out that the Chinese customer is usually grouped by the Australian trade as a lower end market<sup>20</sup>. Chinese mills question why Italian mills seem to get better wool and whilst the obvious answer may go back to price – you get what you pay for – (*yi fen qian, yi fen huo*), with China falling behind Italy in their import volume of finer wool categories. But this consignment quality issue often has a lot to do with the importing system in place. The intermediary retards information flows to Chinese end users. Information flows are affected by the fragmentation, wool consignment objective measurements in the form of test certification have the incentive to be lost along the pipeline. This can be seen in many interviews and visit to Chinese mills and is best exemplified in another quote used by another study into the wool pipeline:

“...in China one company said we had to employ 200 additional staff to reclass all our wool. They said "respecify" but they really meant reclass it. They don't trust

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<sup>19</sup>For example, there are only nine facilities with laser testing equipment in China: Ningbo Reward Ltd (Joint Venture), China Textile University (Shanghai), Shanghai Import and Export Commodity Inspection and Quarantine Bureau (CIQ), Wuxi Xiexin Wool Textile Group, Shandong Ruyi Wool Textile Group, Shanghai Shenyi Wool topmaking Company, Lanzhou Sanmao Wool Textile Group, Nanhai Pindar Wooltop, and Jiangsu CIQ in Nanjing. Wool shipments are always re-inspected at the receiving port and some Chinese wool test procedures are not in accordance with accepted international commercial practices. For example, Zhangjiagang Customs, a port in Jiangsu province, have a 'one bale in six' sampling procedure whereas international practice requires that every bale in the shipment is re-weighed.

<sup>20</sup> As a proportion of Australian wool exports in 2001/2002 China (total exports to China were 240, 726 tonnes greasy equivalent kgs) accounted for 77 per cent of 28 micron and coarser wools, 46 per cent of 24-27 micron wools, 38.9 per cent of 20 to 23 micron, and 30 per cent of 19 micron and finer wools. Italy (total imports: 106,290 tonnes) accounted for 2.8 per cent, 11.2 per cent, 10.7 per cent, and 42.8 per cent respectively over the same categories (Australian Wool Exchange, 2002).

the system, they don't know what they are getting, they have to go through it and class it all over again.” (AWI, 2002)

The majority of mills using raw wool surveyed in this research employed such “reclassers” owing to mills not receiving test certificates with important objective information. Not only do these classing teams not achieve the fibre quality classification performance of modern science — it has been proven forty years ago that the eye cannot determine the fineness of wool fibres — And this has been a noted problem since the early days of the trade relationship<sup>21</sup>. The standard wool contract was seen a one solution to these consignment quality problems. It unfortunately seems to have faded from memory.

### **3. Risks faced by Chinese mills importing wool**

In the decade since 1992 when the Chinese wool import regime opened to more participants since the early 1990, processors have faced two main kinds of risk when importing wool from Australia — price risk and quality risk. A survey of a large number of Chinese wool textile enterprises importing and using Australian wool would indicate that the contract is not being used in the majority of transactions<sup>22</sup>. It is argued here that Chinese traders and wool textile mills, in the absence of structured risk management instruments such as wool futures (widely used by processors in other countries), rely on loosely specified contracts and collaboration within the Chinese trade regime to reduce their exposure to international wool market risk. This is posited as the major reason behind a lack of adoption of the SWC. The SWC is a legal instrument with two functions, the first is based on tightening the specifications used in contracts and is designed to help mills access better quality wool from Australia more consistently, avoiding the problems caused by inferior quality consignments being unloaded by the Australian trade.

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<sup>21</sup> One of the earliest Australian government missions to China in 1985 noted that mills were largely unaware of test certificates and rarely received them (Australian Department of Trade, 1986)

<sup>22</sup> Speaking at a industry conference in Shanghai, an Australian delegate reasoned that usage of the contract was limited was due to a lack of market volatility in recent years, combined with wool prices steadily on the increase over the 1999-2001 period use of the contract fell below expectations. (Quirk, 2002)

Secondly, the contract sets out lucid rules for arbitration and compensation in the advent of any claim being made by either side (White, 2001).

