

IMPACT OF CHINA'S POLICIES ON WORLD COTTON CONSUMPTION

Ray Butler

Cotlook Limited, Merseyside, United Kingdom

In 2010/11, as world prices ran up to unprecedented levels, China's state-held stocks were rapidly depleted as the government sought to maintain price stability. Subsequently, Beijing adopted a temporary state reserve policy to rebuild those stocks and restore what it considered to be a vital, macro-control lever in the cotton market. The consequences, some of them perhaps unintended, have included a sharp decline in China's cotton consumption, a build-up of state reserves to perhaps 1.5 times the amount used annually by Chinese mills and an increase in China's cotton yarn imports. Furthermore, China's textile industry has turned increasingly to more competitively-priced man-made fibres.

The current policy is regarded as unsustainable, and a policy change in the near future is being widely trumpeted. The nature of that change could have a far reaching impact on cotton consumption rates both within China and in those countries that have recently enjoyed increased cotton yarn export sales.

This paper gives the background to the developments described above. By the time of the Bremen conference, more may be known that will permit discussion of the changes to be expected, and their potential consequences.

DESCRIPTION AND BACKGROUND OF CHINA'S COTTON POLICY

The cotton world has been focused on developments in China since the door to economic reform was opened by Deng Xiao Ping and China's subsequent adherence to the WTO. Under China's WTO agreement, specific quota and duty arrangements were prescribed. For cotton, a standard import duty was set of 40 percent but a provision was included for an amount to be imported annually subject to a tariff of one percent. That amount has for several years been set annually at a maximum level of 894,000 tonnes.

China's cotton quotas

- **Standard 40 percent import tariff**
- **Annual tariff rated quota at one percent duty**
- **Voluntary quota, based on a sliding tariff scale from a fixed rate of 570 yuan per tonne up to 40 percent, the cheaper the imported cotton price**
- **Processing trade quota – subject to sliding-scale but effectively tariff free**

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In addition, China has exercised the right to allocate specific cotton import quotas, either for the 'processing trade' (effectively duty-free, provided the manufactured goods are exported) or subject to a sliding-scale tariff quota under a mechanism that has been amended over time.

These arrangements have remained in place in combination with a government state reserve policy, hence in principle lending the government two levers for exercising macro control of the cotton market. The stated purpose of such control has been primarily to protect the cotton farmer and rural incomes, something that has been especially important in two regards: attempting to stem the flow of population to urban centres; the political necessity of safeguarding the social structure in Xinjiang. Whether those aims have been achieved is questionable, but that is not the focus of this presentation.

China's policy aims

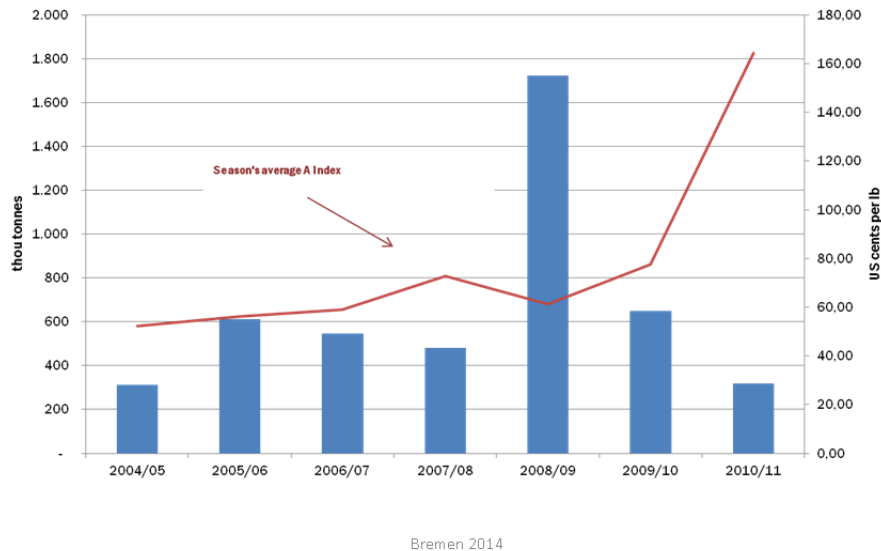
Macro control levers to maintain stable prices and thereby protect rural incomes:

- **To discourage population drift to urban centres**
- **For political reasons in Xinjiang**
- **To maintain market stability**

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From an international cotton market perspective, the fact that decisions of such significance have been in the hands of politicians, rather than a result of market signals, have sometimes placed trading decisions in substantial doubt. In general, however, the system appeared to be working satisfactorily prior to the sea change that occurred in the world cotton market in 2010/11.

