



# australian commodities

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## wool

### outlook to 2012-13

caroline.gunning-trant

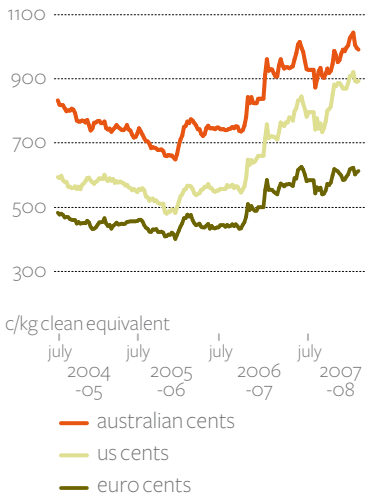
The sheep industry is heading for a period of expansion. Strong prices for both wool and meat, combined with early signs that seasonal conditions in the year ahead may improve relative to 2006 and 2007, have prompted producers to hold on to their breeding stock. However, it will take several years before the expected expansion in the sheep flock flows through to an increase in the size of the Australian wool clip. Consequently, prices are forecast to remain strong in 2008-09 as the wool supply-demand situation remains finely balanced.

In the medium term, prices are expected to decline from current highs as the Australian wool clip expands. The assumed depreciation of the Australian dollar over the medium term is expected to help ensure that prices remain attractive in buyer currency terms.

#### prices to fall as production increases

The Australian eastern market indicator price has been increasing since the third quarter of 2006. Between January and August 2007, the indicator price fluctuated between 900 and 1000 cents a kilogram clean, a price range not attained since the late winter and early spring of 2003. So far this season the indicator price has averaged 20 per cent higher than in 2006-07, reaching a high of 1045 cents a kilogram clean in January 2008.

australian wool price  
eastern market indicator  
weekly, ended 15 february 2008



The upward movement in wool prices that began in spring 2006 appears to have been caused by the uncertainty over the duration of the 2006-07 drought and its effect on wool production, and by strong export demand. The Woolmark Business Survey in September 2006 showed demand for raw wool to be the highest in the past five years. As pastures dried up and feed prices increased, producers moved to trim flock sizes. The increase in wool prices had the effect of drawing more on-farm and brokers' stocks, which were thought to be already low, onto the market. The drawdown in stocks resulted in there being little change in offerings over the previous year despite lower production of shorn wool.

Australian shorn wool production in 2007-08 is forecast to be 395 000 tonnes, down 7 per cent from the previous year. With the 2006 drought continuing into 2007 in most sheep producing regions, numbers of sheep shorn fell further and average fleece weights remained relatively low. In the face of strong export demand, the lower production of shorn wool contributed to continued increases in the eastern market indicator price. Reflecting these upward movements in wool prices, the eastern market indicator price

in 2007-08 is forecast to average 970 cents a kilogram clean, 12 per cent higher than in 2006-07.

### china driving demand for raw wool

China is by far the largest consumer of Australian raw wool, which it processes and manufactures into a range of commodities from textiles to clothing. Substantial quantities of these products are exported to developed country markets. Since the largest export market for wool products is the United States, changes in US demand will have repercussions along the supply chain. Indeed, the duration and severity of the current economic slowdown in the United States creates uncertainties for Chinese exporters of wool products.

Chinese imports of raw wool from Australia will be affected by expectations of Chinese processors about next year's US orders for wool products. Any perceptions on the part of Chinese buyers of a softening in US demand for wool apparel and textiles could translate into lower Chinese imports of raw wool, thereby putting downward pressure on Australian wool prices. Assuming that uncertainty about US economic growth and its effect on demand for finished wool products will be reflected in Chinese buying activity, the eastern market indicator price is forecast to fall by 1 per cent in 2008-09 to average of 960 cents a kilogram clean.

Over the balance of the outlook period, the eastern market indicator price is projected to decline by a further 17 per cent to around 776 cents a kilogram (in 2007-08 dollars) by 2012-13, as wool supply from the expanding Australian sheep flock gradually increases relative to demand.

