WORLD COTTON AND TRADE SITUATION

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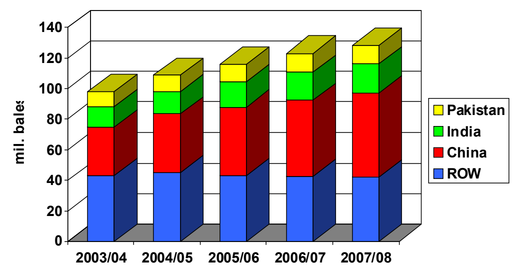
Washington, DC

Introduction

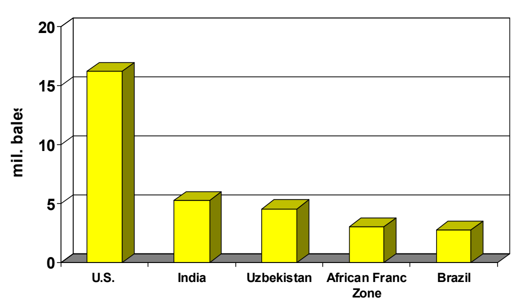
It is a privilege and also a challenge for me to present this outlook for the upcoming season, 2008/09. These are interesting times. As the cotton market becomes more integrated with other global markets, there are an ever greater number of variables to consider in projecting cotton supply and demand. Just two years ago, when we talked about globalization we meant the realignment of the world's cotton textile industries. Economics and the liberalization of textile import quotas shifted cotton spinning growth to China, India, and Pakistan – which together now account for two-thirds of world cotton consumption.

China, India and Pakistan
Account for 2/3 of World Consumption

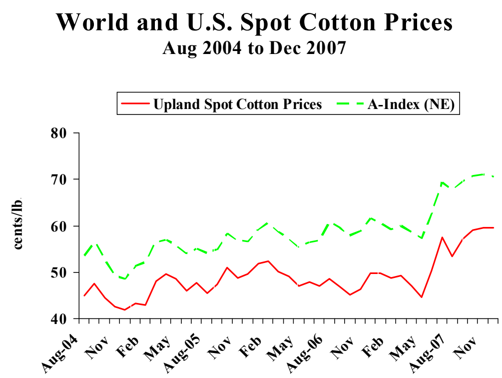


But recently, rising energy prices and the use of agricultural commodities for fuel have integrated agricultural and energy markets. As one soybean analyst recently said, "you can't drive your steak and eat it too."

World's Largest Exporters, 2007/08



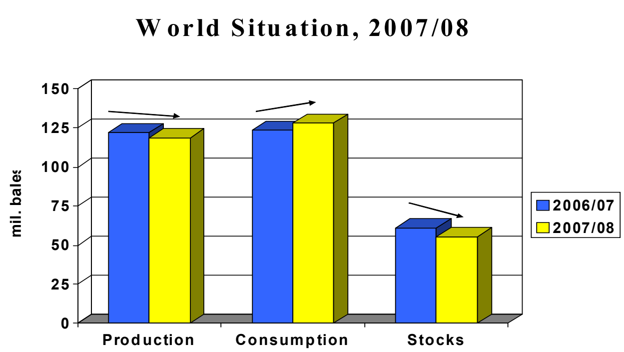
The U.S. and global markets are linked by the U.S.'s position as the world's largest cotton exporter. As long as it appeared that U.S. cotton could comfortably supply the gap between foreign consumption and production, cotton prices stayed relatively flat—monthly spot prices were below 50 cents for most of the period from August 2004 until June 2007. But, with world cotton stocks falling and demand for agricultural products in energy markets rising, there is greater uncertainty about whether the U.S. can fulfill this role. A cotton analyst might say "you can't drive your steak and wear your shirt too." Spot cotton prices averaged just below 60 cents in December, the highest since March 2004. The December 2008 cotton futures price is holding in the mid 70's.



Cotton market fundamentals are still the most important influence on cotton prices. The surge in demand for biofuels affects cotton principally because it constrains cotton production. So what I would like to do today is to pose the question that I think the market is trying to answer: "How much cotton does the world need from the U.S. in 2008/09 and will the U.S. supply it?" This is dangerous territory, as there are many more opportunities to be wrong than right. Since one purpose of this session is to inform producers about risk, I will also highlight the major sources of uncertainty.