Price risk also has an exchange rate component with the Chinese Yuan (RMB) being tied to the US dollar and all transactions being carried out in US dollars. Australian wool has been cheap in US dollar terms for the past five years but in recent months has risen and this has affected the purchasing behaviour of Chinese importers (Queensland Country Life, 2003)<sup>23</sup>. Especially, when the Australian dollar has strengthened against the US dollar by around thirty per cent in the 18 months to mid 2003.

There are other external factors that affect Chinese purchasing behaviour. Chinese mills are very sensitive to consumer markets. With low capital availability for the purchase of raw material, any drop in the volume of orders is immediately felt by the raw wool market. For example, in 2003 Japanese orders have been significantly down on previous years and Chinese processors have reduced the size of the consignments they buy, turning to more 'hand-to-mouth' purchasing methods. An Australian observer noted that: "'Most of the mills either are having financial difficulties or have suffered from bad risk management strategies ... so therefore they are very, very cautious. It is really a hand to mouth situation. They just buy wool in a small quantity [sic], in some cases 10 tonne, 15 tonnes versus the 100, 200 tonnes they bought in the past.'" This sentiment was confirmed by a CHINATEX trader interview.

Smaller raw material consignments are problematic for wool textile processors. A Western European noted that larger lot sizes create efficiencies for the mills and the pre-blending nature of the [wool trading] system<sup>24</sup>. Smaller lots allow greater variability in the raw material used and may inhibit the consistency of the weaver to make a fabric.

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<sup>23</sup> Weekly Australian wool market reports noted that volatility in exchange rates had caused Chinese buyers to hang back at the close of the 2002/2003 selling season and in the opening weeks of the 2003/2004 season (normally the end July).

<sup>24</sup> For example, one agricultural marketing organisation in Australian markets its wool to processors in minimum 10 bale (around 350 sheep) and maximum 70 bale (around 2500 sheep) lots. The average lot size on the Australian Wool Exchange in 2002/2003 selling season was 4.5 bales (AWEX, 2003).

Chinese wool textile mills are often criticised for their ‘cheap’ buying methods as they try to improve fabric quality in the finishing room with high labour intensity (Wang, 2002). However, Chinese mills facing price volatility, especially such large drops as in post-Easter of 2003, are more likely concerned with being caught with too much ‘expensive wool’ in stock and buy in smaller quantities from Chinese traders such as CHINATEX, CTRC and other larger importers with wool in storage.

Wool processors in European, Japan and North America use wool futures and exchange rate hedging to avoid raw material price risk, ‘locking in’ raw material costs so as to accurately cost future orders. Risk management of wool is very important as the price of the raw material is the most significant component of the product Chinese mills produce, accounting for up to 75 per cent of the product’s cost in some stages of wool textile processing (Nanjing Wool Market, 2002).

This absence of an adequate price risk avenue is particularly acute when spinning mills take fabric orders up to twelve months prior to delivery and find their raw material budget from the previous year affords them thirty per cent less wool (as was the case post-September 2002).

The use of modern risk management tools is also important considering the time lags between placing the order in Australia and accepting delivery of the consignment in China averages around four months, and with such a volatile commodity as wool, Chinese importers and mills are exposed to the chance that wool prices may either increase or decrease quite quickly. The ability of Chinese customers to act opportunistically *ex post* either by defaulting or renegotiating contracts means the risk is sometimes transferred to the Australian exporter, who in turn may act opportunistically *ex ante* by sending an inferior quality consignment that still fits within loose specification terms or delaying delivery.

## **Why has the Standard Wool Contract not been more widely used?**

The lack of commercial adoption of the Standard Wool Contract can come down to three basic reasons:

- 1- contract complexity and lack of education
- 2- market stability from mid-1999 to early 2002
- 3- continued use of loosely specified contract terms gives mills increased opportunities to default or renegotiate on grounds of consignment quality

Anecdotal evidence points to many contract disputes coincide with market volatility<sup>25</sup>. When asked about the type of contract used in interviews, the majority of mills answered they had their own contract format. An Australian trader based in China at the time of the contract launch pointed out that perhaps the standard contract is too complex in language, overly legalistic in language, and not suitable to Chinese business culture. The CHINATEX contractual conditions (*Goumai yangmao he maotiao yiban jiaoyi tiaokuan*), which use the specifications in the table shown above, promulgated on July 1, 1990, are used as the industry standard still, and this remains a major cause for quality disputes. The socio-cultural differences in legal systems and attitudes towards litigation and arbitration cannot be underestimated here. Critically, efforts to educate the Chinese industry on the benefits of using the contract were cut short by the re-structuring of the Australian industry body and personnel responsible — this represents a missed

