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Cotton Sector Reforms, 1997-98

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Report Highlights: The Chinese government has introduced market reforms into China's state-centric cotton sector which should reduce government expenditures, expose China's cotton producers to international cotton price signals and improve the international competitiveness of China's textile industry. In the short term the policies will restrict cotton imports, but in the longer term they could lead to renewed imports.

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INTRODUCTION

Because of the historic importance of cotton products in obtaining foreign exchange, and China's need to cloth the world's largest Army, the Chinese Government traditionally saw cotton as a strategic commodity. Even after the farm reforms of l978, cotton marketing remained one of the most heavily planned sectors of the economy. In l980, China depended on cotton products for a quarter of its export earnings. Today, however, with a smaller Army, a wider range of export products and the increased availability of synthetic fibers, cotton has lost its strategic importance. The Chinese Government is no longer willing to pay the high cost of managing cotton supplies. This year, to help cut Government losses, the China is starting to move toward more market-oriented cotton policies.

The Government's efforts to control cotton production and distribution have been very costly, with l998 expenditures estimated at RMB45 billion (US$5.4 billion). Until recently, the government tightly controlled cotton distribution with a "three No's" policy: No marketing agent except the central government, no negotiated prices, and no private trading. The result has been overproduction of poor quality cotton; large government stockpiles, at least some of which is very old and of questionable quality; a large, expensive national bureaucracy to procure, process, store and market cotton; and a textile industry that is losing its international competitiveness.

This year the Chinese government began implementing new cotton policies which, if successful, could fundamentally change the structure of China's cotton sector. China will be moving toward a more market-oriented approach for marketing cotton, including variable prices, marketing choices for farmers, and less government interference. These changes, which go in just the opposite of direction of recent changes in grain policy, reflect differences in the Government's perception of the strategic importance of cotton and grain . However, the primary motivation, for both the grain and the cotton reforms, is the same--to cut government expenditures. In addition, the government is concerned about increasing consumption of domestic cotton, but it also seems willing to let cotton prices fluctuate more freely because of concerns about international competitiveness of China's raw cotton and finished cotton products.

This report explains the recent cotton reforms and assesses their significance for China's cotton production and trade. The report is based on meetings with Chinese officials at national, provincial and local levels, speeches by senior Chinese officials and media reports. It is also based on discussions with numerous textile industry leaders, non-government Chinese cotton experts and trade contacts. Information has also been gained from extensive travel in China's main cotton producing provinces.

1997-98 COTTON REFORMS

In the fall of 1997, after three failed attempts to manage sales of cotton between buyers and sellers at government cotton marketing fairs, then Vice Premier (now Premier) Zhu Rongji outlined future actions the government was going to take with respect to cotton production and marketing. These include:

-- allowing the price for ginned cotton to mills to vary within a specific price range;
-- encouraging cotton mills to buy cotton from Xinjiang Province through price and tax incentives;
-- severely limiting imports of cotton after January 1, 1998; and,
-- permitting cotton farmers located along the Yellow River basin to reduce the area planted to cotton.

Over the next several months more detailed fiscal and regulatory procedures were announced, aimed at encouraging mills to substitute Chinese cotton for imported cotton. The new policies put special emphasis on encouraging sales of cotton from Xinjiang in Western China where high transportation costs have resulted in particularly high stocks.

Lower Procurement Prices

After a very short crop in l993, China raised its cotton procurement price to 14,000 RMB per ton starting in 1994, which at the time was close to the world market price for cotton. However, as international cotton prices fell, China failed to reduce its procurement price. As a result Chinese cotton prices have been well above world levels for the past several years. Chinese cotton production has remained high and spinning mills have substituted cheaper imported cotton for domestic cotton whenever possible. The high volume of domestic cotton that the Government has purchased and stored since then is costing tens of billions of Renmimbi each year.

Table 1. Changes in Cotton Procurement Prices* Since 1993

Announcement	Crop Year	Procurement Price(s)
Fall, preceding year	1993	RMB540/dan** (US$1,306/MT)***
Fall, preceding year	1994-1997	RMB700/dan (US$1,693/MT)
October 1997	1997	29 Provinces: RMB700/dan (US$1,693/MT) Xinjiang: RMB630/dan (US$1,524/MT)
May 1998	1998	29 Provinces: RMB650/dan (US$1,572/MT), +/- 5% Xinjiang: RMB600/dan (US$1,451/MT), +/- 5%
September 1998	1998	29 Provinces: RMB650/dan (US$1,572/MT), +/- 5% Xinjiang: RMB600/dan (US$1,451/MT), no range limits

