

# Making Xinjiang Sanctions Work

## Policy Brief No. 7 – Cotton

### Based on *Making Xinjiang Sanctions Work*, July 2022<sup>i</sup>

*Can economic sanctions address Xinjiang forced labour? The Xinjiang Sanctions research project seeks to answer this question. Drawing on 3 original datasets containing over 12,000 datapoints, confidential interviews and a year of research, this Policy Brief series summarises key findings from the research. For further analysis, and the references and authorities supporting the statements in these Policy Briefs, see the project's main research study at [www.xinjiangsanctions.info](http://www.xinjiangsanctions.info).*

*The Xinjiang Sanctions Policy Brief series:*

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## Key research findings

- The cotton sector has been central to both Western sanctions in response to Xinjiang forced labour, and Chinese counter-measures. It is the sector in which Western sanctions are having the clearest effects.
- Around 1 in 5 garments made worldwide likely contains cotton made with Xinjiang forced labour.
- The XPCC has been central to the development of the Xinjiang cotton sector, and remains centrally involved, both as a producer and in partnership with manufacturing firms that have invested in the region over the last decade. Some of these have close ties to Zhejiang, where President Xi was Party Secretary from 2002-2007.
- Forced labour has been present throughout the sector's development, and seems central to its profitability, given the adverse cost structures it otherwise faces.
- Massive fiscal transfers of around USD 2.5 billion per year from Beijing to the sector have underpinned upgrading over the last decade, supplementing cotton production with processing and textile and garment manufacturing capabilities. Many firms involved have ties to forced labour, through either the VSETC or the Labour Transfers schemes (see Policy Brief No. 1).
- Western sanctions are taking a toll. Xinjiang cotton inventories are climbing, and prices are dropping, as demand dries up.
- Yet it is unclear whether this is translating into policy change. Chinese counter-measures (see Policy Brief No. 5) may actually be shrinking the space available to opponents of forced labour, at least in the short term.
- These Chinese counter-measures appear to have reduced Western brand retail sales in China, in some cases by around 20 to 24 per cent.
- Western sanctions may be working in part because the costs for Xinjiang producers to reallocate to new buyers

- are higher than the costs for Western importers and buyers to find new suppliers. This is a result of global cotton market structure and the elasticity of supply.
- An EU import ban would strengthen these effects, as would the involvement of the Central Asian states that import significant quantities of Xinjiang cotton. Since they are also producers of cotton, this may be in their interest.
- Forensic evidence suggests around one sixth of cotton garments on US store shelves in late 2021 included Xinjiang cotton. Firms may be importing Xinjiang cotton unwittingly, or in defiance of US import bans.
- Changing importers' risk-benefit calculations will depend on effective enforcement of the *Uyghur Forced Labor Prevention Act* (UFLPA), which itself depends on adequate resourcing, technology and penalties.
- Some firms are splitting their supply-chains in two ('bifurcation'), using Xinjiang cotton for most goods but not for goods bound for the US.
- Sectoral bodies have played roles that are both predicted and not predicted by existing scholarship. The predicted role involves efforts to reduce the impact of sanctions, to keep trade in globalized value-chains open. The unpredicted role involves serving as norm amplifiers, promoting respect for international labour standards.
- The latter role has led to geopolitical contestation, with China querying these groups' partiality and promoting local alternatives. This points to the risk of politicization of technical standards and global economic regulation.
- Some investors have begun actively engaging firms that may be buying Xinjiang cotton, although many Western investors remain invested in Chinese entities with close ties to the sector.

## Why is this important?

- The relative success of sanctions in placing a squeeze on Xinjiang cotton offers lessons about the conditions for success that can help us strengthen design and implementation in other sectors.
- The impact of sanctions would be increased by broadening the sanctioning coalition, for example by recruiting Central Asian countries whose own cotton producers are unfairly undercut by Xinjiang cotton produced through forced labour.
- However, the fact that economic impact has not yet translated into policy change, nor remedy for harmed workers, points to a need to strengthen target selection and consider the underlying theory of change.
- There are some firms involved in the Xinjiang cotton sector, such as the Ruyi Group, which may have more influence over relevant policy processes than those entities and individuals specifically targeted to date. These targets may also have significant interests offshore which may be vulnerable to sanctions.
- Western policy makers may need to grapple with the implications of supply-chain bifurcation. It may lead to sanctions' main effect being the reduction of Western buyers' complicity with Xinjiang forced labour, rather than the reduction of forced labour itself. It may also have the potential to accelerate broader economic and technical decoupling between China and the West.

