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# Market Outlook for Malawi's Tobacco Industry

Final Report

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# Market Outlook for Malawi's Tobacco Industry

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Final Report

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**AGRICULTURAL MARKETING IMPROVEMENT STRATEGIES PROJECT**

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| | |
|---|---|
| ADMARC | Agricultural Development and Marketing Corporation |
| BAT | Brown and Williamson |
| CAP | Common Agricultural Policy |
| EFTA | European Free Trade Association |
| FSU | Former States of the Soviet Union |
| JTI | Japan Tobacco |
| MGQ | Maximum Guaranteed Quantities |
| MOA | Ministry of Agriculture |
| OECD | Organization for Economic Cooperation and Development |
| PM | Philip Morris |
| RTM | Romanian Tobacco Monopoly |
| RYO | roll-your-own |
| TAMA | Tobacco Association of Malawi (TAMA) |
| TCC | Tobacco Control Commission |
| TEAM | Tobacco Exporters Association of Malawi |
| TRIM | Tobacco Research Institute |
| VAT | value-added tax |

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## ABSTRACT

This report, funded under the USAID Africa Bureau's analysis of agricultural marketing and agribusiness development in Sub-Saharan Africa, was designed to provide information on market prospects to assist Malawi in projecting its future position in the world tobacco market and in making the necessary production adjustments. This study is a desktop study, with a field focus on Western and Eastern Europe, where fieldwork was conducted. This is not a production study.

The focus of this study is to analyze world demand for Malawi's tobacco and to identify and assess Malawi competitors, without conducting a full comparative advantage study. It evaluates current and projected consumer markets in Europe and Eastern Europe and looks at the potential impact of the elimination of EC tobacco subsidies on Malawi's tobacco prices.

This study only briefly discusses tobacco reserves and price/volume trends, due to lack of time and access to data. Price and volume trends are provided in the various chapters, in addition to a brief coverage in chapter 6.

# 1. PROJECT SUMMARY

The primary purpose of this study is to develop an industry outlook for Malawi tobacco. The tobacco industry is extremely important to Malawi, accounting for over 30 percent of GDP and 75 percent of total foreign exchange earnings. Obviously, Malawi's tobacco industry is dependent on global demand and depressed market prices, resulting form excess tobacco reserves, have created considerable concern over the direction world leaf markets are taking.

In 1992, Germany, the United States, Japan and the Netherlands were Malawi's top tobacco export markets. Changes in these markets could have dramatic repercussions for Malawi's tobacco industry. In an effort to document some of the changes occurring in these markets and draw implications for Malawi's tobacco industry, this study was charged with providing information to assist Malawi in projecting its future position in the world tobacco market and to enable it to make the necessary production adjustments. Specific areas of study included:

- estimate demand prospects for Malawi's burley, dark-fired, oriental and flue tobaccos
- survey current and projected consumer markets for Malawi's tobacco, with particular attention to the eastern European markets.
- evaluate the impact of the elimination of EC tobacco subsidies on Malawi's tobacco industry
- estimate the impact of the recent U.S. legislation to restrict tobacco imports on Malawi leaf exports

Given these primary areas of study, this project complemented existing data and market information with extensive fieldwork throughout Europe. The author traveled to the Netherlands, England, Germany, Belgium, Poland, Romania, Bulgaria and Malawi to conduct in-depth interviews. Discussions were held with the major world leaf buyers, cigarette manufacturers, shag tobacco companies, the EC Commission Tobacco Division, Tobacco Growers's Unions, tobacco and cigarette monopolies of eastern Europe, government officials and a host of other industry experts.

The results of this two-month study are reported here and were presented to various entities that comprise the tobacco industry of Malawi. Following each major section is a discussion of implications for Malawi's tobacco industry.

Despite depressed market prices, Malawi continues to hold significant share of world leaf markets. The high filling capacity, a neutral leaf flavor, and natural low tar content of Malawi's burley will enable the country to retain world market share. Importantly, Malawi continues to hold a strong relationship with the world tobacco industry in general.

The increased demand for low-priced cigarettes to serve the east German and the eastern European market should continue to attract Malawi leaf sales to Germany in the near term, despite declining domestic consumption. Long term growth will depend on the multinational cigarette companies as they position themselves to serve eastern Europe. Eastern Europe displays strong long-term growth potential for Malawi tobacco, particularly for medium-quality and lower-priced tobacco. However, increasing import barriers and loss of preferential tariff status in many Eastern European countries may hamper Malawi's leaf sales in the short term.

The European Community is in the process of further reducing tobacco production and moving to more commercially viable leaf types. Export subsidies (called restitutions in the EC) have been abolished. Malawi will benefit from EC CAP reform, again due to quality considerations, transportation advantages and preferential tariff status.

As U.S domestic cigarette consumption declines, U.S. cigarette manufacturing will continue to move off-shore, accelerated by the recent legislation restricting leaf imports. Malawi's reputation for the high filling capacity of its leaf and for it ability to meet high U.S. cigarette manufacturer specifications will keep Malawi burley in the market, albeit at lower prices.

Japan will continue to be a strong growth market for Malawi burley and flue. However, the recent appearance of China on world leaf markets could be an important source of competition in the future, particularly given its high volume production and stocks. However, this may be offset by lower quality tobacco.

In the current market situation of excess stocks, prices will continue to be low in the near term. However, leaf markets typically run in cycles and maintaining market share is essential. Malawi tobacco producers are faced with several constraints, including lack of adequate credit, possible reductions in quota, and a declining and unstable dark fire-cured market. Of importance to the tobacco industry is securing adequate and stable supplies of good to high quality leaf. Malawi must ensure stability in tobacco production to maintain future market share in world leaf markets.

## 2. OVERVIEW OF MALAWI'S TOBACCO INDUSTRY

The tobacco industry is extremely important to Malawi, accounting for over 30 percent of GDP and more than 70 percent of total foreign exchange earnings. Malawi's tobacco industry is dependent on global demand, however, and in the last year sentiments have swung from one of market optimism to one of market concern as excess global tobacco reserves and depressed tobacco prices have forced a reassessment of the world market. Despite expected record export levels, Malawi is confronted with continued overproduction, high carry-over stocks and plummeting auction prices.

Of the 7.2 million tons of tobacco produced worldwide, Malawi contributes 14 percent of the burley, 4 percent of the dark fired, and 0.4 percent of the flue tobacco production. In terms of the 1.3 million tons of tobacco traded globally, Malawi accounts for approximately 21 percent of the burley, 11 percent of the dark fired, and 4 percent of the flue trade. Although Malawi contributes only 1.4 percent of world tobacco production, it accounts for 7 percent of world trade. In terms of ranking, Malawi is the second largest burley exporter, the third largest dark fired exporter, and the seventh largest flue exporter (USDA/FAS).

The intent of this section is to provide the reader with an overview of the Malawi tobacco industry. The summary comments provide insight to the challenges the Malawi tobacco industry faces in the future.

### 2.1 Government and Association Support

Malawi tobacco production is divided into two distinct sectors: the smallholder growers and the estate producers. Production and marketing comes under the auspices of several government and private sector associations. The tobacco industry is very well supported with research and estate extension financed by various producer levies. Support organizations in the Malawi tobacco industry include:

#### 2.1.1 Agricultural Development and Marketing Corporation (ADMARC)

ADMARC basically represents the smallholder tobacco growers. Headquartered in Limbe, ADMARC is responsible for the registration of smallholder tobacco licenses and production quotas for all tobacco types, with the exception of burley. ADMARC registers and issues licenses annually to approximately 73,000 smallholder growers for oriental, dark fired, and sun-air cured tobacco. In addition, ADMARC purchases output at 40 different markets.

#### 2.1.2 Ministry of Agriculture (MOA)

MOA issues licenses and production quotas to tobacco estates for burley and flue-cured tobacco production only. Licenses and quotas are based on annual estimated production targets as issued by the Tobacco Exporters Association of Malawi (TEAM) to the Tobacco Control Commission (TCC). In addition, MOA registers smallholder burley growers.

### 2.1.3 Tobacco Exporters Association of Malawi (TEAM)

Established in 1930 and headquartered in Lilongwe, TEAM represents all registered dealers, packers, manufacturers, and exporters of Malawi tobacco. TEAM is financed by its members and membership is voluntary.

### 2.1.4 Tobacco Association of Malawi (TAMA)

The purpose of TAMA is to advance and protect the interests of all registered burley and flue tobacco producers, but essentially represents the estate growers. Established in 1929, TAMA is financed by producer levies on tobacco sold on the auction floor (1 tambala/kg). TAMA also directs the recently established Estate Extension System, which is financed through estate tobacco growers (0.35 percent of gross sales).

### 2.1.5 Tobacco Control Commission (TCC)

The TCC is a consortium of association representatives, including two from TAMA, two from TEAM, one from ADMARC, and one from MOA. Established in 1963, TCC has defined 69 grades for burley and 203 grades for flue tobacco. TCC is financed by the tobacco growers through a levy on tobacco sold on the auction floor (0.72 tambala/kg).

### 2.1.6 Tobacco Research Institute (TRIM)

TRIM, founded in 1980, is also funded through auction floor sales (0.65 percent of gross proceeds).

## 2.2 Domestic Production

Malawi tobacco is produced by smallholder growers and estate producers. According to the TCC, in the 1991-92 marketing year, there were 81,142 smallholder growers and around 25,000 estate producers who employed 91,387 tenant farmers. Press Holdings is a prominent player among Malawi's estate producers. Consisting of two subsidiaries, Press Holdings produces 23 percent of Malawi's flue tobacco on 3,600 hectares through General Farming and raises 3,200 hectares of burley through Press.

In 1993, 130,100 ha of land was committed to tobacco production, with 77 percent devoted to burley, 14 percent to flue, and 7 percent to dark fire. Importantly, both burley and flue production have yields at least double that of other tobacco types.

Forecasted 1993 tobacco production stands at 103,300 metric tons dry weight production. Burley accounts for 73 percent, flue 23 percent, and dark fire 4 percent of total production. Negligible amounts of sun/air-cured and oriental are produced. Despite increases in quota allocations, burley production is expected to be up only slightly from 1992 due to unfavorable weather conditions and bushy top disease. Burley production is up nearly 10 percent dry weight over 1992, flue production is about the same as last year, and dark fire production is down 57 percent. High prices for scarce firewood used in processing dark-fired tobacco have raised the cost of production considerably. Although sun/air-cured production is down by over half and oriental production up by nearly as much, total production remains negligible. Air- and sun-cured dry weight production is forecast at 320 tons and oriental 590 tons for 1993.

Due to excess global supply and high carry-over stocks, which have depressed auction prices, the Ministry of Agriculture has attempted to limit the issuance of burley quotas. But the rural economy's dependence on tobacco production and the current political environment have made cut-backs politically difficult. Burley production has continued to grow due to unauthorized production and the issuance of supplemental quotas by MOA mid-season, which precludes the effectiveness of the penalty payment for overproduction. For production over the authorized 115 percent, penalties were not previously enforced, although this appears to be changing. In 1992, growers were permitted to keep 60 percent of floor proceeds from overproduction. In 1993, this amount will drop to 30 percent, penalties will be enforced, and for the first time the Government of Malawi did not issue new production quotas to burley estate growers.

Future burley production is expected to fall within a range of 115,000 to 125,000 tons, and flue production from 25,000 to 27,000 tons, over the next three to five years. Some farmers have abandoned dark fire and air/sun-cured tobacco types in favor of more profitable burley production. This concerns many resident leaf buyers and exporters, who believe that domestic markets have become too thin for these tobacco types, eroding their viability for continued commercial success. The switch to burley has come about for several reasons. Burley prices have dropped by over 1 kwacha per kg, thus far in the marketing year, although prices have stabilized on the auction floors. Smallholder burley growers can now join "clubs" which permits them to market their tobacco directly on the auction floor or sell individually to estate growers, rather than go through ADMARC. Dark-fire prices have strengthened in the 1993 marketing year, primarily due to a smaller than expected crop.

Oriental production is expected to grow to 3,000 to 5,000 tons annually over the next three to five years. Leaf buyers provide support to smallholder growers (who typically cultivate plots smaller than one acre) through resource-providing contracts. Production quotas to this group are expected to reach 10,000 tons by 1995. Major processors and exporters provide considerable financial and technical support to oriental producers, although this tobacco type is grown on marginal land with very low input levels.

Although input programs exist, chemical and credit access may be problematic for the 1994 growing season, due in part to hard currency shortages. In the past, smallholder growers had access to fertilizer subsidies; however, last year these subsidies were completely dropped. The Agricultural Trading Corporation (a subsidiary of Auction Holdings) sells tobacco seed to estate growers and fertilizer through OPTICHEM (a large fertilizer importer who does custom blending).

However, flue production is very capital and management intensive and more conducive to estate production where capital access is less constrained. Given the investment in flue production, it is hoped that the depressed prices are only temporary and that production will not easily fluctuate, despite declining profit margins.

Forecasted ending stocks for 1993 stand at 29,500 mt, a 20 percent increase over beginning stocks. Continued growth in burley production and stocks is outracing the decline in dark fire stocks. Ending world stocks are also at record high levels, reaching 7,037,225 tons in 1992, primarily due to production increases in China, Brazil and Turkey. Record high tobacco reserves and projected end-of-season stocks are responsible, in large part, for plummeting auction prices on the floor this year. Already tobacco grower's planting intentions are expected to be down in 1994, as current prices are frequently below the cost of production.

Malawi flue estimates are relatively accurate, but burley estimates are less reliable and could be problematic. Production miscalculations for some other countries, such as Brazil with much larger flue volumes and huge surpluses, are less of a problem. Conversely, the Malawi burley crop is much larger than that of Brazil's. Consequently, as leaf buyers formulate their purchase intentions per country and per leaf type, production miscalculations are more problematic for small crops than they are for large crops. Shortfalls in expected leaf acquisition can be more easily compensated with additional purchases in another country when world crop size is sufficiently large.

## 2.3 Auction System

All tobacco produced in Malawi, with the exception of oriental, must be sold on the auction floor administered by Auction Holdings (a private entity established in 1937 with ADMARC as the major stock holder). Auction floors which open 15 April and close in late October, are located in Limbe (7,000 bales per day) and Lilongwe (12,500 bales per day, considered the largest tobacco floor in the world). To aid in orderly and efficient marketing, Auction Holdings, in collaboration with TCC, issues delivery quotas to growers, with small quantities scheduled for delivery over a multi-week period.

Malawi dark-fired, sun-cured leaf, and some burley is bought directly from the farmers by Admarc. ADMARC then grades the leaf and gives the corresponding GOM-administered price to the farmer. ADMARC then sells the leaf on the auction floor; if the reserve price is not met, ADMARC can withdraw leaf and sell the tobacco off the floor. Consequently, ADMARC directly competes with international leaf companies on the world market, without having to cover auction costs, thus undercutting leaf buyers on price. Many leaf buyers have complained of this practice. Estate-produced flue and burley leaf is sold directly on the auction floor. Smallholder burley farmers have the option of either selling directly on the auction floor or through ADMARC.

In addition to the above deductions for association support, auction floor sales are subject to a variety of other levies. Classification fees (0.76 tambala/kg), stabilization fees (0.5 tambala/kg), auction holding fees (3.75 percent of gross proceeds), stop orders for bank loans, and a withholding tax of 5 percent are each assessed on floor sales.

## 2.4 Domestic and Export Sales

Total tobacco exports are expected to reach 97,150 tons in 1993, a record volume, up from 95,008 tons in 1992. Of that amount, 65,000 tons (or two-thirds) is burley, 23,000 tons (almost one-fourth) flue, and most of the remainder dark tobacco. Burley exports are up 10,000 tons from 1992, while flue exports remain essentially the same. Flue export volume and value remain fairly stable because Malawi flue tobacco is considered superior to the Zimbabwe crop.

Although burley export volumes look strong, auction prices provide further insight. As noted, tobacco prices are considerably below 1992 levels. Further, prices for various grades are much more disparate. Top grade burley is receiving roughly the same price as last year, while medium and lower grades are selling considerably below 1992 levels. Continued price weakness is forecast as world reserves stand at record volume. However, Malawi leaf is moving off the auction floor very well this year, as expected carry-over stocks are expected to be in the 10,000 ton range.

The world leaf market is basically an oligopoly on the buying side. Leaf buyers or merchants purchase leaf at world auction markets or through contract production, and in turn sell the leaf either semi-processed or in a more processed form to cigarette manufacturers. There are a relatively small number of leaf buyers and only a few cigarette manufacturers dominate world production. Consequently, tobacco growers and most governments have very little leverage in extracting higher prices from the market.

Malawi tobacco is exported to 60 countries by at least one of four resident buyers: Universal, Standard Commercial, Central Leaf and Intabex Dibrell. Limbe Leaf (owned by Universal Leaf, plus a 40-percent Government share through Press Holdings) buys about one-half of the total tobacco crop. Standard Commercial (also a U.S. multinational) is the second largest buyer and purchases 27 percent of local production. Central Leaf (comprised of Casalee (U.K.) and A.C. Monk (U.S.)) and Intabex Dibrell (Intabex of Belgium origin and Dibrell of the United States) purchase the remainder and operate a joint processing factory in Malawi. Intabex also buys dark fire leaf and processes and flavors the leaf through Edwards Goodwin for the African west coast dark-fire buyers. Although tobacco exports are neither subsidized nor taxed, exporters are required by the GOM to exchange hard currency for local currency at the official exchange rate to purchase tobacco on the floor.

In April 1993, Universal Leaf (based in Richmond, Virginia, United States) took over Casalee. As a result of that takeover, Central Leaf, Casalee's previous joint venture with A.C. Monk was in unclear from a legal standpoint. Universal Leaf had a 50 percent interest in Central Leaf, and Universal Leaf sold their interest in Central Leaf. Universal Leaf already has a manufacturing plant in Malawi and did not need the Central Leaf plant so divestiture was the logical solution.

Currently, Universal Leaf is the largest leaf buyer on the world market with nearly a 50-percent market share after the Casalee takeover. Intabex and Dibrell Brothers each control approximately 20 percent of the world leaf market. In Malawi, Intabex and Dibrell have a joint buying relationship. Previously, Universal Leaf had concentrated on the U.S. leaf market and Intabex on the rest of the world. However, with the uncertainty in the U.S. market, Universal Leaf will probably increasingly focus on the EC market, Africa, the Far East and Brazil (Casalee's previous regions of activity). In general, leaf buyers believe that the U.S. leaf market is definitely in a state of decline due to the recent import restrictions, declining consumption, and ultimately production, and the political environment.

In 1992, the United States, Germany, Japan and the Netherlands were Malawi's top tobacco export markets. In that year, the United States purchased 27 percent of Malawi's burley, with another 25 percent going to Germany and 20 percent to Japan. Eastern Europe is a fast-growing market for off-style and lower-priced burley, both of which are becoming increasingly important to Malawi. Preliminary 1993 burley export figures show strong sales increases in the United States, Japan and Poland.

The Netherlands and Japan were Malawi's largest flue markets, with each purchasing around 13 percent of Malawi's exports. The Netherlands was also Malawi's largest dark market, purchasing 40 percent last year. The Netherlands is an extremely important tobacco buyer, engaging in considerable cigarette manufacture and supplying much of Europe. Preliminary 1993 flue exports also report strong volume increases, particularly in the U.K., South Africa, the Netherlands and China.

Exports of dark fire and air/sun-cured tobacco are expected to be down in 1993 due to lower production and reserves. In particular, exportable supplies of dark fire lower leaf will also be down considerably in 1993. Dark fire lower leaf is coveted by European manufacturers due to its lower nicotine content. Dark air and sun-cured tobacco is used in European pipe blends, and low supplies of these tobacco types may force manufacturers to delete these tobaccos from their blends altogether. TEAM has encouraged ADMARC to provide special end-of-season bonuses to dark fire and sun/air-cured producers to boost next year planting intentions. These bonuses are recommended to offset burley's greater profit potential. Smallholder burley growers can band together in "clubs" to place their crop directly on the auction floor. However, dark tobacco producers must still market their crop exclusively through ADMARC and typically receive direct payments from ADMARC that are less than half of what auction prices are bringing.

Of concern to leaf buyers is the expense of moving leaf out of Malawi to points of destination. Malawi has relatively high transportation costs. Much of the leaf must move through Durban, making it expensive to transport to Europe, particularly relative to Zimbabwe leaf. Transportation concerns can erode Malawi's competitive position.

Malawi has a small domestic cigarette manufacturing sector, which purchases its leaf domestically (95 percent of which is flue-cured). Since 1942, British American Tobacco has manufactured and marketed cigarettes in Malawi under various brand names, including Benson and Hedges, State Express, 555, Filter King, Life, Ascot and Tom Tom. Domestic sales are essentially constrained by low per capita incomes. No leaf or cigarettes are imported.

## 2.5 Implications for Malawi Tobacco

The above overview of Malawi's tobacco industry highlights several points essential for this study. Further discussion of these issues can be found in subsequent sections of this report.

1. World tobacco production and stocks are expected to continue growing. *Ceteris paribus*, auction prices in Malawi are expected to remain depressed.

2. It is currently believed that Malawi planting intentions for 1994 are considerably below what the market can absorb. Insufficient 1993 prices and financing appear to be the constraints.

3. Germany, the United States, Japan, and Netherlands remain Malawi's largest export destinations. Changes in these markets are critical to Malawi's tobacco industry.

4. Recent U.S. legislation penalizing "excessive" tobacco imports will alter Malawi's position in the world leaf market.

5. Eastern Europe displays strong long-term growth potential for Malawi tobacco. However, increasing import barriers and loss of preferential tariff status in select markets may hamper Malawi's direct leaf sales in the short term.

6. EC CAP tobacco reform is expected to boost Malawi exports to Western Europe. In particular, dark fire tobacco has growth potential in Europe, if Malawi production can be stabilized and/or increased significantly.

## 3. DEMAND PROSPECTS FOR MALAWI TOBACCO

Malawi tobacco is exported to over 60 countries. In 1992, Germany, the United States, Japan and the Netherlands were Malawi's top tobacco export markets. Burley accounts for 58 percent of Malawi's leaf exports, flue 24.6 percent and dark fire-cured 1.5. percent. Although Germany is Malawi's largest overall tobacco export market, the United States has recently become Malawi's largest burley market, with Germany second and Japan third. The Netherlands is Malawi's largest dark fire-cured market. Eastern Europe has also become an important market for off-style and lower-priced burley, both of which are becoming increasingly important to Malawi. Given current export market trends, this section of the report will focus on the above mentioned countries, with a brief comment on the Former States of the Soviet Union (FSU). Asian markets, particularly that of China, are perceived as huge markets in the future, but currently are unreliable.

The Organization for Economic Cooperation and Development projects that there will be a net increase in leaf use through the end of this century. Malawi should continue to play a significant role in world leaf trade. However, demand will shift around the world as previous markets decline and others open. The current world leaf glut may place Malawi at a disadvantage due to smaller crop size (with the exception of perhaps burley) and less political clout. Any competitive advantage Malawi has, such as filling capacity, should be exploited in a price-based market.

### 3.1 Market Developments in Germany

Germany was the largest destination for Malawi tobacco exports in 1992 in terms of volume and value. Total leaf exports to Germany were 17,165 metric tons, of which 13,839 tons (81%) was burley. Another 2,708 tons of flue tobacco reached Germany, with minor shipments of dark fire, sun/air and oriental leaf. The total value of Malawi leaf exports to Germany was $54.1 million in 1992.

Germany continues to be an important world importer of unmanufactured tobacco. Domestic production is negligible and the German cigarette industry is very well developed to serve both the European Community and newly formed markets in central and eastern Europe. Important market trends that affect the demand for Malawi tobacco include the increased demand for low-priced tobacco and the movement of cigarette manufacturing into eastern Europe.

#### 3.1.1 German Tobacco Overview

Total tobacco production is expected to reach 9,300 tons (green) in 1993, considerably short of the fixed German production quota of 12,000 tons. Badischer Burley and Geudertheimer (dark air-cured) tobaccos are grown under three-year production contracts and flue tobacco under single-year contracts. Approximately 60 percent of German tobacco production is contracted through the cigarette and smoking industry, 25 percent through the tobacco trade and 15 percent through the cigar industry. The German tobacco processing industry has not collected tobacco use and storage data since the mid-1980s; therefore what data is available comes from customs information, etc.

Raw tobacco use in Germany increased by 6 percent in 1992 for all major types of leaf, with total use reaching 205,000 tons. In 1993, raw tobacco consumption is expected to fall by about 5 percent to 195,000 tons due to the expected decline in the manufacture of tobacco products. Raw tobacco supplies in the cigarette industry were very short in 1992.

German manufacturers use a wide variety of leaf in their production, including flue, burley, oriental, dark fire, light-air, dark-air and other leaf types. Of total leaf usage in 1992, 77,483 tons (45%) was flue tobacco, 41,283 tons (24%) burley and 28,510 tons (17%) oriental. The United States has been the primary supplier of leaf to this market, but U.S.-sourced leaf fell 2.4 percent last year.

Germany imported 206,498 tons of unmanufactured tobacco in 1992. Given insignificant domestic production, imports by leaf type generally mirror consumption by leaf type, with flue, burley and oriental tobacco dominating the import market.

In 1992, Germany imported a total of 71,000 tons of flue-cured leaf, with important suppliers being the United States (21,000 tons) and Brazil (20,000). Flue-cured tobacco imports grew 4 percent in 1992. The United States has dominated this market, although U.S. market share is clearly declining (32.4 percent in 1990, 28.5 percent in 1991 and 24.6 percent in 1992).

Germany imported 33,255 tons of unmanufactured burley tobacco in 1992, a decline of 11 percent from 1991, including 13,000 tons from the United States, 8,000 tons from Malawi and 2,000 tons from Italy. Small, but significantly increasing, were sales from India and Thailand. Large leaf import increases were also reported for Malawi and China. Declining sales were reported for the United States, Italy, Korea, Brazil and Mexico. German import figures do not match Malawi export figures due to incomplete trade data and possible transshipments. However, U.S. burley prices (as denominated in DM) increased 7 percent, while prices for Malawi burley increased only 2.2 percent, thus increasing Malawi's burley market share relative to U.S. share.

Despite the decline in burley imports, German use of imported burley tobacco increased 27 percent to 41,200 tons in 1992. This trend is expected to continue as burley use accounted for 20.7 percent of all imported tobaccos, compared with 18.7 percent in 1991. Domestic German burley production is expected to continue to average about 4,000 tons. However, due to the high labor intensity required for burley production, more farmers are concentrating on flue tobacco. German tobacco production is expected to continue to be negligible, relative to the needs of Germany's cigarette sector.

Three related events are increasing demand for low-priced burley and flue supplies; falling international leaf prices, the current recession in Germany, and growing consumer markets in central and eastern Europe. Traditionally, the United States has dominated the German import leaf market. The loss of U.S. market share for both burley and flue leaf types is related to the decline in demand for high-priced cigarettes, thus high-priced tobacco.

Until 1992, rising flue prices worldwide continued to aid the U.S. competitive position. However, recent declines in flue prices have assisted countries such as Malawi in increasing market share. The current economic recession in Germany is prompting increased demand for low-priced cigarettes. As domestic consumption of cigarettes decline, demand for quality brand cigarettes, which require high-quality raw tobacco, has declined. The demand for low-priced brands, particularly on the east German market, do not require high-quality tobacco.

Growing consumer markets in central and eastern Europe also demand low-priced cigarettes, where low per capita incomes are further constrained by hard currency shortages. Importantly, the growth in leaf use for cigarette production has been geared to the export market, which does not require high-priced and high-quality tobacco. A final factor that affects leaf demand in Germany is cigarette smuggling, which will be discussed later.

Oriental leaf consumption is growing rapidly in Germany, reaching 28,510 tons in 1992, compared with 24,694 tons in 1991 and 18,340 tons in 1990. Most oriental leaf imports come from Turkey and Greece, with increasing amounts from Bulgaria. Oriental leaf is used as a filler, and low-priced, relatively poor-quality leaf suffices. Again, much of the increase in oriental leaf imports is to manufacture low-priced cigarettes for the export market.

Total dark air/sun-cured imports totaled 3,983 tons in 1992. Suppliers included Italy, Brazil, France and Indonesia. Germany does produce small amounts (2,925 tons) of Geudertheimer (dark air/sun-cured) tobacco. Geudertheimer is primarily used as a filler tobacco in cigars and some dark cigarettes and finecut tobacco. German use of this tobacco type increased from 3,876 tons in 1991 to 4,173 in 1992. However, as the demand for light cigarettes continues to grow, the demand for dark and nonfilter cigarettes continues to shrink. Further, as domestic cigar and dark cigarette consumption also continues to decline, the demand for this leaf type is not expected to grow.

