

Commodity Spotlight



Weak Demand Dampens Outlook for U.S. Cotton

The 1999 outlook for U.S. cotton producers is somewhat mixed. This season's U.S. cotton crop is projected to rebound from 1998's decade-low output, with cotton area the largest in 3 years. But prospects of potential earnings from the larger output in 1999 are dampened by weak demand and rising stocks. The result is a less-than-robust outlook for the 1999/2000 (August-July) marketing year.

For 1999 spring planting, producers—released by the current farm legislation from acreage restrictions—were free to decide which crops to plant and how many acres of each. With prices for major row crops at recent lows, many cotton producers who had the option to plant other crops decided that net returns for cotton were the most promising this year. As a result, U.S. producers increased cotton plantings in 1999, despite the subpar crop of 1998 still fresh in their memory.

The latest acreage estimate from USDA's National Agricultural Statistics Service (NASS) indicates a 9-percent expansion in planted area and a return to a lower, more "normal" average abandonment in 1999/2000. Harvested area is projected to rise 25 percent from last season. While expected national yield is below a year

ago, cotton production is projected to rise 18 percent this season and inflate supplies.

Despite some weather-related setbacks again this year, production is expected to rise in three of the four regions of the Cotton Belt. For 1999, the Southwest region is projected to capture top-producer status, a distinction recently held

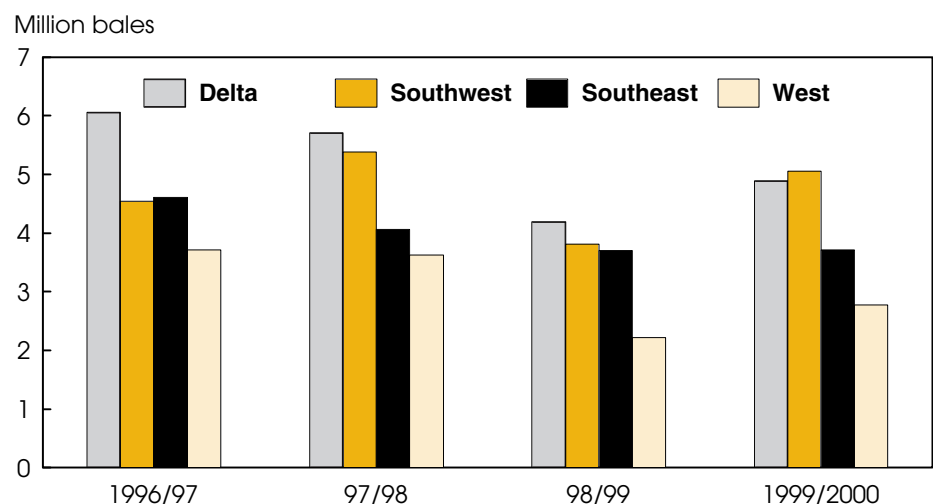
by the Delta, this year's second-largest production area. Each of these regions is expected to contribute approximately 30 percent of U.S. cotton production in 1999, with the Southeast and West contributing the remainder.

Although declining crop conditions have placed the latest NASS production forecast well below the August projection, U.S. cotton production this season is expected to push supplies above the 1998 season, even without the substantial quantity of raw cotton imported last year. Beginning stocks are equal to those of a year ago and imports are projected at a minimum this season. U.S. cotton supplies are estimated to rise 12 percent, perhaps too large an increase in an environment of sluggish demand with the financial crises in Asia still reverberating.

World Demand Is Key To Cotton-Sector Turnaround

Given last season's worldwide decline in cotton demand in the wake of the Asian financial crises, the extent of any demand rebound will play a key role in the 1999/2000 outlook for the global cotton market. Early indications are for world cotton demand to rise more than 2.5 percent this season, above the average long-term growth rate of nearly 2 percent. However, global cotton use is not yet

Southwest to Lead in U.S. Cotton Production



August-July crop year. Bale = 480 lbs. 1999/2000 projected.

Economic Research Service, USDA

Commodity Spotlight

expected to return to the pre-crisis level of 2 years ago, and mill demand is projected to grow for foreign countries in aggregate but not in the U.S.

Sluggish U.S. cotton mill demand expected this season is the result of persistent competition from manmade fibers and double-digit growth in imports of textile and apparel products. As competition from imports continues to force U.S. industry participants to merge, close, or move mill operations abroad, domestic cotton mill use is projected to fall slightly from last season's level and future expansion is questionable.

U.S. cotton exports, on the other hand, are expected to recover in 1999 from the dismal level of last season. Improvement in foreign import demand and consumption are likely to support U.S. shipments in 1999, and exports are projected to rise more than 25 percent. However, formidable foreign competition in the global export market is expected to keep U.S. cotton exports well below the average of the robust 1994-97 seasons. U.S. cotton exports are forecast more than 2 million bales below recent levels and more than 1 million bales below annual average exports in 1986-98, the period since farm legislation introduced cotton marketing loans and ended the loan rate's role as a price floor and a barrier to exports for cotton.

