CHINA'S COTTON TRADE UNDER THE WTO

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China's formal accession to the World Trade Organization in December 2001 sets the stage for sweeping changes in China's economic and trade system. Agricultural trade, in particular, will be fundamentally changed by the introduction of a tariff rate quota system for China's imports of many key agricultural commodities, including cotton.

The prospect of China's accession to the WTO last year generated a great deal of excitement among cotton merchants anticipating significant imports based on the relatively large cotton import quotas proscribed in China's accession package. That excitement was, perhaps, overdone as the cotton trade searched for any glimmer of goods news that might help to put a bottom on declining world cotton prices.

Now that China has actually acceded to the WTO, and is moving, albeit somewhat slowly, to implement the new cotton trading system, it is certainly useful to take a look at what China committed to in its WTO accession agreement, and what changes have already been made by the Chinese government in implementing that agreement. At the same time as the implementation of the WTO agreement is occurring, however, China has also embarked on a significant reform of the domestic cotton pricing, marketing and distribution system.

In particular, this paper will look at the February 7 release by China's State Development and Planning Commission (SDPC) of the rules and regulations governing cotton imports under the tariff-rate quota (TRQ) system that China committed to implement as part of its WTO accession package. These rules, effective as of February 10, 2002, will be examined from the perspective of what the new rules may mean for China's cotton trade. And finally, it will discuss the current state of the reform of the domestic cotton marketing system and the additional liberalization required under China's WTO accession agreement.

Overview of WTO Accession Agreement

In broad terms, there are three major aspects of China's WTO agreement that bear directly on trade in cotton, including the TRQ system, export subsidies, and domestic distribution rights.

TRQ System. As most are now aware, China committed to introduce a TRQ system to govern cotton imports as part of the WTO accession agreement that was formally signed by China and the WTO Secretariat late last year, making China the 143rd member of the WTO on December 11, 2001. China agreed to allow imports of 818,500 tons (3,759,303 480-lb bales) in calendar year 2002, rising to 894,000 tons (4,106,068 bales) in 2004 (table 1). One-third of this quota is allocated to state trading companies and the remaining two-thirds to non-state trading companies.

At the time of its accession to the WTO, China formally notified the Secretariat of four state trading enterprises approved to trade in cotton (both un-carded or combed and carded or combed cotton),

China: Quantities Specified for Cotton TRQ Import System

Item	Unit	Jan 1 2002	Jan 1 2003	Jan 1 2004
Total TRQ quota level	Tons	818,500	856,250	894,000
	480-Bales	3,759,303	3,932,685	4,106,068
Allocated to non-state traders	Percent	67.0	67.0	67.0
	Tons	548,395	573,688	598,980
	480-Bales	2,518,733	2,634,899	2,751,065
Allocated to state traders	Percent	33.0	33.0	33.0
	Tons	270,105	282,563	295,020
	480-Bales	1,240,570	1,297,786	1,355,002
In-quota tariff	Percent	4.0	4.0	4.0
Over-quota tariff	Percent	54.5	47.3	40.0

including the China National Textiles Import and Export Co. (Chinatex), the Beijing Jiuda Textiles Group Co., the Tianjing Textiles Industry Supply and Marketing Co., and the Shanghai Textiles Raw Materials Co.

Export Subsidies. Another significant change for cotton trade was China's commitment to immediately cease using export subsidies upon accession to the WTO. Although perhaps somewhat less prevalent than in the grain sector (primarily corn), export subsidies have nonetheless been used regularly by China in the past to promote exports of cotton in spite of the significant margin between China's domestic price and the world price. At times, this has allowed significant quantities of cotton to move onto the world market when it otherwise would have been uncompetitive.

Distribution Services. Another less widely known, but nonetheless significant provision of China's WTO agreement was the commitment to phase in the right to distribute domestically-produced or imported products in China within three years of accession. Prior to accession, China did not permit foreign companies to distribute or market cotton, whether that cotton was imported or domestic. Under the WTO agreement, however, this prohibition on cotton distribution and marketing will be phased out over three years. Upon accession, foreign-invested enterprises will have the right to distribute and provide related services for cotton produced in China. Within two years after accession, foreign-invested enterprises will have the right to distribute cotton, whether produced in China or imported, and provide related services (storage, etc.). And within three years, wholly foreign-owned enterprises will also have the right to distribute and provide related services for cotton, whether produced in China or imported.