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<sup>25</sup> World economic shocks, such September 11 in 2001, influence wool prices with the greasy wool market in Australia dropping from 779 cents (Australian) per kilogram on September 21, 2001 to 693 cents on November 21, a decrease of 11 per cent over the two month period. Wool is facing tightening supply constraints and is relatively easily influenced by large withdrawals or market entry. For example, strong purchasing by one large Australian trading entity in the early months of 2002 forced the price of wool up quite significantly from 835 cents in early January (11<sup>th</sup>) to 985 cents on the 15<sup>th</sup> of February, the entry of more New Zealand wool halted this rise somewhat but there came a renewed market rush in September of 2002 when prices increased at record rates to be 1141 cents per kilogram on September 27, 2002, a price that represents an increase of 46.5 per cent on September 21, 2001, and 64.6 per cent on 23 November 2001. Additionally, the price rises notably affected Chinese types, i.e. wool that China usually imports (using the broad Chinese Typing system 60s, 64s and 66s). Australian wool is exhibiting a strong trend towards finer types as more and more Australian woolgrowers use better on-farm technology to select sheep according to fibre diameter, the amount of Australian wool going to auction that is below 21 micron is increasing markedly. The number of bales out up for auction in the 21 micron category decreased by 11.7 per cent in the 2001/2002 season over the previous season, the decrease was even more marked for 22, 23, 24 micron, with a 52.6 per cent decrease in the number of bales in the 24 micron range. China is the largest customer for the 21-25 range of micron wools.

opportunity by the Australian industry in establishing more extensive commercial usage of the contract. In addition, immediately after the launch of the contract wool market prices in Australian were relatively stable, exhibiting a generally positive trend since the middle of 1999 (Quirk, 2002).

The third reason is one this paper has primarily focussed on as market volatility will continue with uncertainty in wool supply and consumer demand a major issue in the present global economic climate.

### **Future Industry issues**

The Wool textile Industry structure and development trends will continue to see contractual problems arise. Further integration by either side, in either direction, forward or backwards into the supply chain will not occur very rapidly. The fragmented, individualistic nature of the Australian wool exporter trade means that Australian traders suffer from higher costs of information especially in the checking of credibility in foreign customers. The Chinese importing party may default on a contract and move on to another trader without the new trader knowing or hearing about the customer's previous opportunistic behaviour. Unlike Italian or other export markets where the participants number between eight to ten, China has between 200 and 300 wool importing and processing enterprises of differing size, ownership structure and international trade capability (finance, knowledge). There is no unified front from Australian traders in the area of information sharing with regards customer behaviour or unified credit ratings of Chinese importers, perhaps because they do not want their competitors to know that they have been 'burned' with a consignment into China. There is acute commercial sensitivity evident in wool trading especially in times of tight margins and decreasing market share<sup>26</sup>. Each trader has their own dossier on Chinese customers often rating them on their reliability, relationship history, raw material requirements. Australian traders try and get around a lack of market knowledge by establishing their own offices with former

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<sup>26</sup> In the words of one Australian industry insider: "the [Australian] traders would screw each other for a cent". (Another corrected me upon hearing this anecdote changing the value to "half a cent").

Chinese industry operatives who have no language barrier and the necessary relationship and information networks to insure against credit risk transactions. A principal-agent problem can arise here, however, a many of these operations are not salary based but commission based. This can lead to through-put or quantity being the Chinese agents major incentive and not consignment quality. Any quality problems, although nominally the purvey of the agent are often passed on to the Australian side (especially when the intermediary procurement model is used as in the case study). Alliances can be sought in the form of joint ventures as has happened recently with the same Changzhou Topmaking Company featured in forming a new joint venture with an Australian Wool trader in 2002. These arrangements have obvious benefits from the Chinese enterprise perspective. Raw material needs are somewhat guaranteed as both the raw material supplier and the processor have a vested interest in the product, in this case the wool top or carbonised wool. Search costs are significantly reduced for both sides. Some Sino-foreign wool textile Joint-ventures have been problematic with the earliest and possibly largest, Charguers experiencing teething problems in their joint venture located in Zhangjiagang, Jiangsu province<sup>27</sup>, however while this specific case has improved markedly there are many obstacles to further integration. With improved FDI infrastructure some early stage processing in Australia or other countries may relocate to China in the immediate future but these would probably be wholly-owned foreign enterprises.

