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Deepening Target Price Reform to Maintain Stable Policy Prospects

China Cotton Association

The National Development and Reform Commission and Ministry of Finance together issued the 'Notice of the Deepening of Cotton Target Price Reform' on March 17, indicating the confirmation of the implementation of target price policy in Xinjiang during the next three years. This has stabilised market prospects to some extent, whether for growers, ginning mills or spinning mills.

The decision to deepen target price reform followed the three-year trial period in Xinjiang, which was born against the background of the state purchasing policy that operated during the three preceding years. In 2011, the Chinese government released the reform policy, with the aim of protecting growers' interests and stabilising production. It is undeniable that with the market changing, purchasing of cotton increasing, the spread broadening between prices at home and abroad, the market mechanism weakening, State Reserve pressure increasing, and the competitiveness of textile exports receding, that the provisional State Reserve purchasing policy was difficult to sustain and progress.

Domestic cotton producers were also facing the problem of insufficient income. Because of China's special situation and geographical position, domestic growers mostly consist of small-scale enterprises with a low degree of mechanisation, who face high costs and have poor anti-risk capabilities. It is difficult for them to survive without any government support; their interests would be further impaired and their lives become poorer, especially in Xinjiang, China's largest cotton producing area. Subsidies are directly related to growers' incomes, but are also more about Xinjiang's regional stability and development. If growers' confidence was to be damaged, domestic output would suffer, with adverse consequences for spinners. As a primary cotton consuming country, reliance predominantly on imports would result in a loss of pricing power and could bring negative influences to global cotton production. The provision of appropriate support to domestic cotton producers, so as to maintain a particular degree of self-sufficiency, would benefit the healthy development of the cotton industry, both in China and in the rest of the world.

Subsidies are indispensable to China, but it is still a problematic issue nowadays and further practice and improvement is needed as regards the appropriate methods, as well as how to make intervention more efficient. The government mentioned in the 2014 'Central No.1 Document' that the aims are 'adhering to the principle of market pricing, exploring an agricultural products pricing mechanism and gradually establishing an agricultural pricing system'. For this reason, the provisional state purchasing policy was abolished in the 2014/15 season, and the Xinjiang cotton target price reform trial programme was initiated, leading to a market-oriented cotton industry instead of the policy-oriented mechanism previously in place. The Xinjiang Autonomous Government and the PCC (army group) introduced their implementation plans and confirmed specific subsidy methods right after the start of the following season. In view of the practical implementations in the first year, the overall progress was fairly smooth. The market pricing mechanism based on market supply and demand worked well and some practical experiences have been accumulated, but there are still some problems, including the tedious subsidy process, large financial pressures, and an inefficient subsidy procedure in the 'mainland'. Relevant departments conducted comprehensive evaluations after the completion of pilot work in the first year; besides affirming its achievements and experiences, they also strived to find problems so as to provide a policy basis to the deepening of the reform trials and the improvement of the follow-up policy programme. Accordingly, subsidy modes in the 2015 and 2016 seasons were further perfected: the target price was lowered, procedures simplified, and the costs of implementation have been reduced with the help of the establishment of an information platform.

Three years after the Xinjiang cotton target price trial programme, we have basically reached the expected goals, including agricultural prices being fully decided by the market, having disconnected prices from government subsidies, whilst protecting growers' interests, enhancing the cotton textile industry's market awareness, rationalising the relationship between upstream and downstream markets, regulating national cotton production distribution, improving the competitiveness of domestic cotton on quality and price considerations, and promoting the healthy development of the textile industry, all of which have provided practical experiences. We still


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need to admit that there are some shortcomings, such as unstable policy expectations and an unreasonable subsidy mode, as well as the low efficiency of subsidy quotas in the 'mainland'. In fact, some relevant departments set about the evaluation of the new subsidy policy last year and put forward advice regarding the deepening of cotton target price reform policy. Not long ago, the 'Central No.1 Document' introduced measures 'regulating and improving the Xinjiang cotton target price policy, as well as perfecting the subsidy mode'. The State Council also approved moves to conduct the deepening of subsidy policy and further improve said policy in Xinjiang.

Compared with policy details during the trial period, there are mainly three different features in the 2017 target price subsidy:

The first is to specify the period of pricing. Previously, the target price was confirmed annually, prior to cotton sowing, resulting in uncertainty and destabilising both market expectations and cotton production. According to the latest policy, cotton target subsidy pricing will be changed every three years from 2017, based on production costs with reasonable returns during the most recent three years. If there are significant changes in the cotton market during the three-year period, an adjusted target price level may take effect on approval by the State Council. The target price during 2017 through 2019 is 18,600 yuan per tonne; starting conditions and subsidies in the Xinjiang Autonomous Region and the PCC remain unchanged as before.

The second is an upper limit to the quantity of subsidy. Production in excess of the quantity level (85 percent of national average output during 2012 through 2014) will not enjoy subsidies over that level. Previously, no such limit was in place.

The last is to actively explore new subsidy modes. Although the document has clarified the deepening of cotton target price reform, the government will continue the exploration of a more reasonable way of managing subsidy, so as to further improve the agricultural subsidy policy, such as making good use of some financial tools like insurance and futures, target price insurance, 'insurance + futures' trials and the joint-action mechanism of futures and insurance, as well as the pilot of allocating subsidy based on crop quality.

In the process of researching cotton target price policy, the China Cotton Association (CCA) has been attaching great importance to protecting growers' interests and the healthy development of the whole industry. We have also raised a series of feasible policy recommendations (of which subsidy related to quality is one, whilst another is to increase subsidies in certain cotton planting areas in the 'mainland'), which were partly accepted by the government. Furthermore, CCA has also established a research group of 'Internet+Cooperatives+Insurance+Futures', together with the Development Research Center of the State Council, China Insurance Regulatory Commission and China Securities Regulatory Commission. A preliminary plan has already been initiated, which will help the government to reduce financial pressures and increase growers' market awareness, while at the same time reducing their risks in planting. Such a plan is expected to be regarded as pilot work in parts of the cotton planting areas and working as a trial program for the next step of subsidy reform.

The release of the target price policy, plus the previously published normalised state reserve sales policy, will play a positive role in the stabilisation of domestic cotton production and the cotton textile market. According to the latest survey by CCA, national planting intentions have stopped declining and will recover slightly in 2017, owing to the strong trend of cotton prices in 2016, as well as policy stability. Growers are confident in planting and in market prospects during the near future. Meanwhile, for ginners and spinners, domestic cotton production will maintain a certain level of supply, while the confirmation of the date and volume of state reserve sales will guarantee consumption, and will make their operating decisions steadier.

However, all policies have their own flaws and their own historical conditions, as well as historical limitations, and need continuous improvement. Reform needs to advance cautiously, which requires learning from experience and practice. If we are unsure about the reform, we need to gather experiences from pilot works to make the future of the reform more secure. After the three-year trial period, cotton target price reform was implemented formally, though it needs more exploration and improvement in the future, so as to increase the competitiveness of domestic cotton, and promote the sustainable and healthy development of the cotton textile industry.

Leading Industrial Development Through Medium to High Grade Cotton Production

By Mao Shuchun

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1 Domestic cotton industry scenario

Over recent years, the domestic cotton industry has evolved from the provisional state reserve buy-in and target price-oriented scenario to experience an overall rise in production, imports and inventories, before entering an overall decline and finally moving into a market which lacks medium-to-high grade cotton with a surplus of medium-low grades.

By early 2015, domestic raw cotton inventories totalled 11/13 million tonnes. The market started to digest those stocks, 2,363,000 tonnes of which were sold in 2015 and 2016. Meanwhile, cotton capacity had decreased for three successive years, as had raw cotton imports and consumption.

In this context, cotton textile enterprises started to appeal for the easing of import quotas, especially for US and Australian origins.

The No.1 Document 2017 points out that 'the structural imbalance of supply and demand of agricultural products, the unreasonable configuration of key elements, and the human impact to resources and environment, are urgent issues to be addressed, so as to break the conflicts between increasing output and enhancing quality, high cost and low price, high inventory and dull sales, and the price inversion between domestic and foreign supplies'. Therefore, production of medium to high quality will be the target for China's cotton industry with the help of supply-side structural reform. The aim is to enhance quality and benefit domestic cotton comprehensively, and the ultimate goal is to move toward a dominant and powerful cotton-producing country.

2 To lead industrial development through medium to high grade cotton production

Emphasis on quality improvement is focused on demand side upgrade (variety, quality, brand), as well as the relationship between high production costs and high quality, and up-to-date cotton textile equipment.

1) High production costs should match high quality

The level of production cost is a key indicator in evaluating the competitiveness of lint. According to an ICAC survey, China's production cost increased from 0.89 US cents per kg in the 1997/98 season, to 2.06 US cents per kg in the 2012/13 season, an increase of 131 percent. Around 15 years ago, the cost was 30/40 percent lower than in the US, Australia, India and Brazil, but now China is on a par with the US in this field, and up to 180 percent higher than in some of the other competitors.

In addition, China also has the fastest growth rate of production cost by unit area, which has increased by 279 percent in the past 15 years, with an average annual growth rate of 3.68 percent. In contrast, inputs for Australian cotton grew by 9.8 percent over the same period, with an annual growth rate of just 0.67 percent, and a total cost representing 57.3 percent that of China's.

Furthermore, with the development of the 'One Belt One Road' policy, the cost of cotton production in Central and South Asia will become lower, and more primary raw cotton and cotton yarn products will be produced. In 2015, the ministerial conference of the WTO established the policy that 'developed countries are to cancel subsidies in cotton exports, and the least developed countries are to enjoy preferential tax-free policies in cotton exports to developed countries'. From an international perspective, the future of Chinese procurement of medium to low grade cotton will potentially increase as the source of supply becomes broader.

2) Up-to-date cotton textile equipment affects quality requirements

The first issue is the enhancement of cotton textile efficiency. The spinning efficiency of up-to-date cotton textile equipment has improved significantly, in both the number of twists and the output speed. The second is that different spinning equipment has different requirements of fibre quality; fibres with high length and uniformity are more suitable for efficient spinning. The last is that some new equipment, like rotor spinning, jet spinning and friction spinning, all require a high standard of cleanliness in the fibre, which must be spotless and without any foreign matter.

3) Whether high quality cotton can obtain a high price

The answer is positive. Practice has proved that high prices can be acquired with high quality in the international trade. US cotton is famous for the SJV Acala variety, Australian cotton is well known by the phrase 'one country, one variety', while in comparison, China lacks high quality.

Based on analysis of competitiveness, Australian cotton tops the list, being praised for its high quality in the global market and sought-after by China's cotton textile enterprises. China imported 3,377,000 tonnes of Australian cotton from 2002 through 2014, accounting for 10.2 percent of total imports, after the US and India. The average price during the 13 years was 2,143.9 US dollars per tonne, nearly 15 percent higher than the world average (1,869.2 dollars per tonne). The price of SJV Acala cotton in the Cotlook A Index during the first ten years of the 21st century was 11.29 cents per lb higher than medium staple upland cotton, and the price difference between 'higher grades' and medium staple cotton around the world has expanded by 60.5 percent in the last 40 years, reflecting that the demand for high-quality raw cotton has been growing internationally and especially in the Chinese market.

3 Strategy of medium to high quality raw cotton development

To deal with the problem of high costs and poor quality, we need to stick to the long-term target of quality improvement based on the strategy of supply-side reform, which favours scale protection in cotton production, and the capacity to adhere to the rigid demands of the fibre quality.

1) To create a medium to high quality 'pyramid' model

A team lead by the author Mao Shuchun created a 'pyramid' model in 2016 which aims to improve the quality of domestic cotton. The base level is the degree of cleanliness, second is uniformity of fibre, the third is the quality of ginning, the fourth is a scientific and practicable level of inspection, and the fifth is grade.

Key technology

With the commonly held target of enhancing 'medium to high quality', the next step is to improve comprehensively breeding, production, ginning, inspection and the economic benefit: firstly, to cultivate key germplasm resources that provide the required characteristics in terms of quality, yield and that are well adapted to machine-picking. Secondly, to increase the output rate of medium-to-high grade cotton through study and application of technology that will advance quality and efficiency. Thirdly, to

improve the mechanisation level of cotton cultivation and harvesting, and to resolve technical difficulties and critical equipment issues in machine-picked cotton cultivation.

