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China's Agriculture Policy and U.S. Access to China's Market

As President and CEO of the National Cotton Council, I would like to thank the members of the U.S.-China Economic and Security Review Commission for the opportunity to present testimony regarding cotton trade with China and the effect of China's policies.

The NCC is the central organization of the United States cotton industry. Its members include producers, ginner, cottonseed processors and merchandizers, merchants, cooperatives, warehouse and textile manufacturers. A majority of the industry is concentrated in 17 cotton-producing states. The downstream manufacturers of cotton apparel and home furnishings are located in virtually every state. Farms and businesses directly involved in the production, distribution and processing of cotton employ almost 200,000 workers and produce direct business revenue of more than \$27 billion. Annual cotton production is valued at more than \$6 billion at the farm gate, the point at which the producer sells. Accounting for the ripple effect of cotton through the broader economy, direct and indirect employment surpasses 420,000 workers with economic activity well in excess of \$100 billion. In addition to the cotton fiber, cottonseed products are used for livestock feed, and cottonseed oil is used as an ingredient in food products as well as being a premium cooking oil.

Export markets represent the primary outlet for U.S. cotton production with approximately 75% moving into international trade channels. In most key importing countries, raw cotton faces little if any applied tariff and no quota restrictions. However, an important exception to the relatively open trading situation is the tightly monitored access allowed by China.

China's rapid increase in cotton production, cotton mill use, cotton imports, and textile and apparel exports has made China the dominant force in world cotton trade and world trade in cotton textiles and apparel. Alongside this rise to dominance, China has adopted policies that significantly distort the world cotton and cotton product markets. These policies range from non-transparent and unreliable reporting of cotton supply and demand statistics, centrally-controlled stock and quota policies, and variable rate levies on cotton imports.

With the elimination of the Multi-Fiber Agreement and the accession of China to the WTO, the United States opened its markets to Chinese-produced textiles and apparel (as well as apparel produced elsewhere). Since that time, annual domestic mill consumption of cotton in the United States has declined by over 6 million bales. Unfortunately, the decline in U.S. mill use has been accompanied by a loss of jobs in the textile industry. Between 2001 and 2012, total U.S. textile employment fell by 500 thousand workers.

Instead of selling 2/3 of its production to U.S. manufacturers, U.S. cotton producers must now export 75% of their production to other countries, with China accounting for roughly 50% of

U.S. cotton exports. The distortions in world cotton fiber and cotton product markets caused by this disparity in market openness and access will continue to undermine U.S. manufacturing as well as efforts to liberalize world trade in cotton and cotton products.

Overview of China Supply & Demand

China remains the world's largest cotton producer with a 2012 crop estimated at 35.0 million bales, or 29% of the world total (Table 1). Along with being the world leader in cotton production, China is also the largest processor of raw cotton. For the 2012 marketing year, China's cotton mill use is expected to be 36.0 million bales. China remains a net importer of cotton fiber, but the gap between domestic use and production is expected to narrow for the 2012 marketing year.

China's Textile Exports

For the eighth consecutive year, China was the largest supplier of cotton textile imports into the U.S. Total cotton product imports from China are an estimated 5.4 million bale equivalents in 2012, down 5.6% from 2011. However, cotton textile imports are up by 558% from 2001 when China entered the WTO. China's share of imported cotton goods in the U.S. market accelerated from 10.9% in 2004 to an estimated 31.8% in 2012.

In 2012, the single largest supplier of imported cotton goods into the U.S. market was China. On a square meter equivalent (SME) basis, the largest category of cotton product imports from China in 2012 was "other cotton manufactures", which accounted for 23.4% of all cotton product imports from that country. Trousers was the second largest category of cotton imports from China in 2012, comprising 13.2% of total cotton product imports from that country. Knit shirts accounted for 6.0% of U.S. cotton textile and apparel imports from China in 2012. Nightwear was the fourth largest category and accounted for 5.4% of cotton product imports.

