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COTTON CONSUMPTION TRENDS IN LATIN AMERICA

by

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Ladies and Gentlemen:

When the U.S. Congress passed the NAFTA treaty in 1994 our relations with our two next-door neighbors entered into a new era. The U.S. formally recognized that Mexico and Canada were of special importance, and therefore deserved preferential treatment. Especially Mexico, with its population of about 92 million.

As far as cotton is concerned, Latin America has a very mixed history. Since before W.W.II, and through the early 90's, Latin America was predominantly a producer and net exporter of raw cotton, (Exhibit #1) particularly Mexico, Central America, Brazil and Peru. During this decade, Latin America's raw cotton trade has undergone significant changes; it is now a net importer of over 2 million bales per year (Exhibit # 2). Although Latin America has had a textile industry for a long time, mostly in Mexico and Brazil, it used to be of lesser importance in the global picture. Total cotton consumption was only 2.0 million bales in 1950 and 4.8 million bales in 1980. For 1997/98 it is estimated around 7.5 million bales (Exhibit # 3) or about 8.5% of total world cotton use. On the other hand, cotton production in the region has dropped from its high of 8.2 million bales in 1990/91 to 5.8 million bales this year (Exhibit # 4). What are the reasons for this drop in production? In Mexico and Brazil, growers have received only sporadic support from their governments in recent years, and they have simply turned to more profitable crops, whereas Argentina has invested heavily in cotton's infrastructure and as a result production has risen sharply.

The outlook for cotton consumption in Latin America is good. Led by the two main consuming markets, Mexico and Brazil, I expect that cotton use will increase in excess of 30% over the next five years. This is good news for American cotton farmers who can expect to see continuous and rising demand for U.S. cotton in Latin America, especially in Mexico and Central America.

Let's look at the various markets in detail:

MEXICO:

The Mexican textile industry has benefited strongly from NAFTA. Cotton use was between 525,000 and 875,000 bales per year from 1980 through 1994. Since then, consumption has more

than doubled to an estimated 2.1 million bales in 1997/98. In fact, I feel that Mexico's mill use may reach as much as 2.4 million bales in 1998/99 (Exhibit # 5). With a domestic crop estimated this year at 870,000 bales, the bulk of the consumption will be imported. At least 90% of all cotton imports originate in the U.S., the rest comes from South America and maybe West Africa. I prefer not to say that Mexico is a captive market for U.S. cotton, as this might imply a dangerous complacency. But, the fact is that U.S. cotton has several advantages that other origins simply cannot match. First of all, there is the geographic proximity to the world's largest exporter, meaning not only lower transportation costs and "just-in-time" delivery, but also the widest possible selection of qualities, from short staple, low grade cotton to the finest ELS. Second, every U.S. bale has HVI (High Volume Instrument) class, a feature that the Mexican mills have learned to appreciate, particularly when using Cotton Inc.'s EFS (Engineered Fiber System) technology. Furthermore, some U.S. retailers demand that their products be made of U.S. fiber, not just any cotton. Finally, there is the GSM program, which makes short to medium-term credit available to the Mexican mills at U.S. interest rates. In a country where local rates tend to be high, this is a very important tool.

Mexico has always had the advantage of much lower labor costs compared with the U.S. But, only after NAFTA caused most import tariffs to disappear has the cost advantage come strongly into focus. Mexican mill owners have invested heavily in increasing and up-dating their facilities. U.S. manufacturers have recognized Mexico's potential and entered into partnerships with Mexican companies or are opening up their own production facilities. Textile companies from Taiwan and Korea are doing the same in order to be able to take advantage of the huge U.S. market. Of course, the cost advantage is most pronounced in apparel production, which is very labor-intensive. There are numerous apparel plants which convert U.S.-made textiles into garments that are then shipped back to the U.S. market. Other U.S. garment manufacturers have begun to out-source production to Mexico. Another advantage of the proximity to the U.S. comes into play here: Quick changes in fashion, seasonal or others, be it in color, shades, styles, weight or size of any garment can be made and put back on the U.S. retailers' shelves in less time than from anywhere else outside the U.S.