Recently Announced Rules for China's TRQ System

China's State Development and Planning Commission recently published the final package of rules that will govern the cotton TRQ system. Although the rules as published generally conform to the commitments China made in its accession agreement, there are several areas where this is less clearly the case.

First, the rules as outlined in the regulation took effect as of February 10, 2002, which is a significant delay from the accession agreement, which committed China to actually opening up the cotton import quota for use on January 1, 2002. Therefore, it will likely still be some time until imports are actually shipped under the new TRQ system, as the deadline for applications for quota is February 21, and notification of awards of quota to applicants will not be made until early March (with a notification deadline of March 5).

Process Summary. Applications for a cotton quota allocation for 2002 will be accepted from February 10-21. Provincial-level offices of the State Development and Planning Commission (SDPC), who will manage the collection of necessary paperwork for the application, will forward "qualified" applications to the central SPDC offices in Beijing, who will notify end users of their allocation (if any) by March 5. Note that the determination of a "qualified" application rests with province-level officials rather than Beijing, potentially opening the door for different interpretations of rules in different provinces.

Quota allocated under the tariff-rate quota (TRQ) will be divided into two types: Type A, for general trade (all imports except for processing trade), and Type B, for processing trade (cotton imported for processing and immediate re-export). End users wishing to apply for a cotton import allocation under the quota must first be registered with the State Industry and Commerce Management Authority (as the corporate business license must be affixed to the application for an allocation). In addition, applicants must have a "good financial status and tax payment record" (with the relevant data attesting to this for 2001 attached to the application). Applicants must also have no record of violations with China's Customs Administration, Quarantine Authority, or Industry and Commerce Department. And finally, applicants must have an annual inspection qualification certificate for 2001.

Assuming the following conditions are all met satisfactorily, the applicants for Type A quota allocation (i.e., non-processing trade) must meet at least one of the following criteria in order to be considered for a cotton quota allocation:

(1) Be a state-trading enterprise (Chinatex, etc.);
(2) be a central enterprise that has the authority to hold state cotton reserves;
(3) be an enterprise that recorded general cotton trade in 2001;
(4) or be a cotton-spinning mill with the capacity to run at least 50,000 spindles.

If one of these four initial criteria are met which allows an enterprise to apply for quota, then the actual allocation of Type A (general trade) quota will be based on an enterprise's "historical record, processing capacity, production, imports, sales, or experience, and the capability of providing services on the international market." If applications are received for a total amount less than the total amount reserved for type A quota for that year, then all of the requests will be fully allocated.

However, if the requests for type A quota exceed the amount allotted, priority will be given to those who have an actual history of imports (though not as an "agent"). Applicants with no history of imports will be allocated quota according to their processing capacity and business volume. Applicants who are allocated less than they applied for will receive the full amount requested, while applicants who receive an allocation that is less than what is determined to be a minimum or threshold amount (an amount that is not identified) will receive no allocation.

Applicants for an allocation of type B quota (processing trade) will also need, in addition to the business general business license for all enterprises operating in China, a special "processing license," issued by MOFTEC to apply for the allocation. They will also then apply for and receive a certificate of allocation from the authorized SPDC office in their jurisdiction (province).

Impact of TRQ System on China's Cotton Trade

It is unlikely that China's cotton imports will be significant during marketing year 2001/02, even if there was a significant deficit of cotton (which of course there is not this year given the last bumper harvest). First, at least one-third of the normal import period for calendar 2002 will have passed before end-users will even receive notification of quota allocation. This will only leave four months of marketing year 2001/02 available for imports, and building in time to enlist a trading company, arrange purchase, and then transit time, imports are not expected to be significant this marketing year. USDA is currently estimating 400,000 bales of imports, which is not an unreasonable estimate given the current domestic surplus and the fact that importers will be navigating a new and untried TRQ system for the first time.

