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GOVERNMENT MEASURES AFFECTING COTTON PRODUCTION AND TRADE*

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Structural Change Leading to Lower Prices

The price of cotton is tending downward over the long run. This is a phenomenon common to many primary commodity industries and results naturally and inevitably from market forces in a competitive world economy. If inflation is considered, cotton prices have been falling since the 1950s. The ICAC Secretariat estimates that average cotton prices are likely to be between 50 and 60 U.S. cents per pound this decade, 10 to 20 cents per pound lower than the average of the last thirty years. Consequently, strategies to assist African producers in expanding employment and income derived from cotton production and processing will need to focus on improving efficiency to lower costs of production, improving quality to ensure competitiveness with other cotton producers, and also expanding the quantity produced.

Three fundamental market factors are influencing shifts in the level of world cotton supply and demand: 1) improved technology, 2) expanded production in new cotton areas, and 3) competition with polyester. In addition, government measures that distort production and trade force the burden of adjustment to lower prices onto producers in countries that cannot afford subsidies. Therefore, any strategy to assist African producers must include support for a successful outcome to the talks on agriculture in the Doha Round of the WTO discussions that leads to a reduction in measures that distort production and trade.

Technology

The most visible of the new technologies is genetic engineering. GE varieties already account for 21% of world cotton area and about one-third of world production and trade. GE technology is primarily risk-reducing and cost-reducing, leading to larger area and greater production. Production in East China, affected in the early 1990s by resistance among bollworms, climbed about 300,000 tons between 1999/00 and 2000/01 largely because of the adoption of Bt varieties, and GE varieties in China are now planted on 60% of cotton area. GE varieties account for about 30% of area in Australia, three-fourths of area in the USA, and field trials are underway in other producing countries. GE cotton varieties will probably account for half of world production by 2007.

Incremental advances in proven technologies such as irrigation management, pesticide formulations and pesticide applicators, low till and no till production systems, crop rotations and other management techniques are also contributing to lower production costs and expanded cotton production.

New Area

The development of new areas for cotton in Brazil, Africa and Turkey are contributing to the rise in world production. Production costs in Mato Grosso are estimated well below the world average, and production has climbed from 30,000 tons to 600,000 tons in Mato Grosso since the mid-1990s. Production in the Currency of Francophone Africa (CFA) zone of Africa has approximately doubled since 1994. The

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expansion of irrigation in East Turkey is well documented, and the GAP region now accounts for 500,000 tons of production, compared with 164,000 tons in 1994/95 when the Cotlook A Index averaged more than 90 cents per pound. Together, Mato Grosso, the CFA zone of Africa and East Turkey are accounting for an additional 1.4 million tons of world cotton production representing 7% of the world total that is still expanding and that did not exist in 1994/95.

Polyester

Competition with polyester is an insidious challenge to the cotton industry that is accelerating as fiber production technology results in lower costs of polyester production and an increased range of uses for chemical fibers. Cotton's share of world fiber use exceeded 60% in the 1960s, fell to 50% during the 1980s and currently stands at 39%. While cotton use is rising in absolute terms, the rate of increase averages just 1% per year, compared to world population growth of 1.7% per year, resulting in reduced consumption per capita and declines in market share. Research by the ICAC indicates that the rate of increase in world cotton mill use declines by approximately 1% for every increase of about 6 cents per pound in the price of cotton relative to prices of competing fibers. As the cost of production of polyester has fallen to less than 50 cents per pound mill-delivered in the past ten years, cotton prices are being forced lower over the long run in order to compete.

Outlook for 2004/05

Within a long term trend of declining real prices and average prices of between 50 and 60 cents per pound forecast for this decade, the cotton industry is currently experiencing strong demand linked to record imports by China (Mainland) resulting in relatively attractive prices for producers. However, production will respond to current high prices, resulting in lower prices over the next several years.

Net imports by China (Mainland) are skyrocketing from essentially zero two seasons ago, to 680,000 tons in 2002/03, and to an estimated 1.85 million tons this season, the highest ever. Imports by China (Mainland) alone are accounting for one-fourth of world trade in cotton this season. Because of strong imports, the average Cotlook A Index is expected to be 71 cents per pound in 2003/04, compared with 58 cents last season and 42 cents two seasons ago. China (Mainland) is expected to import 1.5 million tons in 2004/05, down 350,000 tons from the current season, but still substantial.

