RAW COTTON IMPORTS AND PRICE BEHAVIOR

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The analysis I'll share with you this afternoon was prompted by an initial request by the Producer Steering Committee of the National Cotton Council for an industry committee to evaluate whether the cotton program -- particularly the 3-step competitiveness plan -- was working properly. That study was completed in November and a report was made to the National Cotton Council's Executive Committee, Officers and Producer Steering Committee Chairman on December 11. After hearing the report, Council leaders felt it would serve a useful purpose for it to be shared more widely and the decision was made to add a summary report of key findings to today's agenda.

President Smith directed staff to give special attention to:

- The effect of imports and other factors on the price behavior;
- Whether the trigger mechanisms for steps 2 and 3 are working as intended;
- Whether program adjustments are needed; and
- Whether efforts to change the program would result in damaging modifications.

Background on 3-Step Competitiveness Plan

We'll begin by sharing just a little background about the 3-step competitiveness plan. You will recall that it was developed initially by a staff-level task force and subsequently approved by industry policymakers. As envisioned by the task force, the 3 steps would be implemented sequentially:

- Step 1 when prices were relatively low
- Step 2 when prices were moderate
- Step 3 when prices were high

However, neither the statute nor the regulation included language that would ensure that the steps were implemented sequentially. Moreover, the price threshold that triggers out step 2 was not in the task force design nor the one subsequently approved by industry leaders.

The 1991 Budget Resolution added the language which removes authority for step 2 certificates when the adjusted world price (AWP) is more than 130% of the loan. That was a cost-cutting measure and the rationale was that when the AWP exceeds 130% of the loan it signals a fairly tight world supply/demand situation which suggests U.S. cotton can be price-competitive without the help of certificates.

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While the triggers have worked generally in keeping with design, we have had a number of surprises. Step 1 was not as effective as initially expected in reducing loan redemption costs, but, instead, served to increase producer equities (that outcome was, not necessarily bad, of course...it was just a bit different than what was expected).

Another surprise was the bunching of export sales during periods of high certificate values (neither was this outcome all bad...but it was seen as inequitable by domestic mills and the federal government).

A third surprise was the difficulty of shutting off imports when prices fell back below the 130% threshold after a quota had opened under a moderately high-price scenario.

A new import quota has been opened every week for more than a year now and it is *plausible* that the door will not close over the life of the FAIR Act because U.S. cotton tends to command a price premium in the world market. It is also *plausible* that the spread between the U.S. quote for N. Europe delivery (USNE) and the Northern Europe Price (NE) will narrow sufficiently to close the import door by Spring, 1997, as the exportable supply of cheaper growths diminishes.

Experience With 3-Step Provisions

Despite the surprises, the 3-step plan has served the industry rather well. **Exhibit 1** shows the record of U.S. mill consumption since 1970. The solid line is actual consumption and the broken line reflects averages. You can see that U.S. mill consumption improved under the Act of '85 compared with pre-marketing loan years and it improved again under the Act of '90.

We had similar experience with exports (**Exhibit 2)**. Exports were higher under both the Acts of '85 and '90 than during the pre-marketing loan years. To those who question why we didn't do better under the Act of '90 than under the Act of '85, the answer is that world trade in cotton was lower during the Act of '90.

As seen in **Exhibit 3**, our **share** of world cotton trade did improve under the '90 Act. So, the 3-step program appears to have served us well in boosting cotton demand both domestically and in the export market.

All 3 steps of the competitiveness plan were implemented under the Act of '90. Step 1 was used sparingly. It is implemented at the Secretary's discretion and he chose to implement step 1 in just 19 weeks during the '91-92 crop year; he has not done so since. Generally when step 1 reduced the AWP from the formula level, the result was higher equities to growers. Merchants' cost of cotton was not significantly reduced.

Step 2 certificates were also issued in all but the first week of step 1 adjustments. I'm sure this experience influenced the Secretary's decision not to continue making step 1 adjustments.

Step 2 was the main tool for U.S. price competitiveness under the Act of '90. Step 2 was implemented in 131 weeks across the 1991-94 crop years. It generally served the intended purpose of keeping U.S. cotton price-competitive. However, the export sales bunching phenomenon drew fire, requiring two rule changes in an effort to eliminate bunching.