With regard to the TRQ system itself, there are a number of unusual aspects to it that may impact China's cotton imports. The key aspect is the splitting of the TRQ into two parts, one for so-called "general trade" and one for processing trade. This is an unusual addition to the TRQ system, and apparently the U.S. Trade Representative's Office will be scrutinizing this feature closely to insure that it does not act as an impediment to imports. There are several potential issues with regard to this system where the TRQ quota allocation is in part based on the use of the cotton. For instance, if one quota (Type B) is over subscribed but the other (Type A) is under subscribed, is there a process to insure that, in total, China's cotton end users have access to as much of the quota as remains unfilled?

More important, however, is the lack of information regarding the allocation of quota to applicants. For cotton, government or government-related institutions appear to have an advantage in the allocation process. Looking at the criteria for receiving an allocation under the general trade category (Type A), three of the criteria favor the state-owned sector: be a state trading company (Chinatex or one of the other three entities identified as state cotton traders), be a central government institution involved in the state cotton reserve system, or be an enterprise that imported cotton during 2001. The first two criteria are explicitly targeted at government institutions. The third, while not appearing to be limited to such, is in practical terms largely limited to state-owned yarn mills. Although data on cotton importers is limited, most cotton imports under the old import system were restricted to state-owned companies and a small number of joint-venture operations.

The implication of the bias towards state-owned enterprises in terms of accessing cotton quota is that the central government has more ability to influence behavior at a state-owned enterprise than it would at a private enterprise. In fact, an unofficial "nudge" from the central government could dissuade, or at least minimize, state-owned enterprises from utilizing available cotton quota. Although government coercion in the business sphere is far less than it was a decade or two ago, it nonetheless is present, and, given the apparent bias in the rules, could contribute to an under-utilization of available cotton import quota.

In a related provision, the allocation of quota will only be granted if it exceeds an unstated minimum amount. Applications for amounts less than this unspecified minimum would be rejected and the applicant would receive no quota. Again, this provision appears to be an attempt to minimize access to the cotton quota of smaller enterprises, which presumably would be attempting to import smaller quantities of cotton. This skews the allocation process towards large, and in most cases state-owned, enterprises.

The final criteria that qualifies an end user for a cotton import quota is the capacity to run at least 50,000 spindles. While there are many state-owned yarn spinners in China with more than 50,000 spindles, there are nonetheless many operations that have less, including the small, largely township and village enterprises. Based on an assumption of 24/7 production for 50 weeks a year, an operation with 50,000 spindles could consume roughly 50,000 480-lb bales of cotton a year—a significant amount of cotton.

Clearly, a large segment of the potential number of yarn spinners who might wish to import cotton will be excluded based on the 50,000-spindle minimum.

In addition, the criteria as published appear to completely exclude all non-state owned non-woven operations. These end users who consume cotton, but do not use spindles in their production process, appear to be excluded from applying for cotton quota. In addition, the regulation also appears to exclude operations employing open-end (or rotor) spinning, as these operations also do not utilize spindles in the yarn production process. Although I actually find it highly unlikely that China would exclude open-end spinning from quota allocation, it nonetheless appears to be the case because of the imprecise language of the regulations.

And finally, assuming that an enterprise is approved to apply for quota, the means of allocating the total quota among applicants (assuming it is over subscribed) are at best characterized as murky. With few enterprises importing cotton in 2001, "import history" is not a useful predictor of an allocation. Processing capacity, the next criteria on which an allocation will be made, is not explicitly identified in the rules. What are the capacity levels that will be used in making the determination? Will all applicants simply be ranked on capacity and the largest receive quota? Or will there be stepped ranges? Or will some other means be used? The final means of deciding allocation that is noted in the rules is the idea of "business volume." However, as with processing capacity, no additional clarification is provided, such as how business volume is defined, or what the ranking process might be.