2) Major measures

The first measure is to divide protected cotton production areas scientifically and reasonably, and adhere to the principles of 'tripartite layout': cultivated area in Northwest China accounts for less than half of the national total, 30 percent resides in the Yellow River Valley, and 20 percent in the Yangtze River Valley. The second is to take comprehensive action to promote scientific variety, regional distribution, and the improvement of fibre cleanliness and uniformity. The third is to improve seed production capacity and supervision. The fourth is to promote integrated development of the primary, secondary and tertiary industries in cotton production. The last, but not least, is to support the brand cultivation of high-quality raw cotton, as well as promoting the driving effect of the brand.

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Constraints and Prospect Analysis of Domestic Cotton Production

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As the primary economic crop with the largest industrial chain in China, cotton planting is an important source of income to growers in the main producing areas. It is also a vital material to meet national needs in clothing consumption, and has been playing an indispensable role to the healthy development of agriculture, rural production and even the national economy. In recent years, the Chinese government has issued a series of policies such as the improved cotton varieties subsidy, provisional national purchasing policy and the Xinjiang cotton target price reform. However, with the continuous decline of national cotton production and changes in regional planting structures, the conflict of short-term oversupply and long-term short supply is becoming more and more prominent. Several factors have limited domestic cotton development, particularly international market price changes, poor production management of growers, high production costs, and the declining competitiveness of Chinese cotton in the international market. Despite all this, as a developing country with such a large population, the government has been persistently attentive to the industry, so as to stabilise the steady and healthy development of domestic cotton production.

Current situation and problems of domestic cotton production

Production and international position keeps declining

According to data from the National Bureau of Statistics (NBS), cultivated area nationwide was 50,642,000 mu (3,376,133 ha) in 2016, down by 6,308,000 mu from the previous year, or minus 11.1 percent. Output was 5,343,000 tonnes, down by 260,000 tonnes, or minus 4.6 percent, year-on-year. Average yield was 105.5 kilo per mu (1,582.5 kilo per ha), up by 7.2 percent, year-on-year. Although these figures are higher than the assessments of some departments or information agencies such as the Ministry of Agriculture, and the China Cotton Association, the consensus is that the domestic cotton area in 2016/17 has fallen to a record low in recent times. As a result, China has lost its position as the largest cotton producing country. Data from the International Cotton Advisory Committee (ICAC) and United States Department of Agriculture (USDA) show that China's cotton production has been lower than India's in the three years since 2014.

1.2 Regional structure changing and production risks increasing

After years of natural development and market choice, domestic cotton production formed three primary producing areas in the early 1990s, namely the Yellow River Valley, the Yangtze River Valley and Northwest Inland. In recent years, with the development of cotton production in the Northwest Inland area, especially in Xinjiang, and the gradually decreasing area in the 'mainland', the former 'Three Regions' have been divided into two regions: Xinjiang and the 'mainland'. The proportion of area and production in the Yangtze River Valley has decreased from 30.5 and 27.3 percent, to 23.3 and 17.3 percent of national totals, respectively. Proportions in the Yellow River Valley declined from 43.1 and 38.1 percent, to 29.3 and 21.8 percent, respectively. In converse, the Northwest Inland now accounts for 47.2 and 60.9 percent of the total, compared with 25.9 and 34.6 percent, before the shift in production.

Meanwhile, the rapid development of cotton production in Xinjiang has contributed to the emergence of deficient water resources, low organic matter content in soils, decreased fertility and land pollution, all of which will further increase the risk to cotton production in China.

1.3 Large cotton inventories in short term and insufficient supply in long term

China has been the largest cotton producer and consumer in the world since the 1970s, and cultivation was particularly boosted after joining the World Trade Organization in 2001, since when domestic cotton textile and clothing industries have developed rapidly and cotton consumption increased substan-

[1] The author is one of the Oasis Scholars (Professor) of the Shihezi University, and the researcher of the Rural Economy Research Center of China's Ministry of Agriculture.

tially. Annual consumption from 2007 through 2016 averaged roughly 8,800,000 tonnes, reaching a recent peak of 10,886,000 tonnes in 2010. Domestic cotton inventories reached over ten million tonnes in 2011, on account of the three-year provisional state purchasing policy, slow development of the global economy and the sluggish textile and clothing markets. However, from a long-term perspective, domestic supply is still insufficient to satisfy consumption. During the ten years from 2007 to 2016, China's average planted area per annum was 70,610,000 mu, with average yield of 91.1 kilo per mu and average output 6,410,000 tonnes, which is obviously not enough to meet domestic consumption needs. When considered in tandem with the decline in production in recent years, the conflict between supply and demand will become increasingly prominent in the near future.

Restraining factors to affect domestic cotton production development

2.1 international market pressures increase under the contradictory situation of two markets and two resources

China's cotton industry entered a contradictory period of two markets and two resources after the country joined the WTO. China's export delivery value of textiles and clothing accounted for 25 percent of the total output value during 2002 to 2015, and reached its peak in 2011, at above 30 percent. Average imports of raw cotton during the same period reached over 2,600,000 tonnes. The effects of the relationship between cotton prices at home and abroad also became more obvious, in that the correlation between the Cotlook A index and the China Cotton Index reached more than 0.8. Under these circumstances, US and Indian cotton formed a dampening influence on domestic cotton prices with high domestic subsidies, high quality lint and competitive costs, which narrowed Chinese growers' profitability and planting intentions.

2.2 Weak cotton land infrastructure and low capacity of disaster resistance

China's cotton planting areas are mostly concentrated in less-developed economic regions. Limited financial input, poor production infrastructure and low drought-resistance means that production is insufficient to meet demand. According to statistics, the proportion of irrigated area in some provinces in the 'mainland' is less than ten percent. In the progress of adjusting planting structures, some cotton fields have been moved to back-up soils with low productivity, such as slopes, saline-alkali land or intertidal zones, which have poor planting infrastructure and supporting projects, and come with big natural risks to production. Survey results show that yield on the saline-alkali soil is estimated at around 60 kilos per mu, which is equivalent to just 65 percent of the national average. In addition, adverse weather conditions such as drought, floods and hailstorms are estimated to cause damage to over 20 percent of planted area every year.

2.3 Rigidly rising production costs and decreasing planting profits

Planting costs of domestic cotton increased unremittingly during the period from 2001 to 2014, from 638 yuan to 2,278.6 yuan per mu. Labour costs increased faster than material, service and land costs, from 49.8 to 61.8 percent. In addition, 23 labourers are required per mu in cotton production, which is 3.5 times the number needed for wheat, three times that of maize and 2.5 times that of rice. Labour costs reached 1,408.4 yuan per mu in 2014, which marked a record high. With the fluctuations in cotton prices and costs rising, the comparative benefit of cotton planting has been decreasing. By 2014, the cost of producing 50 kg of cotton was 35.7 percent higher than in the United States, so China had lost its advantages in production costs. From 2013 to 2016, domestic cotton prices kept fluctuating, but growers' planting costs have been maintained at a high level.

2.4. Poor ability in production and business management, and low degree of mechanisation

China's average planted area per household[2] is 4.2 mu, which is 1/200 of the United States, and less than half the average areas in India and Uzbekistan. The average age of growers exceeds 50 years, of which 70 percent are women growers with a low degree of education. The ultra-small production scale and poor labour force have resulted in the slow introduction of new varieties, new technologies and new planting patterns, as well as poor absorption capacity in technology, capital and management, which is not conducive to the promotion of social services and has resulted in low efficiency in land output and resource utilisation. Cotton planting is a long-term cycle with complicated field management chains, strong technical elements, a low degree of mechanisation and substantial labour intensity. Over the years, despite the fast development of cotton production in Xinjiang, especially in the PCC (army group), the degree of domestic mechanisation is still in its initial stages. The quality of machine-harvested cotton is poor, resulting in low output and return for growers. It also has a series of problems such as high short fibre content, a high ratio of foreign fibre, poor fibre length and strength parameters.

3. Future development trend analysis of domestic cotton production

3.1 The industrial development status of domestic cotton is irreplaceable

As an important agricultural and industrial textile raw material, cotton plays a vital role in domestic agriculture, the rural economy and even the national economy. The production value of cotton as a significant commercial crop, accounts for 3.5 percent of the value of national agricultural production. The cotton commodity rate is maintained at above 99 percent, and accounts for 15.3 percent of the average income of growers nationwide, which has a remarkable effect in promoting the development of the rural economy. As a primary raw material of the textile industry, cotton has made tremendous

[2] The figure is originated from data analysis survey results of over 1,500 growers from 15 provinces nationwide by the industrial economic research office of the National Cotton Industry Technology system in 2013.

contributions to China's textile and clothing exports. Cotton and cotton textile clothing production, a traditionally labour intensive industry, provides 30 million labour posts to the country every year, of which 80 percent are surplus rural labour forces. Additionally, as domestic cotton production is mainly concentrated in Xinjiang, it is very important to help the region to eliminate poverty, promote national unity and maintain stability in the border area.

3.2 Cotton consumption still has room to grow

It is clear that the increase in domestic textile fibre consumption mainly comes from three sources of demand: the first is the improvement in residents' living standards. China's per-capita fibre consumption level has increased from 7.5 kilo in 2000, to 14 kilo in 2006, which is more than the global average but just equivalent to the level of those developed countries in the 1980s. With the increase in residents' incomes, fibre consumption also showed an upward trend. The second is the net growth of the population. According to the sixth National Census in 2010, China's population exceeded 1.37 billion, and it is predicted that it will reach 1.45 billion in 2020. In 2033, the figure will reach around 1.5 billion. Hence, textile fibre production must meet the needs of a net-increase in population of over 100 million. The last factor is urban relocation of the population. In 2013, the urbanisation rate was 53.4 percent, and it will reach 60 percent in 2020. Meanwhile, the average number of the newly-increased labour force transferring to non-agricultural sectors annually reached nine million during the period from 2011 to 2015, and will be seven million during 2016 to 2020, reducing to five million during 2020 and 2030. Clothing consumption expenditure of urban residents is five times that of rural residents, so fibre consumption will be greatly increased by the urbanisation process.

3.3 The development of domestic cotton industry is supported by two markets and two resources

With the rapid development of the domestic textile industry, China's demand for cotton has been increasing since entering the WTO. As the world's largest cotton producing country, 26 percent of cotton globally is produced in China, which accounts for roughly 15 percent of the world's total cultivated area. China's average annual cotton consumption accounts for 40 percent of the world's total, and Chinese textile and clothing products not only satisfy domestic market needs, but also around 30 percent of international demand. China's cotton production is affected by restrictions such as population, farmland, and water resources, and it is hard to fully meet the requirements of the whole textile industry, so it is becoming more and more common to fill the domestic supply gap with imported cotton. It is also an inevitable choice to stabilise the development of the domestic textile industry.

3.4 Irreversible structure of regional collaboration (balanced) development

Although Xinjiang still enjoys prominent status in cotton production nationwide, and the national cotton production layout has changed significantly, domestic cotton production will persist in all three primary cotton producing areas. Besides Xinjiang, the two other important areas, namely the Yellow River Valley and the Yangtze River Valley, will also enjoy supportive measures, and will actively transfer planting areas to coastal mud flats, saline and alkali, slopes and sand lands so as to exploit new areas of cotton planting. Work will also be based on efficient, modern agricultural practices, employing mechanisation, strengthened technologies, optimised planting layouts and improved yields and quality.

3.5 Chinese government still pays much attention to cotton production

In the 'National Planting Industry Structural Adjustment Plan (2016-2020)' released by the Ministry of Agriculture, national cotton planted area will be stabilised at 50,000,000 mu by 2020. The Plan will strive to increase crop yield and quality, as well as growers' incomes. Experts suggest that given average consumption from 2016 to 2020 is estimated at 7,800,000 tonnes, and the self-sufficiency rate of domestic cotton is around 70 percent, China's cotton output should be around 5,500,000 tonnes.

It is also evident that domestic cotton production touched its recent bottom in 2017, after the low ebb in 2016. In early March 2017, the government issued the notice of 'Deepening Target Price Reform', and decided to continue to implement the target price subsidy policy in Xinjiang at a price of 18,600 yuan per tonne, which will be supportive to the stable development of cotton production in Xinjiang. According to the latest survey of planting intentions by the China Cotton Association, national cotton area this year is expected to increase by three percent from 2016. If we factor in the average yield in 2016, output in 2017 is anticipated to increase correspondingly.

