

## WASHINGTON UPDATE

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### Abstract

This paper reviews operation of the national cotton program over the past year, specifically the "three-step" programs to improve cotton competitiveness. The paper calls attention to the problem posed to mills by short fiber content and urges industry action.

### The Three-Step Competitive Process

Since we met a year ago in New Orleans, the cotton program has undergone some important changes which were to the benefit of entire industry. Further changes, which we hope will also turn out to be pluses for the industry, are just now entering the discussion stage.

Last year, Step 3 was the main point of discussion and source of consternation to producers. By the time of the Beltwide meeting, we had chalked up some 63 consecutive Step 3 import quotas. World cotton price conditions were to remain conducive to the triggering of new quotas until finally, on May 8, the gap between the lower U.S. quotation in northern Europe and the "A" Index narrowed to within 125 points. After having opened 80 consecutive quotas, Step 3 finally triggered out. The last of the outstanding Step 3 quotas from that long series expired on December 12, 1997.

When Step 3 triggered out in May, the way was open once again to resume Step 2 competitiveness payments to textile mills and exporters. The U.S. quotation in northern Europe remained fairly competitive for several weeks, but Step 2 payments finally triggered on July 10. The resumption of Step 2 payments prevented new Step 3 import quotas. Since last July 10, we have never observed more than 4 consecutive weeks of non-competitive status. We have stayed well short of the 10 weeks required to reintroduce the import quotas.

At the present time, with ample worldwide supplies of cotton, none of the market events which led to the triggering of the last series of Step 3 import quotas appears at all likely to recur before this October. On October 1, 1998, the new legislation which changed the triggering mechanism for Step 2 will take effect. Step 2 payments will then be able to run concurrently with Step 3, if it should ever again trigger. As of this October, it will be extremely unlikely that a long series of Step 3 quotas will ever occur again, thanks to the legislation enacted last November.

Since Step 2 payments resumed on July 10, American textile mills have received about \$29 million, and exporters have received about \$10 million. The payment rate over these 26 weeks has averaged about 140 points. Total claims have averaged about \$2 million per week.

Step 2 is now operating in a manner different from the way in which it operated the last time we had significant Step 2 payments, in 1994 and 1995. Then, payment rate for a given export transaction was determined as of the date the export sale was reported to the Commodity Credit Corporation's Kansas City office. The rate was known to exporters and to buyers alike, and the payment could be calculated into the asking price for U.S. cotton. That system was very efficient at transmitting the payment to the buyer and at stimulating export sales.

Today, the Step 2 payment rate is determined only when the exporter notifies CCC that the bale has been shipped. Neither the exporter nor the foreign buyer can know the payment rate at the time the sale is made. The program has lost some of its efficiency in transmitting that payment to the buyer, and, therefore, it has lost some of its effectiveness in stimulating exports of U.S. cotton. Still, exporters have found ways to use the program, and there have been reports that it is helping increase export sales.

Apparently, most foreign buyers understand exactly how the program works, and they are insisting on receiving at least part of the Step 2 payment in the form of discounted prices. With the rate fairly stable at between 1 and 2 cents, the risk to either seller or buyer of an agreement on the disposition of the payment carries minimal risk.

So far today, we have considered Step 3 and Step 2. To continue our countdown, let us turn to Step 1, which triggered on December 18 for the first time in nearly four years. Step 1 is the discretionary authority granted under the cotton program legislation to the Secretary of Agriculture to reduce the marketing loan repayment price, also known as the "adjusted world price" or the "AWP." In determining whether to make such a reduction, the Department must consider the United States' share of world cotton trade, the current levels of export sales and export shipments, and any other data bearing upon the competitiveness of U.S. cotton, including loan activity.

The theory behind Step 1 is that reducing the marketing loan redemption price will make the loan less attractive to producers by providing them with either a higher loan deficiency payment or a higher marketing loan gain, if they redeem cotton already placed under loan. Cotton will move more freely in the marketplace if the loan is less attractive. The competitiveness of U.S. cotton will be enhanced. Producers hold cotton under loan to receive higher prices, but the additional compensation due to the Step 1 adjustment provides incentive to abandon that strategy.

That is the theory. From a practical standpoint, a reduction in the AWP under Step 1 authority can deliver nothing to the producer and cannot contribute to competitiveness unless the AWP is already near the loan rate. There is absolutely no reason to make an adjustment if the resulting adjusted AWP still remains above the loan rate plus interest and storage costs on the cotton. On December 18, and again on December 29 and January 2, there was no effect to be obtained, and the Step 1 adjustment was zero. However, we are not far from the level where the adjustment would make a difference.