The industry has gained enormously from NAFTA. This is a textbook case of what a free-trade agreement can do for the countries involved. In both the U.S. and Mexico, cotton consumption has reached record levels. In other words, it cannot be argued that the expansion of Mexico's textile industry has come at the expense of the U.S. mills.

At present, the export market is strong but the domestic market has been difficult since 1994 and is improving only very slowly. In addition, Mexico's textile industrialists are worried about the turmoil in Asia. Mexico has no import quotas for textiles, so the potential for a flood of cheap garments cannot be dismissed. Still, looking ahead, I am convinced that cotton use in Mexico will increase by as much as 10% per year over the next five years. This could result in an annual cotton consumption approaching 3.5 million bales by 2002/03 (Exhibit # 6). The growth is almost entirely export-related. What could threaten this booming industry? If Central American countries were to be granted C.B.I. (Caribbean Basin Initiative) parity, Mexico would cease to be the low cost producer of the area with the result that some of Mexico's consumption, and potential new investments there, would be shifted into Guatemala, Salvador and other countries.

BRAZIL

Brazil is a typical example of a traditional net cotton exporter gradually turning into a net importer and is unlikely to return to its former prominence as a cotton producer and exporter. Since 1980/81, Brazil's cotton consumption advanced from less than 2.6 million bales to 3.7 million in 1996/97. Due to poor business conditions in the past six months, consumption in 1997/98 is expected to be down somewhat.

There has been a distinct relocation of the textile industry from the south to the northeast. The northeastern states provided generous tax advantages, resulting in some very large mills being set up in the area. In fact, the top three northeastern mills, all denim producers, account for over 40% of Brazil's cotton use. In contrast to Mexico, the growth of Brazil's textile industry is mostly based on the domestic market, which today represents 80% of the consumption.

At this time, the Brazilian industry is also concerned about the economic problems in Asia and the prospects of cheap imports. On the other hand, with a presidential election coming up, money is likely to flow more freely, and textile consumption should pick up. I am estimating Brazil's consumption for 1998/99 at around 3.8 million bales, up nicely from this season's 3.5 million bales (Exhibit # 7).

The outlook is for a continuation of growth in cotton consumption. I project an average growth of over 3% per year for the next five years to 4.3 million bales. Brazil's cotton consumption has a great potential: It already has the installed capacity to process about 4.5 million bales. Even a small increase in the per capita consumption of its 160 million inhabitants would produce a large boost. Brazil has cheap labor and energy, almost unlimited water resources and, finally, can cover all its cotton requirements from its own production and its Mercosur neighbors around the corner, Argentina and Paraguay. Regarding non-Mercosur imports, U.S. cotton does not have a natural advantage in this market. It must fight against fierce competition from West Africa and Central Asia. What are the limitations to Brazil's growth in cotton consumption? The strong need for modernization of the industry, a still missing reduction in cost through a tax reform and export incentives by means of a more flexible exchange rate policy, and the aggressive competition from Mexico in many of Brazil's important export markets, principally the U.S., Canada and Europe.

ARGENTINA

Argentina is the third-largest cotton consumer in Latin America. Annual consumption is running around 500,000 bales. The highest level was 650,000 bales in 1990/91. In contrast to Mexico and Brazil, there is no up-trend in cotton use; it has been essentially flat for the past five years (Exhibit # 8). The country's population is not large enough to sustain a large cotton consumption. Also, contrary to Mexico and Brazil, cotton production has been increasing rapidly. From less than 850,000 bales in the early 80's, Argentina has now reached an annual production level of over 2.0 million bales, making increasingly large amounts of cotton available for export. At this time I do not see an increase of cotton consumption in Argentina.