We're currently operating under the second rule change. It will almost certainly eliminate certificate-related export sales bunching but if step 2 is implemented again, exporters will not be able to reflect it in their quotes for Northern Europe delivery. This will be a problem in at least two significant ways: (1) our cotton will be less competitive for export markets because exporters will be unable to reflect certificate values in their quotes, and (2) the value of certificates for domestic mills may be higher than needed to make U.S. cotton competitive with foreign growths.

Our most recent experience has been with step 3. Step 3 first triggered in the spring of 1995 but no imports came in under the quotas (the world supply/demand situation was tight and foreign cotton was not quoted at attractive prices for delivery to U.S. mills). Step 3 triggered again the first week of November 1995 and has triggered each week since that time. Across the two seasons, we're likely to bring in about 800,000 bales. As we see it, step 3 worked generally in keeping with design, both in the Spring of 1995 when no cotton came in and again since November 1995, when cotton **has** come in.

Because the world supply was relatively tight in the Spring of '95, foreign cotton was not priced attractively for U.S. delivery. In November, we had a very tight U.S. supply but the foreign supply was ample. Under these conditions, you would expect imports. The only surprise (and what, I believe, the original task force would see as "inconsistent" with intent) has been the problem of making a transition out of step 3 and back into step 2.

Price of Cotton and a Healthy U.S. Cotton Industry

Since early this year, Council staff has talked about what we see as a cotton price that is consistent with a healthy U.S. cotton industry. In more than 40 meetings around the Cotton Belt we reminded industry leaders that farmers' revenue under the Acts of '85 and '90 averaged 73 cents a pound, including a 14 cent target price deficiency payment.

At these prices, production averaged about 15 million bales annually. The FAIR Act cuts payments in half and decouples them both from price and production. Both the payment reduction and the decoupling provisions have implications for farmers' decisions about what crop to plant. In our opinion New York Cotton Exchange (NYCE) prices will need to be in the 80s to attract enough acreage to produce 18 to 20 million bale crops on a consistent basis.

The far December price is currently 77 cents and many cotton farmers are considering switching more acreage to alternative crops. Rounding out our dilemma is the cost/price squeeze domestic mills are confronted with. Over-built retail space is keeping pressure on textile product prices and making it very difficult for the textile industry to pass through 80 cent cotton cost.

Exhibit 4 shows the price and revenue expectations of cotton farmers at planting decision time. The solid bars reflect average December futures prices during the February-April period (except '97, which reflects December futures in January '97) and the light shaded bars show farmers' revenue expectations on a per-pound basis. For the years 1991-95 the revenue expectations include returns from the market plus deficiency payments. For 1996 and 1997, however, the revenue expectations are based on market prices only, since the payment is fixed and is earned no matter what is planted.

Looking first at price, it is evident that December '97 price expectations are about as good as they've been in any recent year except last year. However, with far December futures at 77 cents farmers' revenue expectations from cotton are the lowest they've been in any recent year. They're not appreciably lower, but when rising input costs are factored in, the rationale behind farmers' interest in alternative crops can be understood.

Exhibit 5 shows the relationship between corn and cotton revenue expectations at planting time. The curve reflects the corn contract price per bushel divided by the contract price of cotton per pound (taking into account the traditional Mid-South futures/contract basis for both crops). The relationship jumped up significantly in 1996 but, looking ahead to harvest time in 1997, the relationship has fallen back somewhat and is now very near the 1991-95 average.

Exhibit 6 illustrates what a Mid-South farmer might take into account as he makes his spring 1997 planting decisions. In a nutshell, for half the cash outlay, a mid-south farmer could reasonably expect to net $47/acre more for corn than for cotton based on today's outlook for 1997 harvest-time prices. This just factors in lint returns. Seed revenues and any gin or warehouse rebates, need to be factored in for cotton.

Of course, there are other factors which enter into farmers' planting decisions, but this illustrates the process and demonstrates why some farmers may see alternative crops as a better option than cotton next year unless prices change.

Effect of Imports on Price Behavior

Lets turn now to the issue that has, probably more than any other factor, prompted this analysis -- the effect of imports on cotton price behavior. Our analysis suggests that imports have, indeed, had an effect on cotton prices, but much less than most people think.