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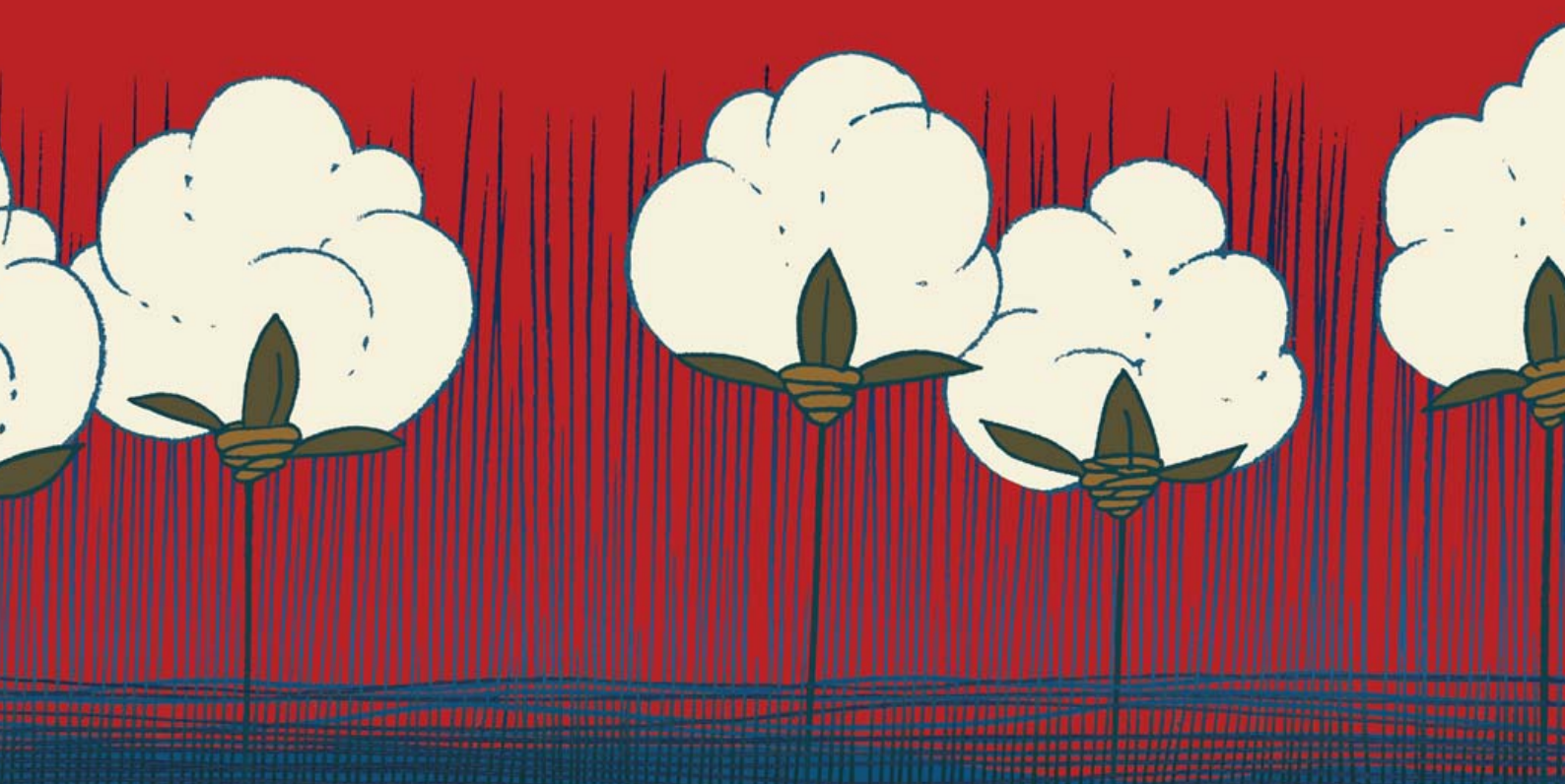

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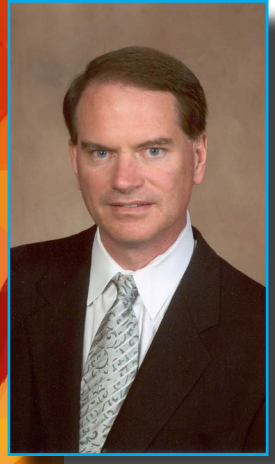


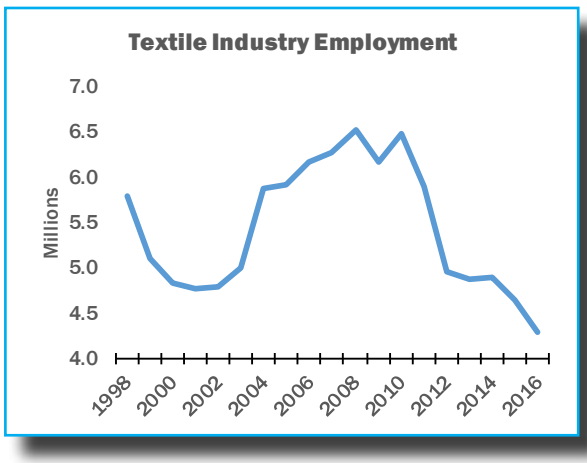
China's Evolving Role in Global Cotton Trade

Joe Nicosia, CEO, Allenberg Cotton Co & Global Platform Head of Group Merchandising of Louis Dreyfus Company

China's recent role in the global cotton trade has been the culmination of national initiatives, economic developments, internal liberalization, trade agreements, demographic changes, and cotton-specific policies. Some of these factors produced the intended and anticipated results, while others brought about consequences that were not anticipated, at least not by the world outside of China.

Significant changes in China often took decades, even centuries, to unfold while others occurred in a blink of an eye. Not until the late 1970s did China open up to foreign trade after five centuries of relative isolation, and initial developments in trade were slow to occur. In 1980, China's trade with the rest of the world (exports plus imports) was estimated at 57 billion RMB. By 2016, China's trade with the rest of the world exceeded 24 trillion RMB. In relative terms, the share of China's GDP contributed by exports grew from 5.9% in 1980 to 18.6% in 2016.

One factor that helped China become a major producer and exporter of goods, and of textiles in particular, was the availability of a plentiful, low cost labor supply. As the chart below shows, employment in the textile industry rose by 35%, from around 4.8 million people in the early 2000s to 6.5 million people in 2008.



Before the mid-1990s, China's cotton policy objective was that of providing competitively priced cotton to its domestic mills, more so than providing support for cotton producers. Procurement prices paid to farmers were typically below world price levels, and domestic mills were, in effect, subsidized.

However, after China's accession to the WTO in 2001, policy shifted slightly towards supporting cotton producers. Upon joining the WTO, China managed the level of cotton imports to serve the interests of both farmers and domestic mills. Cotton consumption nearly doubled from the pre-WTO membership level of 23.5 million bales (480 lbs) in the 2000/01 season, to 45 million bales by the 2005/06 season. While China's production growth from 20.3 million bales to 28.4 million bales during the same period was impressive, it was far outpaced by consumption growth.

Import policy was relatively loose from 2001 through 2004 because China's growing consumption was heavily dependent upon global trade. Imports were needed to fill the production deficit, and import quotas over and above the WTO-agreed 894 thousand tons of 1% tariff quota were issued as tolling quotas and other additional quotas at a 1% tariff rate.

A significant modification to import quotas occurred in 2005, when China applied a sliding scale tariff concept to most of the 1.5 million tons of additional quota. The purpose of the sliding scale tariff was to assign lower tariff rates to higher grade cotton imports than to lower grade cotton imports. In theory, this afforded greater access to the higher qualities needed most by mills. Many of the quotas in excess of the WTO-agreed 894 thousand tons have been associated with some form of sliding scale tariffs since then.

By the end of the 2010/2011 season China's ending stocks dropped to only 10.6 million bales, for a stocks to use ratio of 23%. In an attempt to protect mills from future price shocks such as the one that occurred in 2010/11, state owned enterprises were granted import quotas in 2012 and 2013, specifically for the purpose of increasing the size of the reserve stocks. Domestic prices rose far enough above world prices to make it feasible for mills to import more than one million bales of out-of-quota imports at the 40% tariff from July 2012 through January 2014. China's accelerated purchases pushed total imports to almost 59 million bales during the 2011/12 through 2013/14 seasons, and 2013/14 ending stocks doubled to 62.7 million bales. At the end of the 2013/14 season China held 60% of the world's stocks.

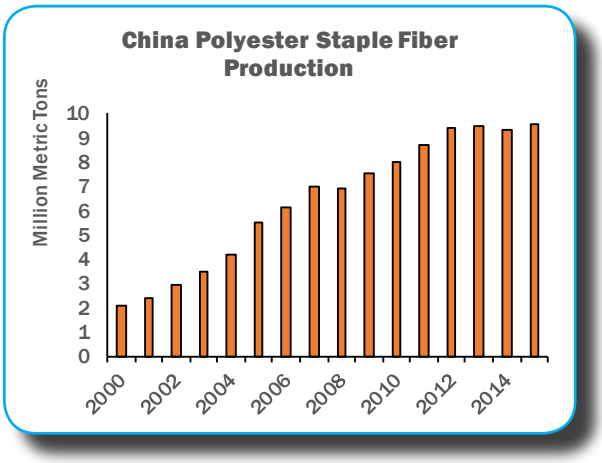
China continued to make reserve purchases of domestically produced cotton at prices well above

world prices during the 2011/12 through 2013/14 seasons as part of the overall goal to support farmers' incomes. Despite reserve sales of 6.7 million tons from September 2012 through August 2014, reserve stocks ballooned. Reserve stocks accounted for 51.9 million bales of the 62.7 million bales of 2013/14 ending stocks. The government was reluctant to reduce the selling price of reserve stocks to market-clearing levels for fear of driving prices downward at the farm level.

Domestic cotton consumption dropped sharply from 46 million bales in 2010/11 to 38 million bales in 2011/12 and continued a gradual decline to 34 million bales before bottoming out in 2014/15. Part of this decline stemmed from the lingering malaise that affected overall world cotton consumption after the global recession of 2008. However, much of the decline in Chinese consumption was the result of cotton policies that limited mills' access to domestic cotton and to imported cotton at competitive prices. Even as late as 2014, China tied access to imported cotton to purchases of Xinjiang cotton from reserve stocks. For every three bales of Xinjiang reserve cotton purchased, mills could purchase one bale of imported cotton from the reserve.

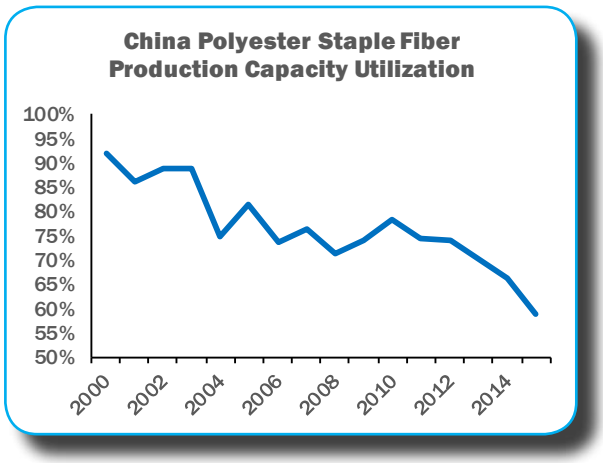
Chinese spinning mills filled the void of competitively priced cotton by substituting their input needs with domestically produced polyester fiber, while fabric producers turned to yarn imports. *Fiber Organon* statistics show that China's polyester staple fiber production grew from 2.06 million tons in 2000 to 9.6 million tons in 2015.

Production capacity grew even faster than actual production, and capacity utilization in China's polyester staple fiber industry dropped from 92% to 59% over the same period. According to Fiber Organon statistics, China's share of world polyester staple production capacity increased from 23% in 2000 to 66% by 2016.