Although the German leaf import market is quite large, the market is also quite competitive with leaf buyers and cigarette manufacturers increasingly price-conscious. Because of the competitive pricing structure, the U.S. foremost position in both the flue and the burley markets is beginning to erode. The United States continues to have a reputation for nesting problems and high MH30 residues (a chemical spray for sucker control), although both situations have improved. In addition, styrofoam chips from flue-cured procedures continue to be found in U.S. leaf. Grading problems persist as well; there is no clear separation of different grades, a complaint not just found among German buyers. Given insufficient U.S. price differentials across grades, the situation is not expected to improve soon.

However, nesting and foreign matter problems are more of an issue in the U.S. flue-cured market than in the burley market. German leaf buyers (who buy for both the German and the western European market as a whole) do not think these problems are significant enough to drive buyers away from U.S. tobacco. Until U.S. price differentials reflect quality differentials, growers will not have the incentive to reduce foreign matter and nesting problems. U.S. market share has fallen from about 30 percent to the current 20 percent.

U.S. market share is being challenged by Malawi, Brazil, India, China, and Thailand. The perception among German leaf buyers is that Malawi tobacco quality is improving. It is perceived by leaf buyers that the proportion of top-quality Malawi leaf is growing, although total crop quality has not improved that much. However, multinational cigarette manufacturers are unwilling to change the blends for their western international brands, although they are willing to purchase cheaper leaf for the generic and low-priced brands. Therefore, German cigarette manufacturers require a minimum amount of U.S. high-quality leaf to maintain brand taste and reputation.

Unreliable Malawi production estimates are not problematic for buyers of Malawi burley and flue-cured leaf. In general, German leaf buyers appear satisfied with the Malawi auction system. But, regardless of quality improvements, Malawi is still perceived as one of many producers on the world market. Malawi leaf quality will probably never surpass U.S. leaf quality (due to soil and climatic conditions), and improvements in Malawi quality will only displace sales from South America, Sri Lanka, Italy, and other similar producers. The quality of Brazilian tobacco has improved significantly, although Brazilian prices have also increased. German leaf buyers continue to perceive Zimbabwe as having no significant nesting problems, providing very clean tobacco and utilizing good auction practices.

### 3.1.2 German Cigarette Market

Demand prospects for leaf tobacco exports to Germany are driven by cigarette demand. Although domestic cigarette consumption is on a slight decline, production is up due to increased export demand in eastern European markets. However, as cigarette manufacturing multinationals move into eastern Europe, leaf imports and cigarette exports may very well decline.

German cigarette production reached a record volume of 222.4 billion pieces in 1992, including 92.1 billion pieces for the export market and 130.3 billion for the domestic market. Percentage increases in production for the export market (a 16.7% increase) offset declines in production for domestic consumption (an 8.4% decline). Total cigarette production is expected to fall to 215 billion pieces in 1993 and 1994.

Cigarette exports reached 77.6 billion pieces in 1992, and are expected to reach 85 billion in 1993 and 1994 (not all 1992 production for export was actually exported). The EC had traditionally purchased about 75 percent of German cigarette production (primarily France and Italy), but that proportion has fallen to about two-thirds. New export destinations include Poland, other central and eastern European countries, and the Former States of the Soviet Union.

Most cigarettes produced for the domestic market are produced in Berlin, whereas cigarettes destined for export are produced throughout Germany. However, increasing production costs in Berlin are driving manufacturers out of that city, particularly the decrease in production subsidies for companies manufacturing in Berlin, which will be completely phased out by 1995. However, most multinational cigarette manufacturers have very good facilities in Berlin with good access to the eastern European and FSU markets as well. Consequently, these plants are not expected to close any time soon.

Cigarettes produced in Germany for export to the eastern European market are manufactured with cheap off-shore tobacco and EC tobacco, and a small amount of high-quality imported leaf. German exports to eastern Europe have nearly doubled since borders were opened. But, as eastern European production increases, exports will slow and German manufacturing might be curtailed. Eastern Europe probably will not export to Germany or most of western Europe because the quality will not be sufficiently high for a long time. But, as

German consumption declines and eastern European production capacity increases, the German cigarette manufacturing industry might decline.

German cigarette manufacturers typically use 5 percent German-produced tobacco, 65-70 percent non-U.S. imported tobacco and 25-30 percent imported U.S. tobacco. What Germany imports of U.S. tobacco is essentially an inflexible demand. German manufacturers are intent upon maintaining a high-quality cigarette for the western market. (RJ Reynolds lost market share in Germany, purportedly after they changed their Camel blend.) Generic cigarettes are either imported or produced by very small cigarette manufacturers. Although cigarette consumption is relatively stable, or on a slight decline, composition of cigarette types and sources are changing. Roll-your-own, cigarette rolls and smuggled cigarettes are both affecting the German market.

Cigarette consumption in Germany is difficult to assess due to the increasing amount of black market trade. However, it is agreed that consumption is at least stagnating, if not declining in real terms. Cigarette consumption in Germany is in one of three forms: traditional cigarettes, roll-your-own (RYO) and tobacco rolls. Smokers are also switching the form of cigarette smoked. Both roll-your-own and tobacco roll consumption is up, and manufactured cigarette consumption down. Tobacco rolls are pre-formed rolls of tobacco, which the purchaser simply inserts into a paper sleeve with an attached filter. Germany also has mainstream brands of RYO tobacco. Roll-your-own consumption has declined significantly, as RYO lost market share to tobacco rolls. In addition, smokers have moved to cheaper brands in general.

Of total German cigarette consumption, 40-45 percent is eastern local brands, 40-45 percent western international brands and 10-15 percent low-price international brands. These less expensive international brands such as Western Savings, Pall Mall and Gold American, are new brands that were introduced primarily into the eastern German market after unification. In 1992, Reemtsma lowered the retail price of West and price differentials became very important. RJ Reynolds then introduced low-priced brands to match the rest of the industry. However, only West has been particularly successful, primarily due to heavy advertising.

In general, the increase in the number of young women smoking has substituted for fewer men smoking, resulting in a fairly stable market overall, despite slightly decreasing tobacco incidence in total. Of total cigarette consumption, 60 percent are male and 40 percent female. Smoking has also declined in the higher income strata, while increasing in the east German working class as per capita incomes have increased.

Previously, tobacco rolls were taxed at the finecut tobacco rate (used for RYO), which is approximately half that of manufactured cigarettes. Cigarettes in Germany are taxed at 72 percent of retail price, whereas finecut and rolls are in the 30-35 percent range. Thus, tobacco rolls are simply a tax avoidance tactic. In the second half of 1992 (after the rolls were introduced) and the first four months of 1993, tobacco rolls were extremely successful. However, on March 1, 1993, the German government raised the tax incidence on tobacco rolls to just below that of manufactured cigarettes. Since then, tobacco roll purchases have declined significantly. But, because tobacco rolls are easier to make than RYO and remain cheaper than manufactured cigarettes, the rolls remain popular in recession-riddled Germany.

Brinkman started with the first tobacco rolls, followed by Reemtsma, who produced the "West Quickie." Now almost all manufacturers produce them, including Philip Morris and BAT. Purportedly, the profit margin on tobacco rolls is higher due to pricing, tax incidence and lower production costs. However, with the new tax increase, the profit margin is the same or less than that of manufactured cigarettes. It is anticipated that by 1998, all tobacco rolls will be taxed like cigarettes. All other things held constant, tobacco rolls will continue to decrease in popularity at that point. Generics typically cost 2.85 DM and tobacco rolls (without the tubes) 3.15 DM. Although manufacturers have suggested in their advertising that roll quality is as good as that of pre-manufactured cigarettes, the quality is clearly inferior when using less expensive leaf.

German cigarette manufacturers are interested primarily in selling high-priced cigarettes, and therefore favor specific tax rates. Specific tax rates allow relatively expensive cigarettes to be more price competitive with lower-priced cigarettes. (A more detailed tax argument is outlined in section 7.2.3.) Another tactic used by German cigarette manufacturers to support profit margins is decreasing pack size. As prices have increased (due to increasing taxes and production costs), many generic and western international brands now contain 19 cigarettes.

As Philip Morris increases cigarette production capacity in the Netherlands and eastern Europe, and domestic EC cigarette consumption declines, demand expansion for German-produced cigarettes will be in Scandinavian countries where monopolies exist, albeit these are low population regions. Central and Eastern Europe are becoming strategic locations for most multinational cigarette manufacturing companies, through cooperative or takeover agreements. In eastern Europe, labor costs and property costs are significantly lower, and the education level is very good. In addition, distribution systems are improving. In the long term, these countries will continue to produce their own cigarettes domestically via these newly formed joint ventures and produce international brands. Investments by Philip Morris GmbH and Reemtsma Cigarettenfabriken GmbH in eastern factories are significantly increasing quality and output.

**Cigarette Smuggling**

Illegal cigarette smuggling is of great concern to Germany. In total, an estimated 15-16 billion non-tax paid cigarettes were consumed annually in Germany last year, slightly less than 10 percent of total consumption. This illicit consumption amounted to about DM 1.6 billion in tax revenue loss in 1992 (approximately US$1 billion). Despite increased police activity, smuggling increased about 5 billion pieces over 1991.

Cigarette smuggling typically involves the movement of cigarettes from eastern European countries to Germany or other members of the European Community. Each EC citizen is permitted to legally carry 300 cigarettes across the German border. In addition, large organized smuggling groups are bringing cigarettes through Amsterdam, Antwerp and Hamburg. These professional smuggler gangs use forged documents authorizing inter-EC travel and travel to eastern Europe, primarily between the Polish and Czech border, and eastern Germany. If caught violating travel authorizations, a $50,000 fine is assessed, a small portion of the potential profit from the load of smuggled cigarettes. Given repeated violations by these smuggling gangs, cigarettes and electronics are now exempt from this TRI travel authorization system and any cigarettes confiscated are destroyed. Previously, confiscated cigarettes made their way back onto the black market once again.

Many of the cigarettes that are smuggled into western Europe are international brands that have been manufactured in Germany or elsewhere in the West. Smuggled cigarettes demanded in Germany, Italy, and elsewhere, are typically high-quality American blends such as Philip Morris' Marlboro, and not low-quality cigarettes that are already available on the local market at low prices. It is not unusual for Marlboro cigarettes produced in the United States or Germany to be exported to Poland at low duty-free prices, only to return to east Germany on the black market at below-German retail prices. (Marlboro produced in Poland had been 20 DM cheaper per carton, or 1 DM per pack, than western-produced Marlboro. However, this market has been shrunk to almost nil because the Polish Marlboro is too low quality for the EC market).

Various entities have been blamed for the smuggling, including both the Italian and Russian mafias, as well as the North Vietnamese. In the past, many Vietnamese were brought as migrant workers to east Germany. Once their work permits expired, many Vietnamese carved out their own territory to move goods illegally across the Polish border. Further, east Germans possess a sociocultural system that overlooks the illegality of a black market system. Consequently, any police authority to discourage smuggling must work within a very challenging multicultural environment in which both suppliers and demanders prefer the status quo. Smuggling by the Italian mafias has been stymied by changes in Italian law that make smuggling more risky. Although these legal changes have reduced smuggling into Italy through Albania, much of the trade has been diverted through the Czech and German borders.

To stop the growth of smuggling, smuggling must be made more expensive through fines and the increased risk of being caught. Increased surveillance and efforts at catching the larger-volume culprits is one approach. The length of the German/Polish border has made effective control difficult at best. One of the large cigarette manufacturers is trying to assist east European governments with this problem by educating them about how the west European tax seal system operates. However, any cigarette tax applied in eastern Europe would have to be quite small due to income constraints. Consequently, east European governments may want to continue the access to hard currency that smuggling brings, rather than generate a small amount of tax revenue. Further, it would be difficult to introduce a tax seal system in eastern Europe, where both governments and citizens are unaccustomed to taxes. Further complicating the issue, Poland has created tax-free zones, which only facilitate smuggling.

An additional 7-8 billion pieces also come into Germany legally through neighboring countries due to tax and price differentials. EC travelers can carry "personal use" cigarettes across the border, particularly from Luxembourg where cigarette prices are considerably below German prices. French and Dutch cigarette prices are also low relative to German prices, although increases in tax incidence in both of these countries have narrowed the price differentials. Consequently, in the absence of EC-wide tax harmonization, natural market prices may drive cigarette prices to harmonization.

One of the main outcomes of smuggling is that the high-quality American blends have hurt the generic cigarette manufacturers (which tend to be small independent manufacturers).

Consequently, generic manufacturers are forced to use even cheaper grades of leaf to remain price competitive with the American blends.

### 3.1.3 German Tobacco Policy Changes

In general, german policies toward tobacco are not expected to change in the near future. Pending changes in EC CAP tobacco reform are outlined elsewhere in this report. Given the slowing of EC unification, many German laws continue to affect tobacco.

The German tax on cigarettes was increased 7.7 percent, effective March 1, 1992. At that time, the tax structure was changed from a 40/60 ratio of specific versus proportional tax to a 50/50 ratio. This move sends a signal that harmonization of the EC tobacco tax structure will be extremely difficult. A limitation of 15 mg tar and condensate levels is imposed on cigarettes.

Although the German Parliament supports increased educational programs to better inform the public of the dangers of tobacco consumption, the Parliament is on record as opposed to the EC Parliament Commission proposal to ban all tobacco product advertising in public places. As a move to avoid regulation, the German cigarette industry prefers voluntary restraints. Recently, the domestic cigarette industry has agreed to not hand out free samples nor to advertise near schools. Other voluntary and required restrictions include not using people less than 30 years of age in cigarette advertising, no television advertising, no advertising that portrays smoking as healthy, and cinema advertising is restricted to adult-oriented movies that are shown after 6:00 pm.

The antismoking movement has been more effective in increasing regulation in the past than it has been in actually decreasing consumer smoking. The Minister of Health has also called for a special health levy on tobacco products. Although the levy is not expected to be enacted, health issues in general continue to be of great concern in Germany.

### 3.1.4 Implications for Malawi Tobacco

The German cigarette manufacturing industry is positioned to serve both the western and eastern European markets. The industry is very well-developed, with a considerable amount of capital invested. The outlook for Malawi leaf sales to Germany include:

1. The German cigarette industry relies almost exclusively on large amounts of imported tobacco leaf. Domestic German tobacco production is negligible and leaf imports totaled 206,498 tons in 1992.

2. The U.S. continues to be the largest supplier of burley and flue leaf to the German market. To maintain brand quality, German manufacturers will continue to import U.S. leaf. However, due to the increased demand for low-priced cigarettes, U.S. market share is declining. A further general decline in U.S. leaf exports is expected due to recent legislation which may open market share for other competitors.

3. The increased demand for low-priced cigarettes to serve the east German market and the eastern European export market should continue to attract Malawi leaf sales to Germany in the near term, despite declining domestic consumption. Long term growth will depend on the positioning of multinational cigarette companies as they reposition themselves to serve eastern Europe.

4. Growth in the eastern European cigarette market has been spurred by exposure to international brands via well-organized smuggling routes. Consumption is hampered by income, but the trend is clearly toward lighter cigarettes.

5. Malawi tobacco continues to receive preferential tariff treatment in the EC, enjoys the reputation of good-quality leaf at a competitive price, and has a transportation advantage over other Asian and South American sources.

6. In the short-term, the German cigarette industry will continue to serve eastern Europe through cigarette exports and pre-blend sales. EC tobacco production is expected to decline given CAP reform. Prospects for stable, if not growing, Malawi burley and flue leaf sales to Germany are expected, albeit at lower prices.

## 3.2 Market Developments in the United States

In 1992, the United States was the largest single buyer of Malawi burley, purchasing 27 percent of Malawi's burley exports. Given declining tobacco consumption in the United States, future growth in tobacco imports is dependent on the vigor of the domestic tobacco manufacturing industry and on re-exports from the United States. Although U.S. tobacco manufacturers continue to import large amounts of tobacco, two important factors will affect U.S. purchases. The first factor is recent U.S. legislation that very possibly might restrict Malawi exports to this market. The second factor is related to the first. As imports are restricted, more cigarette manufacture will move offshore, further dampening U.S. demand for imported tobacco.

### 3.2.1 United States Tobacco Overview

Total U.S. tobacco production is expected to decrease slightly in 1993, reaching a projected 733,734 metric tons, compared with 780,825 metric tons produced in 1992. Reduced planting area, 303,799 hectares in 1993 versus 317,572 hectares in 1992, accounts for most of the decline. Consequently, a 4 percent reduction in area planted and lower yields resulted in a 6 percent drop in production.

In 1993, burley production in the United States is expected to be off 13 percent and flue production off 2 percent. Part of the reduction in burley production is due to the 10 percent drop in the burley quota. Disease problems, particularly black shank, have further reduced burley production to an estimated 280,552 tons this year. The United States produces only nominal amounts of dark air/sun-cured, light air-cured and dark fire-cured tobacco, with no reported oriental production.

The second largest consumer of unmanufactured tobacco in the world (second only to China), tobacco consumption in the United States increased to 826,295 metric tons in 1992, a

19 percent increase over 1991. As ending world tobacco stocks continue to climb (posting a seven percent increase in 1992), U.S. reserves actually dropped five percent in 1992. In fact, U.S. ending stocks have been dropping by small amounts since at least 1988.

The United States is a net importer of unmanufactured tobacco, with expected general imports of 335,000 metric tons and imports for consumption of 375,000 metric tons in 1993. Expected exports of unmanufactured tobacco stands at 250,000 metric tons in 1993. However, the tobacco that the U.S. exports is of much superior quality and value compared with imports. Unmanufactured tobacco exports in 1993 are expected to average $6,300 per ton, compared with an expected value of $3,100 per ton for imports for consumption and $3,000 per ton for general imports.

Of the 561,622 tons of cigarette leaf the United States imported (for consumption and general imports), 237,414 tons was Turkish (oriental), 137,441 tons flue-cured, 124,398 tons burley, and 62,369 tons other tobacco. As total unmanufactured leaf imports in 1992 have risen 63 percent from the 1985-1989 average, burley and flue imports registered proportional increases. However, Turkish (oriental) imports increased only 49 percent, and "other" tobacco imports increased 127 percent. Notably, Turkish or oriental imports for consumption increased by 80 percent from 1991 to 1992, while Turkish general imports fell by 30 percent.

In 1992, the United States imported 23,805 tons of tobacco leaf from Malawi, of which 18,858 tons was burley. TEAM reported 16,568 tons of tobacco was exported to the United States, of which 15,105 was burley and 1,453 was flue leaf. Although the United States is an important market to Malawi, Malawi holds only 3 percent of the U.S. import market. Only in the burley market does Malawi hold a significant market share (15%).

In general, the United States imports lower quality tobacco to blend with higher quality domestic leaf for cigarette manufacture. As domestic consumption continues to decline, an increasing percentage of tobacco manufactured in the United States is headed overseas, primarily in the form of cigarettes. Thus far in 1993, cigarette production is up 2 percent in quantity and only slightly in value over 1992 as more manufacturing is moved overseas.

Thus far in 1993, both general imports and imports for consumption are well above 1992 monthly figures. In terms of metric tons, the first four months of 1993 report imports for consumption nearly doubled and general imports up 37 percent from last year. In terms of value, imports for consumption are up 83 percent and general imports up 17 percent from 1992. Again, lower world prices and higher quality have made foreign leaf more competitive with domestic grown leaf in the United States. Domestic leaf prices in 1994 are expected to be above 1993 auction prices due to greater use of domestic tobacco in cigarette manufacture, despite larger world supplies of imported leaf.

During the first nine months of the 1993 fiscal year, total duty-paid imports of unmanufactured tobacco were up 115 percent and oriental imports up 130 percent. To stem the sharp rise in imports the United States has recently enacted legislation to dampen import growth, which is further detailed below.

### 3.2.2 United States Cigarette Market

As U.S. cigarette consumption continues to decline in 1993 for the tenth straight year, cigarette exports continue to reach new records. Higher cigarette exports are expected to more than offset declines in domestic consumption, culminating in a 5 percent increase in cigarette production for the year ending June 30, 1993. Both cigarettes and cigars designed for the domestic and export markets rely on imported tobacco.

The United States is one of the largest cigarette manufacturers in the world, second only to the Peoples Republic of China. Cigarette production has consistently lingered around the 700 billion stick mark. After increasing 3.5 percent in 1992, cigarette manufacture is expected to reach 720 billion pieces in 1993, a slight increase from the previous year.

However, in 1992, U.S. stocks of imported cigarette tobaccos were at a five-year high. By April 1, 1993, U.S. stocks of imported tobacco for cigarettes and smoking tobacco stood at 406,000 tons, 9 percent above the previous year. With regard to specific types, burley import reserves increased 27 percent and flue stocks 26 percent, while imported oriental stocks fell 9 percent.

For the year ending June 30, 1992, U.S.-produced cigarettes contained about 37 percent imported tobacco; in 1991, this figure stood at 30 percent. For the same 1992 fiscal year, cigars and loose leaf chew contained about 74 percent imported tobacco, also up slightly. For 1989-91, U.S.-produced cigarettes used, on average, 37 percent flue-cured, 29 percent burley, 14 percent oriental, 2 percent Maryland and 18 percent other imported tobacco. From 1981 to 1991, U.S. cigarette manufacturers used an average of 24 percent imported tobacco. It is important to note that imported tobacco usage in the United States varies by tobacco type. The 25 percent off-shore limit in the new import legislation discussed below applies to all tobacco, including burley, flue, dark and oriental types.

The duty on most cigarette imports (for stemmed leaf) is 20 cents per pound. Since July 1, 1992, oriental leaf imports from Turkey and select other countries enter the United States duty-free under the Generalized System of Preferences. The duty on oriental leaf from Greece and Bulgaria remains at 11.5 cents per pound. However, despite these duties, manufacturers can receive "drawback" provisions that effectively lower import duties when imports are offset by exports of similar types of tobacco, whether it be in leaf or manufactured form.

### 3.2.3 United States Tobacco Policy Changes

In addition to the usual myriad of health issues and legal suits involving the tobacco industry, the U.S. government recently passed tobacco import measures which, not surprisingly, have proven very controversial. This sub-section will focus on that legislation and how it will impact U.S. tobacco trade.

#### Background Information Regarding the Legislation

On August 6, 1993, the United States passed legislation, via an amendment to the Omnibus Budget Reconciliation Act, that will restrict tobacco imports. Most important, the amount of off-shore tobacco used in all domestic cigarette manufacture will essentially be limited to 25 percent. The final version of the amendment was a compromise between a two-tier plan that would have set two different imported leaf usage levels for cigarettes produced for the domestic market versus the export market. It is important to understand the posture of the U.S. tobacco industry at the time this law was passed.

A strong impetus for this legislation was the sharp increase in tobacco leaf imports last year. In 1992, U.S. tobacco companies imported 209,500 tons of tobacco, up from 116,900 tons from the previous year. Low world leaf prices, compared with relatively high domestic prices, resulted in U.S. tobacco companies increasing their purchases of imported leaf. Due to the current large reserves of imported tobacco, more imported tobacco is expected to be used in domestic U.S. manufacturing and tobacco imports are expected to drop.

The increase in off-shore tobacco in U.S. cigarette manufacturing is two-fold. Again, declining domestic cigarette consumption has provided further impetus for manufacturers to export cigarettes abroad. These exports typically require a lower quality leaf. Second, the generic cigarette market currently holds about one-third of the U.S. market. It is believed that many of these generics are made of more than 75 percent off-shore leaf. Given the rate of increase in leaf imports, the U.S. tobacco industry was anticipating lower 1993 prices, more crop going into pool and reduced quota levels for 1994.

At the same time, concerns were expressed regarding cigarette output levels at ten-year highs, despite back-to-back burley quota reductions. The Tobacco Improvement Act of 1985 was designed to improve U.S. competitiveness abroad, while the Farm Poundage Quota Revisions Act of 1990 was implemented to reduce U.S. dependence on off-shore tobacco. Despite these rather successful policy attempts to curb tobacco imports, burley leaf imports were up 45 percent in 1992, and 69 percent in the first half of 1993. (It is important to note that much of the increase was in stems, accounting for only 2 percent import volume in 1991, compared to 26 percent of total burley imports in 1992.)

The tobacco industry used the Budget Reconciliation Act as the vehicle to reduce leaf imports and, hopefully, minimize future cigarette excise increases. In order to pass the Budget Reconciliation Act, votes were obtained by the tobacco senators in exchange for the import legislation. The primary goal of the Budget Reconciliation Act is to reduce the U.S. federal deficit. The tobacco provisions of the bill will reduce the deficit by $29 million over the next five years. At the same time, the Clinton Administration is in the process of enacting health reform which purportedly will be paid for by "sin taxes"; that is, with tax increases on tobacco and possibly alcohol products that are more politically palatable. Initial discussions have suggested a two dollar per cigarette pack excise tax, although current estimates are in the 75 cent range.

**Section 1106**

Section 1106 of the Budget Reconciliation Act of 1993 (PL-103-66) includes the following provisions. This legislation is to take effect January 1, 1994.

1. Require domestic manufacturers of cigarettes to certify annually the percentage of tobacco grown in the U.S. that is included in all tobacco used to manufacture cigarettes.

2. Impose a marketing assessment on domestic manufacturers for each pound of imported tobacco used in excess of 25 percent of all tobacco used to manufacture cigarettes. The amount of the assessment would be equal to the difference between the average U.S. burley and flue-cured market price from the preceding year and the average import price of unmanufactured leaf from the preceding year.

3. Require domestic manufacturers to purchase one pound from the burley tobacco pool and one pound from the flue-cured tobacco pool for every two pounds of imported tobacco used in excess of 25 percent of all tobacco used to manufacture cigarettes. Penalties for noncompliance and exceptions for pool stocks falling below set reserve stock levels are specified.

4. Extend the current budget deficit assessment and the current no-net-cost assessment on U.S. burley and flue-cured tobacco to imported burley and flue-cured tobacco.

5. Require importers of tobacco to pay inspection and grading fees comparable to those fees paid by U.S. tobacco buyers.

6. Extend for three years the 10 percent maximum annual reduction requirement for burley and flue-cured quotas for the 1994, 1995, and 1996 crop years. However, the Secretary of Agriculture can waive this requirement for either leaf type in 1995 and 1996 if pool stocks exceed 150 percent of the reserve stock level.

7. Require that future imported cigarettes in excess of the number of cigarettes imported today be subject to a tobacco equity assessment similar to the domestic marketing assessment for each pound of tobacco grown other than in the United States contained in such cigarettes in excess of 25 percent of all tobacco contained in such cigarettes.

8. Provide the Secretary of Agriculture with sufficient authority to require adequate documentation and enforce the new provisions.

9. Allow a referendum to be conducted in Virginia on cross-county leasing of burley tobacco quotas to adjacent counties within that state.

Consequently, despite the price differential between domestic and imported tobaccos, the new legislation will price much imported tobacco out of the U.S. market, based on the assessments alone. The import assessment will basically make imported leaf, which is usually of poorer quality, as costly as U.S. produced leaf. Although early accounts of U.S. auction prices are just now being reported, the 1993 price support for flue-cured tobacco is $1.577 per pound and $1.683 for burley.

As a result of this legislation, importers will be charged a penny-a-pound assessment (already charged on domestic production), which will go toward reducing the U.S. federal deficit. No-net-cost tobacco assessments vary by type. The marketing assessment for the 1993 burley crop is 1.683 cents per pound. To qualify for price-support programs, assessments on Virginia fire-cured are 11.3025 cents per pound and 11.3835 cents per pound for sun-cured tobacco, in addition to the 1.395 and 1.233 cents per pound, respectively, marketing assessment. Marketing assessments are shared equally between producers and purchasers.

**Implications for the U.S. Leaf Market**

Using the 1992 average of 37 percent imported leaf used in U.S.-produced cigarettes, typically 13 to 15 percent leaf usage is imported oriental and 25 to 27 percent imported flue and burley leaf. To reduce the amount of imported leaf used in cigarette manufacturing to 25 percent, many industry experts believe that most of the reduction will come in the flue and burley import market. Oriental leaf is used primarily as a low-quality filler. Given that the United States does not produce any oriental leaf, even if oriental leaf imports were reduced slightly, burley and flue imports would have to drop to 10 to 12 percent of the leaf used in domestically produced cigarettes. Those reductions could come out of reserve stocks, through import cutbacks or both.

As a result of the legislation, U.S. burley and flue exports are expected to decline. Burley imports alone are expected to fall by over 45,000 tons. Further, burley and flue import prices are also expected to fall in the Unites States. Assuming that the U.S. continues to produce approximately 700 billion cigarettes after the legislation goes into effect, imported tobacco is expected to fall to around 155,000 tons (if manufacturers stay within the 25 percent import limitation). Using similar leaf usage proportions as before, imported burley leaf used in cigarettes will stand at 30,845 tons, flue at 28,577 tons and oriental at 95,256 tons. If oriental usage drops below 15 percent, less oriental and more burley and flue leaf will be imported.