State reserves prior to 2010/11



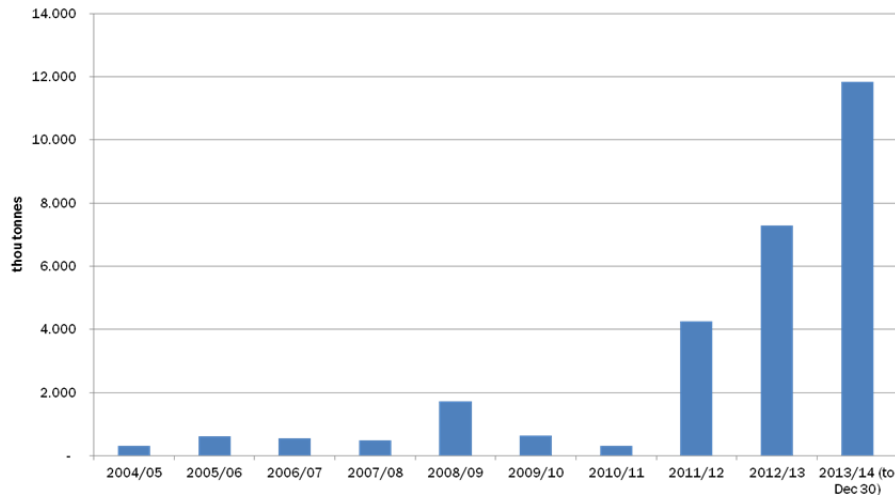
In that season, as prices ran up to unprecedentedly high levels, the Chinese government rapidly exhausted the reserve stocks to hand, thus removing one of the two key macro controls at its disposal. The imperative became to rebuild stocks, almost at whatever cost. Hence, the government inaugurated what was described as a 'temporary state procurement plan' in 2011, whereby it would procure all the current crop offered to it at a set base price (with quality differences) from gins, for later resale to mills, provided (in theory) the ginner had paid a price for seed cotton to the farmer equivalent to, or higher than, a guide price established and reviewed regularly by the China Cotton Association. However, the base price was set at a level below the international market price at the time the policy was initiated (19,800 yuan per tonne, or, at the time, slightly over 140.00 US cents per lb). The subsequent market crash, however, left China's internal price structure divorced from international values.

The state reserve policy went hand-in-hand with a more liberal quota allocation policy, and state reserve purchasing also extended to imports, partly to take advantage of lower prices, and thereby reduce the average cost of the reserves, and partly, one assumes, in an effort to shore up international values, in an attempt to lessen the price divide.

THE EFFECT OF THE POLICY

The effect of the policy in the 2011/12 season was for government stocks to rise from an estimated 320,000 tonnes to almost 4.6 million. A year later the figure was close to 7.3 million and Cotton Outlook's estimate of the current (December 30, 2013) figure (with this season's purchasing and auction campaigns in full swing) was over 11.8 million tonnes.