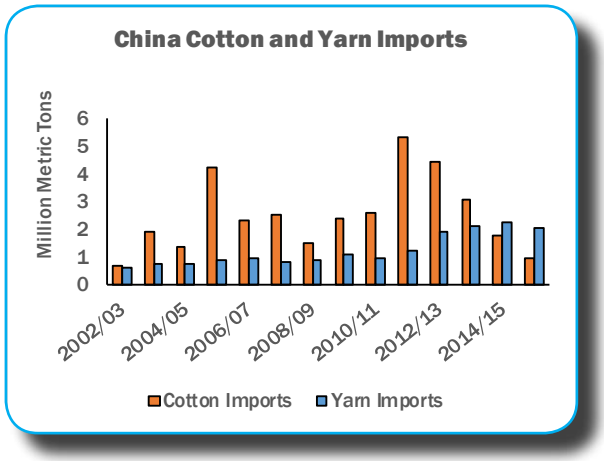


The abundance of polyester staple fiber production, and the excess production capacity, resulted in low polyester staple fiber prices during a period

when domestic cotton prices were artificially inflated. With domestic cotton prices frequently more than double those for polyester staple fiber, cotton's share of total fiber consumption in China sank from nearly 60% in the 2005/06 season to 38% in 2015/16.



As consumption declined and reserve stocks expanded, import policy for cotton became less accommodative. Tariff rates for yarn imports were zero or very nominal depending on the origin. In the ten seasons from 2002/03 through 2011/12, yarn imports were relatively steady and averaged just under 900 thousand metric tons. In 2012/13, yarn imports reached almost 1.9 million tons. Yarn imports exceeded cotton imports in terms of volume by 2014/15, and are expected to continue to be higher through at least the 2017/18 season. Pakistan, India and Vietnam have accounted for the majority of yarn imports into China, with their combined share rising from 69% in 2012/13 to 79% in 2015/16. Chinese ownership of spinning mills located in Vietnam has helped yarn imports from that origin grow from less than one percent of the total in 2006/07 to almost 27% of total yarn imports in 2015/16.



What will affect China's role in the global cotton trade going forward? One factor is the continued effort to shift both cotton production and consumption from the Mainland provinces to Xinjiang.

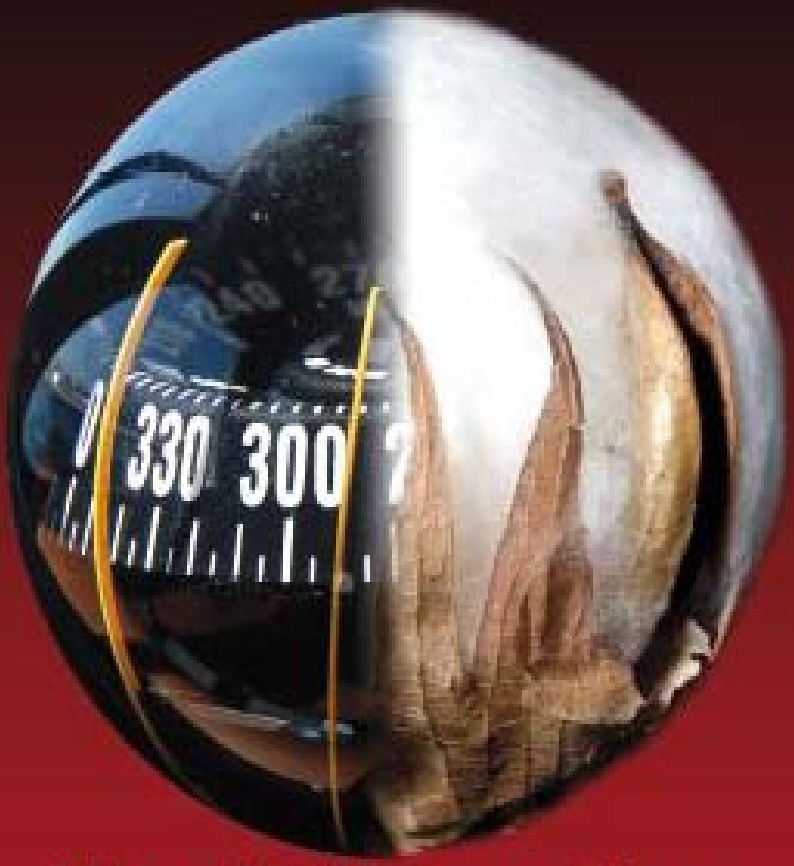
Since 2014/15, the producer support policy shifted, from the reserve procuring domestically produced cotton at prices in excess of world levels, to a program in which producers are paid a subsidy equal to the difference between local prices and a predetermined target price (initially at 19,800 RMB and currently at 18,600 RMB per ton of lint). The target price program applies only to Xinjiang, and if continued, will further concentrate production in that province.

As a part of the overall *"Belt and Road"* initiative, China established a fund of 20 billion RMB in 2014, for major expansion of the textile industry in Xinjiang province. The directive was to increase employment in the region's textile industry from 200 thousand to 1 million by 2023. Subsidies up to the equivalent of about 3,000 RMB per ton of yarn produced are paid to Xinjiang spinning mills. This includes a subsidy of 800 RMB per ton for purchases of Xinjiang cotton. The directive called for increasing the number of spindles in Xinjiang from the 7 million in 2015 to 12 million by 2017 and to 18 million by 2020. Xinjiang cotton yarn production has already expanded from 290 thousand tons in 2014, to 650 thousand tons in 2016.

The *"Belt and Road"* initiative launched by President Xi Jinping in late 2013 is intended to boost growth within and trade outside of China. This extensive initiative includes cooperative agreements with and investments in other countries, large scale infrastructure projects such as the railroad linking China and Europe, and increased emphasis on maritime shipping routes linking China with southeast Asia, the Indian subcontinent, Africa, the Middle East and Europe. If successful, the "Belt and Road" initiative will open new trade routes for China's exports of textiles and other products and expand the drawing arc for importation of cotton and other raw material inputs.

The 13th 5 Year Plan may also indirectly impact China's future role in the cotton trade. This plan specifically mentioned limiting the expansion of the manmade fiber industry, eliminating excess manmade fiber production capacity and increasing the market share of the high technology segment of the manmade fiber industry. Enforcement of more stringent pollution controls could also constrain the growth of the manmade fiber industry.

These policies will be positive for China's cotton consumption. As reserve stocks are reduced, more imports will be needed to fill what is likely to be an increasing production deficit. Assuming that future import policies are accommodative, China will have access to cotton at prices closer to world levels than when it was more heavily dependent upon the reserve stocks. China's resumption of its role as a major importer may very well end up narrowing the difference between the price Chinese mills pay for their cotton versus other countries with which they compete. What an irony it would be for the Chinese textile industry to become more competitive once they run out of stocks than when they had 65 million bales of ending stocks.



Headed to cotton

ICT COTTON LIMITED

www.ictcotton.ch

Global Consumption Pattern Benefits Chinese Domestic Use

BCO

Designed with the intentions of reducing capacity, de-stocking, de-leveraging, reducing cost and improving weakness, the supply-side structural reform process was officially started in 2015. In this context, domestic cotton prices declined rapidly prior to the commencement of the 2016 State Reserve sales programme, and the spread compared with international prices also narrowed considerably. Then in 2017, the second year of the implementation of the grand reform, under the guidance of a de-stocking concept, the policy of State Reserve sales recommenced and created a relatively loose environment in the domestic market, in contrast to the situation of tight supply in the global market, resulting in a further narrowing of cotton prices at home and abroad. The current price spread has basically fallen back to the level in evidence before the implementation of the temporary state buy-in policy. Domestic competitiveness in the international arena was regained within said price spread and consumption also increased in tandem with the declining price trend.

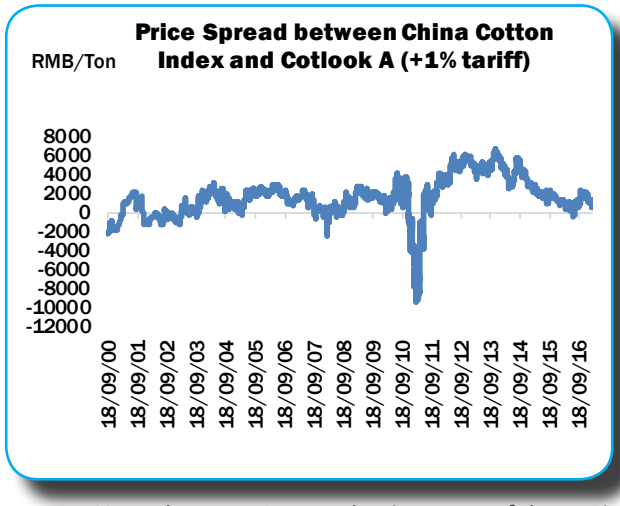
Loose raw cotton supply and optimised domestic industry structure

Loose domestic supply in 2016/17 and relatively stable price spread

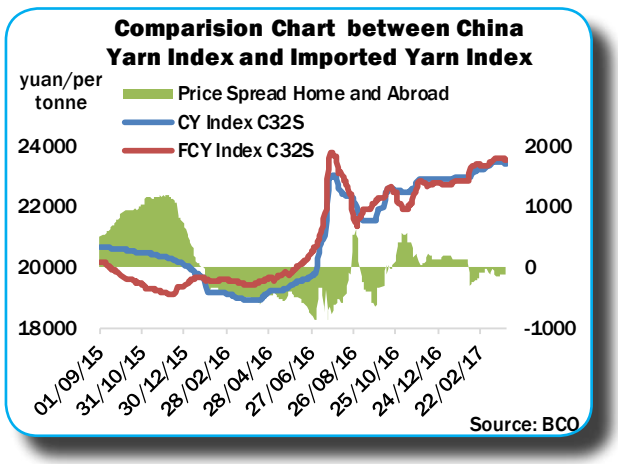
The prospective supply and demand report published by *Beijing Cotton Outlook* (BCO) in its March review indicated output in the 2016/17 season is forecast at 4,750,000 tonnes and consumption at 7,800,000 tonnes. The huge discrepancy will be offset by imported cotton (less than 900,000 tonnes), and the supplement of State Reserve cotton. Theoretically, a total of around 2,400,000 tonnes of lots will be sold within 120 working days, if the average daily transaction is around 20,000 tonnes, indicating domestic cotton in the remainder of 2016/17 will be in abundant supply and prices have no fundamental grounds to surge. Therefore, the domestic cotton market will maintain a steady trend in 2016/17.

Price spread narrowing and domestic cotton products becoming more competitive

The price spread has narrowed to a lower level since the expiration of the temporary state buy-in policy.

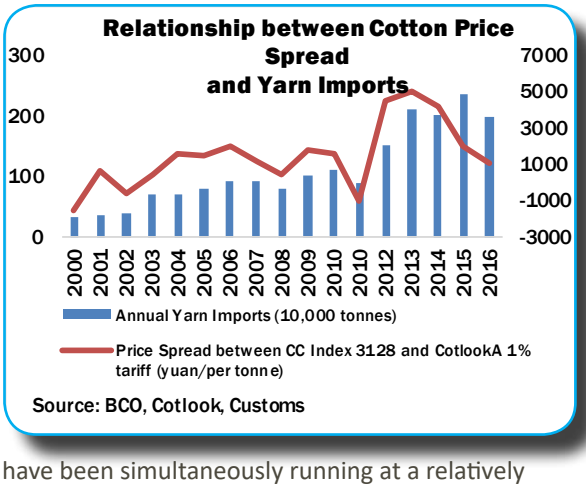


Given that premise, production costs of domestic cotton textile enterprises declined and domestic cotton yarn prices became more competitive. The chart below shows that prices of cotton yarn at home and abroad shrank in the middle of last year and the overall competitiveness of imported cotton yarn is declining.

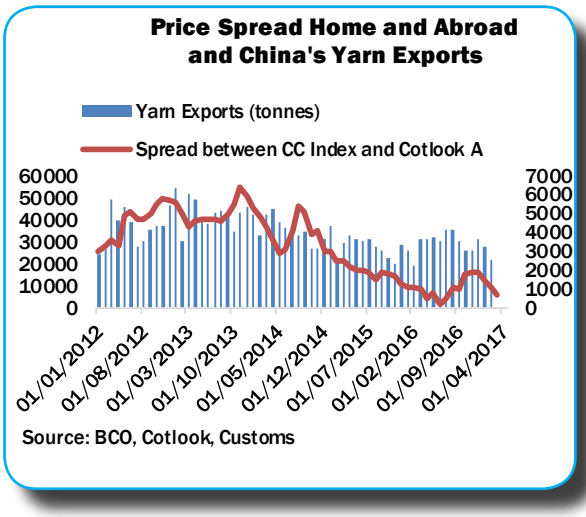


Therefore, cotton yarn imports decreased; the total volume of imports in 2016 dropped by 380,000 tonnes (minus 16 percent) from the previous year, equivalent to a raw cotton consumption of around 430,000 tonnes.