Impact of Liberalization of Cotton Distribution

Over the next three years, China has committed to liberalize domestic marketing and distribution of cotton, including related services such as warehousing. Although China loosened the All-China Federation of Supply and Marketing Cooperative's (SMC) monopoly over cotton procurement, marketing and distribution system in 1999 and again in 2001, the changes to date have not fundamentally changed the cotton procurement or marketing landscape. Most cotton this year continued to be procured (and marketed) by the Cotton and Jute Companies (CJC), although some provinces had greater amounts of activity by non-CJC entities. Practically speaking, CJCs continue to operate as a part of the SMC system, although they are now supposed to be "responsible for their own profits and losses." Though even this is less than a hard and fast rule, as it appears China will implement a bailout of Xinjiang CJCs, which are sitting on a large amount of unsold cotton purchased at prices above the current market price. The central government will shortly begin purchasing a large quantity of this unsold cotton from these enterprises for the national cotton reserve system (though the pricing for these purchases is still not known).

This year, Hebei Province appeared to take the lead in the development of a new procurement system, with the provincial government authorizing more than 700 companies to procure and market cotton in 2001/02. Although many of these companies are simply re-packaged versions of what were once the local operations of the Cotton and Jute Company system, others clearly are not. However, other provinces, such as Xinjiang, are moving much more slowly in terms of allowing the government controlled system of procurement and marketing enterprises to liberalize. As of late last fall, the Xinjiang provincial government has only authorized 28 companies to participate in this year's cotton procurement.

And finally, as expected (if not publicized by the central government), some of the new independent cotton procurement agents are beginning to go under. Liaoning Province, a relatively minor cotton producer (only 6,000 tons in 2000), has already seen some cotton procurement agencies fail. What is not clear, however, is whether these failed agents were newly formed merchants or were part of the Cotton and Jute Company system.

As in many other reform programs in China, implementation is occurring unevenly across the country. Provinces with more reform-minded governments are taking the lead, while more conservative provincial governments are moving slowly, if not actively impeding the reform process in their province. In addition, China's still tightly state-controlled banking system is proving to be an impediment to the liberalization of cotton marketing. Yarn mills wishing to procure cotton directly from farmers are finding that the Commercial and Industrial Bank of China (CIBC), the source of operating credits for industry in China, is unwilling to provide credit for the direct purchase of cotton from producers, a business activity that the CIBC is unfamiliar with and therefore wary of. The China Agricultural Development Bank, on the other hand, which provides loans to CJCs for cotton procurement, are less than enthusiastic about providing credit to yarn mills, an industry with which it has had little experience.

Although China has only made modest progress in unilaterally opening up the domestic cotton distribution and marketing system, as part of its WTO accession agreement the government committed to a full liberalization over the next three years. Although in the short run, when only domestic cotton can be purchases and distributed, the impact on the current system will not be that great. Therefore, over the next year (2002), the current trend of very slow development of an independent cotton marketing system will continue. Although joint venture companies have the right to establish marketing operations in China for domestically produced cotton, there is unlikely to be a rush of such enterprises in the short term.

In 2003, joint venture companies will have the right to market and distribute domestic or imported cotton, and in the next year, this will be extended to wholly foreign owned companies. I believe that this last stage may see the introduction of foreign companies into China's cotton marketing, which avoids the problems that many joint ventures have experienced. This last step in 2004, then, may see the growth of foreign cotton brokers and/or merchants in China. This would put enormous competitive pressures on China's current cotton marketing enterprises, and would likely accelerate the pace of change in the system, perhaps leading to consolidation of the current fractured system and increased bankruptcies of poorly run CJC operations.

However the changes progress (fast or slow), the door is now open for the procurement, distribution, marketing, and warehousing of cotton by non-state owned, and, eventually, wholly foreign owned, companies. The current system, despite the liberalization that has already been introduced, continues to see significant price differentials in different areas of the country for similar grades of cotton. As more efficient (and presumably "hungrier") independent enterprises enter the cotton market, distribution of cotton will improve.

However, there continue to be many impediments to the development of an efficient cotton marketing system, impediments that have not so far been addressed in the reforms. Local cash markets function relatively well because buyers and sellers are known to each other and have long-standing relationships. However, if local demand exceeds local supply, or vice versa, the mechanisms for selling cotton to or sourcing cotton from another province are less effective. With no system of bearer receipts, which would allow cotton lots to be assembled and transferred through intermediaries, mill agents now are required to travel to the point of origin to arrange for purchase and transportation.