OTHER MARKETS

CENTRAL AMERICA

Close to home, we have the small nations of CENTRAL AMERICA. As I already mentioned, Central America used to be a major supplier of cotton to the world market. Today, there is practically no cotton production left in the area. But, the textile industries in Guatemala and Salvador have expanded to the point where these countries are now important customers for U.S.-grown cotton. Mill use in Guatemala runs about 135,000 bales and Salvador about 125,000 bales per year (Exhibit # 9). Both countries are expected to increase consumption in the years ahead, maybe about 5% annually. The textile people are hopeful that their countries will soon be granted C.B.I. parity or one day be admitted into an expanded NAFTA. Either would put their mills on a more level playing field with Mexico and greatly improve the cotton consumption potential of this region. Apart from Guatemala and Salvador, only Honduras, Costa Rica and Nicaragua have very small textile activity at this time.

ANDEAN PACT COUNTRIES

The Andean Pact is a free-trade organization whose members are Colombia, Peru, Venezuela, Ecuador, and Bolivia, with a total population of about 103 million people. Since regionally produced cotton is not always available, U.S. cotton has a good shot at the business in some of these markets.

COLOMBIA used to be an important cotton producer. Cotton consumption has been quite erratic, rising from 250-275,000 bales in the early 80's to about 450,000 bales in 1990/91, and around 350,000 bales at present. U.S. cotton has a chance if it is priced competitively. The industry has modernized somewhat, but much more needs to be done in order to improve productivity and, consequently, the volume of consumption.

PERU is one of the world's oldest cotton-producing countries. Its fine ELS-type cotton, Pima, is well known. Cotton production in Peru has declined, but consumption has been increasing slowly over time, reaching about 300-325,000 bales in recent years. I feel that Peru's consumption will increase steadily over the next few years. The creative approach to marketing their high quality fabrics and garments in the U.S. and Europe will allow its industry to grow.

VENEZUELA uses about 175-200,000 bales of cotton per year, and this has not changed much in the past decade. Domestic production covers less than half of their consumption. The country is a small but steady buyer of U.S. cotton. I do not expect to see much change in the rate of cotton consumption in the years ahead. ECUADOR and BOLIVIA are small consuming countries that may reach 100,000 bales in five years. Ecuador has imported limited quantities of U.S. cotton in recent years, and should continue to do so (Exhibit # 10).

OTHER SOUTH AMERICAN COUNTRIES

This leaves us with CHILE, PARAGUAY and URUGUAY, with a total annual consumption of about 200-225,000 bales. Chile has a small textile industry, which obtains its cotton mostly duty-free from South-American suppliers. U.S. cotton faces a 11% import duty. The granting of NAFTA parity could change things rapidly. Otherwise, Chile, being an associate member of the Mercosur customs union, is expected to become a full member by the year 2006. I cannot see an increase in its consumption until NAFTA parity is a reality or when Chile will be able to "free trade" with Brazil and Argentina, the dominant members of the Mercosur. Paraguay is a major

cotton-producing country, with only a small domestic spinning industry (Exhibit # 11).

SUMMARY

To sum up, cotton consumption is clearly in an up-trend, led strongly by Mexico and Brazil. The granting of C.B.I. parity, extending NAFTA, or the implementation of other free trade agreements with the U.S. would boost cotton consumption in the respective countries, just as it did for Mexico, which has greatly benefited from the free access to the huge consumer market of the United States. Latin America is a significant market for cotton. U.S. raw cotton has a definite advantage in Mexico and Central America, and must fight for market share in the other countries.

I am projecting Latin American cotton consumption to increase by about 30% over the next five years, from 7.55 million bales in 1997/98 to 10.0 million bales by the year 2002/03 (Exhibit # 12). At this time, I do not see polyester as much of a threat to cotton consumption in the region. Polyester production in Latin America is small and therefore relatively expensive.

