Commodity Spotlight

Jack Harrison

Declining Cigarette Consumption Follows Price Hikes

Wholesale cigarette prices increased dramatically on the signing of the November 1998 settlement between cigarette manufacturers and most state attorneys general. The initial increase, 45 cents per pack on the day the settlement was announced, was the largest in history and was followed 9 months later by an 18-cent-per-pack increase. Together they produced a 50-percent increase in wholesale prices and an estimated 6 percent slide in cigarette consumption to about 435 billion pieces, the lowest since 1957. This drop follows 1998's 3-percent decline in U.S. cigarette consumption. Further decreases in cigarette consumption are likely as prices continue to increase, excise taxes rise, and restrictions expand on smoking in public places.

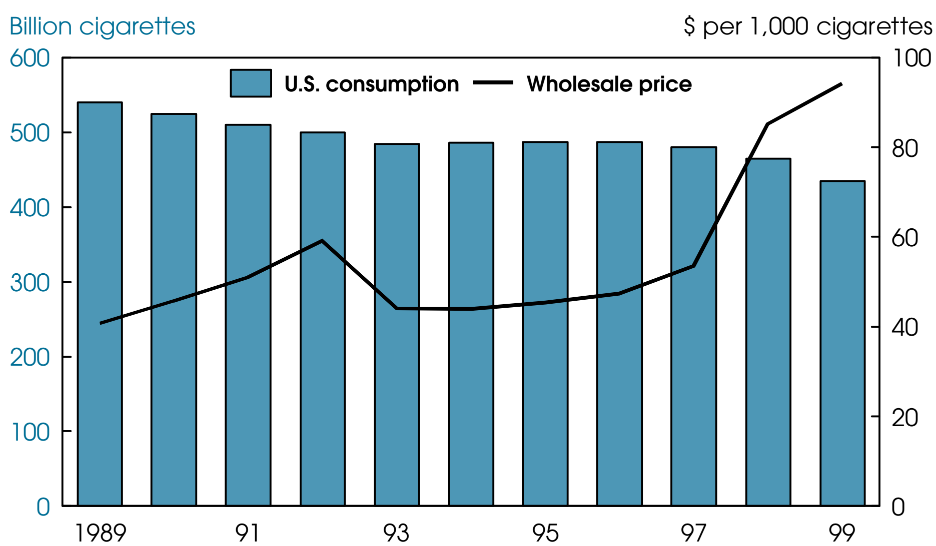
In addition to paying higher prices imposed by cigarette manufacturers, partially to cover expenses of the settlement, cigarette consumers have faced numerous state tax increases in recent years. Furthermore, the 24-cent per pack Federal excise tax on cigarettes increases 10 cents in January 2000, and will rise another 5 cents per pack in January 2002, to a total of 39 cents per pack. The Consumer Price Index (CPI) for cigarettes indicates that retail prices in November 1999 were 32 percent higher than a year earlier, compared with the 1998 price rise of 12 percent.

The price increase of November 1998, combined with lagging exports, set the stage for reduced domestic consumption and output. Total U.S. cigarette production was 679.7 billion pieces in 1998, down 5.5 percent from 1997 because of lower exports and shrinking U.S. consumption. In preliminary estimates for 1999, production will continue 1998's slide. Output of cigarettes is expected to drop 7 percent to 635 billion pieces, reflecting continuing declines in consumption and exports.

The U.S. is the world's largest exporter of cigarettes, and for many years burgeoning exports offset declines in domestic consumption. However, export volume that peaked at 243 billion pieces in 1996 has fallen to an estimated 170 billion in 1999. Cigarette exports are falling as U.S. manufacturers transfer production of cigarettes to overseas sites to reduce costs and as consumption declines in some of the major U.S. export markets as anti-smoking activity increases.

January-September 1999 cigarette exports were 115.7 billion pieces, compared with 157.1 billion during the same period of 1998. During the first 9 months of 1999, shipments to Japan were steady, but shipments to the European Union (EU), the countries of the former Soviet Union, and some Asian markets plummeted. Shipments to the EU dropped to 17.6 billion cigarettes, less than half the level of the same period in 1998 and 70 percent below

U.S. Cigarette Consumption Declines as Prices Rise



1999 forecast. Prices as of December 31; excludes Federal excise tax.

Economic Research Service, USDA

the high of 59.1 billion during January-September 1995. Exports to Turkey were 67.8 million pieces in 1999, compared with 4.5 billion during 1997.

