WASHINGTON UPDATE

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Abstract

Washington has spoken. Definitively. With apparent utter finality. Little remains of the farm programs from which to create excitement about which direction the policy might go; to stimulate anxiety about how much damage it might do; to raise hopes, or fears, about how the policy might strengthen the hand of this or that group before the relentless pressures of the marketplace. The Farm Program today is like the universe, itself: it exists. That is all that can be said about it. Whatever happens within its framework is, by definition, natural. No criteria are set forth which allow any value judgments.

Introduction

The purpose of the Federal Government in farm policy today, as revealed to us in language of the Agricultural Market Transition Act of 1996 (1996 Act) is not very lofty or inspiring. It is: to authorize production flexibility contracts; to make nonrecourse marketing assistance loans; to establish a Commission on 21st Century Agriculture. That is all. Nothing about securing adequate food and fiber for the nation. Nothing about fair returns for farmers. Nothing about sustaining rural American institutions. Not even anything about the international competitiveness of American agriculture. Yet, neither is there an explicit affirmation of faith that market forces will see to these needs.

The Danish philosopher, Soren Kierkegaard said, "Life can only be understood backwards, but it must be lived forwards." Recognizing, then, that many of the programs which used to support farming are very likely to have disappeared, perhaps never to return, it is well to take stock of what remains, then to use it to best advantage. Yesterday, I was privileged to attend one of the sessions which the Council put on concerning the management of cotton price risk through the use of futures and options and by keeping better informed as to market conditions. At least for the foreseeable future, that is your best strategy for staying alive as cotton growers. The rest, I think, including anything we might do in our office, will not be much more than tinkering around the edges.

Nonetheless, interest among members of the cotton industry has remained high in the various facets of the cotton marketing loan program, including the 3-step competitiveness process, which was left intact in the 1996 Act. Particularly, concerns are evident that the continual triggering of Step 3 import quotas is unwarranted and contrary to the original design of the provisions and may prove harmful to the long-run health of the industry.

It would be well, first, to review these competitiveness provisions.

The nonrecourse loan is still available, and it may be taken on all of the upland cotton production on most farms. The loan rate may range between 50 cents and 51.92 cents per pound. The loan may be repaid at the lesser of the original loan rate, plus interest, or the adjusted world price (AWP). The maximum term of the loan is about 10 months.

Three Steps for Competitiveness

Step 1 is the discretionary power that belongs to the Secretary of Agriculture to adjust the AWP downward when it is deemed that there is a chance such an adjustment might contribute to the competitiveness of U.S. cotton by facilitating loan redemptions or encouraging farmers to take loan deficiency payments. In other words, Step 1 was designed to make it worthwhile for farmers at certain times to stop using the loan program to support their prices. This was, at times, needed because exporters and mills were finding it too difficult to sell raw cotton and cotton textiles into international trade. (Sometimes, Step 1 could have made it worthwhile for merchants to stop using the loan program to support prices, too, but there is no need to go into that here.)

Step 1 has essentially been rendered useless by the low loan rate cap of 51.92 cents placed by the 1996 Act. Neither USDA nor the Congressional Budget Office (CBO) projects that any marketing loan activity will occur during the life of the 1996 Act, given reasonable assumptions about future yields.

Step 2 is the provision of law whereby certificates or cash payments are made to textile mills and to exporters to enable them to sell textiles or to offer raw cotton for export at prices which reflect those prevailing in world cotton trade. The amount, per pound, of the Step 2 payment is the amount by which the U.S. quotation C.I.F. northern Europe exceeds the average northern Europe quotation for the 5 cheapest world growths. This figure is sometimes known as the "A" Index. Exactly how Step 2 triggers into effect is a subject for considerable discussion later, so I'll move on to Step 3.

Step 3 provides for import quotas to trigger into effect and allow domestic mills to purchase cotton at world prices if U.S. prices are too high and Step 2 payments prove insufficient to achieve competitiveness. Step 3 triggers after a period of 10 consecutive weeks in which the weekly average US northern Europe quotation exceeds the weekly northern Europe average of the cheapest 5 growths by 1.25 cents per pound. Thus, "competitiveness" means that the

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US quotation closes to within 125 points of the northern Europe average.

