**WASHINGTON UPDATE**
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By now, it should have become well known that the upland cotton program consists basically of a series of complicated dance routines that were not invented by Arthur Murray.

- There is the Step 1, in which everybody hesitates, hoping for a better number. The band has not played this one for years, but still they hope.

- There is the Step 2, in which, at first, everybody bunches up trying to be first in line. Then, the tune changes, and everybody wants to be last in line. This one has been outlawed until further notice.

- There is the Step 3, in which half the crowd swoon in delight at the prospect that (cheap) foreign beauties will be brought onto the floor. The other half madly look for an exit because they have heard this one too many times before, and they think the foreign hussies might cheapen the place.

Today, I should like briefly to examine each of these Steps in turn. We shall look at Step 2 first. Then, we shall look at Step 3 second and, finally, Step 1 third.

**<u>Step 2</u>**

Like a Christmas top spending its momentum, Step 2 finally wobbled to a pre-ordained stop on the morning of December 15. Program participants, some of whom reportedly spent long hours in the cold Kansas City light in order to be last in line, were notified that their agreements with the Commodity Credit Corporation were, thereby, canceled.

When all the paperwork is done, Step 2 will have paid out $701 million dollars. A little bit less than two-thirds of it , about $440 million, went to American textile mills for processing American-grown cotton, and a bit over one-third of the money, about $260 million, went to exporters of American-grown upland cotton. We do not have exact figures as yet because the FSA office in Kansas City is still processing the applications for payment.

We have an even less exact notion of just what the $701 million bought. Anecdotal evidence abounds that Step 2 both aided in making export sales and in stimulating mill demand. As the Step 2 program approached its end, the payment rate stabilized at around 12 to 13 cents per pound. No doubt, foreign buyers insisted they were not interested in American cotton without a substantial discount of, say, 12 to 13 cents. These were the anecdotes we heard that indicated a high "additionality" for the last few bales sold for export under the program. Additionality is a term used by some economic analysts to indicate the effectiveness of the program in stimulating additional exports or mill use. If we absolutely would not have sold the bale but for the Step 2 payment, the additionality was high. On the other hand, if the buyer was merely holding us up for the money and would have bought the bale anyway, the additionality was low.

There are complications in trying to gauge the additionality of the Step 2 export payments overall, however. Three people were trying to get the money. It is hard to know how much each one got. The first was you, the farmer, who reasoned that, since the merchant who was dickering for your cotton would be getting a check when he shipped, maybe your loan equity should be higher, or the basis should be a little thinner. Next, there was the merchant, who wasn't sure what the payment rate would be when he shipped, and wasn't sure how much of the payment he would have to pass on to the foreign buyer and how much to you. Naturally, he was also hoping to keep some himself. The third person who wanted the money was the foreign buyer.

A big complication was that it was not possible to know in advance exactly how much the payment would be. Therefore, none of the three parties had a particularly strong hand from which to make demands on the other two, but the uncertainty had to favor the party who was actually handling the money.

The current Step 2 program that was capped at $701 million operated between July 1997 and December 1998. In the 1997 crop year, supplies of good quality American cotton were adequate. Export shipments totaled over 7 million bales from the 1997 crop. The Step 2 payment rate for the 1997 crop year averaged only 4.47 cents, but it had climbed to well over 10 cents by the end of that crop year. A payment of 4.47 cents indicates that U.S. prices exceeded the "A" Index by about 5.7 cents, on average, not far from the 5 cents that is generally recognized as "neutral" because of the superior American quality control and reliability in delivering against contracts.

As the U.S. quotes moved further away from the "A" Index, beginning about March 1998, it is likely that Step 2 payments became more important in sustaining the export shipments from the 1997 crop. Still, with the U.S. prices generally in a competitive position in the world market, Step 2 probably was not overly effective in 1997 with regard to its additionality, or the extra exports it caused. My own estimate is that it stimulated exports of 225,000 to 450,000 bales that otherwise would not have been shipped during the 1997 crop year.

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In the 1997 crop year, domestic mill use remained at over 11 million bales. The additionality of Step 2 payments for mill use has been even more difficult to determine than it is for exports. It was never possible for mills to know with much certainty what the payment would be on a given bale. The only reasonable option for them was to retain most of the money. Some undoubtedly was passed through to consumers of cotton textile products, but the value of the cotton contained in a product is a small percentage of the total value. The consensus is that the additionality of Step 2 was quite low for mill use, perhaps 100,000 to 200,000 bales in the 1997 crop year.

