China's WTO Compliance
Summary of Oral Testimony
To Be Presented by Wally Darneille
President and CEO of Plains Cotton Cooperative Association
& Chairman of the National Cotton Council
Submitted September 17, 2014

On behalf of The National Cotton Council, Mr. Darneille will present testimony regarding China's compliance with WTO commitments.

According to their WTO accession agreement, China's base level of product-specific Aggregate Measure of Support (AMS) for cotton is zero. In addition, China agreed to maintain any product-specific support at less than the *de minimis* level of 8.5% of the value of production.

In 2011, China began an aggressive cotton stock-building program. It paid an administered price of 19,800 RMB for domestic cotton and placed the cotton in state-owned reserves. It then sold a portion of the cotton at a similar price to Chinese domestic textile mills. By calculating domestic support as the difference between the administered policy price and the fixed external reference price for the 1996-98 base period, the support provided to cotton producers in 2011 is estimated at 19.4% of the value of production. China continued the policy of reserve accumulation for the 2012 and 2013 crops, with the reserve price increased to 20,400 RMB. By the same methodology, the support provided to Chinese cotton producers is estimated at 30.8% and 30.6%, respectively, of the value of production in those years.

For the 2014 crop, China is changing the support program to a regionally-specific target price. China now provides a target price for cotton produced in the Xinjiang province, which is estimated to account for 68% of all Chinese 2014 cotton production. The Xinjiang target price is 19,800 RMB. Again, compared to the fixed external price of 14,584 RMB and given the current expected value of production, support is estimated at 25% of the value of production and again exceeds the 8.5% allowable limit.

While providing support in excess of their allowed 8.5% as accorded in their WTO Accession Protocol, China's government-owned reserves now account for more than 50% of the world's cotton stocks. The U.S. cotton industry is concerned by the sustained levels of support and the resulting accumulation of reserves now held by China. China has no stated policy regarding the disposition of their reserves and the entire cotton market is subjected to a high level of risk and uncertainty.

China's WTO Compliance
Written Comments of the National Cotton Council
Submitted September 17, 2014

As Chairman of the National Cotton Council, I would like to thank the members of the Trade Policy Staff Committee for the opportunity to provide written comments regarding China's cotton policies and compliance with its WTO commitments.

The NCC is the central organization of the United States cotton industry. Its members include producers, ginners, cottonseed processors and merchandizers, merchants, cooperatives, warehousers and textile manufacturers. A majority of the industry is concentrated in 17 cotton-producing states. The downstream manufacturers of cotton apparel and home furnishings are located in virtually every state. Farms and businesses directly involved in the production, distribution and processing of cotton employ almost 200,000 workers and produce direct business revenue of more than $27 billion. Annual cotton production is valued at more than $6 billion at the farm gate, the point at which the producer sells. Accounting for the ripple effect of cotton through the broader economy, direct and indirect employment surpasses 420,000 workers with economic activity well in excess of $100 billion. In addition to the cotton fiber, cottonseed products are used for livestock feed, and cottonseed oil is used as an ingredient in food products as well as being a premium cooking oil.

The U.S. cotton industry participates in a highly competitive global market. Export markets represent the primary outlet for U.S. cotton production with approximately 75% moving into international trade channels. As a result, government policies and developments in supply and demand in key countries have a direct impact on the U.S. cotton fiber and textile industries. In the current cotton market, there is no country with the potential to have as great of an impact as China.

Overview of China Supply & Demand
China is the world's largest cotton producer with a 2013 crop estimated at 32.0 million bales (Table 1), or 27% of the world total. Along with being the world leader in cotton production, China is also the largest processor of raw cotton. For the 2013 marketing year, the U.S. Department of Agriculture estimates China's cotton mill use at 34.5 million bales (32% of the world use). For the past decade, China has been a significant net importer of cotton fiber, and recent import totals have increased due to internal policy changes. However, cotton policies in China are scheduled for another significant change in 2014, and those changes could have a significant impact on world cotton prices.

With its dominant position in world fiber markets, China has adopted policies that significantly distort the world cotton and cotton product markets. These policies range from support prices set well above world market prices, centrally-controlled stock and quota policies, and variable rate levies on cotton imports. There is significant concern that China's current and recent policies may be at odds with the commitments under its 2001 Accession Protocol, the Agreement on Agriculture, the SCM Agreement, and the GATT 1994.

