Commodity Spotlight

Cigarette Price Increase Follows Tobacco Pact

The recent agreement worked out between the tobacco industry and state attorneys general on November 16, 1998 requires manufacturers to reimburse states for costs of treating smoking-related illnesses and provides for specific measures to reduce underage smoking. Combined with expenses from four previous individual state settlements, the agreement will have an inflationary effect on cigarette prices. Manufacturers had already raised wholesale prices four times in 1998 prior to the settlement, resulting in a 14-percent overall rise at the wholesale level, in part in anticipation of future expenses. Adding increases since the settlement, the wholesale price of cigarettes, including tax, has gone up nearly 50 percent since January 1998.

Key elements of the pact require manufacturers to pay $206 billion to states over a 25-year period (including $300 million annually for research to reduce youth smoking and to support other anti-smoking measures). The pact also limits sporting event sponsorship and advertising (including a ban on cartoon characters) and prohibits "branded" merchandise—merchandise made available to customers that displays the name or symbols of a brand of cigarettes. Tobacco industry organizations such as the Tobacco Institute and the Council for Tobacco Research are disbanded. Agreements in the four previously settled individual state lawsuits commit the industry to an additional cost of about $45 billion over 25 years.

Signed just a few days after it was announced by the 46 states that had not already settled individually, as well as by the District of Columbia and several territories, the new tobacco settlement, unlike the abortive June 1997 agreement, requires no approval by Congress. The narrower scope of the current agreement reflects its more limited goals: reimbursing states for smoking-related health costs under Medicaid, restricting advertising and promotional sponsorships by tobacco companies, and putting an end to lawsuits initiated by states against cigarette manufacturers. This agreement forgoes a complete ban on advertising for sporting events, as well as authorization for the regulation of tobacco by the Food and Drug Administration (e.g., possible restrictions on nicotine content of tobacco products), which would have required Congressional approval. And the industry remains subject to individual and class action lawsuits.

On November 23, the day of the new settlement's signing, two major cigarette companies raised wholesale prices by 45 cents per pack, the largest increase in history. Other manufacturers will follow. Retail prices, while not likely to reflect the entire increase, will rise substantially, as most of the settlement's cost will be passed on to consumers.

Higher cigarette prices, as well as increased taxes in some states, could cause consumption to slide as much as 25 percent over the next 10 years, compared with an expected decrease of 17 percent at the current rate of decline. Growing restrictions on permissible smoking areas and increased awareness of health risks associated with smoking had already fueled a decline in U.S. cigarette consumption at a rate of about 2 percent per year since its peak at 640 billion pieces in 1981. Domestic cigarette consumption is forecast to decline to 470 billion pieces in 1998 from 475 billion in 1997.

After increasing nearly every year since the mid-1980's, U.S. cigarette exports also turned downward in 1997 as offshore production by U.S. manufacturers rose and as demand declined in some major consuming nations. U.S. cigarette exports fell 11 percent to 217 billion pieces in 1997, and the decline is expected to continue. The economic crisis in Asia is likely to exacerbate shrinking demand in Pacific Rim nations.

In 1998, U.S. cigarette output is expected to total 680 billion pieces, down from 720 billion in 1997 when cigarettes sales were $50.4 billion and accounted for 94 percent of U.S. tobacco product sales. Lower cigarette consumption will likely curb demand for tobacco leaf. While the tobacco agreement calls for no specific compensation for growers, manufacturers are negotiating voluntary payments to make up for lost value of quotas due to declining leaf demand. At press time, no agreement had been reached.

Tobacco Auction Prices Higher

Flue-cured and burley tobacco represent 95 percent of tobacco grown in the U.S. *Flue- cured* tobacco, also known as Virginia-type tobacco leaf, is grown in the southeastern U.S. and cured under heat to achieve world-renowned golden leaf. *Burley* tobacco is air-cured; leaf is hung in a well-ventilated barn during the curing process and is grown in Kentucky, Tennessee, Virginia, West Virginia, Indiana, Ohio, Missouri, and North Carolina. Both types are used primarily in cigarette manufacture. Tobacco is also used in cigars, snuff, chewing tobacco, and smoking tobacco.

Flue-cured auction markets closed November 12 after being open for 64 days, about the usual period. Quality was good, similar to last season. Depending on grade, prices averaged $1.76 per pound, up 1-3 cents from a year earlier.

