

# Influence of trade policy on world cotton markets

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Agriculture remains one of the most heavily protected and subsidised sectors of the global economy. Up to USD300 billion was spent in 2001–02 within OECD countries on agricultural support programs. The general trend for producer support has been downward, but it is still high. Farmers receive up to a third of their income on average from government programs.

Reforms to reduce the level of government support in the areas of opening up market access, removing export subsidies and reducing domestic policy supports have been slow.

At the most recent world trade reform meetings, lack of commitment by certain countries to establish agendas for a new round of trade negotiations is expected to hinder the future benefit of trade reform.

## Trade and trade support in the cotton industry

The volume of cotton trade as a proportion of total production is relatively high in comparison to most other major commodities. A big percentage of cotton processing facilities are not located within the major producing regions, so this trend is not surprising (Figure1).

There are many variables influencing the direction and growth of the global cotton industry. These include:

- Cotton's relationship with synthetic fibres;
- World economic growth and its impact on consumer textile demand;



- Seeking new consumption markets for cotton products; and,
- Fibre innovation to enhance the spinning ability of the raw cotton, with the aim of encouraging demand.

The level of domestic production and trade support within the cotton industry, which has varied substantially over the past 20 years, is also another factor directing the activity within the cotton supply chain.

At the beginning of the Uruguay Round trade talks in 1986, 66 per cent of raw cotton production received some form of direct price or income support. By 1998, this had fallen to 50 per cent in line with efforts from the trade reforms to remove duties on imports of cotton lint.

During the late 1990s, export subsidies remained in only two countries — with the US and China reinstating them after they had been removed from all production regions by 1990. With China's accession to the WTO in 2000, it has agreed to eliminate export subsidies on a number of industries including cotton.

Production subsidies for producers did not change much over this period. A sharp rise in direct assistance was seen in 2001–02, where it reached 73 per cent (Figure 2). The rise in support was a result of a combination of factors including weakening world economic growth, especially in the US, the collapse of a number of US mills, the failure of Chinese imports to lift global trade demand and expectations of rising global production,. This led to a fall in raw cotton demand and lower world prices, which for the fourth consecutive year average below US60 c/ lb.

Direct support for the cotton industry was estimated at USD4.4 billion for 2001–02.

Actual assistance per pound of cotton varies

FIGURE 1: Proportion of primary production traded, 1996–2003

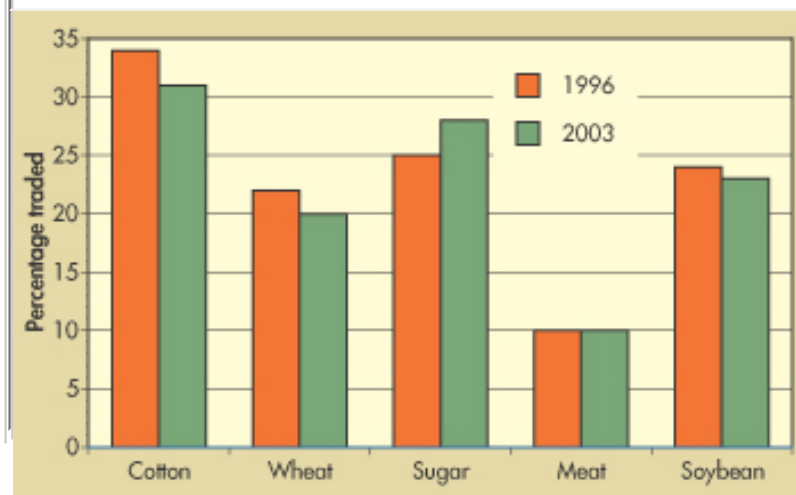
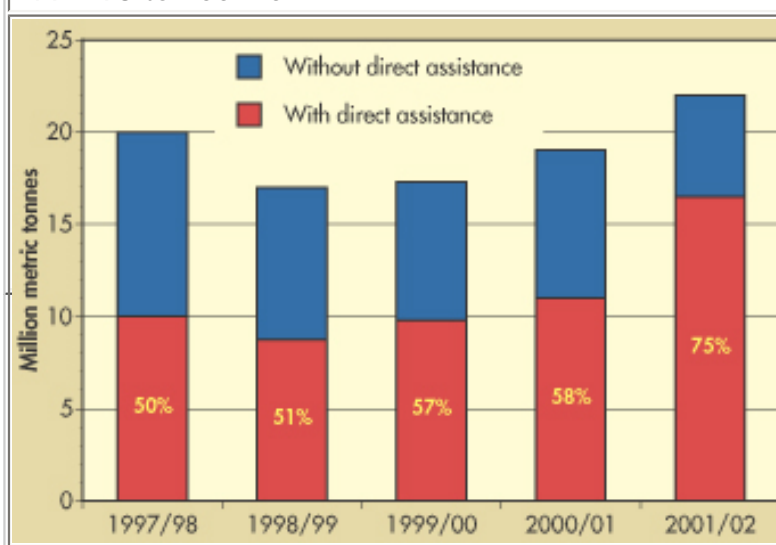