Increases in domestic leaf usage will increase cigarette leaf costs. To offset these increases in production costs, cigarette manufacturers may turn to other alternatives of lowering leaf content. The use of filters, domestic stems, reductions in cigarette circumference, and new leaf expansion processes could reduce the volume of leaf per cigarette.

Analysts estimate that the U.S. generic cigarette industry utilizes approximately 70 to 80 percent off-shore tobacco. It will be very difficult for generic cigarette manufacturers to meet the 25 percent import restriction, thereby damaging their low-cost production capacity. The import legislation is expected to be devastating to the U.S. generic industry and will force generic manufacturers to utilize even cheaper tobacco to remain price competitive. To further edge out generic cigarettes, Philip Morris launched a price war in 1993, reducing prices on many of it's premium brands such as Marlboro. If the generic cigarette market collapses, there will be some opportunity to increase cigarette retail prices, which is favorable for companies such as Philip Morris that have engaged in retail price wars to regain market share lost to the generic manufacturers.

Further, cigarette manufacturers in the United States that utilize a large portion of imported tobacco will obviously be hurt as well. It is estimated that domestic U.S. cigarette production by Philip Morris and Lorillard already meets the 25 percent quota, whereas RJ Reynolds probably utilizes a slightly larger proportion of imported leaf. Other manufacturers, with less extensive operations overseas such as Ligget & Meyers, will probably be hurt the most by this legislation to restrict imports.

It will be very difficult politically for these companies to exceed the 25 percent barrier, in addition to not making economic sense. Although the penalties are severe for exceeding the 25 percent maximum, certain manufacturers may choose to exceed this quota in order to maintain market share (such as the generic manufacturers and the smaller cigarette producers which use a higher import average). It is possible that U.S. cigarette manufacturers will exceed the 25 percent barrier as a short term strategy to retain market share during a re-adjustment period. It may also be politically viable to exceed the maximum in the name of saving jobs, retaining production levels, and reducing off-shore carry-over stocks. In addition, the larger cigarette manufacturers, such as Philip Morris with tremendous production capacity already overseas, can easily meet the 25 percent import maximum and will continue their public support of the legislation.

U.S. opponents argue that the legislation will drive manufacturers out of the U.S. market. Generally, the larger U.S. multinationals have already moved a considerable amount of their production off-shore and their domestic facilities continue to serve the domestic market, which requires a large amount of high-quality American tobacco. However, U.S. cigarette manufacturers are expected to increase existing plant production off-shore and perhaps add new plants. Not surprising, Philip Morris, which has already greatly expanded its cigarette manufacturing facilities overseas, is in favor of the legislation. However, other U.S. tobacco manufacturers were adamantly opposed to the amendment. RJ Reynolds has already noted that this legislation will force them to move more tobacco manufacturing overseas.

As a result of these retail price reductions (i.e., wars) and narrowing profit margins, RJ Reynolds Tobacco Co. announced September 14, 1993 that it would cut nine percent of it's staff or 1,000 tobacco-company jobs. The $2.5 billion RJR marketing budget is also expected to be cut in the near term. Tobacco industry analysts claim that these cuts are overdue and necessary to remain competitive. In parallel, Philip Morris claims it has also cut personnel and costs by 11 percent over the last two years. This downsizing of the U.S. cigarette industry is expected in the wake of a more competitive environment, spurred by the generic market, declining consumption and increasing concerns over damaging litigation.

When 1993 flue markets first opened in the United States, in the first week only one to two percent of the leaf offered went to stabilization reserves. However, the very next week 25 percent went to the pool, (although quality of leaf offered also declined significantly in subsequent weeks). Many leaf buyers believe that U.S. cigarette manufacturers are busy re-calculating just how much leaf they will need to buy off the domestic market, and that these calculations may be changing their perceived needs. Currently, U.S. cigarette manufacturers are producing as many cigarettes as possible with as high of imported leaf content as possible. Thus, cigarette production may slow in the next calendar year, slowing leaf imports even further, possibly with the hopes that the legislation will be appealed or mitigated in the least.

Leaf buyers generally see the U.S. leaf market in a state of decline. Most tobacco experts anticipate higher taxation on U.S. cigarettes due in part to health reform, declining consumption and declining leaf production due to an aging farm workforce. In addition, lower labor costs of manufacturing elsewhere will accelerate the declining U.S. share of the world leaf market in the long term. In response to the import legislation, there may be less U.S. leaf on the world market in the short term. It is believed that Malawi, Zimbabwe, and Brazilian leaf will be able to increasingly compete with U.S. leaf on world markets, as the trend will be against U.S. supplied leaf.

**Implications for the World Leaf Market**

Implications of the new U.S. import restrictions for the world tobacco market are obviously difficult to assess. In general, world leaf buyers anticipate a slightly larger supply of non-U.S. of burley and flue leaf on the world market. It is anticipated that both U.S. burley and flue exports and imports will decline next year as manufacturers buy a greater proportion of the domestic crop. Given that excess world production and stocks are already placing downward pressure on prices, the U.S. legislation will only provide additional downward pressure on world leaf prices. The world market for Malawi burley and flue leaf is expected only to become more price competitive.

During the formulation of this amendment, there was considerable opposition from U.S. importers and world suppliers of tobacco. Reports are that 13 tobacco-producing countries complained to the United States about this legislation, including India, Malawi, Zimbabwe and countries of Central and South America. World tobacco exporting countries are very concerned about the possibility of restricted exports to the United States. However, the official U.S. stance is that most tobacco-exporting countries have more restrictive tobacco import policies than the United States. Consequently, although the United States does not want to engage in trade confrontation, they are not inclined to change their position.

The European Community is angry over the legislation to reduce tobacco leaf imports. The EC expects to lose exports, particularly oriental and low-quality leaf, to the United States. Italian and Greek producers are particularly angry, as they produce large amounts of low-quality, inexpensive tobacco for the U.S. market. Given that oriental use could fall as low as 10 percent, very inexpensive oriental sources will be needed. Most likely, Turkey and Greek oriental sales will decline and cheap Syrian and Thai oriental leaf might gain. Some medium-quality burley and Virginia (flue) leaf exports will also be cut. Excess quantities, for example, from Brazil, Zimbabwe and Malawi could end up on the world market, which will further lower world prices.

The U.S. legislation has come at a particularly bad time because world leaf markets already have a tremendous oversupply of leaf. Adding to this oversupply is China, with a tremendous flue-crop expected this year of approximately 3,300 million tons. It is assumed that China will be trying to dump this excess production on world markets at ridiculously low prices. However, due to underproduction of leaf in eastern Europe and the FSU, some of this inexpensive leaf will be absorbed by Russia and the CSIS.

Of critical importance to world leaf buyers is continued access to high-quality U.S. leaf that is essential to retain blend quality. If U.S. manufacturers are forced to purchase more U.S. leaf, domestic leaf prices might increase, depending on leaf taken out of reserve and quota announcements in the near term.

Malawi continues to have the reputation for one of the highest filling capacity burley in the world. This alone should prove to be a tremendous advantage for Malawi to retain it's competitive position in the U.S. burley import market. But, leaf buyers expect Brazilian, Zimbabwe and Malawi sales to be off some this year.

### 3.2.4 Implications for Malawi Tobacco

1. U.S. cigarette consumption continues to decline. The anticipated cigarette excise tax increase, to fund health reform, will accelerate this decline, particularly among young smokers who are more sensitive to price increases. U.S. tobacco production has stabilized, with declining production foreseen in years ahead.

2. U.S. cigarette manufacturing will continue to move overseas, accelerated by the new import legislation. However, significant investment exists in the U.S. market, which will go a long way in offsetting any other advantages of moving cigarette manufacture offshore, such as lower labor and leaf costs.

3. As a result of the import restrictions, burley imports are expected to decline over 45,000 tons. Assuming leaf composition remains the same, 1994 off-shore burley usage should be approximately 30,845 tons, flue 28,577 tons and oriental 95,256 tons. Depending on the ability of manufacturers to reduce the oriental proportion, flue and burley imports could be slightly higher, at the expense of lower oriental imports.

4. Increasing domestic leaf costs will force U.S. manufacturers to be extremely cost-conscious, lower leaf import prices, and provide incentives for lowering leaf content per cigarette.

5. Malawi's reputation for filling capacity and high U.S. cigarette manufacturer's specifications will keep Malawi burley in the U.S. market, although prices might be lower than last year. Thus, if Malawi burley leaf quality remains high and production sufficient, exports to the United States will decline only slightly.

## 3.3 Market Developments in Japan

Japan is Malawi's third largest leaf export market in terms of volume and second largest in terms of value. In 1992, Malawi exported a total of 14,302 tons of leaf to Japan, comprised of 11,245 tons of burley and 3,057 tons of flue leaf. Due to insufficient Japanese tobacco production, more high-quality tobacco leaf goes to Japan than to the United States. Given the terms of reference for this project, the Japanese section of this report is brief and not complemented by industry interviews as all other sections.

### 3.3.1 Japanese Tobacco Overview

As a result of favorable weather conditions and higher yields, Japanese tobacco production is expected to reach 71,380 dry weight production, a 13.5 percent increase over 1991 figures. Although 1993 authorized planting area was slightly increased, production is expected to fall closer to 70,200 tons dry weight production. Approximately 67 percent of Japanese tobacco production is flue, 30 percent burley and 3 percent native types. Native leaf frequently brings a relatively higher price due to its filling capacity.

Leaf imports have continually increased from 84,000 tons in 1991 to 114,000 tons in 1992 and an expected 119,000 tons for 1993. Generally, Japanese leaf imports are 50 percent flue, 40 percent burley and 10 percent oriental. Leaf exports are essentially non-existent.

Including domestic production, total leaf consumption has also been increasing and is expected to reach 175,500 tons in 1993. Ending stocks are typically quite large, estimated at 387,753 tons for end of year. But, this years domestic production is expected to replace depleting inventories in cure, so imports are expected to remain strong.

The United States continues to dominate the leaf import market with a fifty percent market share in terms of value and 30 percent in terms of value. Malawi is the next largest supplier with 13 percent of the import market. Turkey, Greece and Brazil are other top leaf suppliers. The price differential between U.S. and other countries, particularly Brazil, is continuing to close (currently about $3 per kg for burley and $2 per kg for flue). However, the lower leaf prices continue to be attractive and future import growth is expected to go to non-U.S. countries. In order to keep cigarette production costs down to compete with imported international brands, U.S. burley content will be minimized, and high-quality burley from other sources substituted. Thus, burley imports will remain strong, with Brazil and Zimbabwe the main beneficiaries.

Malawi continues to be an important supplier of flue leaf to the Japanese market. In 1992, Malawi supplied 1,004 tons non-stripped flue and 8,852 stripped flue to the market, representing a 4 percent and 22 percent market share, respectively. In the stripped market, Malawi leaf is moderately priced at 685 yen per kg CIF, compared with 973 for the U.S., 733 for Brazil, 605 for Thailand and 596 for Zimbabwe. Previously, China has had a very small market share. However, with leaf priced at 362 yen per kg and a tremendous 1993 flue crop, China may try to dump flue on the Japanese market this year at even lower prices.

### 3.3.2 The Japanese Cigarette Market

Japan is the third largest cigarette manufacturer in the world, after China and the United States. In 1993, Japanese cigarette production is expected to reach 294.6 billion pieces, down slightly from 1992, but well over production rates of the 1980s. Japanese-produced cigarettes typically contain 41 percent domestic leaf, with the remainder imported, although domestic leaf content is slowly declining as cigarette production has continued to increase faster than leaf production. Just a few years ago, domestic leaf content of Japanese-produced cigarettes was 80 percent.

Japanese cigarette imports have slowly increased to 58 billion pieces or about 16 percent of total supply. The U.S. controls 95 percent of the cigarette import market. Cigarette exports have also slowly increased to an expected 15 billion pieces in 1993. Major cigarette export destinations include Hong Kong, the United Arab Emirates, Korea and Singapore. Domestic cigarette consumption has continued to grow and is predicted to reach 337.6 billion pieces this year. However, anti-smoking campaigns are growing and declines in domestic consumption are predicted to off-set expected export increases.

Currently, there are about 33.5 million smokers in Japan; 60 percent of the men and 13.3 percent of the women smoke. About 36 percent of the Japanese population smokes cigarettes. Average cigarette consumption is 24.4 pieces per day for men, compared with 17.2 pieces per day for women, for a 23.2 average daily consumption. Notably, it is not uncommon for Japanese smokers to vary consumption across 5 or more brands, as "trying something new" replaces brand loyalty.

### 3.3.3 Japanese Tobacco Policy Changes

Instead of a price support program for tobacco, Japan Tobacco (JTI) guarantees farm income through setting prices for various grades of leaf. Production policy is negotiated by JTI and the Tobacco Production Deliberation Council, an advisory group of farmer representatives and academics.In recent years, JTI has successfully encouraged farmers to increase burley plantings at the expense of reduced native leaf production.

In 1985 Japan opened the domestic market to increased leaf and cigarette imports. As cigarette import tariffs were reduced, foreign competition became quite fierce. Since then, JTI has become more market-oriented and has stabilized market share.

JTI plans on increasing cigarette exports to 20 billion pieces. Domestic factories are expected to run at full capacity to offset increasing cigarette imports. JTI is also trying to diversify its business portfolio and has recently launched a printing concern in cooperation with Morinaga Confectionery Co. and Mitsubishi Corporation.

### 3.3.4 Implications for Malawi Tobacco

1. Japanese leaf production will continue to slowly decline as the farm workforce ages.

2. Japan will continue to import large amounts of flue, burley and some oriental leaf.

3. As leaf costs continue to be of importance, U.S. import share will continue to erode and third-country sources will increase market share.

4. Short term opportunities for Malawi leaf exports to Japan are promising.

5. Long term opportunities for Malawi leaf exports to Japan depend to a large extent on how aggressively China pursues the leaf export market.

## 3.4 Market Developments in the Netherlands

The Netherlands is Malawi's fourth largest tobacco export market in both value and volume. A total of 12,763 tons, worth $35.6 million dollars was shipped to the Netherlands in 1992. Importantly, the Netherlands is Malawi's largest dark fire-cured market, purchasing 40 percent of Malawi's crop last year. The Netherlands is also a significant burley and flue market for Malawi.

The Netherlands is one of western Europe's most important tobacco markets, particularly with respect to the cigarette industry. The health of the Dutch cigarette industry is crucial in determining demand prospects for Malawi tobacco. Three important trends in the Netherlands are affecting the demand for Malawi tobacco; declining domestic consumption, stagnant export sales and the expansion of the Philip Morris cigarette manufacturing plant. The increase in domestic cigarette prices and subsequent decline in domestic consumption, combined with a stagnant cigarette export market, has resulted in declining production and profits for the cigarette industry. However, the expansion of the Philip Morris cigarette facility is expected to increase demand for leaf imports to fuel Dutch cigarette exports in the near term. With specific regard to the dark-fire market, significant opportunities exist for Malawi leaf, if Malawi can sustain domestic production.

### 3.4.1 Dutch Tobacco Overview

Cigarette production in the Netherlands relies heavily on the leaf import market, as domestic tobacco production is non-existent. After reaching a record high in 1991, total raw tobacco imports fell to 92,545 tons in 1992, a decline of 6.5 percent. Again, declining domestic cigarette consumption is responsible. Dutch tobacco consumption is expected to decline again in 1993, falling from 88,236 tons in 1991, to 86,924 in 1992 and an expected 86,600 tons this year. Beginning stocks have also been declining in recent years, and are expected to total 64,955 tons in 1993.

Of the total 92,545 tons of unmanufactured leaf the Netherlands imported in 1992, other EC countries held a 22.7 percent market share (primarily from Italy) and the United States held a 19.8 percent share. Malawi's import share was seven percent. The Netherlands also serves as a re-export center for unmanufactured tobacco, exporting 12,078 tons in 1992. Re-exports were nearly divided between flue and dark air sales.

Dutch leaf buyers show a strong preference for U.S. tobacco, yet are concerned about increasing price. Although U.S. flue tobacco is in demand for flavor, burley for smoothness and Kentucky dark fire-cured for roll-your-own or shag tobacco, U.S. prices are well above international prices. Although U.S. import market share increased one percentage point last year, Dutch leaf buyers are continuing to source high quality, yet reasonably priced, leaf from Africa and Brazil.

Despite annual fluctuations, flue retains the largest share of the tobacco import market at 45,171 tons (49% of the total) in 1992. Large amounts of burley, (16,501 tons) and dark fire-cured (13,866 tons) are also imported. Oriental and dark air imports totaled 8,966 and 6,928 tons, respectively, in 1992. Both burley and dark fire-cured have shown increases in imports in recent years, while import demand for dark air and oriental has declined.

Dark fire-cured leaf is Malawi's most important tobacco export to the Netherlands. The United States is Malawi's biggest competitor in this market, holding 28 percent market share compared to Malawi's 19 percent market share. Other EC countries, primarily Italy, and Indonesia are also important suppliers. In general, EC has lost market share as Malawi, Indonesia and Tanzania have gained.

Dark fire-cured imports, essential for shag tobacco, are expected to stabilize or decline slightly to 12,600 tons in 1993. Dutch buyers would like to increase their U.S. purchases, and are encouraged that the U.S. quota was increased 7.5 percent in 1993. If the United States is unable to effectively increase production, Dutch buyers will primarily rely on increasing production in Malawi and Tanzania, with additional purchases from Uganda, Italy, and Indonesia. But, the quality of Italian dark fire-cured production is declining as the younger farmers do not want the trouble of curing the leaf due to the dirty and primitive work. Even if EC premiums for dark fire-cured leaf are increased, Italian dark leaf production is not expected to increase.

Particularly problematic for the dark fire-cure leaf users is the relatively small amount of world-wide production. Small changes in production result in dramatic price changes. With respect to Malawi, production estimates of dark fire-cure leaf are substantially off what actual sales are in a given year. The sentiment among leaf buyers is that Malawi is too unstable politically and that supply might stop altogether. Transportation from Malawi is also questionable in that it can be disrupted. Malawi depends on other countries to get leaf out (the same concern was cited for Tanzania). An unstable political environment and infrastructure conditions make Malawi leaf less reliable.

According to the largest dark fire-cured leaf user in the Netherlands, there is tremendous variation in Malawi fire-cured supplies. In 1987, dark fire-cured leaf was 11 million kilos, down to 5.8 million kilos in 1989, up to 23 million kilos in 1991 and is expected to be less than 4 million kilos in 1993 (or, less than 4,000 tons). Originally, ADMARC first gave a dark fire-cured estimate of 12 million kilos, then cut the estimate to 10, then to 8, and finally expect production to reach only 4 million kilos. Reportedly, leaf dealers are also poor at estimating crop size. Although leaf users understand the difficulties in estimating crop size, the smaller the crop the more problematic incorrect estimates are and the greater the price swings.

Due to the unreliable supply of dark fire-cured leaf from countries such as Malawi, Zimbabwe, Brazil, and Italy, leaf buyers are increasingly relying on U.S. leaf production. Other countries such as Uganda also have a small dark fire-cured crop, but their supply (under BAT management) is much more reliable. In general, the buyer mentioned above purchases a minimum amount of dark fire-cured leaf off the U.S. market due to price, and then goes to other sources to fulfill their needs. In the U.S. market, dark fire-cure leaf buyers can purchase directly from the buyer, also known as country buying. Although this is one way to secure supplies, prices are usually greater than what they are at auction. In times of a tight crop, this may be the only way to secure supplies. Complaints against U.S. leaf are aimed at the auction system, but the superior climate, soil and handling give U.S. dark fire-cured leaf the best flavor. After U.S. dark fire-cured leaf, Malawi and Italian leaf are rated second. The quality of U.S. tobacco is only one factor which makes it superior to Malawi leaf. Leaf buyers also cite handling, grading and presentation advantages of U.S. leaf.

Price changes for dark fire-cured leaf are particularly troublesome for RYO manufacturers. Cigarette manufacturers have more leeway in altering blends due to raw leaf costs. RYO manufacturers must maintain minimum dark fire-cure leaf proportions to retain flavor characteristics. In RYO production, leaf costs are proportionately higher than for manufactured cigarettes, so increasing leaf costs are of greater importance. Currently, the U.S. leaf market provides the greatest amount of price and supply stability. Further, all major leaf buyers sell in U.S. dollars, thus leaf prices around the world are traded in relation to the dollar. In addition to dark fire-cure purchases, shag or roll-your-own tobacco manufacturers frequently buy flue and burley leaf from Zimbabwe.

Burley tobacco is Malawi's second largest export to the Netherlands. Burley imports increased in 1992 to replenish low stocks, but 1993 imports are expected to return to the 14,500 ton range. The United States is Malawi's main competitor in this market sector, with 40 percent of the market compared to 11 percent for Malawi. Importantly, U.S. market share has increased from 31.4 percent in 1991. Italy and Belgium/Luxembourg are also important suppliers. Dutch leaf buyers are less willing to hold large inventories of burley leaf due to the availability of high quality leaf, and are pursuing a just-in-time delivery policy.

Nearly half of Dutch tobacco imports are flue tobacco. Of the total unmanufactured flue-cured leaf imports, 20 percent is supplied by the United States. Brazil and Zimbabwe are also important suppliers, holding 13 and 11 percent of the market respectively. Malawi holds a five percent market share. After a decline in total flue imports in 1992, imports are expected to increase to 48,500 tons in 1993.

In general, Dutch cigarette manufacturers have not seen an appreciable narrowing of the quality difference between U.S. and non-U.S. tobacco. Brazil had improved quality, but improvements have slowed. Most countries continue to focus on volume and not on quality. The United States continues to have the ideal soil and climate to produce top-quality leaf. However, leaf handling and presentation in the United States continues to be a problem for some leaf buyers. Some leaf buyers claim that Malawi, Zimbabwe and Brazil are better handlers and presenters, particularly for buyers with a preference toward hand-tied bundles rather than bales, although other leaf buyers dispute this assessment and claim the United States remains superior in all respects. Nesting is a problem in all countries. Domestic flue production in Zimbabwe and Brazil appears abundant and of good quality.

This year appears to be a buyers market in the Netherlands with sufficient flue leaf available at reasonable prices. Flue imports are expected to increase as Philip Morris increases its production capacity and ending stocks are very low. Assuming stable U.S. production, Zimbabwe and Brazil appear to be Malawi's competition in the near future.

In the Netherlands there is very little opportunity for direct promotion or marketing activities. Only one cigarette manufacturer (Rothmans) and the shag tobacco manufacturers (basically reduced to two after recent mergers) make their purchasing decisions locally. In general, the Dutch believe that export servicing activities are only effective in the exporting country, where large buyers are present locally. Many Dutch tobacco experts are concerned about the increasing concentration of packers and leaf dealers worldwide.

### 3.4.2 The Dutch Cigarette Market

The Dutch cigarette industry had a difficult year as cigarette price increases dampened domestic consumption and exports remained stagnant. Increased smoking and health activities and saturated markets further slowed domestic tobacco use. In 1992, 42 percent of the adult population smoked.

Total Dutch cigarette production is expected to increase to 82 billion pieces, a slight increase over 1992 figures, but a six percent decline from 1991. Most of the actual drop has been in filter production, but proportionally non-filter production has declined more. In addition, imports have increased to 18 billion pieces, a 32 percent increase over 1991. Consequently, total supply has remained essentially constant over the last three years as declines in production have been offset by import increases. In general, generic cigarette consumption is not growing in the Netherlands.

According to USDA/FAS figures, total exports and consumption have remained fairly constant over the last three years, at 75 and 25 billion pieces, respectively. However, using tax seal data from the Dutch Cigarette Manufacturers Association, domestic cigarette sales fell from 16,073 million pieces in 1991 to 15,743 million pieces in 1992, a 2 percent drop. (The latter statistics are adjusted for border sales and anticipation purchases.)

A tax increase boosted cigarette prices Jan. 1, 1993. In the last two years, cigarette prices in the Netherlands have risen 26.4 percent. Advance notification of the price hike hoisted cigarette sales in the last quarter of 1992, causing upward distortion on reported cigarette consumption. Thus, the lower Dutch Cigarette Manufacturers Association figures.

The export market has become increasingly important to the Dutch cigarette industry. Exports, as a proportion of domestic production, have increased from 92 percent in 1989, to 85.9 percent in 1990 and 87.9 percent in 1991. In 1992, approximately 94 percent of Dutch cigarette production was exported, and this proportion is expected to increase further in the next three to four years due to production expansion. Most cigarette exports are to Italy and France, and much of the 3.3 percent decline in 1992 exports was attributed to decreased sales to Italy. In September 1992, Italy closed her borders to Dutch produced Marlboro cigarettes due to reported smuggling. In general, western Europe has experienced large scale smuggling of American blend cigarettes from eastern Europe.

The tendency in the Dutch cigarette industry is to use more American tobaccos, with more pronounced blends and less fillers. The industry is looking for stronger burley, flue-cured and oriental leaf sources to meet changing tastes and preferences. Simultaneously, the trend is toward low-tar cigarettes, which reinforces the need for stronger, more pronounced blends. To lower tar content, manufacturers must make the cigarette more airy. To reduce tar (a condensate), the manufacturer must make the cigarette burn differently, which usually ends up as a higher nicotine content. In 1997, when the 12 mg. tar maximum rule takes effect, cigarette manufacturers will need even more pronounced, stronger taste U.S. burley, flue and dark fire-cured tobacco leaf.

Both the Netherlands and Norway are big roll-your-own populations, with about half Dutch and Norwegian cigarette consumption RYO. Although consumption has declined in recent years due to health and excise reasons, consumption is expected to recover. Shag or RYO tobacco requires a significant amount of dark fire-cured tobacco. Douwe Egberts holds approximately 65 percent of the Dutch shag market, with Niemeyer and a few smaller manufacturers controlling the remainder. Douwe Egberts has four packing facilities in the Netherlands and one in Ireland (which is responsible for exports to the EFTA countries). About half of Douwe Egberts production is exported.

Shag companies do have some flexibility when it comes to leaf blending and buying practices, as relative leaf prices change. Shag manufacturers frequently use 15 to 17 different tobacco types. In addition, shag manufacturers have introduced lower priced blends. However, most RYO users are very brand conscious and leaf buying has changed very little as premium blends continue to dominate the market.

The dark fire-cured leaf used in RYO tobacco is high in tar content and reaching minimum tar requirements could be difficult. The tar content is much easier to regulate in cigarettes. Techniques are much more limited to reduce tar content in RYO tobacco. It is also much more difficult to measure tar in RYO, which depends to a great deal on the size of the cigarette rolled. Currently there are no tar regulations on RYO tobacco, due to in part to industry opposition, although experts believe that regulation is on the horizon.

As RYO prices increase, shag companies will continue to produce cheaper shag tobacco, therefore with less U.S. tobacco. In general, shag manufacturers believe the market has stabilized demand-wise, after three price increases in the last year. Most of these price increases have come from the Dutch government tax assessments to generate revenue to finance the deficit.

RYO cultures exist and are not created. Reportedly, the Eastern Bloc is not a RYO culture and cigarettes are too cheap. Thus, it is too expensive and time-consuming to create a RYO culture and no expansion into eastern Europe is expected. On the contrary, France has changed from a cigarette to a RYO market due to cigarette price increases. Thus, RYO export growth, demand expansion and increasing market share will come where cigarette prices are considerably greater than RYO prices. In times of recession, RYO sales also do quite well.

About 10 percent of the Dutch market is generic cigarettes, which require less expensive, lower quality tobacco leaf, resulting in lower flue imports. The roll-your-own market declined 9.5 percent in 1992, due to heavy price increases, resulting in lower dark fire-cured imports.

On the bright side of the industry, Philip Morris is in the process of expanding a large cigarette manufacturing facility at Bergen op Zoom in the Netherlands. Annual production at this plant is expected to increase from its current output of 50 billion pieces to 75 billion pieces by the year 1996. This will represent 91 percent of current Dutch cigarette production. The new facility should be complete by the end of 1993, thereby increasing tobacco leaf imports, particularly flue imports, to support cigarette exports.

France, Spain and Portugal can not produce "foreign" cigarettes in those markets, so cigarettes are frequently manufactured in the Netherlands and exported to those countries. Most of Rothman's cigarette exports go to France, based on a price negotiated between Rothman's and the French monopoly. Philip Morris also has a variety of sales agreements with these countries.