## Research overview

The cotton sector – including production, processing and garment, textile and apparel manufacturing – has been at the centre of Western sanctions efforts in response to

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Xinjiang forced labour. It has also been central to the Chinese counter-measures discussed in Policy Brief No. 5. This is the sector in which the impacts of Xinjiang sanctions have been most visible and apparently most costly to date.

Around 1 in 5 garments currently manufactured worldwide likely contains cotton made with Xinjiang forced labour. Xinjiang produced 91 per cent of Chinese cotton in 2021, and China is the second largest cotton producer in the world.

## Cotton and Xinjiang governance

Cotton has been at the centre of the PRC's development strategy for XUAR since the 1950s – first as a focus of land reclamation efforts led by the XPCC, and since 2014 as a centre of industrial upgrading efforts. The XPCC has been a key player, today controlling around 40 per cent of XUAR cotton production, with 110 XPCC regiments involved. More than half of all Xinjiang farmers (70 per cent of whom are from an ethnic minority) grow cotton. Many of them sell it to the XPCC or other 'leading' firms, often under near monopsony arrangements. The cotton sector has been central to the processes of dispossession, proletarianization and Sinification that have characterized CCP stabilisation efforts in Xinjiang over the last 8 decades.

Over the last decade, Beijing has fostered a massive upgrading of the sector's industrial and manufacturing capabilities, from 680 factories in 2014 to over 3,500 in 2019. Through public and private investment, the sector may now employ as many as 600,000 people in Xinjiang, with over 80 per cent of all China's cotton processing companies present in XUAR. This has been achieved through massive fiscal transfers of around USD 2.5 billion per year, as well as Beijing setting a price floor for Xinjiang cotton. The government has also used pairing schemes to encourage investment by established firms in China's eastern provinces. Some of these come from Zhejiang province, where President Xi was Party Secretary from 2002 to 2007.

Forced labour has been present in the sector from its early days. It initially took the form of annual 'work-study' programmes forcing millions of children to assist with the cotton harvest, and may also have involved prison labour. More recently, both the VSETC system and the Poverty Alleviation through Labour Transfers scheme (see Policy Brief No. 1) have coerced Uyghur and other minority workers into the sector, as producers, harvesters and factory workers. This has involved massive mobilization by state and Party authorities, visiting minority households one at a time to recruit workers; placing children in institutionalized care; and physically transferring groups of workers to worksites inside and outside Xinjiang. Cotton producing and processing locations within Xinjiang have become increasingly militarized.

This underpaid, coerced labour force has been critical to the success of the Xinjiang cotton sector, allowing it to overcome high cost structures such as transport costs and low productivity rates. It has also been central to the CCP's intrusive governance strategy for XUAR since 2014.

## Western sanctions and Chinese counter-measures

Firms and individuals connected to the cotton sector are to date amongst those most frequently targeted by Western sanction responding to Xinjiang forced labour. These measures include import controls (especially in the US and Canada); targeted financial and travel bans; and export controls.

Even before the UFLPA was enforced and before the adoption of a proposed European forced labour instrument, Western sanctions appeared to be squeezing the Xinjiang cotton sector. By encouraging downstream buyers to avoid products that may contain Xinjiang cotton, the sanctions are forcing upstream producers to sell at a lower price to firms that will sell into other markets. One target of US sanctions, Changji Esquel Textile Co. Ltd. (溢达纺织有限公司) has reported losses of hundreds of millions of dollars, lost suppliers and closed factories (in Mauritius, not in Xinjiang) as a result of these sanctions.

By mid-2022, Xinjiang cotton prices appeared to have dropped around 30 per cent as a result of reduced demand, occasioned by Western sanctions. Xinjiang cotton producers reported growing stockpiles of Xinjiang cotton which they could not sell. Some were beginning to talk of looking for ways to evade Western sanctions, for example by presenting fake documents to misrepresent the provenance of cotton.

The Chinese government responded to Western sanctions by initiating a series of formal and informal counter-measures, many of them targeting Western apparel brands. These included strengthening China's sanctions infrastructure, strategic regulation, informal blacklisting and fomenting online boycotts. These counter-measures are discussed separately in Policy Brief No. 5. It appears that they have led to declines of 20 to 24 per cent in sales for some leading Western brands such as Adidas and Nike.