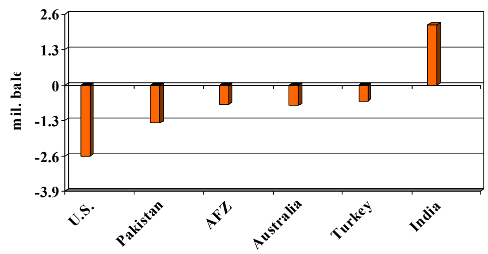
The World Cotton Situation in 2007/08

World stocks are falling in 2007/08 as demand exceeds supply. USDA's December forecasts indicate that world stocks will drop nearly 10 percent. Foreign stocks were already relatively tight at the beginning of the season, as most of the world's surplus stocks were held in the U.S. And foreign stocks are likely to tighten further as the season progresses, resulting in demand for exports from the U.S. Declining stocks in 2007/08 are one key to the 2008/09 outlook, because world production will need to rise in 2008 to meet rising demand.



To review the major trends of 2007/08, world production is estimated about 3 percent lower due mainly to the decline in U.S. production. Pakistan's production is down 14 percent due to excessive rain and insect problems. Production in the African Franc Zone is also sharply lower due to a combination of weather, price, and currency problems; production in Australia and Turkey has been reduced by drought. Partly offsetting these reductions is an increase for India. China, the world's largest producer, is projected to harvest a crop similar to 2006/07.

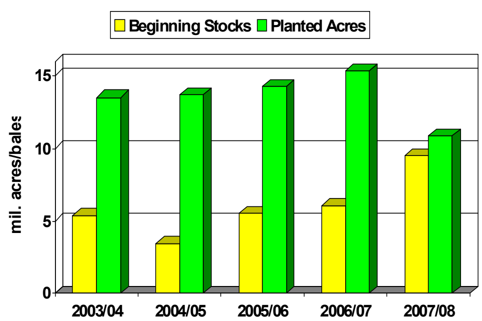
Estimated Changes in World Production, 2007/08 from 2006/07



World consumption is growing at about 4 percent, due mainly to continued strong growth in China. Despite problems with the U.S. economy, rising incomes in developing countries, especially China and India, are supporting world demand.

Turning to the U.S. in 2007/08, we saw very large beginning stocks--the largest in 40 years—which were mostly offset by lower production, with the result that total supply is slightly above 2006/07. These large stocks were offset by the lowest planted area since 1989/90.

U.S. Beginning Stocks and Planted Acres



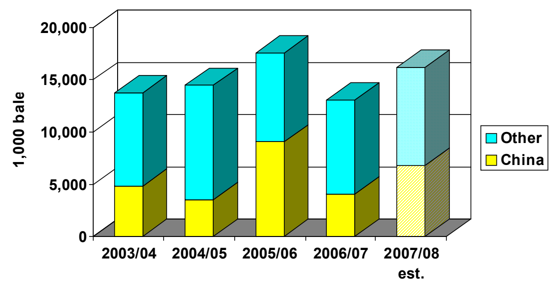
U.S. cotton production exceeded early expectations due to 60-year low abandonment and record yields, making 2007/08 a season of real extremes. With the slightly larger supply, higher exports are likely to reduce ending stocks.

U.S. Supply and Demand Estimates
December 2007

	2006/07	2007/08
Beg. Stocks	6.0	9.5
Production	21.6	19.0
Imports	0.0	0.0
Total Supply	27.7	28.5
Consumption	4.9	4.6
Exports	13.0	16.2
Total Use	18.0	20.8
Ending Stocks	9.5	7.7

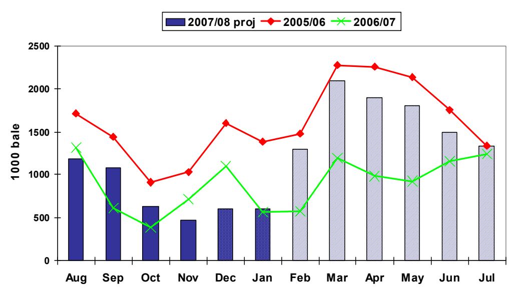
Since the current marketing year is not even half over, it is important to recognize developments that might limit the reduction in U.S. stocks. The most important is China's imports and their effect on U.S. exports. China is the largest customer of U.S. cotton and the U.S. is China's biggest supplier. The U.S. is projected to export nearly 7 million bales to China this season. However, the level of China's import demand has proven much less predictable than that of other U.S. markets.

U.S. Exports, Total and to China



Current purchases by the Chinese in world markets, especially purchases from the U.S., indicate that China's imports will remain fairly weak through the first half of the season. However, the China supply-demand balance sheet for 2007/08 shows that, with production about even with last season and consumption rising, China's imports will likely rise to 14.5 million bales. Thus, we anticipate that China's imports will be concentrated in the second half of the season, as they were in 2005/06 and 2006/07, but the lag in activity casts uncertainty on the final outcome.