China's Cotton Import Policies

China's WTO accession negotiations established a tariff rate quota (TRQ) of 4.1 million bales. This TRQ is not adequate and not reflective of China's position as the number one cotton producer and processor in the world. Since it acceded to the WTO in 2001, China's growth in cotton consumption, mill use and apparel production, coupled with the loss of U.S. mill use as a result of Chinese competition, have dramatically changed the world cotton market. While China's cotton mill use increased by 20 million bales, U.S. mill use dropped from 11 million bales to below 4 million bales. China's access commitments must be re-evaluated in light of its dominant position in the world textile and apparel market.

At various times during the year, China will announce additional quota above the WTO-required TRQ. The process for determination by Chinese authorities of additional quota is unknown and completely nontransparent. Generally, those imports are subject to a variable levy ranging from 5% to 40%, in order to maintain cotton prices in China significantly above international prices and protect prices paid to Chinese cotton growers. Additionally, importers must receive import licenses from the central authorities before entering into import contracts.

Cotton can also be imported outside of the quota system. However, the importer is still required to acquire an import license and will be assessed a 40% tariff.

China's Support Price and Internal Reserve System

In calendar years 2010 and 2011 world cotton prices went through a period of extended strengthening and increased volatility. Mills in many countries became highly concerned with cotton availability. India went so far as to impose a ban on cotton and cotton yarn exports. China saw their total year-end cotton stocks fall to the lowest level in 20 years, just over 10 million bales. Responding to concerns about reserves and prices for growers, in September 2011, China initiated a policy of purchasing cotton into their national reserves at a level of 19,800 yuan per ton. At current exchange rates, that equates to approximately \$1.40 per pound. China is continuing to operate the reserves policy for the 2012 crop at a procurement price of 20,400 yuan per ton, a 3% increase from the 2011 level. By the end of the current marketing year, China could hold more than 33 million bales in government reserves.

World cotton price, as reported in Cotlook Ltd Far East "A" Index has averaged 86 cents per pound for the most recent 12 months. By purchasing domestic production at prices 40 to 50 cents above world prices, China is insuring that their internal prices are well above world prices, and causing their cotton spinning to be uncompetitive (Figure 1). China's current policy, while supporting prices received by farmers, acts as a tax on textile mills and has furthered the shift to manmade fiber.

While China's policy is providing short-term support to the cotton market, there is increasing evidence that the policy will provide a longer-term drag on cotton demand in China. While the "A" Index has moved to a level much more competitive with polyester prices, the same cannot be said for cotton prices in China's domestic market. The current differential between cotton and polyester prices in China ranges between 50 and 60 cents. As a result, textile manufacturers are shifting to manmade fiber, and cotton is losing market share.

China just recently announced that the support price will be maintained at the 2012 level of 20,400 yuan per ton with no limits on the quantities that may enter the government reserves. At current exchange rates, the support price equates to \$1.48 per pound.

Cotton's Fiber Market Share

According to PCI Fibres, China's 2013 manmade fiber (MMF) mill use is estimated at 158 million bales, which is more than 4 times the size of their cotton mill use. Since 2007, China's MMF mill use has grown by 52 million bales, while cotton mill use has fallen by 15 million bales (Table 2). As a result, cotton's market share has fallen from 32% in 2007 to a projected 18% in 2013. Unless there is a dramatic change in relative prices in China, it will be extremely difficult, if not impossible, to reclaim that market share.

The current support program is also causing changes in the textile supply chain to Southeast Asia, South Asia and Latin America. With China's textile mills unable to pay the higher prices for raw fiber, there has been an increase in yarn imports, primarily being sourced from Pakistan and India (Table 2). While China has import duties on raw cotton, it does not have import duties on cotton yarn. However, only one out of every three bales of lost mill use is being offset by increased yarn imports. The net effect is an erosion of cotton demand due to internal prices being maintained as levels well above world market prices.

