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World Cotton Consumption in the Year Ahead

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You can't explain the market decline by the Supply and Demand reports released Tuesday. The U.S. 2003/04 supply and demand projections were unchanged from December. The world supply and demand projections for 2003/04 included only very slight adjustments to production, consumption, and stocks. Bottom line, world ending stocks were raised slightly, which you would think would tend to help prices.

One negative released last week was the Cotton Inc. planting intentions survey, which indicated that farmers plan to plant about 14.76 million acres of cotton here in the US. They have Alabama down for about a 20% increase, and I just don't know where they plan to put it. I don't think it will happen. They have declines in Georgia and Florida, and I think that is probably more likely for Alabama too. Most of the big increases were out west I think. You've got to remember that forecast is based on intentions made known last December, so plans can change. Another negative may be the poultry flu fiasco. Traders must think that any trade issue dispute will disrupt cotton flow into China, who seemed to have been the big buyer for our export cotton lately.

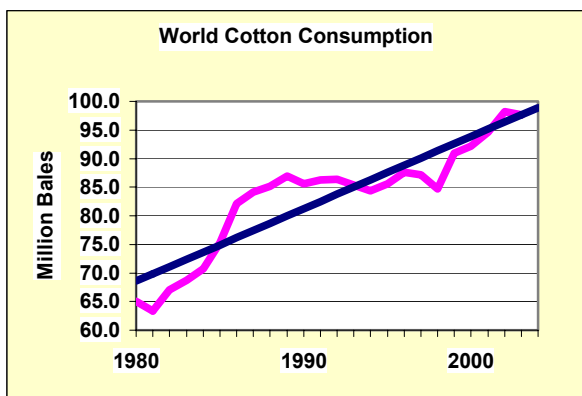
In the last newsletter I discussed world cotton production. I was considering the effect on prices of an 100 million bale world cotton crop. If you went down the list of major cotton producers, I concluded that an 100 million bale crop wasn't likely, but that it was possible. A big 14.76 million acre US planting could help, but I left it for this column to discuss the other side of the equation – demand.

In economics, we describe the demand for products in terms of "elasticity". There are many kinds of elasticity, but the most common are price elasticity and income elasticity. Price elasticity refers to the percentage change in the amount of a product you would buy for a small percentage change in price. Similarly, income elasticity refers to the percentage change in the amount of a product you would buy if you experienced a small change in your income. With price elasticity, the idea is that if the price of something went up, holding everything else constant, you would buy less of it. Elasticity describes how much less. If the price of something went up 5% and you reduced your purchases by less than 5% less, the demand for that product would be termed "inelastic". The demand for many "necessities" is inelastic. The demand for many luxuries is "elastic". In other words, if the price rises consumers reduce their purchases by a larger percentage than the price rise. Consumers

respond more to price changes for luxuries than for necessities. Cotton is, in general, a necessity. Price increases or decreases don't affect the demand for cotton as much as for other goods with higher "elasticities"

This same description holds true for income elasticity. With an inelastic product you buy more when your income goes up, but not as much more, on a percentage basis, as your income rose. All products that you buy more of when your income goes up are called "normal" goods. There are a few items that people generally buy less of as incomes rise, and these are called "inferior". Lard is an example of an inferior good. It doesn't mean there isn't some fine lard out there for sale, it's just that rich people tend to buy less lard than poor people. If you are reading this and you produce lard, please don't write telling me what kind of great lard you produce. It's not personal, lard is "inferior" product not because of the way it's made, but because of the demand characteristics it has. It's not my fault.

As you can see in the graph, world cotton consumption has been increasing steadily over the past quarter century at the rate of about 1.25 million bales per year. This increase in



consumption seems closely tied to population increase. However, a recent study by Sammy Marselli at the University of Georgia found that US demand was closely linked to Gross Domestic Product. He found that for every percentage rise in GDP, demand for cotton increased by over 2%. In other words, cotton is not an "inferior" good like lard. In the world market, cotton demand was most closely linked to two factors. One was World Gross Domestic Product, and Marselli found a similar effect on demand from a rise in income. However, the most telling (to me) factor regarding

export demand over recent history was the level of beginning stocks not held in the United States. He found that demand decreased one percent for every percentage increase in beginning stocks held outside the US. These results were statistically significant. The lesson is that over the long-haul, pay attention to ending (beginning) stocks.

In a final note on my analysis of demand, I have to notice that in 11 of the past 12 years, demand has been equal or less than trend. I guess in economic theory there isn't much room for something called "pent-up" demand. However, I just did a search on the internet for "cotton" and "pent-up demand" and I got about a jillion hits. Even though we economists probably don't believe in it, it might be there. There is about a 17 million bale deficit over the past decade in cotton consumption below trend. Unless the trend has flattened out, you have to think we need a few years on the high side of trend. After all, that's the way it has seemed to work in the past.

Bottom line, the trend 2003-04 world cotton consumption is already over 98 million bales. The market will have a lot less trouble using up that mythical 100 million bale crop than the

farmers of the world will have producing it. We will probably go over 100 million bales in consumption before we do in production.

As this newsletter is written, I believe the bleeding in the futures market is about stopped. However, in terms of contracting or booking next year's cotton, I think its time now to sit on the sidelines. I believe cotton is underpriced, and that farmers will have an opportunity to book cotton before or during planting at higher prices. I would still plan on booking cotton when NY futures are above 68 cents, and you'll have to watch the market to catch it on the rally. On the other hand, now is the time to place those call options. You can get a December call option in the low 70's for about two cents. That's a pretty good bargain if you think, as I do, that fundamentals will eventually prevail in this market and prices will again rise. As the market rises, the value of those call options will increase, regardless of the strike price you choose. In general, however, the more expensive the option the greater the increase in option value for a given move upwards in the market..

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