Exhibit 7 shows raw cotton imports during calendar 1996. The first imports under step-3 quotas arrived in January, but there was no appreciable volume until the summer months. The real **need** for imports was during the months of July - October. There were insufficient working stocks to service domestic and export demand at the prevailing monthly rate of 1.5 million bales from the end of the 1995 season until a significant volume of 1996 U.S. new crop cotton was available. Once the '96 new crop was on stream, imports began to drop dramatically.

The effect of imports on price behavior has been rather widely misunderstood, in our opinion. Imports **have** had an effect on prices, especially old crop ('95 season) prices. But other factors were involved as well.

Exhibit 8 compares the nearby NY contract with the 'A' Index, beginning August, 1995 and continuing until the July '96 contract expired. Nearby NY prices began to fall the week of October 12, 1995 and continued on a generally downward path for the rest of the marketing year. Across the October 1995 - July 1996 period, the 'A' Index fell 14 cents and the nearby NY contract fell 22 cents.

Exhibit 9 compares the Delta spot price with the nearby NY contract and the 'A' Index, beginning January 1996. The spread between the Delta spot price and the NYCE price reflect a fairly typical basis during the early part of the year. Then, around March, the Delta price moves above the nearby NY contract, reflecting a shortage of U.S. high quality cotton.

From early April through early June, all the prices moved lower. It was in June that the fall in the nearby NY contract was so much greater than both the 'A' Index and the Delta spot price. (While Southeastern spot prices are not charted, they were generally consistent with the Delta spot price.)

We believe much of that sharp fall stemmed from certification of Desert Southwest and West Texas cotton perceived to be sticky. As seen in **Exhibit 9,** spot prices for West Texas and Desert Southwest growths generally mirrored the sharp fall of the NY contract while the Delta spot price remained relatively strong. Again, as we see it, imports **did** affect old crop prices, but there were other factors affecting old crop price behavior as well.

Exhibit 10 compares new crop NY prices with the 'A' Index. The series begins in April when the 'A' Index was first reported for new crop cotton. The spread between the 'A' Index and the December NY contract is fairly typical from April through July. The NY contract began to move up in August as USDA lowered its estimates of the U.S. crop from 19 million bales in July to 18.6 million in August and 17.9 million in September. However, the estimates were raised again beginning in October and the more traditional spread between the NY contract and the 'A' Index has returned.

We don't see any evidence that raw cotton imports have had an appreciable effect on new crop prices. The world supply/demand relationship, more than anything else has driven both the world price and the December NY contract.

Here's how we would summarize the effect of raw cotton imports on old crop prices:

- Imports no doubt prevented old crop prices from rising above the "dollar-a-pound" level;
- Imports were primarily responsible for the April-May decline of nearby NY prices (from 87 to 81 cents); but
- A declining world price, the perception of certificated sticky cotton and weak mill demand were also factors.

Imports also prevented a cutback in mill output and/or manmade fiber substitution...one or both of which would have been necessary without imports.

For new crop prices, we believe:

- Imports had a minimal effect; and
- The world supply/demand relationship was primarily responsible both for declining world price and NY futures prices.

It would be difficult for the NY price to rise much above the 'A' and remain there for any appreciable time, even if imports were shut off. If the NY price rises above the 'A' while there is an uncommitted U.S. exportable supply, our exports will suffer...and if U.S. exports sales drop, the price will "correct."

Triggers for Steps 2 and 3

Lets focus now on the trigger mechanisms for steps 2 and 3. I will introduce these observations by saying that we generally feel the triggers have worked in keeping with expectations **except** triggering out of step 3.

Is there, in fact, a trigger problem? As we consider the question, these observations seem relevant:

- Step 3 was initially seen as a price/supply remedy of last resort;
- Initially there was no "trigger out" price threshold for step 2; and
- There was no step 2/step 3 "exclusivity" provision (this was added in the '91 Budget Resolution).

If the current transition problem (from step 3 back to step 2) had been foreseen, the provision in the '91 Budget Resolution probably would have been opposed by the National Cotton Council. We probably would have favored a provision allowing step 2 to supersede step 3.

As we consider our current situation, several questions seem relevant:

- Will the existing step 2/step 3 trigger mechanism be troubling in the future?
- If so, can an agreement be reached on an amendment to current law?
- If an agreement is reached, what are the prospects for getting it approved by Congress without incurring damaging program modifications?