Imports account for a tiny proportion of total U.S. cigarette consumption. Cigarette imports grew from 3.2 billion pieces in 1997 to 4.3 billion in 1998, due primarily to increased grey market shipments—legally exported U.S. cigarettes that are shipped back for sale in the U.S. Grey market cigarettes, despite duties and taxes, are still cheaper than cigarettes manufactured for sale in the U.S., because of their lower initial price. Manufacturers charge wholesalers less for cigarettes destined for export than for those to be sold domestically. Imports are expected to advance again in 1999 to nearly double 1998 levels.

Tobacco Leaf Crop & Exports Reflect Drop in Cigarette Use

About half of tobacco grown in the U.S. is used in domestic cigarette production. Flue-cured and burley tobaccos are the main components of cigarettes. The typical cigarette contains 34 percent U.S. flue-cured, 22 percent U.S. burley, and the remainder is imported flue-cured, burley, and oriental leaf (oriental leaf is not grown in the U.S.). For 1999, flue-cured acreage declined 64,000 acres from the previous year while burley acreage slid less than 2,000 acres. The December 1 production forecast for all tobacco is 1.28 billion pounds, 14 percent below last year. During the past marketing year (1998/99), about 63 percent of U.S.-produced tobacco was used for domestic manufacture and the remainder exported. Estimated use of U.S. leaf totaled 1.45 billion pounds, 4 percent below 1997/98.

For 2000, flue-cured leaf manufacturers' purchase intentions are 286 million pounds, down from 1999's 327 million pounds. As cigarette output has shrunk in recent years, manufacturers have used less leaf. Purchase intentions have plummeted and loan stocks have accumulated. Oversupply was worsened by weak export demand. The result has been lower marketing quotas (the amount growers are allowed to sell) for flue-cured and burley tobacco. Quotas dropped substantially in 1999 as manufacturers lowered purchase intentions in response to declining cigarette consumption in the U.S. and lower export volume. Flue-cured basic quotas slipped 18 percent to 667.7 million pounds, and burley quotas fell 29 percent to 450.6 million pounds.

The value of U.S. tobacco leaf and product exports in 1998/99 (July-June) was $5.7 billion, down from $6.5 billion the previous year. Imports were valued at $1.2 billion, resulting in a tobacco trade surplus of $4.5 billion. Unmanufactured tobacco export value totaled $1.4 billion, about the same as 1997/98, while product exports slipped nearly half a billion dollars to $4.3 billion. Unmanufactured tobacco imports were $372 million, about 23 percent below the previous year. Lower cigarette exports were the main factor in the declining tobacco trade surplus.

The proportion of imported tobacco used in U.S. manufactured cigarettes has a significant impact on tobacco growers. Imported leaf for cigarettes consists of flue-cured, burley, and Oriental leaf types. Flue-cured and burley imports are generally of lower quality and price than those varieties produced in the U.S. and are substituted in blends to reduce manufacturing costs.

In 1998, imported leaf made up 43.4 percent of U.S.-manufactured cigarettes, compared with 44.8 in 1997—the highest level ever. The import share of the blend began rising in the early 1990's, along with the popularity of discount cigarettes that use greater proportions of imported leaf to reduce costs. Since inception of the Tariff Rate Quota (TRQ) for tobacco leaf in 1998, imports have risen because the TRQ is high enough that it does not constrain imports. Furthermore, leaf that is imported and subsequently exported in the form of products is subject to a refund of most of the duty. Previously, U.S.-manufactured cigarettes could contain no more than 25 percent imported leaf.

Tobacco Program Quotas & Price Supports

The USDA tobacco program is designed to stabilize and enhance grower incomes through a system of marketing quotas and price supports. Operating expenses of the program are paid from assessments levied on producers and buyers for each pound of tobacco sold under the program. Marketing quotas (the amount growers are allowed to sell) for flue-cured and burley tobacco are determined by manufacturers' purchase intentions, loan stocks, exports, and some discretion by the Secretary of Agriculture. Manufacturers' purchase intentions are the amount of tobacco leaf companies commit to buying before the marketing year begins. Companies are penalized if they do not purchase at least 95 percent of the amount declared in their purchase intentions. Loan stocks are the tobacco stocks held by grower cooperatives just prior to the quota determination. The export component is the average of 3 previous years' exports. The sum of these components can be adjusted as much as 3 percent, up or down, by the Secretary of Agriculture.