So the competitiveness of domestic cotton yarn has increased. Given that prices of Indian cotton

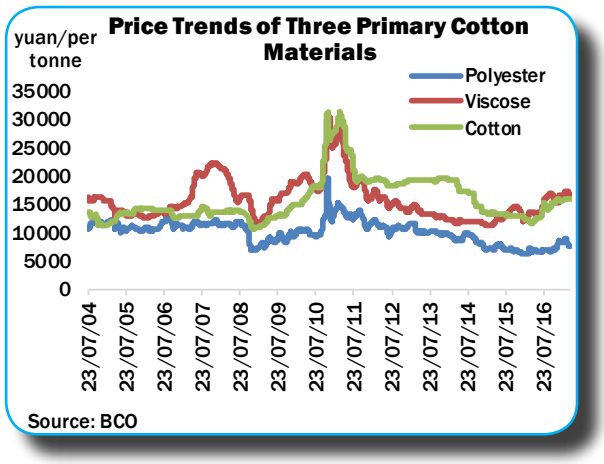


have been simultaneously running at a relatively high level, the international cotton yarn market, especially the competitive environment of medium to high grade yarn, has improved and China's cotton yarn exports increased. Domestic cotton yarn exports have reversed their weak tendency and maintained steady growth. China exported 355,200 tonnes of cotton yarn in 2016, up by 3.3 percent year-on-year. Meanwhile, exports of cotton fabrics increased by 6.03 percent, and cotton clothing by 1.06 percent. Hence, the operational situation in the midstream domestic cotton textile industrial chain has improved significantly during the past year.



Change of situation between cotton and non-cotton materials

As an industrial product, polyester fibre has its unique advantages, such as good uniformity, low inventory needs, and a relatively low risk of price fluctuations. It is therefore a reliable material supplement for cotton and textile enterprises. With the development of the industry, however, the substitute of man-made fibres for cotton has been declining gradually since the 2014/15 season, especially since the second quarter of 2015, when viscose staple fibre maintained a strong trend in price but cotton prices stayed relatively stable, and the price spread narrowed, even reversing at times. According to the China Chemical Fibre Association, new capacity of domestic viscose staple fibre in 2017 is expected to be lower than in previous years, so its substitute of cotton will remain fairly weak, though capacity will rise in 2017/18. In the longer term, the development of downstream differential products is predicted to be faster. It remains to be seen what the effect of the price inversion may have on the recent rise in cotton consumption.



The optimisation of domestic industrial structure leads to the rise of cotton consumption

Although in recent years, the growth rate of domestic investment in the textile industry declined to some extent, there has been more and more investment towards Midwest China, resulting in huge growth in Xinjiang. With the help of preferential policies and the advantages of being the main cotton producing area in this region, the development of the textile industry in Xinjiang increased rapidly. The current spinning capacity in Xinjiang is thought to have exceeded 12 million spindles, most of which are used to process cotton. It is estimated that cotton consumption in Xinjiang in the current season will be around one million tonnes. With the support of national policy, the competitiveness of the cotton yarn market in Xinjiang has been improved, and the strengthening of market supply will be favourable to maintain the development of the domestic market. Domestic production is expected to replace a portion of imported cotton yarn, as well as bringing cotton consumption back to China at a faster pace.

Minor adjustment to global consumption structure is beneficial to domestic cotton consumption

Global consumption expected to increase

According to the USDA, as regards the assessment of global cotton consumption, world consumption has been increasing in the past five years, while the pattern of consumption in individual countries has changed slightly: China's domestic consumption has rebounded significantly, as has consumption in emerging countries in Asia including Vietnam and Bangladesh. In contrast, consumption in the traditional major cotton consuming countries such as Indian and Pakistan has declined.

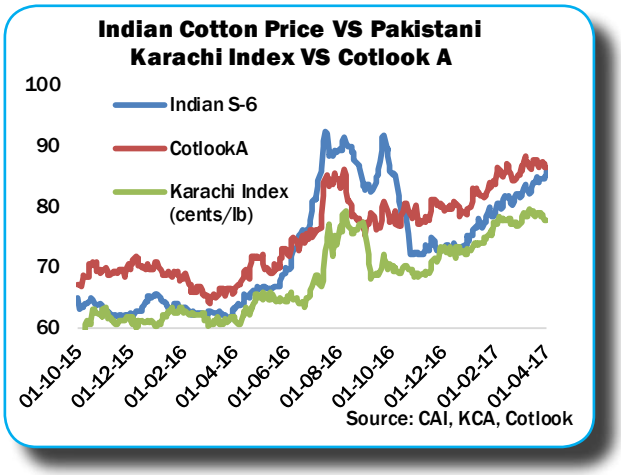
High prices of Indian and International cotton are conducive to domestic cotton consumption

USDA data show that Indian output has decreased by ten percent in the 2015/16 season, and Pakistani cotton is down by 34 percent. The tight supply situation in the two countries has driven their cotton prices much higher than the level in the international market. The big fall in output led to a relatively low level of ending stocks in the previous season, which accompanied by the 'demonetisation'

USDA Supply and Demand
(Consumption Changes) 10,000 tonnes

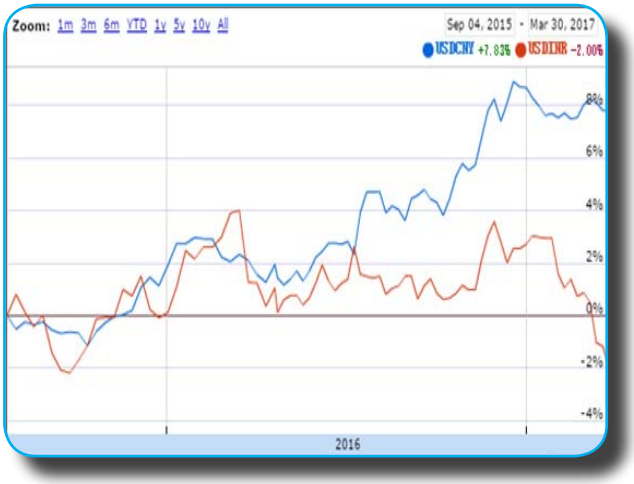
	2012/13	2013/14	2014/15	2015/16	2016/17	Five-year Trend
China	783.8	751.2	740.3	762	789.3	
India	473.6	506.2	533.4	528	517.1	
Pakistan	234.1	226.4	230.8	224.3	222.1	
Bangladesh	102.3	115.4	126.3	132.8	145.9	
Turkey	131.7	137.2	139.3	144.8	137.2	
Vietnam	49	69.7	89.3	95.8	115.4	
United States	76.2	77.3	77.8	75.1	71.8	
Others	510.6	506.9	488.5	458.9	449.2	
Total	2361.3	2390.3	2425.7	2421.7	2448	

policy in India resulted in rising prices, and became a supportive factor for international cotton rates. As a result, the international competitiveness of cotton yarn and cotton products in many countries including India has been weakened. Meanwhile, international cotton prices have been supported by strong demand from emerging countries and the dramatic sales progress of the US crop in this season, contributing to the already strong tendency of international cotton prices, which is favourable to Chinese domestic cotton consumption to some degree.



Foreign exchange market volatility accelerates domestic cotton consumption

The fluctuations in international foreign exchange rates also played a vital role in the growth of domestic cotton consumption. With the shift of the market's expectations towards US monetary policy, the international currency market has changed significantly in the past two years. The tendency of the RMB exchange rate has reversed and started to depreciate sharply, especially after the RMB exchange rate reform event on August 11, 2015. The weakening of RMB and the narrowing of the cotton price spread at home and abroad quickened the weakening of the competitiveness of imported cotton yarn and cotton products, and the depreciation of the exchange rate stimulated exports of domestic cotton yarn, cotton products and textiles, which has led to the increase of cotton consumption from the downstream up. Secondly, the Indian rupee has appreciated sharply since early 2017, in contrast to the depreciation of the RMB, resulting in domestic cotton yarn demand turning away from India and back to China.



A relatively optimistic domestic consumption forecast in 2016/17

In conclusion, the rise of domestic consumption expectations in 2016/17 will be achieved under favourable market conditions at home and abroad. On the premise of the current world market situation and the price spread of cotton and cotton yarn, it is expected that China's cotton yarn imports will decrease to 1.5/1.7 million tonnes in this season, the price competitiveness of domestic cotton yarn and cotton products will recover steadily, and cotton yarn exports will increase slightly. Meanwhile, downstream product exports will follow the same trend, as will domestic cotton consumption. The de-stocking effect will be remarkable and the rebounding of business circumstances in the whole industry chain will help the market to regain confidence.

2016 & 2017 China Long Staple Market Analysis

Fu Changjian, Changzhou Worldwide Co., Ltd

The 2016/17 season is a watershed year for China's long staple market. Cultivated area, total supply, consumption, imports and price will begin to change significantly.

Current situation of China's long staple market

1. **Area and yield increasing with quality improving**

   The relatively higher seed cotton price and much more satisfactory returns of long staple planting compared with upland cotton planting in 2015 stimulated a sharp increase of domestic long staple area in 2016, which reached 2,200,000 mu (146,667 ha). Aided by favourable weather conditions, yields increased greatly (by around 30 percent) and final output was around 200,000 tonnes. In addition, quality parameters also improved considerably: strength indicators rose by two percent, ginning outturn gained one percent and length increased by around two millimeters. The only unsatisfactory element was poor leaf grade following delayed picking on account of rainfall and hailstorms, as well as low temperatures and high winds, during September.

   Over supply, price declines and then rebounds

   The good harvest, oversupply of new crops and high beginning stocks have resulted in excessive oversupply of Xinjiang long staple cotton, leading to a downward tendency in domestic long staple prices. The benchmark value of Type 137 lint dropped from 21,500 yuan per tonne prior to the arrival of new crops to a low point of 19,500 yuan before the Lunar New Year. Supported by the increases in upland cotton prices at home and abroad, strong global long staple prices, and rising consumption and stock replenishment from domestic spinners, long staple prices recovered after the holidays, and rebounded back to the level of 21,500 yuan per tonne on April 10, 2016.

2. **Low price ratio, great price spread, dramatic increase in consumption**

   Domestic upland prices increased continuously by over 4,000 yuan per tonne after hitting a bottom in mid-March, 2016. However, long staple prices declined during the same period; the price ratio between the two styles dropped from a high point of 1:2, to a low of 1:1.2 before the Lunar New Year Festival. Meanwhile, imported long staple prices continued to rally along with the strong trend of upland cotton, and in late April were over 10,000 yuan per tonne higher than domestic lots, which marked a record high price ratio (the imported long staple price was 7,000 yuan per tonne higher than domestic lots in the first half of 2008, which narrowed soon after the government's approval of long staple exports). Therefore, the fundamental reason for price weakness is the huge volume of long staple inventories at home, which are not allowed to be exported but can only be consumed domestically, to avoid having a big influence on the international market. China's cotton export policy, set during the period of planned economy, can no longer adapt to the market and is in urgent need of change. We sincerely hope that the related departments can pay enough attention to this issue. The low price ratio compared with upland cotton, has stimulated the

China's long staple balance sheet

	ten thousand tonnes			
	2013/14	2014/15	2015/16	2016/17
Beginning stocks	10	8	6	7
Output	4	8	13	20
Imports	10	6	5	3.5
Exports	-	-	-	-
Consumption	16	16	17	22
Ending stocks	8	6	7	8.5

Note:

1) China's cotton season runs from September through August.

2) Inventories include industrial inventory, commercial inventories and inventories at ports.

increase of domestic long staple consumption, while the huge price spread between long staples at home and abroad led to the decrease of long staple imports, as domestic spinners switched to using as much Xinjiang long staple as possible.