State reserves after the price shock

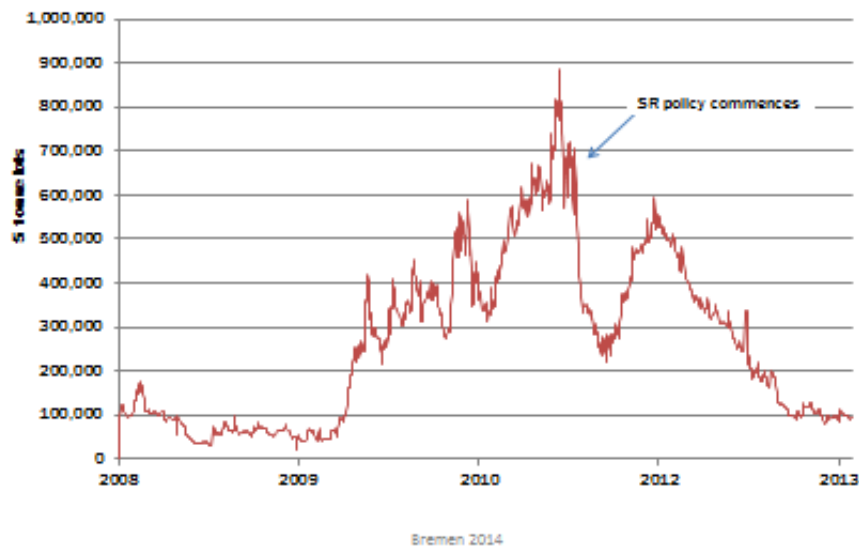


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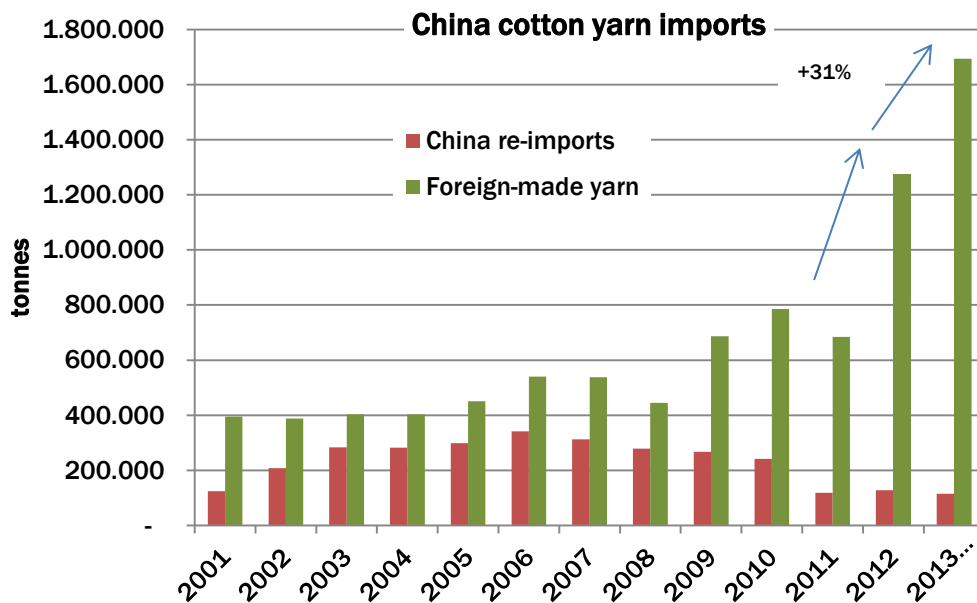
The state reserve policy has had substantial consequences, both internally and externally. Our view is that many of these were unintended by the policymakers and that their result leaves the government in an invidious position.

Firstly, there has been, and remains, a huge financial cost, not merely in financing the purchases but also in carrying the cotton (2,000 yuan per tonne per year for 10 million tonnes would be 20 billion yuan – substantially in excess of US\$3 billion) and in disposing of the reserve at a lower price when selling to mills.

ZCE open interest



Secondly, internal commercial markets have been rendered ineffective. Zhengzhou cotton futures, which reached a peak open interest of 887,158 contracts, each of 5 tonnes, on July 28, 2011, saw that dwindle to as little as 76,844 contracts by September 30 last year, since when the figure had been only briefly above 100,000 until late December. At that point, a revival of activity and open interest was witnessed, presumably as signals of an impending change in government policy grew stronger.