* Price for lint cotton at procurement station; does not include processing or transportation costs.
** 1 dan = 50 kilograms;
***exchange rate: US$1 = RMB8.27

To cut the Government's costs in procuring cotton, and help bring Chinese cotton prices closer to international levels, the procurement price paid to farmers was reduced. At the time of Zhu Rongji's speech the price of cotton from Xinjiang was cut from RMB14,000 per metric ton (MT) to RMB12,600/MT (from US$0.77 to US$0.69 per pound). Then in April 1998, just as farmers were starting to plant, it was announced that the price of cotton from other provinces would be reduced to RMB13,000/MT (US$0.71/lb). In addition, the new procurement prices were allowed to fluctuate by to 5 percent, thereby increasing the possible real price reduction farmers were facing. [NOTE: Prices have always varied a small amount based on fibre quality. RMB14,000--the price paid for Chinese grade 327 cotton--is but a midrange point.]

Chinese cotton prices remain well above international prices. However, by allowing some variation around the target prices, the government has begun moving toward a more a market-oriented pricing policy. In the case of Xinjiang cotton, this trend was moved even further when a decision was made this fall to completely liberalize prices. It appears the central government is committed to allowing cotton prices, at least in the case of Xinjiang cotton, to fall to whatever levels are necessary to improve competitiveness and cut Government losses.

The price of ginned cotton sold by the government to mills has also traditionally been fixed, with variation permitted only according to fiber quality. However, along with lowering prices paid to farmers for their raw cotton, the government announced it would allow the price of ginned cotton sold to the mills to vary by as much as 10 percent from the target price. In April 1997, at China's second annual cotton fair where government agencies that hold cotton stocks met with cotton mill representatives, these prices were allowed to vary for the first time, up to a maximum of 4 percent. In the Fall of 1997, the amount of price variation permitted was increased to 10 percent.

Most industry contacts do not expect the price cuts to date to have a significant impact on Chinese cotton production in 1998. Even though cotton procurement price reductions are larger than the modest cuts that have been implemented for grains the price relationship between cotton and grains will continue to favor cotton in many areas.

Tax Breaks

To further stimulate the use of Xinjiang cotton, the Government began offering rebates of the Value Added Tax (VAT) on cotton purchased from Xinjiang. Textile and apparel products made with Xinjiang cotton sold on the domestic market received a partial rebate, while exported products were granted a full rebate. Initially, this applied only to 500,000 MT of cotton, but later it appears that the quantity eligible for such rebates was open-ended. Zhu Rongji also promised to establish a permanent, year-round cotton wholesale market in China.

Import Reductions

In the face of huge cotton surpluses the Government has chosen to cut cotton imports, just as it cut grain imports. To limit imports, the government has cut import quotas, tightened import licensing procedures and encouraged stricter foreign exchange controls. For example, the government has begun requiring all importers, including joint venture (JV) mills, to obtain import permits before they import cotton. Further, rather than issuing a permit for the total quantity of cotton a mill plans to process in a year, Customs now issues individual permits for specific shipments. In order to get the permit for subsequent shipments, the mill must show proof that the requisite amount of product to cover previous cotton imports has been exported.

MORE REFORMS COMING?

Additional reforms, which one cotton official describes as "inevitable," are expected to be announced before the 1999 cotton crop is planted. Under the reforms which are rumored for early next year, the Government will give up its control of cotton marketing, and prices will be allowed to fluctuate freely. These reforms are in marked contrast to this year's grain reforms under which the Government is strengthening its monopoly on grain distribution and grain pricing.

According to knowledgeable sources, the government will stop setting procurement prices for raw cotton next year. Instead, the government will suggest non-binding target prices, and actual prices will be permitted to vary with market conditions. According to persons familiar with this proposal, the idea was initially to have been implemented in 1998, but because of the flooding it was decided to delay its implementation at least one year.

A second reform to take effect in 1999 is that farmers will be permitted to sell cotton directly to cotton mills or to third parties other than the Cotton and Jute Corporation (CJC), such as State farms which produce cotton.

This reform will force CJC stations to become more efficient since they will have to compete with new leaner, entities whose cost structure will probably to be much lower. This approach is directly the opposite of the approach which is being taken in grain distribution, where private traders are being prohibited from buying grain from farmers. In order to support farm incomes when necessary, CJC will be given special authority to buy specified amounts of cotton at a prices above market prices. In such cases, the amount of the subsidy which will be paid by CJC will be specified in advance so the limits of any government losses will be clarified in advance.