Arbitration is a last resort in the advent of a wool contract dispute. Aside from costs, arbitration may involve the local customs authority that may lead to further scrutiny of imported consignments and thus delays in the future. Arbitration costs are also to be considered. Based on average greasy prices on the Australian Eastern Market Indicator for the months between April and August 1995 and according to the claim value arbitration would have come at a cost of 35,000 Rmb or around AUD 7000 base

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<sup>27</sup> Japan's wool textile industry has also relocated a large part of their early stage operations to China. In the 1970s, Japan was the largest destination for Australian wool importing up to 45 per cent of the Australian clip (299,200 tonnes greasy) in 1972/73. In 1991/92 Japan imported 143,000 tonnes of greasy wool compared with 21,000 tonnes in 2001.

arbitration fee plus AUD 3000 which is a rough equivalent of 2.5 per cent of the claim above the RMB 1 million amount<sup>28</sup>.

Probably one of the most significant developments to come out of Standard Wool Contract Bi-lateral discussions has been the decision by the China International Economic and Trade Arbitration Commission (CIETAC) to establish a specialist panel for any wool disputes. This panel has already decided on ten contractual disputes in the last three years, a panellist whilst citing that many of the disputes have valid contractual issues such as: dates for the opening of Letters of Credit not being adhered to, delivery dates passing, consignment quantity discrepancies, moisture regain rates, consignment quality (length, strength being major issues as well as insect and water damaged wool), packaging non-conformance; however the panellist was acute to note that large market movements are not be discounted in motivation for many of the disputes (Wang Chengjie, 2002).

## **Conclusions**

This research has found is that these institutional changes, and others sought by the Australian Industry have no large affect on how mills access Australian wool or the cost of the wool to the Chinese mill. An analogous theme of this paper (which is part of a much more holistic analysis of the Sino-Australian wool transaction) is that the traditions within the transaction interface do not change in the post-WTO environment. In essence, the song remains the same. This research shows that WTO reforms and instruments such as the Sino-Australian-New Zealand Standard Wool Contract do not have any significant impact on the way mills access Australian wool because of the following reasons:

1. The nature of the transfer of ownership in the wool trade (the commodity price volatility, the heterogeneity of raw wool,)

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<sup>28</sup> These figures and costings for arbitration by the China International Economic and Trade Arbitration Commission (CIETAC) can be found at their web site on [www.cietac.org.cn/english/E\\_cd/E\\_fr\\_9.htm](http://www.cietac.org.cn/english/E_cd/E_fr_9.htm). According to CIETAC fees for arbitration have not risen much since 1995.

2. The segmented nature of the supply chain, and the participants and the culture of the trade combined with inherited characteristics growing out of China's planned economic system.
3. The lack of price risk management options for Chinese mills.
4. The economic realities faced by many Chinese mills does not afford them the luxury of buying raw material to Worlds' best practice'

It is important, at this juncture, to superimpose the reality that many Chinese mills are struggling but desperate to upgrade their products especially for export markets; and to do this mills need access to better raw material, i.e. a higher quality wool. The Standard Wool Contract was set up with this firmly in mind, the increased use of tighter contract specifications to improve and avoid the quality problems that were becoming endemic in the trade. The inherited plan style production system has contributed to a large number of Chinese mills (mainly State-owned enterprises) being too constrained financially and knowledge wise to purchase raw material via modern international channels. Until wool processing mills have better price risk management alternatives available and market volatility continues, contractual disputes based on consignment quality will continue to arise, many unnecessarily, from time to time. Australian woolgrowers spend AUD 30 million annually on objectively certifying wool for the benefit of processors (AWI, 2003). These measurements are central to Standard Wool Contract adoption and it would appear that the industry has missed an opportunity to educate and improve the long-term prospects of the Sino-Australian wool trade.

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