

Commodity Spotlight



National Cotton Council

U.S. & World Cotton Markets Diverge in 1998/99

The U.S. and the foreign cotton sectors face divergent circumstances in the 1998 season, and the marketing year (August-July) has begun with an unusually wide gap between U.S. and world prices. Adverse weather, the Asian crisis, and U.S. and foreign government policies on cotton are among the factors affecting U.S. production and exports in 1998/99.

With U.S. stocks shrinking and with foreign stocks outside of China expected to grow, the price premium for U.S. over foreign cotton has jumped. Moreover, government payments to encourage use and exports of U.S. cotton—under domestic Step 2 of the cotton marketing loan program—have soared, and funds are likely to be depleted well before potential reauthorization in 2002.

U.S. Crop To Shrink In 1998/99 Season

For the U.S., the 1998/99 outlook continues the trend toward smaller acreage planted to cotton. This trend is a result of the most recent U.S. farm legislation, currently in its third year, which allows producers greater flexibility to plant the crops they choose in response to market signals. Producers have sought to limit

their risk, given cotton's relatively high cost of production. As planting time approached this spring, net returns for some competing crops looked more favorable than for cotton in many areas of the Cotton Belt, signaling a need to plant fewer acres to cotton.

USDA's *Prospective Plantings* report, released in March, had indicated farmers' intentions to plant 13.2 million acres to cotton this season, 4 percent below 1997/98 and 22 percent below the recent high in 1995/96. However, cool, wet weather in California and dry conditions in Texas during planting time slashed cotton area further. In the June *Acreage* report, USDA indicated that cotton area planted—and to be planted—totaled only 12.9 million acres this year, 6 percent below 1997/98.

The U.S. Cotton Belt stretches across the southern-tier States and is usually divided into four major producing regions (West, Southwest, Delta, and Southeast). Although each region's cotton acreage is below 1997/98, the degree of decline varies. Based on USDA's August *Crop Production* report, declines ranging from 3 to 18 percent are projected for the cotton-producing regions.

The largest percentage decline projected for this season is in the West, where a cool, wet spring delayed planting and kept some intended cotton acreage from being planted at all. USDA's National Agricultural Statistics Service (NASS) projected area at 1.2 million acres in August, a drop of more than 18 percent. NASS estimated that the West would produce nearly 2.6 million bales in 1998/99, suggesting an average yield for the region of 1,021 pounds per harvested acre, both well below normal.

The Southwest plants and harvests the largest share of cotton area. However, drought conditions in Texas and Oklahoma have limited plantings this season, and the continued lack of moisture is likely to force large acreage abandonment. Planted area for the Southwest was projected in August at 5.5 million acres, only 5 percent below last season. However, the harvested area projection is only 3.4 million acres. In addition, the production estimate of 3.3 million bales is well below the region's 5-year average of 5 million bales and the lowest output since 1989.

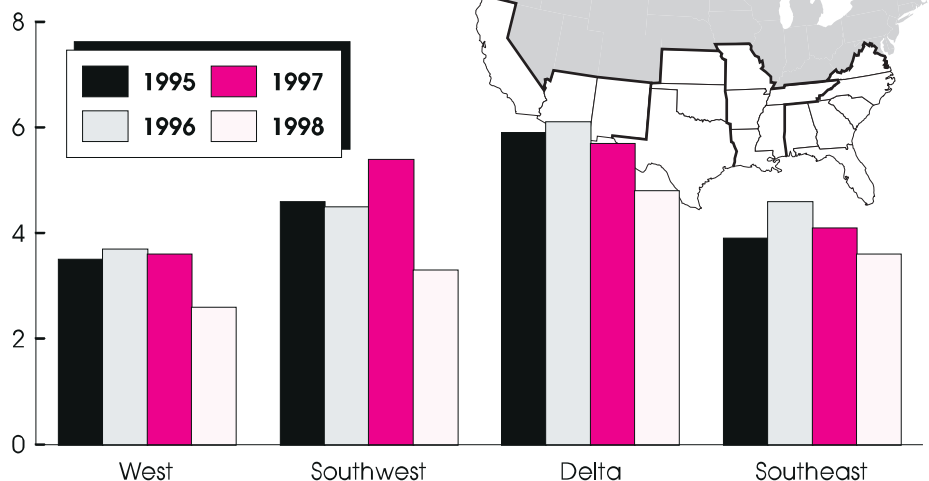
In the Delta, the largest producing region by volume, cotton area has declined continuously since enactment of the 1996 farm legislation, reflecting the expansion of alternative crops in the region. NASS projected planted area at 3.1 million acres, about 9 percent below a year earlier. But with better growing conditions than in the West or Southwest, the Delta is projected to have above-average yields—747 pounds per harvested acre—and is expected to produce a crop of 4.8 million bales this season.