Other proposed reforms have reportedly been rejected by senior government leaders. One idea was to establish a “risk” fund, to protect cotton farmers against low prices. Grain producers continue to benefit from minium prices and some officials wanted to maintain price supports for cotton as well. However, this proposal is believed to have been rejected by Premier Zhu Rongji on the grounds that farmers can choose to grow grains instead of cotton if they wish to enjoy price protection.

China has turned to subsidized exports of corn and rice to bring down high grain stocks, and some have argued that subsidies should be use to get rid of cotton as well. However, because the Government wants to cut its losses and Chinese cotton prices are currently so far above international prices, subsidized exports are not feasible for the present. Moreover, there is a good understanding that if China were to begin large scale subsidized cotton exports, it would drive world prices down and further increase the gap between domestic and international prices.

The idea of subsidizing cotton exports has frequently been associated with cotton from Xinjiang Province in western China where stocks are said to be particularly high. In September 1998 there were reports of a proposal to subsidize the export of 500,000 MT of Xinjiang cotton, but the proposal was reportedly rejected by the Ministry of Finance for fiscal reasons. A more open-ended variation on this proposal which has also been suggested and rejected would be to create a two-tier cotton marketing system. Xinjiang cotton would be priced for the international market, with the government adding an export subsidy when necessary, and cotton produced in other provinces would be marketed domestically with strictly enforced minium procurement and re-sale prices. In addition to being costly, this system would be unwieldy since it would be difficult to ensure that there is no leakage of cheaper Xinjiang cotton into the domestic market, much as it is now difficult to control leakage of cheaper, higher quality imported cotton into domestic mills.

REASONS FOR COTTON REFORMS

Changes in cotton policies reflect:
- The need to cut government losses in the face of the rising cost of buying and storing cotton.
- Surging imports by joint ventures which have exacerbated the stock problem.
- The reduced strategic importance of cotton
- A desire to keep China’s textile industry competitive internationally.

Correcting The Excesses of State Planning

Although the l978 reforms gave farmers more freedom to plant what they wanted, the government continued to regulate cotton production by setting production goals and tinkering with seed, fertilizer and other input allocations to farmers. Each year in August or September a National Cotton Conference has been held where government officials traditionally set the procurement price farmers would be paid for their cotton, set production targets for the next year, and reviewed the national marketing plan for cotton. Sometimes there have been further refinements of the policy during the marketing year, such as occurred this year. This sort of state planning resulted in artificially high prices which encouraged farmers to grow too much cotton and led to high Government stocks and large losses. As the number of cotton farmers, the amount of cotton they produced and the size of cotton stocks increased, central planning became both harder to accomplish and harder to abandon.

In addition to the growing costs associated with buying and storing cotton, the size and cost of the large state bureaucracy charged with managing the cotton sector also grew. The CJC, which is responsible for buying cotton from farmers, ginning and storing it, then selling it to mills, has over 660,000 employees nationwide at 15,000 cotton procurement stations and 2,300 ginning and storage stations. It is believed to currently owe the Government's Agricultural Development Bank RMB90 billion. Half of this is new debt to buy this year's cotton crop from farmers. The other half is old debt owed by mills (some of which are now bankrupt) for cotton received and never paid for (RMB12 billion), and for cotton purchased from farmers in previous years which is still in storage or was sold at a loss (RMB33 billion).

Regaining Control of Joint Venture Mills

Another factor which has contributed to the current imbalance between the supply and demand for cotton in China has been large cotton imports. Most of these imports arrive through JV mills, which until recently did not need an a permit to import cotton. These mills were set up to import raw cotton which was to be processed into finished or semi-finished products and then re-exported. They were expected to reconcile with China Customs the volume of ginned cotton imported vs. cotton product exported in order to receive a rebate of the VAT on imported products, a difficult task given the different units for measuring raw cotton and finished products. Other mills, primarily state-owned (SOE) cotton mills, needed an import quota to procure imported cotton to produce finished cotton products for export.

Most JV mills were set up with the understanding that they would be producing textiles for the international market, they were given liberal license to import raw cotton at world prices. They were also allowed to import cotton directly without going through CHINATEX, the state cotton trading authority. As a result, these mills became a window, outside of Government control, for importing cotton that was cheaper and generally of better quality than domestic cotton. As a result China's cotton imports increased rapidly in the mid 1990's. By 1995 cotton imports had exceeded 880,000 tons (3.67 million bales), or about 20 percent of China's cotton demand, at a time when China's own cotton production was believed to have reached record levels and consumption was flat.

