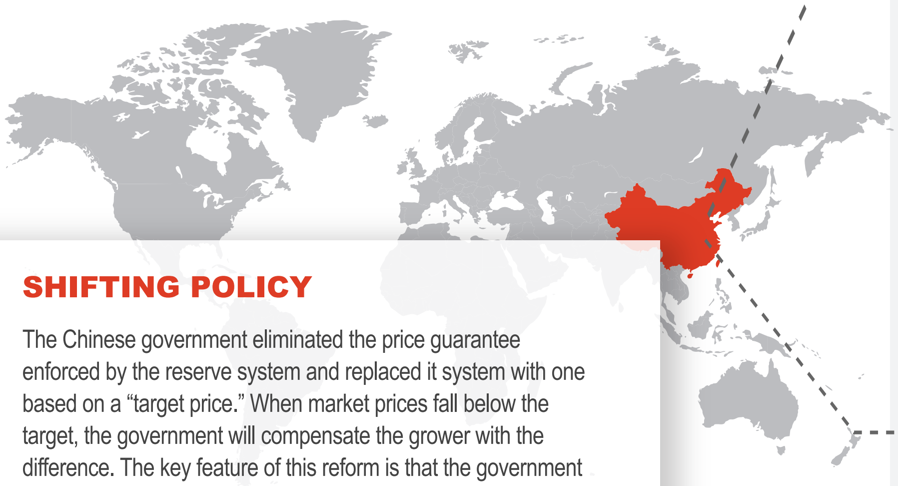
Cotton Incorporated

CHINESE COTTON POLICY

POLICY ORIGINS

In 2010/11, lower cotton acreage contributed to record prices. At the same time prices peaked, China announced a plan to stabilize Chinese acres. This plan involved guaranteed prices enforced by the reserve system and continued control over import volumes.

After the price spike, world cotton prices fell as global stocks were rebuilt and climbed to record levels. Meanwhile, Chinese prices remained high and stable near the government's guaranteed prices.



SHIFTING POLICY

The Chinese government eliminated the price guarantee enforced by the reserve system and replaced it system with one based on a "target price." When market prices fall below the target, the government will compensate the grower with the difference. The key feature of this reform is that the government is no longer accumulating supplies. Instead, it has evolved into a net seller of cotton.

WORLD MARKET IMPACTS

In recent years, when much of the Chinese crop was moving into reserves, China imported more cotton. This situation kept supplies outside of China tight and supported prices globally. With China holding a large supply of cotton in reserves, and with reforms allowing cotton to again flow directly from field to gin to mill, an important question for the world market is—how much will China import in future crop years?

The Bottom Line: Reforms to Chinese policy allow for the re-creation of a domestic market, with cotton grown in China able to flow from farm to mills without falling under government control. The availability of supply from the harvest, as well as through sales from reserves, suggest ample domestic supply. Increased emphasis on the use of domestic supplies means lower Chinese imports and should help keep cotton prices at lower levels.

CHINA DOMINATES WORLD MARKET

As the world's largest cotton grower, consumer, and importer, any change to China's cotton situation affects prices around the world.

28%
Production
China grows nearly one third of the world's cotton

35%
Consumption
Chinese mills spin over one out of three bales consumed globally

42%
Imports
China represents more than forty-percent of global import demand

61%
World Stocks
Over half of world stocks now reside in the country, enhancing Chinese influence on world price direction

HOW MUCH WILL CHINA IMPORT?

When the reserve system was absorbing cotton, Chinese imports were used to supply mills. Strong Chinese import demand kept stocks outside of China low. In turn, this kept prices high.

More cotton imports into China	Implies *upward* pressure on world cotton prices
Less cotton imports into China	Implies *downward* pressure on world cotton prices

Reforms have already led to lower Chines imports, and this had helped stocks increase outside of China. In turn, this has allowed world prices to drop to lower levels.

Source: USDA, all figures are averages for the three crop years when price guarantees were enforced by reserve purchases. The stocks figure is for 2013/14 and represents a cumulative effect of these policies.

CHINESE COTTON POLICY

TWO POLICY TOOLS IN OPERATION: A LOOK AT THE RESERVE SYSTEM & IMPORT QUOTA

GOVERNMENT

The Chinese government uses its reserve system and import quota policies to regulate the domestic cotton market.

IMPORTS

There are three categories of Chinese import quota:

1. Tariff-Rate Quota (TRQ)
2. Government Discretionary
   - Sliding-scale quota
   - Processing trade quota
3. Outside the quota system (40% tariff)

The type and volume of imports accessed by mills determines the raw material costs.

Chinese import quota is issued on a calendar year basis.

RESERVE SYSTEM

The government can use the reserve system to buy and withhold cotton from the market. Accumulated reserves are mostly domestic cotton, but also contain some imported fiber. The most recent set of auctions from reserve supplies involves Chinese cotton grown in 2011 and 2012, as well as some foreign-grown supplies held by reserves. The older cotton is sold at a cheaper price (near 97 cents/lb for 2011 cotton, 104 cents/lb for 2012 cotton) and the foreign cotton is sold at a premium (111 cents/lb).

In previous auctions, there has been limited interest from mills. To incentivize purchases, the Chinese government tied import quota access to reserve purchases through a ratio-based system. No mention of such a system has been announced for the current round of sales.

IMPORT QUOTA OPTIONS

1. Tariff-Rate Quota (TRQ): Part of China's accession to the WTO in 2001 requires that 4.1 million bales be allowed into the country at a low 1% tariff rate. The government allocates this quota among mills.

2. Government Discretionary: The volume and allocation of this quota type is determined by the government and can change from year-to-year. Tariffs applied to *sliding-scale quota* vary with world cotton prices (5 to 40%). With the A Index near 70 cents/lb., the sliding scale tariff is about 20%. If a mill is export-oriented, they may receive a tariff-free *processing trade quota* from the government.

3. Outside of Quota: Mills pay a high 40% tariff. Given the size of the tariff, this option was not considered feasible before the record gap between Chinese and world prices. In the fall of 2012, the price disparity was wide enough for Chinese mills to profitably import outside the quota. If the separation between Chinese and world prices widens to levels that make this option profitable again, Chinese import demand could increase.

Regardless of the tariff rate, all cotton imports are subject to a 13% value added tax.

FLOW OF CHINESE COTTON FROM FIELD TO SPINNING MILL

With policy reforms, Chinese cotton can flow from farms to mills without passing through the reserve system.

GROWERS

When the market price is below the established "target price," the government pays the difference to the grower.

GINS

In China, the cotton containing seeds is sold to gins. After separating the seeds from the fiber, gins then move the cotton to mills. In between each stage, merchants may be involved to facilitate transactions.

MILLS

Following recent reforms, mills have possible sources of supply from 1) the Chinese crop, 2) sales from reserves, and 3) the international market. With much more domestic supply available, low levels of imports can be expected for years to come.