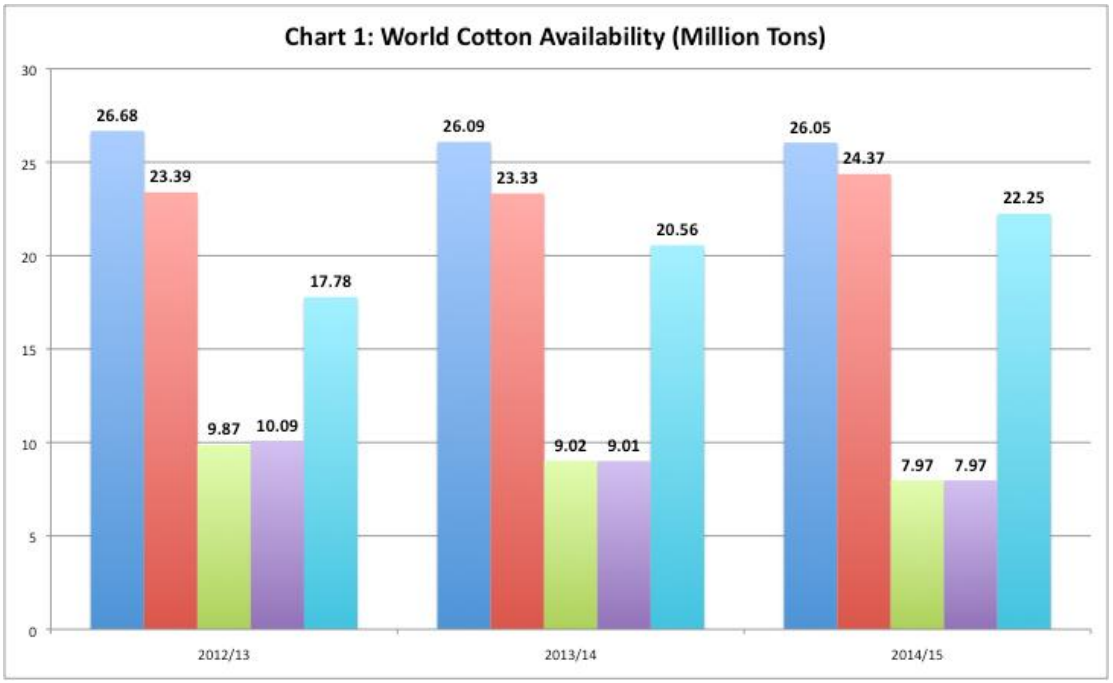
The Cotton Conundrum

C.P. Chandrasekhar and Jayati Ghosh

In a relatively underreported sequence of developments the demand-supply balance in the world's raw cotton trade has shifted towards excess supply, driving down prices and hurting exporters. Underlying this trend is an unusual situation with regard to the global production and exports of raw cotton. China, the world's leading producer of raw cotton is not among the leading exporters of the fibre. The two leading exporters are India and the United States, which rank second and third on the production league table. But even among them, India has witnessed a dramatic reduction in exports. Thus, though major producers, China and India absorb domestically much of their production and export little or none, whereas countries such as the United States, Brazil, Uzbekistan and those in West Africa such as Benin, Burkina Faso and Cameroon export much of their production. Exports from the African Zone rose from 2 million tons in 2010/11 to 3.8 million tons in 2013/14.

