CHINESE COTTON POLICY: DECISIONS AND EFFECTS

POLICY INSTRUMENTS REGULATE THE MARKET

Chinese Reserve System: 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 spinning 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.

Price Gap Origins: 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.

Prices Interpretations: 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).

HIGHER RESERVES, SUPPLY QUESTIONS

Reserve Purchases and Sales: 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. Over the last two crop years, the purchasing period for Chinese reserves has been between September and March. In 2011/12, a total of 14.4 million bales (3.1 million tons) were purchased by the reserve system during this timeframe. Since September 2012, 26.6 million bales (5.8 million tons) have been bought.

On January 14th, the NDRC began a second round of sales from reserves. 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).

QUOTA SYSTEM OFFERS OPTIONS AND AMBIGUITY

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.

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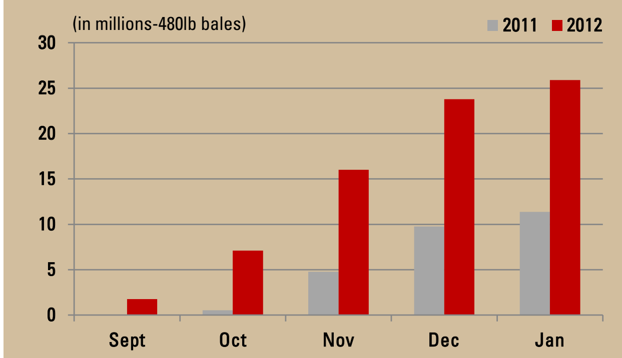
Forty-percent Flat Rate Tariff: Historically, the price difference between domestic Chinese prices and world prices was small enough to prevent the 40% tariff option from being profitable. Due to the record separation between Chinese and international cotton prices, this possibility has become viable 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.

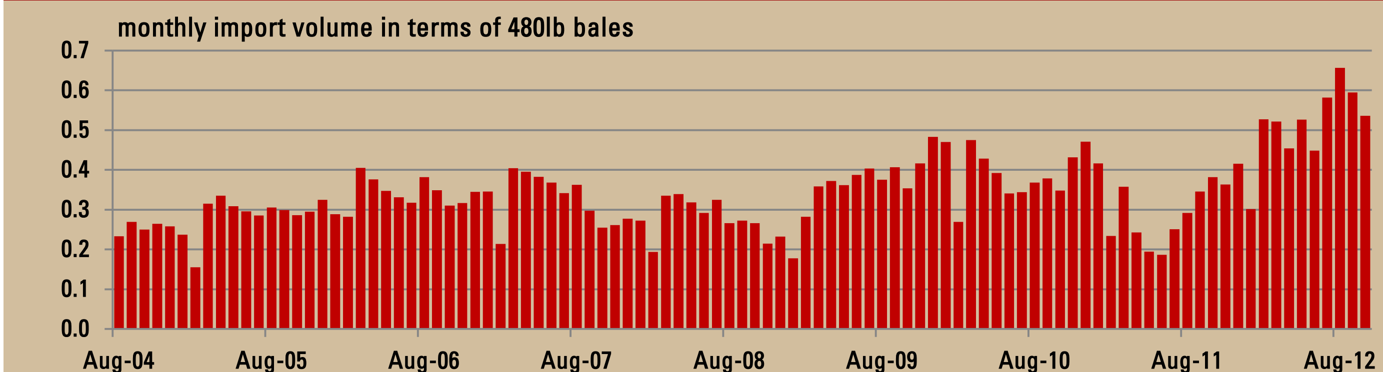
Processing Trade: Exported-oriented mills that operate on a model of importing fiber and exporting manufactured textile goods can also have improved access to quota.

2012 CHINESE RESERVE PURCHASES RISE



Source: Cotlook

CHINA YARN IMPORTS DATA INDICATE OVERALL INCREASE IN 2012



Source: China Customs

PROJECTED COST OF IMPORTED FIBER AFTER TARIFFS AND VAT (Cents/lb)

CFR prices (cents/lb)	Tarrif Rate Quota (TRQ, 1%)	Sliding-Scale	40% (out-of-quota)
100	116.15	119.82	161
95	110.34	115.27	152.95
90	104.54	110.96	144.90
85	98.73	106.89	136.85
80	92.92	103.05	128.80
75	87.11	99.44	120.75

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.