Step 3 Examined in More Detail

When the Step 3 provision was first written in 1990, U.S. textile mills still faced a limit on imports of raw cotton of about 10,000 bales per year under Section 22 of the Agricultural Adjustment Act of 1933. Mills wanted protection against high U.S. cotton prices, especially as growers were being allowed to hold cotton under extended government loan for up to 18 months. The import provisions were considered by some to be a quid pro quo tradeoff of the 8-month loan extensions against the potential for imports. In fact, in the 1990 Act, the trigger for implementing the import quota based on spot market prices is identical to the trigger which formerly was used to suspend the 8-month loan extensions. The 1996 Act retained both the spot market quota import authorities and Step 3 but repealed authority for the 8-month loan extensions.

Implementation of Step 3 requires that the US quotation in northern Europe exceed the average of the 5 cheapest growths by 125 points for 10 consecutive weeks. Since the introduction of the Step 3 provision on August 1, 1991, there have been 2 separate episodes when import quotas were actually triggered under Step 3. The first began with a series of announcements of Step 3 quotas on April 6, 1995. Quotas were announced weekly until June 1, 1995. Little notice was paid to Step 3 at that time because, though quotas totalling 1.53 million bales were announced, only 6,000 bales were imported.

The second series of Step 3 quotas is the current one, which began on October 25, 1995, and has triggered weekly since then. So far, it has proven impossible for the U.S. northern Europe quotation to move low enough to close Step 3. As of January 2, 1997, we had announced the 62nd consecutive Step 3 quota in this series. The total potential for upland cotton imports reached its likely maximum of about 4.7 million bales as of January 2. Given current projections for mill consumption, it will now begin to decline slowly as imports arrive.

The amount of upland cotton that actually has been imported under Step 3 is about 400,000 in the 1995/96 marketing year and about 370,000 more in this marketing year. The USDA Interagency Cotton Estimates Committee projects that another 80,000 bales will arrive in the U.S. this marketing year. Thus, their expectation of imports for the 2 marketing years totals about 850,000 bales.

Importance of Step 2 for Controlling Imports

Though Step 2 was conceived primarily to buy down the US price in order to sell more cotton, it also has been important in limiting the opening of Step 3 quotas. Before 1995, there were several instances in which the count of weeks for purposes of triggering Step 3 reached 7 or higher, only to be interrupted when the US northern Europe quotation again fell to within 125 points of the northern Europe average and stopped the count. Usually, the interruption resulted from the application of Step 2 certificates to bid down the US northern Europe quotation.

However, Step 2 must be suspended when the AWP reaches 130 percent of the current loan rate, so Step 2 was triggered out by high world prices on December 1, 1994. Thus, it has not been available to help reduce the US northern Europe quotation and thereby impede the triggering of Step 3. Step 2 also must stop whenever the conditions for triggering Step 3 exist, i.e., when the count of weeks reaches 10. Though world prices (the AWP) declined on June 27, 1996, to levels which otherwise would have permitted Step 2 payments to resume, their reintroduction has been blocked by the inability of the US northern Europe quotation to close to within 125 points of the northern Europe average. That would both close Step 3 and start Step 2.

Triggers for Step 2 and Step 3 No Longer Mesh Well

As I mentioned above, Step 2 must be suspended whenever the AWP reaches 130 percent of the current loan rate. Unlike the Step 2 payment rate, itself, which adjusts to market conditions, the 130-percent trigger is an absolute level which implies nothing about the relationship between the US northern Europe quotation and the northern Europe average. The US northern Europe quotation might well still be uncompetitive, but the program for addressing that problem, Step 2, must stop when the AWP reaches 130 percent of the loan rate. Import quotas under Step 3 then become much more likely to trigger.

Under the 1990 Act, annual loan rates were determined by market price levels. Though somewhat sluggishly, the loan rate eventually would reflect any long-term upward trend in the world price level. However, with loan rates now capped, the trigger which suspends Step 2 has become inconsistent with the other triggering mechanisms. As world price levels rise, the AWP goes up, but the trigger to suspend Step 2 payments cannot go up. This makes Step 2 trigger out much more easily, and Step 3 triggers in much more easily.