Concluding Ruminations

In the context of the new TRQ system for cotton imports, the lack of an efficient domestic marketing system, and an infrastructure to support it (bearer receipts, financing, timely price information, etc.), it stands to reason that some mills may turn to foreign imports when local demand outstrips supply. This could occur even when the national cotton supply situation is in surplus as it is now. However, the extent to which this occurs will largely be a function of the new cotton TRQ system—does it effectively open up imports to qualified mills or other end users, or is it restrictive and impose unacceptable costs on an enterprise seeking imports (whether in terms of the uncertainty of obtaining quota, or an excessive expenditure of time and effort in order to obtain quota).

Cotton imports under the new TRQ system are likely to occur relatively quickly, if for nothing else than to show the world that the new system is "up and running." However, the many ambiguities in the rules of the system may well impede the system from operating in a fashion that allows end users to freely access imported foreign cotton.

And to the extent that China's domestic marketing and distribution system remains largely based upon the traditional CJC companies, then the inefficiencies in the system will continue to exist—most notably relatively wide price gaps between the different regions of the country. It is likely, then, that enterprises located in regions with local shortages will be more willing to incur the "costs" of navigating the TRQ system to procure imported foreign cotton. And with the liberalization of the cotton marketing and distribution likely to proceed relatively slowly, even given the additional impetus supplied by the changes mandated in the WTO accession agreement with regard to joint venture or wholly foreign owned entrants into the system, this may well be a significant driver of imports over the next few years.

However, predictions of import behavior by China tend to be wrong just about as often as they are right. It remains to be seen how the new TRQ system will operate, and to what extent the government seeks to or is successful in manipulating it to meet its own policy goals. However, over the medium term, and perhaps as early as 2002/03, the TRQ system will likely begin to operate much more smoothly and as originally envisioned by those who negotiated it, even if only through challenges in Geneva for breaches of the agreement.

Once that occurs, the question then becomes how China's farmers will respond to world price signals as transmitted through imports. Although farmers in China are certainly going to respond to price signals, what is less certain is the competitive advantage of the different crops in China vis-à-vis foreign producers. China is also liberalizing grain trade through a TRQ system, and if these crops are even less competitive than cotton, then farmers could well shift more area into cotton as the lesser of two evils. This "fallout" among China's different crops, based on relative prices, will be very important to how much or how little China needs to turn to cotton imports to make up for any reduction in domestic production.

The bottom line, therefore, is that China will likely import 75,000-100,000 tons this marketing year, far less than the upper bound set by the quota. Imports in 2002/03 are much less certain, and any projection of trade will need to take into account how well the TRQ system operates this year (whether allowing or impeding imports) and how cotton fares in the overall structural adjustment that will be occurring as China's farmers come to terms with the impact of increased trade in many of China's major crops.