The rise in prices this season is leading to increased world production in 2004/05. Planting in the Northern Hemisphere is now largely completed, and world cotton area is expected to rise by 6% to 34 million hectares in 2004/05, the highest since 1995/96. World production is forecast at 22.1 million tons, up 1.6 million tons from this season, and the second largest crop on record. Part of the increase in production will be in China (Mainland), and imports by China are expected to decline to 1.5 million tons, still substantial, but down from this season.

With rising production and reduced demand, the Cotlook A Index is expected to average 65 cents per pound in 2004/05, down six cents from the average anticipated for the current season.

Government Measures Distort

Agricultural industries are among the most distorted markets in the world economy, and direct income and price support provided to the cotton industry accounts for about 1% of subsidies provided to agriculture in OECD countries. In 2001/02 government measures supporting cotton totaled $5.8 billion worldwide, equivalent to about one-fourth of the value of world cotton production. Government support for cotton production declined to $3.8 billion during 2002/03, equivalent to about one-seventh of the value of world production. And, in 2003/04, government measures in cotton declined to an estimated $3.4 billion, equivalent to about one-tenth of the value of production this season. The lower levels of government expenditure during 2002/03 and 2003/04 are the result of program formulas driven by lower production and higher market prices, not because of changes in government programs or policies. Should market prices turn lower again in future seasons, government spending in support of cotton under current policies will automatically rise.

The ICAC Secretariat estimates that U.S. cotton production would be reduced by between one-fourth and one-third in the absence of the U.S. cotton program, and production in the EU would probably drop by three-fourths without the income support program. China (Mainland) is also known to support domestic prices above market levels, and a withdrawal of subsidies would probably result in a significant decline in production. Mexico, Brazil, Egypt and Turkey also have modest programs that support cotton farmers. In the absence of government measures, world production would still be large enough to satisfy demand, but the location of production would shift from countries that provide subsidies to countries that do not. Further, during years of declining prices, the responsiveness of supply to reduced demand would be greater in the absence of government measures, meaning that the reductions in supply necessary to balance demand during years of slow economic growth would be spread over all countries rather than just among those subject to market forces.

Direct income and price support expenditures on cotton by the U.S. government were $3 billion in 2001/02. New legislation came into effect in 2002, and the 2002 farm bill determines the levels of support for the U.S. cotton industry through 2007. Total direct income and price support in the USA for cotton amounted to $2 billion in 2002/03 and is estimated at $1 billion this season.

Government expenditures to assist cotton growers in China (Mainland) are estimated at $1.6 billion in 2003/04, about the same as in previous seasons. Most support in China (Mainland) is in the form of high domestic prices defended by border protection.

Cotton growers in Spain and Greece are offered assistance through the EU Common Agricultural Policy (CAP). Payments under the CAP amount to about $1 billion each season.

The government of Egypt provided between $23 million and $33 million a year to cotton growers during 2001/02 and 2002/03, but support this season has been discontinued because of increases in market prices.

The Government of Turkey provided direct support payments totaling about $60 million in 2001/02 and 2002/03, but support is falling to about $20 million this season.

Support by the Government of Mexico to cotton growers is estimated at $18 million in 2001/02, $7 million in 2002/03 and $6 million this season.

In addition to production subsidies, China (Mainland) and the USA provide subsidies to exports of cotton. However, these subsidies are far smaller than the levels of support for production. Export subsidies provided by China (Mainland) and the USA amounted to $121 million in 2001/02, $316 million in 2002/03 and about $160 million in 2003/04.

Estimates by the ICAC Secretariat indicate that in the absence of government support for the cotton industry in 2001/02, market prices would have been approximately 70% higher than they were. For 2002/03, the ICAC Secretariat estimates that cotton prices would have been about 15% higher than the actual result if government measures had not supported production in some countries. The Secretariat has not completed estimates for 2003/04, but because market prices have returned to average levels, the effects of government measures on market prices this season are relatively modest.