In the Southeast, where cotton area has remained relatively stable since 1996, plantings are projected at 3 million acres. Despite some weather-related problems of its own, the Southeast is projected to produce a crop of 3.6 million bales, equal to the 5-year average but implying a below-average yield of 585 pounds per harvested acre.

Based on the August *Crop Production* report, USDA currently projects this season's total output at 14.3 million bales, well below the 19-million-bale crops of the past 2 years. The national yield is

U.S. Cotton Production To Drop Sharply

Million bales



One bale equals 480 pounds. 1998 forecast.
Economic Research Service, USDA

forecast near the 5-year average, at 640 pounds per harvested acre, while the U.S. harvested area is projected at only 10.7 million acres.

With U.S. production significantly below the previous two seasons, beginning stocks near last year's 4 million bales, and imports forecast at 100,000 bales, cotton supplies for the 1998/99 season are currently projected at 18.3 million bales, 20 percent below 1997/98. As a consequence of tighter U.S. supplies, in addition to steeper competition from abroad, U.S. cotton exports are expected to be constrained this season.

As of August 12, USDA forecasts domestic mill use at 10.8 million bales during 1998/99, compared with 11.35 million bales last season, as the recent slowdown in cotton use is expected to continue in the near future. Factors likely to limit mill use this season are slower growth in the U.S. economy and the continued influences of the Asian crisis, which has provided relatively cheap cotton textile and apparel imports into the U.S. Liberalization of textile trade under the North American Free Trade Agreement has also contributed to increased imports.

Although U.S. cotton textile exports have risen this year, they have not kept pace with imports. Meanwhile, U.S. exports of

raw cotton are expected to take the brunt of the decline in 1998/99 and are projected at only 4.9 million bales, 35 percent below last season. The 2.6-million-bale decline in raw cotton exports is attributable in part to the loss of U.S. production in areas that typically provide cotton for the export market. Other factors are the financial problems across Asia and an anticipated increase in foreign competition, particularly from China.

Asian Consumers Reeling

The decade's most rapidly growing economies have sustained a severe setback as a result of the Asian crisis, and world cotton demand has suffered. At the same time, China appears poised to exchange its place as the world's largest importer of the last few years for a position among the world's largest exporters. These two developments have tended to depress world cotton prices and have contributed to the large disparity between U.S. and world prices.

Clothing is a semidurable good, and like true durable goods (e.g., cars and appliances), its purchase can be deferred at a given time while consumers rely on earlier purchases (unlike the purchase of food and many services). While Korea's urban consumer expenditures fell 9 percent in the first quarter of 1998, pur-

chases of durable goods fell 39 percent. Garment sales have reportedly fallen less than car sales, but perhaps as much as household appliances. In Southeast Asia, the contraction of GDP and consumer spending has been even more severe, and substantially larger declines in clothing purchases are likely.

Together, consumers in Southeast and East Asia could cut their purchases of cotton-containing products by 1 to 1.5 million bales during calendar 1998, the equivalent of about 1.4 percent of world consumption. Since income prospects in the region have been reduced for the foreseeable future, cotton consumption is not expected to rebound fully. This has exerted a negative influence on world cotton prices. While developed economies other than Japan are expected to continue expanding in 1998 and 1999, the increased demand will be more than offset by Asia's loss.

China's shift from net importer to net exporter of cotton has also depressed foreign prices. China vaulted to the position as the world's largest importer in the mid-1990's as policymakers encouraged imports to rebuild stocks and help tame soaring inflation. Now, China's economy may be undergoing deflation, and the years of high imports and large cotton crops appear to have driven stocks uncomfortably high.

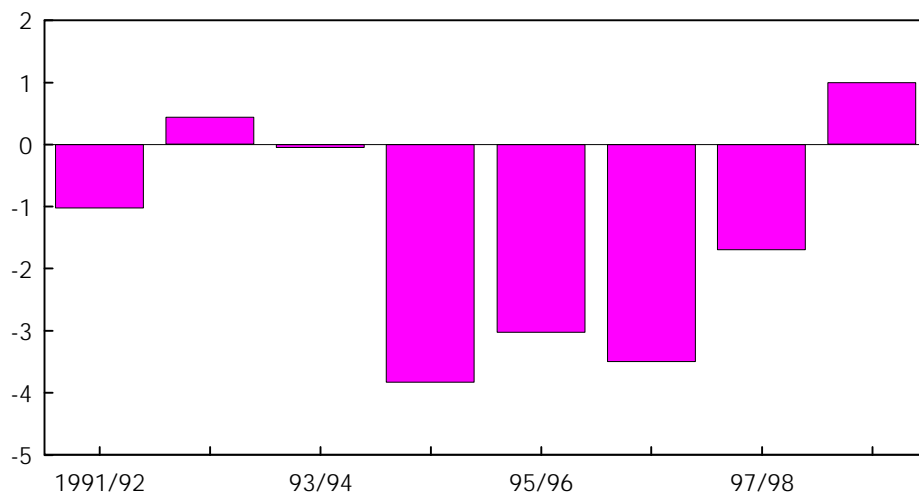
The precise levels of China's production, consumption, and stocks are subject to wide debate in the cotton trade. But there is no question that China began restricting imports at the beginning of 1998, and during April 1998 it announced a large export tender.

