

Meeting The Challenges of Producing Cotton in the United States

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A cotton grower suggested to me in 1996 that cotton prices had forever moved to a new plateau. His reasoning was that inflation had driven prices higher and that the typical base range for cotton prices should reasonably be expected to be between 75 and 85 cents per pound. The failure of his analysis was in realizing that cotton is “just another commodity” and like any other commodity it is subject to wide price swings based on global economic conditions as well as global cotton production trends.

Risk management has become the enlightenment word of the final decade of this millennium. That notwithstanding, a grower’s long-term success in cotton production will be judged by his ability to successfully manage both production and marketing risks. The past generation of cotton growers largely found success via government programs. Success during the early years of my generation was footed in government programs. However, the globalization of world economies, coupled with the movement of United States agricultural policy toward a single world market, has clearly demonstrated that the US cotton grower of the future will obtain an ever and ever insignificant proportion of his revenue from the government.

The challenges of risk management facing today’s cotton grower can be described in terms of: (1) Government Policy, (2) Marketing, (3) Technology, and (4) Weather. These categories are interlocking and highly correlated. The common thread is finance and risk management.

Government Policy

The goals of the 1996 FAIR Act (Federal Agriculture Improvement and Reform Act) were to reduce both the government’s regulatory and financial involvement in agriculture. This legislation was the most dramatic change in farm legislation since the 1930's. The first goal was approached by allowing producers the freedom to produce any crop. The second goal was accomplished by moving from the traditional target price concept in favor of “transition payments” and by a commitment to restructure crop insurance. For the first time since 1933 the producer

Appreciation is expressed to Dr. John E. Lee, Dr. Keith H. Coble, and Dr. Stan R. Spurlock for their review and critical comments. The author accepts responsibility for all comments. was given total control over his crop mix.. Program payments were decoupled from crop

production and a producer's total production was eligible for Commodity Credit Corporation (CCC) loan.

The cautious cotton grower should perceive "transition payments" as the beginning of the end of programs. However, we were able to find 6 billion dollars in emergency funding last year and the 1996 farm legislation was worded so that Congress reverts to permanent legislation in 2002. One must remain skeptical that the era of "no program" is near. Nevertheless, this is very difficult for growers. What is the economic decision criteria a grower should use in the consideration of land and equipment purchases? Thus, we see that major intermediate-and long-run decisions depend on knowing the future direction of government policy. That is, on knowing the unknown, as decisions to purchase land and equipment and at what price depends on the future of government programs.

Thus, from an average payment of 14 cents per pound during the 1985 and 1990 farm bills, the 7 cent average under the 1996 legislation should be viewed a precursor to the elimination of payments in the first decade of the 21st century. Additionally, be aware of discussion that payments may be decoupled from land ownership and made only to operators or owner-operators. This necessitates an entirely new structure for landlord-tenant relations.

The FAIR Act removed the safety net of previous farm programs. Since then cotton supplies have been volatile as have prices. However, the essence of the FAIR Act promised growers that the Risk Management Agency (Federal Crop Insurance Corporation) would develop products for cotton. Thus, a major failure of the "intent" of the FAIR Act has been the failure of government to modernize crop insurance with respect to cotton.

Insurance subsidies were raised in 1995 and free catastrophic coverage was instituted. Yet, just like the additional premium subsidy this year, these benefits are of little value to the cotton grower because of the ineffective programs. However, the Risk Management Agency (RMA) has authorized a crop revenue product for the South. Other revenue products are likely to be available in 2000. However, two significant problems exist. First, "good" growers find insurance unaffordable and grossly unfair. This problem will continue until the RMA institutes an effective rate structure. Second, there are not any products that offer a price guarantee above the harvest month futures quote. This implies a very low coverage for a crop year like 1999—the current year. Under the current structure, attempting to insure a price above the market price raises rates dramatically and makes insurability problems worse.

The cotton industry must closely monitor these two problems. There is a major concern that the RMA is looking only at the second problem and not the first. Only when the first problem is solved can crop insurance be viewed as a partner in the cotton grower's risk management strategy. Currently, it is a non-program for most cotton growers. Yet, it cannot be viewed as a substitute for deficiency payments. The following considerations should be debated: raising the subsidy, establish accurate rates, expand revenue products to all cotton regions, devote resources to risk management, and consider risk management saving accounts.

The lack of an effective insurance program, coupled with the burdensome affect on price resulting from an oversupply of foreign produced cotton, frame the current situation and outlook for cotton.

These events have brought focus on cotton imports and the 3-step competitive provision of cotton legislation. In 1996 the Step 3 program allowed an unmanageable amount of import quotas to accumulate. Step-3 import quotas were allowed to build even when US manufacturers were not importing cotton. Then, in 1998 the Step-2 program was allowed to run out of money, thus reducing domestic sales, expanding imports and effectively cutting off export sales. Calendar year 1999 begins with a similar outlook. Both of the provisions need reviewing as the program may increase market volatility.

World trade and the uneven playing field for cotton floats under the umbrella of government policy. With cotton so heavily subsidized in most of the exporting countries, too much cotton moves onto the world market at prices below the true economic cost of production. The result is that global market prices are unnaturally depressed making it difficult for US cotton to compete without a competitiveness program like Step-2. In effect, it brings into question the legislative legitimacy of the FAIR Act for cotton. The next round of WTO trade negotiations must give high priority to this de-facto dumping of cotton in the world market.