The national quota for a given type of tobacco is divided among growers in proportion to the share of the total quota they farm. Individual growers can market up to 103 percent of their quota without penalty. Individual grower over-marketings up to 103 percent and under-marketings down to 97 percent are carried forward to the next marketing year.

In addition to restricting the quantity of tobacco marketed, the USDA tobacco program also provides a support price (the loan rate) for each grade of tobacco. The overall support price for flue-cured and burley tobacco is the annual flue-cured and burley price support for the preceding year adjusted by changes in the 5-year moving average of market prices (omitting high and low years) and changes in the cost-of-production index. Costs include general variable expenses directly related to tobacco production. The Secretary can set the price support between 65 and 100 percent of the calculated change, as price supports vary by the grade of leaf. The weighted average of the price support for each grade within a type is equal to the overall support price for the type of leaf.

Flue-Cured Auction Sales Plummet

Flue-cured auctions for 1999 ended on November 16, 1999. Sales ran for 56 days. Producer sales at auction totaled 645 million pounds, compared with 815 million pounds in 1998. Auction prices this season averaged $1.74 a pound compared with $1.76 last year. The decline of 170 million pounds in producer sales of flue-cured leaf is a result of the sharp decline in the flue-cured effective quota in 1999—671.5 million pounds, down from 819.6 million pounds in 1998. Cash receipts for flue-cured growers are expected to be 22 percent below last year's.

Hurricane Floyd interrupted the 1999 marketing season, and flue-cured tobacco sales were cancelled for 1 week in late September. Ultimately, much of the damage caused by the hurricane and subsequent flooding was to tobacco that had already been purchased and was being processed or in storage. Cooperatives purchased 136.4 million pounds, 21 percent of the sales. Last year, 82.4 million pounds (10 percent) went under loan.

Flue-cured quality in 1999 suffered from hot, dry weather in much of the production area from the time of transplanting until early June. In addition, a third of the Georgia crop was damaged by tomato-spotted-wilt virus. U.S. flue-cured production is estimated at 658 million pounds.

Use of foreign-grown flue-cured leaf and stems declined in 1998/99. On July 1, 1999, stocks of foreign-grown flue-cured were 16 percent lower than a year earlier. Stocks declined as cigarette manufacturers reduced cigarette leaf imports, drawing down stocks of foreign leaf instead.

Burley Crop Down Slightly

The December 1 forecast of the 1999 U.S. burley crop is 545.4 million pounds, down about 8 percent from last year. Quota cuts reduced planted acres. Moisture was adequate during the spring, but extremely dry weather during late July and August lowered yields. Yields for the 1999 crop are expected to decrease slightly from last season.

Tobacco Production Contract Proposal

Prior to the 1999 marketing season, Philip Morris proposed a system of contract purchases for leaf tobacco. The company presented the plan as a way to ensure the availability of U.S.-grown leaf of the type and quality it requires to manufacture cigarettes. It offered to buy, under a 3-year rolling agreement, all the tobacco a grower could produce at a predetermined price based on stalk position, grade, and quality. Philip Morris would communicate with the grower regarding quality and ways to increase farm productivity. Included was the firm's commitment to enter into contracts with large and small growers in all flue-cured and burley production areas. Warehouse owners would be compensated for receiving and processing tobacco produced under contract.

The proposal was dropped after growers indicated a strong preference for the current auction marketing system. However, given trends in other commodities, contracting arrangements for leaf tobacco may receive further consideration in the future.

The future of the tobacco program under production contracts would be uncertain. Tobacco sold in this way bypasses the price support components of the program. Price support is only available to growers who sell at auction. Growers remaining in the program could be burdened with larger no-net-cost assessments if costs of maintaining large loan stocks were spread among fewer growers.

WINDOW on the PAST

Excerpts from USDA publications

The World's Exhibit of Leaf Tobacco at the Paris Exposition of 1900

The cultivation and manufacture of tobacco has become an industry of great importance to every civilized country of the world. Few products of the soil contribute more to the support of the Government than tobacco, and this applies to most countries whether producing or importing. At the world's exhibit in Paris, where all the countries were invited to display the resources and products of their soil, at least thirty countries placed on exhibit leaf tobacco, hoping by this contest to extend their trade and create new demands for their leaf. . . .

