As the world’s largest cotton grower, consumer, and importer, China has long been at the center of the global cotton market. Since the spike in fiber prices that occurred during the 2010/11 crop year, China has become even more important to discussions of cotton prices. A principal reason for China’s commanding influence in the market has to do with government policies, which are expected to result in China holding half (50%) of world cotton stocks.

With the bulk of China’s cotton supply being held by the government, any decisions involving Chinese stocks should have a major impact on global price direction. Developing an understanding of Chinese cotton policy and learning how decisions made in China could affect the world cotton market are essential to stakeholders throughout the cotton supply chain.

**POLICY INSTRUMENTS REGULATE MARKET**

Chinese cotton policy functions through the operations of two primary tools: government reserves and import quota. Traditionally, the reserve system has operated as a means of stabilizing Chinese prices and has acted to support both spinners and growers. However, recent operations have tilted in favor of growers. Much of this shift resulted from the introduction of a minimum guaranteed price in March of 2011—coinciding with the peak in global cotton prices. Higher fiber prices in China can be a burden on spinning mills and put upward pressure on prices downstream in Chinese supply chains.

Fiber prices in China, largely influenced by government policies, resulted in record premiums relative to the A Index. Between the 2004/05 and 2009/10 crop years, the average difference between Chinese mill-delivered prices (CC Index 328) and the A Index was 19 cents/lb. Thus far into the 2012/13 crop year, the difference has averaged 53 cents/lb. The record gap between Chinese prices and world prices has challenged the ability of Chinese spinning mills to compete in the global yarn market and has been a likely contributor to decreases in Chinese cotton consumption over the last several crop years. Relative to 2007/08, the forecast for Chinese consumption in the 2012/13 is 15.5 million bales lower, representing a decrease of over 30% in use among Chinese mills in five years.

**HIGH RESERVES, SUPPLY QUESTIONS**

This crop year, purchasing by the reserve system has far outpaced purchases from last year. At the time of publication (late-January 2013), a total of 25.9 million bales (5.8 million tons) of the 2012/13 crop had already been purchased. This figure is nearly double the total amount purchased in the entire 2011/12 crop year, with 9.5 million bales purchased in the 2011/12 crop year. The 41% increase in purchases is due to a number of factors, including the minimum guaranteed price and the previously discussed record premium between Chinese and world prices.
year. The importance of the volume of reserve purchases in the current crop year becomes apparent when considered within the context of the Chinese cotton harvest. The USDA forecasts that the 2012/13 Chinese harvest will reach 33.5 million bales. The USDA’s projection, coupled with the expectation that Chinese mills will consume 35.5 million bales implies that nearly 80% of this year’s crop has already been moved into government warehouses. Because the cotton purchased by the reserve system can be withheld from the market and China is still the world’s largest consumer of cotton fiber, a major question for the global cotton market is how the government will decide to supply their mills—through sales from reserves or imports.

QUOTA SYSTEM OFFERS OPTIONS AND AMBIGUITY

To enhance the effectiveness of the reserve program, in terms of its impact on domestic prices, the Chinese government also enforces an import quota system. The Chinese import quota system allows for cotton to be brought into the country under three options: WTO-related tariff-rate quota (TRQ), sliding-scale tariff, and 40% flat rate tariff. It is accepted that the WTO-related amount will be imported this year.

While there is transparency regarding the different choices for importing cotton under the quota system, the process of quota allocation is unclear. For both the WTO-related and sliding-scale options, the Chinese government makes a decision on which mills have access and the factors in this decision are not public knowledge. Since Chinese cotton prices are almost always higher than international prices, access to imported cotton can greatly affect the competitiveness of Chinese spinning mills. Among the firms, which are eligible to obtain cotton from the import quota policy, are state trading enterprises, the reserve system, mills that have at least 50,000 spindles, and exported-oriented mills, known as the “processing trade.”

Last crop year, the Chinese government decided to supply mills primarily through imports, and a record volume of imports (24.5 million bales) were brought into the country. At the time of this publication, no details have been released from the Chinese government regarding import quota in the 2013 calendar year. Nonetheless, there have been a series of speculative reports indicating that the volume of import quota will be tied to the volume of cotton purchased from reserves.

CHINESE COTTON POLICY HAS RIPPLE EFFECTS

Chinese cotton policy has global consequences, with the most direct link being through imports. This crop year, the USDA has assumed that China will supply mills through a combination of imports (12.5 million bales, about half of 2011/12 volume) and releases from reserves. Unofficial statements appear to confirm this assumption. However, no formal announcement from the National Development and Reform Commission (NDRC), the agency responsible for managing both reserves and import quota, has been made about the amount of import quota that will be released. Any future announcements may have a significant impact on world cotton prices.

Beyond imports, Chinese government policy and the world cotton market share some less direct links. While import quotas are in place for cotton fiber, there are no quotas affecting yarn. As a result, Chinese fabric manufacturers can import cotton yarn without restriction. With high domestic fiber prices putting pressure on domestic yarn prices, demand for yarn imports has increased. Pakistan and India have been the largest suppliers of Chinese yarn imports, providing 40% and 20%, respectively. The rise in fiber demand within countries that provide China with yarn could affect fiber prices in those countries, if their domestic supplies become scarce.