The right to delineate production preferences has generated significant structural changes on many farms across the four cotton production regions. For example, between 1995 and 1998 corn acreage increased 74 percent in the Midsouth, 23 percent in the West, 22 percent in the Southeast, and 18 percent in the Southwest (Texas and Oklahoma only). The most dramatic change was in Louisiana where corn acreage increased 213 percent in that same period. Even more dramatic changes have been noted on many individual farms. More than a few Midsouth cotton growers have left cotton altogether in favor of grains. Midsouth and Southeast cotton growers have come to appreciate the agronomic benefits of a cotton-corn rotation. Peanut acreage has expanded on some farms in the Southeast, Midsouth and Southwest. Some cotton growers that did not have peanuts in 1995 now have more land seeded to peanuts than cotton.

These acreage shifts, coupled with the resulting changes in infrastructure shifts necessary to adjust to changing cropping patterns and the decreasing importance of government support, are speeding the transition of farming as a "way of life." Growers slow to recognize this pattern are those that are being moved out of production agriculture. These events are speeding the need for growers to control more and more acreage. Nevertheless, after two successful grain crops, cotton growers have learned that grain profits will not cover a cotton debt. Too, profits from grains have not been sufficient to allow for acreage expansion. The successful grower must expand his operation while controlling his debt-to-equity ratio.

Marketing

Cotton growers are presently held in the vice-tight grip of old crop prices well below the cost of production and facing a planting season that suggests another year of the same. Yet, of the just expired 24-month period that the December 1998 cotton futures contract was traded, January 1997 through December 1998, prices were above the 75 cent level in 15 of those months. Too, on six specific occasions of one week or longer, the December futures contract

was above the 76 cent level. Nevertheless, I would guess that over the last six weeks, I have fielded 400-500 questions about “what to do with my old crop.”

Historically, average annual prices received by growers have covered the cost of production in only 8 of every 10 years. Thus, growers have had to extract enough market (and government) income in eight years to cover ten year debts. Recalling that government payments averaged 14 cents per pound under the 1985 and 1990 farm bills suggests that the growers future in cotton production will be determined by his ability to manage price risk. During the days of tight regulatory production control growers became accustomed to using the CCC loan as a primary part of their marketing strategy. They simply entered cotton into the loan program and sold the cotton later in the marketing season when seasonalities suggested higher prices. An outgrowth of this is to make delivery of the physical cotton at harvest, but delay fixing the price until later in the season, using either the December, March, May or July contract. Historically, most growers have rolled the price fixation from contract month to contract month expecting prices to move higher.

This marketing strategy, and its outgrowths, can only be classified as the “hold and hope” strategy. This hold and hope strategy, more often than not, was successful during those times. Yet, the FAIR Act, coupled with the 3-Step competitiveness provision, has redefined the world cotton marketplace. Just as the foreign textile mill has always been a significant market for US cotton, foreign cotton now has an easy path into the US. Too, growers forget that the CCC loan period is now only 9 months, not 18 months. Thus, their decision making horizon has been reduced.

This redefinition of the world marketplace has brought into question another of the time honored traditions of the cotton market...delaying the sale until after harvest. Since 1996 the hold and hope strategy has had dubious results. However, an increasing number of growers indicate both their willingness to use and their actual usage of the cotton options and futures markets. The use of put options for the establishment of a price floor is common with an increasing number of growers. Likewise, the use of a call option that allows for a higher price after the fixation is gaining some understanding. Certainly, the number of growers using option spreads is increasing. This indicates an increasing level of market knowledge.

However, extracting a profit from the market has not historically been the goal of most cotton growers. Rather, they have tended to look for specific prices. The survivors will quickly learn that the market is a tough taskmaster, it gives the test first and the lesson afterward. The marketing lessons will be hard learned, as for nearly three generations the government has been there. There is an overwhelming need for grower marketing plans to become pro-active rather than maintaining traditional reactive strategies.

Technology

The elimination of the boll weevil slowly moves west, but it continues to move. Research and extension lie at the heart of an agricultural community. A high dollar, high risk commodity like cotton demands it. Cotton growers have been masters in accepting and implementing new technology. The worn out adage, you must lower your cost of production will always be true. Innovations in GIS, equipment, precision farming, and biotechnology will flow yearly. The

innovators will succeed, the non-innovators will fall out of cotton. One challenge is for the grower to learn just how costly the extra 10 pounds of yield may be. Growers have been slow to accept this and it is an increasing problem.

Weather

There is nothing unusual about weather disasters. We have good years, bad years, great years and the like. The El Nino and La Nina phenomena have been well documented. These weather cycles, predictable or unpredictable as they are, are at the extremes. Nevertheless, there is a weather disaster somewhere every year. The private market, along with government interaction, has responded with crop insurance programs as discussed earlier. While these programs have been important to some in the cotton industry, the majority of cotton acreage is not covered by insurance. The development of a workable program was “promised” in the debate surrounding the FAIR Act. The absence of such a program leaves the majority of cotton growers without a tool with which to manage weather related production risk.