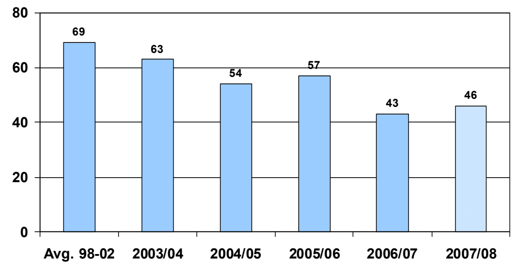
China Monthly Imports Needed to Reach 14.5 MB in 2007/08



Many of you know that there are difficulties with the China balance sheet, owing to lack of good information and also lack of transparency of government policies. Despite these difficulties, there are valid reasons to think that China's imports will exceed last season's 10.6 million bales. First, growth in China's textile exports and the incomes of consumers in China remain strong. Second, China's mills typically buy cotton very hand-to-mouth, and are likely to demand significant imports once their 2007-crop domestic supplies are committed. Finally, a build-up of stocks during the 2005/06 season is likely to have depressed 2006/07 imports – and those stocks have now been depleted.

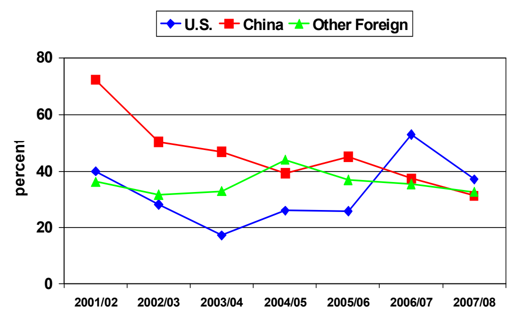
The lag in China's import demand is causing U.S. export sales to lag. As of week 22 of the marketing year, commitments had reached 46 percent of the total needed to reach the forecast of 16.2 million bales. However, the recent trend is for export commitments to shift to later in the marketing year, and this season's activity to date is consistent with the trend.

Percent of Annual Export Sales by Week 22



To summarize, USDA's current forecasts for 2007/08 show stocks falling in the U.S., China, and foreign countries outside of China. Comparing the forecast stocks-to-use ratios to recent history, only the U.S. is expected to have a small cushion at the beginning of 2008/09, with foreign countries, including China, at historically low levels.

Stocks-to-Use Ratios for
U.S., China, and Other Foreign



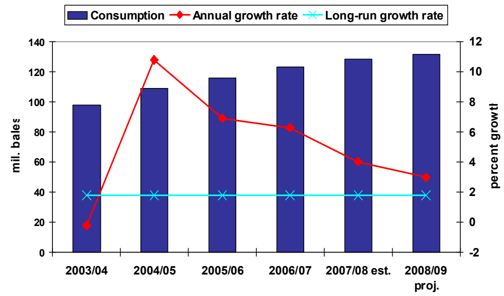
The 2008/09 World Outlook

In addressing 2008/09, I want to point out that USDA currently has no official projections; these remarks are based on my own opinions and observations, with input from other members of USDA's Interagency Cotton Estimates Committee. The first official USDA projections for 2008/09 will be presented at USDA's annual Outlook Forum on February 22.

World Consumption and Supply Requirements

World cotton consumption will continue to grow in 2008/09, but at a slower pace, adding a potential 3 percent, or nearly 4 million bales, to reach a level of about 132 million. Over the past five years, world consumption has climbed rapidly, averaging nearly 6 percent per year, well above the long-run average of below 2 percent.

World Consumption and
Consumption Growth Rates



The main factors supporting consumption have been strong world economic growth, especially rising incomes in developing countries, favorable cotton prices relative to polyester, and the liberalization of world textile trade. Consumption growth will decelerate in 2008/09 due to rising cotton prices and economic problems stemming from the credit crisis in the U.S.; however, consumer spending in developing countries is likely to continue strong. Moreover, recent data on China's net textile exports of cotton continue to show gains averaging around 20 percent.

China's Net Cotton Textile Exports
and Growth Rates since January 2007

Growth in world consumption for 2008/09 will need to be offset either by higher world production or by a further draw-down of world stocks. At the projected consumption level, world stocks could fall another 3 million bales next season and still be minimally adequate. World production would need to rise about 6 million bales. However, foreign production will need to rise more than 6.0 million bales, due to likely reductions in U.S. production, which will put additional pressure on foreign supplies.

