June Intensive Revision

## Demand and Supply – Q2 (H2 A Level 2012)

**The Market for Cotton**

**Table 1: Cotton in selected economies (million bales)**

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
|  | **Production** | | **Consumption** | |
|  | **2008/09** | **2009/10** | **2008/09** | **2009/10** |
| **Brazil** | 5.4 | 5.3 | 4.2 | 4.4 |
| **China** | 36.7 | 32.0 | 44.0 | 48.5 |
| **India** | 22.6 | 23.2 | 17.7 | 19.5 |
| **Pakistan** | 8.7 | 9.6 | 11.3 | 11.0 |
| **United States** | 12.8 | 12.2 | 3.6 | 3.5 |
| **World total** | 107.1 | 101.2 | 109.9 | 117.2 |

*Source: United States Department of Agriculture*

Decrease in supply as production reduces while increase in demand as consumption increases – increase in price

**Extract 1: Brazil's cotton growers seek to boost output as India restricts exports**

Cotton prices have soared 73% in the past year and reached a 15-year high of US$1,064 on 28 September 2010 after India, the world's second-biggest exporter after the United States, said it would limit exports. The Indian government will limit exports to 5.5 million bales in 2011, compared to 2010 when exports were 8,3 million bales. The price of cotton is expected to stay above US$1 until June 2011.

Cotton growers in Brazil, the world's fifth-largest exporter of the fibre, plan to increase output in 2011 after the rise in world prices. Planting for the 2011 harvest may rise to 1.1 million hectares from 830 000 hectares in 2010.

Brazil's government may consider increased financial support for cotton growers to encourage them to raise output in 2011, according to the Brazilian Agriculture Ministry. A four-month drought hurt the quality of the crop this year in Brazil, causing output to fall. In September the government temporarily eliminated a 10% tariff on cotton imports as domestic supplies fell short of demand.

*Source: Bloomberg, 1 October 2010*

**Extract 2: UK retail clothing firms far from cheerful about future of cheap fashion**

It was a sign of the times; fashion so cheap it became "disposable’ as globalisation brought container-loads of low-cost clothes to the UK. But clothes retailers are now warning that the era of constantly falling prices is coming to an end and that prices could rise in 2011. A huge rise in the price of cotton to a 15-year high could not be ignored, they said. At the same time, retailers are facing higher labour costs in Asia, the impact of a weaker pound and a rise in Value Added Tax (VAT) from 17.5% to 20% from January 2011.

The chief executive of clothes retailer Next predicted that the prices of Next's clothes were going to rise by up to 8% in 2011. He said that he suspected that shoppers would have to cut back on the number of new outfits they buy: 'Our best guess is that if prices do rise by 8%, then volume of sales will be down by 10%. The clothing retail industry hasn't experienced price increases for 15 years and the truth is we don't really know what the response will be.’

The director of a leading research company said consumers are facing what could be a permanent change in the clothing market: 'Prices can't keep failing forever: they reach a floor, and we are now at a point where retailers' profits are really quite low. Because of the recession they are finding it difficult to maintain sales. This means that when costs rise, they have to be passed on to the consumer.'

Primark, a clothing company known for its ability to emulate designer looks at rock-bottom prices, has been at the forefront of the disposable fashion movement. Its breathtaking prices - this autumn you can still buy jeans for £8 and a top for £4 - caused a stampede when its first store opened, on London's Oxford Street in 2007, Another company. Asda, sold its cheapest pair of own brand jeans for £14.97 in 2000; now the price is down to £4.

Some have argued that the increase in the cotton price has its roots in the financial crisis of 2008, when farmers stopped planting low-value cotton and switched to higher-value crops such as corn and soya, When retail sales picked up, demand for cotton also rose and prices shot up - just at a time when major cotton-producing regions such as China and Pakistan were suffering devastating floods, and India, the second largest producer, was limiting exports.

The deputy chief executive of a well-known department store explains that 60% of the cost of clothing is in the fabric and about 30% of the fabric cost is in the raw materials: ‘The approach we are taking is to pass it on to customers and we think most other retailers will have to do the same.’ He says its prices will rise, like Next's, by up to 8%, He also points to Increased labour costs all around the world’, less spare capacity in Chinese factories, rising freight costs and the unfavourable impact of foreign exchange movements as other pressures being faced by retailers.

Some analysts argue, however, that the gloom is being overdone. The chairman of the department store John Lewis Partnership, which last week reported a 20% increase in fashion sales, certainty thinks the future is brighter than some of his peers say. ‘Prices may rise a little but tough competition will take some of the heat out of these rises.’

*Source: The Observer, 19 September 2010*

**Questions**

(a) (i) Why might the changes shown in Table 1 have led to an increase in the world price of cotton? [1]

(ii) Given the information contained in Table 1, identify the country that has had the greatest impact on world prices. Justify your answer. [3]

(b) What can you conclude from the evidence in Extract 1 about the price elasticity of supply of cotton in Brazil? [2]

(c) Explain the likely reason why the Brazilian government eliminated the 10% tariff on cotton imports and the Indian government restricted cotton exports. [3]

(d) In Extract 2, the chief executive of Next considers the effect of an 8% rise in the price of Next’s clothes. With reference to the concept of price elasticity of demand, explain the expected impact of this price rise on the firm's total revenue. [3]

(e) With reference to the data where appropriate, discuss the view that supply factors are likely to be more important than demand factors in explaining changes in the price of cotton. [8]

**[Total: 30]**