### wool outlook

	unit	2005 -06	2006 -07	2007 -08 f	2008 -09 z	2009 -10 z	2010 -11 z	2011 -12 z	2012 -13 z
eastern market indicator (clean)									
- nominal	Ac/kg	713	864	970	960	930	920	900	880
- real a	Ac/kg	755	888	970	934	883	852	813	776
auction price (greasy)	Ac/kg	464	544	616	614	605	598	585	572
sheep numbers b	million	91	86	85	87	90	92	94	96
sheep shorn	million	104	100	94	94	95	98	100	102
cut per head	kg	4.43	4.21	4.23	4.30	4.40	4.45	4.50	4.50
wool production (greasy)									
- shorn	kt	461	426	395	404	418	434	450	459
- other c	kt	49	51	42	43	45	47	48	49
- total	kt	510	477	437	447	463	481	498	509
wool exports (balance of payments basis)									
- volume (greasy equiv.)	kt	543	566	437	447	463	481	498	509
- nominal value	A\$m	2544	3065	2647	2541	2535	2517	2541	2591
- real value a	A\$m	2691	3151	2647	2473	2407	2332	2297	2284

a In 2007-08 Australian dollars. b Closing sheep and lamb numbers at 30 June. c Includes wool on sheepskins, fellmongered and slipe wool. d Privately held stocks of unsold wool. f ABARE forecast. z ABARE projection.

Sources: Australian Bureau of Statistics; Australian Wool Exchange; ABARE.

### *wool clip to increase with flock expansion*

Strong prices for both sheep meat and wool, in addition to the encouragement provided by the recent good rains in many areas, can be expected to result in wool producers moving to expand flock sizes. Where there is an option to run sheep or grow crops, producers will weigh up the benefits of increasing their flock numbers against the potential benefits from planting additional areas to crops in order to benefit from high grain prices. With wool, meat and crops each achieving high prices in recent months, the decision to increase numbers of merinos for wool production will depend on expected relative returns from each enterprise. Given that the time for flock rebuilding is just beginning, any marked increase in shorn wool production will not be realised until 2009-10.

Assuming at least average rainfall over the remainder of 2007-08, many areas will benefit from an improvement in pasture conditions. Average seasonal rainfall will translate into increased fleece weights and improved staple strength. One downside risk associated with better seasonal conditions is the potential for a reduction in the quantity of fine wool produced as a proportion of the total clip. Some of the fine wool supplied in 2007-08 would have been 'hunger fine' because of poor pasture availability.

In the short term, Australian shorn wool production is forecast to rise slightly in 2008-09 to 404 000 tonnes, largely as a result of a slightly higher number of sheep shorn and increasing fleece weights. In the medium term, shorn wool production is projected to increase to 459 000 tonnes by 2012-13, an increase of 16 per cent over the 2007-08 estimate.

### *exports reflect low wool supply*

In 2006-07, the decline in Australian shorn wool production did not translate into lower shipments of Australian wool. This was because the sharp increases in wool prices in the latter half of the year encouraged a significant reduction in stocks held in brokers' stores and on-farm.

Since the beginning of 2007-08, offerings at auction have been principally of fresh wool, a firm indication that stocks are close to exhausted. Without the availability of stocks to buffer the drop in production, exports of greasy wool declined by 15 per cent between July and December 2007 compared with the same period in 2006-07.

Reflecting the lower production of wool and relative lack of stocks, total wool exports are forecast to be 437 000 tonnes in 2007-08, a decline of 23 per cent relative the previous season. With increased prices partly offsetting the revenue effects of the lower volume exported, export receipts are forecast to decline by 16 per cent to \$2.6 billion. Because wool production is not expected to increase to any significant degree until 2009-10, Australia's

total greasy wool exports are forecast to increase slightly in 2008-09, with receipts forecast to decline by 3.8 per cent to \$2.5 billion as a result of the lower forecast prices.

China continues to be the largest importer of raw wool from Australia. In 2006-07, 66 per cent of Australian total shipments of greasy wool were destined for China. Between July and December 2007, that proportion dipped slightly for two reasons. The first was the uncertainty surrounding the cessation of import quota permits issued by the Chinese Government to wool importers in July 2007. That issue was resolved when the Chinese Government decided to reallocate any quota that remained unfilled by 15 September 2007. The second reason was the appreciation of the Australian dollar compared with the US dollar later in the season. With US economic growth assumed to slow in 2008, and China's economic growth rate assumed to also slow, Chinese demand for Australian raw wool in 2008-09 could weaken if orders for wool apparel and textiles decline.

With the US economic slowdown assumed to be relatively short lived, demand for consumer products, including woollen textiles and apparel, is assumed to be recovering by early 2010. An assumed depreciation of the Australian dollar relative to the US dollar will also assist demand for wool through the projection period. This will make Australian wool cheaper for foreign buyers who trade in US dollars or currencies that are closely tied to it, such as the Chinese yuan.

Over the medium term, it is expected that continued strong growth in the Chinese economy will help maintain import demand for Australian greasy wool. Although total shipments may not reach the same levels as achieved in 2006-07 because of supply constraints, the proportion of Australia's total exports destined for China is expected to remain much the same as now.