Consequently, there is an increasing concentration of cigarette production in the Netherlands (as well as BAT production in Brussels) to serve these markets. Philip Morris is also trying to increase market share with their plant capacity in Germany. Reemstma and Philip Morris are currently engaged in a price war using their lower brands (such as West) to gain market share.

### 3.4.3 Dutch Tobacco Policy Changes

Despite the minimum "harmonized" EC excise tax on cigarettes of 57 percent of retail price, considerable price variation exists across the Community. Typical of northern EC members, the Netherlands has relatively high cigarette retail prices. Southern countries have fought to keep cigarette prices low in their attempt to compete with American-blend brands and northern countries fear cheaper southern cigarettes will flood their markets as EC borders are dismantled.

The 57 percent Dutch excise tax is divided into a proportional element (21.05 percent of retail price) and a specific element (79.10 Dutch guilders per 1,000). In addition, the Netherlands imposes a 14.89 percent Value-Added-Tax. For the most popular cigarette pack-price ($5.50), 20.9 percent of the retail price is the proportional excise tax, 35 percent the specific excise tax, 14.9 percent the VAT and 28.2 percent cost and margins. The tax seal already has the retail price specified. The cigarette manufacturer must buy the tax seal and attach prior to retail sale. Exports are without VAT or excise tax.

Excise increases in the 1980's, particularly on roll-your-own tobacco, has cut cigarette consumption by one-third over the last ten years. The 57 percent excise tax applies only to cigarettes and the price gap between RYO and ready-made cigarettes is due primarily to the excise tax.

As in other EC member countries, maximum allowable tar levels in ready-made cigarettes cannot exceed 15 mg after Jan. 1, 1994 and 12 mg of tar after Jan. 1, 1997. These tar requirements will continue the trend toward lighter cigarettes and the shift from high quality tobacco to more moderate or lower quality grades. Again, tar and nicotine standards exist only for cigarettes and not RYO, although industry analysts believe they will come. Each package of cigarettes and roll-your-own tobacco includes one of several health warnings, which are changed on a rotating basis.

Smoking in the Netherlands is prohibited in most public buildings, where the general public has access. The tobacco industry has voluntarily agreed to prohibit advertising near schools, hospitals and television by 1994 and in cinemas by 1996. In addition, sports and smoking cannot be associated together and cigarette sampling is prohibited. As a result, cigarette manufacturers have curtailed their advertising budgets. In addition, the World Health Organization has been applying pressure locally to further encourage an anti-smoking sentiment and are negotiating with the Department of Public Health to further restrict advertising.

Under the Lome Convention, many countries can export leaf to the EC duty-free including Malawi, Zimbabwe and other African, Caribbean and Pacific countries, up to the amount of allocated import quota for each country. Again, for further discussion of EC CAP reform and other Community-wide proposals affecting the Netherlands, see section 7 of this report.

### 3.5 Implications for Malawi Tobacco

1. The Netherlands is Malawi's largest dark-fire export market, purchasing 40 percent of last year's crop. The Netherlands is also an important burley and flue market for Malawi.

2. Dutch burley and dark fire imports have been growing, despite declining domestic cigarette consumption, to fuel the export market.

3. Philip Morris will expand a new cigarette manufacturing plant in the Netherlands in the fall of 1993, which will almost double cigarette manufacturing capacity in the Netherlands. Malawi is in an excellent position to take advantage of expected increases in leaf imports, due to Malawi's leaf quality, transportation advantages and duty-free tariff status.

4. Dutch leaf buyers are very interested in procuring more dark fire leaf from the Malawi market. Significant increases in Malawi dark fire production and improved production estimates are critical in retaining this market.

5. Lower tar maximums go into effect in 1994 (15 mg) and 1997 (12 mg). These changes will require more burley, flue and dark-leaf with a stronger, more pronounced taste, and leaf that is naturally low in tar. In addition, more moderate or lower quality grades will be needed. Again, Malawi is in a good position to supply these changing needs. Malawi burley is valued for its naturally low tar content and "good drinking" qualities; that is, with a high absorption capacity for added flavors and taste.

# 4. MALAWI COMPETITORS IN THE WORLD TOBACCO MARKET

The Organization for Economic Cooperation and Development (OECD) predicts that leaf usage will increase through the end of this century. However, world production and reserves are both at all time highs, depressing world prices, although world supplies typically are cyclical, resulting in cyclical price movements. As consumer tastes and preferences have migrated toward an American-blended cigarette, world burley production and trade has soared. International western brands produced by multinational cigarette manufacturers are replacing local brands which generally rely on stronger flue and dark type tobaccos and oriental leaf. As demand for premium cigarettes has grown, so has competition in world burley markets. Importantly, as world demand increases for medium to high quality burley and other leaf types, the competitive positions of various countries vying for market share changes.

Discussions throughout this report provide substantial comments on Malawi's competitive position in burley as well as other leaf markets, including flue and dark fired-cured tobacco. Malawi's competitive position is country-specific in many cases, due to regional tastes and preferences, transportation advantages and trade policy environments. Therefore, discussions surrounding Malawi's competitive position permeates this report on a country-by-country basis.

Given the relative importance of burley exports to Malawi and the increasing demand for burley leaf world-wide, this section will focus primarily on Malawi's competitive position in the world burley market. In 1992, 63 percent of the value of Malawi leaf exports was burley tobacco, compared with 26 percent of flue exports and 9 percent of dark fire-cured exports. Malawi's burley production and exports are expected to remain strong in 1993.

Five countries dominate the world burley export market. In 1992, both Malawi and the United States held a 21 percent share of the world burley export market, followed by Italy at 14 percent, Argentina 6 percent and Brazil 5 percent. In general terms, U.S. and Italian market share has declined as other countries have increased their volume and quality of burley leaf production.

This section draws considerably from a study by Walters and Snell for the U.S. Burley Tobacco Grower's Cooperative. Their project is part of a larger comprehensive study of U.S. price competitiveness in world leaf markets.

## 4.1 Malawi

Malawi is one of the largest burley producing countries in the world, second only to the United States. In the last ten years, Malawi burley production and exports have grown tremendously as U.S. exports stagnated in the 1980's. In recent years, U.S. production and exports have stagnated or declined and the U.S. has lost market share to Malawi. Generally, Malawi burley is deemed good quality, although inferior to U.S. burley leaf.

The majority of Malawi burley production is by tenant farmers on private estates. However, according to the USDA, burley estate size is quite large by U.S. standards where quota limitations have prevented economies of scale. Forty-five percent of Malawi's burley crop is produced on estates with an average crop production of 3 to 10 tons, 20 percent of the crop from estates raising 10 to 30 tons, and 35 percent of the crop from estates raising 30 to 100 tons each. MOA has begun to allocate burley quota to smallholders, but production from these farmers remains negligible relative to total crop size (8 percent). Although growers are allowed to market 115 percent of their quota, overproduction remains a problem given estimates that 20 percent of the burley crop is produced illegally.

Most inputs must be imported for tobacco production and the government of Malawi provides no direct input subsidization for burley production. Further, grower prices received are not subsidized by GOM. In nominal terms, burley prices have increased over 500 percent from 1980 to 1992 (1.2 kwacha per kg to 6.5 kwacha per kg). During the same period, production also increased over 500 percent (approximately 18,000 tons in 1980 to almost 100,000 tons in 1992). Obviously, nominal price increases have been mirrored by production increases. However, during this period, real grower prices received have remained at their 1980 level, with very little variation.

In 1992, domestic prices fell four percent from the previous year due to a large domestic crop of lower quality. But, in U.S. dollars (the currency in which most tobacco trade is denominated), Malawi grower prices fell over 30 percent due to two substantial devaluations of the kwacha. Despite lower market prices and higher input costs, production costs averaged 30 cents per pound compared with an average price received of 79 cents per pound.

Prices received by Malawi burley producers are comparable to U.S. grower prices in that neither are subsidized, although the U.S. has a price support system in place. Over the last ten years, the average grower price differential between U.S. and Malawi burley has ranged from about 70 cents to $1.30 per pound, with considerable variation across years. In addition, as U.S. export values have remained relatively constant over the last ten years, Malawi export values have steadily increased, thereby narrowing the price differential between U.S. export values and Malawi values. This narrowing reflects the improved quality of burley leaf coming from Malawi and, importantly, the change in blending strategies by cigarette multinationals. Lower priced, good quality leaf is growing in demand for the generic market in the United States and in developing markets around the world. Export values of Malawi burley compared with those of its leading competitors can be found in the Appendix of this report.

Burley quality in 1993 has a mixed record, thus far. Malawi tobacco continues to be praised for its high filling capacity, allowing less Malawi burley to be used per stick. Despite a lower average leaf weight, less bodied leaf, and a reduced nicotine content compared with last year, the crop has been described as having excellent smoking characteristics. Again, Malawi burley tobacco continues to have the reputation as one of the highest filling capacity of leaf on the world market. This filling capacity permits cigarette manufacturers to use less leaf per stick. Further, Malawi burley has a very low nicotine content and overall is very well regarded in western Europe and the United States.

Thailand also produces a burley somewhat comparable to Malawi burley for its filling capacity. Zimbabwe burley is not as highly regarded as Malawi leaf due to its higher nicotine content, smaller crop size and lower filling capacity. In the past, Dutch, German and U.S. cigarette manufacturers have been willing to pay a premium for the filling capacity of Malawi burley, but eastern European manufacturers either don't believe the benefit or are unwilling to pay extra for the benefit.

To remain competitive in world burley markets, Malawi must continue to compete on the basis of price and quality. Leaf buyers frequently suggest the need to maintain continuity and share or position in the market. Some leaf buyers have suggested that Malawi initiate more barter and counter-trade with the CSIS and claim that leaf merchants are willing but the Malawi government opposes such a strategy.

Malawi flue leaf has been favorably described as more soft-natured and open-grained than last year, with a superior color. However, the liberalization of Chinese tobacco production has resulted in a tremendous flue crop this year which is likely to depress world flue prices. Although Chinese flue is generally of poor quality; some improvements have been made in both flue and burley production. China is looking to Brazil to purchase burley, and have sent delegations there to assure their purchase is not contaminated with blue mold. This buying activity is significant in that China does not ordinarily purchase leaf on the world market.

Malawi's dark fire-cured position on the world market is tenuous. Renowned for high-quality leaf, Malawi dark fire-cured production is down dramatically this year. Increasing, as well as stabilizing, production is essential to maintain market share. A more complete discussion of Malawi's competitive position in the dark fire-cured market can be found in Section 3.4 of this report.

In general, Malawi's competitive position in world leaf markets is quite good due to its unique leaf characteristics, specifically filling capacity and low tar content, and good overall quality. However, the possibility of quota reductions, credit constraints and depressed world leaf prices may significantly reduce Malawi leaf production in 1994. Maintaining total dry weight leaf production in the current 100,000 ton range is essential to maintain world market share in a surplus crop year.

## 4.2 United States

Section 3.2 provides a considerable amount of information on the U.S. competitive position in the world tobacco market. U.S. exports of unmanufactured tobacco are expected to drop slightly in 1993 (down four percent from 1992) as imports for consumption are also expected to fall nearly six percent. General imports are expected to increase three percent in 1993. Values per ton follow the same trend. Export and consumption import values per ton are down slightly in 1993, as general import values are up slightly. However, recent import restriction legislation may further reduce U.S. leaf imports and exports, as U.S. cigarette manufacturers are required to purchase more leaf off the domestic market.

Of the 260,526 tons of unmanufactured tobacco the U.S. exported in 1993, 146,100 tons was flue-cured and 64,481 burley. U.S. burley exports stagnated in the 1980's as domestic price supports priced U.S. leaf out of the world market and production growth was limited by quota reductions. Beginning in 1991, burley exports have grown substantially from the 40,000 to 50,000 range in the 1980's to over 60,000 tons for the last three years.

Thus far for 1993, flue exports are running slightly below 1992 monthly shipments, but burley exports have dropped by a third. In terms of value, flue exports are down 10 percent and burley exports down again by a third in 1993.

The United States is the largest burley tobacco producer in the world. However, as U.S. burley production has remained stagnant or declined, world market share has fallen from 56 percent in 1960 to 21 percent in 1992. The U.S. exports to many of the same markets as Malawi, including the Netherlands, Germany and Japan. An important distinction is that the United States produces a wide variety of tobaccos, with the exception of oriental, which are used in cigarette manufacture. Consequently, the U.S. exports tobacco in both leaf and processed form. However, in recent years, many of the cigarette manufacturers have moved some of their production off-shore, as the domestic market has declined and overseas markets have grown.

Tobacco production remains controversial in the United States, as health reform, anti-smoking activities and budget deficits have reduced tobacco support. To salvage the industry, U.S. burley production and the marketing system has become more market-oriented and self-supporting through the no-net-cost program, marketing fees and adjustments in support prices to respond to world conditions. In addition, the leasing of burley quota across county lines and the sale of quota within the same county have led to some economies of scale in production and marketing, and mitigated the problem of underproduction of quota. Many of these changes are a result of the Tobacco Improvement Act of 1985. These efforts have allowed the U.S. burley industry to remain competitive on world leaf markets.

It is believed that the decline in U.S. market share, both in the world market as well as domestically, is not necessarily due to an increasing U.S./foreign burley price differential, which against some countries, such as Malawi, has actually been declining. Rather, the loss in world market share is attributed to the change in cigarette blending practices which utilize lower quality leaf. Manufacturers are less willing to pay the premium for high priced, high quality U.S. burley leaf. Because of the U.S. price support system, it is expected that the United States will be unable to respond very quickly to changing market conditions. As burley production and trade continues to grow, the United States will have a more difficult time in remaining price-competitive against countries such as Malawi where prices are market determined. See the Appendix of this report for graphical depiction of U.S./Malawi burley export price differentials.

Of perhaps more concern is the U.S. grading system, which no longer adequately rewards growers for quality premiums. As the demand for lower-priced, medium quality leaf grows, the price differential across grades has almost disappeared. Given U.S. cigarette manufacturers are now required to purchase more domestically-produced leaf, more pronounced price differentials across grades may appear. However, to keep leaf costs down, the demand for lower-priced leaf will continue to grow.

## 4.3 Italy

Section 7 of this report discusses tobacco policy in the European Community and changing market conditions in Italy's tobacco market. Similar to the United States, Italy has lost world market share. In 1960, Italy controlled 20 percent of the burley export market, second only to the United States, yet currently holds a 14 percent market share. Italy's burley production is generally deemed of fair quality, but considerably below that of Malawi or U.S. leaf.

Italy is the fifth largest producer of burley in the world. Burley production has floated in the 40,000 to 60,000 ton range since 1980. Importantly, during this time, nominal prices have grown, but in real terms have fallen by a third. Italy's burley exports have also fluctuated dramatically, ranging from 25,000 to 40,000 tons since 1980. In 1991 and 1992, increases in real prices encouraged production and exports increased.

In 1993, Italian burley exports are expected to fall dramatically to about 30,000 tons. Due to EC CAP reform, export subsidies and premiums have been abolished. Reductions in minimum guaranteed quantities have also been announced; although burley production has not been reduced, overproduction remains a problem. The drop in exports is primarily due to the loss of export restitution, which had been greatly abused. Major Italian burley export markets include Germany, the United States, and the Netherlands. However, a considerable amount of leaf entered the former Soviet Union and eastern Europe with the aid of export subsidies. With these subsidies no longer available and hard currency in short supply, exports to these countries are expected to fall.

With tobacco reform underway, it is unlikely that Italian burley tobacco production will increase, although some farmers might switch to the relatively more profitable leaf in the future. Although Italian leaf is inferior in quality to Malawi leaf, emerging markets in eastern Europe may prove quite profitable for Italy. Importantly, Italy may shift more leaf sales to eastern Europe and away from the United States due to transportation costs advantages and loss of export restitution. Further, the loss of preferential tariff treatment for Malawi in some eastern European countries and higher transportation costs may make it more difficult for Malawi to compete with lower-priced Italian burley in these markets. The Appendix of this report provides graphical analysis of Malawi versus Italian burley export prices.

### 4.4 Brazil

All tobacco production in Brazil is under contract between small farms and cigarette manufacturers and leaf dealers. Burley prices in Brazil are not government supported nor are exports subsidized. Despite the lack of direct government subsidization, growers can borrow government money for operating costs at subsidized rates. In addition, cigarette manufacturers and leaf buyers provide technical assistance and inputs to the growers at an estimated value of 30 percent of the price paid to growers. These contractual arrangements allow inputs to be bought in bulk, thus at a lower price per unit, and buyers have considerable control over varieties and amounts produced. Negotiated pricing has permitted Brazilian burley production to respond to changing market conditions.

Importantly, extensive contractual growing arrangements have allowed Brazilian burley quality and quantity to improve dramatically and place Brazil in an excellent competitive position in the U.S. and European markets. Brazil is the third largest burley producer in the world. Burley production in 1992 reached 95,000 tons, a 50 percent increase over 1991 production. Burley production for 1993 is expected to remain roughly the same as least year. Half of Brazil's 16,000 tons of burley exports was shipped to the United States, with the remainder going to Japan and western Europe. Malawi's export average in 1992 was just under $2.00 per pound, compared with $2.25 per pound from Brazil. Despite political and economic difficulties in Brazil, significant investment by cigarette companies and leaf buyers ensure that Brazil will stay competitive on world burley markets.

### 4.5 Argentina

Burley tobacco is produced in Argentina under conditions very similar to that in Brazil. The Argentine government has very little involvement, as tobacco companies and cooperatives render resource-providing contracts to tobacco farmers. Again, significant foreign investment is present. Many leaf buyers rate Argentine burley as the second or third highest quality in the world. Because of this reputation, burley production and exports have grown tremendously in the past few years. Burley production has increased from about 20,000 tons throughout the 1980's to over 50,000 tons in 1992. Similarly, exports have grown from less than 5,000 tons throughout the 1980's, to over 20,000 tons last year. Major export markets include the United States, Mexico and Japan. With the recent abolishment of the tobacco export tax, exports are expected to grow in 1993. Average export values are just under $2.00 per pound (see the Appendix of this report for price differentials with Malawi burley exports).

Previously growers received the contract negotiated price for the specified grade as well as a supplement from the Special Tobacco Fund, financed by cigarette taxes. The Fund accounted for approximately 40 percent of the price the grower received. However, the government has announced that the Fund will be phased out over a three year period. Producers claim that production will drop significantly without the additional incentive and buyers argue the supplement is necessary to remain competitive in world burley markets. Given that production alternatives are few, combined with the strong demand for high quality Argentine burley, production and exports are expected to continue growing.

## 5. CURRENT AND PROJECTED CONSUMER MARKETS IN EASTERN EUROPE

Central and eastern Europe have undergone significant changes in recent years, restructuring their economies and initiating market reforms. These reforms have resulted in declines in industrial and agricultural output as economic, political and social upheaval has transpired. In recent years, both tobacco and cigarette production has declined, although recent gains have returned production to near "normal" levels.

All eastern European countries have been plagued with high rates of inflation and unemployment. Beginning in 1991, Poland, Czechoslovakia and Hungary have made significant strides in reducing inflation; unfortunately progress in this area for the other EEC countries has been less successful. As the economies in this region restructure, unemployment has risen and is generally underreported, and underemployment has increased rapidly. Current account balances have also been negative in many EEC countries, although Hungary and Poland have recently posted surpluses, due primarily to increased exports to the EC and other western nations.

Tobacco production in Eastern Europe has declined in recent years, both in terms of area planted and production. Total hectares planted fell from 173,608 in 1991 to 159,696 in 1992 to an expected 151,390 in 1993. Consequently, total tobacco production in Eastern Europe fell from 260,962 tons in 1991 to 214,842 in 1992 to an expected 205,092 tons in 1993. Bulgaria, the largest tobacco producer in Eastern Europe, has reduced production from 85,047 tons in 1991 to 71,011 tons in 1992 to an expected 58,660 tons for 1993. Polish production is also off 8 percent from 1992. These declines have not been made up by the increased tobacco production in Hungary and Romania, with Yugoslavian production essentially constant.

Almost 42 percent (an expected 85,503 tons in 1993) of Eastern Europe's tobacco production is of the oriental type, with nearly all production accounted for by Bulgaria and Yugoslavia. Most of Eastern Europe's flue tobacco (an expected 64,559 tons in 1993) is produced in Poland, with Yugoslavia also an important producer. Likewise, these two countries are also the biggest burley producers. In regard to dark air/sun-cured tobacco, Albania produces about half of the expected 30,050 ton 1993 crop.

All major cigarette multinationals have developed a presence of some sort in eastern Europe. Cigarette manufacturers are purchasing access to production capacity in eastern Europe primarily through joint ventures, as licensing agreements are not sufficient. Current cigarette producing capacity in eastern Europe is inadequate in terms of quantity and quality. Foreign investment and technological expertise is essential. For example, Philip Morris has purchased companies in Czechoslovakia and Hungary and is pursuing Poland aggressively as privatization becomes more of a reality.

Most eastern Europe cigarette manufacturers have close ties with the farmers and employ large numbers of workers. It is the strategy of the tobacco multinationals to continue to nurture these ties and buy production capacity to slowly improve productivity and quality in sync with these previously defined relationships. Consequently, multinationals must retain good relationships with local farmers and local manufacturers. In general, multinationals desire to improve and develop local brands and introduce their own western international brands onto the market. Eastern European markets are essentially a two-tier market, given demand for high quality American blends such as Marlboro and lower quality U.S. brands manufactured with lower quality African and EC tobacco.

Consequently, many EEC countries will continue to rely on tobacco as an important source of foreign exchange and government tax revenue. The strong demand for tobacco products (primarily cigarettes) is predominately constrained by income (or hard currency), rather than by health concerns. Importantly, the quality of local leaf production is very poor. Consequently, multinationals rely on both imported and local tobacco. Again, a lot of eastern European tobacco is oriental and not burley or flue-cured leaf.

## 5.1 Current and Projected Markets in Poland

Poland has the highest per capita cigarette consumption reported in the world. The tobacco industry in Poland remains outdated and considerable foreign investment is needed to modernize processing and manufacturing capacity. To obtain the estimated one-half billion U.S. dollars needed for modernization, public monies are not sufficient and the Polish government is relying on local private and foreign investment. To gain access to foreign capital and expertise, the state-owned enterprises are expected to be privatized soon. Partial privatization has already been pursued as the industry has developed close ties with RJR Reynolds, Reemstma, BAT, Rothmans and Philip Morris (the latter for the past several years). Last spring, Poland imposed a state monopoly law on tobacco to provide the structure for taxation and producer support.

### 5.1.1 Polish Production and Consumption

Previously, the Polish tobacco industry was controlled by Interbac, the state-owned monopoly. During the last four years, Interbac's role in tobacco has been severely reduced although they continue to represent the interests of the state. Interbac negotiates between what is left of the state monopoly and the Ministry of Agriculture, the Ministry of Finance and Foreign Corporations and the Office of Tariffs and Foreign Duties. Interbac continues to collect data concerning production and consumption of leaf and cigarettes, as well as other economic factors, although apparently this information is not easily obtained. It is expected that Interbac will be dissolved in the near future.

Many leaf buyers and cigarette manufacturers have been very active in improving tobacco varieties and agronomic conditions to improve domestic leaf quality in eastern Europe. These programs are a direct result of declining U.S. production and national politics to restrict imports. Many buyers believe that it is their responsibility to improve leaf quality, such as they have been doing in Italy and Greece, for example, for years. There is evidence of increased direct contracting in eastern Europe, particularly in Poland, by leaf buyers. However, some cigarette manufacturers, notably Philip Morris, have also engaged in agronomic leaf programs to improve leaf quality. Much of this forward contracting involves forward financing in the hope to guarantee crop variety, quality and consistent supply. In general, leaf quality and quantity is expected to improve, with a residual demand going to countries such as Malawi, Brazil and Zimbabwe (particularly as U.S. leaf production declines). The demand for high quality, low-priced leaf will continue to grow for these eastern markets. As eastern European countries continue to rely on domestically produced leaf and erect import barriers, it may be more difficult to move crop around.

Despite a strong foreign presence, Poland's tobacco industry remains state-owned and is divided into seven multi-unit tobacco companies. These seven enterprises are comprised of 14 production facilities of which 5 process leaves, 6 manufacture cigarettes and 3 both process leaves and manufacture cigarettes. Leaf processing capacity is around 100,000 tons per year. For the 1993 marketing year, domestic production according to Interbac is expected to be about 36,000 or 37,000 tons after processing, compared with an expected 80,000 tons consumption. (Leaf buyer's estimates are 22,000 tons dry-weight production and 95,000 tons consumption for 1993.) Of 1993 tobacco production, approximately 45 percent is dark fire-cured, 40 percent is Virginia flue-cured, 8 percent burley and 6 percent Kentucky fire-cured. The dark air-cured tobacco Poland produces has a very high nicotine content. Since tobacco production is about half of Polish needs, the balance must be imported. In 1992, a considerable number of farmers were not paid, as domestic leaf was too expensive to buy, store and pay the high interest charges relative to the good quality, cheaper leaf imports.

There are eight fermenting or leaf processing plants in Poland. Some of these plants serve the same regional areas, for example, three serve the Crakow region alone. These eight companies are contracting production with farmers based on contract terms. The contract also specifies the tobacco variety and quantity, but grades and prices are negotiated later in the marketing year. There has been an increased pressure to improve leaf quality. There is no government interference in that process. The processing plants negotiate (or set) prices, usually at the time of harvest. Currently, 1993 prices are being negotiated. Consequently, there is no price support system or reserve stocks operated by the Polish government, although individual processing plants or cigarette factories may keep their own reserves.

Since all leaf processing plants are connected to the cigarette plants, multinationals with production agreements send requests back to the farmers for specific leaf needs. It is estimated that Philip Morris Marlboro production is utilizing 60 percent imported leaf and 40 percent local leaf content. Camel, Prince and West cigarettes are manufactured from 100 percent imported leaf. RJR whose cigarette production is less than the authorized 5.5 billion pieces, is probably importing exclusively without local contract production, although local leaf content rules will go into effect in the near term.

Poland accounts for about one-half of total EEC cigarette consumption. Polish cigarette production is approximately 80 to 90 billion pieces, with cigarette consumption at 100 billion pieces annually, including approximately 10 to 20 billion pieces smuggled in from Germany. However, it is estimated that another 10 billion sticks are smuggled back to Germany. The Interbac official cigarette smuggling estimate is 15 to 20 percent of local consumption, although cigarette imports are officially about zero. Cigarette processing capacity is about 120 billion pieces. With domestic production capacity of 120 billion pieces, current cigarette production is slightly underutilized at 90 billion last year. About 11 percent of domestic consumption is considered a premium market. Domestic brands control about 70 percent of the market and foreign brands hold a 30 percent market share.

Although there are few restrictions on Polish tobacco production, and the prices of tobacco and cigarettes is set by companies and by the market, cigarette production itself is more tightly regulated. The Ministry of Agriculture authorizes production licenses for all cigarette factories by setting maximum production levels for both local brands as well as international brands. State-owned companies and multinationals must apply to the MOA for these cigarette production licenses. Currently, there is excess domestic leaf available, due primarily to inferior quality, below what the cigarette factories require. The Polish government is working very diligently to make sure that all domestically produced leaf is absorbed by the factories through differential tax schemes, local content requirements, and stiff leaf import duties. In the future, these laws are expected to be altered to require a domestic leaf content and different tax rates will apply depending on the proportion of domestic leaf content. The proposed local content law will generally give tax breaks for increasing local leaf content. The exact excise tax relative to local leaf content is being negotiated.

Improving domestic leaf quality is of prime importance to the Polish government and the cigarette manufacturers. As noted above, leaf buyers and cigarette processing plants do have some type of agronomic service they provide to farmers, although the Ministry of Agriculture is not directly involved. However, these plants have scientific labs which do receive funding from the Ministry of Agriculture. New information and expertise continuously flows from the multinationals. Philip Morris, who is celebrating their twentieth year of operating in Poland, has a ten-year-old agronomic program. Leaf International, a division of Universal Leaf (International) Ltd., is also working quite closely with producer associations and Rothman's to improve leaf quality.

Intabex has also been working closely with one region of Poland to improve leaf quality. For the last three or four years, Intabex has been involved with replacing flue and dark leaf production and increasing burley production in the north. Specifically, Intabex is focusing on burley varieties TN 86 and 90. The Polish government has signed a contract with Intabex for the leaf company to provide other social services and inputs to the tobacco farmers. Intabex, Grujons (of Italy), and a cigarette factory have formed a foundation to meet these objectives. Reemstma has licensed production at that factory and they are already using better domestic leaf. Intabex has approximately 60 percent of the leaf market in Poland and 50 percent of the market in Russia.

