US and Chinese cotton production support policies

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Cotton came into the spotlight last month at the World Trade Organisation (WTO) Ministerial Conference in Cancun, Mexico. Mali, Chad, Burkina Faso and Benin, who rely heavily on the cotton sector for a large proportion of their GDP, put forward a proposal at the ministerial meeting to eliminate all cotton subsidy programs.

Known as the Cotton Initiative, the proposal sought considerable change in current programs that effect cotton, particularly from the US. If it had been successful, the initiative would have been used as a framework for renegotiation of programs affecting a range of commodity markets.

It is therefore timely to follow on from last issue's overview of the scope and impact of domestic production support policies within the cotton industry and look specifically at the structure of the major production and trade subsides currently in place, highlighting their impact upon Australia.

Production support policies in the cotton industry are structured with the basic aim of sustaining domestic production and farmer incomes. While the policies are domestic in focus, the weight of such programs has had a greater impact on the export market.

One of the key reasons why the policies of the US and China have a substantial influence over the global market is the significant role these countries play from a production and trade perspective. Non-subsidised cotton producing regions continue to lobby to have all support programs removed through WTO negotiations, because they believe there is a large impact on world prices and the profitability of their domestic operations.

AUSTRALIAN RETURNS

There are a vast number of variables influencing the returns received by Australian cotton growers. They include currency movements, quality and grade of the cotton, level of carryover stocks, consumption trends and production dynamics, cost of production, alternate crop returns and world prices.

With Australia exporting over 95 per cent of its annual production, making up approximately 10 per cent of the world export market, Australia is very vulnerable to the volatility of world prices and trade dynamics. Due to the structure of the Australian domestic textile industry, its reliance upon the export market is not expected to change. So it is important to understand the production support programs in place and how they influence the global market place.

The programs of the US and China appear to have the greatest overall impact on the world market price and export market share and represent approximately 70 per cent of the world expenditure on cotton subsidies.

CHINESE MARKET ACCESS

With China's domestic textile industry expanding, access to this market will become increasingly important. The tariff-rate-quota system in place for Chinese cotton imports will dictate the ability to enter this market.

Since the quota became available in early 2002, many exporters have been frustrated by the difficulties in gaining access. The administration of the tariff-rate-quota has not being as efficient as first anticipated. The introduction of the allocation was late and gaining access to the quota by Chinese importers has been difficult.

Domestic mills have to go through an extensive process to be issued with a formal quota and it is believed that this process will continue to be dictated by internal government decisions based on their assessment of domestic supply and demand dynamics.

Some exporters have found the quota system can act as barrier to trade.

Another concern with the system are

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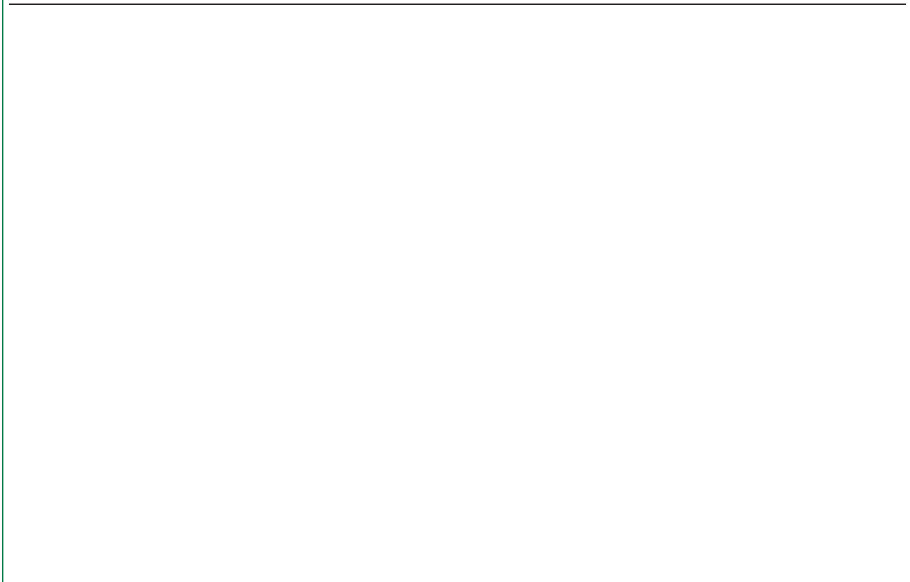
FIGURE 1: Cotton export market share, 1991–92 to 2004–05[f]



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the limitations placed on the quota allocation. That is, a set proportion of cotton imports can only enter the Chinese market if the cotton is processed and re-exported. This has been of particular concern for the US domestic textile mill industry, as a number of the products re-exported compete directly with US produced products.

US export market share has risen steeply in recent years to 39 per cent in 2001–02 and is expected to remain at close to 40 per cent over the next two to three years (Figure 1). As the US domestic textile industry further shrinks due to competition from lower cost regions, its export/domestic production profile will continue to shift in favour of exports.