Overall, then, in 1997, Step 2 probably added about 400,000 to 600,000 bales to disappearance and added, at most, a nickel to the farm price. During the 1997 crop year, a total of $390 million was spent on Step 2 payments. The additional value to farmers probably did not exceed $400 million.

For the 1998 crop year, I think a very different story can be told about Step 2. U.S. quotes in northern Europe have never been competitive during this crop year, consistently exceeding the "A" Index by more than 10 cents. Of course, this has been a result of the 30-percent decline in U.S. production. Many thought that the large spread between the U.S. quote and the "A" also reflected the availability of Step 2 payments. There was no particular reason to hold U.S. quotes in check, it was argued. Alas, Step 2 payments are over, but the spread isn't. It's still 13 cents.

Merchants and co-operatives have sold a total of 3.7 million bales for export in the 1998 crop year. While Step 2 was operating, they sold.....3.7 million bales. After Step 2 stopped operating, they sold....1000 bales, net. To make the USDA projected export figure for 1998-crop upland cotton, 3.97 million bales, we only need to sell 270,000 bales more.

It is likely that U.S. cotton was heavily discounted because of Step 2, particularly as the program neared its end, and rates were driven up to record levels of 12 and 14 cents by a combination of the short U.S. crop and large exportable supplies among our foreign competitors. Competition among foreign suppliers was fierce, as the "A" index dropped from 67 cents per pound on September 3, just 4 months ago, to 56 cents today.

To me, it seems that Step 2 was very effective in helping move the 1998 crop. It could be that, at the end of the year, when most of our foreign competitors would have sold out, we would then have sold our cotton, even without Step 2. We might have sold the same amount of cotton, but later in the year. Perhaps. Without Step 2, we may not even be able to hold onto all of the sales we have made but have not yet shipped. At the end of the year, I think it will be clear that Step 2 has been extremely helpful in addressing the difficult market position we are in because of our poor 1998 crop.

Is there more Step 2 in our future? Or, should we look for some other policy that may accomplish a similar objective, but more effectively? The recent attempt to "fix" Step 2 by increasing the threshold to 3 cents was based on sound policy. Unfortunately, it appears to have suffered from unsound politics and did not accomplish one of its objectives of extending the life of the Step 2 program and postponing the advent of Step 3 import quotas. The effort was a useful guide to proper procedure in the future.

It is unlikely that Congress would grant open-ended funding for a new Step 2 program. Our recent experience with how Step 2 ends as the money runs out should caution us against seeking another program of limited funding. Few people would want to go through that again, I'll bet. Therefore, it might be time to entertain new thinking about how best to maintain competitiveness in world cotton trade.

## Step 3

A special global import quota must be announced after a period of 10 consecutive weeks in which the lower U.S. quote for upland cotton for delivery in northern Europe, cost, insurance and freight paid (CIF), adjusted for any Step 2 payment rate available in the previous week, exceeds the average of the five cheapest growths quoted for delivery in northern Europe, CIF ("A" Index) by 3.00 cents per pound. The U.S. quote last closed to within 3.00 cents of the "A" Index in January 1998. Since then, adjustment of the U.S. quote by the Step 2 payment rate each week prevented Step 3 from ever triggering.

FSA has determined that the last week in which Step 2 operated was the week of December 11 through December 17. For weeks after that, the Step 2 payment rate will be zero for adjusting the U.S. northern Europe quote to determine if the week qualifies for Step 3. The first qualifying week was determined on December 24. We are now nearing the end of week 2. Week 10 will very likely be determined on February 25, 1999. The first Step 3 import quota probably will be announced the week of March 1.

These quotas are equivalent to one week's domestic consumption, about 205,000 bales. Imports under the quotas are entered at "in-quota" tariff rates, usually either zero or 2.2 cents per pound, depending on staple length. The non-quota tariff is about 15 cents per pound. Importers must purchase the foreign cotton within 90 days of the date the quota takes effect and must import the cotton within 180 days of the effective date. A new quota is announced each week in which the price condition is met for a tenth consecutive week, and up to 26 quotas can be in effect simultaneously.

The short U.S. cotton supply will not improve until the 1999 harvest, while exportable supplies in many of our foreign competitor nations are adequate. This situation is expected to cause the U.S. northern Europe quote to continue to exceed the “A” Index by a wide margin. Market conditions thus indicate that a new quota will be announced every week for many weeks. It is possible that quotas totaling several million bales could be opened. That does not mean that millions of bales will be imported. Imports under the quotas are now projected by the USDA Interagency Cotton Estimates Committee to reach 400,000 bales in marketing year 1998/99.