### 5.1.2 Polish Tobacco Trade

With leaf buyer estimates of domestic production falling nearly 73,000 tons short of consumption in 1993, leaf buyers anticipate that Poland will continue to import the same amount and varieties of leaf as they have in the past, despite the recent increases in leaf import tariffs. However, the sources will change. The EC suppliers such as Italy and Greece never had preferential tariff treatment, but due to transportation advantages and sufficient quality characteristics, will be quite competitive in the Polish market. Flue-cured leaf from the EC is expected to remain competitive in the Polish market, particularly as domestic leaf prices increase. However, those countries which have lost their preferential tariff status, including Malawi, may see their leaf sales to Poland decline. In 1992, Malawi exported 2,237 tons of leaf to Poland worth $5.1 million dollars. Of that amount, 1,229 tons was flue-cured, 896 tons dark fire-cured and 202 tons burley leaf.

Leaf buyers anticipate that pre-blend tobacco will continue to form the bulk of leaf imports. Rather than import tobacco leaf and pay the $1.35 per kg duty, companies can import pre-blend at $1.65 per kg duty which makes more sense economically. The $1.35 duty is applicable on all leaf, including waste, thus making the duty on pre-blend relatively lower. The large burley crop in Malawi will probably lower Malawi prices enough to keep Malawi leaf competitive in the Polish market, although the loss of preferential treatment will be damaging. Otherwise, the varieties that Malawi offers are very compatible with the Polish market. However, other burley's on the world market have properties very similar to Malawi burley and price will be the determining factor.

Further, leaf buyers claim that it is cheaper to raise leaf in Poland, ship to Germany for processing and then re-export blends back to Poland. The difference between the green price and the finish pack price is extremely high. The margin is frequently $4.50, using an estimated $1.50 green price and a $6.00 finish pack price, due to high labor costs of keeping excessive numbers of Polish employees. RJ Reynolds has the clear advantage in that they can avoid this high margin by using their own trained workforce in their own plant.

### 5.1.3 The Role of Multinationals in Poland

Every major world tobacco company is already present in the Polish tobacco market. Foreign investors include RJ Reynolds, Reemtsma, Philip Morris, Rothmans, BAT and a Japanese tobacco company. Several new private Polish firms are also establishing processing capacity. The RJR plant is fully-owned by RJ Reynolds, but all other cigarette factories are comprised of local and foreign capital. With the exception of RJ Reynolds, no foreign companies have actual ownership, but instead have licensing authority through one of the cigarette factories to produce their own brands as well as assist in local brand improvement. In total, the MOA has authorized 24 billion cigarettes to be produced by the multinationals. This is not state-owned production, but is done as a service to the foreign companies operating in Poland.

In essence, the multinationals are providing capital, technology and expertise to improve local brands and to give factories authority to produce their own brands. The multinationals then are permitted to market their own brands. Importantly, although privatization of the tobacco industry is forthcoming, licensed production continues to be regulated by the MOA. Before the MOA authorizes production, the company must demonstrate processing capacity. For example, RJR currently holds licensed production for 1.5 billion pieces. When the new cigarette facility is completed, they have a promise from the MOA to increase their licensed production. Each state-owned company has their own license, separate from the multinational in which they have a production agreement, and multinational production must fall within the licensed production parameters within that cigarette factory. According to the MOA, it is not clear how future cigarette licenses will be issued. Importantly, multinationals are permitted to buy tobacco leaf directly off the world market to use in Polish cigarette production.

The Philip Morris plant is located in Crakow, where half of local leaf production is situated, and is completing their twentieth year of local manufacture. This Crakow factory is supposedly the most modern in Poland, not surprising given Philip Morris's long term relationship with the factory. This plant has approximately 40 percent of the Polish market, including local brand production. For the last ten years, PM has been working with farmers to improve domestic leaf quality.

The RJ Reynolds plant, located just south of Warsaw, is the only foreign plant totally owned by a foreign entity in Poland. The decision to build their own facility was based in part on the size of the market and domestic production costs, which are still lower than in western Europe and in the United States. Initially RJR wanted to buy shares in another cigarette factory, but no laws existed to allow for private ownership. RJR then elected to build their own factory and applied to the Ministry of Agriculture to get a license authorizing production. In 1991, RJR was granted permission to produce cigarettes and production began that November. Initially RJR refurbished an existing cigarette facility and provided training programs for the workers. Utilizing imported ready-made tobacco from subsidiaries in west Germany and Switzerland, the plant manufactures Camel, Camel Lights, Monte Carlo and Salem. In June 1992, RJR purchased land for a new facility and by the end of 1993, that facility will be completed and production relocated. Consequently, RJR holds two cigarette production licenses, one for the existing plant and one for the new facility.

The new $33 million plant, with expected production capacity of up to 12 billion pieces, should rival the Philip Morris plant technologically. The new facility includes a separate leaf processing center. Of all multinationals licensed to produce in Poland, only RJR has a domestic leaf content restriction. If production at the RJR plant exceeds 5.5 billion pieces, then local leaf consumption must be 10 percent for all cigarette production. For all production over 5.5 billion pieces, 30 percent of that must be exported. If production exceeds 8.6 billion pieces, then 40 percent of additional production must be exported. All exports are tariff-free and exempt from the VAT and excise tax. The existing plant currently exports to Russia. Because of these exports, the 30 percent local content rule is not a concern to RJR.

RJ Reynold's decision to build a wholly-owned cigarette plant, rather than rely on licensed production, has given RJR two distinct advantages. Any new domestic leaf contents laws are expected to be greater than 10 percent and the export stipulations are not severe. In general, negotiated restrictions are better than what new laws stipulate. Thus, RJ Reynolds has possibly two advantages over the other multinationals in Poland, lower domestic leaf requirements and few export stipulations.

After 4 years, RJR must sell 20 percent of their shares to Polish investors on the local market, although this stipulation is loosely specified. It has been proposed that the new ownership structure be a maximum of 60 percent foreign-owned, 20 percent employee-owned, and 20 percent owned by the growers. It has been noted that considering changing market conditions, a lot can happen in Poland in four years.

However, RJR expects to retain product quality, and does not want to rely on inferior domestically produced leaf. In response, RJR has initiated "Agriproduct", an agreement between the company and the Tobacco Growers Union. Working with 18 pilot farms, RJR is implementing new agronomic and varietal test plots. In the future, RJR expects to contract with grower associations directly or go to other solutions such as tobacco auction markets.

Rothman's also has a licensing agreement with a cigarette factory in Poland. The cigarettes produced in this factory are of lower quality, have less American tobacco and mainly use domestically-produced leaf to avoid imports. In addition, Rothman's produces fewer brands that complement existing Rothman exports to Poland. Rothman's (like the other multi-nationals) must import the paper, filters and packaging materials. Finally, Rothman's has agreed to a specific clause that restricts Polish output to the domestic market and is not for re-export. Thus far, this has not proved problematic for Rothman's.

In spring 1992, the Polish government passed a monopoly law on tobacco. This legislation and subsequent decrees provided for further government taxation and producer support, including an explicit preference for the use of domestic leaf in cigarette manufacture, although various specific proposals have been discussed and subsequently rejected. The Ministry of Privatization requires that a state-owned company be commercialized before it can be privatized. However, in February 1993, all further privatizations were restricted until January 1, 1994. The State is in the process of developing a strategy of how to create or maintain a tobacco monopoly. For other industries, foreign investors must promise to invest a certain amount of capital, set employment retention standards and other standards in order to invest in Polish industries. It is expected that similar stipulations will be established by the tobacco industry as it is further privatized. Privatization law also allows for a company to be 60 percent foreign owned, with 40 percent reserved for employees, but the tobacco industry is excluded from this legislation. As local cigarette plants are privatized, another important question for multinationals who owns the brand names.

New rules governing the continued privatization of the tobacco industry are expected after Parliament is re-established in late September 1994. It is expected that new stipulations governing the role of the multinationals will include domestic leaf consumption requirements (30 percent has been widely suggested). Foreign investors already connected with state-owned industries claim they will support domestic content laws, although some privately suggest that they might not. The Ministry of Agriculture claims that some of the leaf processing plants will also be sold, retaining one or two under state-ownership, to create a balance between Polish and foreign interests.

### 5.1.4 Polish Tobacco Policy Changes

Beginning July 5, 1993, the new import tariff on tobacco leaf is 30 percent or a minimum of 1.13 ECU per kg (approximately $1.35 per kg.). Further, detrimental to many countries such as Malawi, there is no preferential treatment for any countries. Prior to this change in tariff law, Malawi and other medium-quality producers paid zero import duty. Consequently, imported tobacco leaf has become very expensive on the Polish market. The multinationals continue to require high-quality imported leaf, particularly from the United States, in order to maintain brand quality. It is the new tariff minimum, as well as termination of preferential tariff treatment, that is expected to reduce low-end leaf imports to virtually zero. Leaf buyers expect to only import high quality U.S. leaf, to mix with domestically-produced leaf. Obviously the new tax law is aimed at increasing domestic leaf production and raising revenue. In 1992, tobacco tax revenue stood at $900 million.

Prior to this new import duty law, Malawi paid zero tariff and had the reputation of good quality leaf. It is expected that Malawi exports to Poland will be priced out of the market. Similarly, other African and South American leaf will find it difficult to compete. Significant oriental imports will probably continue from Mediterranean countries such as Bulgaria, Greece and Turkey. Future burley and flue imports will continue to be from the United States, as Brazilian exports will likely be discontinued. However, until domestic production improves appreciably, many multinationals will continue to import leaf, much of it ready-made, from western Europe subsidiaries for their licensed production of high-quality international brands.

Despite high leaf import tariffs, production costs remain lower than they are in western Europe and the United States. Further, the position of Poland is strategical in serving the huge Russian market and other countries in eastern Europe. These profit margins will allow multinationals to continue importing some leaf to maintain required quality standards.

In addition to the import tariff, the new excise tax on cigarettes is about 40 cents per pack for imports and cigarettes produced under license (which essentially are the western American blends) and 15 cents for cigarettes below 18 mm in length (essentially the low quality local brands, frequently without filters). Those cigarettes greater than 18 mm in length must pay about 3 times the tax that shorter cigarettes are assessed. Some of the foreign companies are considering introducing a shorter premium cigarette to take advantage of the lower excise tax. The new July 5, 1993 tax legislation also requires a 22 percent VAT on all products, including cigarettes, whether they are local or international brands.

To limit smuggling and raise government revenue, no cigarettes are permitted to be imported without a tax seal, beginning Sept. 1, 1993. Import tariffs on cigarette are 90 percent, or a minimum of 9 ECU per 1,000 pieces, and 55 percent on cigars. Tariffs on cigars and other tobacco types is 55 percent.

Currently there is no domestic leaf content rule in Poland, but various proposals are being considered, as previously noted. (As mentioned above, RJR does have some domestic leaf restrictions.) Any new law on privatization of the tobacco industry is expected to contain some type of domestic content stipulation, with 30 percent frequently discussed. Domestic content laws are a tax revenue generating scheme as well as a social policy to protect farmers. Some tobacco experts believe that eastern Europe will continue to put up protective barriers to keep out leaf imports and multinationals will do local manufacturing relying primarily on local leaf production with improved agronomic conditions.

The Ministry of Health controls tobacco health and advertising regulations. By 1995, health warnings will be required on all cigarette packs. In January 1995, television and juvenile press tobacco advertising will be restricted and additional health warnings required.

### 5.1.5 Implications for Malawi Tobacco

In general, leaf production and cigarette manufacture in eastern Europe has fallen dramatically. The tremendous amount of smuggled cigarettes into the eastern bloc has created a strong demand for American-blend cigarettes, which poor-quality local cannot meet. Almost 42 percent of eastern Europe's leaf production is oriental. The role of multinational cigarette companies is driving market development.

1. Poland has the highest per capita cigarette consumption reported in the world.

2. Leaf buyers estimate that 1993 dry-weight production is 22,000 tons and consumption is forecast at 95,000 tons. Excess domestic leaf is available, due to inferior quality.

3. Multinationals present in Poland insist on leaf imports to retain brand quality.

4. On July 5, 1993, Poland imposed a new import tariff of 30 percent or a minimum of 1.13 ECU per kg (approximately $1.35 per kg) on leaf. Further, Malawi, among other countries, no longer has preferential tariff status, allowing duty-free imports. leaf buyers expect to import primarily high-quality leaf.

5. Pre-blend leaf can enter Poland at $1.65 per kg duty. Leaf buyers anticipate leaf blends will continue to enter Poland via Germany.

6. The new excise tax on cigarettes is 40 cents for imports and 15 cents for essentially local brands. The import tariff on cigarettes is 90 percent beginning Sept. 1, 1993.

7. Malawi leaf will continue to enter the Polish market either through smuggled cigarettes or through pre-blend leaf from Germany for domestic production of international brands. Despite improving local tobacco production, Malawi indirect leaf opportunities are very promising in Poland.

## 5.2 Current and Projected Consumer Markets in Bulgaria

Generally speaking, Bulgaria is the most important producer of tobacco and cigarettes in Eastern Europe. Up until recently, Bulgaria was the largest cigarette exporter in the world. From 1986-91, Bulgaria was the second largest cigarette exporter (after the United States), in addition to being a major leaf exporter. Historically, tobacco accounts for approximately 40 percent of Bulgaria's agricultural exports. However, reduced oriental production and economic strife in other parts of the CEE and FSU have dramatically reduced exports and disrupted Bulgaria's tobacco industry. Bulgaria had also been an important oriental tobacco producer, relying on Turkish laborers and expertise. However, due to ethnic conflict, many Turks have left Bulgaria, dramatically reducing oriental production.

Given that Bulgaria basically satisfies domestic tobacco consumption needs, particularly with respect to volume, future production growth will depend on export potential for both leaf and cigarettes. Given improved economic, political, and social stability, continued privatization and land reform efforts, and input availability, production has the capacity to increase.

Currently, all stages of tobacco production and manufacture in Bulgaria are controlled by the state-owned monopoly, Bulgartabac. Although Bulgaria is in the process of privatizing many industrial sectors, Bulgartabac appears to have been exempted. Albeit tobacco production is very labor intensive and requires a high level of management expertise, Bulgartabac has kept grower prices low, forcing many producers to switch to other crops. Consequently, a tobacco growers union has re-formed to pressure Bulgartabac to increase prices.

### 5.2.1 Bulgarian Production and Consumption

Bulgaria produces mainly oriental tobacco (about 80% of total Bulgarian tobacco production), with some flue and burley production. Bulgartabac claims that the slump in production is a normal consequence of upheaval when moving to a democratic system.

Future increases in tobacco production will largely come about in the wake of agricultural reform. Land tenure reform will be crucial in improving productivity and grower participation. Major reforms to the land tenure system were passed in 1990, allowing for private ownership, but actual land distribution from the large collective farms has been slow. These reforms will assist tobacco in the long run, particularly for oriental tobacco production which is more conducive to small-scale production rather than by the larger state-run farms. Currently, the government privatization programs operate by selling off state enterprises through stock ownership. In addition, Bulgaria has proposed to expand its privatization program by issuing bonds that citizens could invest in state-owned companies. Preliminary proposals outline the state offering $1,100 credit to every Bulgarian over the age of twenty to privatize about 500 firms valued at $6.6 billion. This proposal is to go before the Bulgarian Parliament in September 1993.

Total 1993 tobacco leaf production is expected to be about 45,000 tons. The ratio among the various varieties will remain about the same, with an expected harvest of 8,000 tons flue, 1800 tons burley, and the balance oriental leaf. As previously noted, both domestic and foreign reasons are the cause for this slump in production. Flue tobacco production has also increased in recent years. However, climatic, agronomic and irrigation limitations have limited flue production to approximately 25,000 acres.

The Union of Tobacco Growers estimates that 1993 leaf production will reach 60,000 tons. The Union claims that it is impossible to sell even this tobacco due to restricted leaf exports. The Union also believes that Bulgaria is limited to a maximum of 30,000 tons on the world market. Thus, the rest of the 30,000 tons will go to cigarette production or go unsold since cigarette factories are currently buying extremely little domestic leaf due to idle factory conditions. Last year, cigarette factories only operated approximately half the available days, and not then at full capacity.

Bulgartabac usually borrows money (using credit from commercial banks), purchases any leaf that goes unsold, and places the leaf into storage. Consequently, huge excess stocks exist, although no estimates are available. Consequently, the Union understands the need to reduce leaf production capacity. The Union of Tobacco Growers solution to overproduction is to stabilize and re-estimate cigarette production and then stabilize leaf production through a quota system. They have proposed the establishment of special guarantee funds to purchase all tobacco production to be placed into a reserve. A special tax would also be placed on purchased tobacco paid for by the leaf buyers, with a maximum level of 5 percent, which could vary as needed.

Almost 100 percent of Bulgarian tobacco production is private, with all sales going directly to Bulgartabac. Seed stock for production comes from the Scientific Institute (a Bulgartabac division) based on U.S. tobacco varieties. In general, Bulgarian leaf growers are producing most leaf at the upper end of the quality chain. There is a tremendous difference in prices across varieties and qualities. Most production is already geared towards the high priced oriental varieties. About 14 percent of all oriental production is first grade, three-fourths is second grade, 10-12 percent third grade and 1.5 percent fourth grade. For burley production, 40 percent of the leaf produced ranks first grade and 53 percent second grade.

It is difficult to assess whether farmers are acting rationally to maximize the difference in production costs and purchase prices by grades. Typically, farmers do not keep records, and as discussed later, 1993 purchase prices were announced after production was nearly complete and harvest begun. But, the 1991 purchase price schedule clearly encourages production of the highest quality leaf and a minimal amount is given for low quality leaf. A few tobacco farmers have formed cooperatives, but they have essentially no choice but to sell to Bulgartabac.

Further, Bulgartabac operates a purchasing office in each growing region and farmers can only sell leaf to that office.

Despite the slump in production and corresponding low purchase prices, Bulgarian tobacco experts are divided over leaf export potential. The Bulgarian tobacco industry has the potential to produce 120,000 to 130,000 tons of tobacco, if markets can be found. However, contrary to Bulgartabac's assertions, the Tobacco Growers Union thinks that it is impossible to increase irrigated big-leaf or burley tobacco production, and imports must continue, regardless of domestic production. Future cigarette production most likely will require a blend of high quality domestic oriental leaf, medium quality domestic big-leaf and high quality imported big-leaf. Bulgaria's major competitors are also increasing oriental production include China, India and Greece.

Current cigarette consumption stands at about 15-16,000 tons, or 15 billion pieces, including both domestic and imported. Bulgaria currently produces six to seven billion pieces for the domestic market and an estimated eight to nine billion pieces is smuggled into the country. Foreign cigarette exports are constrained, so current leaf purchases are constrained. Maximum cigarette industry capacity is about 90 billion pieces.

All domestic cigarette manufacturing is controlled by Bulgartabac. Cigarette factories were developed in various regions, but at varying levels of technological proficiency. The last three years have been stagnant and technological proficiency has not improved. During this time, many private firms were allowed to export from Bulgartabac on to world markets, while Bulgartabac was relatively inactive on the export market. In the past few months, almost 100 percent of cigarette exports were by private firms, who simply purchased cigarettes from Bulgartabac for re-export. Bulgartabac inactiveness is exemplified by the fully staffed Moscow office which is not open for business.

Agromproekt is the traditional partner of Bulgartabac, who is also responsible for building cigarette factories, drying facilities and implementing ideas from the Scientific Institute. In addition, they have also built five leaf manipulation factories in Iran and two in Iraq (before the recent U.S. entanglement). Both Bulgartabac and Agromproekt are very active in privatization efforts, and not just in the tobacco industry. There are currently joint projects with U.S. companies in re-tooling manufacturing facilities, although there are no private cigarette factories. However, experts claim that the Bulgarian government is preparing the documents to privatize some factories although the timetable is not clear.

Consumer trends have been away from a oriental-based cigarette to more of a big leaf or American blended cigarette. Much of the change in consumer tastes can be attributed to the recent surge in both legal and illegal imports of western international brands. Bulgartabac is trying to change production from oriental to more burley and flue leaf production. However, limited water supplies, necessary for the irrigation of these tobacco types, are the limiting factor. Thus, increases in production of these tobacco types is very risky. However, Bulgartabac believes that these problems can be overcome (again, contrary to the Tobacco Growers Union assertions).

### 5.2.2 Bulgarian Tobacco Trade

About 80 percent of combined leaf and cigarette production is for the export market, primarily the FSU. However, structural changes in the FSU and eastern European countries are in the process of forming new tobacco and marketing structures and it is difficult for Bulgartabac to access these markets using the old paradigms. However, Bulgartabac officials do not see any changes in the proportion of cigarette to leaf exports and changes in imported versus domestic leaf in cigarette production will depend on the market.

Traditionally, Bulgaria exports leaf tobacco to the FSU and the United States. Limited imports of high-quality U.S. tobacco has been blended with Bulgarian leaf to produce cigarettes destined for the Middle East. Although these shipments have fallen somewhat since the mid-eighties, the exchange of Most Favored Nation status will likely increase trade. Imports from developing countries such as Malawi will also likely increase, due to preferential tariff treatment.

Bulgaria also serves as eastern Europe's largest importer and exporter, and the second largest consumer of tobacco (after Poland). In 1992, Malawi exported only 77 tons of tobacco to Bulgaria worth $314,000, all of which was flue-cured, and that amount has been steadily dropping each year. Tobacco exports have dropped dramatically since 1989. The United States is Bulgaria's largest single import market for oriental leaf, amounting to about 10,000 tons in 1992. About 12,000 tons of tobacco leaf went to Europe and the United States last year and 1993 sales are expected to be about the same. However, leaf sales to Russia, the Ukraine and other ex-Soviet Republics are down. In addition, Russia has asked Bulgaria for help in expanding Russian oriental tobacco production.

Previously, Bulgartabac was responsible for all leaf and cigarette trade with Bulgaria. However, in the past six months that has changed. Bulgartabac, as mentioned previously, is currently very inactive on world markets. In the past few months, almost 100 percent of cigarette exports were by private firms. Similarly, SOKOTAB (an independent U.S. subsidiary operating in Bulgaria, with offices in Geneva and New York) and Universal Leaf are handling leaf exports. SOKOTAB buys directly from Bulgartabac, although reliable sources claim that this year they might be permitted to purchase leaves directly from the growers. SOKOTAB also buys leaf from Greece and other surrounding countries to accumulate larger shipments for export.

Import activity is also through SOKOTAB, who in turn sells the leaf to Bulgartabac on a commission basis. Apparently, SOKOTAB does not maintain an office in Bulgaria, but utilizes a traveling representative who is responsible for several countries.

As noted previously, through Bulgartabac, Bulgaria at one time was the largest cigarette exporter in the world. However, declining sales to Russia and Iran, due to the inability to pay, have dramatically reduced exports. Trade between the CSIS is much more difficult now because goods are quoted in money and rarely bartered. Since cigarette export have fallen, leaf imports have declined, including from Malawi. Previously, imports could be duty-free if headed for the export market.

Cigarette export markets are changing very rapidly. Bulgartabac believes that to survive they must be very price competitive. Inflation is increasing in Bulgaria faster than it is in many of their export markets. Foreign partners are also unstable, thus negotiation is very difficult. However, Bulgartabac sees this as a short-term challenge only. Most tobacco experts believe that the slump in leaf production and cigarette exports was inevitable and are taking a strategy of damage minimization.

In the past, the major cigarette export market for Bulgaria was the Russian market, which remains the largest purchaser. But, Russian cigarette imports from India, Turkey, Vietnam and China are replacing Bulgarian cigarettes in the Russian market. The prices of Bulgarian, Yugoslavian and Turkish tobacco and cigarettes are now more expensive than Asian prices.

Cigarette imports have increased dramatically in the last three years, both legal and illegal. Import tariffs on cigarettes on based on value and not per unit. Importers undervalue imports to receive low import tariff assessments, and import huge quantities of cigarettes. Again, Bulgarian customs is lax. A considerable amount of cigarette imports are controlled by economic groups, including "mafia" types, which appear to be only interested in quick profits, and not long-term market development.

There are four main issues surrounding the Bulgarian tobacco industry. Bulgartabac, the state-owned monopoly is in the process of restructuring. Low support prices and increasing production costs have created economic hardship for growers, resulting in severe production declines. Proposed changes in Tobacco Law will come before the Bulgarian Parliament and have the potential to dramatically alter the tobacco industry. Finally, the role of cigarette multinationals has increased in Bulgaria. Each of these areas deserve further attention and will be discussed in greater detail below.

### 5.2.3 Bulgartabac

Bulgartabac is responsible for leaf storage, sorting, grading, and manipulation; cigarette manufacturing; and export and import activities regarding both leaf and cigarettes. Bulgartabac sells cigarettes to private firms who in turn re-sell them on the retail market. Some sources claim that Bulgartabac will be effectively dismantled by the end of September 1993, although this is not certain.

Currently, domestic cigarettes have a excise label but there is no true tax seal system as of yet. For export, Bulgartabac must pay an excise tax to the Bulgarian "Budget" department to declare those cigarettes for export. Proposed tobacco law will provide a new tax seal provision for the domestic market (to be discussed later).

Bulgaria does have an increasing problem with cigarette smuggling. Last year, any association of any type (e.g., student or business associations) could freely engage in business activities. Consequently, many private businesses imported foreign cigarettes without duty. Popular cigarettes include western international brands such as Marlboro from Turkey, and high quality cigarettes in general. Bulgartabac complained and the legislation has since been changed. However, Bulgarian customs control is not very reliable. The average price of imported cigarettes is US$1.79, compared with US$0.70 for Bulgarian cigarettes.

After 40 years of communism, many Bulgarians believe that Bulgartabac is responsible for both the former and the present problems that the tobacco industry has suffered, and blames Bulgartabac for not doing anything constructive to solve these problems. Before 1990, Bulgaria was a centrally-planned economy, and in the last three years that economic system has been destroyed. The Bulgarian government simply introduced a market economy with no transitional policies to facilitate the conversion. No structures were put in place to make any transitions for the tobacco industry, with the exception of excise duties levied on imported cigarettes.

In general, Bulgartabac has severe marketing and sales problems. Due to changing consumer tastes for American-blended cigarettes, which has driven the import market, there is a limited local market for low quality cigarettes which Bulgartabac produces. It has also become increasingly difficult for Bulgartabac to export cigarettes. High leaf import duties (for the small amount of high quality leaf they require) and increasing production costs have made Bulgarian cigarettes less price competitive on the eastern European and FSU markets. In addition, the import duty on cigarettes has recently been reduced from 80 to 40 percent.

The Bulgarian Parliament has been studying the restructuring of Bulgartabac for the last year. In the fall of 1992, several groups submitted proposals for review. Many were rejected, Parliament accepted new proposals, and created a working committee of tobacco experts in the industry to study the issue in the spring of 1993. There are currently two main proposals to restructure Bulgartabac. One recommendation has been presented by the Ministry of Finance, which proposes to reform Bulgartabac as a private stock company comprised of the partnership of 22 companies. In this version, there would be independence between cigarette production and leaf export. The profitability of each individual sector would be kept separate. It is much more profitable to export leaf than cigarettes. Keeping these activities separate would prevent cigarette losses from eroding leaf export profits.

The alternative recommendation to restructure Bulgartabac is a proposal from the Ministry of Agriculture that would involve the formation of a holding company. This approach is based on the nine largest cigarette factories that exist in Bulgaria. All other smaller factories will play a very small role. The tobacco growers oppose this plan as growers must sell to the factory in their region even if prices are unprofitable. Growers would like the freedom to sell on markets that are most profitable, including the export market. Consequently, growers prefer the Ministry of Finance proposal.

During the time of Parliament review, other groups have submitted alternative plans to restructure Bulgartabac. One influential group has strongly advocated complete freedom of the tobacco industry from all government regulation and intervention. Although it appears that the government is receptive to this idea, they prefer to retain, if not increase, large import tariffs on leaf and cigarettes to build revenue for the budget department. The Union of Tobacco Experts denounces the above plan, believes that limited government intervention and regulation is needed, and has proposed a plan modeling the Bulgarian tobacco system very similarly to the U.S. system. The Union of Tobacco growers also put forth a proposal advocating some regulation similar to the U.S. system.

### 5.2.4 Declines in Production

Severe declines in Bulgarian leaf production are attributed to increasing costs of production that have not been compensated by sufficient increases in grower purchase prices. On the cost side, high land rents, increasing variable input costs and lack of credit has caused production costs to soar. Grower purchase prices, as defined by Bulgartabac, are frequently less than production costs. Understandably, many farmers have left tobacco production all together, resulting in severe production declines. Currently, there are large strikes by tobacco growers in the main growing regions.