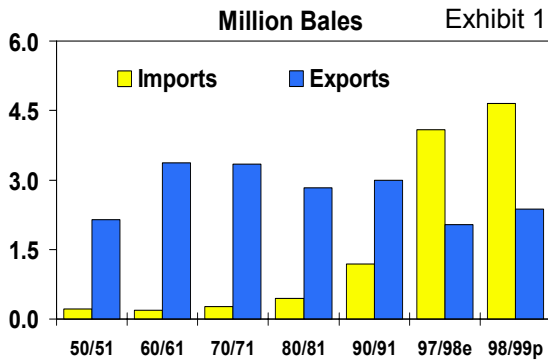
What else will change over the next five years? Inter-American alliances will be formed and mergers/joint-ventures will increase between the large U.S. manufacturers and their counterparts in Mexico and Brazil. Both these countries have two significant advantages over other cotton consuming countries of the world: close access to very competitively priced raw cotton, U.S./Mexican cotton in the case of Mexico, and Brazilian/Argentine/Paraguayan for Brazil. Furthermore, both countries have cheap labor. Considering that the cost of raw cotton represents over 60% and labor about 10% of the inputs that go into a heavy-weight denim fabric, these are very significant advantages!

**Cotton
Consumption
Trends in Latin
America**

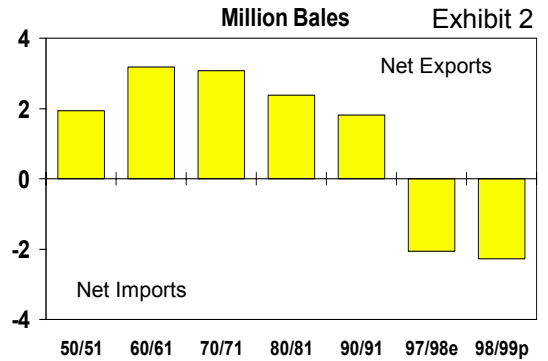
**Paul Ruh, President
Paul Reinhart, Inc.**

February 1998

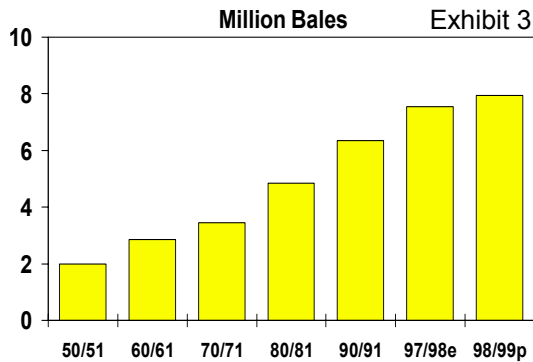
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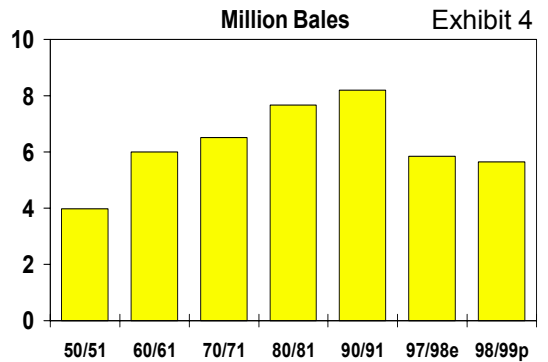
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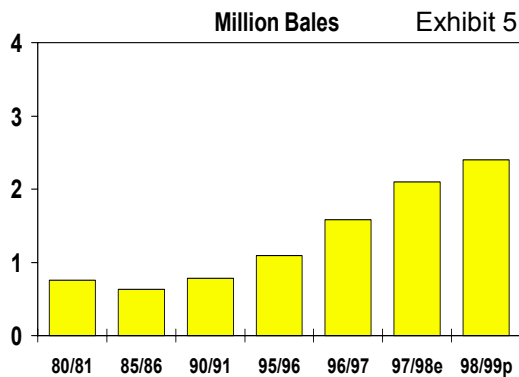
Latin America Cotton Consumption



