

U.S. Flue-Cured and Burley Tobacco Situation and Outlook

September 21, 2004

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As the 2004 flue-cured marketing season came to a close and the last of the burley crop was harvested, tobacco farmers awaited Congressional action on a corporate tax bill that contained provisions for a tobacco buyout. Over the past several years numerous bills have been introduced that would provide an end to the current federal tobacco program and provide compensation to quota owners and tobacco growers. However until the summer of 2004, no buyout legislation had come to a vote in either the House or Senate. In summer 2004 both the House and Senate passed versions of a bill repealing an export tax rebate (unrelated to tobacco) that contained buyout legislation as well as numerous provisions not related to tobacco. At writing, the Senate and House versions of the bill were scheduled to go to a conference committee for reconciliation. Whether or not buyout legislation remained in the final version of the bill and, if so, what version, was uncertain.

Buyout Status

At writing, buyout legislation was part of HR 4520, a bill to repeal an export tax rebate that had been declared illegal by the World Trade Organization. Numerous other provisions had been attached to HR 4520, ranging from provisions for an earlier energy bill to the tobacco buyout. Versions of HR 4520 had passed both the House and Senate.

The Senate and House versions of the tobacco buyout contained in HR 4520 differed substantially. The \$12 billion Senate version of the buyout was \$8/lb for quota owners and \$4/lb for growers based on 2002 quota paid out in equal payments over 10 years. The Senate version included limits on post-buyout production and restricted production to traditional growing areas. The Senate buyout would be paid for through user fees from companies and would result in elimination of the remainder of Phase II funds (approximately \$2.7 billion). The House version was \$7/lb and \$3/lb on 2002 quota paid out over 5 years, totaling \$9.6 billion. The House version had no post-buyout

program or restrictions. The House buyout would be paid for from general revenues and would not result in elimination of Phase II. The Senate bill includes FDA regulation of tobacco products, but the House version does not include FDA regulation. Both versions eliminate future price supports on tobacco production in the U.S.

Differences in the Senate and House versions of the HR 4520 could be resolved by the conference committee. Resolution could include modification or even elimination of the provisions, including the tobacco buyout, attached to the bill. The Senate appointed conferees before the August recess. As of mid-September, the House had not appointed conferees. Chair of the House Ways and Means committee, Bill Thomas, had been appointed to chair the conference. Lobbying for or against inclusion of FDA regulation of tobacco and the method of payment for a buyout were intense during the August recess. At writing, speculation was intense as to whether or not HR 4520 would be resolved by the conference committee before the November elections.

2004 Flue-Cured Tobacco Crop

U.S. flue-cured production for 2004 was forecast at 512 million pounds, up slightly from 2003. The 2004 flue-cured basic quota was 471 million pounds and the effective quota was about 500 million pounds. Consequently, many flue-cured producers expected to have extra tobacco to carry over to 2005. At writing, the Flue-cured Tobacco Cooperative Stabilization Corporation (Stabilization) was taking about 16 percent of the crop. About 80 percent of the 2004 crop was sold via contracts. Stabilization had 81 million pounds of old crop tobacco in inventory. If Stabilization takes 15 percent of the 2004 effective quota, new crop inventory will be about 80 million pounds, giving a total inventory at the end of the season of about 161 million pounds. Use of U.S. flue-cured by U.S. cigarette manufacturers has declined from over 500 million pounds in the mid-1990's to an estimated 411 million pounds in 2004. Unmanufactured exports of U.S. flue-cured have declined from close to 400 million pounds to an estimated 190 million pounds during the same period.

World flue-cured production for 2004 was projected at 8.29 billion pounds, up 4.3 percent from 2003 according to the August, 2004 "World Leaf Production Summary" by Universal Corporation. The report estimated Brazil's 2004 flue-cured production at

1.545 billion pounds, compared to estimates of 505 million pounds for the U.S. and 132 million pounds for Zimbabwe. Zimbabwe's flue-cured production has continued to erode, down from 523 million pounds in 2000, with Brazil picking up much of Zimbabwe's lost production. While world flue-cured producers are not in an over-supply situation, supplies are ample.

2005 Flue-Cured Outlook

The outlook for U.S. flue-cured tobacco, and to a lesser extent world flue-cured tobacco, depends mainly on whether the U.S. tobacco program ends or continues. With most of the U.S. and Brazil crops under contract, changes in production after a buyout will be largely coordinated by international leaf and cigarette merchants. Since the 2005 Brazil crop will have been contracted for and planted by the time any buyout legislation is passed, it is unlikely that leaf merchants or cigarette manufacturers will expand 2005 U.S. production substantially. However, if the U.S. tobacco program ends, U.S. flue-cured production could increase towards a level of 800 million pounds over the next two to three years. Many flue-cured farmers would exit production with the end of the program. The pace of consolidation of production units would increase resulting in fewer farms, but in larger aggregate U.S. production. Price would decline to under \$1.50 per pound within one to two years and could decrease toward \$1.25 as production expanded.

World production of flue-cured tobacco would not likely expand substantially. Increases in the U.S. would likely come as merchants shifted some production from Brazil to the U.S. and moved future decreases in Zimbabwe production to the U.S. Brazil will remain the dominant producer and exporter of flavor type flue-cured tobacco. However, merchants have expressed some nervousness about disease or weather risk associated with having so much of the world's flavor type flue-cured production concentrated in the small geographic production region of southern Brazil.