If we assume that a bale has been under loan for 2 months, there would be about half a penny of interest and a penny of storage per pound against that cotton. The redemption value would be about 53.5 cents. Let's say the AWP is 59 cents, not far from where it is today. The maximum permissible adjustment in any week is the difference between the lower U.S. in northern Europe quote and the Northern Europe Index. Let's say that difference is 3 cents, again, not far from what the difference really is today.

Adjusting the AWP by the full permissible amount, down to 56 cents, still provides a loan repayment rate which is above the loan redemption value of 53.5 cents, so there would be no point in making the adjustment. However, the point at which CCC would begin to pick up some of the storage and interest might not be so far away. We would not necessarily recommend a Step 1 adjustment even if it began to have financial meaning. The criteria we must consider, namely U.S. export performance and the influence of the loan program on cotton flow, would point away from making an adjustment at this time. Our export sales are well above the pace needed to reach our projected export shipments for crop year 1997. There are only about 1.8 million bales, about 10 percent of the crop, now under loan, with ginning and classing nearing completion for the year. At this time, there is no evidence that the loan program is interfering in any significant way with cotton flow.

### Spinning Quality and the Loan Schedule

Last year at New Orleans, Mr. Andrew MacDonald, an important customer of U.S. cotton in Brazil, told the Beltwide Conference that cotton was in danger of losing its market share to manmade fibers because cotton was not keeping up with advances in spinning technology. With faster spinning machines required for mills to remain competitive, there was less tolerance for inferior cotton fibers. He singled out **short fiber content** as a problem which needed immediate attention. Neps, which prevent even dyeing of fabric, are another of his complaints.

Another perceptive statement on the risk of lost market share for cotton was given at this year's meeting of the International Cotton Advisory Committee in Paraguay by Mr. Suresh Kotak, president of the East India Cotton Association. Mr. Kotak cited as one of the weaknesses of cotton in the

race against manmade fibers that cotton fiber properties sometimes do not meet standards required by modern, high-speed spinning machines. To raise productivity, he said, textile manufacturers are increasing processing speed. Breaks are costly. Polyester is preferred over cotton now not only because of a cheaper price but because of polyester's more desirable spinning characteristics.

Mr. Stephen Felker is chairman of the cotton committee of the American Textile Manufacturers Institute. He imported Uzbek cotton under Step 3. He has praised Uzbek cotton because its short-fiber content was much less than some American cotton he has spun.

So, cotton may be losing some of its world market share partly because of inability to compete on non-price physical characteristics. Apparently, American cotton does not compare favorably with some foreign cottons on the basis of short-fiber content. To preserve the market for cotton, we must become more concerned about short fiber content of the cotton we are sending to market.

Our market system has been very successful at producing the right kinds of cotton and delivering cotton to mills at competitive prices. Market signals have accomplished this most clearly in the case of strength. Price signals did, indeed, increase strength, and they have done so to the point that there is hardly any premium for strength in today's market. However, the market has not handled quite as well the issue of color and leaf content.

In 1993, color and leaf content became separate grading factors. One of the chief objectives of separating color and leaf grades was to reduce the incentive to "over-clean" the cotton. A complaint which American mills had was that our cotton was being over-ginned or over-cleaned because of the ease with which a bale could be promoted to a higher grade simply by removing trash. However, neps, pepper trash, and broken fibers were more prevalent. The introduction of the new grading system gave the Department of Agriculture an opportunity to help signal farmers through the loan program that over-cleaning was not necessary and would not be recognized in the marketplace with higher returns, as it had been in the past.

However, in re-reading some of the testimony presented in 1993 as we were trying to set loan premiums and discounts under the new grading system, we are struck by the ambivalence in the views expressed. There was no clear statement of what the cotton industry wanted from the grading process and the loan schedule.

Some said the objective of rigorous cleaning was to achieve the highest possible color grade. But a cautionary note was sounded by others, who worried that too much cleaning would cause unacceptable physical damage to the cotton fiber. It was perceived that removing more leaf could work toward a higher color grade. It was counter-argued that only

a **certain** --but unspecified-- amount of leaf trash should be removed at the gin, an amount which would leave the cotton just short of the threshold of unacceptable fiber damage.

Underlying these positions were the tacit hopes of the producer to receive a higher price for cleaner, whiter cotton, and of the buyer, who hoped to pay a lower price for cotton which had not been cleaned quite enough or was not quite white enough.

It now turns out that cotton is still being over-cleaned. Mills still complain about short fibers and neps. Producers still say they are being discounted too heavily for spots. Thus, the market and the loan schedule must still be sending contradictory signals which lead both to over-cleaning and to reduced spinning quality.