We noted earlier that it is *plausible* that step 3 will not trigger out over the life of the FAIR Act. That's because U.S. cotton tends to be worth more than foreign growths and, in the absence of prospects for high U.S. carryover stocks, it is unlikely that the USNE would be quoted within 1.25 cents of the NE.

We also noted that it is *plausible* that step 3 quotas could be shut off by Spring 1997. That's because the exportable supplies of cheaper foreign cottons may be rather short by that time.

Exhibit 11 shows the growths currently included in the 'A' Index. Both the Greek and Syrian growths are beginning to be in short supply and, by Spring, the Central Asian growths are likely to be tight. Under these circumstances, and with prospects for U.S. carryover stocks in excess of 4 million bales on July 31, 1997, it is *plausible* that the spread between the USNE and the NE could narrow to within the 1.25 cent threshold for shutting off import quotas.

Even if this occurs, though, any subsequent opening of step 3 quotas would be difficult to close **--** for the same reason they've been difficult to close this time. U.S. cotton is simply worth more than foreign cotton.

Are Program Adjustments Needed?

Whether agreement can be reached on program adjustments depends on a number of factors. To begin with, it depends on industry members' perception of (a) how badly the program is "broke," (b) what it will take to fix it, and (c) whether a fix will require increased federal spending and, if so, whether Congress require an offset. And, of course, what's at risk. Is it possible that an attempt to fix one problem will result in a still bigger one?

When all the facts are considered, I frankly don't know what industry leaders will decide.

Producers will have to decide whether the price of cotton is low enough to incur the risks associated with attempting to adjust the cotton program. Manufacturers will have to decide whether the U.S. cotton production base is seriously jeopardized in the absence of some sort of program adjustment.

Processors and handlers will have to decide whether the infrastructure is in jeopardy without program changes. And all segments of the industry will have to decide whether effective changes can, in fact, be made to the cotton title in light of the FAIR Act's flexibility and decoupling provisions.

To say that opening the farm bill for cotton title adjustments involves risks may be an understatement:

- Any effective change will almost certainly involve legislation;
- A rule change will also be needed;
- If legislative adjustments are scored by CBO as a cost above its new baseline spending estimate, Congress would likely require a spending offset;
- A legislative change will be an uphill battle even if we have a united industry front and next to impossible without it.

Legislative and regulatory adjustments may very well be resisted by some key Congressional leaders, by the General Accounting Office, by USDA's Office of Inspector General and by the Office of Management and Budget.

In considering options, several other points would seem to merit consideration. Our assessment suggests that:

- Much of the price softness attributed to imports was actually caused by other factors (world supply/demand, quality problems, etc.);
- The 3-step competitiveness plan has perhaps not had a thorough test under the FAIR Act; and
- Facilitating a transition from step 3 import quotas to step 2 certificates is not a "cure-all" for low cotton prices.

Here's why we say increased reliance on marketing certificates is not a "cure-all." **With an effective rule** (which would involve a rule change permitting certificate values to be reflected in the USNE), the result would be more aggressive U.S. pricing in the world market. This would cause downward pressure on the 'A' Index and, under most market conditions, downward pressure on the NYCE contract. Producers no longer enjoy target price protection since payments have been decoupled from prices. Therefore, if the NYCE contract is driven lower, the first 20 cents or so comes right out of growers' pockets (until the AWP falls below the loan, activating the marketing loan).

The greatest returns from more reliance on step 2 most likely will be longer term -- i.e., the benefits of moving the current crop to market, removing the stock overhang and discouraging foreign production. These are the same benefits we sought initially through implementation of the marketing loan and subsequently with the addition of the 3-step competitiveness plan. However, producers had better price protection when payments were in the form of deficiency payments tied to a target price.

The problem under FAIR's decoupled payments, of course, is that aggressive pricing could have short-term consequences that would not be welcomed by farmers. The probability of these adverse price consequences is greater in periods when carryover stocks are expected to be high. That's when pressure is greatest for **all** sellers to price aggressively and move stocks to market.

Without an effective rule for exports, step 2 certificates would be costly but would have limited value. Currently, for example, the spread between the USNE and the NE is about 5 cents/pound, meaning certificates would be valued at about 3.75 cents (and would have been as high as 9 cents at mid-year). Without an effective rule for export certificates, this value could not be reflected in the USNE. The certificates would, therefore, have limited value as a tool for boosting export sales.