Tobacco is very important to Bulgaria, both economically and from a cultural perspective. Leaf production and cigarette manufacture is a rather emotional issue to the heritage of most Bulgarians. As tobacco grower support declines, tobacco problems become ethnic problems. Since most Bulgarian tobacco production is oriental and most oriental producers are Turkish, the ethnic Turk issue is very important. There are two different hypotheses concerning lack of grower support. As leaf production is no longer viable, Turkish farmers and their families are forced to leave the southern growing regions of Bulgaria, and many return to Turkey. In effect, the exodus of Turks has the potential of eliminating ethnic unrest, such as what is occurring in Yugoslavia, which the Bulgarian government would like to avoid. The alternative explanation of low purchase prices is that the leaf industry is de facto underwriting the unprofitable cigarette industry, both of which are controlled by Bulgartabac.

On the cost side, land rents, increasing variable input costs, and inflation have eroded leaf production profitability. Land reform was a cornerstone the Bulgarian democracy movement. In the past, all land was moved to state ownership. The 1992 Reform Law specified that all land should be returned to former owners. Obviously this is very difficult, as previous owners have died and current land users need time for adjustment. Consequently, actual return of private lands is a very slow process and currently only 30 percent of land is in private hands. Of this, only about eight or nine percent of land owners have actual titles to their land and the rest have only land certificates. Further, only 20 percent of arable land is in private hands and most arable land is owned by Bulgarians, and not by Turks.

Consequently, Turks must rent arable land from Bulgarians, which can only be done at very high lease rates. Turks have basically three options available to them; produce tobacco, engage in mining activities or move back to Turkey or another region. Thus, tobacco policy is in reality ethnic policy and social policy.

Bulgartabac believes that the role of the government should increase in the area of land reform, e.g., through credits for production, economic rents controls for land, improving water and electrical access and costs, and controlling inflation to reduce increasing input costs. Taxes and interest rates are also on the rise. Bulgartabac does try to provide some inputs for free, but due to economic conditions is generally incapable of providing much assistance. Bulgartabac claims that discounts for buying in bulk are very small, so cooperative opportunities are minimal. Interviews with the Tobacco Growers Union are to the contrary and they believe that cooperative structures show great promise to lower grower costs.

Other variable input costs are extremely high, further squeezing tobacco profitability for the growers. In recent years, fuel costs have increased 21 times and fertilizer costs have increased 30 to 40 times. Conversely, the Bulgarian equivalent of the Consumer Price Index has increased 19 times, and tobacco prices have increased only 3 times. Commercial banks are very reluctant to loan money to agricultural producers given insolvency is a very big problem for farmers. In the fall of 1992 and early spring 1993, the Ministry of Finance tried to create a budget allowance for agriculture, which is the only subsidy agricultural growers receive. However, commercial banks refused to participate as interest rates are about 70 percent and inflation about 60 percent.

In light of increasing production costs, increases in purchase prices are insufficient. Lack of economic stimulation is primarily responsible for the slump in leaf production. Bulgartabac is responsible for setting purchase prices by variety and grade each year, and then will purchase all leaf off the market based on these announced purchase prices. The Scientific Tobacco Institute, a division of Bulgartabac, calculates purchase prices based on production costs, quantities produced and consumed, the ratio of varieties and grades produced in each growing region, and foreign market demand. Bulgartabac then proposes purchase prices and the Finance Ministry approves the prices. However, if purchase prices as a ratio of production costs are compared across commodities, tobacco has the lowest ratio.

The current grower strike is primarily an effort to pressure the Bulgarian government to increase purchase prices. Growers are concerned about the timing of announced purchase prices, low purchase prices in general, and price differentials across varieties. In February 1993, proposals were put forth to Bulgartabac to set purchase prices for various varieties and grades of tobacco. But, it was not until July 1993 that Bulgartabac issued a special decree announcing 1993 purchase prices, well after planting and at the beginning of the harvest season. Although Bulgarian tobacco farmers are very limited climatically and agronomically as to the variety of tobacco they grow, late announcement of purchase prices made their production decisions irretractable. Further, and most important, the new 1993 purchase prices were on average 14 percent higher than in 1992. Inflation for the first seven months of 1993 alone, averaged 33 percent. During this same 7 month period, the retail price of cigarettes increased 49 percent. (According to the Union of Tobacco Growers, this cigarette price increase was mainly for the employees of Bulgartabac and to increase their profit picture, and not for the benefit of the growers.) Further, Bulgartabac claims that it is impossible to build inflation into purchase prices. The Tobacco Growers Union believes that it is better to export cigarettes and use domestically-produced leaf for Bulgarian consumption. Higher cigarette prices will drive purchase prices, so the Union believes that the marketing of cigarettes is most important.

The leaf buyers recommendations for Bulgaria include completely privatizing Bulgartabac, privatizing all 11 cigarette factories, changing to more desirable varieties of domestically produced leaf, and cutting domestic leaf production in half.

### 5.2.5 The Role of Multinationals in Bulgaria

Bulgarians have a tremendous pride of their tobacco industry, which can not be underestimated. Of partial consequence, many Bulgarians are very sensitive about and fearful of foreign investment in an industry they believe is crucial to Bulgarian heritage. Many tobacco experts in Bulgaria believe that most multinationals and foreign countries are interested in a weakened Bulgarian tobacco industry, making it an easier target for a take-over. Bulgarians as a whole distrust multinationals and claim they're only interested in Bulgarian markets and not in Bulgarian capacity.

Consequently, some tobacco experts believe that currently there is a stagnation between the Bulgarian tobacco industry and the cigarette multinationals, particularly for burley and flue. It is believed that further contact with foreign investors should stimulate burley and oriental production in Bulgaria. In addition to high level talks with cigarette multinationals, other economic groups in the country are reportedly collecting large sums of money to invest in certain enterprises, particularly those enterprises which are operating at a loss and thus can be purchased at a cheaper price. It is purported that "Mafia" style groups are on the horizon to purchase into the Bulgarian tobacco industry.

There also is concern over the role of multinationals in any newly created form of Bulgartabac. According to Bulgarian law, it is easier to privatize a monopoly with a small amount of assets. Accusations have made that Bulgartabac is undervaluing their assets to attract foreign investment. Growers believe that Bulgartabac wants financial bankruptcy to invite foreign direct investment, of which they are very sensitive. According to Bulgartabac officials, the future of the state monopoly depends on more of an economic partnership with limited influence from foreign entities. Currently, there is no legislation allowing Bulgartabac to establish contacts with multinationals. However, there are unofficial reports that Bulgartabac is actively negotiating with a cigarette multinational. Despite these concerns, all the major cigarette manufacturers purportedly are negotiating with Bulgartabac to explore market entry strategies.

### 5.2.6 Bulgarian Tobacco Policy Changes

Import tariffs on leaf are 30 or 40 percent for some countries and non-existent for others. For Zimbabwe and other larger African countries, Asia and other developing countries, including Argentina, leaf import tariffs are 30 percent. All EC, U.S., Brazilian, South African, Turkish and eastern European leaf must pay 40 percent import duty. However, Malawi and other very small African countries can enter the Bulgarian market duty-free. The import tariff on cigarettes is currently 50 percent. Cigarette import taxes had been 80 percent, before being reduced to 40 percent and then increased to 50 percent a few months ago. Bulgartabac expects (and hopes) that cigarette import tariffs will increase to 90 or 100 percent with a new law for tariffs and customs duty.

In September 1993, the Bulgarian Parliament will again discuss proposed changes in Bulgarian tobacco law. The restructuring of Bulgartabac was discussed in an earlier section.

It has been proposed that a special fund using general budget monies be established to assist tobacco producers. The fund could be used to buy all quantities of leaf of the market and, importantly, not just the high quality leaf. This system would be loosely based on the U.S. system.

If a tax seal program is implemented, revenue collected would go to the general budget and not necessarily to the tobacco program. Bulgartabac hopes that the tax seal system will be introduced soon to stem smuggling.

Paradoxically, foreign cigarette manufacturers are permitted to advertise brands on the Bulgarian market, via radio, television, billboards, etc. But, Bulgartabac is not permitted to advertise, further decreasing domestic cigarette sales potential. However, there are proposed changes in the new Tobacco Reform Law that would permit Bulgartabac to advertise.

According to some industry experts, Bulgartabac will cease to exist by the end of September and will be effectively dissolved. The Union of Tobacco Growers has requested the resignation of Bulgartabac's chairman, as one of the concessions of the growers strike. However, the chairman is expected to speak at the World Tobacco Symposium at the end of September, in Moscow. Regardless, the future role of Bulgartabac is at least tenuous.

### 5.2.7 Implications for Malawi Tobacco

1. Until recently, Bulgaria has been the largest cigarette exporter in the world, primarily to the FSU. However, cigarette exports are down considerably, due to the inability of buyers to pay.

2. Although tobacco production is down considerably, Bulgaria continues to overproduce tobacco leaf and cigarette factories sit idle. About 80 percent of Bulgarian leaf production is oriental.

3. Bulgartabac, the Bulgarian tobacco monopoly, is in flux. Until the status and responsibilities of Bulgartabac are re-defined, Bulgaria's tobacco industry, including privatization, is in flux.

4. Duty on leaf imports into Bulgaria are 30 or 40 percent, depending on origin. However, only Malawi and a few other small countries have duty-free status. Although privatization appears forthcoming and Malawi is in an excellent position to provide leaf to this market, developments will be slow to materialize.

5. In the last six months, SOKOTAB and Universal Leaf are handling leaf and cigarette trade.

### 5.3 Current and Projected Consumer Markets in Romania

Although tobacco production and cigarette manufacture is negligible and declining in Romania, demand for international brands is tremendous. Smuggling plays a significant role in developing western tastes. The Romanian Tobacco Monopoly (RTM) has essentially been dissolved, but privatization of the industry is still under negotiation.

#### 5.3.1 Romanian Production and Consumption

Romania's tobacco production declined 48 percent in 1992, reaching 6,570 tons, due to a reduction in area planted. Late payments made by the Romanian tobacco monopoly in past years, compounded by competition from other crops such as vegetables and corn, have been instrumental in reducing tobacco plantings to the smallest on record. Average tobacco yields are also down, to 281 kg/ha in 1992 from 1,128 kg/ha, due to unfavorable weather conditions and availability of inputs. Although industry officials hope than higher producer prices (up 70 percent for the 1993 crop) will increase plantings in 1993, inflation ran 215 percent in 1992. In addition, Romanian tobacco is considered not of high quality due to improper storage and curing facilities. However, Romania does export a small amount of tobacco to Western Europe and North Africa, although 1992 sales were off 56 percent as tight domestic supplies cut exports to 1,100 tons.

The total tobacco area planted can range from 10,000 to 70,000 hectares, but at the upper end considerable technical assistance is required, including seeds and other inputs. Since 1989, RTM contracts directly with private farmers. Farm cooperatives have been dissolved and each farmer now has individual small plots. Farmers use to get low prices, supplemented with other benefits were available. Since the Revolution, the benefits are gone, but acquisition prices have only slowly increased.

The Romanian Tobacco Monopoly, established in 1864, has been historically responsible for tobacco growing, curing, cigarette production and marketing, and tobacco leaf imports and exports. Climatic conditions in Romania are very favorable for oriental varieties with low nicotine content, and flue and burley leaf are of reasonable quality. Romanian burley is desirable for it's water absorption capacity to add other flavors or casings such as fruit flavors to the blend. Domestic flue leaf is toasted to bring out the 20 to 25 percent sugar content. Other sun-cured and oriental varieties distinct to Romania are also grown.

In 1988 and 1989, 35,000 hectares of tobacco was cultivated. After the revolution, area planted fell to 8,000 hectares in 1992 and 10,000 to 11,000 hectares in 1993. The slight increase this year was due to the slight increase in acquisition prices to encourage production. In addition, productivity has increased to 1500 kilos per hectare. Organization of tobacco growers remains a problem. Previously, 5,000 to 8,000 hectares were irrigated in southern Romania. Now, irrigated surface has fallen to 2,000 hectares, due to disorganization of the farmers. RTM is trying to once again increase irrigated acreage. Acquisition prices are set according to labor costs and variable input costs. Tobacco goes from the farm to the growing center in that region or directly to the factory. In addition to the private farms, associated farms and the few remaining state farms, Romania has 400 regional grower agents and 30 grower centers. Each five or so grower centers then form a factory. After fermentation, leaf may move across growing regions to various cigarette factories.

In 1990, RTM reorganized as "Tobacco Regie", with a new general manager and specialized managers for growing, drying, fermentation and delivery. All fermentation, cigarette production, and research is under control or coordination of this entity and all factories are part of the Tobacco Regie. There are six cigarette factories in Romania.

Before the partial privatization of the Romanian Tobacco Monopoly (RTM), commissioned Romanian trading companies imported leaf and other raw materials needed for cigarette production, including cigarette filters, paper and packaging materials. Essentially RTM would calculate domestic cigarette production and consumption and would transfer this information to the trading companies. However, these companies knew nothing about the market itself and were only order-fillers. Consequently, these trading companies are not involved very little with leaf trade at this point given that they have no advantageous ties with the industry itself.

Domestic cigarette production is about 24,000 tons per year, while consumption stands at 34,000 tons. Domestic cigarette capacity is about 35,000 tons per year. RTM believes that cigarette production can recover to previous levels in two years. Locally produce cigarettes contain approximately 28-30 mg. tar, compared with 15-16 for the major international brands. Romanian Tobacco Monopoly does not want tar and nicotine maximums lowered. Local brands rely on more dark tobacco, which is naturally higher in tar content. There are some claims that a strong regional preference exists for cigarettes with an exclusive domestic leaf content. Although that might be true to a limited extent, the large amount of cigarette smuggling that exists (70 percent of current consumption) refutes that claim. Domestic cigarette prices for Camel are 1300-1400 Lei per pack, 1600 Lei for Marlboro and 200 for Snagov (the Romanian Tobacco Monopoly's most popular brand), before the new excise tax and VAT assessment.

Currently, the Romanian Tobacco Monopoly has six cigarette factories. Strong domestic production is required to meet domestic cigarette needs, particularly if leaf imports are cut. Currently, Romania does not have any effective agronomic program for tobacco production.It is expected that Romania will implement some type of agronomic program like Bulgartabac has in place.

### 5.3.2 Romanian Tobacco Trade

After 1989, anyone could import tobacco leaf into Romania and many small importers sprang-up. The cigarette factories can also import directly. However, hard currency shortages are severely restricting tobacco leaf imports and domestic cigarette production is very small. Now the role of RTM is to encourage production and control support prices. Most leaf trade continues to be with former communist countries such as China, Vietnam, and CSIS, and frequently is traded in rubles.

Given 1993 forecasted dry weight tobacco production of only 11,115 tons and leaf consumption of 13,415 tons, Romania will continue to import some leaf. Although ending stocks stand at 8,000 at year end, Romania is expected to import 7,000 tons of leaf tobacco in 1993. In 1992, Romania imported about 9,500 tons of leaf, primarily lower quality grades. Approximately 80 percent of leaf imports are flue tobacco. Leaf suppliers were China, Turkey, Greece, Albania, Italy, Indonesia and Bulgaria. Recently, RTM requested hard currency access from GOM to increase leaf imports to maintain cigarette production, but little action has been taken. Predicted exports stand at 1500 tons.

Cigarette trade is difficult to estimate due to the high incidence of smuggling. For 1992, cigarette imports were estimated at 9.5 billion pieces, up from 8 billion in 1991. For 1993, cigarette imports are expected to climb to 11 billion pieces, due to insufficient, low quality domestically-produced cigarettes. However, given the new 200 percent tariff on imported cigarettes July 1, 1993, legal imports are expected to drop to zero. Cigarette exports are non-existent due to poor quality.

Leaf buyers do not believe the Romanian market will completely close to leaf imports. Access to high quality leaf is extremely important to the multinational cigarette companies with licensing agreements in Romania. Some buyers are even optimistic that the market will open up even further in allowing leaf imports.

### 5.3.4 The Role of Multinationals in Romania

All the major multinational cigarette companies are beginning to establish a presence in Romania. For example, RJ Reynolds established a sales office in Bucharest one and one-half years ago. Western international brands have already made their presence known in Romania through international travelers and the black market. Although multinationals are not permitted to sell directly on the Romanian market, they are actively monitoring the market, calculating market share, documenting price differentials and closely following changes in tobacco policy.

There are a multitude of private importers which have sprung up, to provide the domestic market with foreign cigarettes. An important issue related to the privatization of the RTM is ownership of the local brands, which is an issue across eastern Europe.

The Bucharest cigarette factory has a licensing agreement with Brown and Williamson (BAT) and the Tg Jiu factory with Papstratos, a Greek company. Other cooperative agreements include Philip Morris with the cigarette factory Timisoara, and Rothman's with St. Gheorge. These cooperative arrangements serve to produce improved Romanian local brand cigarettes and, in the future, to allow for the production of one international brand per agreement.

Intabex has also introduced some burley varieties in Romania and have had very good success. Approximately 1,000 hectares are under production for domestic consumption.

### 5.3.5 Romanian Tobacco Policy Changes

Tobacco leaf, stems and scrap are subject to a 25 percent import duty. Pipe tobacco is subject to a 60 percent import tariff. The primary barrier to leaf imports is the non-convertability of the local currency.

For all practical purposes the Romanian Tobacco Monopoly ceased to exist July 1993. However, at the same time the Romanian government levied a new tax schedule on imported cigarettes. Beginning July 1, 1993, a new excise tax of 200% was levied on cigarette imports. In addition, all products are subject to an 18 percent VAT, including both domestic and imported cigarettes. This new tax schedule has effectively dropped legal cigarette imports to zero. The 200 percent tariff applies to imported and luxury cigarettes, compared to a 70 percent excise tax levied on local brands.

Although this tax system was designed, in part, to generate revenue, imported cigarettes account for only five percent of the market. In the first half of 1993, local brands, produced by the Romanian Tobacco Monopoly, held 65 percent of the market, with imported cigarettes holding the remainder. However, since July 1, locally produce brands have increased their market share to 95 percent of the legal market. But, according to reliable sources, the black market has an estimated 95 percent total market share since the tax change. Obviously, this has placed the cigarette multinationals in a very precarious position. Even if western international cigarettes were locally manufactured, current tax law requires an 185 percent excise tax assessment. Before the new excise and VAT assessments, Camel cigarettes were selling at 1300 to 1400 Lei per pack and Marlboro at 1600 Lei per pack. After the new tax schedule went into place, Snagov (the RTM brand), increased market share from 65 percent to 95 percent, as foreign brands lost market share.

The Romanian government receives very little direct tax revenue from the new tax schedule. But, illegal payments to government officials on the black market are significant. Further, although the Romanian government would like this new tax program to put pressure on multinationals to purchase production capacity, multinationals are very reluctant. Although these stiff tax assessments could be Romania's attempt to place leverage on the multinationals, none of the major cigarette manufacturers are anxious to buy into the Romanian cigarette industry given the current environment. In order to induce multinational investment, Romania must show signs of significant domestic leaf production,which is contrary to current conditions. Further, multinationals will require a strong domestic agronomic program to improve varieties and quality, as well as some type of scientific institute for tobacco.

Most tobacco experts believe that Romania will eventually follow the same path as many other eastern European countries and will continue to put up protective barriers to leaf imports. Consequently, cigarette multinationals will engage in local manufacturing and local leaf quality will improve due to agronomic advances.

Cigarette advertising is not restricted, although rates are 6-7 times what other manufacturers must pay, and no anti-smoking movement exists. Warnings are not required on advertising because higher prices can be extracted from the cigarette multinationals in hard currency.

Romania is expected to get its first bank funded entirely with foreign capital. The new Bank of Bucharest will be 60% owned by the Credit Bank of Greece with an additional 15 percent owned by one of its units, and 25 percent owned by the European Bank for Reconstruction and Development. The latter is a multilateral lender that promotes economic development in the former East bloc. Given leaf imports are severely restricted by lack of hard currency, this financial restructuring could aid future leaf trade.

### 5.3.6 Implications for Malawi Tobacco

1. Romanian tobacco production is minimal and declining.

2. The Romanian Tobacco Monopoly essentially ceases to exist, although privatization of the tobacco industry continues to be negotiated.

3. Beginning July 1, 1993 a new excise tax of 200 percent was levied on imported cigarettes, causing legal cigarette imports to drop to zero (from their previous 5 percent official market share). Locally manufactured western brands would be subject to an 185 percent excise assessment, if production were permitted.

4. Near-term Malawi leaf exports to Romania do not look promising. However, Malawi tobacco will continue to enter this market, probably in increasing amounts, via the black market. Long term prospects are much more encouraging.

## 5.4 Other Eastern European Countries

In addition to leaf market opportunities in Poland, Bulgaria and Romania, Hungary and Czechoslovakia are also promising markets. In the short term, hard currency shortages are constraining leaf imports and consumption of international brand cigarettes. However, these problems are being resolved. Future sales to Yugoslavia also hold promise, but current unrest makes this market politically and economically difficult, at best.

### 5.4.1 Hungary and Czechoslovakia

The tobacco industries in Hungary and Czechoslovakia have been completely privatized. Both of these markets are expected to increase their imports of high quality tobacco, including Malawi, Zimbabwe and Thai leaf. Importantly, Hungary and Czechoslovakia continue to give preferential treatment to developing countries. Further, the multinational which dominate these markets have demanded the right to purchase leaf off the world market as needed.

The Czechoslovakia Monopoly was sold in total to Philip Morris. In 1992, Malawi exported 1,214 tons of tobacco leaf to Czechoslovakia, of which 1,012 tons was burley and 202 tons was flue-cured leaf. Leaf sales to this market have already been recorded for 1993.

### 5.4.2 Former Soviet Union

Tobacco production in the FSU is expected to increase 70 percent over 1992 levels, and reach 245,110 tons in 1993. However, this increase reflects a return to normal output levels following last years drought. In general, domestic leaf production is insufficient for consumption needs.

Recent land legislation has altered the rights of land ownership. Individuals now have the basic right to own, sell and mortgage land. Foreigners still are unable to purchase land, although they may lease it for as long as 99 years. Local authorities would then be responsible for regulating private property. Land reform has been slow in coming to Russia's 25,000 collective and state farms. This legislation is expected to have significant impacts on Russia's agricultural sector. In 1992, private farmers accounted for only 1.5% of the country's total.

In general, Russia will continue to enter world leaf markets looking for very inexpensive leaf to supplement domestic underproduction. Typically, Russia will be looking for more air-cured leaf and not flue tobacco. However, it is expected that Russia will procure small amounts of burley and flue off world leaf markets. The former Soviet Union purchased 14% of China's leaf export quantity in 1991, but that dropped to near zero in 1992.

Intabex has half of the leaf market in Russia. In addition, Intabex has their own growing operation and sell to a cigarette manufacturer in Russia. However, thus far all transactions are in rubles. Apparently, Intabex is the only one with such an operation.

Barter and counter-trade has been extremely valuable in opening up many of the CSIS markets. For example, after gaining independence in 1980, Zimbabwe wanted to form relationships with many CSIS countries to barter tobacco for manufactured goods. After some success, Zimbabwe is now in the position to sell for cash and has outlawed counter-trade. Some leaf buyers have suggested that this route might also be useful for Malawi.

Currently Malawi is not selling any leaf directly to the FSU. The FSU prefers semi-oriental leaf from Greece, Italy and the CSIS. According to leaf buyers, prospects for Malawi tobacco in Russia are not promising. However, leaf continues to enter the FSU via a well-developed black market.

# 6. GLOBAL TOBACCO RESERVES AND PRICE/VOLUME TRENDS

Global tobacco reserves have continued to grow, primarily in developing countries, as agricultural production persists as the foremost source of income for rural areas. Tobacco exports have proven to be an important source of foreign exchange in countries faced with shortages of hard currency. The current record amount of tobacco ending stocks has been blamed for the leaf glut on world markets and for the resulting reduction in world leaf prices. Due to time and data limitations, this section of the report only provides an overview of these issues.

## 6.1 Global Tobacco Reserves

Ending world tobacco stocks continue to climb, posting a seven percent increase in 1992. Ending world stocks in 1992 stood at 7,037,225 metric tons dry weight. The build-up in global reserves is attributed in large part to China, the largest tobacco producer (accounting for 42 percent of global production in 1992) and the largest reserve holder (33 percent of global reserves). China's ending stocks increased another 19 percent to 2,329,102 tons dry weight during 1992. As the appendices show, from 1986 to 1990 China's stocks of flue-cured tobacco more than doubled, increasing to 1,861,593 metric tons.

During the period from 1986 to 1990, ending world stocks of Burley tobacco dropped a total of 26.9 percent, down to 773,904 metric tons. During the same period, world stocks of flue-cured tobacco increased 27.8 percent to 3,675,406 metric tons. Stocks of Oriental tobacco increased only slightly, up 2.1 percent to 746,808 metric tons.

The second largest holder of tobacco reserves is the United States, with 1,385,255 tons dry weight by 1992 year end. However, U.S. reserves actually dropped five percent over 1992. In fact, U.S. ending stocks have been dropping by small amounts since at least 1988. Data for the period from 1986 to 1990 shows a total 15 percent drop in ending stocks of unmanufactured tobacco. This drop was primarily composed of a 7.3 percent drop in stocks of flue-cured tobacco, down to 794,072 metric tons in 1990; of a 60.4 percent drop in stocks of burley, down to 226,737 metric tons; a 53.6% drop in dard air-cured and sun-cured tobacco, down to 11,002 metric tons; a 96% drop in light air-cured tobacco, down to only 623 metric tons; and a 29.7 percent drop in dark air-cured and cigar tobacco, down to 32,865 metric tons.

Turkey, Japan, Italy and Brazil also hold large stocks of tobacco, in the range of 300,000 tons as of 1992. Over the last 5 years, Turkey's ending stocks have increased 36 percent, Japan's have fallen 15 percent, Italy's have grown by 21 percent and Brazil's have increased by 52 percent. The table, Unmanufactured Tobacco Stocks, 1988 to 1992 in the appendix shows overall ending stocks from 1988 to 1992. The largest holders of world stocks of Burley, Flue-cured, and dark fire-cured tobacco are detailed in the appendices.

## 6.2 Price/Volume Trends

Leaf prices vary not only over time, but also across markets and by leaf type. Of importance to Malawi is Malawi leaf prices relative to that of it's competitors. Chapter 4 and the Appendix of this report provide price information to this effect.

The Appendix of this report also provides graphical depiction of world leaf trade.

# 7. EC COMMON AGRICULTURAL POLICY TOBACCO REFORM

Historically, the European Community has been an important buyer and competitor of Malawi's on the world leaf market. On the purchasing side, demand prospects for Malawi tobacco has been discussed in detail in Section 3 of this report. This section will discuss how changes in EC Common Agricultural Policy with respect to tobacco will affect the future ability of the EC to compete on world leaf markets.

The European Community is comprised of Belgium, France, West Germany, Italy, Luxembourg, the Netherlands, Denmark, Ireland, the United Kingdom, Greece, Spain and Portugal. A unified monetary system is expected to help move the European Community closer to economic integration and to mitigate the disruptions in trade that can occur from currency exchange rate fluctuations. All members of the EC except Greece and the United Kingdom participate in the exchange rate mechanism of the European Monetary System. Member countries deposit gold and dollar reserves with the European Monetary Cooperation Fund in exchange for the issuance of European currency units. The European Currency Unit, or ECU, is the weighted average of all European Community currencies, except Spain and Portugal, which fluctuates against third country currencies and is used for internal EC accounting purposes. In agriculture, the ECU is the unit of account in which common farm prices, subsidies and import levies are established.

Recent upheaval in the EC's monetary system will most likely slow the movement towards monetary unification and EC CAP reform. The German designed European Monetary System (EMS) is held responsible for current high interest rates and the ensuing recession that plagues European economic growth. The demise of the Exchange Rate Mechanism could boost EC trade with the world, as select EC members slowly lower interest rates to spur economic growth. From a trade perspective, a stable economy and currency would boost EC trade, whether that stability comes from the demise of the EMS or from full monetary union and a single currency. On the down side, the monetary upheaval in the EC will very likely slow European integration as individual members pursue separate agendas. Consequently, any setback in EC unification might lead to increased trade protectionist behavior.

Current and proposed EC Directives also have important implications for trade with the European Free Trade Association (EFTA) countries (Austria, Finland, Iceland, Norway, Sweden and Switzerland) and the Central and Eastern Europe countries (Bulgaria, Czechoslovakia, Hungary, Poland, Romania and the ex-Yugoslavia states). Several members of EFTA have proposed joining the E.C., which would expand the European Community from 350 to 450 million households. Proposed EFTA additions to the Community are on hold, pending further progress towards unification, although most EFTA countries are expected to join the Community by the year 2000. Therefor, EFTA members are extremely concerned over EC unification progress, as late membership would require acceptance of EC Directives with little input from new EFTA members. Although many Central and Eastern European countries also desire EC membership, they currently lack the institutional and economical means to fully comply with EC law.