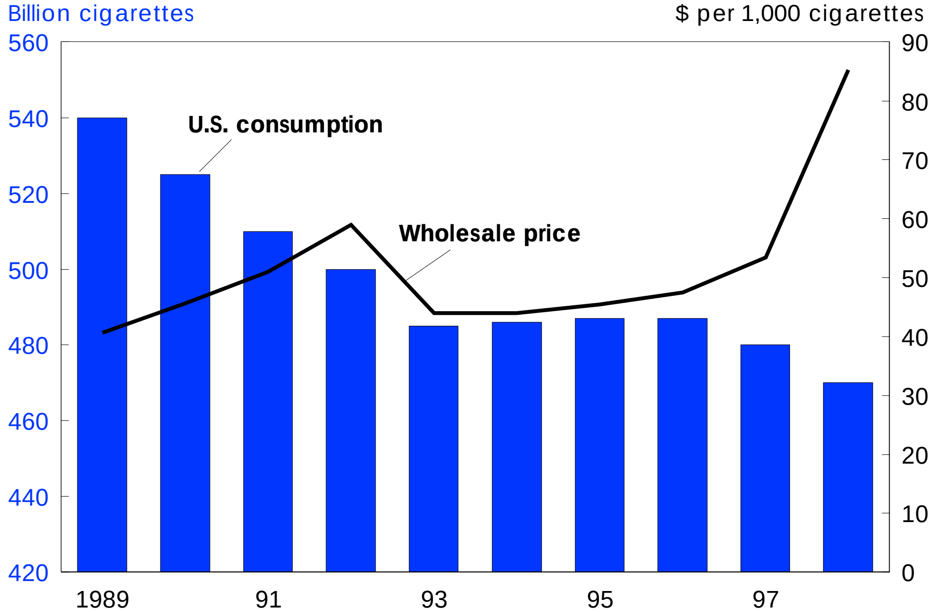
Traditionally, flue-cured tobacco has been sold in “sheets,” piled on large burlap squares. This year, bales—which can be moved more efficiently in warehouses—were tried and proved successful. Sales of baled leaf were substantial in some markets and brought higher per-pound prices.

Production in 1998 was lower, and marketings totaled just 816 million pounds compared with about 1 billion last season. Drought in Florida, Georgia, and South Carolina lowered yields, and reduced domestic demand for leaf and declining exports led to a drop in the 1998 quota.

Under the federally administered tobacco program, growers are allowed to market up to a quota set to support tobacco prices. The Flue-Cured Stabilization Corporation, a quasi-governmental corporation, offers to buy tobacco that does not receive an auction bid greater than its support price. With a smaller crop, different grade mix, and large world supplies, the Flue-cured Stabilization Corporation took 10 percent of total producer sales compared with 19 percent last season.

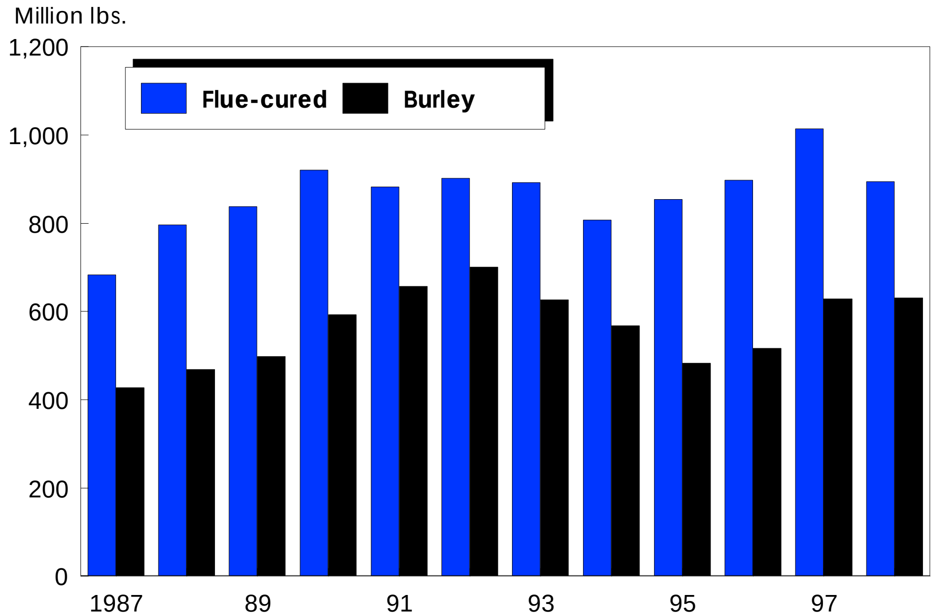
On December 15, USDA announced the flue-cured marketing quota for the 1999/2000 marketing year (July-June). The quota prior to adjustment for previous year’s over- and under-marketings is 666 million pounds, 18 percent below the 1998 quota of 814 million pounds and 32 percent below 1997’s quota of 974 million pounds. The 1999 quota is the lowest since poundage quotas were instituted for flue-cured in 1965.