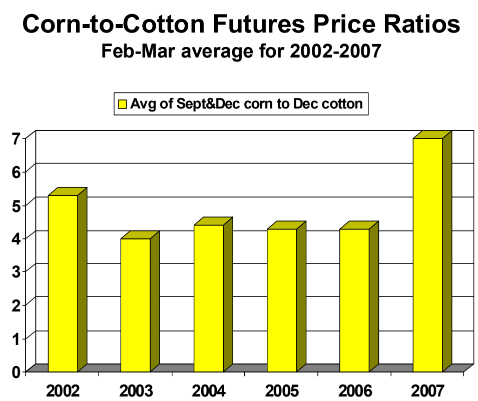
World Cotton Balance Sheet, 2008/09
(mil. bales)

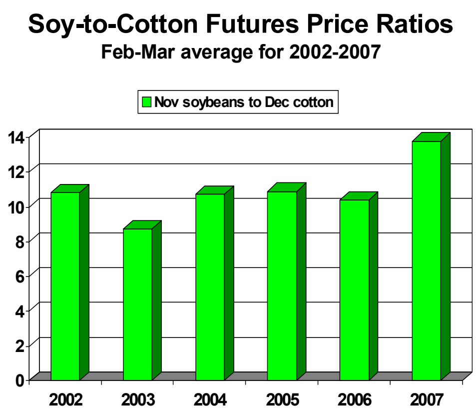
	2007/08	2008/09	Difference
Beg. Stocks	61.0	55.3	
Production	118.8	125.0	+6.2
Imports	41.7	44.0	
Total Supply	221.4	224.3	
Consumption	128.3	132.0	+3.7
Exports	41.4	43.6	
Total Use	169.6	175.6	
Residual	-3.5	-3.7	
Ending Stocks	55.3	52.4	-2.9
Stocks-to-Use (%)	43.1	39.7	

Prospects for U.S. Area and Production in 2008

Forecasting 2008 U.S. planted area is extremely difficult, with most analysts now in the 9.0-10.0 million acre range. The reason for the difficulty is the shifting relationships between the price of cotton and alternative crops, especially corn, soybeans, and wheat.

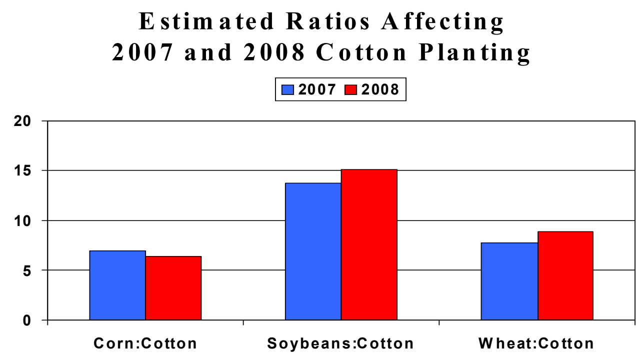
U.S. cotton area fell 29 percent in 2007. Plantings fell in all regions, but the largest reductions occurred in the Southeast and Mississippi Delta and the majority of the reduced area shifted primarily to corn and secondarily to soybeans. New-crop futures price relationships in the early spring of 2007, when producers were making planting decisions, were historically high for both corn and soybeans relative to cotton, but especially so for corn.





Most analysts expect further cotton area reductions in the Southeast, Delta, and Far Western states in 2008, with Southwestern area more stable when compared with 2007. In the Far West, a long-run decline in area will be exacerbated by water restrictions stemming from environmental concerns.

In projecting area for the Southeast and Delta, note that cotton prices, as indicated by the December 2008 futures contract, are significantly higher than they were last spring. When compared with corn, cotton prices have risen slightly more, which suggests that corn may be a less attractive alternative than it was a year ago. On the other hand, soybeans and wheat prices have risen more than cotton prices and double-cropping of wheat with soybeans was especially attractive at fall planting time. There is no question that a significant number of traditional cotton acres in the Southeast and Delta will be planted to alternative crops in 2008. However, with shifts taking place among four commodities, it is difficult to project the magnitude of reduction in cotton area from 2007.



Ratios of futures prices at planting time. 2008 corn and soy ratios based on futures prices for Jan 2-4, 2008. Wheat ratios based on Sep-Oct avg.

This past fall USDA projected cotton plantings of 10 million acres for 2008. Using this figure as a starting point, with abandonment rising to more normal levels, and yields approximately equal to those of the current season, the U.S. could produce 16.6 million bales, a reduction of 2.4 million bales from 2007. However, it is also important to recognize the downside risk for both area and yield. At planted area of 9.0 million acres, and a 5-year average yield, U.S. production would fall below 14.5 million bales, or another nearly 2.5 million, for a total annual reduction of nearly 5.0 million.