Table 1. China Cotton Supply & Use (Million Bales)

	2008	2009	2010	2011	2012	2013	**2014**
Production	36.7	32.0	30.5	34.0	35.0	32.0	**29.5**
Imports	7.0	10.9	12.0	24.5	20.3	14.1	**8.0**
Mill Use	44.0	50.0	46.0	38.0	36.0	34.5	**36.5**
Exports	0.1	0.0	0.1	0.1	0.0	0.0	**0.1**
Loss	-1.3	0.0	0.0	0.0	0.0	0.0	**0.0**
Ending Stocks	21.4	14.2	10.6	31.1	50.4	62.0	**62.9**
Stocks/Use	48%	28%	23%	82%	140%	179%	**172%**
Source: USDA Production, Supply & Demand Database							

Market Price Support to Cotton Farmers

China has not filed any WTO notifications regarding domestic support provided to agriculture since notifying the support provided in 2008. That notification (G/AG/N/CHN/21) was filed in October, 2011. According to WTO documents, China has filed notifications for market access and export subsidies through the 2011 year, but domestic support notifications are considerably lagging. With India's recent domestic support notifications covering through 2010, China now stands out for having the poorest track record of notifications among major agricultural producing countries.

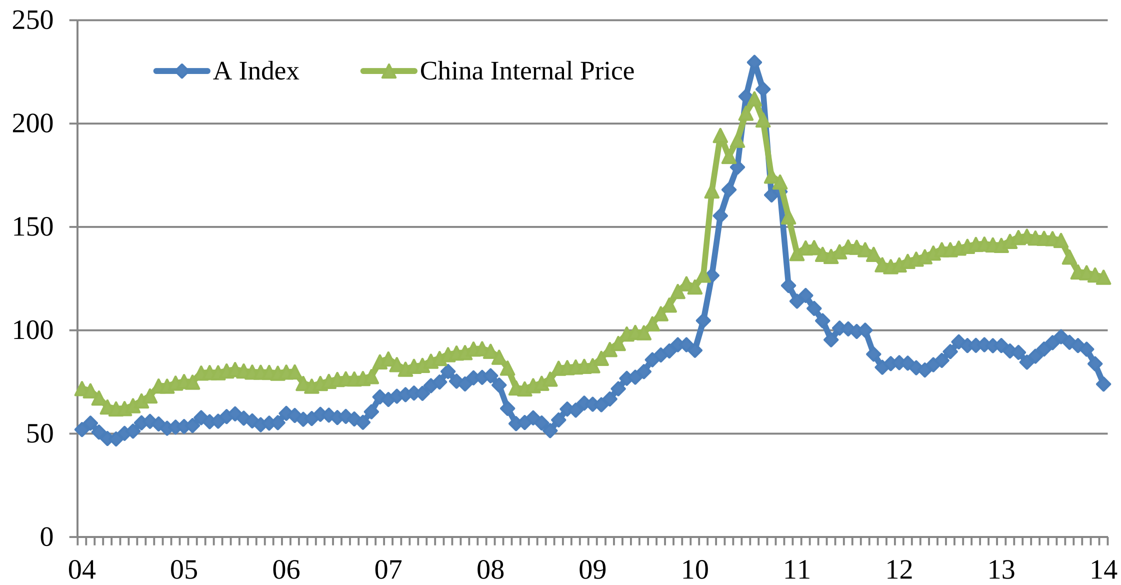
In its schedule of commitments for allowable levels of domestic support (WT/ACC/CHN/38/Rev.3), China established or notified no baseline level of product-specific domestic support for cotton based on the 1996-98 reference period. As a result, China's WTO commitments allow product-specific support for cotton at no more than 8.5% of the value of production.

In 2010 and 2011, world cotton prices went through a period of significant strengthening and increased volatility. Mills in many countries became highly concerned with cotton availability. India went so far as to impose a ban on cotton and cotton yarn exports. China saw its total year-end cotton stocks fall to the lowest level in 20 years, just over 10 million bales. Responding to concerns about available reserves and supporting prices for growers, in September 2011, China initiated a policy of purchasing cotton into national reserves at a level of 19,800 RMB per ton. At current exchange rates, that equated to $1.39 per pound. China continued to operate the reserves policy for the 2012 and 2013 crops at a procurement price of 20,400 RMB per ton, a 3% increase from the 2011 level. Applying the appropriate exchange rates to the latest procurement price results in values of $1.47 and $1.49 per pound, respectively.

Essentially all domestic production was eligible to be purchased into the reserve, which was managed by the National Cotton Reserve Corporation. Data on purchases indicate that 85 to 90% of the 2012 and 2013 crops were purchased into the reserves (Source: International Cotton Advisory Committee (ICAC)). Some of the reserves have been made available to textile mills through an auction system, but the majority of the 2011-2013 crops remain in the reserves. As of July 31, 2014, ICAC estimates that 56.8 million bales of cotton remain in China's government reserves. By comparison, the combined cotton stocks in all other countries stood at 38.3 million bales for the same date.

