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THE GLOBALIZATION OF THE U.S. COTTON MARKET

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When I was initially asked to speak on this topic, I was at first overwhelmed and then intimidated by the subject matter. After I caught my breath and gave some thought to the idea, I realized that my views, my approach, and my actions toward the cotton market have been and still are shaped in great part by the recent turbulent and volatile activity in the global economic and financial markets. For instance, there are some days when I wake up and wonder which hat will I be wearing to work based on the business news of that day. Will I wear a currency hat, an Asian stock market hat, a Fed Reserve hat, or hopefully, leave my hedge fund hat at home. It is not just brokers or analysts or business managers who have become attuned to the impact of the world's economic difficulties on cotton demand and therefore prices here and abroad. During the height of the Asian stock market crisis, a customer who is a merchant in the SE, indicated he found himself getting up in the middle of the night to check the Tokyo and Hong Kong stock markets based on their possible effect on cotton futures the following morning. Everyone involved in the US cotton market has become far more aware of a whole host of global factors that are significant in not only our daily dealings but in our projections for US cotton.

The effects of the globalization of the US cotton market have been more obvious this year and last but can be traced back much further. There are two ways in which I will examine the recent globalization of the US cotton market, a timeline perspective and a domino effect. Let us begin by examining the timeline of world events and the direction of cotton prices beginning in the Summer/Fall of 1997. Years of unrestrained growth, questionable lending policies, over-expansion and poor fiscal policies by various countries in the Far East began to take their toll on currency values and stock market prices by August 1997. The crisis appears to have begun in Thailand but quickly spread to Indonesia, Taiwan, Malaysia, South Korea, the Philippines and also encompassed an already weak Japan. Currency values quickly depreciated by at least 10% and in some instances as much as 50% initially. Throughout 1998, continued devaluations became an almost daily event. Many countries were plunged into a serious recession, if not depression, where they have remained with negative GDP growth during 1998 with predictions of the same in 1999 and possibly into 2000. As the purchasing power of these countries dropped, so did their ability to buy US cotton although ultimately as seen this crop year, their ability to export textile products would be greatly improved over time. During 1997/98, the world supply of cotton would grow by almost 3 million bales where as the world demand fell marginally resulting in a jump of world stocks of 3 million bales, 2 million of that housed inside China. From July 1997 to April 1998, the A index fell by more than 17 cents with the US futures falling by an almost identical amount as the market attempted to absorb the higher

supply and also stimulate demand. The last leg of this sell-off in US and World prices would be prompted by a surprisingly high USDA March 31 Planting Intentions for the US followed up shortly by China's entry into the export market with 1 million bales.

By May 1998, a delivery based squeeze struck the July 1998 contract forcing futures to recover all of their loss and ultimately move to new contract highs resulting in a rally of almost 25 cents. Also playing a very prominent role in pushing futures higher was a growing concern for inadequate rainfall adversely affecting acreage in the West Texas region along with low irrigation supplies. Though the crisis in Asia had not eased, our attention was diverted to events at home as each subsequent USDA report reinforced our own ideas of an ever-dwindling US crop. By late June, new crop futures hit a high of 78.00 basis the December 1998 contract and remained in the mid to low 70's range over the next three and a half months as we postulated about just how low US ending stocks might fall. At its lowest level, US stocks were forecast at 2.3 million bales based on a crop of 13.2 million bales, although lower demand held the stocks to usage ratio to a more comfortable 15%. With a crop 30% lower than 1997's and the lowest in a decade, even higher prices, if not now, then later, certainly seemed in the cards. After all, in the summer and fall of 1995, the US cotton futures market rallied from the low 70's to the high 90's in just over 2 months as the crop size was cut by more than 4 million bales to 17.9 million bales. So why not higher prices for the US market in the wake of this year's much smaller crop in the US? During most of July and August of 1998, the A index remained nearly unchanged or only modestly lower. However, by September, the lack of demand and the burgeoning new crop supply began to re-exert itself resulting in renewed downward pressure on the A index and ultimately futures. The lack of demand for cotton and the soon to be followed lower prices proved merely to be symptomatic of the ongoing global economic fears as reflected through the sizeable break in stock market values in the US, Europe and Asia to multi-month lows during September and October, 1998. Part of the financial pressures stemmed from the collapse of Russia's banking system pressuring the ruble to much lower levels which in turn forced Yeltsin's government to default on large foreign loans. Back at home, our interest was deflected to the possible failure of a little known hedge fund, Long Term Capital Management, as its collapse and subsequent losses could have spread to other funds resulting in an ever widening crash here in the US and overseas.

The combined effects of these erratic monetary and currency fluctuations on a global scale reinforced perceptions of just how deep-seated the weaknesses were in many foreign economies. This, coupled with concerns regarding the performance of the US debt markets and the constraints it might put on corporate borrowing, proved significant enough to prompt the Federal Reserve to ease US short term rates on 3 occasions from September to November, 1998.