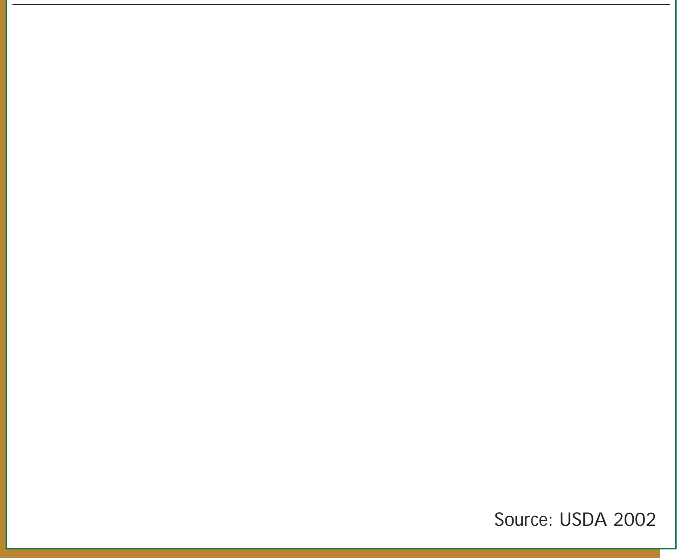
Many participants in the cotton industry believe that the production support programs in place under the 2002 Farm Bill have encouraged this position through maintaining inefficient overproduction.

Currently there are approximately 11 million bales exported and seven million bales domestically processed. Naturally this expansion from the US will pressure the ability of other exporters to sustain market share — particularly countries like Australia where there are limited opportunities to expand production. In Australia's case, the outlook for exports is for a decline in market share from approximately 16 per cent in 2000–01 to an estimated seven per cent in 2004–05.

There are three programs in place that provide US cotton growers with direct payments for their cotton production. They are:

- The Loan Deficiency Payment (LDP);
- The Direct Payment, which replaces the Production Flexibility Contract Payment (PFCP); and,
- The target price.

FIGURE 2: Example of payment structure for one pound of US cotton, 2001–02



Source: USDA 2002

US cotton growers are guaranteed a payment of US52 cents/lb — the loan rate. The LDP ensures that growers receive a payment when the adjusted world price (adjusted for shipping, quality and location differentials) falls below US52 cents/lb, to make up the difference.

The target price is set at US72.4 cents/lb and established to deliver payments to the grower when the world price is between US52 cents/lb and US72.3 cents/lb (Figure 2). The practical implication of this policy is that US growers are encouraged to grow cotton regardless of true world price signals and demand expectations in the world market. Worse case scenario is that this leads to an oversupply of cotton on the world market and places downward pressure on prices.

Under the direct payment program, a grower can receive a payment of US66.7 cents/lb for growing an eligible crop, cotton being one of them. Under the 2002 Farm Bill, the direct payment reference period on which the payment levels have been calculated has been altered to 1998–2001.

This has raised the question of whether or not these payments have been recoupled with production and therefore are they correctly positioned in the WTO Green Box which classifies policies as non-trade distorting.

The Step 2 program and the Export Credit Guarantee (GSM102) program are not paid directly to growers but indirectly influence production and also play an important role in maintaining US exports on the world market.

The Step 2 program acts as a buffer between the domestic US price and world prices. It is paid to domestic mills and export shippers, which allows them to purchase or export cotton which is competitively priced with the world market price throughout the year.

The two major concerns with the Step 2 program from an Australian trade point of view are:

- The Step 2 program can enhance the level of US futures, which in turn will impact upon the Australian basis; and,
- It may encourage US exports which can further drive down world prices.

EXPORT CREDIT GUARANTEE PROGRAM

The structure of the Export Credit Guarantee program sees the US government offer credit to importers and spinning mills that import US cotton.

The financial risk is taken on by the US government and not by the export shippers. The difficulty that Australia faces with this program is that importers in developing countries who may experience financing difficulties may display preference for US exports over Australian exports.

While much evidence points to the distortions that production policies and direct farmer support programs have upon the world cotton market, the US government and industry are quick to defend their positions. Many US industry participants emphasise there are a number of factors that have contributed to the decline in world prices over the past few years — such as competition from synthetics, declining economic conditions, rising global production due to good seasons and currency fluctuations.

The US government has also pushed the argument that focus needs to be placed upon the entire cotton value chain to promote cotton product consumption rather than a country just relying upon raw cotton production.

The pressure for change by non-subsidised countries is continuing to gain momentum. This was demonstrated at the Ministerial conference in Cancun and also by the request last year by the Brazilian government for consultation with the US government through the WTO dispute settlement process regarding US cotton subsidies. The Cotton Initiative plan suggested by Benin, Chad, Mali and Burkina Faso is targeted at eliminating distorting measures as well as implement transitional compensation payments by subsidisers to developing countries to assist them during the adjustment period.

With the trade talks in Cancun collapsing, the path to trade reform will once again become longer and harder to travel along. The dispute settlement action put forward by Brazil faces a major constraint in achieving any real progress.

That is, Brazil must prove that the US policy has caused a detrimental effect upon Brazil's exports. Although there has been an indication that there has been a trend of rising US export market share, the question remains as to whether this can be directly/solely attributed to the US Farm Bill.

Non-subsidised countries will continue to be challenged by cotton protection and its influence over global production, export trends and world prices. It is important to continue lobbying as a collective group to establish a framework to renegotiate the policies in place. As with all agricultural reform negotiations to date, it will be a difficult but a necessary process.

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