## Dynamics of sanctions on the cotton sector

Sanctions theory suggests that sanctions will be most effective where sanctioning states and their firms can find alternative business partners at relatively low cost, while sanctioned firms face high costs in finding alternative business partners. These conditions appear to hold in relation to the Xinjiang cotton sector. The US is easily the largest importer of cotton and cotton-mixed products in the world, both by value and weight. If the EU bans Xinjiang cotton, this will enlarge the sanctioning coalition and increase the impacts on the Xinjiang cotton sector. So, too, would the involvement of the Central Asian states that represent a major source of demand for direct exports of Xinjiang raw cotton. This is important because Chinese demand for cotton does not yet come close to absorbing domestic supply, and while it may be feasible for producers and exporters to reallocate trade to alternative markets this inevitably involves price reductions and thus revenue losses. Importers in sanctioning states also face costs from lost Chinese supply. But cotton is relatively homogenous, and supply is relatively elastic. Already there are signs that the gap left by Xinjiang cotton in the US market may be met by increased production from other sources in Asia.

Nevertheless, forensic evidence suggests that as of late 2021 16 per cent of cotton clothes on US store shelves still contained Xinjiang cotton. Some firms appear not yet to be adapting their supply-chains, despite the shadow of the *Uyghur Forced Labor Prevention Act* (UFLPA). Some Xinjiang cotton producers are also clearly exploring the options of trade deflection and sanctions evasion, sending their products to sanctioning markets through third-party intermediaries in order to disguise their origin. Changing firms' risk-benefit calculus will depend on effective enforcement, which will be a function of resourcing, technology (such as use of DNA, genotyping or isotopic analysis), target selection and penalties. Some firms are in fact already pursuing product transformation. Chinese imports of Brazilian and US cotton have risen in the last two years, apparently as some Chinese garment and apparel

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manufacturers switch away from Xinjiang cotton in order not to be excluded from North American markets.

There is growing evidence that this is leading to supply-chain bifurcation – using non-Xinjiang cotton for products sold into sanctioning markets, such as the US, but continuing to use Xinjiang cotton for sales in China and other markets outside the sanctioning coalition. Existing sanctions do not prohibit or penalize this – a lacuna that policymakers may need to address if they want to maximize the effectiveness of these sanctions.

Western sanctions on Xinjiang cotton have clearly been perceived as threatening by Chinese policy actors, inducing the counter-measures discussed in Policy Brief No. 5. However, this does not mean that they have strengthened the position of actors that oppose the use of forced labour in the sector. In fact, the draconian nature of Chinese counter-measures may have shrunk the space for such opposition in the short term.

Western sanctions on the Xinjiang cotton sector have to date focused on firms with clear ties to forced labour, and on key figures within the XPCC who have implemented the VSETC and related policies. The degree of influence a target might exert over policy processes in Beijing does not appear to have been a criterion for target selection. Moreover, the sanctions imposed work to cut the connection between, on the one hand, Western actors (importers, buyers, exporters) and, on the other, Xinjiang forced labour. They do not prevent Western *investors* profiting from firms in the Xinjiang cotton sector. Nor do they yet work to ensure the provision of remedy to those already harmed by forced labour in the production of Xinjiang cotton.

China's textile and apparel industries are now so globalized that it would not be difficult to identify cotton sector firms and interests for further targeted sanctions, if the sanctioning coalition sought them. For example, the Ruyi Group, under investigation in France for crimes against humanity as a result of its connection to Xinjiang forced labour, owns British high-end clothing manufacturer Aquascutum and has controlling interests in both US-based The Lycra Company and Australia's largest cotton farm, Cubbie Station (which is co-owned by one of Australia's largest banking groups). Ruyi's President, 'Jerry' Qiu Yafu, who was also a Deputy to the Tenth National People's Congress (2003-2007) (signalling his connections to Beijing policy makers), appears to own extensive residential property overseas.

## Sectoral bodies

Sanctions theory suggests that sectoral bodies representing producers in sanctioning states may support (and even drive adoption of) sanctions, because they can create positive externalities and protections benefiting local producers. But trade theory also suggests that firms that are more integrated into global value-chains tend to favour open trade. Sectoral bodies have indeed responded to Xinjiang cotton sector sanctions by arguing for streamlining of import processes, delayed enforcement of the UFLPA and a raft of exceptions.

On the other hand, sectoral bodies have also played another key role in Xinjiang sanctions which has not been predicted by sanctions theory nor trade literature. Multistakeholder bodies focused on promoting environmental labour standards, such as the Fair Labor Association and the Better Cotton Initiative, have emerged as important norm amplifiers, adducing and assessing evidence of labour

standards violations, and attempting to work with their members on remediation. As a result, however, the role of these bodies has become highly contested, with the Chinese government actively resisting and portraying these groups as tools of Western governments. Several 'local' standards assurance processes have emerged in China, one of them with the active support of the XPCC, as alternatives. This dynamic resembles the geopoliticisation of sustainability standards processes seen previously in other sectors, such as palm oil. This points to the potential for disputes over the Xinjiang forced labour 'narrative' to spill over into technical standards and regulatory processes, including debates on Environmental, Social and Governance (ESG) finance.