Great transformation for Xinjiang long staples

1. **Changing period of cultivated area and output**
   Cultivated area and output of domestic long staples reached a peak after the large expansion of planted area in the previous two seasons. Seed cotton pickers were hard to find for the 2016/17 harvest and costs were expensive, factors which, together with the big decline in seed cotton prices, have seriously damaged growers' planting enthusiasm. Spring sowing has been under way but cultivated area of long staples is expected to be halved from last year. Yields and final output figures are of course uncertain. All in all, it seems improbable for long staple area and output to surpass the recent high point in the longer-term.
2. **Changing period of price ratio and price spread**
   The price ratio between long staples and upland cotton will gradually return to a level that is acceptable in the market.
3. **Changing period of supply and consumption**
   The boost to long staple consumption as a result of lower prices in 2016 will result in domestic inventories being digested, bringing the balance between supply and demand to a normal level.

Long staple price outlook

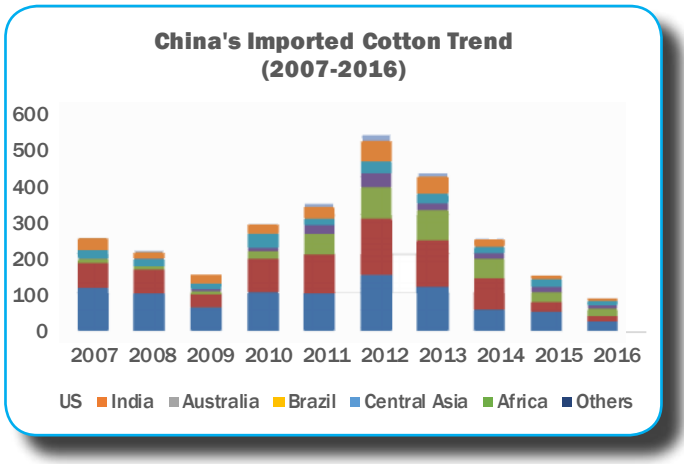
The domestic long staple market will grow stronger in the later stages of this season, limited only by the pace of reduction in inventories. Domestic values seem likely to increase further in the 2017/18 season but imported long staples should decline in price, resulting in a narrowing of the spread between the two.

Imported Cotton Market Outlook

CNCE

1. De-stocking, strict controls on imported cotton quotas

Declining domestic cotton prices ended the downward trajectory present during the previous five years in 2016, under the general influence of supply-side reform and the de-stocking process in the cotton industry. Meanwhile, the capacity of the domestic textile and clothing industry was optimised and upgraded, and cotton consumption recovered after the rebound in the domestic market. The government adhered to a strict policy regarding imported cotton quotas, even stopping the distribution of sliding-scale quota. As a result, domestic cotton imports declined substantially. In 2012, China imported 5,137,000 tonnes of raw cotton, compared with 4,148,000 tonnes in 2013, 2,440,000 in 2014, 1,472,700 in 2015 and less than one million tonnes in 2016.



USDA predicts that China's inventory consumption ratio will be 133 percent in the 2016/17 season. That is to say, domestic inventory is enough to meet demand for 1.33 years. However most of the stocks are being held in the state reserves (around 9.5 to 10 million tonnes), and the annual carryover stock is of a very small amount. The government will remain strict in its import policy during the years to come and give priority to domestic consumption. The narrowing of cotton prices at home and abroad will affect enthusiasm for imports.

The price gap during the past few years has led to a sharp increase in cotton yarn imports since

2011, which were estimated at around 600,000 tonnes in that year. The figure was increased to 2,350,000 tonnes in 2015, and declined to 1,960,000 tonnes in the following year. The lots were mainly sourced from India, Vietnam and Pakistan, whose competitive edge in the textile clothing industry has improved significantly during the years that China has been implementing the state purchasing policy. With the narrowing of the cotton price gap, China's cotton consumption will be increased markedly if the market share which has lately been occupied by imported yarn can be recaptured by the domestic market. If the price spread is to be broadened further, the volume of imported yarn will continue to increase, as well as the world's cotton consumption, but global cotton inventories (except in China) will decrease.

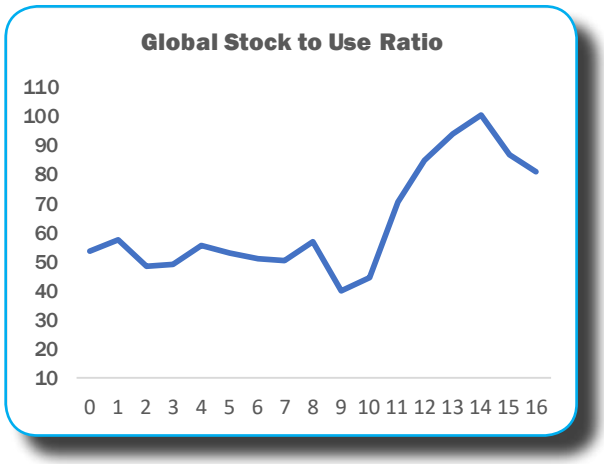
2 Capacity transfers and global cotton inventories decline

Throughout the past five years, global cotton planted area has been declining, especially since 2014, when China adjusted policies in cotton planting. Domestic output started to fall sharply, from 7,620,000 tonnes in 2012 to 4,790,000 tonnes in 2015, but at same time consumption was increasing steadily, by dozens of tonnes every year.

Consumption in the main countries was basically stable, except for Vietnam, where the incremental change was slightly bigger, due to the appreciation of the Yuan, limitations of cotton import quotas and consumption transfer from China caused by

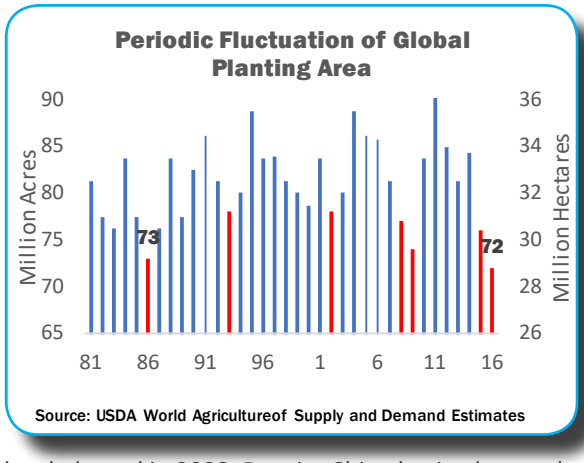
soaring domestic production costs. China's cotton consumption has been broadly stable at 7,800,000 tonnes during the past five years, while the figure for Vietnam increased from 490,000 to 1,150,000 tonnes, Bangladesh rose from 1,020,000 to 1,500,000 tonnes and global consumption increased from 23,610,000 to 24,500,000 tonnes.

Under the circumstances of output declining and consumption increasing, the world's cotton inventory consumption ratio also fell from a historical high level. It is inevitable that international cotton prices will rise again. The global cotton market in the 2016/17 season will be in a tight balance, and the decreasing export of Indian cotton, as well as good sales of US cotton, will be supportive to global cotton prices. The only uncertain factor is China's huge State Reserve stocks. But of course, the regional limitations of State Reserve cotton, plus the limitations of import cotton quotas, will mean China's State Reserve cotton will only affect the international market through its influence on domestic cotton prices. In general, international cotton prices have ended their weakness and ICE is expected to reach 90 cents per lb in 2017.



3 Supply and demand situation clearer, imported cotton market recovers

The labour-intensive Chinese textile industry remains the world's biggest textile product producing country, and has released a plan which is designed to develop the Xinjiang textile industry during the next eight to ten years. Meanwhile, China's cultivated area has been constantly decreasing in the past five years, and is anticipated to decrease by eight percent in 2016/17, which will represent only half of the



level planted in 2008. Despite China having lowered planted area in the 'mainland', areas in Xinjiang have remained stable. With the development of the domestic textile industry and huge consumption of State Reserve cotton, demand for imported will increase sooner or later in the years to come.

For the next ten years, USDA predicts exports of US cotton will show an increasing trend in 2017 and then decline, but will recover again after five years. During this period, the United States will remain on top in international cotton exports, which will account for 26 percent of the world total, while India and Brazil combined will account for roughly 28 percent. In the following five years, it is estimated Bangladesh and Vietnam will be the main importers of US cotton, but with the decrease of State Reserve stocks, imports from China will increase in 2019. China will subsequently become the world's largest importer of raw cotton, followed by Bangladesh, Vietnam and Turkey. According to this forecast, China's imports will reach 3,140,000 tonnes in 2026/27.

In short, China's de-stocking process also means the de-stocking of the world market. With the development of the process, the domestic cotton market in the future will be fully in line with international standards, and domestic textile products will finally integrate with the whole world. Under the current circumstances of the rebound of the domestic macro economy, and with a clearer cotton planting policy, China's imported cotton market will become more prosperous and promising.

Domestic Cotton Planting under Futures, OTC Options and Insurance Services

Wanda Futures: Du Ying, Ma Yongbo

In the 2011/12 season, the government began a three-year cotton purchasing programme, and invested a huge amount of funds in order to protect growers' interests. However, the global competitiveness of the domestic cotton textile industry declined during the same period of time and large amounts of cotton lint were added to national reserve inventories. Hence, the government decided to implement a target price subsidy policy in the 2014/15 season, adopting a market-pricing policy and giving payments, corresponding to the spread between the market price and the target price directly to growers. The unrestricted purchasing and the target price policy did seem to protect growers' interests, but at the same time most growers lost some risk awareness, and it became hard for the government to make any adjustment to planted areas through pricing.

To solve this problem, in the 2016 'Central No. 1 Document', the government emphasised the need for innovation in dealing with problems related to issues of agriculture, including the development of a derivative product market and a creative approach to services. The 'Document' pointed to 'creating new agricultural futures and carrying out an agricultural product options pilot', 'exploring a linkage mechanism which will cover agricultural subsidies, credits and insurance', 'steadily expanding the insurance and futures pilot program' and 'forming and perfecting the pricing mechanism and state purchasing system for key agricultural products like grain'. In this context, the mechanism of 'insurance + futures' was born. Under this arrangement, growers' risks related to cotton prices will be transferred to insurance companies once the insurance premiums have been paid. Insurance companies will then transfer all of the price risk to futures companies, who will in turn transfer the risk to futures markets through derivatives, functions of the futures market and hedging. As a result, growers' interests will be guaranteed through market-oriented means and the domestic cotton industry will be more competitive.

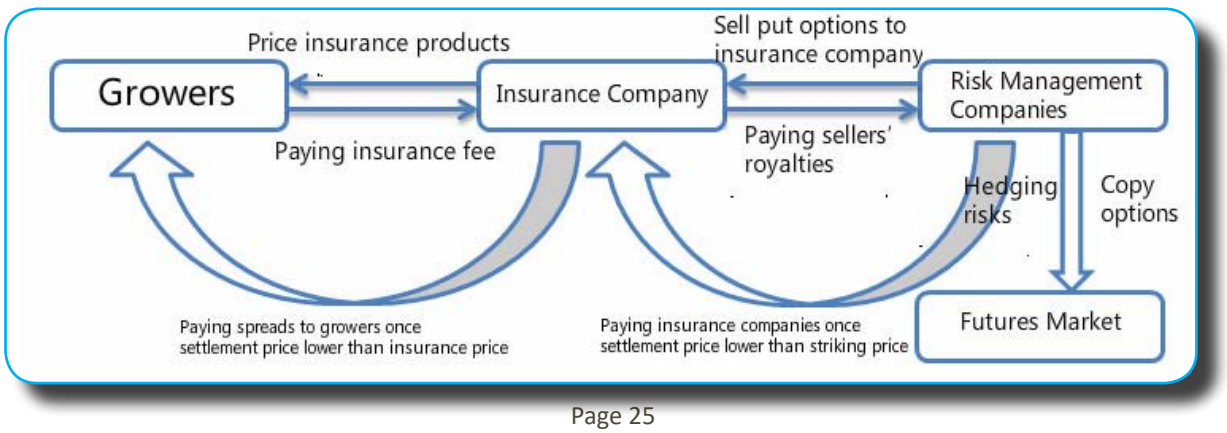
1. Technical process of Insurance + Futures

1. Growers buy cotton price insurance products from insurance companies so as to avoid price fluctuations, or in other words, sales prices have been locked in for the future.

2. Insurance companies will set up corresponding insurance products with different prices based on growers' requirements. If adverse changes subsequently occur to prices of agricultural products, insurance companies will have to pay out the difference to growers. Compared with other types of insurance, the compensation claim ratio of agricultural insurance is relatively high, especially when prices fluctuate substantially, and insurance companies can face a high volume of claim payments. In order to avoid such risks, insurance companies will purchase some over-the-counter (OTC) options, provided by risk managers of futures companies, to guarantee 'reinsurance'.