China's Cotton Trade Under the WTO

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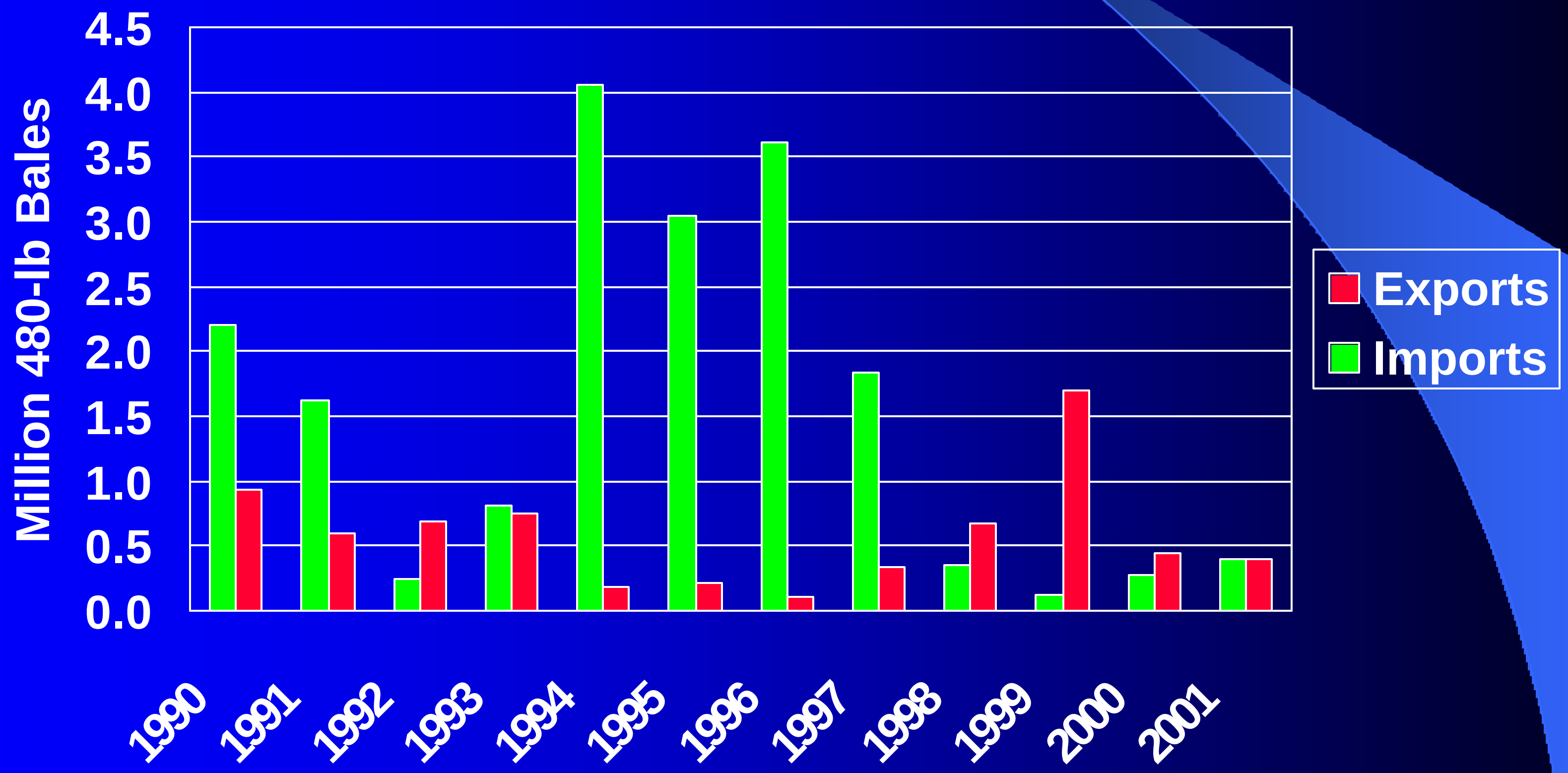
Why Do We Care?
Potential for Large Net Imports