An assumption underlying USDA's October forecasts for both export and domestic consumption is the continuing inactivity of Step 2 of the Cotton Marketing Loan Program (AO September 1998). Funding for Step 2 through fiscal year 2002, aimed at keeping U.S. cotton competitive on the domestic and global market, was exhausted in December 1998; Congress recently passed legislation to provide additional funding for reactivating Step 2. It is generally accepted that some expansion in exports and domestic use is likely to result from a reactivated Step 2, but the extent depends on the circumstances under which the program operates, and estimates vary widely.

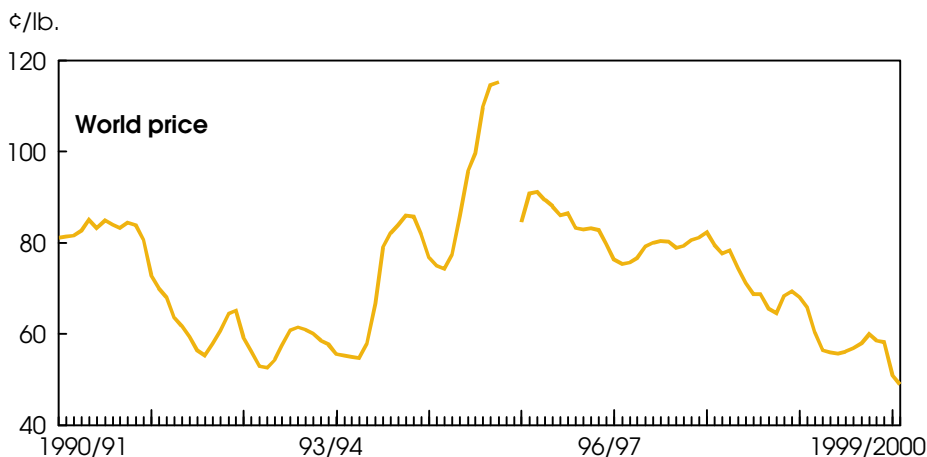
China—a Strong Influence On World Cotton Prices

Among the major changes the world has seen in the last 40 years has been the growing integration of China into the world community, and increased openness of information about events in China. However, there is ample room for further progress in the world's understanding of China's cotton sector, and lack of understanding may translate into greater world price instability. A number of uncertainties about China's behavior have been holding down world prices during the first months of 1999/2000.

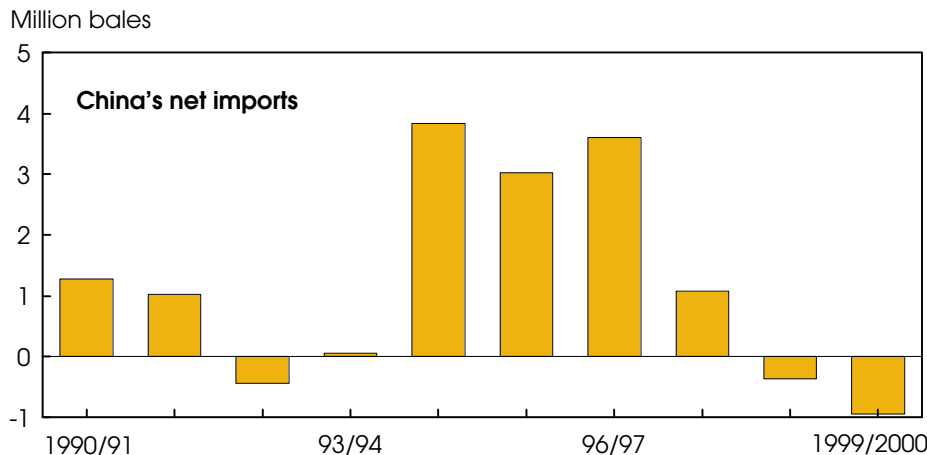
World cotton prices early in marketing-year 1999/2000 were the lowest since the beginning of 1986/87. At that time, U.S. policy changed course, ending government's acquisition of stocks to support market prices and ending the withholding of government-purchased stocks from domestic and world markets. These changes were made in a way to ensure that despite short-term price declines as a result of this policy change, U.S. farmers would maintain sufficient resources in agriculture to meet longrun demand. China exported large amounts of cotton that season, further pressuring prices.

China again figures strongly in the causes underlying this season's relatively weak

World Cotton Price Reflects China's Imports



Price data are monthly, August-July marketing year. Data unavailable for June-July 1995. Source: *Cotton Outlook*, Cotlook Ltd., Liverpool.



August-July marketing year. 1999/2000 projected.

