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U.S. Tobacco Outlook

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The U.S. tobacco industry is in the throes of one of the most serious dilemmas it has ever faced. The economic pressures on our industry will force many farmers out of business this year or next. Many growers face a bleak reality: They don't have enough quota to make a decent living. Conditions are especially hard for some of the younger growers who simply cannot handle the cash flow of their heavy debt loads. We can expect extensive social shifts and economic strains in rural areas that depend on tobacco for cash. And there will be no help from other commodities as all are in bad shape.

The Master Settlement Agreement has had a momentous impact on our business – mainly through its effect on inventories and on the demand factor in calculating quota. We face a greatly reduced crop size that strains the finances of growers, warehouse operators and leaf processors. The situation creates such serious selectivity problems for our export customers that our reputation as a reliable supplier could be seriously jeopardized.

Leaf export trade continues to suffer from the market pressures of international prices and abundant supplies. Frankly, this year's meager burley and flue-cured quotas could devastate our export market, which is already shrinking at an alarming rate. Leaf exports through November 1999 were down 3.5% on the same period a year ago. Flue-cured exports were off 11.5% in the first eleven months of this year and burley exports dropped 2.4%. These may not sound like huge numbers, but they represent a continuing steady decline in leaf exports over the last several years. Today, total U.S. leaf tobacco exports are about half what they were two decades ago, and in the past ten years, shipments have fallen another 25%. Indeed, the downward trade spiral has accelerated since the Asian Economic Crisis set in.

Continuing economic recessions in the Asia/Pacific region as well as other parts of the world have restricted hard currency. This has made it difficult, if not impossible, for many of our traditional markets to purchase U.S. tobacco. These customers want our tobacco, but they either cannot afford it or are unable to get authorization to spend the hard currency.

Complicating this picture is the fact that leaf tobacco is not eligible to participate in the GSM loan guarantee programs that are available for other agricultural commodities. Many countries simply cannot manage private financing for commodity imports. Access to GSM would allow them a more favorable debt repayment schedule when they purchase U.S. leaf tobacco. This situation will not change under the current Administration.

Looking at specific key markets we see a mixed trend.

- Exports of U.S. leaf tobacco to Japan, which traditionally has been one of our largest overseas customers, have fallen steadily for several years. Shipments to Japan are about 43% less than ten years ago. On the positive side, competition from international brands

in the Japanese market helps to ensure a place for U.S. leaf in Japanese brands. In addition, we believe Japan Tobacco will continue to require U.S. leaf for the international brands that it acquired through its purchase of RJR International.

- U.S. flue-cured exports to Thailand have dropped significantly as a direct result of economic pressures. Shipments to Thailand are about a third of what they were ten years ago. We do not expect this market to recover until the economic situation improves.
- Leaf exports to Turkey have fallen in response to price, economic restrictions, and increased market competition from lower priced cigarettes that do not contain U.S. leaf tobacco.
- Our leaf exports to Europe are holding steady overall. Volume shipped to specific countries in the EU may vary widely from year to year, but the total European market is essentially level.

The bottom line: Any improvement in the prospects for U.S. leaf tobacco exports will have to wait for the global economy to improve – or we will have to adjust our prices to world market prices. We are cautiously optimistic about improved prospects in Asia. Several of these countries seem to have turned the corner toward economic recovery, but there is still a long way to go. We hope to see some increased interest in resuming their normal purchases, possibly by 2001.

And we are encouraged by the possibilities for establishing new markets. China is one example. If China is admitted to the World Trade Organization, and if WTO policies continue as they are, this market will finally become available to the U.S. tobacco industry. Even a small step in this trading door will make a tremendous difference for U.S. tobacco trade in the 21st Century.

Extensive research led by Dr. Harvey Spurr at the Oxford Research Station in North Carolina has produced reams of data proving that U.S. tobacco does **not** pose a threat for introducing blue mold into China. Yet China's phytosanitary restriction remains in place. U.S. Trade Negotiators will continue to try to reach an agreement with China to remove this barrier during this summer's bilateral trade negotiations.