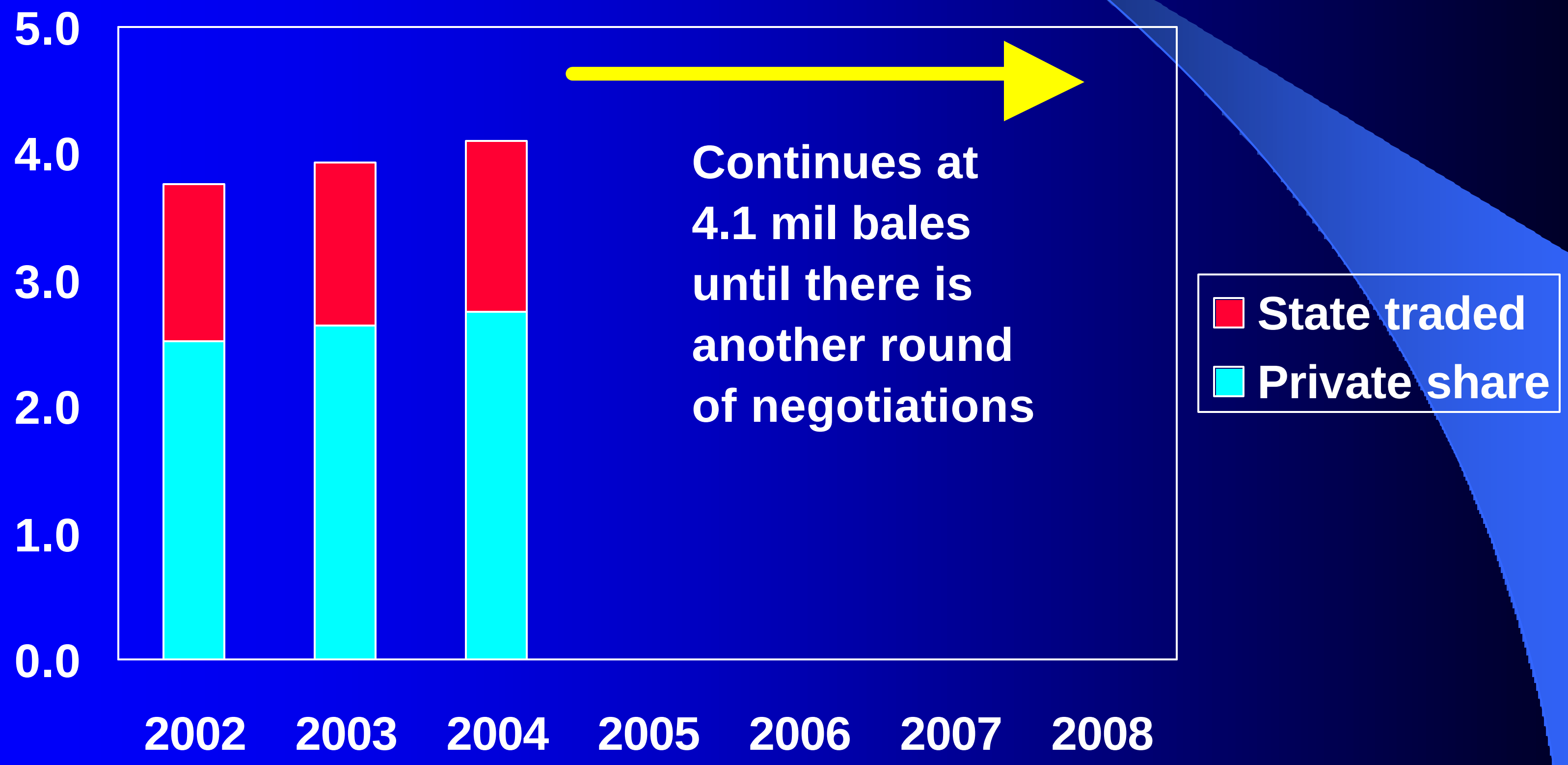
What Does WTO Accession Mean for China's Cotton Trade?

- Examine new trading rules
- Envision how practical application of those rules may proceed
- Speculate on impact on China's cotton trade over the short and medium term

Timeline

- China accedes to WTO on December 14, with implementation of commitments to take effect on January 1, 2002.
  - Tariff-rate quota system for cotton imports
  - Cotton export subsidies banned
  - Domestic cotton marketing and distribution services liberalized

China's Cotton Quota Limit



Tariff Rate Quota System

- Up to 818,500 tons in CY2002 at 1%
  - Above quota tariff at 54.5 %
  - Two-thirds of quota to non-state trade, remaining one-third to state trade
  - Quota rises to 894,000 tons in 2004
    - Above quota tariff declines to 40 %
  - Unused state quota reallocated by Oct 1

Export Subsidies

- China committed to end use of all cotton export subsidies upon accession
  - Successfully used in past, most recently to promote exports of Xinjiang cotton
  - VAT rebates, if do not exceed actual VAT rate, will likely continue as they do not seem to come under this provision

Distribution Services

- Phase in rights to cotton distribution over three years
  - Year 1: Foreign invested ventures may distribute domestic cotton
  - Year 2: Foreign invested ventures may distribute domestic or imported cotton
  - Year 3: All ventures, including wholly foreign owned, may distribute cotton from all sources