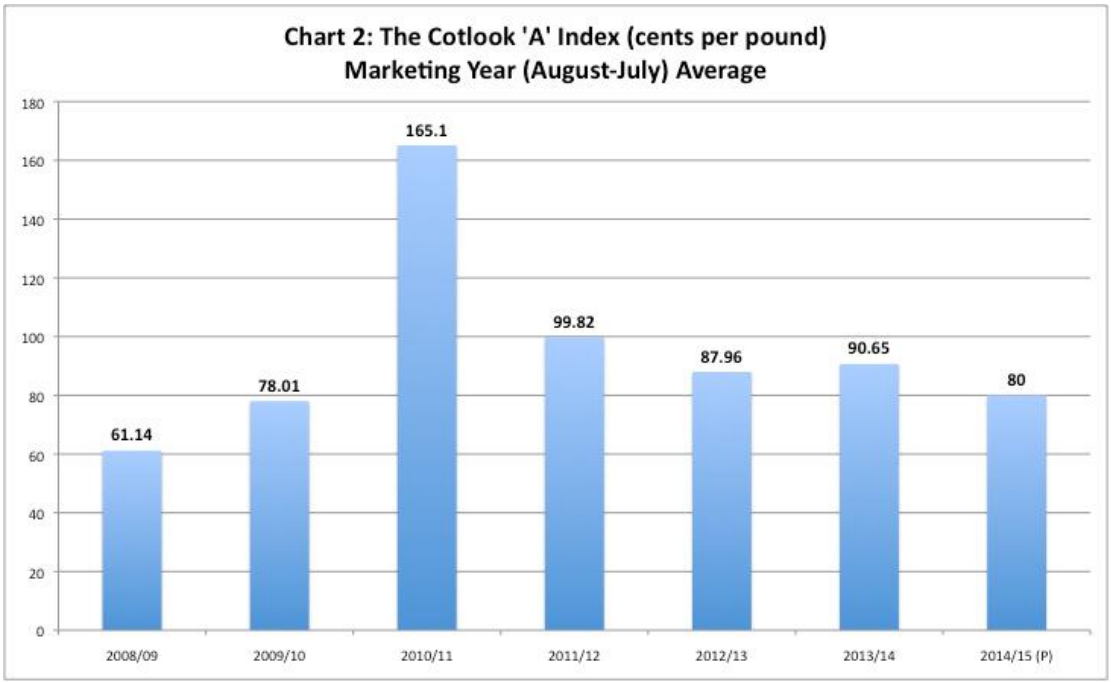


Overall, the growing concentration of textile production in developing countries has resulted in a situation where developing countries are the principal consumers of raw cotton. In 2012/13, developing countries accounted for 96 percent of global cotton mill use, 97 percent of imports, and 81 percent of production, but only for 52 percent of global cotton exports.

The fact that China and India, the leading producers, absorbed much of their domestic production meant that the exporters of cotton were spared of two major sources of competition in global trade. And as India's exports began to decline, that competition was declining even further. Moreover, globally cotton stocks have been at high levels and have risen from 18 million tonnes in 2012/13 to 20 million tonnes in 2013/14 and an estimated 22 million tonnes in 2014/15. This willingness to hold stocks has meant that production remained high and ensured that prices are low and stable.

However, there are other challenges that still confront small producers and exporters like Brazil and the African countries. The first is that global production has in recent years been consistently above the volume of raw cotton use or consumption. According to the International Cotton Advisory Council (ICAC), 2014/15 would be the fifth consecutive

marketing year when global cotton production exceeds consumption. Though production is expected to decline by 400,000 tonnes in that year to 26.05 million tonnes, and consumption to rise by 4 per cent, the latter would touch only 24.4 million tonnes, resulting in a surplus of 1.7 million tonnes. Consecutive years of surplus had already taken the cumulative excess of consumption over production between 2010/11 and 2013/14 to 12.3 million tonnes. That figure is projected to rise to nearly 14 million tonnes by end 2014/15.