FIGURE 2: World production under direct assistance, 1997–98 to 2001–02



significantly between countries, ranging from US2 c/lb in Cote d'Ivoire to US76 c/lb in Spain in 2001–02. Protection and trade barriers increase substantially along the value chain as the industry becomes textile oriented and processing regions seek opportunities to capture greater value and protect their domestic textile industries.

As domestic trade policies come under increasing pressure and textile policies are phased out and/or reduced over the next two years, it will be interesting to see if this leads to a reduction, increase or adjustment in the destination of raw cotton trade. Particularly as some of the major cotton producing regions such as China and India may become larger importers to meet the demands of their growing domestic textile industries. Other regions such as the US will most likely continue their trend of expanding exports as their domestic textile industries become smaller (Figure 3).

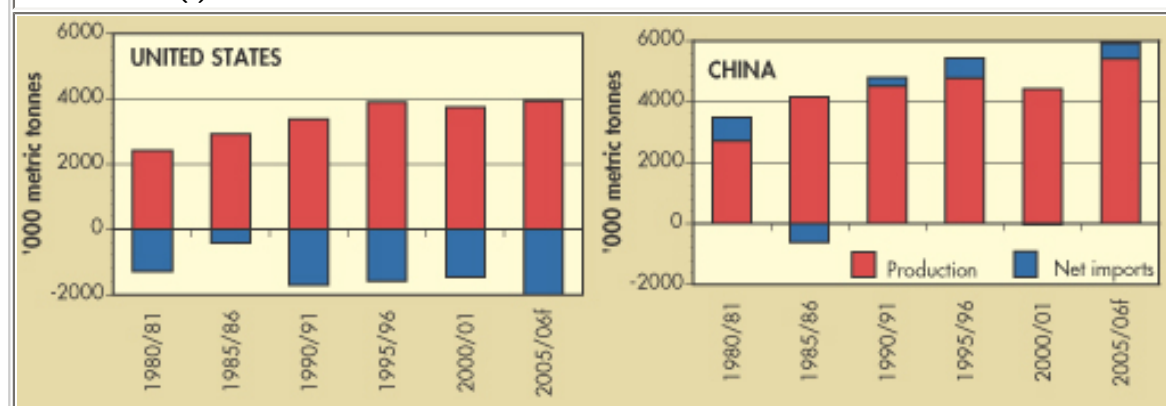
#### Impacts of trade policies

A number of developing economies are negatively impacted by the volatility in cotton prices, in part due to trade distortions. The Ministry of Textiles in India has estimated that the average price of cotton would be USD75 c/lb rather than its current average of USD44 c/lb if full trade liberalisation was to occur.

Price support and direct income support programs cause world prices to fall in two ways. Under price support programs, cotton producers are not operating in a perfectly competitive environment, so they are not responsive to normal production and consumption signals.

Direct income payments also cause production to sit at higher levels than would normally be needed. The combined effect of these two programs on global production is to cause a distortion in the supply and demand balance, which dampens world cotton prices through excess supply. Lower cotton prices in turn cause

FIGURE 3: Production and net imports for the United States and China, 1980–81 to 2005–06 (f)



a reduction in supply from non-subsidised countries.