If the U.S. tobacco program continues, then the 2005 flue-cured quota could decline by 25 to 30 percent from its record low level of 2004. The assessment could increase substantially from its level of 10 cents per pound in 2004. The exodus of farmers from tobacco production could be substantial as many who have tried to maintain production in hopes of a buyout give up and exit without financial assistance. Quota

rental rates would escalate even further than their already high levels. Factors that could keep the quota from falling dramatically are 1) a substantial increase in purchase intentions (highly unlikely), 2) purchases of inventories from Stabilization by manufacturers (less unlikely than an increase in purchase intentions, but still unlikely given ample world supplies), or 3) a government bailout of the program through government purchases of Stabilization stocks, discounts of Stabilization stocks, or through a mandated floor on the quota (unlikely, but more likely than the first two factors).

2004 Burley Crop

U.S. burley tobacco production for 2004 was forecast at 301 million pounds, 7% higher than the 2003 crop, but still representing only 91% of the national effective quota of 332 million pounds. Burley markets open in November. In the 2003 marketing year, the Burley Tobacco Cooperative and Burley Stabilization received 40 million pounds out of 272 million pounds marketed or about 15 percent of marketings. Based on contract prices and price support schedules, average U.S. burley prices for the 2004 crop should continue to hover around \$1.95 to \$2.00 per pound. Look for approximately 80% of the burley crop to be contracted, with the majority of auction marketings going under loan.

U.S. burley demand continues to be hampered by increasing use of less expensive imported tobacco, declining domestic cigarette consumption and a growing deep discount U.S. cigarette market which uses very little U.S. burley. One bright spot for the burley sector of late has been a surprising expansion of leaf exports. After slumping for several years, U.S. burley exports increased 6% in 2003 and an additional 12% so far for the first six months of 2004. Despite the recent modest increase in exports, total use of U.S. burley has generally fallen from its traditional level of 500 to 600 million pounds to approximately 300 to 350 million pounds.

World production of burley tobacco in 2004 was estimated at 1.88 billion pounds according to Universal Corporation's August, 2004 "World Leaf Production Summary." This is an 11.4 percent increase over 2003. Burley production in Brazil has increased steadily from 209 million pounds in 2000 to an estimated 317 million pounds in 2004. Argentina has increased burley production from 86 million pounds to 123 million pounds

during the same period. The quality of burley produced in Argentina and Brazil reportedly has also increased such that Brazilian and Argentine burley tobaccos are now close competitors to U.S. burley. Malawi has remained a substantial producer of “filler” burley tobacco, producing an estimated 286 million pounds in 2004.

2005 Burley Tobacco Outlook

As with flue-cured tobacco, the outlook for U.S. burley tobacco depends primarily on the outcome of tobacco buyout legislation. If the buyout passes late in 2004, the production/price environment for 2005 will be very, very uncertain. Prices would fall to reflect the absence of quota rents and price supports, but it remains unclear what types of price incentives the companies would offer to encourage enough growers to remain in business. Labor, credit, and mgt constraints may limit expansion in the short-run. However, over a two to three year period U.S. burley production could increase to over 400 million pounds without production controls. Price likely would decline toward \$1.50 per pound during this period.

A large exodus of small producers is expected, particularly in the Appalachian region. Some exceptions to this scenario may be in areas of Appalachia where few alternative sources of income exist. As with flue-cured, the pace of consolidation of burley farms would increase. While the number of burley farms likely would decline dramatically, those burley farms remaining would be considerably larger so that aggregate U.S. burley production increased.

If geographical restrictions are not included in a buyout, production will tend to shift out of the higher cost or production regions such as eastern KY, eastern TN, western North Carolina, and West Virginia. Some farms in central Kentucky and Tennessee may grow more, but most of the growth will likely be in the western half of Kentucky in response to the low-cost environment created by higher yields and cropland availability. Additional expansion could occur in southern Illinois, southern Indiana, and perhaps parts of central North Carolina and Virginia.

If the buyout does not materialize, 2005 quotas and price supports will once again be determined by legislative formulas. The U.S. burley quota outlook does not appear to be in as dire a situation as the outlook for the U.S. flue-cured quota. Unlike flue-cured, burley exports have been stable to increasing in recent years which will help partially offset some of the

additional pool stock intake from the 2004 crop. Purchase intentions are always a difficult call as the burley industry witnessed last year when the companies surprisingly boosted intentions by 10 million pounds (5%). Imports are readily available and given the declining U.S. cigarette market, the companies need less overall burley. But with the companies anticipating underutilization of quota in some areas, coupled with carry-forward limitations (i.e. the 10% rule) that could easily go in effect again for the 2005 effective quota calculations, perhaps these factors will help to offset some of the adverse market conditions. If burley purchase intentions stay relatively constant, the burley cut would be in the 5 to 10 percent range.

Information Sources to Stay Updated

NCSU Tobacco Economics http://www.ces.ncsu.edu/depts/agecon/tobacco_econ/

UKY Tobacco Economics Online <http://www.uky.edu/Agriculture/TobaccoEcon/>

UT Agricultural Policy Analysis Center <http://agpolicy.org/tobquota.html>

USDA-ERS Tobacco Briefing Room <http://www.ers.usda.gov/Briefing/Tobacco/>