Economic Research Service, USDA

prices to date and the expectation of relatively weak U.S. exports. China's current policy—like that of the U.S. in 1986/87—is aimed at lowering government-held stocks, making policy adjustments to free up some old stocks, and putting into place measures to prevent 1999/2000 and future crops from becoming government-owned.

The centerpiece of China's new policy is termination of government's role as sole legal purchaser of cotton and government's guaranteed purchase of all available cotton at a price well above world levels. Although withdrawal of this price floor has been widely anticipated in China, production in 1999/2000 is nevertheless expected to be only slightly lower than the year before. However, many forecasters expect a stronger downward production trend in subsequent years. Given China's need to maintain employment in a slowing economy, and a long tradition of high agricultural self-sufficiency, it is unclear whether the government's willingness to accept the social consequences of falling producer incomes will persist in the face of potentially large declines in cotton production.

Another source of uncertainty relates to China's stock holdings. Until recently, stock levels in China were regarded as a state secret, and while stock levels have been publicly discussed lately by government sources in China, none of the various published numbers can be verified. There is even some question about whether or not all the reported stocks really exist. If they do exist, the quality and condition of these stocks is highly uncertain; they may even be unusable.

Disposition of stocks from earlier years may depend partly on some adjustment in current government policy. The Cotton and Jute Companies that procured stocks for the government at guaranteed support levels above market prices cannot release this older cotton at current prices without recording monetary losses, which policy forbids. Conceivably this policy constraint could change.

China still publishes no complete estimate of domestic cotton use. In addition, its production data have long been questioned by a wide range of observers, and even trade data are somewhat suspect due

Refueling Step 2 to Bolster U.S. Cotton Competitiveness

The 1990 farm legislation provided a mechanism—Upland Cotton User Marketing Certificates or "Step 2" of the Cotton Marketing Loan Program—for keeping U.S. cotton competitive on the world export market as well as for encouraging domestic mills to use U.S. cotton instead of importing cheaper foreign cotton. Step 2 provides payment to exporters and domestic mill users of U.S. upland cotton when:

- after 4 consecutive weeks, the U.S. price on the world market remains more than 3 cents per pound above the weekly average of the five lowest cotton price quotations from a variety of countries, and
- the adjusted world price is no more than 34 percent above the per-unit government loan rate available to cotton farmers.

Farm legislation passed in 1996 limited Step 2 expenditures to \$701 million during the period FY 1996 through 2002, but the program funds were exhausted by December 15, 1998. The program has been inactive since then, but Congress recently passed legislation to provide additional funding.

See AO September 1998 and July 1997 for details on Step 2.

to the acknowledged widespread smuggling of a variety of commodities. In these circumstances, it is difficult for the rest of the world to react to anything but China's recent actual transactions with the rest of the world—i.e., reported exports and imports.

Current information indicates that China's net exports are trending upwards. With little available information, the rest of the world generally expects the level of cotton exports from China to continue rising. As a result, world prices have been dipping lower.

Cotton Consumption Reflects Economic Health

In the 1990's, stagnation in global cotton consumption has been the order of the day, in contrast to the 1980's, when cotton consumption underwent one of its greatest sustained surges of the century. The current decade has seen the collapse of cotton consumption in countries of the former Soviet Union, growth in production of polyester—a competing fiber—rebounding to nearly record levels, and finally, financial crises in Asia that drove cotton into the deepest consumption slump seen in decades, contributing to depressed global exports and prices.

Rebounding consumption in 1999/2000 is not expected to fully make up for the

4.1-percent decline in consumption in 1998/99. Although world economic growth slowed only modestly in calendar 1999, a number of once rapidly growing developing countries suffered severe setbacks, and longrun consumption prospects there have weakened as a result.

The 1998/99 consumption decline probably reflects reduced consumption expectations of cotton consumers (purchasers at the retail level) for a number of years into the future. Cotton consumers in Southeast Asia undoubtedly have adjusted their longrun domestic consumption expectations downward because of the economic crisis in Asia that began in 1997, and therefore the export share of the region's mill use (textile production) is higher, pressuring mills elsewhere in the world. Cotton consumers in China are probably less certain about their longrun cotton consumption prospects, especially since China's textile exports have not been robust lately. Devaluations and increased uncertainty have affected the outlook for Brazilian and Russian cotton consumers.

There are no obvious market candidates displaying positive longrun economic adjustments that will lead to significant expansion of cotton consumption. U.S. short-term general economic performance, however, continues to surpass expectation, and generally positive news has been coming recently from Europe and Japan.