While a second export tender was in effect withdrawn, China has announced an unprecedented cut in the government procurement price for 1998 crop cotton and the withdrawal of a price floor for procurement in Xinjiang Province, traditionally China's main exporting region. China's cotton procurement prices have been above world levels in recent years, so that exports would likely have required subsidies. This year's freeing of procurement prices in Xinjiang while freeing prices to end-users throughout China may open the way to exporting without exposing China to

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China's Net Exports of Cotton Rebound

Million bales



One bale equals 480 pounds. 1997/98 estimated; 1998/99 forecast.

Economic Research Service, USDA

charges of “dumping” cotton. Since China is not a member of the World Trade Organization (WTO), the validity of any dumping charges would be resolved bilaterally rather than through the dispute settlement mechanism of the WTO.

China's *imports* seem largely restricted to coastal mills that are joint ventures with foreign investors and that meet strict regulations mandating re-export of products made with imported cotton. But it seems likely that larger amounts of cotton will be available for *export* once adequate crop prospects are secure.

Exhaustion of Step 2 Funding Could Further Erode Demand

The 1990 farm legislation provided a mechanism—the Step 2 program—for keeping U.S. cotton competitive on the world export market as well as encouraging domestic mills to use U.S. cotton instead of importing cheaper foreign cotton. The Step 2 program is now an integral part of the upland cotton marketing loan provisions of the U.S. cotton program. But Step 2 funding for compensating domestic mills and exporters is close to depletion.

Step 2 provides a 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 is more than 1.25 cents per pound above the weekly average of the five lowest price quotations offered (A-Index). In addition, the adjusted world price (AWP) must be no more than 30 percent above the per-unit government loan rate available to cotton farmers (AO July 1997). On October 1, 1998, the 30-percent threshold will be raised to 34 percent.

The 1996 farm legislation limited Step 2 expenditures to \$701 million during the period FY 1996 through 2002. As the end of FY 1998 approaches, well over half of the budgeted amount for the 7-year period has already been spent, and the balance is expected to be depleted in FY 1999.

Early depletion of the Step 2 funds is the result of several concurrent developments last season. With U.S. prices already above world prices by the start of 1997/98, Step 2 payments averaging about 1.5 cents per pound were in effect from August 1997 through January 1998.

By the spring of 1998, the price gap widened as U.S. planting delays associated with weather problems diminished crop prospects and increased U.S. prices. Meanwhile, world prices declined as a result of the Asian crisis and of China's large offering of cotton for export.

Consequently, Step 2 rates increased, averaging 5 cents during February-April 1998, and rising to 7 cents in May. With the continued decline of the U.S. cotton crop, especially in Texas, and with prospects for a large foreign crop underway, the Step 2 rates jumped dramatically, averaging more than 11 cents per pound in June and July, with the rate peaking at 13.5 cents for the week of July 3-9.

The Step 2 program cost nearly \$400 million in 1997/98, and the program functioned as intended by keeping U.S. cotton competitive. Estimates of increased demand resulting from Step 2 last season ranged from 300,000 to 650,000 bales. The increased demand kept U.S. stocks from rising in 1997/98 and U.S. average farm prices held near 65 cents per pound for the season.

As the 1998/99 season begins, the gap between U.S. and world prices is still wide, but prices are more closely aligned, and Step 2 rates have fallen to about half the rates seen in June and July. Despite the lower rates, the funds allocated for the Step 2 program are expected to be depleted sometime this season. The timing of the program's termination will depend on the level of future payment rates, the pace at which domestic mills use upland cotton, and the pace at which exporters ship the cotton to foreign markets.

Given the program's imminent demise, demand is expected to increase during the first part of the season to capture these payments. But if additional funding for the program does not materialize, domestic and foreign demand for U.S. cotton is expected to weaken in the short term.