Despite the separation of color from leaf in 1993, achieving a higher **color** grade is still an important objective in the cleaning process. In rare cases, the presence of leaf may reduce the color grade assigned. More frequently, vigorous cleaning may blend spots into near invisibility and gain a higher color grade.

What is the **color** of raw cotton really worth to mills? At the margin between 31 and 32 or between 41 and 42 color, isn't the probability of error in the color grade about as large as the difference in color's value to the mills? Given that the difference in color between 41 and 42 at the margin is very small, is the better color worth more to the mills than the costs of higher short fiber content? Does the color of raw cotton play as important a role in the value of the manufactured product as it does in the pricing of raw cotton?

Since leaf content, itself, is important in pricing and spinning, it is not to be overshadowed by the discussion about color. Gins remove leaf in order to create a product which is cheaper for mills to use than would be cotton without cleaning. The key word is cheaper. Presumably, cleaner lint commands a higher market price because it is cheaper for mills to use. It cuts their costs by lessening their own need for investment in cleaning equipment and by reducing the frequency of ends down and rejected product. What other reasons could there be for mills to care about the leaf content of raw cotton? Why else would they be willing to pay more for clean cotton than they pay for leafy cotton?

However, mills sometimes buy cotton which is cleaner than they need. It has been over-cleaned. It **adds** to their costs by increasing down time and defects. But, mills buy it anyway. Why? Are mills also "victims" of a system that is sending conflicting signals?

What is the maximum amount of trash that mills' equipment can handle before their quality of the product begins to be affected? What is the **least** amount of trash the cleaning

equipment must handle before their investment in it begins to be waste? How do these two extreme amounts of trash relate to the short-fiber content and the neps they are receiving in their feedstock? What is the cost in down time and defective product associated with given levels of short fibers and neps, and with the amounts of non-lint material introduced into their manufacturing process?

How much are mills really gaining by maintaining a large price differentials for color and trash content if they also invite neps, pepper trash, and higher short fiber content? In short, how much trash are mills willing to buy, and how much are they willing to pay for it, to spare themselves the costs associated with neps, pepper trash, and short fibers?

Finding the answers to some of these questions will help make American cotton more competitive by moving toward a system in which cotton is priced according to its true worth for spinning. This is an objective which has been sought by mills for some time.

There are efforts under way at this time to help find some of these answers. A ginner in Alabama has been experimenting with what he calls "prescription ginning," in which he is attempting to adjust his gin output to meet certain specifications given to him by mills. Computers make this a reachable goal.

Having had his experience with Uzbek cotton, Mr. Felker is attempting to calculate the difference in processing costs between that cotton and other cotton with greater short fiber content. Other mills may help him with data, as well.

Work is progressing well toward establishing a measurement of the short fiber content of a cotton sample which can be reported to growers along with the color, staple length, trash content, micronaire, and the other characteristics already included in the grading report.

The National Cotton Council recently constituted a new task force to examine cotton quality issues as they relate to the loan difference schedule. That group has already had one meeting. The loan schedule and quality issues are emotional subjects. We hope the task force's work does not degenerate into an argument about high loan rates versus low loan rates. Instead, we hope it will address some of the issues we have raised today.

Here is our initial suggestion on how to address the problem of over-cleaning through the loan schedule, which we offer for the consideration of the Cotton Council task force:

- At present, working from the base quality, the discount for 42 color is 390 points. "Half-step" premiums and discounts should be established which would provide appropriate incentives or disincentives for short fiber content.

- A range of tolerance for short fiber content should be identified. For example, it could be established at a maximum of 10 or 15 percent, as reported on the grade card.
- A bale with a color grade of 42 and with short fiber content outside the tolerance range could receive the full discount of around 400 points.
- A bale with a color grade of 42 but with short fiber content within the tolerance range could receive a discount of only about 200 points.
- A bale with a color grade of 41 and short fiber content outside the tolerance range might receive no adjustment from the base loan rate.
- A bale with a color grade of 41 and with short fiber content within the tolerance range might receive a premium of 200 points.
- Similar desirable ranges for leaf content could be established and treated similarly, so that disincentives to over-clean the cotton are present, and incentives to market cotton with less short fiber content are offered.

This suggestion may appear to be more complicated than necessary. Why not just create a simple schedule of premiums and discounts over an array of short fiber readings? We are reminded of what happened with strength premiums. Over time, they have all but disappeared. Fiber strength is basically a genetic phenomenon. Once it has been bred into the cotton, it is not easily removed. Short fiber content is basically a physical phenomenon which arises in the treatment of the cotton after it has been picked. It can come back at any time.

We would suggest as a goal that whatever solution is developed to address the problem of short fibers should be implemented beginning with the 1999 crop. We will be pleased to work with the task force on this very important problem.