Rules for TRQ Cotton Imports

- Apply for quota Feb 10-21
- Notified of allocation by Mar 5
  - Significant delay from Jan 1 start
  - Factor in enlisting trade company, arranging purchase, and transit time, first TRQ imports may not land until early April
  - One-fourth of calendar year gone, and only four months of MY 2001/02 remaining

China Imposes Surprise Rule

- Quota and application process split between “general trade” and “processing trade”
  - May be a problem in future if impedes trade
  - How balance allocation if one type is over-subscribed and other is under-subscribed
  - Language in rules for process trade access to quota very unclear, difficult to assess impact

Criteria to Determine if End Users May Apply for Quota

- To be able to apply for quota, must meet at least one of the following criteria:
  - State-trading company (Chinatex, etc.)
  - Central government enterprise that can hold state cotton reserves
  - Imported cotton in 2001
  - A yarn mill with more than 50,000 spindles

Allocation of Quota

- Allocation principles in order of precedence
  - End users with a “history of imports”
  - “Processing capacity and business volume”
  - Additional factors impacting allocation:
    - “production, sales, experience, capability of providing services on the international market”
  - Allocations below an unstated “threshold” will not receive any quota

Implications of the Application Criteria?

- Notable bias towards state-enterprises…
  - State cotton trading company
  - Gov’t institution holding state cotton reserves
  - History of imports…if gauge is 2001, few meet criteria as imports only 230,000 bales, and primarily are state-owned mills (some JVs)
  - 50,000+ spindle mill….only larger mills qualify, again mostly state-owned enterprises

How Many Mills Qualify?

- Unable to research numbers, but likely not a large share of the total universe of China’s yarn mills
  - 50,000 spindles running 12/7 for 50 weeks, means consume roughly 25,000 bales a year
  - Excludes township and village spinning operations
  - An important limiting factor…will this promote consolidation in future?

What is Not Mentioned…

- Spindle language is confusing…
  - Does this exclude all non-woven enterprises?
  - What about open-end spinners who don’t have spindles?
  - Spindles “registered,” but underreporting rampant to avoid gov’t drive to reduce capacity
- Wiggle room for gov’t, or just an oversight?
- Excludes foreign firms w/out a yarn mill

Distribution Services

- China must allow foreign-funded enterprises to compete in the cotton marketing and distribution system
- System already in flux with two unilateral rounds of liberalization (1999 and 2001) of SMC/CJC system

Current State of Distribution

- Mixed picture depending on province
  - Hebei officials more aggressive, approved over 700 firms to participate in procurement and marketing, though many are simply repackaged versions of CJCs
  - Xinjiang approved less than 30 enterprises
- Many impediments to moving into this business…particularly access to credit

Impact of Distribution Reform

- In short order (3 years), China's domestic cotton marketing system is likely to be faced with wholly foreign-owned competitors….perhaps some of the larger U.S. merchants
- Current system relatively weak and fractured
  - Lack of credit, overstaffed, etc.

Implications of WTO for China's Cotton Trade

- USDA currently estimating 400,000 bales of imports in 2001/02
- Some imports likely to occur very quickly, if only for PR reasons
- Unlikely to see big volumes this mktg year
  – Delay in establishing TRQ system
  – Navigate a Byzantine and untried TRQ system

Real Question is 2002/03

- Birthing pangs of new system over?
  – Cotton production may fall 15-20 percent as recent intentions survey suggest
  – But large stock overhang from 2001/02 unless consumption growth stays high
  – Imports likely above this year, but not reaching TRQ limit

So Many Questions….
So Few Answers

- A more realistic projection of imports under the new TRQ system in 2002/03 must wait for the system to actually function
- Important questions remain…
  - Non-mill sector access to quota
  - Allocation principle not clearly defined

One Person’s WAG…

- In 2002/03, total imports could rise to between 1.5 and 2 million bales
  - Assume at least 10 percent decline in output, and continued growth in offtake
  - Optimistic?…rules may limit access to TRQ
  - Impact of plan to purchase for state reserves?
  - Need see TRQ system actually operate for a while