By guaranteeing a minimum price for cotton producers, and also administering a closely-monitored import policy (to be discussed in greater detail in a later section), domestic prices in China have been supported at levels well above the recognized world price, referred to as the “A” Index (Figure 1). Since 2011, China’s market price averaged 46 cents higher than the “A” Index, representing a difference of 50%.

Figure 1. World and Chinese Fiber Prices (Cents/Lb)



To determine the policies’ contribution to China’s product-specific Aggregate Measurement of Support (AMS) for cotton, the administered price can be measured against a fixed external reference price with the gap applied to the quantity of eligible production. This is the approach foreseen in the Agreement on Agriculture and is commonly used for WTO notifications. It also appears consistent with domestic support notifications submitted by China for other commodities for the years 2005-2008.

Table 2 details the calculations for China’s estimated domestic support. According to a 2001 communication from China (WT/ACC/CHN/38/Rev. 3), the average external reference price for 1996-98 was 14,584 RMB/ton. The external reference price is 5,216 RMB below the 2011 procurement price and 5,816 RMB below the procurement price in 2012 and 2013. Multiplying the price difference by USDA’s estimate of China’s total cotton production yields market price support ranging between 38 and 44 billion RMB. Based on prevailing exchange rates for those years, market price support ranged between $6 and $7 billion annually.

China’s WTO commitments call for cotton support to remain below 8.5% of the value of cotton production. Using USDA data for cotton production and producer price data from USDA’s Economic Research Service and the Food and Agriculture Organization (FAO) of the United Nations, the value of cotton production is determined for the 2011-13 crops. It is recognized that the value of production is inflated due to the effect of China’s policies supporting internal prices, which will tend to understate the full amount of China’s subsidization. However, with that caveat in mind, market price support ranges between 19% and 31% of the value of production, well in excess of the 8.5% *de minimis* level.

By providing domestic support to cotton producers in excess of its commitments, China may be in violation of Articles 3.2 and 6 of the WTO Agreement on Agriculture, as well as of its obligations under the SCM Agreement and the Accession Protocol.

China has announced a change in policy for its 2014 cotton crop. Government officials have indicated that they no longer guarantee a minimum floor price by procuring cotton into their reserves. Instead, a target price mechanism will be implemented with the support price set at 19,800 RMB per ton. Officials have further indicated that the target price will apply to production in the province of Xinjiang, but not to cotton produced in other regions of China. According to USDA Foreign Agricultural Service GAIN Report CH14041, Xinjiang is expected to account for 68% of China's 2014 cotton crop. Further details regarding the exact implementation of the program are yet to be announced.

Although exact operation of the program for 2014 is still prospective, it is clear that support provided under the program will remain at a high level. As illustrated in Table 2, the target price exceeds the fixed reference price by 5,216 RMB per ton. Applying the price difference to Xinjiang's share of cotton production gives support of 22.8 billion RMB ($3.7 billion), or 24% of the projected market value[1] of China's production.

However, the support to Xinjiang through the target price program does not capture the full extent of support provided to China's cotton farmers. Cotton production in other provinces also will benefit from the closely-controlled import policies. Applying a price-gap methodology yields another 2.9 million RMB in support to cotton production. When combined with support from the target price program, support to China's cotton producers is conservatively estimated at 25% of the value of production. If total support levels for 2014 were calculated based on current world market conditions, the effective support conveyed to China's cotton producers would total 44% of the production value. Therefore, the announced policy changes will not bring China into line with its WTO obligations. Instead, the announced policy changes may broaden the gap between the levels of support China provides to its cotton producers and the maximum levels of support it is allowed to provide under the WTO agreements.

While the calculations shown in Table 2 are already well in excess of 8.5%, it is important to point out that the calculations do not capture all forms of subsidies provided to China's cotton farmers. Both USDA and ICAC reports have documented seed subsidies and transportation subsidies provided to cotton. Although relatively small by comparison to the market price support, the other programs would further increase the product-specific AMS for cotton.

[1] Estimated market prices reflect NCC projections based on expected supply and demand factors.

Table 2. Calculations of China's Support to Cotton Producers

	2011	2012	2013	2014
China's Cotton Production (Million tons) [1]	7.40	7.62	6.97	6.42
China's Producer Price (RMB/ton) [2]	26,920	18,900	19,000	16,000
China's Value of Production (Million RMB)	199,279	144,025	132,376	102,766
External Reference Price (RMB/ton, 96-98) [3]	14,584	14,584	14,584	14,584
Reserve Procurement Price (RMB/ton)	19,800	20,400	20,400	
Price Difference (RMB/ton)	5,216	5,816	5,816	
Target Price for Xinxiang (RMB/ton)				19,800
Price Difference (RMB/ton)				5,216
Market Price Support (Million RMB)				22,782
Support as % of Value of Production				22.2%
Market Price Support outside Xinjiang				
Difference between Internal & External Prices (RMB/ton)				1,416
Support outside Xinjiang (Million RMB)				2,911
Support as % of Value of Production				2.8%
Market Price Support as % of Value of Production	**19.4%**	**30.8%**	**30.6%**	**25.0%**
Allowed Support as % of Value of Production	8.5%	8.5%	8.5%	8.5%