U.S. Cigarette Consumption Declines As Prices Rise Sharply



Prices as of December 31; excludes Federal excise tax. 1998 forecast.
Economic Research Service, USDA

Tobacco Marketings Down in 1998



Season begins July 1 for flue-cured and October 1 for burley. 1988 forecast for burley.
Economic Research Service, USDA

The tobacco quota is calculated using a formula that sums domestic manufacturers’ purchase intentions, the average of the preceding 3 year’s exports, and an adjustment to maintain a minimum stock level. This sum can be adjusted up or down as much as 3 percent by the Secretary of Agriculture—the Secretary adjusted the quota upward by the full 3 percent in 1998.

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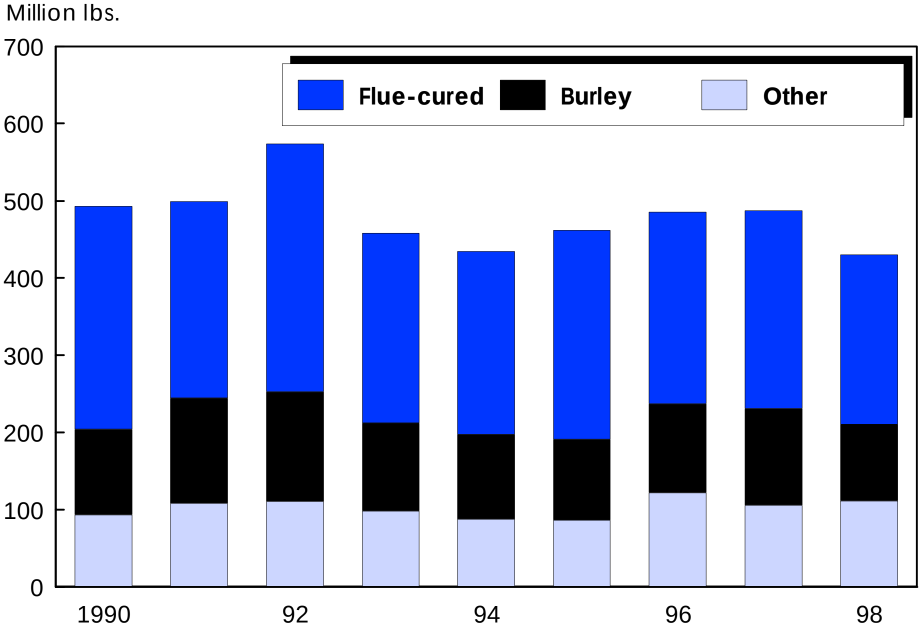
U.S. Tobacco Exports Off in 1998



Unmanufactured tobacco. 1998 forecast.
Economic Research Service, USDA

Burley auction markets opened on November 23 for the 1998 season. Burley markets generally open in November and continue through late February or early March. The 1999 burley marketing quota will be announced February 1.

Despite larger harvested acreage, lower yields pulled down 1998 burley production by 2.5 percent to an estimated 632 million pounds (including 450 million in Kentucky). This year's quality is good, better overall than last season. With a smaller crop and higher price supports, prices are expected 2-3 cents per pound higher than a year ago to about $1.91 per pound. The price support level for 1998 was set at $177.80 per cwt, up $1.80 from 1997.

Any rise in cigarette prices in 1999 will be mostly related to post-farmgate market developments rather than higher tobacco prices. Tobacco is a relatively small part of the total cost of producing cigarettes—about 5 percent—and cigarette companies can adjust for higher domestic prices by increasing their use of imported leaf.

U.S.-made cigarettes and a growing share of foreign production are "American-blend," containing a blend of about 47 percent flue-cured, 40 percent burley, and 13 percent Oriental leaf. About 60 percent of leaf in U.S.-made cigarettes is domestically grown. Oriental tobacco, which is not grown in the U.S., is mostly imported from Turkey, Greece, and Macedonia.

Cigarette manufacturers import about 35-40 percent of the tobacco used in cigarettes because foreign tobacco is less expensive (although lower in quality). As a result, the U.S. is both the world's largest tobacco importer and one of the world's largest exporters of leaf. About one-third of U.S. output is shipped to foreign markets for manufacturing cigarettes.

This year's higher tobacco prices mask the effects of declining quota levels, which could reduce overall cash receipts for growers. While tobacco support prices shelter farmers from large downturns in prices, declining demand for tobacco leaf over time—caused by declining cigarette output—results in lower quotas. As growers' tobacco marketings are restricted, their incomes fall.

The long-term decline in demand will inevitably result in lower incomes for growers and their communities. Increased exports of tobacco leaf may provide some relief to growers, but may be limited by the tobacco program itself. Since the program was designed to protect U.S. tobacco farmers by increasing U.S. prices, it also has the effect of making U.S. tobacco less competitive on the world market. Over time, U.S. tobacco farmers will be forced to turn to supplementary crop or livestock enterprises or off-farm sources of income.

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