The continued political and economic unification of the twelve members of the European Community has important ramifications for the tobacco industry. Although the pace of unification has slowed significantly from what was originally envisioned, as illustrated by delays in signing of the Maastricht Treaty, the EC has made meaningful strides in removing barriers to trade and harmonizing standards across borders. Concurrently, changes in consumption patterns are altering tobacco sales in many European countries. Consumption is being curtailed by higher taxes, particularly in the northern countries. Consequently, the European Community's role in tobacco trade is slowly changing.

## 7.1 Market Developments in Western Europe

European Community tobacco production is expected to decline sharply due to changes in tobacco policy through the CAP (Common Agricultural Policy). CAP is the set of regulations by which member states of the European Community attempt to unify their individual state programs. Two key components of CAP are the variable levy (an import duty amounting to the difference between EC target farm prices and the lowest available market prices of imported agricultural commodities) and export restitutions or subsidies (used to promote exports of goods that can not be sold within the EC at target prices).

Tobacco production in the European Community is expected to fall to 404,673 tons in 1993, 11 percent below 1992 production figures, primarily due to EC CAP reform for tobacco. Proposed changes include a quota for each tobacco type, by country (with no payments for above quota production) and an end to controls on trade, including the abolishment of export subsidies.

With regard to particular tobacco types, EC flue-cured production is expected to decline by 16% in 1993, to 141,914 tons, with Greece and Italy remaining the top EC producers. Burley production is also expected to fall 4%, reaching 86,579 tons, again with Italy the top producer. Similarly, oriental tobacco production will drop 5 percent to 125,000 tons, primarily due to declines in Greece's production, and dark air/sun-cured production will decline to 38,100 tons, or 21 percent from last year.

Tobacco production exceeded the Maximum Guaranteed Quantities (MGQ) again in 1991, resulting in an increased effort to reduce overproduction through reductions in producer premiums and MCG. Consequently, total EC tobacco production is expected to fall to 404,673 tons in 1993, 11 percent below 1992, primarily due to Common Agricultural Policy (CAP) reform. Recent and proposed CAP tobacco revisions impact tobacco production through a quota system and enhance tobacco exports through subsidies.

In general, the EC faces problems with leaf overproduction, but there continues to be some unique Turkish orientals, Italian burley and Greek varieties which do have a good market niche. Approximately half of the flue production in the EC is under production contract. If the world surplus continues, that could be reduced. Contracts are through the leaf merchants and not through the manufacturers.

In terms of imports, Germany remains the second largest world tobacco buyer (the United States was number one), although imports fell 5 percent in 1992, reaching a total of 198,000 tons. The United Kingdom was the third largest tobacco importer in 1992, purchasing 138,770 tons, and the Netherlands was sixth, purchasing 92,545 tons.

The Confederation of EC Cigarette Manufacturers, with it's office in Brussels, is the main lobbying arm for the cigarette industry. Representing 65-70 percent of the industry, all multinational manufacturers are represented including Philip Morris, RJ Reynolds, BAT, Rothmans, Gallaher (also involved in the alcohol industry), Imperial (a subsidiary of American brands) and Reemtsma (a German company). The Confederation does not represent the tobacco monopolies of France, Italy, Spain, Portugal and Greece. (France, Italy and Spain have agreed to privatize, which may alter their representation). Most of these large manufacturers export primarily to France and Italy, with some licensing arrangements in Spain on the Canary Islands. It is the view of the Confederation that the previous CAP tobacco program was a scandal, with many growers producing a very poor crop and still receiving subsidization from the E.C.

One of the biggest problems affecting the EC cigarette industry is intra-EC price differentials. On average, 70 to 75 percent of the retail price of cigarettes is excise taxes and the VAT. In particular, cigarette prices from the southern monopoly countries do not reflect the true costs of production. As example, Denmark has the highest priced cigarettes and Spain the lowest. This tremendous difference in price has led to both legal and illegal cigarette smuggling within the EC as cigarettes move from low-price countries to high-priced ones. It is estimated that 80 percent of the cigarette consumption in Naples is smuggled cigarettes. Consequently, even if the EC achieved total tax harmonization, lower cigarette prices would still exist in eastern Europe, artificially low prices in southern EC members would persist, and smuggling would continue.

Smuggling is a pervasive problem to the entire European Community cigarette market. Purportedly a combination of Italian and Russian mafia, cigarettes are moving from Eastern Europe to Hamburg and the rest of Western Europe. Many of these cigarettes are legally produced Marlboro (manufactured either in the EC and sold duty-free for export or manufactured in Eastern Europe) which find their way back into the German market.

To combat the threat of smuggling and the E.C.-wide recession, EC cigarette manufacturers are trying to develop second-tier brands and are responding with price wars on premium brands. As a consequence, southern countries are losing market share. In response, France, Portugal and Italy have introduced tobacco advertising bans to protect state monopoly interests under the guise of health protection.

In general, the cigarette industry in the north is approaching the health issue via self-regulation. The southern members are more accustomed to the government imposing regulation. An important difference between the northern and southern countries of the EC is their attitude towards tax harmonization. Currently, the proportional or ad valorem tax must be between 5 and 55 percent, as long as the total tax incidence is a minimum of 57 percent. The

Federation, which basically represents the multinational cigarette manufacturers of the northern countries, supports more specific tax incidence. A ratio of high ad valorem tax results in price increases that get multiplied due to the additional ad valorem tax. A specific tax would minimize the price differential between low and high priced cigarettes. Tax harmonization will go for review again in 1994. It follows that most of the multinationals would also prefer a specific tax system in eastern Europe.

Philip Morris (PM) is the largest cigarette manufacturer in Europe, in terms of unit volume and sales revenue. In 1992, PM brands accounted for over one-fourth of the EC cigarette market, with Marlboro alone taking 18 percent of the market. Europe's largest and most modern cigarette plant, the Philip Morris Holland B.V. manufacturing center at Bergen op Zoom, will soon be producing 76 billion cigarettes per year. By the end of the decade, PM expects to be producing 50 percent more cigarettes in the EC region, based on an expected annual growth of 3.8 percent (which is considered conservative, due to PM's 9.8 percent growth in 1991).

Cigarette production in Spain, Greece and Italy is typically done through the state controlled monopolies, supplemented by licensed production by the large multinational cigarette manufacturers. It is expected that the French government will sell 47 percent of the tobacco selling monopoly. Apparently Philip Morris is not interested and experts speculate that the German cigarette manufacturer Reemstma will buy the share to serve the EC market.

Current and proposed minimum tar requirements has made EC cigarette manufacturers pay more attention to tobacco processing. A lot of new research has been conducted on building a cigarette. To drop the tar maximum even further would be against the southern members and their dark tobacco.

These tar limits have hurt Philippine and Taiwanese leaf exporters, while benefitting Thai flue and Malawi burley. Thai flue is reasonable to good quality, with very low tar and nicotine content. Thailand has also retained a stable currency, which is good from an economic stability perspective, but has made Thai leaf more expensive. Thai leaf also blends very well with other tobaccos. In general, Thai burley is cheaper than Malawi leaf, but not nearly as good.

An important advantage Malawi leaf has over Brazilian leaf is the preferential tariff treatment extended to countries of Africa. African leaf exporters pay no duty upon entering the European Community, whereas Brazil must pay approximately 35 cents import duty per kilo.

## 7.2 EC Common Tobacco Policy

Common tobacco policy in the EC is comprised of three basic elements: leaf support, state tobacco monopoly liberalization and tax approximation (or harmonization). The primary goals of EC tobacco reform are to reduce tobacco support cost and to discourage the production of less commercially-viable tobacco types. Regulation 2075 of 1992 specifies reform regarding market organization, Regulation 2076 specifies the two-year quota and premia program and Regulation 2077 encourages forward integration linkages in the industry.

### 7.2.1 Leaf Tobacco Support

Although tobacco production is one of the European Community's most efficient agricultural sectors, 1992 brought significant policy reform to the tobacco industry. EC tobacco expenditures have increased dramatically over the last ten years, with almost 10 million ECU (1 ECU = US $1.25) spent on tobacco premia, export refunds and storage in 1992, compared with less than 1 million ECU in 1983. Due to the high cost of leaf tobacco support, both economically and politically, the EC is restructuring buyer premiums and eliminating export restitution payments.

Abuses of the former tobacco program were wide-spread, providing further impetus for reform. For example, in Italy "premium-hunters" received premiums for purchasing intervention stock and then exported the leaf to receive the export subsidies. Given that tobacco premiums were based on leaf weight, tobacco's were unfairly weighted to make the buyer premiums larger, further increasing the profit margin on what was typically unusable leaf. Previously, the premium was based on the difference between the target price and the intervention price. To avoid the aforementioned abuses, CAP tobacco reform has abolished intervention prices and export subsidies and now buyer premiums are based on the difference between the target price and the world price.

As buyer premiums are lowered and export restitutions abolished, leaf tobacco costs will drop for domestic manufacturers, especially for black tobacco users. In general, tobacco production will be discouraged, particularly in Greece and Italy. Importantly, production of flue-cured Virginia and burley tobacco will be encouraged against black tobacco.

Tobacco reform is attempting to encourage production of leaf types with greater commercial appeal. Although the EC is a significant exporter of low quality leaf, it imports nearly 70 percent of its tobacco needs. While exports are mainly to Eastern Europe and the former USSR, imports are of higher quality tobacco to meet the increasing demand for lighter, American-blended cigarettes. In general, EC consumption of dark tobacco is declining and the demand for low-tar cigarettes growing, particularly in the northern countries.

For the 1992/93 marketing year, prices and premia were left unchanged, in anticipation of major reform in upcoming years. The current CAP tobacco proposals include a regrouping of varieties, national production quotas and the conversion to more commercially-viable tobacco types. The 1992 MGQ was reduced from 390,000 tons to 370,000 tons in 1993, and allocated to seven member states. In 1994-1997, the MGQ will be further reduce to 350,000 tons.

A challenge already encountered by the EC Commission is overproduction of quota. In 1992, production was forecast at 450-460,000 tons, but final estimates were lowered to 410,000 tons. Overproduction is expected to be a problem again in 1993, especially in Italy and Greece.

In particular, Virginia (flue-cured) tobacco is being overproduced in Greece, with current estimates running at 70,000 tons, double the 35,000 ton quota. Apparently, producers plan on receiving the full premium on half their crop, thereby receiving half the premium on their entire crop. Further, Greek producers are expected to use this years overproduction to ask for increases in quota next year. Greece produces good quality oriental tobacco, but in general leaf quality is very poor in the European Community.

All tobacco produced above the quota can be sold without the premium, thus at a much lower price. Now the premium for each variety is the same all over the EC and no longer varies by country. However, there is a phase-out program for northern countries until 1997 to lower premiums gradually until commensurate with lower premiums in the south. In addition, there is a ten percent premium for producers who market their tobacco through producer associations. The EC Commission is attempting to increase the bargaining power of associations.

The MGQ will be assigned to processors, or producers with sufficient production history. Quotas will be assigned for eight tobacco types: flue, light air, dark air, fire and sun-cured; and the Greek varieties Basmas, Katerini and K. Koulak. The seven eligible countries are Italy, Greece, Spain, Portugal, France, Germany and Belgium. Initially, only Greece, Italy and France will have their quotas reduced; the others will remain the same. In general, CAP reform is trying to change leaf types and improve quality. However, in the south, countries do not always have the soil types, water etc. to make the tobacco variety changes announced. Importantly, the CAP tobacco program is seen as a social program, rather than an economic one. In many countries such as Greece where one-fourth of the farmers produce tobacco, alternatives are few and CAP reform must move slowly to prevent social and economic upheaval in these rural communities.

Quotas and premium are established by a committee that calculates what can be marketed and at what price. So the 1994 quota will probably be changed later this fall (before Christmas). Thus, the quota was established on a two-year cycle, but it can be adjusted in the second year. Premium, also proposed by a committee of experts, will also be changed based on 1993 production and price results. Thus,there is a trade-off between quota changes and premium.

Reductions in quota vary by tobacco type. Slight reductions in the Greek varieties (Basmas, Katerina and Kaba) will be accompanied by larger cuts in flue, dark air and sun-cured. The black or dark air-cured quota has been severely cut, particularly in Italy. Light air and fire-cured production is expected to remain about the same. In general, there will be an increase in production of burley and flue tobaccos or movement out of dark tobacco production to blonde American types. Burley can be produced on small plots, but flue tobacco is more capital intensive due to water requirements, curing facilities, and larger plots of land needed for economies of scale. If flue-cured production increases, quota will then be assigned to larger farmers, and less to smaller farmers. As smaller farmers leave, quota will also be re-assigned to larger farmers. (Quota can not be sold or leased separately. But, farmers can sell or lease their land which has the quota attached.)

Farmers that produce over quota are not eligible for growers premiums for that excess production. Further, growers can only get premium if they have a contract with a buyer. Many tobacco experts believe that at the end of 1993, the EC Commission will totally overview the tobacco subsidy program and there is a chance that the program will be abolished completely (although the Commission refutes this claim, at least for the near term). At a minimum, many anticipate further reductions in buyer's premium across all varieties. As EC tobacco becomes increasingly expensive, leaf buyers will continue to look overseas.

Contracts are made between growers and the leaf buyers or packers, and the large Italian corporations. If the tobacco program were abolished, some tobacco experts see more contracts with packers at "decent world prices" and it is questionable whether that is feasible.

However, it is important to note that producer premia will be reduced by for those tobacco types that exceed their MCG. The system of intervention stocks is also abolished under CAP reform. Previously, tobacco that was not sold for minimum designated prices was sold into intervention stocks. This system is no longer in existence, with the exception that small 1009/91 and 1991/92 production intervention stocks will remain until they are sold.

Under CAP tobacco reform, both intervention stocks and export refunds will be abolished. Although these components of total tobacco program costs are relatively small compared with producer premia, they have been increasing. Most export refunds go towards the lower quality and less commercially-viable tobacco types, thus reduction of export support should reduce production in this area. The lack of export refunds will also discourage overbuying. Small stocks will then be sold off, to reduce carry-over inventory costs. However, the EC might re-introduce intervention stocks for specific varieties if really needed, but not simply due to the overproduction of quota.

The European has suffered considerable scandals under the previous export restitution and intervention program. For example, in Italy "premium hunters" received premiums for buying intervention stocks and then exported the leaf to obtain the export subsidies. The tobacco premiums were based on weight. Tobacco was unfairly weighted with foreign matter and water to make the buyer premiums much larger. Buyers could also buy tobacco straight off the market and still receive a premium based on the difference between the target price and the intervention price. Current CAP tobacco policy has abolished the intervention price and export subsidies. The allowable premium now is basically the difference between the target price and the world price.

### 7.2.2 State Tobacco Monopolies

There are no tobacco growing monopolies in the EC anymore, but there are manufacturing monopolies. Portugal continues to maintain a nationalized tobacco industry, while Spain, France and Italy have made limited efforts to reform their state tobacco monopolies. Spain supports her tobacco industry through Tabacalera, Italy through Monopoli di Stato, and Portugal through Tabaqueira. It appears that Italy's monopoly will be privatized. Other EC member states have abolished their wholesaling and importation monopolies and the retailing monopolies have generally been placed within the jurisdictions of the respective Ministries of Finance.

If the Treaty of Maastricht is ratified, member countries could be admonished for interfering with price formation. This would encourage the trend towards privatization of state tobacco monopolies. Anti-smoking and health issue activists will also apply increased political pressure for governments to withdraw state support for their tobacco industries. As state tobacco monopolies are privatized and government price controls relaxed, industry margins and retail selling prices should increase in southern member states.

### 7.2.3 Tax Approximation

Tax approximation (or harmonization) is one of the most divisive issues facing the European Community's tobacco industry. Tariffs on cigarettes and other tobacco products vary by country and by product Further, the taxation can be applied as a *specific element* or as a *proportional element* tax. Various proposals have attempted to harmonize excise taxes across EC members with limited success. Combined taxes in most countries account for about 70 percent of the retail price of cigarettes.

A specific element tax is usually assessed per unit, such as 1,000 cigarettes. The U.K., Denmark, Germany, Belgium and the Netherlands all rely on high specific excise taxes to inhibit consumption and generate revenue. Excise taxes per 1,000 cigarettes range from US$91.75 in Denmark to US$31.30 in the Netherlands. Consequently, retail cigarette prices in these countries are among the highest in the EC Specific excise taxes in the remaining EC countries are in the US$1 to US$3 range.

The proportional element tax is comprised of the ad valorem and the value-added tax (or VAT), which is a percentage of price. Both the ad valorem and the VAT vary by country. In the E.C., proportional element taxes range from 33 to 87 percent. In general, the higher the specific tax a country imposes, the lower the proportional element, although this is not always the case. The ad valorem tax has somewhat of a multiplier effect in that cigarettes with higher manufacturing prices, reflecting higher quality tobacco and components, are competitively disadvantaged. This is because small differences in ex-factory prices are magnified at the retail level once the ad valorem tax is added.

In general, the northern countries utilize a lower proportional element and a relatively higher specific duty. In contrast, southern countries rely on the reverse. The northern countries (representing high-margin, free enterprise companies) favor a specific element of taxation in which a specific tax amount is levies on a specific volume of goods. Northern manufacturers would prefer to see a narrower price spread that more nearly reflects ex-factory prices. On the other side of the argument is the southern countries, characterized by low-margin, state-controlled monopolies. The southern tobacco industry favors the ad valorem or proportional tax system. Southern manufacturers use primarily locally produced tobacco to produce a lower quality, thus lower priced, cigarette. Thus, they are concerned that tax harmonization would increase their cigarette prices such that they would lose market share.

The multinational cigarette manufacturers also favor a specific tax system to minimize the difference between low and high priced cigarettes. With a ratio of high ad valorem tax, any price increase gets multiplied due to the additional ad valorem tax that would be levied.

In an attempt to narrow the band of tax rates, in October 1992 the European Council of Finance agreed upon a minimum excise incidence of 57 percent of the retail price for cigarettes, 5 percent for cigars, 20 percent for pipe tobacco and 30 percent for roll-your-own tobacco. The ad valorem or proportional tax must be between 5 and 55 percent, as long as the total tax incidence is 57 percent. Added to that is a minimum 13.04 percent value-added tax (VAT), bringing the minimum excise tax on cigarettes to 72 percent. Importantly, setting a minimum is significantly different from tax approximation or harmonization. It has also been proposed that two different tax structures be created for northern and southern manufacturers. Again, this would defeat the spirit of unification.

Consequently, total tax yields vary considerably from country to country. For example, in 1991 total tax yields per 1,000 cigarettes was 145.7 ECU in Denmark, 52.32 ECU in the Netherlands, and 13.93 ECU in Spain. Generally speaking, the northern countries have higher total tax yields and the southern countries have lower.

The EC is required to review excise rates every two years, with the next review slated for 1994. Thus, drive toward tax approximation will continue, although harmonization will be impeded by the lack of progress on monetary union.

Since 1993, private individuals can purchase cigarettes for personal use in other member states. This reinforces the notion that consumers will provide the market incentives to harmonize tax rates or countries will be faced with continued illegal trading.

According to the U.K.'s Tobacco Advisory Council, the U.K. expects to lose about $6 billion cigarettes (or 6 percent of the market) each year from cross-border shopping. This will result in a loss of over 400 million sterling pounds of government revenue. Although travelers entering Britain are permitted to bring in 800 cigarettes for personal use, the allowance is only a guideline and has not been legally tested. The German government expects to lose about 800 million sterling pounds from cigarettes smuggled to Poland.

Three different types of smuggling are expected to flourish as customs borders are removed and tax differentials persist. Illegal trade will follow large-scale container loads, small-scale order takers and individuals wishing to circumvent the system for their own personal use. Many believe that organized crime will become involved. Higher tariff schedules might be introduced by individual states to counter the loss in revenue. However, higher taxes, in for example Britain, might simply push domestic manufacturers out and force them to relocate where tax conditions are more favorable.

The current EC proposal for consumption taxes on cigarettes and other manufactured tobacco provides guidelines for narrowing divergent state taxes schedules. This proposed EC Directive imposes a specific excise tax of 19.5 ECU per 1,000 cigarettes and a proportional tax element of between 52 and 54 percent of the retail selling price (including taxes). Individual countries have the discretion of how to allocate the proportional tax element between the ad valorem and the VAT.

The EC proposal also suggests narrowing divergent state tax schedules on manufactured tobacco, other than cigarettes. It is proposed that other manufactured products be subject to an ad valorem excise tax calculated on the maximum selling price of each product. The combination of this tax and the VAT should amount to between 34 and 36 percent of the retail price (taxes included) of cigars, between 54 and 56 percent of smoking tobacco, and between 41 and 43 percent for snuff and chewing tobacco.

Import tariffs on manufactured tobacco products have been historically high since post-war German reconstruction. Tariffs are expected to remain high to continue protection to manufacturers, with the exception of perhaps imported cigars which have limited access.

## 7.3 Other Policy Developments

Other policy changes in the European Community have important consumption and trade implications. Duty-free purchases, advertising restrictions and labeling regulations all vary by member country and are subject to EC unification revision. Movement controls on tobacco are impacting the market structure of both tobacco trade and manufacturing in the European Community.

### 7.3.1 Duty-free Tobacco Purchases

Until mid-1999, intra-EC travelers can continue to purchase duty-free items for personal use at duty-free shops. However, due to the lack tax approximation, EC travelers legitimate purchases, as well as boot-legging operations, will continue to move tobacco products from low tax to high tax countries. Due to varying tax structures and local manufacturing advantages, cigarette prices vary from 4.13 ECU per pack in Denmark, to 2.06 in Portugal and 1.29 in Greece. Consequently, EC officials might be hoping that natural market forces will bring tax approximation without official decree.

### 7.3.2 Advertising Restrictions

Tobacco product advertising is already banned on television in the European Community. In addition, France has imposed stiffer regulations that basically prohibits all advertising except at the point-of-sale and severe restrictions on public smoking. In an attempt to harmonize advertising, other EC proposals have suggested restraining all tobacco advertising except at the point-of-sale. However, there has been stiff opposition to advertising restrictions by several member countries, including the U.K., Germany, the Netherlands, Greece and Denmark. These member-countries prefer voluntary member restrictions to mandated regulations from Brussels. Further, there is considerable discrepancy over whether the EC Commission has the legal authority to legislate health and may be violating EC treaty. Critics have voiced strong opposition to a total ban on all advertising, given that the Community has no "competence" (as EC documents read)to pursue public health objectives.

### 7.3.3 Labeling Regulations

Currently, each member-country has individual labeling regulations over tobacco products. Proposed labeling regulations include new front and back label warnings, as well as tar and nicotine limits. Current EC law requires that the various warnings be written in a variety of languages, depending on the country. A 1990 Directive requires that maximum tar levels be set at 15 milligrams per cigarette by 1993 and 12 milligrams by the end of 1997.

### 7.3.4 Movement Controls

To replace the border control regulation of physical good movement, in 1993 the European Community has adopted a system of linked-bonded warehouses for tobacco products. Manufacturers and traders must move taxable products through this system.

### 7.3.5 Tobacco Health Litigation

Recent rulings in the United States regarding tobacco manufacturer's liability may impact the EC market, although not through the court system. The U.S. high court has ruled that smokers may hold cigarette manufacturers liable for misleading consumers about the adverse health affects of tobacco products. However, the number of lawsuits posted in the EC are few, compared with the United States. However, Europeans may use these rulings to pressure for banning tobacco advertising or adopting more aggressive public health polices.

## 7.4 Implications for Malawi Tobacco

1. European Community tobacco production is expected to decline sharply due to changes in tobacco policy through the CAP (Common Agricultural Policy). Production is expected to fall to 404,673 tons in 1993, 11 percent below 1992 production figures.

2. The current CAP tobacco reform include a regrouping of varieties, national production quotas and the conversion to more commercially-viable tobacco types (with no payments for above quota production). The 1992 MGQ was reduced from 390,000 tons to 370,000 tons in 1993, and allocated to seven member states. In 1994-1997, the MGQ will be further reduce to 350,000 tons.

3. For the 1992/93 marketing year, prices and premia were left unchanged, in anticipation of major reform in upcoming years. Both intervention stocks and export refunds will be

abolished. Loss of export restitution will make it more difficult for EC tobacco to move onto world leaf markets.

4. An important advantage Malawi leaf has over Brazilian leaf is the preferential tariff treatment extended to countries of Africa. African leaf exporters pay no duty upon entering the European Community, whereas Brazil must pay approximately 35 cents import duty per kilo.

5. Current and proposed minimum tar requirements has made EC cigarette manufacturers pay more attention to tobacco processing. These tar limits have hurt Philippine and Taiwanese leaf exporters, while benefitting Thai flue and Malawi burley.

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Walters, Kelly S. and William M. Snell. "Price Discovery Methods in World Burley Markets: Impacts on Prices, Production and Trade." Burley Tobacco Grower's Cooperative.