3. Risk managers are mainly responsible for selling OTC options to insurance companies, collecting royalties and undertaking the corresponding claims obligations. Risk management departments must compensate insurance companies if there is a big negative change in agricultural product prices.

4. Ultimately, the risks will be transferred to risk management departments through the futures market, in order to protect growers' interests. Risk managers will take advantage of the characteristics of derivatives and hedge in futures.



2. Insurance Product Design

The primary need of growers is to avoid the risks associated with a decline in prices, therefore an insurance product should set a certain target price. If the actual price is lower than the agreed level after the due date has passed, insurance companies will compensate growers. The terms are as follows:

1. Subject-matter insured

The qualified cotton varieties that are compliant with the government's authorisation, and which adhere to local planting and technical management requirements, can be regarded as insured. To accomplish the standardisation and impartiality of the policy, cotton futures on the Zhengzhou Futures Market (ZCE) will generally be selected as the object of insurance, in order to facilitate the determination of the claim price.

2. Insurance period

The insurance period of the contract is determined based on the growth and market features of the cotton, and negotiated between applicant and insurer. Details are specified in the insurance policy. To guarantee growers' interests and to lower premiums, the insurance period refers to the harvest period of cotton (from September 10 through to November 30).

3. Target price

Target price is the minimum selling price level under which insurance companies will award compensation. The target price is often determined by both parties, according to factors such as the costs during the period of planting and the grower's anticipated returns.

4. Insurance amount

The insurance amount is calculated according to the following formula, which will be specified in the policy of insurance:

Insurance amount = (cotton target price) X (insurance quantity)

5. Insurance liability

If the average value of the closing price of a certain agreed contract month is lower than the appointed target price level, insurance companies will be responsible to compensate in accordance with the insurance policy.

The closing prices of cotton futures contracts involved in the insurance contract are based on price data released by ZCE.

6. Insurance claims

The insurer should be responsible for compensating the applicant, based on the following formula, if losses and damage are caused by the insured liability.

Amount of compensation = (target price) – (average value of the closing price of a certain cotton contract month on trading days during the agreed period of time).

3. Risk factors and control measures of option hedging strategies

Currently, exchange-traded options are rare in the domestic market, so the options product can only be implemented by way of 'copy', however, there are certain risks in the process of 'copy'.

1. The existence of risk exposure is inevitable

The derivation of the options pricing formula is based on the ability to copy the option of the underlying asset, which in theory requires continuous replication, though this is not feasible in practical terms, especially with a unilateral market trend, whereby risk exposures arise quickly after every hedging process. As a result, obtaining an OTC options price by such a formula is unlikely to cover the risk exposure in hedging. The risk is unavoidable, but relatively controllable.

2. Commission charge and hedging cost

In theory, the higher the hedging frequency, the smaller the risk exposures, but with increased commission charges and hedging costs.

Control measure: calculate the costs under different hedging frequencies, so as to reach a balance between hedging frequency and costs.

3. Low futures deposits

In cases of drastic fluctuations in prices, or unilateral rises, losses in the futures market will be very significant and deposit risks will arise.

Control measure: to prepare enough capital in advance to lower the risks associated with a rising margin.

4. Pricing risks

The most important part in OTC pricing is estimating the potential volatility of cotton futures, however, accurate estimates are often very difficult. If the anticipated volatility is lower than reality, it will lead to losses from low premiums and high hedging costs.

Control measures: understanding fundamental and technical situations in cotton trading, analysing the rule of price volatility in both long term and short term aspects and striving to undertake pricing and hedging in a relatively comprehensive manner.

4. Significance of price insurance

1. To enhance credibility for insurance companies

To introduce growers to participate in the futures market and protect their interests under the risk of big fluctuations in cotton prices. The credibility of insurance companies will boost the promotion of insurance products such as 'options + futures'.

2. To help growers get rid of risks without losing profits from a possible rise in prices

The difference between price insurance and order-based farming, is that, although growers have locked in vested interests, they may also lose extra profits through possible rises in new crop prices. Meanwhile, there are credit risks to both parties in an order-based farming business; any sharp fluctuation in prices could lead to breach of contract. If insurance companies can play the role of intermediary agents, defaults of this nature would be avoided.

Growers could also stay away from the risks of price decline at a relatively lower cost, and at the same time acquire extra profits from any price rally in the future.

5. Problems and shortcomings

Currently we can only find OTC options products for bean pulp and sugar in the domestic market, instead of cotton, which is mainly developed and conducted through risk management subsidiary companies and investment companies controlled by futures companies. However, such derivative transactions have encountered a number of problems and deficiencies:

1. Small market capacity

The cotton 'futures + insurance' product is mainly based on the price risks of hedging from OTC options to the insurance company. An OTC options seller will avoid risks by hedging in the futures market, and since such trading is in its initial stages with small volume, it will be hard to popularise it on a larger scale.

2. High insurance costs

Hedging costs and insurance premiums are relatively high due to the small scale of OTC options.

3. Short period of insurance pricing

The cost of insurance premiums is mainly composed of operating costs and options costs. The latter will change significantly, along with changes in the futures market. As a result, the current 'futures + insurance' companies are mostly pilot businesses and a series of problems need to be solved, but with the business development and product innovation in the domestic futures market, some new products to farmers, including price insurance and income insurance, will enable substantial development in the future.

Xinjiang Textile Industry Survey

China National Cotton Group Corporation Xinjiang Cotton Co., Ltd

As China's main cotton producing area, cotton resources in Xinjiang account for nearly 80 percent of the national total output and enjoy good quality parameters second only to Australian and US cotton. Superior resources are a unique advantage to the development of the local textile and clothing industry in Xinjiang. With the purpose of boosting the development of the whole cotton industry, promoting employment and maintaining social stability, the Xinjiang Autonomous government has released a textile industry development target covering the period between now and in 2020, as well as a series of preferential policies to promote the rapid development of the textile industry in Xinjiang.

The number of textile and clothing enterprises in Xinjiang in 2014 was 680, which increased to 1,549 in 2015 and reached 1,860 in 2016. Production reached 14,000,000 spindles (including open-end yarn), with viscose production capacity at 800,000 tonnes and carpet at 1,800,000 square meters. From 2014 to the end of 2016, fixed-assets investment in the textile clothing industry was in the region of 74.2 billion yuan, while industrial added-value reached 6.259 billion yuan, and profit 1.213 billion yuan. The economic benefits of industrial development therefore showed a sustained gradual increase. Furthermore, the initial shape of the industrial cluster development pattern- 'Three Cities, Seven Districts and One Centre', was formed to benefit the Xinjiang textile industry, namely the establishment of Aksu Textile City, Shihezi Textile City and Korla Textile City, Hami, Bachu, Arael, Shay, Manas, Kuitun and Khorgos Industrial Districts, and the Urumqi Textile International Trade Centre.

From the perspective of required output and resources, yarn production in Xinjiang consists of mainly pure cotton yarn and viscose yarn. In 2015, the production of yarn in Xinjiang was 600,000 tonnes (including viscose yarn), and cotton consumption was 500,000 tonnes; in 2016, production of cotton yarn was 1,000,000 tonnes, with viscose at 670,000 tonnes, and consumption of cotton and viscose staple fibres were 900,000 and 200,000 tonnes, respectively. In 2017, given an estimated spindle capacity of over 14 million spindles (already operating), cotton consumption is expected to be over a million tonnes.

With the progress of international cooperation continuing under the 'One Belt One Road' policy, regional development in Xinjiang has been actively stimulated with the help of experience gleaned from the 'mainland' textile and clothing industry. Given the exceptional geographical advantage that locates Xinjiang in the centre of inner Eurasia and eight neighboring countries, the region has been expanding cooperation with those countries that established the 'One Belt One Road' textile and clothing cooperative project with Kazakhstan. Through this project, high-end garments will find an export channel to Central Asia and Europe. The external development has established Xinjiang's role as China's westward bridgehead, as well as an important site along the Silk Road economic belt. Data show that textile and clothing exports from Xinjiang land ports in 2016 totaled over 50 billion yuan, an increase of 50.1 percent compared with the same period in 2015.

The Xinjiang textile and clothing industry gradually expanded from cotton and yarn, to downstream industries like weaving, dyeing, knitting, and manufacture of garments and accessories. Yarn products are also being developed toward higher counts and higher quality products. So far, Xinjiang spinning mills are mainly producing 32 to 40 count yarn styles, with the highest yarn products of up to 120 count.

According to 'Apparel Industry Development to Bring More Employment Opportunities', Xinjiang introduced ten supportive policies in 2014, and another eight preferential policies in 2016, covering favourable measures in finance, tax, freight and cotton consumption, which boosted the development of the textile and clothing industry. The preferential policies in 2014 included: 1. To establish an industrial development fund for textile and clothing sectors of around 20 billion yuan, with an annual expense of two billion yuan, to ensure enterprises can enjoy preferential subsidies for ten years. 2. To strengthen supporting forces in southern Xinjiang and to ensure the allocation of special funds to the four special prefectures (Kashgar, Hetian, Kizilsu Kerghiz and Aksu) accounts for 49.94 percent of the total. 3. To strengthen financial support by offering a two to four percent interest subsidy for fixed-assets and liquidity loans. 4. To implement a special preferential tax

policy, investing all value-added tax collected from textile and clothing enterprises into the supportive development of the industry, on the basis of the existing tax policy. 5. Support for building a high standard and high level of technology in dyeing sewage treatment facilities in the three comprehensive textile and clothing bases in Aksu, Korla and Shihezi, and providing subsidies for operating costs during certain periods. 6. Implementing a preferential low electricity price policy for textile enterprises, to limit electricity costs to around 0.35 yuan/kWh. 7. Providing a different textile and clothing freight subsidy policy in Xinjiang, namely 800 yuan per tonne in the north and east and 1,000 yuan per tonne in the south, and to expand the scope of subsidies to industries such as wool spinning, linen spinning, clothing, home textile, blankets, socks and gloves, etc. Also to provide special freight subsidies for those textile and clothing products that are processed in Xinjiang and are to be exported westwards via international freight trains, so as to ensure freight costs are maintained on a par with shipping prices. 8. To provide a subsidy of around 800 yuan per tonne, based on actual consumption by cotton textile enterprises in Xinjiang, for consuming Xinjiang fibre (including viscose), during times when a big gap exists between cotton prices at home and abroad. 9. To implement a corporate social security subsidy policy for textile and clothing enterprises. 10. To implement a training subsidy policy for textile and clothing enterprises (1,800 yuan per person in the north and 2,400 yuan in the south, on the basis of actual employment after the training program).

Preferential policies introduced in 2016 include: 1. Shortening the period of enterprises' interest subsidies and freight subsidies from annually to quarterly, so as to further improve the cost-effectiveness of funds and reduce production inputs. 2. Setting up the Textile Clothing Industrial Guidance Fund with a total of ten billion yuan, which will be used to launch equity investment for well-known domestic textile and clothing enterprises in Xinjiang, so as to reduce the cost of financing. Meanwhile, the industrial special construction fund of the National Development and Reform Commission will also provide support to Xinjiang textile and clothing industry. 3. State-owned asset investment companies will construct standard factory buildings in the key textile clothing industrial parks of Xinjiang and those main villages and towns in the special four prefectures in southern Xinjiang, while offering three years rent-free to the labour intensive 'mainland' clothing and home textile enterprises. 4. Setting up special funds with the aim of expanding the international market share of textile clothing industries, to provide special support to those export-oriented clothing and home textile enterprises in Xinjiang. 5. Setting up technical training bases for the production of army bedding and clothing to help the directional procurement of army bedding and clothing goods, to implement provisional measures of the intra-regional preferential procurement of school and working uniforms. The procurement of army bedding and clothing goods in Xinjiang totaled 150 million yuan in 2016, and the figure is expected to rise to 200 million yuan in 2017. 6. To provide an interest subsidy pilot program for the lease of textile clothing equipment in the Aksu Textile Industrial City. Such a policy will be introduced to the four prefectures in the south in 2017. 7. To provide special subsidies and professional introductions from the 'mainland' to textile clothing enterprises in the four southern Xinjiang prefectures. 8. Implementing special tutoring services for small-scale clothing enterprises in the southern four prefectures, to help them improve technical management levels and labour productivity.