China's Support to Cotton Farmers

The combined effect of China's import quota allocation and stocks policies is a domestic price to their cotton farmers that consistently exceeds world prices. Using price wedge analysis, the effective subsidy ranged between 11 and 37 cents per lb. for the years 2005-2011, and data suggest an even larger gap for 2012. While one of the stated goals of the reserves policy is to support the price received by farmers, the impact of the current policy is to create a tax on domestic mills, thus discouraging use of cotton and encouraging the shift to polyester.

Looking Forward

China's total raw cotton imports are estimated at 16.5 million bales for the current marketing year, roughly three-fourths of the 24.5 million bales imported in the 2011 marketing year. Total ending stocks for the 2012 marketing year are projected to reach a record level of 45.6 million bales. The sharp decline in mill use and the very significant build-up in cotton stocks has been the direct result of changes in their cotton policy.

For the coming year, China's decision regarding sales from the reserves and the allocation of import quotas/licenses is the key uncertainty. With projected production of 31.2 million bales, it is assumed that 85% of the crop will enter government reserves, which is consistent with the percentage of the 2012 crop entering reserves. Assuming China sells 21 million bales from the reserves over the course of the 2013 marketing year would still result in a significant increase in government holdings. In order to supply projected mill use of 35.6 million bales, China would import 9.0 million bales. Under this scenario, total imports for the 2013 marketing year are slightly more than half the import level for the current marketing year.

Should China choose to be a more active seller in the coming year, China's imports could fall to the required WTO quota of 4.1 million bales. Given current U.S market share of China's cotton imports, a 4.9 million bale decline in imports translates into almost 1.7 million fewer bales of U.S. exports. China could also go to the other extreme and choose to sell very little of their reserves. Under that scenario, imports would increase to levels comparable to the current marketing year. Such an outcome is more bullish for U.S. exports in the short term, but the scenario only delays the inevitable outcome of working the cotton reserves back onto the market.

The U.S. cotton industry remains very concerned with the lack of transparency in Chinese cotton policy. What government reserve level constitutes sufficient stocks? Do Chinese officials monitor and report cotton stocks not held in the government reserves? Are Chinese mills bound to any set purchase pattern between domestic cotton and imported cotton? How are decisions on the quantity of import licenses beyond the TRQ to be made? Uncertainty with Chinese policy has the entire cotton world on edge.

Thank you for this opportunity to present the concerns of the U.S. cotton industry.

Table 1. China Cotton Supply & Use (Million Bales)

	2007	2008	2009	2010	2011	2012	2013*
Production	37.0	36.7	32.0	30.5	33.1	35.0	31.2
Imports	11.5	7.0	10.9	12.0	24.5	16.5	9.0
Mill Use	51.0	44.0	50.0	46.0	38.0	36.0	35.6
Exports	0.1	0.1	0.0	0.1	0.1	0.1	0.1
Loss	-2.5	-1.3	0.0	0.0	0.0	0.0	0.0
Ending Stocks	20.5	21.4	14.2	10.6	30.2	45.6	50.2
Stocks/Use	40%	49%	28%	23%	79%	127%	141%

**Source: National Cotton Council Economic Outlook*

Table 2. China Fiber Statistics (Million Bales)

	2007	2008	2009	2010	2011	2012	2013*
Cotton Mill Use	51.0	44.0	50.0	46.0	38.0	36.0	35.6
MMF Mill Use**	106.8	103.0	118.3	130.7	141.6	150.7	158.3
Total Mill Use	157.8	147.0	168.3	176.7	179.6	186.7	193.9
Cotton's Share	32%	30%	30%	26%	21%	19%	18%
Cotton Yarn Imports	2.3	2.7	3.7	3.4	5.0	7.3	8.0

**Source: National Cotton Council Economic Outlook; ** PCI Fibers.*

Figure 1. World and Chinese Fiber Prices (Cents/Lb)