Commodity Spotlight

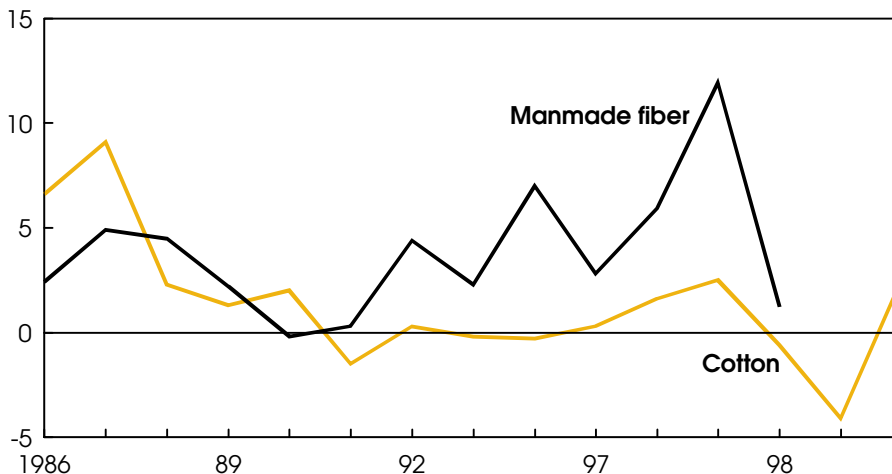
World cotton consumption is expected to rise 2.6 percent in 1999/2000, well below the rate in some years when consumption rebounded from earlier declines, but still above the likely long-term growth potential. With world economic growth expected to continue improving in calendar 2000, the lagged effect of recent lower cotton prices should support an above-average outlook for cotton consumption. If stable economic growth is maintained, cotton consumers' longrun outlook should eventually improve as well.

Improving economic performance expected in the coming 12 months suggests clothing demand could be rising in many developed as well as developing countries. China's increased export rebates, floating procurement prices, and recovering profitability in the textile sector indicate that cotton consumption in China could increase in 1999/2000. Favorable exchange rates for the Russian ruble and Brazilian real also suggest that cotton consumption should improve in those countries. Because increased consumer demand for cotton textiles in one country can translate to increased mill use of cotton in a number of other countries, it is unclear where cotton mill use will grow in 1999/2000. However, additional use in textile exporters like India, Mexico, and Southeast Asia seems reasonable.

Another—although perhaps less certain—factor in favor of growing cotton consumption in 1999/2000 is reduced investment in manmade (chemical) fiber production, particularly in Asia. Worldwide, the profitability of chemical fiber production suffered from the recent economic slowdown, and in Asia the cost of capital

Global Cotton Use to Rebound in 1999/2000

Percent change



August-July marketing years for cotton (e.g., 1998=1997/98 marketing year). 1999/2000 forecast. Calendar years for manmade fiber.

Source: International Cotton Advisory Committee and Fiber Economics Bureau for manmade (chemical) fiber data.

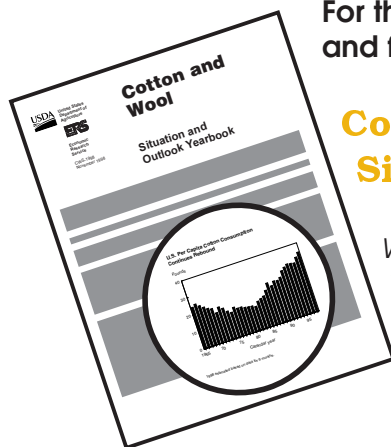
Economic Research Service, USDA

has risen with the introduction of floating exchange rates and the higher degree of economic uncertainty in the region. Some industry sources indicate that while manmade fiber production rose 6 percent in 1996 and 12 percent in 1997, growth slipped below 2 percent in 1998. Capacity growth has reportedly slowed dramatically, suggesting an even smaller gain in global manmade fiber production in 1999.

With abundant cotton supplies projected again in many countries around the globe, even the relatively robust consumption forecast for 1999/2000 is expected to reduce world ending stocks only slightly. In the U.S., ending stocks are projected to

rise to 30 percent of use, equaling the highest level in this decade. China's stocks are expected to fall, but virtually no change is expected in the total for the rest of the world. In hindsight, the 1986/87 shift in world prices—ushered in by the 1986 U.S. policy change to draw down government stocks—helped sustain booming cotton consumption through the end of the 1980's. Only time will tell if a similar outcome will follow China's policy revisions and the pause in manmade fiber capacity gains. **AO**

Stephen MacDonald (202) 694-5305 and
Leslie Meyer (202) 694-5307
stephenm@econ.ag.gov
lmeyer@econ.ag.gov



For the latest research, outlook analysis, and data on the U.S. and foreign cotton markets

Cotton and Wool Situation and Outlook Yearbook

Watch for 1999 edition on the ERS website later this month
www.econ.ag.gov/prodsrvs/s&o.htm

Also, see our website for free cotton outlook updates—available electronically 10 times yearly.