Also, since certificate values would not be reflected in export quotations the spread between the USNE and the NE would remain wide and certificate values would remain large. What, then, would be the expected return on weekly issuance of certificates valued at 3.75 cents?

We've already noted that the value of certificates for boosting export sales in the absence of a rule change would be minimal. Exporters would receive a certificate valued at 3.75 cents for sales already made. And, for **new** sales, exporters could not know whether certificates would be available on the date of shipment (which, under the current rule, is the only time certificate values can be established.) In all likelihood, exporters would regard step 2 certificates much like producers regard fixed, market transition payments -- i.e., they would become exporters' "decoupled" payments.

Issuance of certificates to domestic mills would also provide limited returns. They would not encourage greater use of cotton unless there were expectations of receiving the certificates over an extended period of time. They would not discourage raw cotton imports under today's circumstances, since domestic mills are not purchasing foreign cotton at current price relationships.

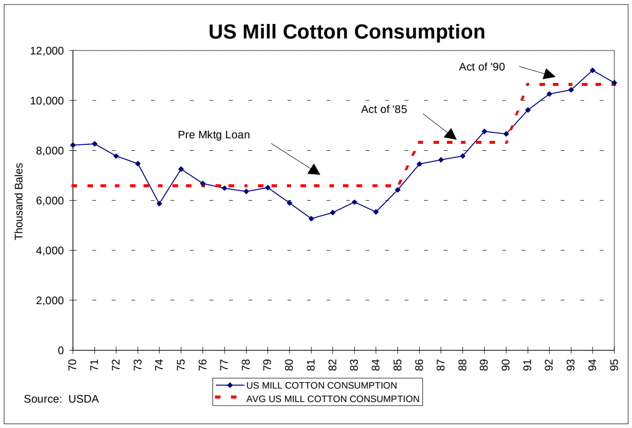
So, in order for certificates to be useful, both a legislative change and a rule change appear to be needed. Even then, the short term results might not be what many would expect. In all likelihood the combination of legislative and rule changes to facilitate the transition to step 2 certificates (whose value could be reflected in the USNE) would:

- Boost U.S. exports, because U.S. cotton would be quoted at lower prices for export markets;
- Cause the world cotton price (the 'A' Index) to be lower, because the USNE would be lower and foreign competitors would most likely reduce their quotes in an effort to maintain a competitive price;
- Cause NYCE trading levels to be lower, because there tends to be a fairly strong correlation between the NYCE contract and the world price;
- Cause the near-term price received by farmers to be lower, because offers to farmers are keyed to NYCE contract values and there is no empirical evidence that the availability of certificates affects basis;
- Cause farmers' near-term revenue to be lower, because fixed, decoupled payments would not compensate for lower prices;
- Improve the longer term outlook both for U.S. prices and U. S. acreage, because carryover stocks would be reduced and aggressive pricing would discourage expansion of foreign acreage;
- Have little effect on demand by domestic mills for U.S. cotton in the near term, because under current price relationships they are not buying foreign cotton;
- Increase domestic mill demand for U.S. cotton over the longer term, because it would discourage imports and improve competitiveness against manmade fibers.

Our conclusion is that results of program changes to facilitate a transition from step 3 to step 2 would be mixed. The greatest returns would be long term and producers would need to be prepared for the possibility of some short term downward pressure on prices.

Mr. Chairman, I'll stop at this point. I would just add that the report to the Council's Executive Committee included several options for program adjustments. While each one offered different provisions, they all were focused on ways to facilitate a transition from step 3 import quotas to step 2 certificates. However, none jumps out as a risk-free solution. We continue to look for a solution that doesn't present significant risks and on which our industry leaders can reach consensus. Council delegates will have an opportunity to speak to the issue at our Annual Meeting next month and the staff of the National Cotton Council will be guided by the resolutions they approve.