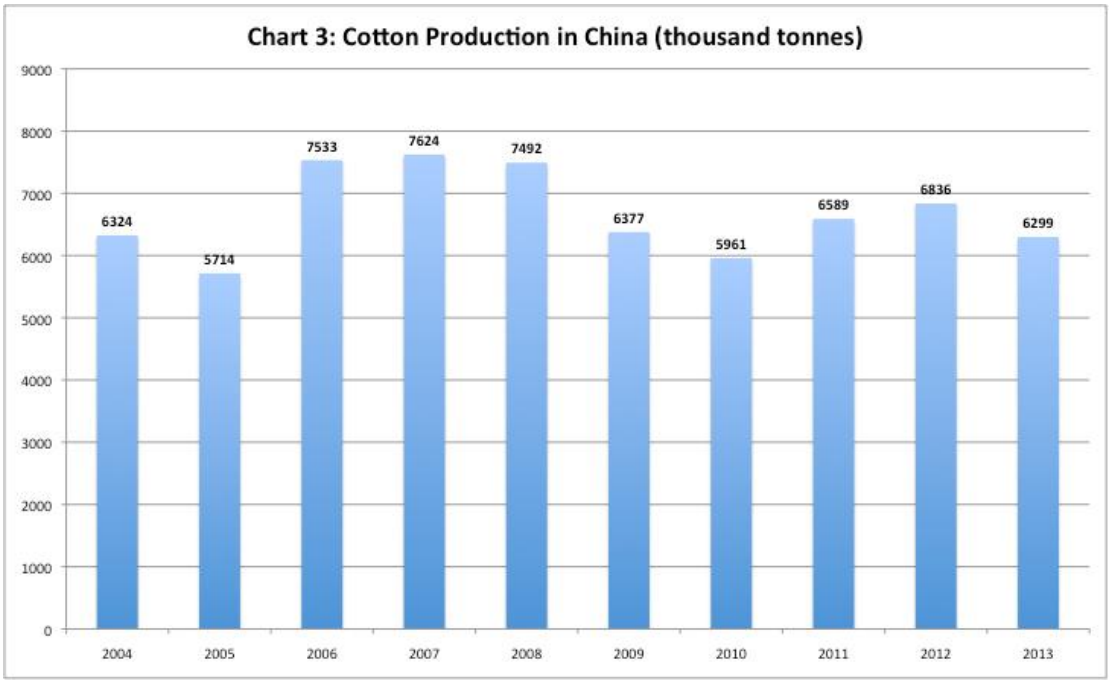


As a result of this excess supply the Cotton "A" Index, a proxy for the world price of cotton computed by the National Cotton Council of America, which rose to a peak of 165.1 cents per pound in 2010/11, fell to 99.82 cents to the pound in 2011/12 and averaged 89.3 cents to the pound during 2012/13 and 2013/14 (Chart 2).

A second challenge is that this situation of excess supply, being partly the result of subsidies provided by the governments of leading cotton-producing countries to their cotton farmers, is not easily reversed. Subsidies that keep production much higher than it would have otherwise been are quite substantial. In 2011/12, a study by the ICAC Secretariat reported that ten countries were providing subsidies to their cotton industry. China had emerged the largest provider of support to its cotton sector in 2009/10, overtaking the United States.

To support cotton growers, especially in Xinjiang province, with a minimum support price policy and import quotas, domestic cotton prices in China were maintained well above international cotton prices. Total government support to the Chinese cotton sector was estimated at around $3 billion in 2011/12. In comparison, total support provided to the U.S. cotton sector was around USD 820 million through subsidised crop insurance. Moreover, China, which is the main destination for exports of cotton from Africa, imposes import duties of up to 40 percent on cotton imports in excess of the annual import quota related to WTO obligations.

However, the effect this would have of aggravating excess supply in the global cotton economy by enhancing the level of production, has been partly moderated by the Chinese government's policy of purchasing and accumulating stocks of domestically produced cotton to back its minimum support price policy. Over nine million tonnes of cotton were purchased from domestic producers in 2011/12 and 2012/13. This did help stabilise cotton production in China (Chart 3). Besides the objective of stabilising domestic supplies, the fact that higher domestic prices forced domestic mills to turn to imports, especially up to the WTO mandated import quota, necessitated large purchases.



By November 2013, cotton reserves held by the Chinese authorities stood at around 10 million tonnes or close to half of total global stocks. The China National Cotton Reserve Corporation had purchased another 5.5 million tonnes since the beginning of the 2013 cotton season. Rising stocks finally prompted the government to discourage imports. In 2013/14, China's total imports are estimated to have fallen by nearly one-third relative to the previous year. However, in the same year, as a result of drought, production in the US fell 25 per cent, limiting the country's exportable supply. These contrary influences on the demand-supply balance in global trade moderated the effects that China's withdrawal from the market had on world cotton prices.

But as of November 2013 the trend has been otherwise. In that month, China began to draw down its cotton stocks through sales via auction. The China National Cotton Reserve managed to sell 12,312 tonnes of cotton, or roughly half of the 24,354 tonnes on offer, for an average price of Rmb17, 737 per tonne ($2,900). The shortfall relative to the offer was because this was "old" cotton, often held in the warehouses for a year or more, and mills reportedly expressed a preference to buy fresh imported cotton. That notwithstanding, the auction triggered fears because, if China decided to accelerate stock disposal by offering large discounts on sales outside the auction route, market prices could crash.

In fact in March 2014, China announced plans to slash the prices at which it sold cotton from its reserve, bringing them close to international prices to boost demand. The result has been a downward trend in the prices of cotton futures and raw cotton. In fact, the ICAC projects that the Cotton "A" Outlook Index is likely to fall 11 per cent to 80 cents per pound during 2014/15. Since the China National Cotton Reserve would have to continue with purchases as part of its minimum support policy, and cannot afford too large a reduction in its sale prices since that would increase losses it would suffer from disposing of stocks acquired at high prices, the process of unwinding stocks is likely to continue for long. So prices are likely to remain weak till production and supplies adjust. That would be damaging for the African exporters who have already been hurt by the American subsidy policy.

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