**Step 1**

Speaking in public about Step 1 is like lighting a big cigar while standing on a barrel of gasoline. It can be done, but if not done carefully, heat in the posterior region is sure to follow. I do not want anybody here to assume that Step 1 will be exercised at any time in the immediate future. Do not factor any Step 1 adjustment into any marketing strategy. Do not hold waiting for one. Do not buy or sell assuming a Step 1 adjustment will occur.

The statutorily prescribed conditions under which the adjusted world price (AWP) may be further adjusted in any week are: (1) the AWP is less than 115 percent of the base quality loan rate and (2) the U.S. northern Europe quote exceeds the “A” Index. The adjustment can range from a minimum of zero to a maximum equal to the entire difference between the U.S. northern Europe quote and the “A” Index for the week.

Factors to be considered in determining whether a Step 1 adjustment should be made are specified in the law. They are: (1)the U.S. share of world exports, (2)the current level of cotton export sales and cotton export shipments, and (3)other relevant data, as available. Under that last category, we at USDA have considered the volume of loan activity to be very important.

Step 1 authority has been in place since October 1989. Both conditions to trigger Step 1 were met for the first time in August 1991 and continued to be met each week thereafter through January 1994. However, Step 1 was used to lower the formula AWP only 19 times during that period--twice in August 1991 and 17 times between November 1991 and April 1992. On only three occasions was the maximum adjustment applied. In general, it was concluded at the time that these adjustments were not effective in inducing loan repayments or in moving farmers to select an LDP over a loan. However, conditions in 1991 and 1992 were different from those of today in that the concept of Step 1 was not yet well understood in the industry. USDA was testing for the effects of Step 1. In January 1994, the AWP rose above the 115-percent mark and it remained above that level until December 1997, precluding Step 1 during that period. Step 1 adjustment has been possible since December 1997.

It has been widely opined that Step 1 affects U.S. competitiveness only when it either brings the formula AWP below the loan rate or further lowers a formula AWP that is already below the loan rate. In other words, Step 1's effect is felt most when the marketing loan repayment situation is already in effect. According to this line of reasoning, if CCC holds considerable loan cotton, an AWP reduced through Step 1 would encourage more redemptions. If heavy loan placements appear imminent, a lower AWP could help move cotton into the market instead of to the loan. These results are predicted because farmers will perceive either that they will earn a larger marketing loan gain if they redeem loan cotton or that they will earn a larger LDP by deciding not to place the cotton in the loan. Under this line of reasoning, the key ingredient for Step 1 to work properly is **uncertainty**. Farmers should never be sure whether USDA will again announce a Step 1 adjustment in the following week. Therefore, to take advantage of the increased benefit, they must move in the current week.

That is one way to look at Step 1 --as a short-term fix when cotton flow to market appears to be interrupted because the loan is as attractive, or more attractive, than market returns. As pointed out above concerning the history of the very few Step 1 adjustments that have been made, this theory has not been proven.

An alternative theory of Step 1 is that it should be operated during a specific period as a clearly defined pricing strategy aimed at providing “carry-plus” so that U.S. cotton can be offered in world trade at more competitive prices. A version of this was proposed by a group of producers in November. They advocated a flat 10-cent Step 1 adjustment to apply to every bale redeemed from the loan or claiming a loan deficiency payment until May 31, 1999, the last day for making loans on the 1998 crop. Under that plan, the AWP would float at 10 cents under where it is now. It would fluctuate from week to week, as it does now. At today’s prices, that would be very expensive, providing about 20 cents per pound ($100 per bale) on at least 7 million bales.

This plan was proposed, I think, as an additional payment program to help address this year’s low prices and below-normal yields. Step 1 was not intended as a disaster assistance program.

It was, instead, Step 1 of the three-step competitiveness process designed in the 1990 Farm Bill. It was intended as the initial effort to offset the price effects of the cotton loan program while holding farmers harmless. Now that Step 2 is not available to help with competitiveness, Step 1 becomes all the more important. We believe it can be used effectively to help price U.S. cotton so that it may compete better in world trade. Whenever, in the future, it might be demonstrated that the loan program is impeding the flow of U.S. cotton to market, Step 1 is a strategy for improving flow while maintaining farmers' market power. We will give very careful consideration to its use in that circumstance.