In fact, not all the cotton brought into China by joint venture mills went into products which were exported. Some products made from imported cotton remained in China, as JV mills began taking advantage of their special status to circumvent import controls. In other cases, SOE mills which had joint venture operations were importing cotton nominally for the JV part of their operation, but actually using the imported cotton in their domestic operations.

Joint venture mills are now being forced to fully document their exports before they can obtain future import licenses and buy foreign exchange for future purchases. These restrictions, along with a new system of import quotas, and tighter foreign exchange controls have resulted in much lower imports by JV mills, at least in the short run.

Declining Economic Significance of Cotton

The distortions caused by state controls and a dual marketing system have increased the burden of China's cotton policies on the government. However, such financial burdens alone would not predict the changes towards greater market-oriented price and distribution policy that have been announced. The Government is facing even greater costs in the grain sector; yet the response there has been to try to tighten rather than loosen state controls. (See CH8051 for a discussion of recent grain policy reforms.) The difference perhaps is in the declining economic and social importance of cotton.

Thirty years ago, lint cotton and textiles and apparel were major sources of foreign exchange. Today, however, cotton and textile exports play a much smaller role as a source of foreign exchange relative to other export products. In 1980, cotton and textile exports accounted for around 28 percent of the total value of exports from China. By 1997, that figure had dropped to around 15 percent. Although China's trade statistics do not differentiate between natural and synthetic fibre exports, it is clear that the cotton content of textiles has fallen sharply. In 1990, natural fibers accounted for 71 percent of the content of textiles, compared to 29 percent for synthetic fibers. In 1997, the natural fibre content of textiles had fallen to 45 percent. Therefore, the real significance of cotton fibre in China's exports today is probably no more than 10 percent.

In the past cotton played a much more important role in providing income and social stability in both rural and urban areas. Cotton was a principal source of cash income to farmers who otherwise grew grains either to feed their families or to meet Government quotas. Today however, farmers have many more options for cash crops as well as opportunities for off farm income in the industrial sector. Measuring such changes is difficult in China. The Chinese Academy of Agricultural Science estimates that the contribution of cotton production to farm income has fallen from seven percent in 1985 to three percent in 1996.

In the cities, the cotton industry is also losing its significance. In 1990, that industry employed 7.5 million people. By 1997, that number had fallen 20 percent to 6.0 million people. At the same time other parts of the economy were creating new jobs, further reducing the relative importance of the textile industry as an employer.

PRODUCTION AND TRADE IMPLICATIONS

China's cotton reforms are likely to be far more successful in solving China's cotton problems than this years grain reforms will be in solving China's grain problems.

- By lowering procurement prices and allowing them to fluctuate with market conditions, the new system will use market forces to discourage surplus production.
- By opening cotton distribution to new competitors, the reforms will put pressure on the Cotton and Jute Corporation to become more efficient, and thereby lower the cost of ginned cotton for spinners .
- By allowing prices for ginned cotton to fall, the reforms will help keep China's textile industry competitive internationally, thereby increasing demand for raw cotton and cutting stocks.
- By moving away from support prices, the Government will cut its losses related to cotton production and marketing.

The four factors that will most affect cotton production and trade over the next few years will be:
- The speed with which China moves forward with its reforms,
- The speed with which China modernizes its textile industry

- Developments in other parts of the Chinese economy which could make products like cotton which require a high labor input less attractive to farmers.
- Changes in international cotton prices.

Production & Stocks

If prices are allowed to fall as has been the case thus far, cotton production is likely to decline, particularly in Eastern China where farm families have more options to supplement their income with off-farm employment. However, the proposed reforms appear to give the Government leeway to continue to subsidize cotton production by offering specific subsidy levels to help assure a reasonable return to cotton producers. If this authority is widely used, and prices are kept near current levels, Chinese cotton production could continue to exceed demand and stocks could continue to grow.

While most cotton farmers would continue to plant cotton at today's prices, the high labor input required to produce cotton is starting to discourage production, especially in coastal provinces were farmers have more opportunities to supplement their income. According to a recent Australian study, while farmers can earn 2-3 times more growing cotton than grain, they also have to invest 2-3 times as much time in growing cotton. Since most of China's cotton is grown on small plots, mechanized production is not attractive. However, if general economic development in China slows, cutting off-farm income, some farmers may return to cotton supplement their incomes.

The reforms should result in lower stocks. CJC appears resistant to procuring any new cotton which it may later find difficult to sell, including cotton procured at high prices--without a government subsidy--and low quality that cannot easily be sold. Procurement in 1998 is forecast to be 3.25 million MT, from production of 4.0 million MT. This amount is less than what CJC officials believe demand will be which they believe will enable them to reduce CJC-held stocks. However, farmers may be left more stocks which next year to sell to the new firms that reportedly will be allowed to market cotton in competition with the CJC.