From September 1998 until January 1999, the A index along with US futures continued their downward movement as buyers remained scarce and supplies hefty. Adding to the US woes was the demise of the Step 2 program as its funding was exhausted leaving US exporters unable to compete for export business and exposing the US to imports sometime late in the winter of 1999. The expiration of Step 2 was not a surprise but did remove the insulation the US enjoyed from poor world fundamentals and therefore low world prices. Adding insult to injury, in mid-January, another shoe fell as Brazil first widened the bans on its currency, the Real, and then allowed the Real to float on the world market. Although concerns about the Brazilian economic

fallout were not as great as the Asian contagion due to its perceived limited exposure, the result was another break to new contract lows by US cotton futures even as the US stock market rebounded from a 2-day sell-off. No sooner had we absorbed the news about Brazil than fears about China following a similar course of devaluation rocked commodity values including cotton, soybeans and grains. Though various high-ranking Chinese officials were quick to deny any plan to devalue the Yuan during 1999, the damage was done as cotton and other commodities dropped once again to new contract lows. This sell-off can best be exemplified through the Commodity Research Bureau Index, a basket of commodity values, which plunged to a 24-year low only last week as crude oil, grains, meats and softs including cotton all experienced a lack of demand and an excess of supplies worldwide.

By mid-February, the USDA confirmed what we had all suspected yet feared in their 1998/99 monthly supply and demand report. World demand was reduced to a 12 year low of 84.6 million bales and despite a world crop that also fell to a 5 year low, ending stocks were projected at 41.6 million, the highest level since the mid 1980's. To put the world usage figure in better perspective, think back to the early 1990's when the Soviet Union broke apart, a political event that qualifies as one the most momentous of this century. The disruption and loss of several million bales of Soviet and Eastern European mill consumption as well as the flooding of several million bales onto the world market required several years to be absorbed by the market place. This huge imbalance kept prices captive and in a trading range of the low 50's to low 60's from 1991 until 1993. The economic damage from the Soviet break-up on commodity prices was significant yet pales in comparison to the current global economic crisis that has encompassed almost every major country and region on this planet.

The effect of this year's poor fundamentals has been to push cotton futures down by more than 25 cents from last summer's highs while depressing the A index about 15 cents since the season began on Aug 1. In addition, this recent sell-off in cotton prices carries futures and the A index down to 6-year lows, last seen in the Fall of 1993.

Now that I have determined the how and the when of world economic events as they shaped US cotton prices, I will demonstrate the effects of worldwide fundamentals on US cotton if viewed as a game of dominos. We know that the initial weakness in overseas currency values in late 1997 substantially increased the cost of buying US raw cotton while the decline in overseas stock market values further reduced foreign buying power. The combined effects lowered cotton imports from the US and other exporting countries, hence leaving a larger 1997/98 crop supply with no home. With the advent of the next crop year, the need for foreign exchange by major exporters such as Uzbekistan started the sell-off in the various growths that make up the A index as sellers increasingly fought for market share. With buyers remaining sparse and an abundance of aggressive sellers, the net effect was a downward spiral of prices that may have only recently gained some stability. This downward spiral of business and of prices is similar to a row of dominos, knock the first one down and they all begin to tumble. It is interesting to note that as futures were breaking into the mid-50's two weeks ago, the A index failed to move much lower from its 55-56 cent level as sellers saw little to be gained by discounting offers while demand remained so weak according to Cotlook's daily commentary.

As the dominos representing the supply side has continued its fall, they have intersected another

row of dominos depicting the mill sector that began its drop gradually but has gathered momentum in recent months. In their 1999 Economic Outlook, NCC's Economic Services stated "The demand for textile products is directly related to income. Slowing growth rates across the world's economies spells further difficulties for textile product demand." With foreign consumers economically strapped, foreign mills increasingly were forced to turn to the export market to find a home for their products. Returning to NCC's Outlook, they state "where some foreign textile markets were only 20% export driven, many are now upward of 80%." Although the falling currency values may have first worked against many Southeast Asian countries with their raw cotton purchases, their much weaker currencies have allowed them to sell their textile goods at substantially lower prices to the chagrin of the US manufacturers. Mr. Greenspan's often quoted description of the US as an "oasis of prosperity" explains in large part why the US has been the repository of huge textile imports in the last two years and will continue to be in the near term. By most accounts, US cotton textile imports are up by almost 50% since 1995 and 1996 and according to the Commerce Department, US imports of cotton products through November 1998 increased 18% over the same period last year. Reviewing this same data shows how the fight for textile market share can disrupt traditional sources when previous customary clientele are lost. For instance, Pakistan had been exporting a large portion of its textiles - yarn, fabric and finished goods to Asia but when that market came under pressure from some of the above mentioned problems, Pakistan turned to the US as a home for its products. Per the Commerce Dept, US imports of textiles and apparel from Pakistan grew 37% (by volume) from January to November 1998 compared to the corresponding period in 1997. Pakistan is now considered the second most important source of fabric into the US displacing Mexico and number three in yarn imports just behind Mexico and Canada, the US's NAFTA trading partners. This huge inflow of Pakistani goods has prompted US authorities to take action by meeting with officials from Pakistan two weeks ago here in Washington.