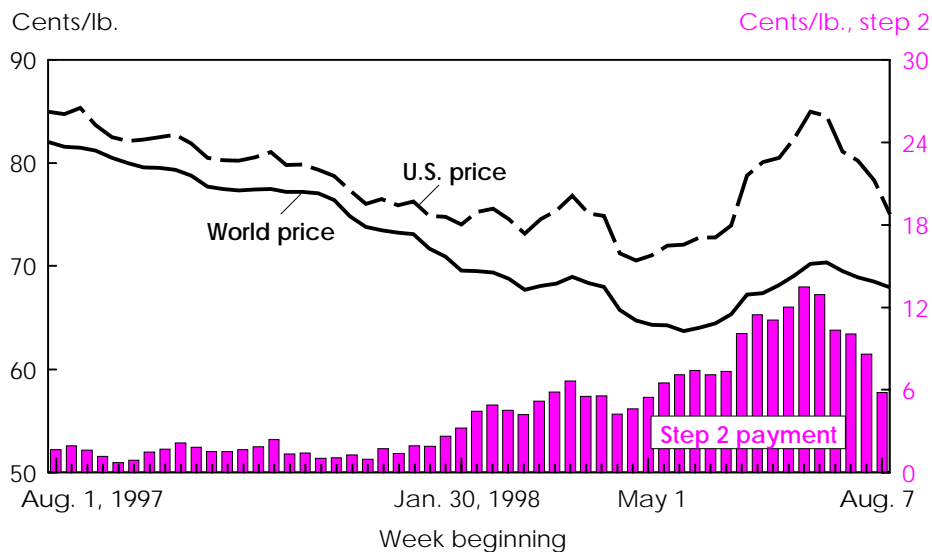
Shortly after the Step 2 program is terminated, special import quotas would likely be triggered under Step 3 if U.S. cotton prices remain above the rest of the world. Step 3, which effectively raises quotas for imports at low tariff rates, ensures the U.S. textile industry access to competitively priced cotton. The program is authorized when, for 10 consecutive weeks, the U.S. price on the world market remains more than 1.25 cents per pound above the average of the five cheapest quotations offered (A-Index), after subtracting any Step 2 rate from the previous week.

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However, the opening of Step 3 quotas does not necessarily result in large quantities of U.S. cotton imports. Ordinarily, the price of domestic cotton to U.S. mills is lower than imported fiber because of relative costs of transportation; in addition, U.S. cotton may command a premium due to quality, reliability, and the efficiency of “just-in-time” delivery. Therefore, tariff reduction by itself will not generate significant cotton imports. The magnitude of the price gap between the U.S. and the foreign source (including transportation costs) will be crucial, as well as the domestic availability of specific qualities of cotton that might be imported. Many variables, both in the U.S. and overseas, will be at work to determine the competitiveness of U.S. cotton.

Despite a potential setback in demand for U.S. cotton this season, the forecast decline in U.S. production exceeds the drop in demand—stocks at the end of 1998/99 are projected to decrease from the beginning level. The latest estimate places U.S. ending stocks at 2.6 million bales, just under the 1995/96 level and the lowest since 1990/91.

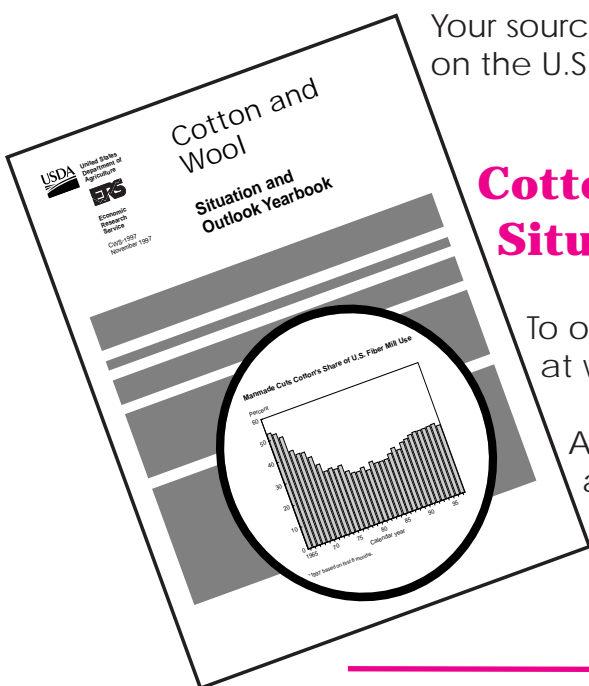
Gap Between U.S. and World Cotton Prices Widened in Spring 1998



World price (A-Index), and least expensive U.S. cotton quote offered in Northern Europe. Source: Foreign Agricultural Service, USDA. Economic Research Service, USDA

While it is still early in the 1998/99 season, the outlook for cotton prices and U.S. competitiveness this year and the implications for 1999/2000 may well be determined over the next several months.

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



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