### 'confidential' exports on the rise

Changes in the official ABS reporting of destination markets for greasy wool make it increasingly difficult to determine exactly where exports of Australian wool are going. In 2006-07, for example, the reporting of wool exports showed a sharp upswing in the volume of purchases deemed 'confidential', thereby omitting any details about countries to which the shipments were destined.

Confidential purchases of greasy wool accounted for 5.5 per cent of the total in 2006-07. Between July and December of 2007, they accounted for more than 13 per cent of total Australian wool exports.

The lack of information about the destination of confidential shipments reduces market transparency and will hinder the wool industry's efforts over time to better gear research, production and marketing efforts to the needs of particular processors, buyers and end users.

European buyers, who have been less affected by the appreciation of the Australian dollar in 2007-08, will continue to demand finer micron wools over the projection period.

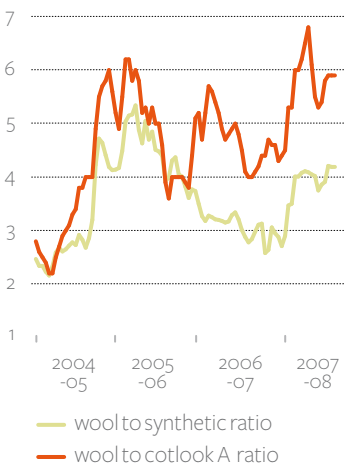
*prices of alternative fibres critical to wool's competitiveness*

The demand for wool is affected not only by its own price and exchange rates, but by consumer preferences for different fibres and the relative price of substitute fibres that can be spun into yarns with similar end use characteristics. Substitute fibres include other natural fibres, such as cotton, as well as synthetic fibres.

Because of its versatility and the variety of products made from synthetic fibres, the share of synthetic fibres used in textiles and apparel has been rising for thirty years. Currently about half the fibre used across the world is synthetic fibre (including polyester, acrylic, nylon, polyolefin and spandex), with wool currently making up only around 2 per cent of the total fibre market.

The ratio of wool prices to synthetic fibre and cotton prices provides a guide to wool's relative price competitiveness. The ratio of wool prices to synthetic fibre prices averaged 4 to 1 between July and December 2007, compared with a six year average of 3.5 to 1 between 2000-01 and 2006-07. Past experience suggests that if wool prices relative to synthetic prices remain above this longer term average for an extended period, there is likely to be some substitution of lower cost fibres for wool.

price ratio of wool (21 micron) to alternative fibres monthly, ended december 2007



Over the medium term, the uncertainty about world oil prices complicates the future price scenario for synthetic fibres. It can be expected, however, that strong growth in Chinese domestic demand for consumer goods, such as clothing, from a burgeoning middle class will put upward pressure on the demand for synthetics. Assuming that prices of synthetics are largely maintained at current levels, the wool to synthetic price ratio is projected to trend down as wool prices decline out to 2012-13.

The wool to cotton price (Cotlook A) ratio averaged 5.7 to 1 between July 2007 and January 2008, an 11 per cent decline from the preceding six months. This decline occurred because of the much stronger increase in cotton prices relative to those of wool in the first half of 2007-08. With lower world cotton production forecast to keep cotton prices relatively high in the 2008-09 season, the wool to Cotlook A price ratio is likely to decline further. Over the medium term, the wool to cotton price ratio is projected to fall to around 5.0, a value close to its six year average of 4.7 to 1.

### *improving wool's attractiveness*

Given the versatility of cotton and synthetics in the world fibre market, the continued success of the wool industry depends not only on the relative price competitiveness of wool but also on its ability to remain in demand as a desirable fibre in products sold to consumers. The promotion and marketing of wool as a key component of various textiles that are used across a range of fashion items may assist in ensuring that demand is sustained over the longer term.

Technological advances in the production of textiles have allowed the wool industry to benefit directly from niche markets that cater to changing consumer preferences. One such example is an apparent trend in consumer preferences back toward natural fibres. Advances in the processing and treatment of wool yarns have enabled the re-emergence of wool in sportswear. Before the widespread use of synthetic fibres in these garments, wool was used for its insulating qualities. It subsequently lost its foothold in this area as synthetics proved to be less costly, more effective at protecting wearers from the elements, and easier to care for.

Initiatives by the wool industry to market those characteristics of wool deemed desirable by certain consumer groups have the potential to maintain demand for raw wool. Such activities will be an essential component of the industry's efforts to compete successfully against less costly fibres.