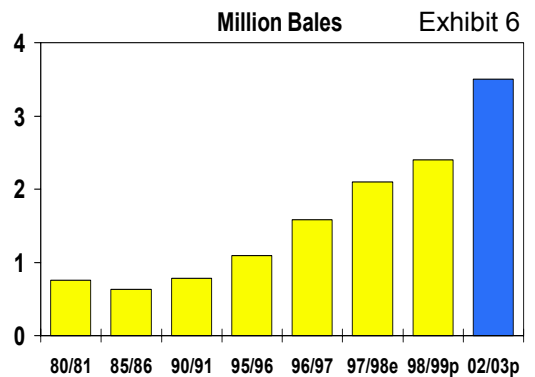
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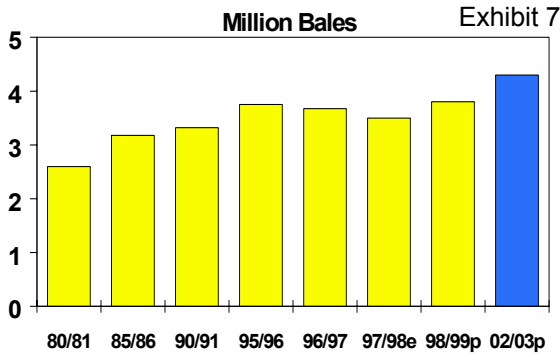
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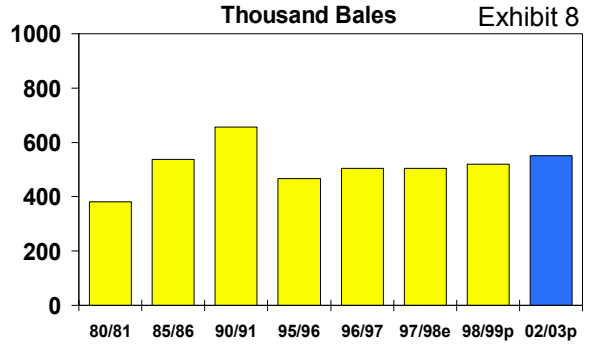
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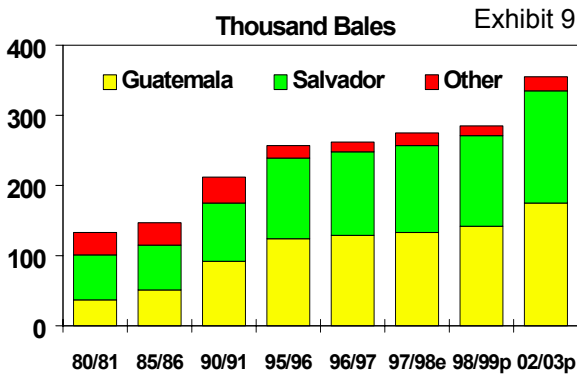
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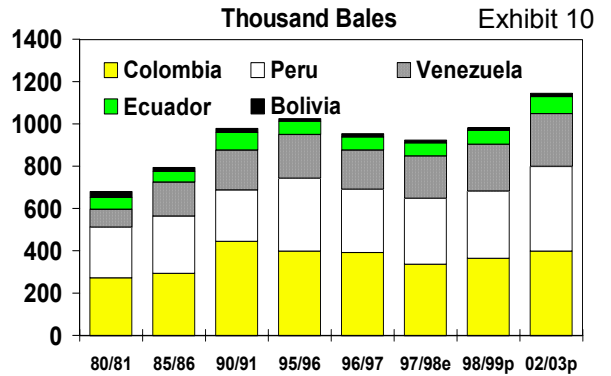
Argentina Cotton Consumption



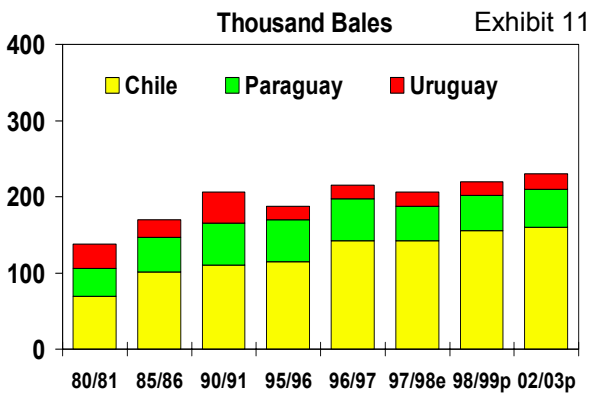
Central America Cotton Consumption



Andean Pact Cotton Consumption



Other South American Countries Cotton Consumption



Latin America Cotton Consumption