Many industry leaders are closely watching the recent upturn in imports. There are three factors influencing the increased arrival of imported leaf tobacco:

- First, a number of small and start-up operations now account for about 5% of the domestic cigarette market. In many cases, these new companies are using significant amount of imported tobacco in their products.
- Second, we're seeing renewed interest in low- and medium-priced brands.
- Third, reports indicate there is a significant gray market for cigarettes in this country. By "gray market" we're referring to cigarettes that are produced for price-sensitive off-shore destinations, but which find their way back to the United States in response to the rising demand for lower priced products.

On the product export side, U.S. cigarette exports continue to fall, with volume down more than 20% through November 1999. American-blend cigarettes continue to gain popularity worldwide. Nevertheless, the volume of product manufactured for export is declining. There are at least three reasons for this:

1. the expansion of off-shore manufacturing facilities;
2. the requirement of some countries to use domestic tobacco in product blends; and

3. the Tariff Rate Quota on imports into the U.S. limits the access of various tobaccos from around the world to make products that supply price-sensitive markets.

At the same time, the domestic cigarette market continues to shrink, with sales down about 10% since the price increase following the Master Settlement Agreement. We do not expect to see a recovery in the next couple of years as prices will be forced even higher by a scheduled 15¢ increase in the Federal Excise Tax on cigarettes that will bring the tax to 39¢.

Already we are seeing a major change in product inventory management at all levels – retail, wholesale, distribution, and manufacturing – and this will have a major short-term impact on the need for tobacco.

What can be done to help the industry through its current crisis? Three needs are clear:

- Credit programs must be made available for U.S. leaf tobacco exports. These programs, which are available to other commodities, allow countries short in hard currency to arrange financing to purchase U.S. commodities. However, tobacco has been unfairly excluded from these programs, and the impact of this exclusion is seriously damaging our growers' ability to make a decent living. Meanwhile, tobacco products are still being made around the world – but with our competitors' tobacco.
- We must review cigarette markets worldwide to identify those to which we have limited or no access because of trade barriers. Then we must work to remove the trade barriers that obstruct our trade.
- In particular, we must continue to pursue access to China's market. This will be critical to tobacco trade as China moves toward accession to the World Trade Organization and expanded trade relations with the world.

Now, I want to update you on a couple of scientific developments affecting tobacco.

First, tobacco-specific nitrosamines, known as TSNAs. The industry is devoting considerable time and resources to addressing TSNAs. The present research suggests that TSNAs are developed, in part, during the curing process by a chemical reaction between nicotine contained in the uncured leaf and various oxides of nitrogen found in all combustion gasses, regardless of fuels. The significant reduction or elimination of these nitrogen compounds in the curing air has been shown to substantially reduce or eliminate TSNAs in cured tobacco to nearly undetectable levels. Essentially, the findings indicate this reduction can be achieved by changing from open combustion to a heat exchange system in curing flue-cured tobacco.

In response to this on-going research, the Tobacco Industry Leadership Committee has developed recommendations for heating and air handling equipment that may be installed as retrofitted equipment in existing curing barns and as original equipment in new barns. Based on this committee's recommendations, the industry is in the process of organizing a conversion program that will split the cost between producers and purchasers. Details of the plan may be announced as early as next week. The plan calls for completing the conversions as rapidly as practical, with the target completion date of July 1, 2001.

I should point out that the flue-cured tobacco grown in competing countries – for example, Brazil and Zimbabwe – isn't cured via an open combustion process. So, for competitive reasons, it's critical that the industry move quickly on this project as we expect a strong demand for low-nitrosamine tobacco, beginning this year.

Second, a brief word on genetically modified organisms, known as GMOs. Questions continue to crop up regarding the use of genetically engineered varieties in the United States. Certainly, there is on-going research to improve varietal characteristics through genetic engineering, and technology is advancing. Some day in the future, GMOs may help us deliver tobacco that fits our customers' specifications. But today, the issue of public perception persists, and the issue is being used as a trade barrier against various commodities – including tobacco.

Finally, I want to address the latest tactic in the World Health Organization's plan to destroy the cigarette industry – and, in the process, to put the exporters as well as all other segments of our industry out of business. To accomplish its goal, the WHO is proposing what it calls an International Framework Convention on Tobacco Control. This Framework Convention is comprehensive and unprecedented. It calls for – among other things – global hikes of cigarette taxes, international trade restrictions on tobacco products, crop substitution and diversification, the regulation of tobacco products as drugs, and even more litigation against makers of tobacco products.