## Capital markets

Although cotton firms have not been explicitly targeted by Western capital market sanctions, global investors are increasingly asking questions about the companies' connections to Xinjiang cottons. Groups such as Investor Alliance for Human Rights (IAHR) have led extensive active engagement with the apparel industry. In 2021 a shareholder proposal initiated by Domini, an investment manager, saw 27 per cent of Nike shareholders support additional action to address Xinjiang forced labour. Some firms have begun to pre-emptively de-risk. For example, Lu Thai, a major shirt maker, sold its Xinjiang subsidiary in late 2021. Yet many Western investors remain invested in publicly listed Chinese entities with close ties to the Xinjiang cotton sector.

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## Sectoral dynamics of Xinjiang sanctions

|                                     | Cotton  | Tomatoes  | Solar  |
|-------------------------------------|---|---|--|
| <b>Overall impacts to date</b>      | Significant impact on demand for Xinjiang cotton, price. Some targeted firms closing manufacturing plants, laying off workers. Western brands have lost market share (see Part 2). No sign of remediation to victims of forced labour.  | Limited sanctions enforcement to date. No clear evidence of impacts. No sign of remedy for victims of forced labour.  | Limited impact – prices at 10-year high. Possible supply-chain bifurcation. No clear roadmap for developing alternative supply means established firms capturing new ‘slavery-free’ demand. No sign of remedy for victims of forced labour.  |
| <b>Strengthen policy opponents?</b> | Sanctions have responded to evidence of ties to forced labour, rather than sought to impact those with ties to policy makers. No differentiation of enforcement approach between XPCC firms and those with more direct influence in Beijing (eg Ruyi Group). Targeted sanctions on firms and leaders’ foreign assets could increase impact. | Sanctions have responded to evidence of ties to forced labour, rather than sought to impact those with influence in policy processes. No differentiation of approach between XPCC firms and those with more direct influence in Beijing (eg COFCO Tunhe).   | Sanctions not yet targeting industry leaders with influence over policy makers (eg those with ties to ‘Zhejiang Clique’, those with ties to Deng Xiaoping family & PLA).   |
| <b>Cost asymmetries</b>             | Asymmetries marginally favour sanctioning coalition because of Western share of demand and higher price Western consumers will pay. This could be further strengthened by broadening coalition to include Central Asian buyers of raw and spun cotton.  | Asymmetries currently favour Xinjiang producers. This will change if: 1. EU import ban adopted, enforced; 2. African or Middle East countries recruited into the sanctioning coalition; 3. US takes more robust enforcement action eg against fast food companies; or 4. sanctions focused more on the broader COFCO group – though this risks being perceived as an attack on China’s food security. | Asymmetries strongly favour Xinjiang producers and work against Western importers. This could be addressed by focusing sanctions on high-quartz quality exports from the US, and through industrial policy to increase alternative supply of slavery-free polysilicon.   |
| <b>Trade adaptation strategies</b>  | Evidence of reallocation, deflection and transformation. Clear risk of sanctions evasion – enforcement strategy will be determinative.  | Evidence of deflection which may shade into evasion. Some reallocation / social dumping emerging. Enforcement strategy will shape firm-level adaptation.  | Evidence of trade reallocation and some deflection (via South East Asia). Dominant firms in middle of supply-chain increasingly engaging in product transformation and supply-chain – without giving up forced labour production for some products. This raises cross-subsidization concerns.                        |
| <b>Sectoral body conduct</b>        | Sectoral bodies representing globalized firms push for limits on import controls. Standards-oriented bodies provide norm amplification. Chinese government responds by politicizing standards processes.  | No activity evident.  | Sectoral bodies’ policy stances respond to both positions in global value-chains and local regulatory signals. Globalized value-chains lead sectoral bodies to push for more open trade. Thin-film & ultra-low-carbon producers more vocal in support of sanctions, as they may improve their competitive positions. |
| <b>Capital markets engaged?</b>     | Increasingly, but primarily through private active engagement, including via IAHR. Some emerging shareholder proposal activity.   | Some impacts on XPCC family firms, eg removal from stock indices. Early signs of active engagement by IAST-APAC and IAHR. No shareholder actions to date.   | Western investors remain invested in these firms. Development finance bodies most engaged, some signs of engagement by institutional investors, private equity. But no signs of shareholder actions or delisting to date.  |

<sup>i</sup> James Cockayne, *Making Xinjiang Sanctions Work: Addressing forced labour through coercive trade and finance measures* (Nottingham: University of Nottingham, 2022).