In the process of the development of Xinjiang's cotton and textile industry, affected by economic situations, China's textile and clothing exports declined by 1.7 percent in 2016, year-on-year: textile exports increased by 1.9 percent, while clothing exports were down by 3.9 percent. At the same time, influenced by the external environment, the Xinjiang textile industry faces some problems as below:

1. Cotton planting has not yet achieved large-scale cultivation, as machine-harvested planting is impractical for small-scale growers, with high costs, uneven qualities in planting, and foreign fibres restricting production of high-quality cotton products as well as international competitiveness. 2. Cotton prices are fragile and easily affected by natural conditions, supply and demand, and planting situations, which increase the uncertainty of spinning mills' costs in production. 3. The growing pace of Xinjiang's cotton textile spindles is too rapid and technical development is insufficient. 4. Facilities in support of the industrial chain are imperfect; downstream weaving and dyeing enterprises are concentrated in southeastern coastal regions, which has increased the timescale and cost of transport. 5. Although support exists in the guise of related policies and subsidies, the implementation of policies is lagging and failing in being timely and complete. 6. The unstable external environment, slow market economic recovery, weak external demand and rising production costs have weakened the traditional advantages of spinners. 7. A prominent problem is the shortage of professionals in textile engineering. Skilled workers are difficult to find, and even employment of ordinary staff has many limitations, which will be difficult to improve in the near future.

For the problems existing in the Xinjiang textile clothing industry, we still need to carry on innovating, self-improving and upgrading via technical transformations, so as to get rid of the dependence on preferential policies as soon as possible, to make the development steadier and more sustainable. How to settle these problems, and translate Xinjiang's advantages in geography and resources into industrial strength, is key to the development of Xinjiang's textile industry, and eventually making Xinjiang a real paradise in the cotton and textile industry.

Global supply and demand

Alice Robinson, Cotlook Ltd

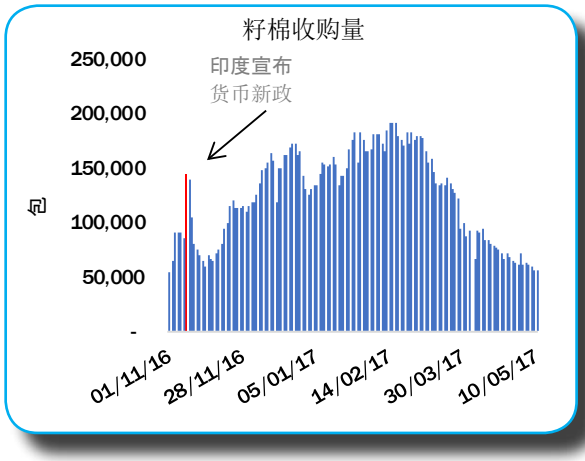
Overview

The various factors that affect cotton production and consumption around the world inevitably present difficulties when attempting to glean a clear impression of the potential outlook for global supply and demand. However, thorough consideration of the climatic, logistic and economic factors in force provide a projection that is at least well informed, if still subject to change. In the current season, high prices have acted in converse to the trajectory implied by the configuration of world stocks alone, owing to a tight short-term supply situation. Nevertheless, the prolonged inversion of prices in the New York No. 2 cotton contract supports the bearish outlook presented by current assessments of world supply and demand. This demonstrates the importance of analysing short-term market movements within the wider context of longer-term physical supply.

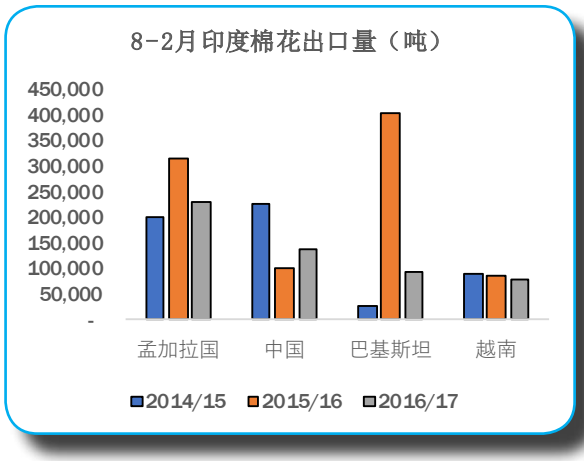
Stock scenario in 2016/17

Supply bottleneck

The above-mentioned tightness of cotton available for nearby delivery in the current season came about through a number of factors, not least of which were the effects of India's 'demonetisation', introduced in November 2016. The policy resulted in significantly restricted liquidity in the local market. Seed cotton arrivals slowed to such an extent that conjecture began to circulate regarding crop assessments, which were then verging on six million tonnes, according to the Cotton Advisory Board. That doubt has proved to be largely unfounded, however, and though downward adjustments have been made to most assessments, output in the region of 5.8 million tonnes remains in prospect.



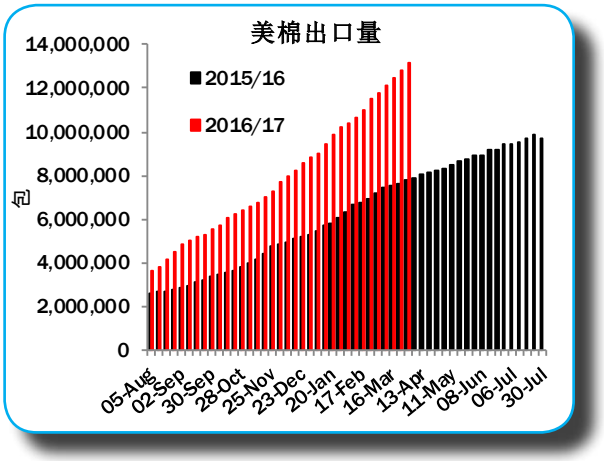
Arrivals subsequently recovered and the total volume of seed cotton delivered to Indian gins by May 4 was in excess of 5.1 million tonnes, compared with 4.93 million at the same point in the previous year. However, restricted supply, exacerbated by stocks being withheld in an effort to support prices, had already reduced the competitiveness of Indian lint on the international market, with the result that exports were severely impacted.



Cotton from the African Franc Zone benefited from India's reduced competitiveness, and was becoming difficult to source nearby as early as the first quarter of 2017. Whereas traditionally, the Franc Zone crop was an origin that remained available virtually year-round, with spinners using the growth to meet short-term requirements, the situation in recent seasons has been transformed. Mills in Bangladesh, for example, have warmed to West African cotton and the increased desirability has seen a considerable increase in imports to that destination.

A trend of declining production has continued in Uzbekistan, as marginal land is diverted to other crops, while domestic use is increasing. Exportable stocks from Central Asia were well committed early in the year.

US cotton, which remained competitive by dint of output of almost 3.7 million tonnes, benefited enormously from the relative lack of alternative supply on the international market. Weekly export registrations reached 480,000 running bales at their highest, and in USDA's April estimate, exports were increased to 14 million bales of 480 lbs, which would represent the fourth highest on record, and no less than 40 percent of global trade in 2016/17.



Persistently high asking rates for competing growths caused spinners to take a selective approach to purchases during the early months of 2017. On paper, however, the volume of cotton available for export throughout the duration of the season remains substantial; in India alone, up to one million tonnes of the theoretical total exportable surplus had still to be committed by early May. The outlook for supply in the remainder of the year could therefore entail a substantial volume of uncommitted stocks remaining in the market as the peak period for delivery of Southern Hemisphere crops approaches.

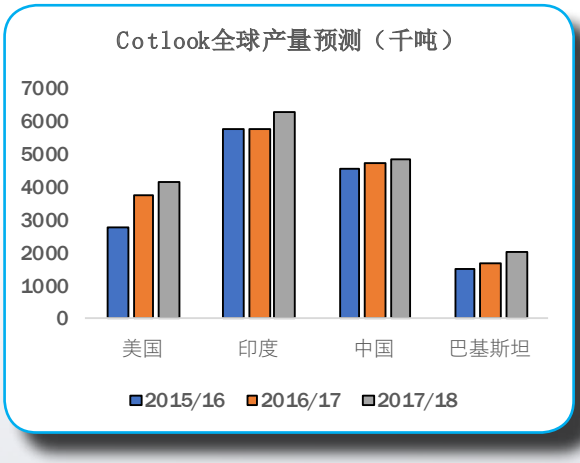
Australian output is poised to be in the region of one million tonnes, the highest since 2012/13, owing to a considerable expansion of planted area and good water availability. Production in Brazil is also expected to increase, to 1.5 million tonnes, boosted by excellent weather and increased yield.

Cotlook's current estimate envisages that stocks outside China will rise by roughly 750,000 tonnes by the end of the 2016/17 season. Meanwhile, several Chinese commentators have expressed the view that state reserve auction sales will match last year's total, portending a further decrease in China's government-owned stocks of over 2.5 million tonnes, a projection that the pace of sales so far would seem to support. China's stock reduction would thus still offset the prospective increase in the rest of the world by quite a margin.

Outlook for 2017/18

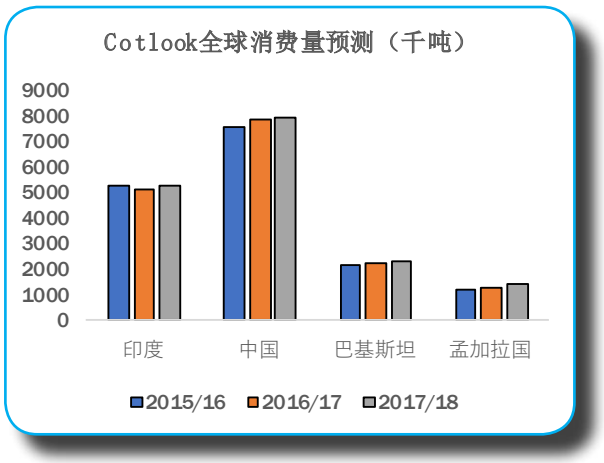
Persistently high prices in the current season, coupled with conducive weather conditions for growing cotton in a number of producing countries, have increased farmers' enthusiasm for planting cotton. Early indications for 2017/18, though subject to change, imply total world production in the region of 24.4 million tonnes, representing an increase of roughly 8 percent on the previous year.

The foreseeable rise in global production is mainly attributable to increased output in the US, India and Pakistan. In the first-mentioned origin, high yields and heavy exports have characterised the current season, and farmers are said to have made good returns. USDA's March Prospective Plantings report implied an increase of 600,000 hectares in area, and lower than average abandonment in Texas.



Output by Cotlook's estimate is placed at over 4 million tonnes, which would be the highest since the 2007/08 season. USDA's current projection of exports in 2017/18 is 14 million 480 lb bales, over 2.5 million of which had been committed by early May.

The earlier-mentioned firmness of prices in India has persuaded farmers to plant more cotton there. The increased output will be derived from a larger planted area, rather than from a general improvement in yield, which will remain considerably lower than the world average, at 540 kg per hectare (or less than a third of the average reported in China). The area cultivated in India during 2017/18 is expected to account for over 36 percent of the world total. Early projections foresee a crop in the region of 6.3 million tonnes, representing an increase of around nine percent, but this is dependent on the timely and well-distributed arrival of the Southwest monsoon. The Indian Meteorological Department's initial forecast for 2017 indicated a 'normal' level of rainfall, but the crop will inevitably be at the mercy of potentially changing weather conditions throughout the monsoon season.



In Pakistan, improvement is anticipated across the board in area, yield and, therefore, production. Poor water availability hindered very early sowing in April, but an increase in area of up to ten percent remains in prospect, mainly driven by the good prices obtained for the current crop. At this early juncture, Cotlook envisages a rise in output of no less than 20 percent. However, Pakistan is also exposed to the vagaries of the Southwest monsoon.

Projected output in other countries is only modestly altered at this very early stage, particularly for crops in the Southern Hemisphere, for which, typically, national average yields have been adopted.

Forward picture

Cotlook's current production and consumption estimates envisage, by the end of 2017/18, a rise in world stocks outside China of around 1.922 million tonnes, while the contraction in China is expected to be around 1.97 million, resulting in a virtually unchanged world stock level at the end of the season.

In general, good prices received in 2016/17 have enthused many farmers to choose cotton as their main cash crop. However, the potential remains for crop numbers to shift as the growing season progresses; a major weather event in a key producing country would not be untypical and this could alter the entire configuration of world supply and demand. Cotlook will continue to follow developments as they unfold and report them as accurately as practicable to our subscribers.

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