Developing regions, which generally operate small subsistence farms, are unable to achieve economies of scale and can find it difficult to remain profitable during periods of lower world prices. For some developing regions this is critical as cotton can account for up to 60 per cent of export earnings — Burkina Faso for example.

Reduced production and lower incomes can have a flow-on effect throughout an economy due to a diminishing need for support services. For example the transport and ginning industries in India have lost USD200 million over the past five years as a result of falling production.

Additionally, regional problems can transfer through to urban areas with growing unemployment — particularly in developing countries as farmers migrate to the cities because they are unable to remain profitable and have lost their land. A decline in textile employment may also occur as supply to the industry diminishes.

During the period between 1998–99 and 2000–01, direct assistance to cotton growers increased and production grew by half a million tons in subsidised regions, while production in non-subsidised regions fell by 1.5 million tons. China and the US, which give the largest amount of assistance to their cotton producers, showed marked increases in production for the 2001 crop.

China had a 20 per cent rise in tonnage due to increases in acreage and yield and the US strengthened its market share with production rising by 3.5 million bales — approximately a third of the global increase in production for that year. To some degree, the improvement in production can also be attributed to irrigation efficiency and yield growth from genetically modified crops.

Unlike a number of other commodity markets including soybeans, rice and sugar where production market share of industrialised countries has fallen, developed countries have increased their market share of raw cotton production over the past two decades.

Import barriers and export restrictions are the major source of protection on yarn, fabric and apparel productions. They are far higher than domestic price and income support for the early part of the cotton value chain. Such measures also play a role in influencing world raw cotton prices and so can adversely affect world production.

These trade barriers to protect domestic textile industries, can cause domestic prices to rise above world levels, which can dampen domestic consumer demand and cause global demand and world prices to weaken.

These barriers to textile and apparel trade will be lowered in the short term under the Multi Fund Agreement (MFA), which is phasing out all quotas on yarn, fabric and clothing products and reducing tariffs on these items significantly by 2005.

### No more trade distortions?

As domestic trade policies of large producing regions continues to cause distortion to supply and demand of raw cotton and creates volatility in the world price, pressure will continue from developing or unsubsidised developed growing cotton countries. With the two largest regions accounting for over 40 per cent of production and approximately 90 per cent of trade support, changes to their domestic policies could substantially alter the dynamics of the cotton global market.

Modelling of trade liberalisation of world cotton markets by the USDA found that it would lead to an increase in the trade of cotton and the welfare of developing regions would improve

slightly — but highlighting that the overall effect would not be as significant as some would expect.

Research by the Centre for International Economics, looking at the specific impact upon Australia of trade liberalisation, found that the removal of production and export subsidies and tariffs on raw cotton, would lead to a 44 per cent increase in the production of cotton in Australia and 53 per cent increase in net income for producers.

The overall rise in global production would not offset the fall in production within China and the US, causing world prices to rise and global consumption of cotton to fall marginally.

It is difficult to tell what the end effect on global trade would be from the removal or reduction of raw production price and income support programs. It will depend upon the degree to which it happens, the time frame, widespread development of fibre innovation technologies, privatisations of state-owned-enterprises in major textile processing regions such as China and entry of other major cotton producing regions such as Uzbekistan to the WTO.

By reducing distortions in the trading market and allowing for a relatively competitive market to operate, greater balance can be found between supply and demand and volatility in the market can be removed to a certain extent. The industry could witness a movement away from traditional trading patterns, which would in turn change the role of domestic infrastructure and institutions of cotton producing countries. Removal of the Agreement on Textile and Clothing (ATC) will also influence the trade direction, but this will be further explored in an article later this year.

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The next article in this series will look at how the domestic trade policies of the two major producing cotton countries, the United States (US) and China have and could influence the development of the Australian cotton industry. This will

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be followed up by an article which will review how the phasing out of the Multi-Fibre Agreement (MFA) will impact upon the destination of raw and semi-processed cotton in the coming years.