Exhibit 1



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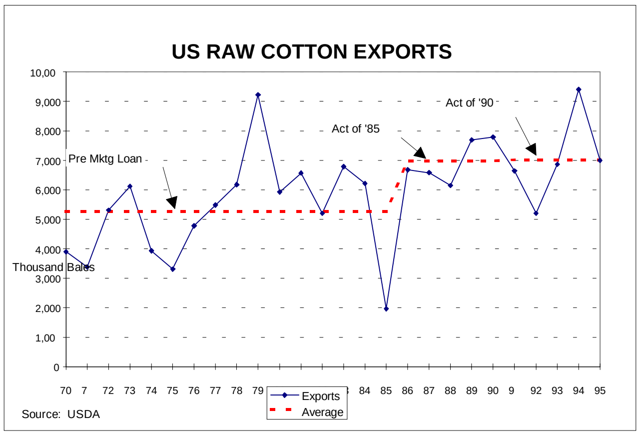

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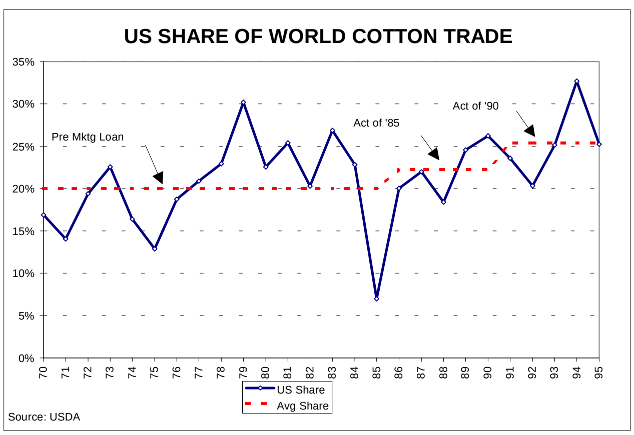

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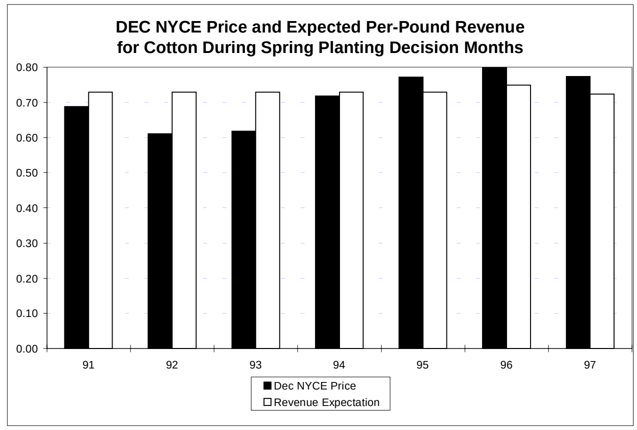

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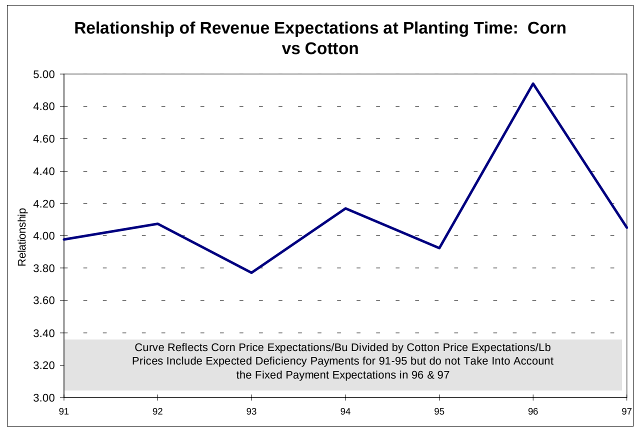

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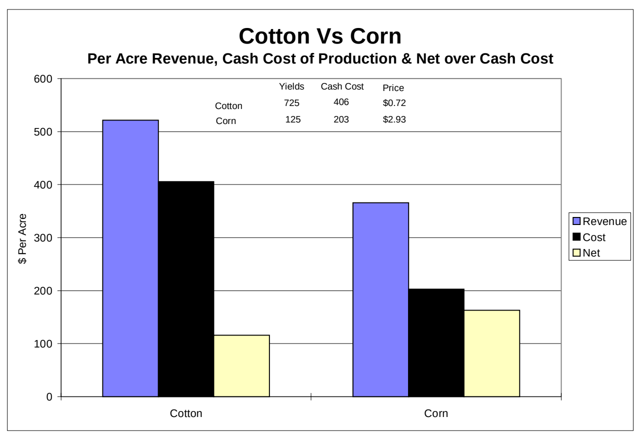

