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China October Cotton Market Update

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Report Highlights:

The short-term impact of recent high cotton prices in China will cause some restructuring as smaller marginal firms struggle to absorb the impact of tight, costly supplies, but in the longer term, the situation should neither significantly impact the industry nor prompt government policy changes. Industry leaders are confident that upgrading internal management and efficiencies, and improving product quality and mixes are key tools for the industry's survival.

General Information:

Overview

The short-term impact of recent high cotton prices in China will cause some restructuring as smaller marginal firms struggle to absorb the impact of tight, costly supplies, but in the longer term, the situation should neither significantly impact the industry nor prompt government policy changes. Industry leaders are confident that upgrading internal management and efficiencies, and improving product quality and mixes are key tools for the industry's survival.

Coping techniques by smaller mills include lowering stocks, fiber substitution (lower quality, cheaper cotton, man-made fibers) when possible, reduced shifts and avoiding long term price commitments. Some industry consolidation among smaller mills has occurred. Upstream players, farmers, traders and mills are profiting from the high prices while downstream garment/textile manufacturers predominantly have sufficient inventory and/or financial assets to buffer the higher price. Mills and cotton traders are taking a cautious approach to purchasing the new high priced crop. Elasticity of demand by domestic and international consumers will impact whether increased input prices can be passed to consumers or must be absorbed, for now, by the Chinese manufacturers.

Government Supply Management Measures

In late September, the Chinese government offered another 400,000 MT of state cotton reserve at auction for a total release of 1 MMT since midsummer (some argue that although providing additional supply, this move also aggravated price pressure). Government stocks may be at a reportedly historic low of 300,000 MT although this figure cannot be substantiated. Given twin tensions of tight world supply and cotton's importance as a strategic commodity, we anticipate the government will reenter the market to replenish cotton reserves, but when, to what degree and at what price, remain undetermined. October's historically high price, although fluctuating, still remains high.

On September 30, NDRC announced that procedures for the 2011 cotton import TRQ of 894,000 MT would remain unchanged. TRQ processing is currently underway so we expect imports to reach the mills/traders before the end of December, or earlier. According to our sources, the NDRC will take a flexible approach to adding TRQ's for MY10/11, adjusting according to the supply and demand situation.

New Crop Statistics

MY10/11 harvesting, ginning and marketing are all later than normal. According to cncotton.com, as of October 15, only 40% of the new crop had been harvested, 20% lower than the average rate for the previous three years; marketing of the new crop is 50% complete, down 12% compared to last year, with an estimated 106,000 MT marketed, down 137,000 MT from last year, and an estimated 456,000 MT of cotton was baled, down 217,000 MT from the previous year. Based on the China Fiber Inspection Bureau, the official classified new crop stood at 315,000 MT as of October 20, compared to 628,000 MT at the end of October 2009.

MY 10/11 Domestic Production

Post estimates that MY 10/11 domestic production will be smaller than last year. Industry information

is that planted area and yield in the Yellow River region are both lower than originally forecast, Xinjiang has a stable planted area and likely average yields, and a slight increase in production from the Yangtze River region due to area growth.

In late September, NDRC estimated MY10/11 production at 7MMT while China's National Statistics Board called for 6.38 MMT. On October 18, CCA lowered its MY 10/11 domestic cotton production to 6.64 MMT, down 2.3% from CCA's estimated production for MY 09/10, and 266,000 MT lower than its August estimate. However, CCA said that, based on NSB and MOA data, MY10/11 production is down 4% from the previous year. Cncotton.com has not updated its October estimate but we expect it be lowered from its previous mark of 7.04 MMT.

Shandong and Henan also report falling numbers. Shandong production is likely to fall 20% based on a 15% decline in planted area and lower yield. In Henan, some sources are reporting that planted area could be much lower than previously expected. Cotton quality in these two areas has also been affected by August's rainy weather. Mills are also worried that Xinjiang's shortened harvest time may also lead to lower yields. Cncotton.com reports that Shandong and Anhui cotton growth and maturation was adversely impacted by the rainy weather, and production could slide 20% from the previous estimate.

However, on October 8, Xinjiang's Provincial Television station reported Xinjiang's MY10/11 harvest is expected to increase due to better irrigation and seed inputs. On October 12, Xinjiang Agriculture Bureau reported that MY 10/11 Bazhou (Kuerle City) cotton production is expected to hit a record high of 300,000 MT, up 10% over the previous year based on increased planted area (up 7.7%) and higher yields (up2%). CCA also reported that September and October weather conditions in the three major cotton-producing regions remained sunny and warm facilitating the maturation of the crop.

Prices

China Cotton Association estimated that cotton production costs generally exceeded RMB22, 000/MT (or \$3,245/MT), and the selling price will reach RMB23, 000/MT. Xinjiang seed cotton price hit a record high range from \$1,578 to 1,637/MT. Xinjiang industry leaders warned that cotton cost will reach RMB23, 500 (or \$3,466/MT) to 24,000/MT (\$3,540/MT), making cotton ginning and trading a highly risky business.

In the Yellow River region, seed cotton (with lint ratio of 38.5%) also hit \$1,548/MT to \$1,590/MT. An industry source reported that a large mill in Shandong even had difficulty buying cotton at RMB24, 000/MT (\$3,540/MT) for grade 3 cotton delivered to the factory. In the Yangtze River region, the seed cotton price also reached \$1,415/MT to \$1,563/MT (with lint ratio from 35% to 38%).