/1 Source: USDA Production, Supply & Demand Database.
/2 Source: USDA Economic Research Service, UN's Food & Agriculture Organization, 2013 & 2014 values estimated based on market reports; supply & demand factors.
/3 Source: WTO Document WT/ACC/CHN/38/Rev.3.

China's Cotton Import Policies

China's WTO Accession Protocol established a tariff rate quota (TRQ) of 4.1 million bales. This TRQ is not adequate and not reflective of China's position as the number one cotton producer and processor in the world. Since it acceded to the WTO in 2001, China's growth in cotton consumption, mill use and apparel production, coupled with the loss of U.S. mill use as a result of Chinese competition, have dramatically changed the world cotton market. While China's cotton mill use increased by more than 10 million bales, U.S. mill use dropped from 11 million bales to below 4 million bales. China's market access commitments should thus be re-evaluated in light of its dominant position in the world textile and apparel market.

At various times during the year, China will announce additional quota above the WTO-required TRQ. The process for determination by Chinese authorities of additional quota is unknown and non-transparent. This lack of predictability and transparency in the administration of the import quotas would appear to be inconsistent with China's obligation, under Article X:3(a) of the GATT 1994, to administer such instruments in a uniform, impartial and reasonable manner. Furthermore, those imports are generally subject to a variable levy ranging from 5% to 40%, in order to maintain cotton prices in China significantly above international prices and protect prices paid to Chinese cotton growers. Variable levies are inconsistent with Article 4.2 of the Agreement on Agriculture and have been condemned in prior WTO disputes.[2] An additional problem is that importers must receive import licenses from the central authorities before entering into import contracts.

[2] Chile's price band mechanism was found to be inconsistent with the Agreement on Agriculture in *Chile – Price Band System* and *Chile – Price Band System (Article 21.5 – Argentina)*.

Cotton can also be imported outside of the quota system. However, the importer is still required to acquire an import license and will be assessed a 40% tariff. As previously discussed, the combined effect of China's import quota allocation and stocks/price support policies is a domestic price to their cotton farmers that consistently exceeds world prices.

Impact on Cotton's Fiber Market Share

According to PCI Fibres, China's 2014 man-made fiber (MMF) mill use is estimated at 164 million bales, which is almost 5 times the size of their cotton mill use. Since 2008, China's MMF mill use has grown by 63 million bales, while cotton mill use has fallen by 8.5 million bales (Table 3). As a result, cotton's market share has fallen from 30% in 2008 to a projected 18% in 2014. Unless there is a dramatic change in relative prices in China, it will be extremely difficult, if not impossible, to reclaim that market share.

China's support and import policies have bolstered their internal cotton production while creating a more difficult climate for cotton demand. Imports suffer as a result of the policies and the impact on world cotton prices is felt by producers in the United States as well as other cotton-producing countries.

Table 3. China Fiber Statistics (Million Bales)

	2008	2009	2010	2011	2012	2013	**2014**
Cotton Mill Use*	44.0	50.0	46.0	38.0	36.0	34.5	**36.5**
MMF Mill Use**	101.4	115.3	129.2	140.8	152.8	161.7	**164.4**
Total Mill Use	145.4	165.3	175.2	178.8	188.8	196.2	**200.9**
Cotton's Share	30%	30%	26%	21%	19%	18%	**18%**
Cotton Yarn Imports	2.2	3.4	3.9	3.4	6.2	8.8	**8.3*** **
*Source: *USDA; ** PCI Fibers, ***NCC Estimate based on Global Trade Atlas data through June 2014.*							

Looking Forward

For the coming year, China's exact implementation of support to producers, the allocation of import quotas/licenses and the disposition of almost 60 million bales of government-owned cotton are creating an uncertain environment in world fiber markets. All of these decisions have the potential to have a tremendous impact globally. The U.S. cotton industry remains very concerned with the lack of transparency in Chinese cotton policy. What government reserve level constitutes sufficient stocks? Do Chinese officials monitor and report cotton stocks not held in the government reserves? Are Chinese mills bound to any set purchase pattern between domestic cotton and imported cotton? How are decisions on the quantity of import licenses beyond the TRQ to be made? Uncertainty regarding Chinese policy has the entire cotton world on edge.

Thank you for this opportunity to present the concerns of the U.S. cotton industry.