U.S. Supply and Demand Estimates
with Scenarios for 2008/09

	2007/08	2008/09 Low	2008/09 High
Planted acres	10.85	9.0	10.0
Harvested acres	10.54	8.3	9.2
Yield/harv. acre	864	820	864
Beg. Stocks	9.5	7.7	7.7
Production	19.0	14.2	16.6
Imports	0.0	0.0	0.0
Total Supply	28.5	21.9	24.3
Consumption	4.6	4.5	4.5
Exports	16.2	14.0	15.6
Total Use	20.8	18.5	20.1
Ending Stocks	7.7	3.4	4.2
Stocks-to-Use	37%	18%	21%

Can Foreign Production Fill the Gap?

At the higher level of U.S. production of about 16.5 million bales, foreign production would need to rise by about 8.5 million bales in 2008 to achieve a 6-million-bale increase for the world. A review of cotton production trends in the major foreign countries indicates that it will be challenging, but not impossible, to gain the needed production increase. The world's largest producer, China, is not projected to make significant gains in production due to strong demand for food crops and government concerns about food security; however, China could add another 1-2 million bales with slight increases in area and higher yields. With rising area and yields, India could contribute another 2 million bales. In addition, the countries which had lower production this season due mainly to weather, price, and insect problems – Pakistan, Australia, the African Franc Zone, and Turkey--could make a partial recovery, adding 3-4 million bales. And Brazil has the capacity to raise production if cotton prices are attractive, possibly another 1 million bales. Thus, 7-9 million bales of additional foreign production appear to be achievable if prices are favorable and none of the world's major foreign producers experiences serious weather and/or insect problems.

If, however, U.S. production falls to a level closer to 14.0 million bales -- as illustrated by the scenario with 9.0 million acres planted and only average yields -- it would be more difficult for foreign countries to offset the U.S. loss, and world stocks could come under pressure not experienced since the mid-1990's.

Uncertainties and Developments to Watch

All projections of 2008 U.S. planted acreage are highly speculative at this point. The National Cotton Council will publish the results of its survey on February 8 and the USDA March 1 plantings survey will be published on March 31 – these surveys will provide a better indication of producers' intentions. The market's other major difficulty at this point is knowing how much world stocks outside of China are likely to be reduced in 2007/08 – the most important indicator being the level of China's imports. As stated earlier, China's imports are unlikely to pick up until later in the season, so the resolution of the world 2007/08 carryover will probably not occur until after the 2008 spring planting window. If China imports only 12.0 million bales instead of 14.5 million, U.S. exports will be lower and stocks higher, providing larger supplies to be consumed in 2008/09.

So, to summarize the key sources of uncertainty: (1) the first is the extent of stocks drawdown in 2007/08, which will affect supplies carried into 2008/09; in particular, (2) import demand by China; (3) macroeconomic conditions affecting demand projections for 2008/09. This outlook assumes continued positive world economic growth. If problems in the financial markets result in worldwide recession, cotton demand will be reduced and less U.S. production will be needed; (4) area response in the U.S. and elsewhere for 2008; and (5) weather conditions affecting production.

The U.S. as Residual Supplier

One concluding comment I would like to make is about the U.S.'s role as the world's "residual supplier" of cotton. In the past, the term "residual supplier" sometimes meant that U.S. cotton was less desirable in terms of quality or price than foreign cotton, but these negative connotations are not generally true of the current situation. The U.S. is the world's residual supplier in a purely arithmetic sense--as the world's largest exporter, it supplies cotton at the margin where foreign supply falls short of foreign demand.

There are several reasons why the U.S. is functioning as the residual supplier: (1) most of the world's largest cotton consumers, such as China, India, Pakistan, Turkey, and Brazil, are also cotton producers and look to imports after their own crops are exhausted; (2) the U.S. has a well-developed infrastructure for storage and shipment, which makes it a reliable and expeditious supplier, so that cotton tends to be stored in the U.S. until there is an immediate need; and (3) the U.S. industry also has the world's best system of price discovery and risk protection, enabling producers and merchants to withstand price variability better than their foreign counterparts.

Recent history illustrates how sensitive U.S. exports and stocks are to small variations in foreign supply and demand. But the converse is also true – if U.S. exportable supplies are insufficient to meet world demand, then the U.S. domestic balance sheet will become a key driver of world prices.