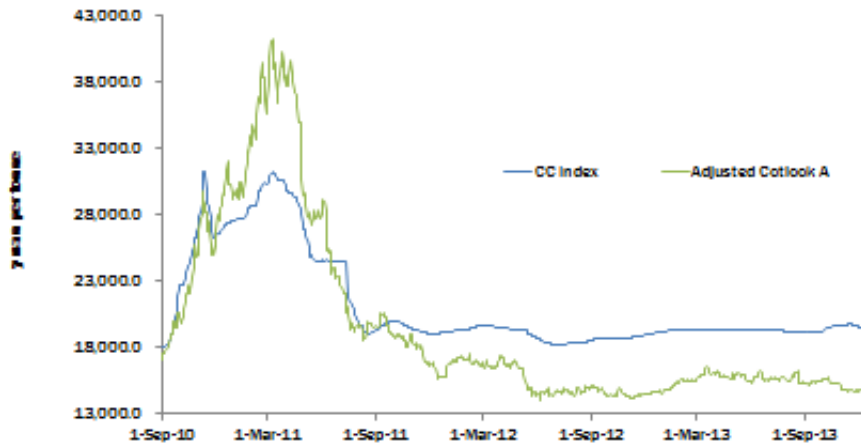
Thirdly, imports of cotton yarn, which are not under quota control and subject to various rates of import duty, ranging from zero to a few percent, depending on the country of origin, have skyrocketed as textile enterprises look to remain competitive in their production of textiles.

In 2012, import volume increased by an impressive 87 percent, and growth has continued in 2013 (the figure for the first eleven months was 31 percent more than that for the whole of 2012).

THE IMPACT ON PRICES

To demonstrate the extent of the divide that has arisen since 2011 between Chinese and international cotton values, the accompanying chart compares the Cotlook A Index, adjusted to approximate delivered mill China terms, with the China Cotton Index. The A Index includes sliding-scale duty – the gap shown would of course be wider if a tariff of merely one percent is applied.

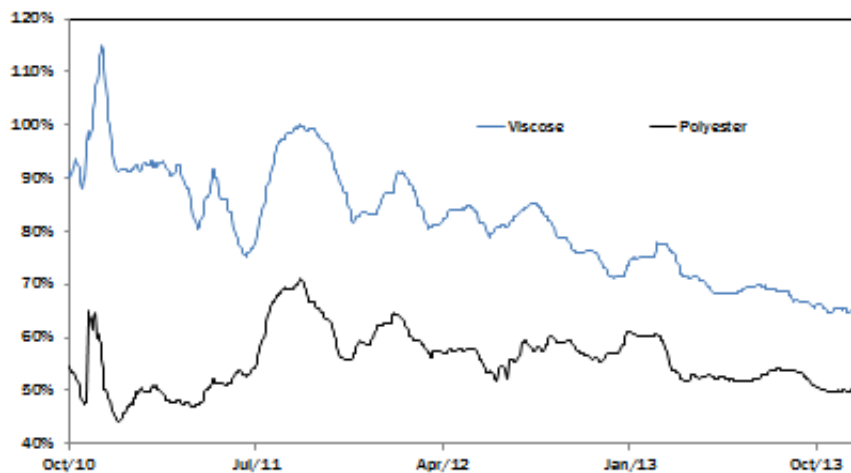
Chinese v. World cotton prices



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Domestic cotton values have been running at levels much higher than the prices ruling internally for man-made fibres. The average ratio of polyester staple to cotton prices over the last three years has been 50 percent (the figure at the time of writing was 51 percent), compared with viscose staple at 82 percent (64 percent).

Ratios of MMF to cotton prices (CC Index)



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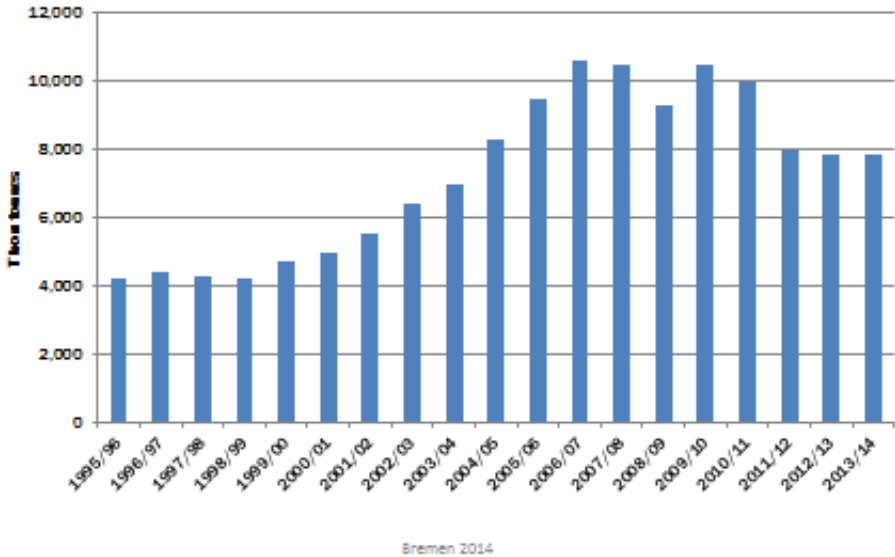
The predominant effects, therefore, have been, on the one-hand, to boost China’s cotton yarn imports and on the other hand to induce the domestic industry to switch to the more competitive man-made fibres, even in product lines that might customarily be considered the principal domain of cotton.