Exhibit 7

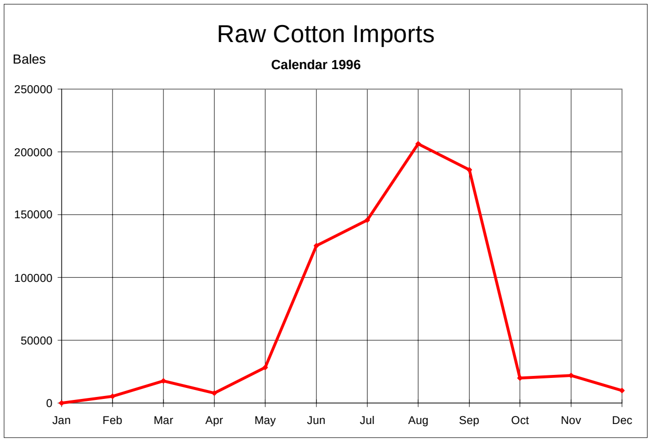

Exhibit 8

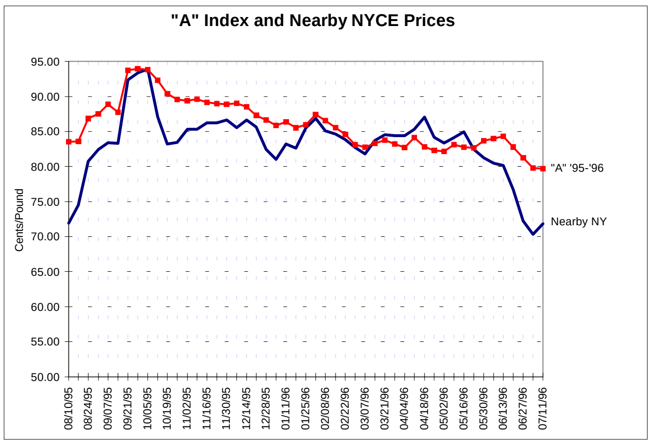

Exhibit 9

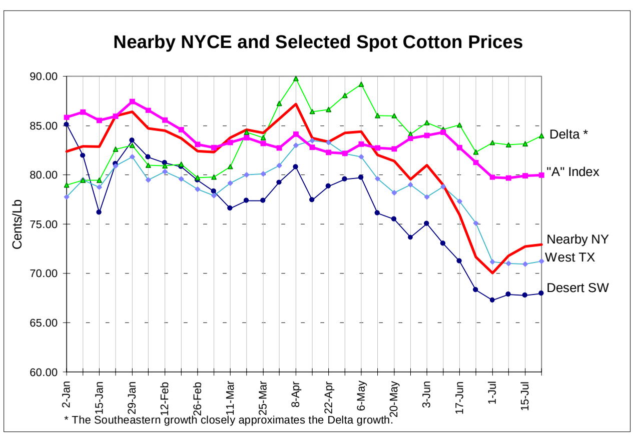

Exhibit 10

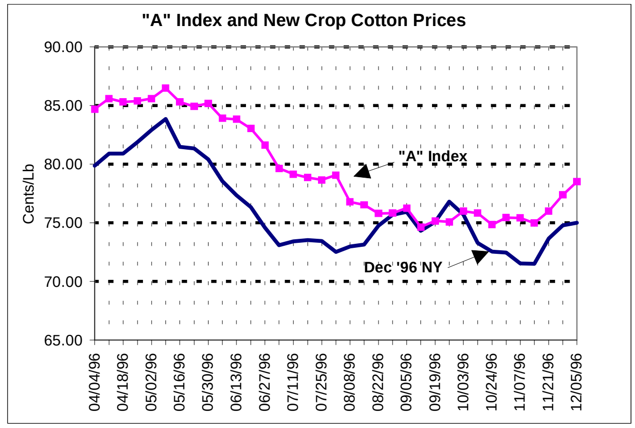

Exhibit 11. Growths in the 'A' Index

Current 'A' Index = 79.50

- CIS 75.5
- Greek 78.50*
- African 79.50
- Syrian 80.00*
- CA/AZ 84.25

* Out soon?

Other Quotes

- Australian 84.50*
- Memphis 84.50

* Eligible January 1, 1997