Conversely, should world prices begin to average lower, Step 2 cannot trigger into effect as fast as it is needed because the 130-percent trigger is essentially frozen at a low absolute level, out of line with the world market. Thus, enactment of the loan cap in 1996 made
Step 2 permanently less effective in helping to trigger out Step 3 when imports are no longer needed.

As of January 2, 1997, however, the AWP is only 125 percent of the loan rate. Thus, in this instance, the issuance of Step 2 certificates is not being stopped by a high AWP. Remember, if the 10-week count has been reached which triggers Step 3, then Step 2 cannot operate. We now face a classic "Catch-22." Step 2 cannot resume because of the very inability of US quotations to move to within 125 points of the northern Europe average and stop Step 3. Yet, Step 2 certificates could help reduce the US quotations.

Let us try to assess how serious the situation with the cotton program really is, what remedial action might be taken, and what obstacles lie in the way of success.

Outlook for Future Imports

It appears that the key factor which actually stimulates purchases of foreign cotton by American mills is the spread between the US northern Europe quotation and the average northern Europe quotation, or the "A" Index. At least, judging from the one and only experience we have had with imports under Step 3, that appears to have been the stimulus. For a period of 6 or 7 months, beginning at the end of calendar 1995 and ending about June of 1996, the US quotation rose to extraordinary levels with respect to the northern Europe Index. There was a differential of between 8 and 15 cents. There has not been such a long period of such a large differential since these data have been kept.

Allowing for a lag to accomplish purchasing and shipping, this period of high differentials coincides with the period during which unprecedented amounts of foreign cotton arrived in the US. The peak months for imports were May through September of 1996, when imports totalled about 700,000 bales. The differential between the US quotations and the northern Europe average dropped after that, and is now back in the 5 cent range, where it has been for 3 months. Only a trickle of imports arrived in this period.

In gross terms, then, it appears that in periods of short US supplies, in which foreign supplies are adequate enough to maintain the "A" Index at 10 cents or more below the US quotations, American mills will get interested in foreign cotton. When the differential declines, whether due to an increase in US supplies or to a decrease in foreign supplies, or both, interest in imports becomes less.

Today, we are seeing the effects of the US harvest and the decline in availability of foreign supplies. Prices are fairly high. The "A" Index is near 80 cents, but the US quotation is less than 5 cents below that. With the "A" Index that high, foreign cotton cannot be delivered to a US mill at a price that can compete with the domestic price. There is little incentive for mills to consider foreign cotton. The actual importation of significant quantities of raw cotton in the immediate future is, therefore, unlikely, given the tightening supply situation outside the U.S.

In future marketing years, even with a "normal" world supply/use situation, Step 3 quotas are likely trigger regularly. Prices projected in the baseline indicate that US quotations would often be higher than the northern Europe average by more than 125 points. However, supplies and prices projected in the baseline indicate that volumes of imports would not be large unless a shortage developed in the U.S. and the cotton were needed.

At worst, it appears that the potential for imported cotton may lower the peak of any price spike that would otherwise develop in response to a short supply in the US.

Program Change

The component of the 3-step competitiveness process which most appears to be broken and in need of fixing is the triggering mechanism which suspends Step 2 payments. When the northern Europe average reaches about 82 cents, Step 2 must be shut down. Then, Step 2 cannot be reactivated when the northern Europe average again falls below that level unless US is already competitively priced.

Concentrating efforts on this trigger will preserve the basic genius of the cotton program, which is that it relies on price signals to operate. In my view, reliance on any other signal would weaken the program and leave it less able to protect the core interest of the industry. I would state that interest as: preserving cotton's market share in an internationally competitive mill sector which relies on American growers to supply its raw cotton.

Increasing the trigger threshold to, say, 145 percent, and permitting Step 2 to operate whenever the AWP is below that amount --even if Step 3 continues to operate-- would restore the program to approximately the way it functioned before the 1996 Act capped the loan rates.

Bringing such a change into being would not be easy. We at USDA cannot do it by changing the regulations. It would require legislation. There would be budget questions raised, and those are more difficult than ever to deal with. The key to success in bringing this or any other proposal to fruition is to have the entire cotton industry united behind it. Without that, you will not even be able to make a respectable start.