The WHO's anti-tobacco agenda is clear and persistent. The entire industry – growers, warehousemen, processors, exporters, manufacturers, wholesalers, distributors – all are its direct target. For some time now, the anti-tobacco organizations have furthered their own agenda by exploiting some tobacco grower leaders. They played on growers' fears and uncertainties – and, no doubt, their egos. They never had any intention of helping U.S. tobacco growers. Instead, they duped some grower leaders into signing the Core Principles agreement. And now this is coming back to haunt our industry in a big way.

First, it's an American product that's under attack. The WHO's anti-tobacco agenda targets only **international** brands – the brands that contain largely U.S. leaf tobacco. While it supports bans on the trade and marketing of international cigarette brands, the WHO ignores local brands and alternative cigarettes like the estimated 800 billion bidis produced annually in India or the kreteks produced in Indonesia. The direct threat to U.S. tobacco growers is unmistakable; I can assure you that you won't find any U.S. tobacco in bidis and kreteks!

Second, the WHO's promises of so-called "transitional" assistance to tobacco growers doesn't include U.S. producers. After all, U.S. producers are NOT WHO/World Bank clients. These organizations focus on helping developing countries, so they are less concerned about the impact of their global regulations on U.S. farmers, and you can be sure their call for "help for the poorest farmers" does NOT include growers in Kentucky and North Carolina.

Third, tobacco won't get any help from the U.S. government. The United States has only one vote at the World Health Assembly, and that vote is controlled by U.S. health officials, who strongly support the WHO's agenda.

Finally, and most important, the WHO and the World Bank believe they have already divided and conquered the tobacco industry in the United States. They believe they have already co-opted producer support of their agenda. After all, some U.S. grower leaders have endorsed "the cause."

Let there be no doubt about it: Anti-smoking groups are **not** friends of tobacco producers. **Not** the World Health Organization. **Not** the World Bank. And certainly **not** the grower leaders who joined forces with them by signing the Core Principles agreement. I don't claim their betrayal was malicious; I'll give them the benefit of the doubt and believe they were played for

suckers. But whatever their reasons, they were wrong.

Where do we go from here? Our production and economic problems are enormous. Even worse are the adversarial forces of politicians who want to fund their vote-fetching wish lists with higher tobacco taxes. You know, no one has ever been able to explain to me just how they plan to pay for all their pet projects after they've run tobacco out of business.

Legions of external and internal forces are at work shaping tobacco's future. Externally, we face escalating excise taxes, smoking restrictions, trade barriers, a multitude of regulations and fights with government agencies (such as FDA) who want control of our industry, and damages in unconscionable amounts being awarded in class action lawsuits against manufacturers.

All of this bears on the stability and prosperity of our industry. Indeed, we've struggled against these and similar forces for many, many years, yet we are still here – for many reasons, not the least among them being the law of nature that says it's never in the best interest of a parasite to destroy its host.

No, these external forces alone will not destroy us. The greater threat to our industry lies in what we do to harm ourselves. If we sue our customers to satisfy greed… If we ignore our export customers' requests to provide selectivity and quality elements… If we decide that price is not a function of the marketplace… If we continue to ignore our opportunities to sell to a larger market strata… If we decide not to follow the best production and marketing practices that help keep non-value-added costs to a minimum… If we continue to do these things, then the cumulative effect can only be that the United States would no longer be in the business of producing and marketing tobacco.

With or without a domestic tobacco industry, millions of persons in the United States will continue to use tobacco products. Without a domestic producer base, the leaf for these products would have to be imported. And, of course, without a domestic manufacturing base, the products themselves would be imported. A grim scenario, indeed.

Thousands of Americans depend on tobacco to feed, clothe, and educate their families. For generations, tobacco has built and sustained communities. Somewhere along the way, we began to attract parasites who cleverly contrive to redirect tobacco cash into their own pockets. Their Marxist scheme to redistribute our net worth threatens to drain the lifeblood completely out of our industry and leave us with a hollow shell that's beyond repair.