According to Cncotton.com's October 25th report, based on the current purchasing price of \$1720/MT per grade 3 seed cotton in the Yellow and Yangtze River regions (excluding Xinjiang region per cncotton.com), the baled cotton price will reach RMB24, 288/MT (or \$3630/MT); In Xinjinag, grade 3 seed cotton priced at \$1730/MT, converted to baled cotton price at RMB24337/MT (or \$3635/MT).

Mill Operations

Smaller mills, with fewer resources, are more vulnerable to the price rise. Most are continuing operations to meet fixed costs, but lowering variable input costs, such as reducing shifts, substituting

cheaper inputs where possible (although the cost of man-made rayon and polyester is also rising) and avoiding long term futures commitments. This is making it difficult to lock in a production cost for future business contracts.

Procuring Intention

According to a recent survey by cncotton.com of mills, 77% plan to procure cotton, up from 70% at the beginning of September, 23% plan to “wait and see,” compared to 25% at the beginning of September, and no one responded they had “no intention to procure,” compared to the 5% of respondents in early September.

Cotton Share Adjustment Intention

2% of the mills replied they planned to increase cotton share, compared to the 5% in the beginning of September, 16% planned to reduce cotton share, compared to 2% in early September, and 82% expected to maintain stable cotton share, down from the 93% in the beginning of September.

Stock Levels

The survey further revealed mill stocks declined to an average of 32.7 days (including imported cotton ordered but not yet delivered), down 10.9% compared to the beginning of September, however, up 6% compared to October 2009, and up 14.3% compared to the average stock levels of the last 3 years. Based on the survey, total industry stocks are estimated at 955,000MT, down 8.7% over September, however, up 8.5% over the October 2009, and up 17.3% over the average stocks level during the most recent 3 years. Industry stocks vary widely among provinces, with Fujian (52 days), Shanghai (51 days) and Hebei (45 days) holding the highest levels and large yarn producing-provinces Jiangsu (38 days) and Shandong (33 days) holding lower levels.

Post contacted various mills located in Shandong, Hebei, Hubei and Jiangsu, regarding their stocks level and found they varied greatly:

Hebei XD mill - capacity 200,000 spindles- 3 months of stocks

Shandong LT mill – capacity 630,000 spindles -5 months of stocks

Shandong GX mill – capacity 600,000 spindles – 1 month of stocks

Shandong HH mill – capacity 100,000 spindles – 1.5 months of stocks

Hubei Y mill – capacity 200,000 spindles – 1.5 months of stocks

Jiangsu H mill – capacity 2 million spindles – 2 months of stocks plus 4 months contracted stocks (will be delivered over time)

Shandong HY mill – capacity 130,000 spindles – 6 months (the mill’s total yearly cotton use is 8,000 MT)

These mill managers believe Cncotton.com’s results are representative of the variety in the industry. Some mill managers said there are small to medium scale mills which maintain very low stocks ranging from 10 to 15 days.

Yarn Production and Prices

Some industry insiders believe the current high price of cotton will curb the growth of cotton consumption, thus possibly slowing the high growth rate of yarn production in MY10/11. China’s industry sources indicate that China’s yarn production for the first 9 months reached 19.97 MMT, up

2.77 MMT or 16% from the same period in the previous year. The 2010 September yarn production was 2.44 MMT, up 298,000 MT from September 2009, but 30,000 MT lower than August.

According to industry sources, yarn prices maintained strong growth in response to the cotton price changes since September. The C32S yarn price averaged RMB32, 400/MT (or \$4,830/MT) in the week of October 11 to 15, up 4.5% over the previous week.

Textile Operations

The profit margins for the cotton textile sector remained “good” in the first half of 2010. Opinion is divided about whether textile mills that increase prices to reflect higher cotton costs are more vulnerable to the domestic or international market consumer. Along with the high GDP growth rate at 10.6% for the first three quarters of 2010, domestic demands for textile products are expected to continue to grow in MY10/11. Total textile and apparel product export value increased by 31% and 19%, respectively, in the first nine months of 2010, compared to the previous year.

Regional News

Xinjiang : The Xinjiang provincial government recently announced new measures to promote the local textile industry, including \$2.9 million annually in discounted government loans for upgrading equipment and facilities; transport subsidy for Xinjiang yarn at RMB200/MT (\$29/MT) for yarn of 32 counts and above and RMB100/MT (\$15/MT) for yarn below 32 counts, partial tax exemptions from the textile enterprise income tax (2011-2015), land and property tax exemptions for newly established textile enterprises (2011-2015).

In addition, the Chinese government recently announced that the city of Kashgar in the Xinjiang region has been chosen to be a planned special economic zone (SEZ), similar to Shenzhen. If the project is implemented, the region would receive hefty government investment in local infrastructure, including new railway connections which would link it to many more markets in the central Asian market (Krygyzstan, Pakistan, Uzbekistan). With scarcer resources than other cotton producing regions, this development could spur additional investment and cotton production in the region. A July news report said the board chairman of a Shandong Textile Group, had decided to build a 100,000 spindle spinning plant in Kashgar.

Hubei production: Hubei Cotton Association recently reported Hubei had increased planting area of 7,208,000 Mu (488,500 Ha, up 4.3% from MY 09/10) with lower yield of 970.5 Kg/Ha (down 72Kg/Ha over the previous year) with estimated production of 466,500 MT, down 2.9% over last year. The forecast is based on (1) low production due to unfavorable weather conditions during the planting/maturation period and (2) in an effort to plant winter wheat, farmers harvested cotton in an “abnormal manner” by removing many plants earlier and harvesting green bolls/unmatured cotton.