Economists often differ in their choice of models and assumptions, and consequently different studies result in different estimates of the impacts of subsidies on prices. Nevertheless, even conservative estimates of the impact of subsidies paid to producers in the USA, Europe, China (Mainland) and elsewhere are substantial. The ICAC Secretariat estimates that losses to all producers in 2001/02 caused by lower prices linked to government measures amounted to $14 billion, and that losses during 2002/03 amounted to $3 billion.

For sub-Saharan African producers alone, the losses in income linked to subsidies to cotton production are estimated at $920 million in 2001/02 and $230 million in 2002/03. The impact of these loses to individual countries with high cotton dependency, such as Benin, Burkina Faso, Chad, Mali and Sudan was substantial.

Recommendations for Competitiveness

Producers need to respond to competitive pressures with strategies that facilitate access to inputs and appropriate technologies, expand demand, improve quality in order to better compete with other cotton producers and with synthetic fibers and reduce government measures that distort production and trade. In particular there are six areas of activity of direct benefit to African producers that might be explored.

1) Input supply has emerged as the single biggest constraint to expanded cotton production in many developing countries. Producers in developing countries tend to have below-average costs of production and could profit at market prices from expanded output. It is self-evident that inputs must be provided to farmers in advance of harvest, usually on credit. However, in countries where farmers lack collateral, where credit institutions are weak and where the private sectors are not well developed, small holders are often not able to expand production, despite economic incentives to do so. A number of national, regional and international initiatives are underway to address the problem of input supply. A theme common to all the projects is the strengthening of capacity in the private sector to provide quality inputs to small holders on credit in commercially sustainable systems, and I hope that this approach can be endorsed today.

2) One of the reasons that small holders often do not have access to production inputs on credit is because price risk management tools are not available or are not appropriate to domestic conditions. The CFC and The World Bank are funding risk management projects involving cotton and other commodities in developing countries to alleviate this constraint, and sustained efforts in risk management are necessary.

3) There is an emerging international consensus that instrument-based quality evaluation systems are superior to traditional hand-classing methods for cotton, but these systems are expensive and involve the operation of complex instruments in air-conditioned environments with trained personnel. African countries need assistance with the adoption of new cotton classing technologies to enable them to compete in the international marketing of cotton.

4) Slow growth in demand caused by competition with synthetics reduces the income potential from cotton production. In order to strengthen the market for cotton, the ICAC is encouraging all countries to require fiber content labels in all textile products sold at retail. There is abundant research showing that when consumers are aware of fiber content, they consistently choose cotton products. However, only 59 out of 166 countries recently surveyed have laws requiring that fiber content be labeled in products sold at retail. Consequently, many consumers are not able to readily identify the fiber content of products offered for sale in their countries, thus inhibiting efforts to boost retail level demand for cotton. The support of the international community to require fiber content labeling of products sold at retail can help to boost demand for cotton.

5) Institutional support for the ICAC, and other International Commodity Bodies (ICB's), can also help to strengthen commodity markets. In a liberalized world economy, some governments are questioning the importance of commodity industries and re-evaluating the worth of membership in international commodity bodies. ICB's assist governments in facilitating healthy commodity economies. Together with UNCTAD, the CFC and FAO, ICB's, raise awareness of commodity problems, provide scientific and statistical information critical to decision making and facilitate cooperation between governments and industry segments on issues of shared concern. The support of the international community in encouraging governments to maintain their memberships in ICB's can be of significant benefit to commodity economies.

6) Finally, the most constructive effort the international community can make at this time is to ensure that the talks on agriculture are a priority in negotiations within the WTO. At its most recent plenary meeting in Poland in September 2003, the ICAC strongly supported a successful outcome to the talks on agriculture and other topics being conducted under the auspices of the WTO. The overwhelming majority of member governments reaffirmed the negative impacts of subsides and other government measures on cotton production and trade affecting cotton farmers, especially in the developing and least developed countries, and urged that all government measures and subsidies on cotton be removed. The international community can advance the interests of agricultural trade liberalization by articulating a positive program of mutual benefit within the talks on agriculture being conducted under the auspices of the WTO.