Among the leaf-tobacco exhibits most worthy of note may be mentioned those of the Dutch East Indies (Sumatra, Borneo, and Java), Cuba, Mexico, Brazil, Turkey, Italy, Japan, France, Germany, Russia, Hungary, Bosnia and Herzegovina, Greece, Servia, Canada, and the United States of America. . . .

The collective exhibit made by the Department of Agriculture of the United States may justly be considered the largest and most comprehensive display of leaf tobacco ever gotten together . . . a collection of nearly 2,000 samples was prepared and exhibited.

Yearbook of Agriculture, 1900

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Marketings in 1999/2000 are forecast at about 536 million pounds, compared with 589 million a year earlier. The effective quota of 690.1 million pounds will likely be under-produced by less than 25 percent, compared with a shortfall of nearly 40 percent last season. Since 1985, marketings have consistently fallen short of the effective quota, especially in Tennessee. Beginning in 1991, the quota law was changed to permit greater use of burley quota, including belt-wide sales of burley quotas within counties, and lease and transfer of quotas across county lines in Tennessee. These changes make it easier for quotas to be aggregated into economically feasible operations.

U.S. auction sales began on November 29 and were open for 13 sales days before the Christmas break. During the first 8 days, 235 million pounds were sold for an average price of $1.90 per pound. Loan takings were 76 million pounds, or 33 percent of producer marketings. The 1998 crop sold for an average $1.903 per pound, up 1.8 cents per pound from the previous marketing year's $1.885. In 1999, price supports will average $1.789 per pound for all burley grades, a gain of 1.1 cent per pound. The no-net-cost fee (an assessment paid by growers and buyers to cover costs of the price support programs) is 3 cents per pound each for growers and purchasers. Burley producers, like flue-cured growers, will likely face a cut in cash receipts.

Domestic use of U.S. burley in 1998/99 is expected to slide about 8 percent from 1997/98 to about 350 million pounds, a much smaller decline than the previous year's. About 63 percent of the crop will be used for domestic cigarette production, 34 percent exported, and the remainder used for other products, primarily smoking tobacco. Lower cigarette output and reduced leaf exports contributed to the decrease in use. Carryover of U.S.-grown burley is expected to rise about 6 percent as marketings exceed use. For the 1998/99 marketing year, exports should total 168.7 million pounds, just above 1997/98, but short of the previous year's record 209.5 million pounds.

The November 1998 tobacco settlement between cigarette manufacturers and state attorneys general is having a significant effect on tobacco growers. Cigarette manufacturers increased prices to cover costs of the settlement, driving consumption down. Declining cigarette consumption caused manufacturers to reduce cigarette production and purchases of leaf. Unless higher exports or reduced imports of leaf compensate to maintain total use of tobacco, the USDA tobacco program will automatically stabilize the market by reducing marketing quotas for growers, preventing an oversupply which would drive prices down. Although prices are steadied for the next year, nothing can compensate for the underlying slide in overall demand for leaf and the inevitable reduction in grower incomes in the longer run. AO

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Upcoming Reports—USDA's Economic Research Service

The following reports will be issued electronically on dates and at times (ET) indicated.

January

12 World Agricultural Supply & Demand Estimates (8:30 am)
*13 Oil Crops Outlook (4 pm) ***
*Rice Outlook (4 pm)***
*14 Feed Outlook (9 am)***
*Wheat Outlook (9 am)***
*20 Sugar & Sweeteners**
25 U.S. Agricultural Trade Update (3 pm)
*26 Livestock, Dairy, & Poultry (4 pm)***

February

11 World Agricultural Supply & Demand Estimates (8:30 am)
*14 Cotton & Wool Outlook (4 pm)***
*Oil Crops Outlook (4 pm)***
*Rice Outlook (4 pm)***
*15 Feed Outlook (9 am)***
*Wheat Outlook (9 am)***
*22 Agricultural Outlook**
24 Outlook for U.S. Agricultural Trade (3 pm)
*28 Agricultural Income & Finance**
29 U.S. Agricultural Trade Update (3 pm)
*29 Livestock, Dairy,& Poultry (4 pm)***

*Release of summary, 3 p.m.
**Available electronically only

Looking ahead in 2000...

* China's accession to the World Trade Organization
* Biotechnology and its effects on grain marketing
* Retrospective: farm policy in the 20th century
* Issues for the wheat industry in the 21st century

...in upcoming issues of *Agricultural Outlook*