Europe has not been immune to the textile import pressure as they too have been forced to try and compete against a huge inflow of cheaply priced foreign textile products. Per the Feb 5 issue of Cotton Outlook Magazine, "European Union textile interests are keen to discuss with Brussels what steps can be taken to protect their markets from the impact of imports from sources such as Turkey." The fallout for the US and Europe as well as any others in similar straits is a contraction in their own cotton consumption as domestic mills are unable to compete profitably against imports. US cotton consumption is down almost 10% this crop year compared to 1997/98 with little change anticipated in the short term. In the last two months, there have been a series of announced consolidations, closings, and mergers by US textile manufacturers that may involve upwards of 1 million bales of cotton consumption. By some accounts, the majority of this mill usage may be irrevocably lost as manufacturing facilities are moved overseas. Any improvement in US mill usage into the new crop year will be tied to the stabilization of foreign currency rates as it relates to the decrease of textile imports and just as important, the refunding of Step 2.

In each of these steps, we seem to find another reason for the dominos to gather speed as they round the corners in an attempt to complete the tumbling process. We have a major economic crisis in Asia and no sooner does the world begin its recovery but Russia deals us a major blow taking most of the world's stock markets with it. But as we patch this problem and move on, Brazil jumps in our path. We as an industry and as global participants can not but help wonder

who, where and when the next problem will occur. The currency and stock markets appear to have developed a tough skin. Obviously, cotton and other commodities similarly affected have not been so fortunate thus far.

Although this globalization process may appear to have begun less than two years ago, in fact, it has been building for sometime. In the mid-80's a huge shift began in countries such as Pakistan and India to expand their textile manufacturing industry as the foreign exchange earned from exporting finished goods was much greater than that of exporting raw cotton. Countries that made up the former Soviet Union, such as Uzbekistan, have learned this same principle, as attested to by their efforts to build a textile manufacturing industry though it is still in its infant stage. Another country that has greatly expanded its mill capacity in recent years is Turkey. The US has been unique in that it has always enjoyed a large textile manufacturing sector while being a major participant in the exporting of raw cotton, albeit less in some years when we were perceived as only a residual supplier. As George Soros, the great financier said "You have political systems which are national and financial markets which are global." Not only is this true but this principle has been around since before the building of the Great Wall of China. The only difference is that now it does not take as long to move goods or currencies. The high speed at which information is communicated to everyone has exacerbated the ongoing dilemma the US cotton market finds itself in. At the NCC annual meeting held two weeks ago in Memphis, the general view was that every major segment in our industry had been adversely affected by the events of the last two years. From producers and ginners to merchandising and warehousing to manufacturers, everyone has been impacted by the oversupply of and weak demand for raw cotton and textiles not only in the US but abroad as well. Improving the demand at the retail level for textile goods in many Pacific Rim countries would obviously alleviate many of the problems that the US industry is facing as supplies of raw cotton and textile goods would become more manageable. However, that improvement may only come from the stabilization of currency values, rising stock levels, and most important, positive GDP growth.

As we look to the future, there are trends setting the stage for the continued globalization of the US cotton market. We need only check the labels of any newly bought clothing to see this process in action. The fiber content and directions for cleaning are often given in two or more languages. As it relates to manufacturing in the US, a shift in spinning operations from the US to Mexico is underway. Again, per the NCC's Outlook, "this shift may be in response to NAFTA incentives and does involve some joint ventures with US spinners. Though the implications are unclear, this trend may bear on attitudes of various interests in the development of new parity agreements."

In closing, I ask you, are our fortunes tied to those of the Pacific Rim region, South America, Russia and Europe? The answer, in my opinion, is a resounding yes. This year and last, we have been made painfully aware of our connection with the world. As stated earlier, just as we are dependent on them to pull themselves up by their boot straps to help salvage US prices on a long term basis, they look to us as a safe haven for their goods when their own populace can not absorb them. On occasion, we may find our attention focused at home whether the issue is supply or demand-oriented. With Step 2 funding, assuming Congressional approval is granted, we may be partially insulated from the world's fundamentals but not isolated from them. The future of the US cotton market is forever linked with that of the world and all its parts. Thank you for allowing me to speak to you today.