Given the influence of Chinese cotton policy on the world fiber market, it is important to track developments related to reserves and import quota. Stakeholders throughout the cotton supply chain can stay current on the latest developments through Cotton Incorporated’s *Monthly Economic Letter.*
POLICY INSTRUMENTS REGULATE THE MARKET

Chinese Government Reserves: Similar to reserve programs for other commodities around the world, the Chinese cotton reserve functions by purchasing, holding, and selling supplies. Historically, when supply is low and prices are high, the Chinese government will release cotton from reserves. These tactical actions can benefit spining mills by making additional supply available and helping bring prices lower. Conversely, when supply is plentiful and prices are low, the Chinese government can help cotton farmers by purchasing cotton for reserves. In recent years, the relevance of the reserve system has grown due to its role as the buyer that enforces China’s minimum guaranteed price. Since the cotton procured by the reserve system is withheld from the market indefinitely, this can place upward pressure on prices.

Minimum Guaranteed Price: When speaking about Chinese cotton policy, market commentators may refer to the price paid by reserves or the price received by growers. The difference in these two quoted values can be a source of confusion. The use of different exchange rates, the inclusion/exclusion of ginning costs, and a 13% value-added tax (VAT) are the main reasons for the separation in these prices. For example, the 19,800 RMB/ton that was offered by Chinese reserve system in the 2011/12 crop year implied a price received by growers of about 16,425 RMB/ton or about 118 cents/lb (using the average exchange rate over the purchasing period for the 2011/12 crop year and discounting ginning costs and the VAT). For the 2012/13 crop year, the reserve price increased 3% to 20,400 RMB/ton, which was equivalent to about 147 cents/lb (using the exchange rate at the time it was announced in March 2012). The implied price received by growers is 16,950 RMB/ton or 123 cents/lb (using exchange rates since September 2012).

Record (Price) Gap: Part of the reason for the separation between Chinese and world prices is due to the high level of Chinese prices relative to historic averages. Another reason for the difference is the collapse in world cotton prices, since their peak. At the time that the guaranteed minimum price was announced, the declared price, 19,800 RMB/ton (equivalent to 134 cents/lb in March 2011), was much lower than world prices (A Index averaged 230 cents/lb). Higher prices generally provoke two market responses; an increase in production and lower demand. Cotton growers will generally increase their acreage when prices are high in order to increase their earnings. Motivated by record prices, growers planted a record volume of cotton acreage in the spring of 2011 and harvested a record crop in the 2011/12 crop year. Since the spike in cotton prices, world cotton consumption has been depressed, and remains at levels below those experienced during the global recession that occurred in the 2008/09 crop year. The combination of larger harvests with weak demand has resulted in large surpluses. Excess cotton supply pulled world prices lower at the same time that China’s minimum price policy maintained Chinese prices at high levels.

HIGHER RESERVES, SUPPLY QUESTIONS

Reserve Purchases and Supplying Mills: Merchants selling bales of Chinese cotton can either sell to mills or sell to the reserves. With reserve prices being higher than international values, a significant amount of cotton has flowed into the reserve system. The first round occurred in September 2012 and resulted in the sales of 2.3 million bales (494,000 tons). The current series of sales have resulted in about 940,000 bales or about 200,000 tons (through January 21) moving from reserves to mills. The price for base grade cotton currently being sold is 19,000 RMB/ton, which represents a discount of about 7% (about 10 cents/lb) relative to the 2012/13 reserve price. Mills that want to buy from reserves are eligible to purchase up to two months of annual consumption and are prohibited from re-selling any released cotton to reserves. Although unconfirmed by the NDRC, a government textile news service reported that 3.0 million tons would be released in the initial round of sales and that import quota would be allocated according to the volume purchased at a ratio of 3:1 (implying that for every three tons bought from the government, one bale of import quota would be released).

Sliding-scale Tariff: The relationship between the sliding scale tariff and import prices is inverse. When world prices are low, the sliding scale tariff is higher. When world prices are higher, the tariff decreases. Values for the tariff range from 40% at the high-end to a flat value of 570 RMB/ton at the low-end. The amount of sliding-scale cotton that might be allowed into the country this year is unknown.
The table values listed for each import quota option indicate the estimated cost to get imported cotton fiber through customs. These prices include taxes, but exclude the cost of transporting fiber from a port to Chinese mills. To illustrate the possible outcomes of different international prices and the three import methods, estimated importer costs are shown for A Index prices ranging from 75 cent/lb to 100 cent/lb. For comparison, the Chinese government is buying cotton at prices near 150 cents/lb (20,400 RMB/ton).

**Access to Quota Matters:** At the current A Index price near 85 cents/lb, the implied cost per ton price is 98.73 cents/lb for a Chinese mill/importer with access to TRQ import quota, 106.89 cents/lb for an importer with access to sliding-scale quota, and 136.85 cents/lb with the 40% flat rate quota option. Since there is no stated limit on out-of-quota imports, the 40% quota figures could be considered as the maximum price a mill/importer would pay for fiber at the current price near 85 cents/lb.

Forty-percent Flat Rate Tariff: Historically, the price difference between domestic Chinese prices and world prices was small enough to prevent the 40% tariff option from being profitable. Due to the record separation between Chinese and international cotton prices, this possibility has become viable and there have been reports of some mills pursing this option. Nonetheless, the amount of fiber that may have been imported using this avenue is not known and there has been speculation that the government may restrict this type of import in order to encourage additional purchases from reserves.

Processing Trade: Exported-oriented mills that operate on a model of importing fiber and exporting manufactured textile goods can also have improved access to quota.