Trade

Lower stocks and lower prices should eventually create more opportunities for Chinese cotton imports. If stocks are cut back quickly, and world prices decline, China might well resume imports to keep its mills competitive internationally. However, if world prices were to increase faster than Chinese stocks are drawn down, China may be tempted to export cotton to bring down its stocks.

Ultimately, the international competitiveness of Chinese textiles will depend on the efficiency China's textile mills as well as the price of raw cotton. While China has some modern joint venture mills with state of the art technology, many Chinese mills are so old and efficient that they could not compete internationally even if they had free access to unlimited supplies of cotton at international prices. In the first 10 months of this year, according to official sources, China's textile exports dropped 3.7 percent compared to the same period in 1997. The decline is mainly attributed to the negative impact of the Asian financial crisis. Some 40 percent of China's textile exports go to other Asian countries.

But industry inefficiencies are also to blame for the loss of export markets and the Chinese government is trying to address that problem. Earlier this year, the government announced an ambitious plan to eliminate 10 million old spindles (of a total of 41.7 million) by the end of the year 2000. It reportedly has also met the target of eliminating 4.6 million of these spindles by the end of this year. However, there are still many SOE's with high production costs that will have difficulty competing internationally.

Unless China's domestic cotton milling industry is prepared to make further financial and technical changes, and unless China's textile industry is willing to undergo a massive and expensive retooling--something which, to date, has been talked about more than carried out--JV mills will continue to dominate the production of textiles for the export market. To compete, these mills will want ready access to imported cotton.

The prospects for significant exports of cotton from China, at least at current domestic procurement prices are not good. If China still holds stocks of low price cotton from 1993 or earlier, theoretically it could be exported without subsidy. However, the quality of such cotton and the willingness of cotton traders to buy it are in doubt, as China's experience with a cotton export tender this past spring suggests. In March China announced that it sold cotton from its stockpiles to an international cotton trader for delivery before the end of 1998. Chinese officials would not disclose the age of the cotton, the quantity sold, the terms of the sale--including price--or the identity of the buyer. According to trade sources and confirmed unofficially by Chinese government sources, some 200,000 MT of cotton was sold to a single cotton trading company for less than US$0.55 per pound. The cotton, which included mostly stocks from 1996 production and older, was to have been shipped at the rate of 30,000 MT per months beginning in May. However, to date (through October), only 25,000 MT of cotton have been exported. A second tender, announced in June, was canceled due to low offer prices.

It is too early to tell if procurement prices will in fact be permitted to decline to world market levels in order for cotton fibre exports to occur with export subsidies. Although the central government has eliminated all price supports for Xinjiang cotton, the Provincial government has stepped in and set a minimum price of RMB570/dan (US$0.63/lb.), reportedly with central government approval. If this minimum price is honored, the price of Xinjiang cotton will remain well above world market levels. This price does not include the cost of shipping the cotton to east coast ports.

CONCLUSION

China's latest cotton reforms appear to signal that the government is ready to abandon state planning and to rely more on market forces for managing this sector of its agricultural economy. While reducing the financial burden of excess production and large stocks is probably the principal motive for these reforms, their timing signals a shift in the government's thinking about the importance of cotton in China's economy. The impact of these reforms on China's cotton fibre trade in the short run has been a sharp reduction in imports and attempts, albeit unsuccessful to date, to begin exporting cotton again. While it may not be a primary motive for these reforms, growing concerns about the export competitiveness of China's textile industry which still employs several million people nationwide were very likely also a factor.

It is too early to forecast with any certainty the future of China as an export market for U.S. cotton, or as a competitor to U.S. cotton in third markets. It appears likely that China will continue to need good quality cotton at world market prices, if it wishes to continue exporting textiles.

Finally, the reforms pose a serious challenge to the government in balancing the interests of western cotton growers in Xinjiang with eastern cotton growers and users. Xinjiang producers continue to increase their production with the expectation that the government will buy all or most of it at guaranteed prices. However, cotton mills, located along China's eastern seaboard, have been very resistant, to date, to buying Xinjiang cotton in significant quantities due to transportation and quality issues. Further, cotton producing provinces in eastern China appear unwilling to stand by and watch preference be given to Xinjiang cotton while their own crops pile up in warehouses. Balancing regional interests and market realities could result in further adjustments in China's cotton policies in the future.