It could be construed that this consequence is not necessarily unintended. China lost the capacity to be self-sufficient in cotton for all its requirements a number of years ago. This was replaced by an aim to be self-sufficient at least in respect of meeting the demands of the domestic market. However, finite availability of usable arable land for food crop production inevitably poses a constraint on the area that can be devoted to cotton, leaving yield enhancement, and the vagaries of the weather’s impact on each season’s crop, as the main determinants of the level of output. In contrast, China can, and has become, more than self-sufficient in polyester fibre and yarn production.

The impact on China’s cotton fibre consumption

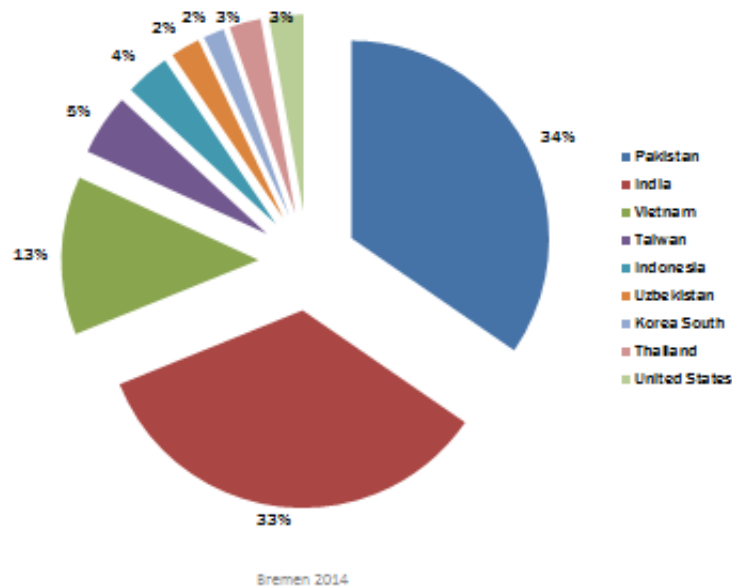


China’s cotton consumption



China’s cotton consumption recorded growth – often double digit – in every cotton season from 1999/2000 through to the onset of the financial crisis in 2008, reaching a peak of 10,600,000 tonnes in the 2006/07 season. That level was almost achieved once again in 2009/10, before the run-up in prices and the subsequent implementation of the state reserve policy. Since then, cotton use has declined by around 25 percent, to less than eight million tonnes.

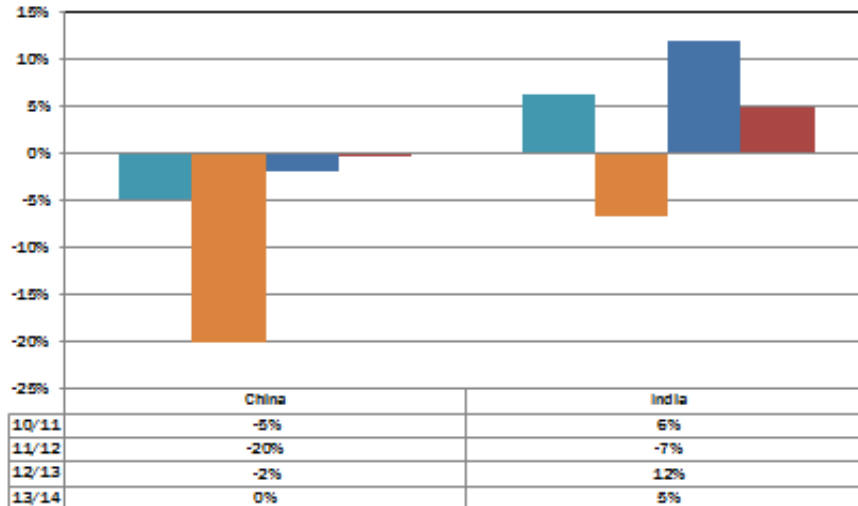
China's sources of cotton yarn imports



The beneficiaries of China's appetite for yarn have been spinners in numerous countries. Everyone has shared in the gain to some extent, though top of the list is undoubtedly India, from where imports more than doubled in 2012 and were more than two-thirds above the previous calendar year's total by the end of October, 2013. India's volume in the first ten months of last year almost matched the amount shipped from Pakistan – traditionally the leading supplier of China's cotton yarn imports. However, Pakistan's volume has also recorded successive periods of double-digit growth. Other suppliers to record strong increases have included Vietnam, Indonesia, Thailand, Uzbekistan, and even the United States.

It is difficult to isolate one factor as an influence on cotton consumption when looking at the bare statistics. What can be demonstrated is that cotton consumption increased in the countries mentioned in 2012/13 and is predicted to do so in 2013/14. Some of the gains are marginal, others are more significant, but the contrast between India and China is vivid.

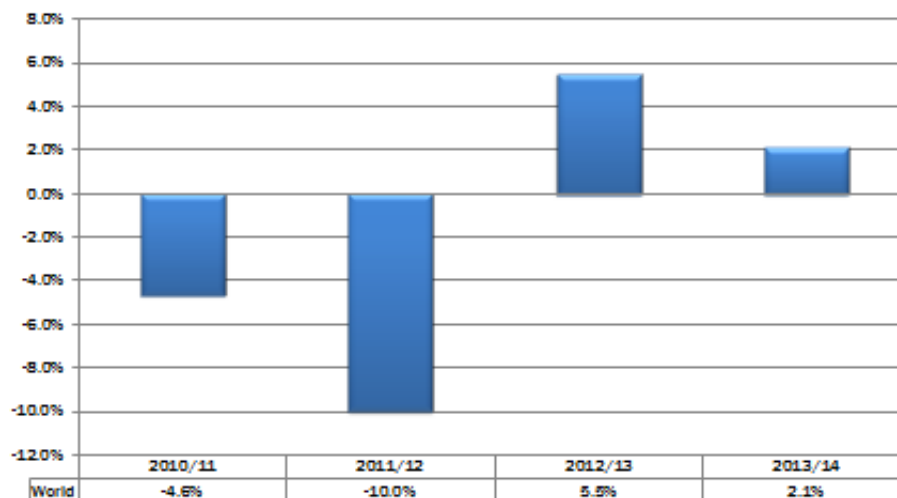
Changes in consumption: China v India



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World cotton consumption has thus shown a partial recovery from the losses that occurred in 2010/11 and 2011/12 but these have been insufficient to close the gap with world cotton production, which has been in surplus now, by our reckoning, for four seasons.

Changes in world cotton use



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So, the scenario I am describing is one in which entrepreneurs have invested in cotton spinning capacity outside of China, on economic grounds, which would encompass raw material, labour and energy costs. The raw cotton cost element, however, is a function of China's government policy, and the questions that yet remain unanswered are what will happen should Beijing's policy be amended to result in significantly lower cotton prices in China, and should that occur, what influences might be brought on patterns of trade in cotton yarn and on the location and quantity of cotton consumption? Would there be a material effect on the supply of cotton goods available to the market in general?

Recent policy statements have alluded to the Chinese government's intention to allow market forces to play a more prominent role in setting market prices for soya beans and cotton, and for there to be a reduction in the government's interference in the market. For cotton, trials of direct subsidy systems have been put in place in Xinjiang, the main cotton producing area. Moreover, the expectation at the time of writing this presentation was that 2014 would see reduced allocations of cotton import quota as an attempt is made to digest some of the burdensome government stocks. It will be interesting to see whether, by the time of the Bremen conference, more has been revealed on policy intentions that might cast some light on cotton consumption prospects both in China and elsewhere.



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