## Conversion Factors

| | | |
|---|---|---|
| 1 Metric Ton | = | 2,204.622 Pounds |
| 1 Pound | = | 0.0004536 Metric Tons |
| 1 Kilogram | = | 2.2046 Pounds |
| 1 Pound | = | 0.4535924 Kilograms |
| 1 Hectare | = | 2.471 Acres |
| 1 Acre | = | 0.4047 Hectares |
| Dry Weight | = | 88 to 92 percent of farm sales weight[1/] |

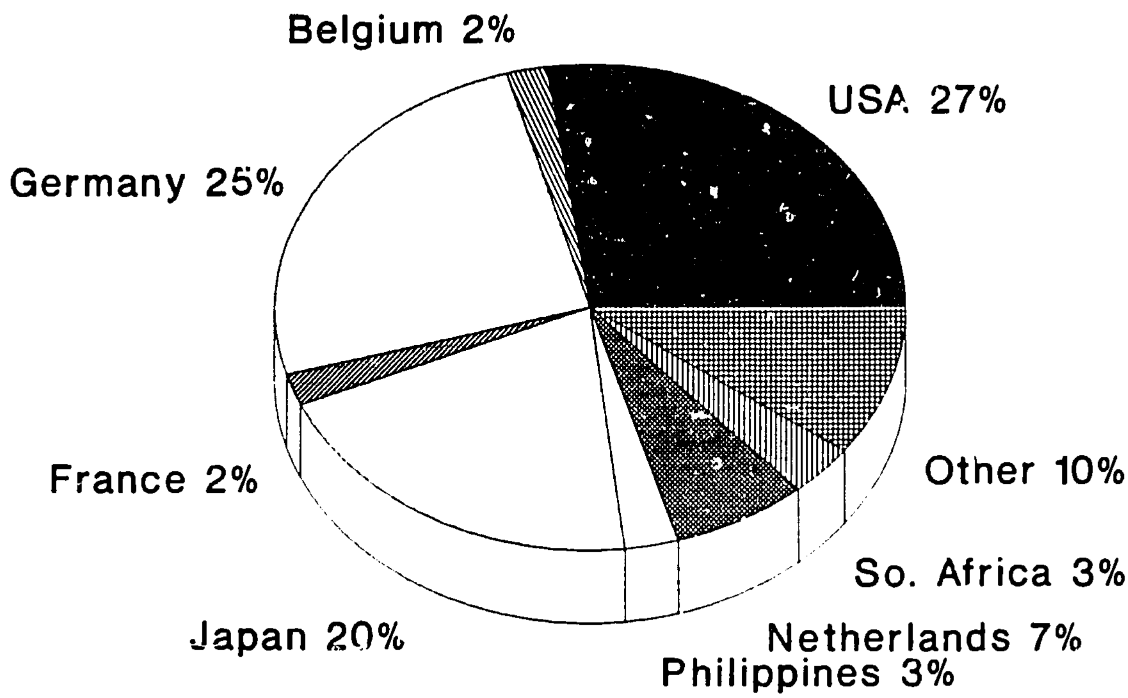
[1/] Dry weight on the average equals 88 to 92 percent of farm sales weight. This conversion varies for each country, depending on various cultural, processing, and economic factors, and can be as low as 60 percent. (FAS)

# APPENDIX

## SUPPORTING GRAPHS AND FIGURES

# Destination of Malawi's Burley Exports
## 1992 (Metric Tons)

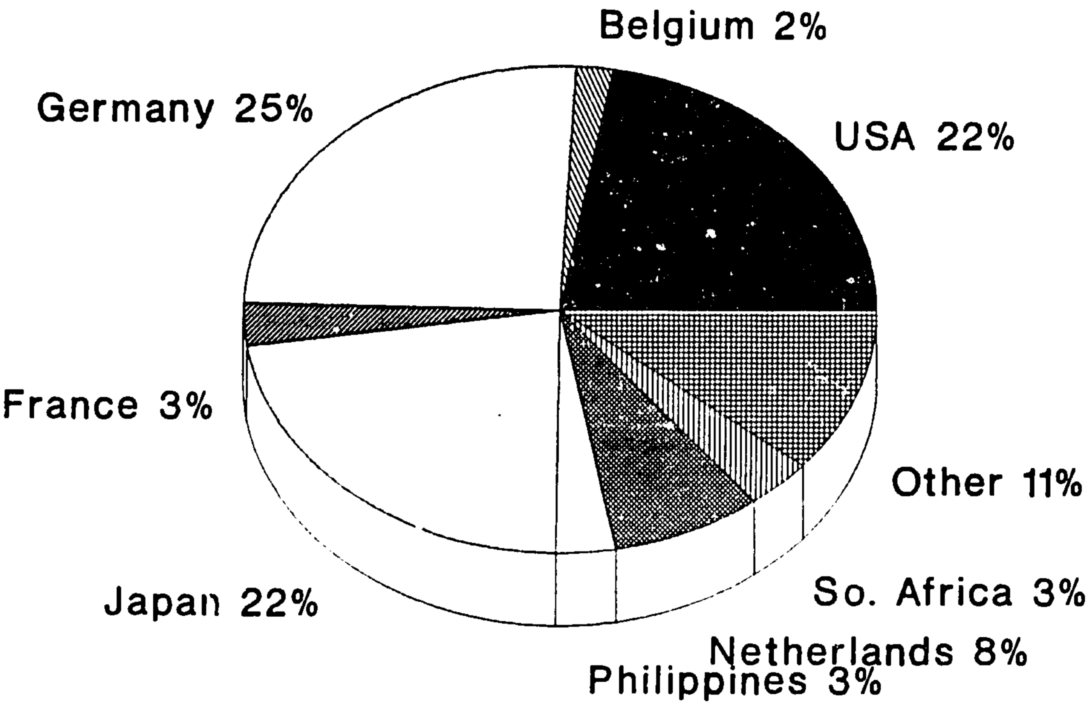
Total Burley Exports 55,381 MT




Source: USDA/FAS & Abt Associates

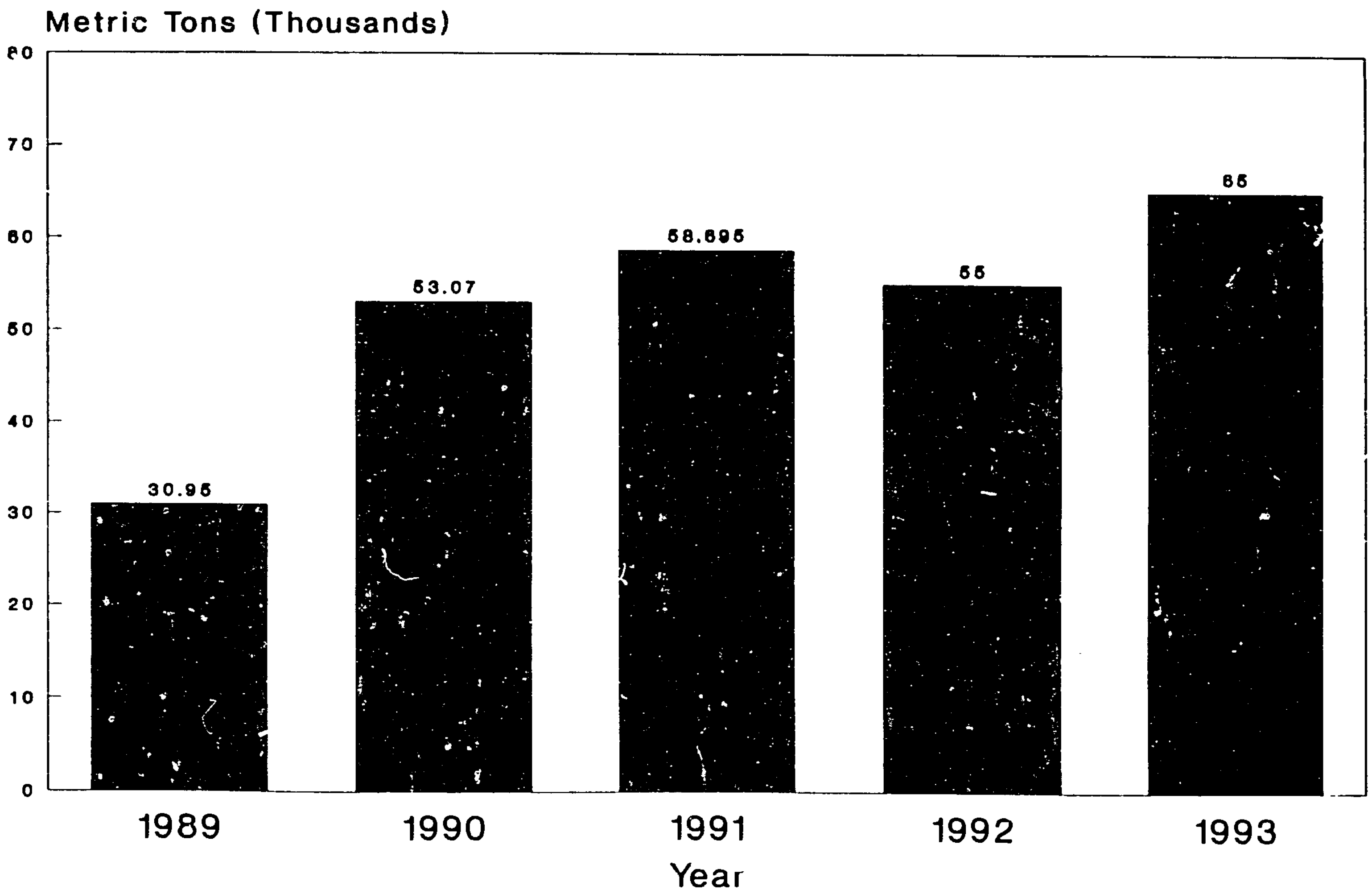
# Value of Malawi Burley Exports
## 1992 (U.S. $ 000s)

Total Value Burley Exports US $178,872




Source: USDA/FAS & Abt Associates

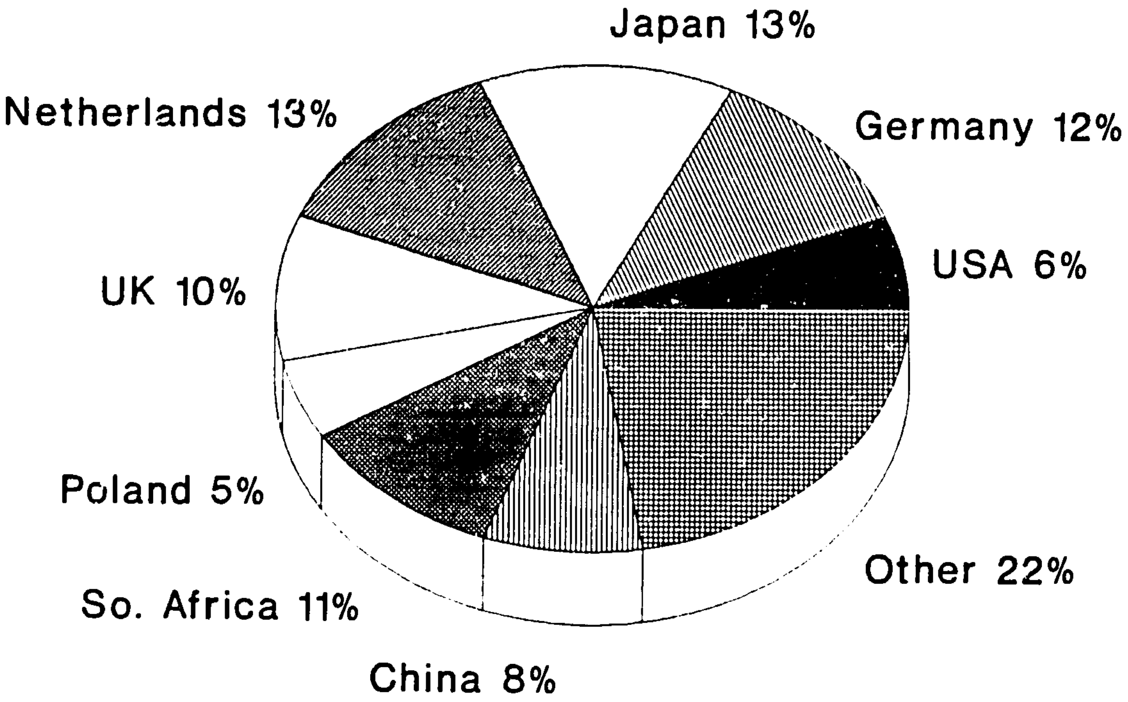
# Malawi Exports of Burley Tobacco
## 1989 - 1993 (est.) (Metric Tons)




Source: USDA/FAS & Abt Associates (1/93)

# Destination of Malawi Flue-cured Exports - 1992 (metric tons)

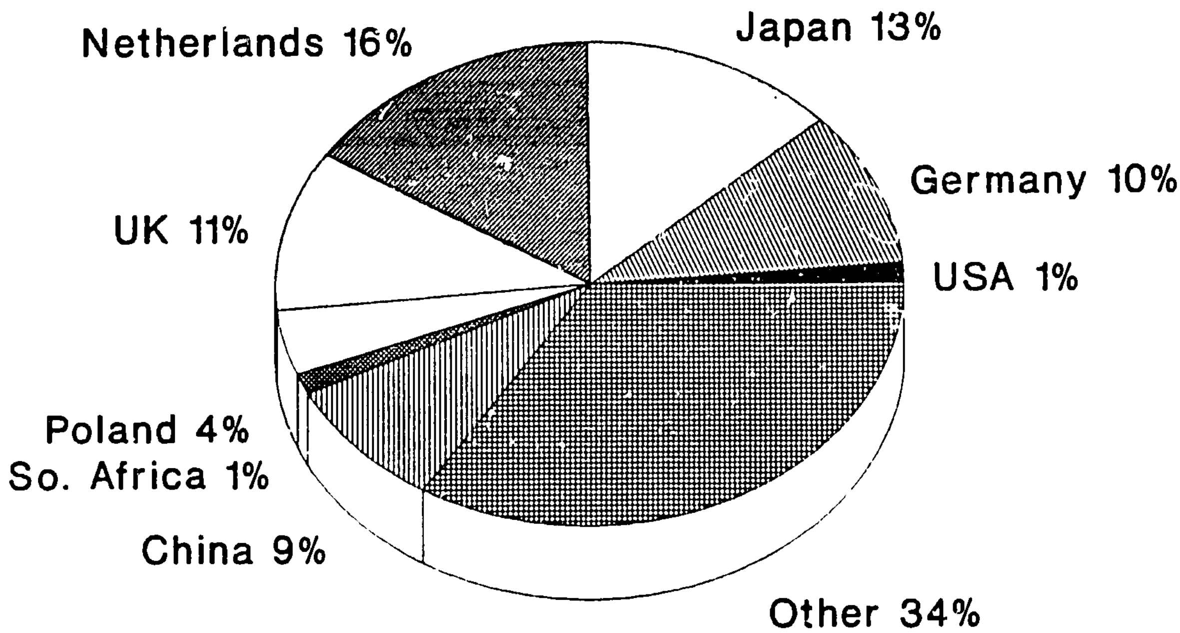
Total Flue-cured Exports 23,385 MT




Source: USDA/FAS & Abt Associates

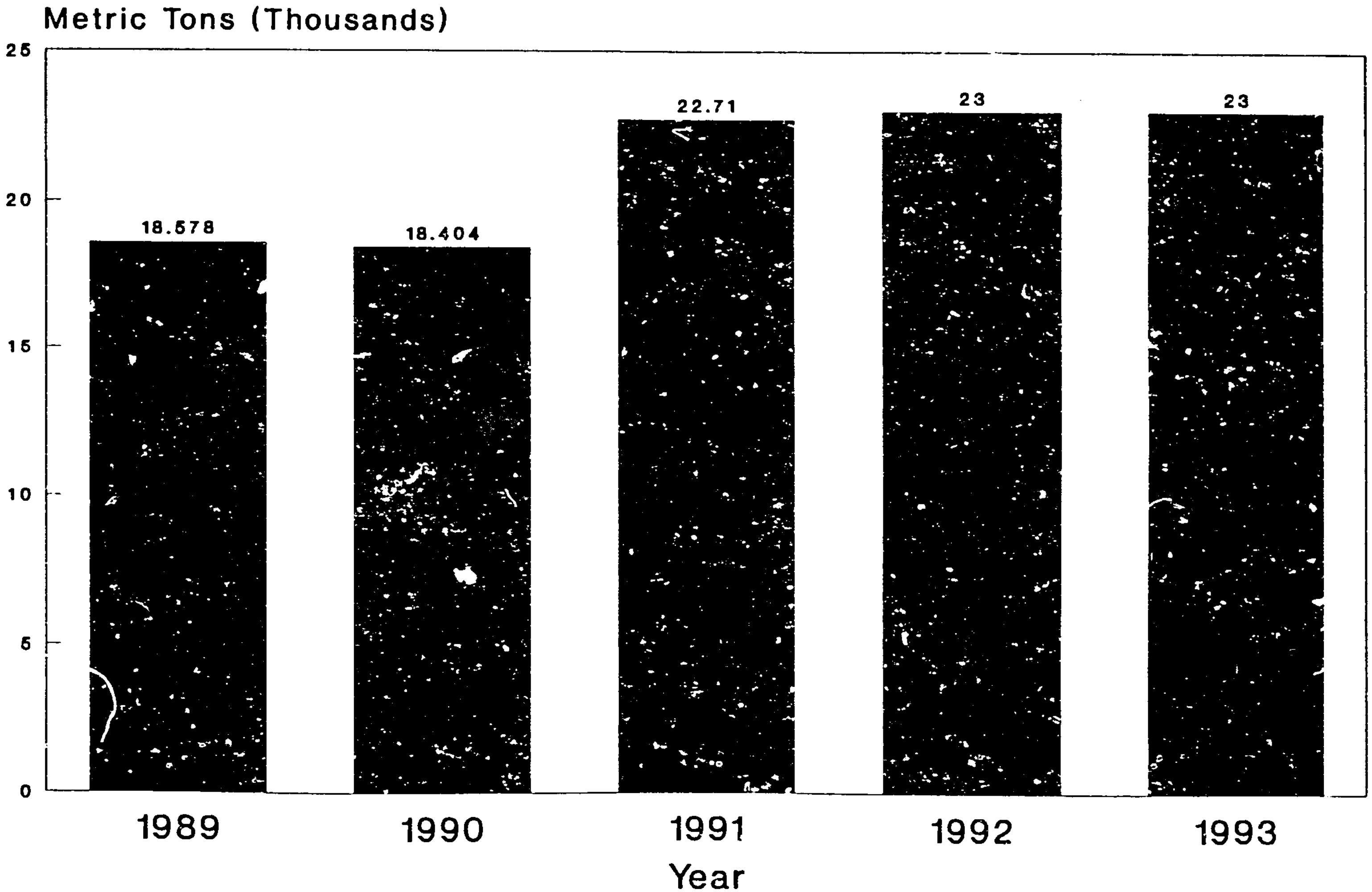
# Value of Malawi Flue-cured Exports - 1992 (US $ 000s)

Total Value Flue-cured Exports US $74,259




Source: USDA/FAS & Abt Associates

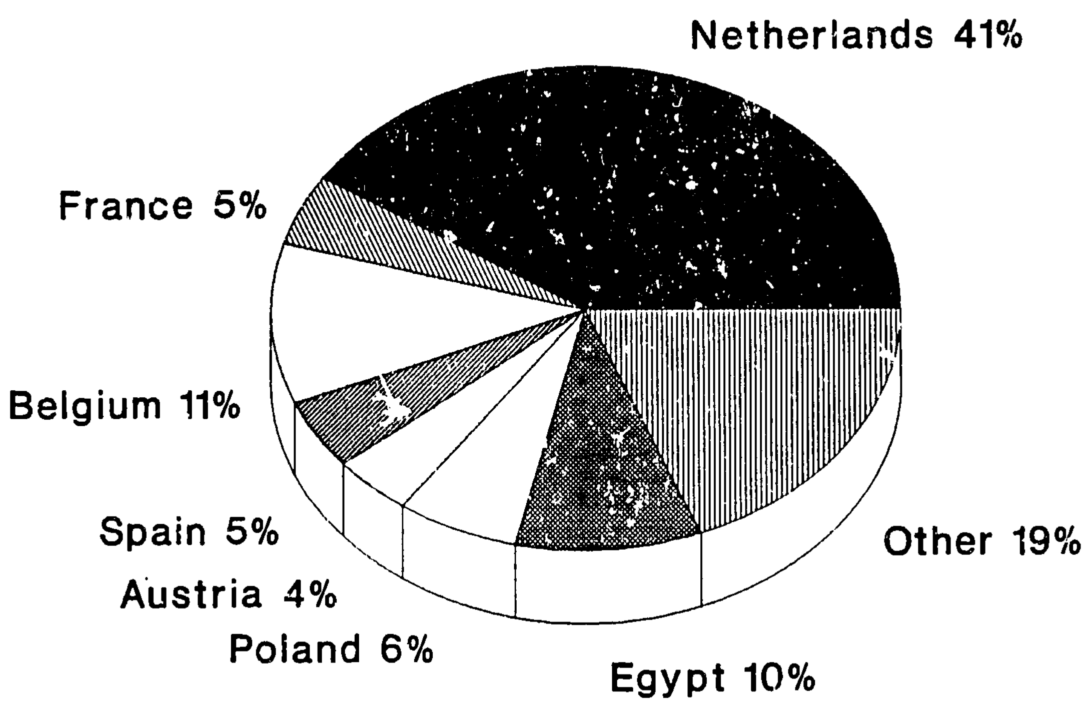
# Malawi Exports of Flue-cured Tobacco
## 1989 - 1993 (Metric Tons)




Source: USDA/FAS & Abt Associates (1/93)

# Destination of Malawi Dark-Fire Cured Exports - 1992 (Metric Tons)

Total Dark-Fire Cured Exports 14,709 MT




Source: USDA/FAS & Abt Associates

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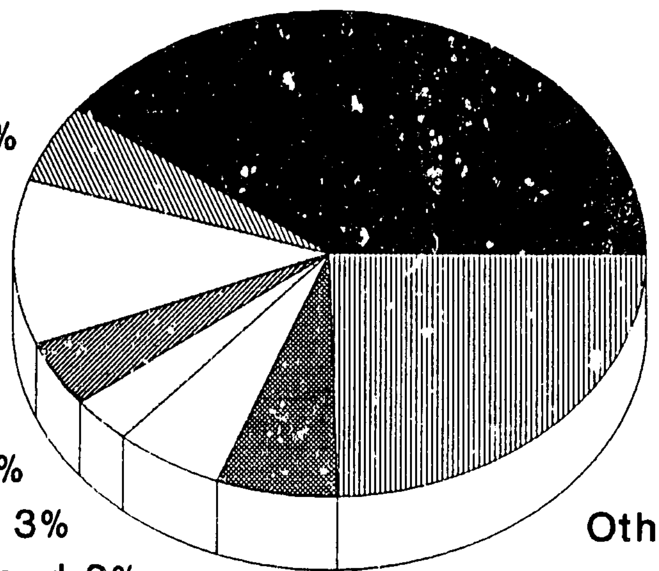
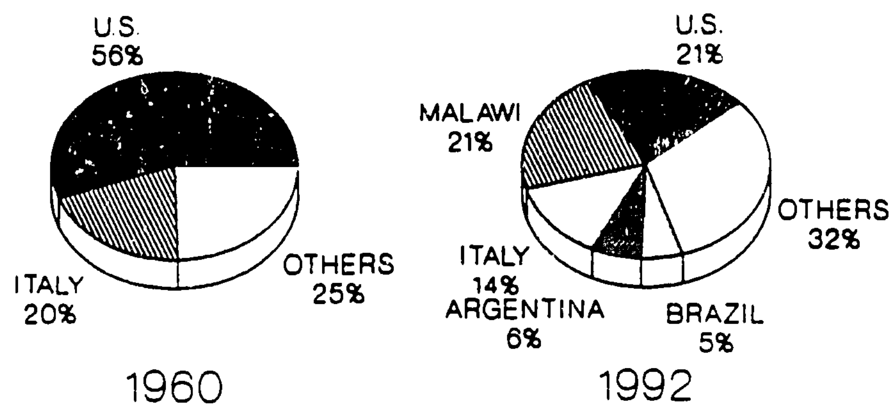
# Value of Malawi Dark-Fire Cured Exports
## 1992 (U.S. $ 000s)

Total Value Dark-Fired Exports US $25,168



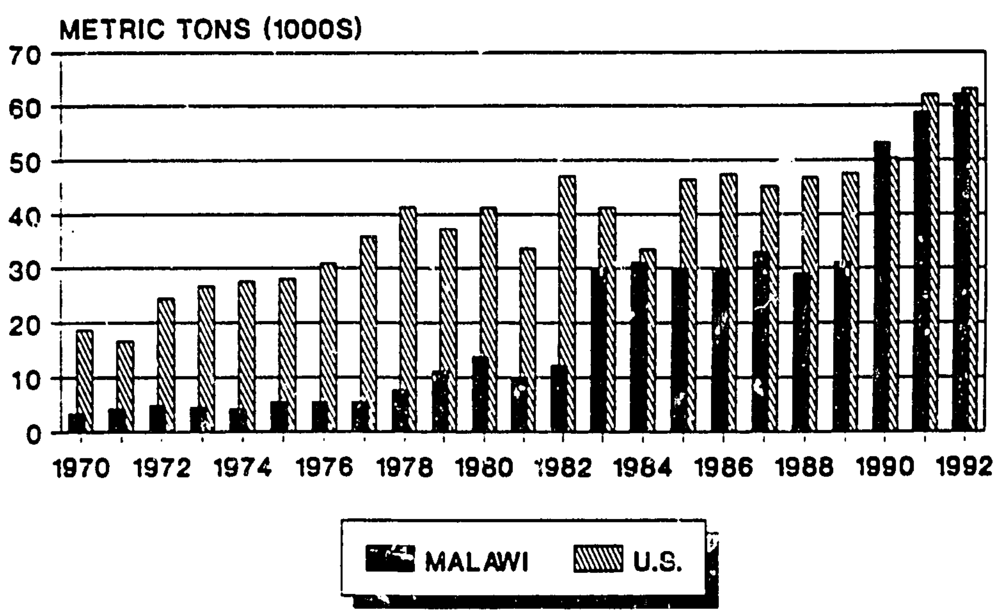

Source: USDA/FAS & Abt Associates

# WORLD BURLEY EXPORT MARKET SHARE




Source: FAS/USDA

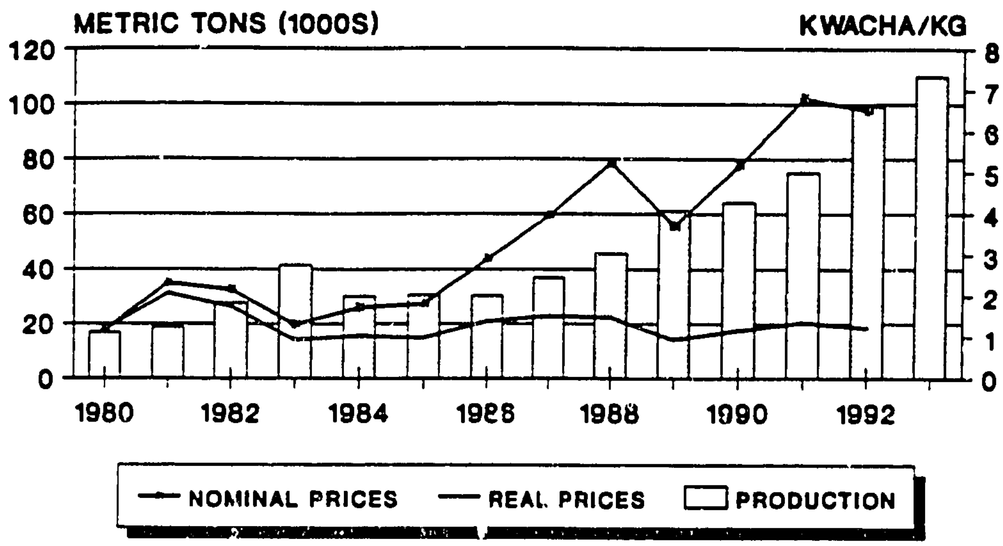
# MALAWI VS U.S. BURLEY EXPORTS




SOURCE: FAS/USDA
1991 SUBJECT TO REVISION
1992 FORECAST

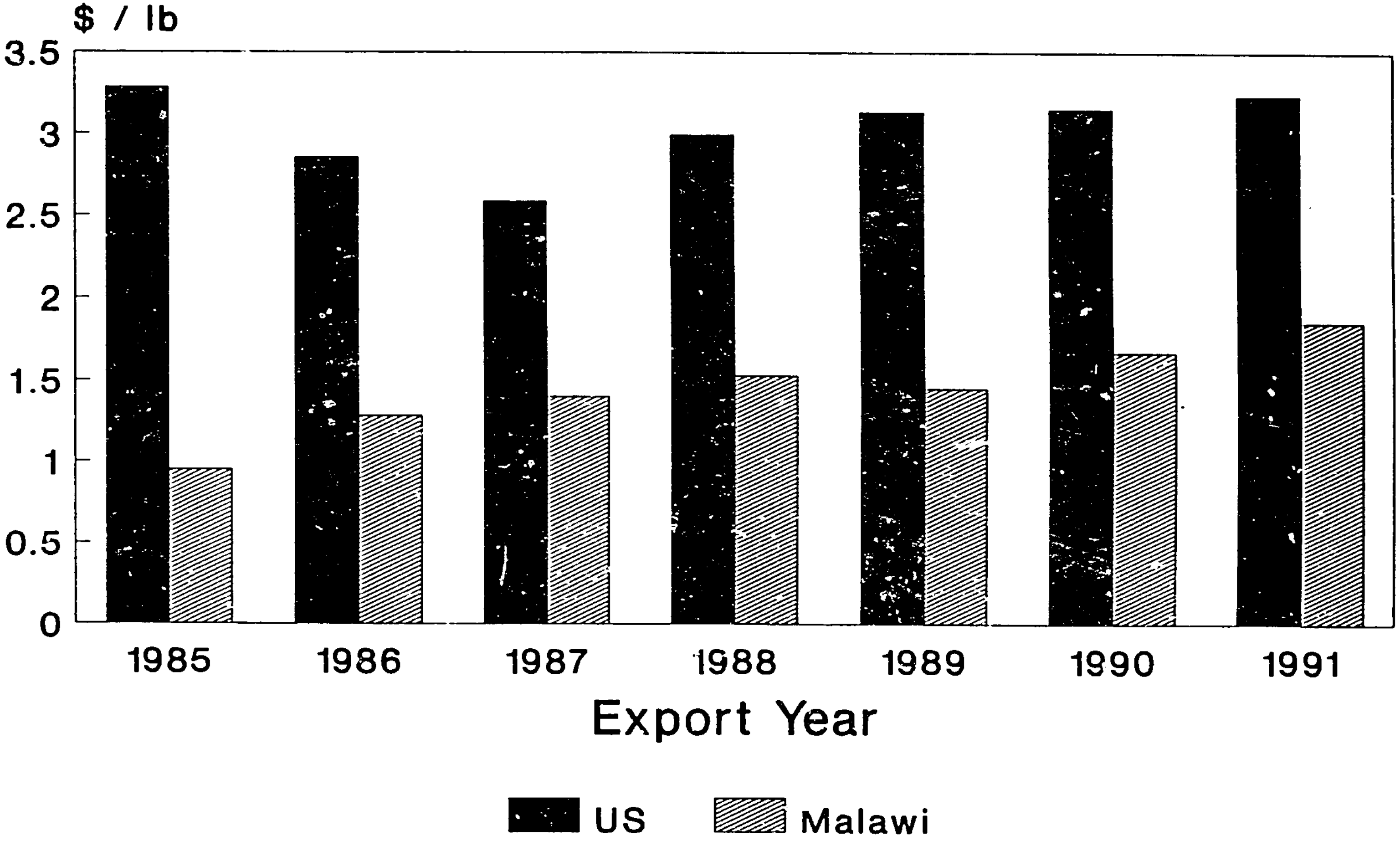
93

# MALAWI BURLEY PRODUCTION & AVERAGE GROWER PRICES



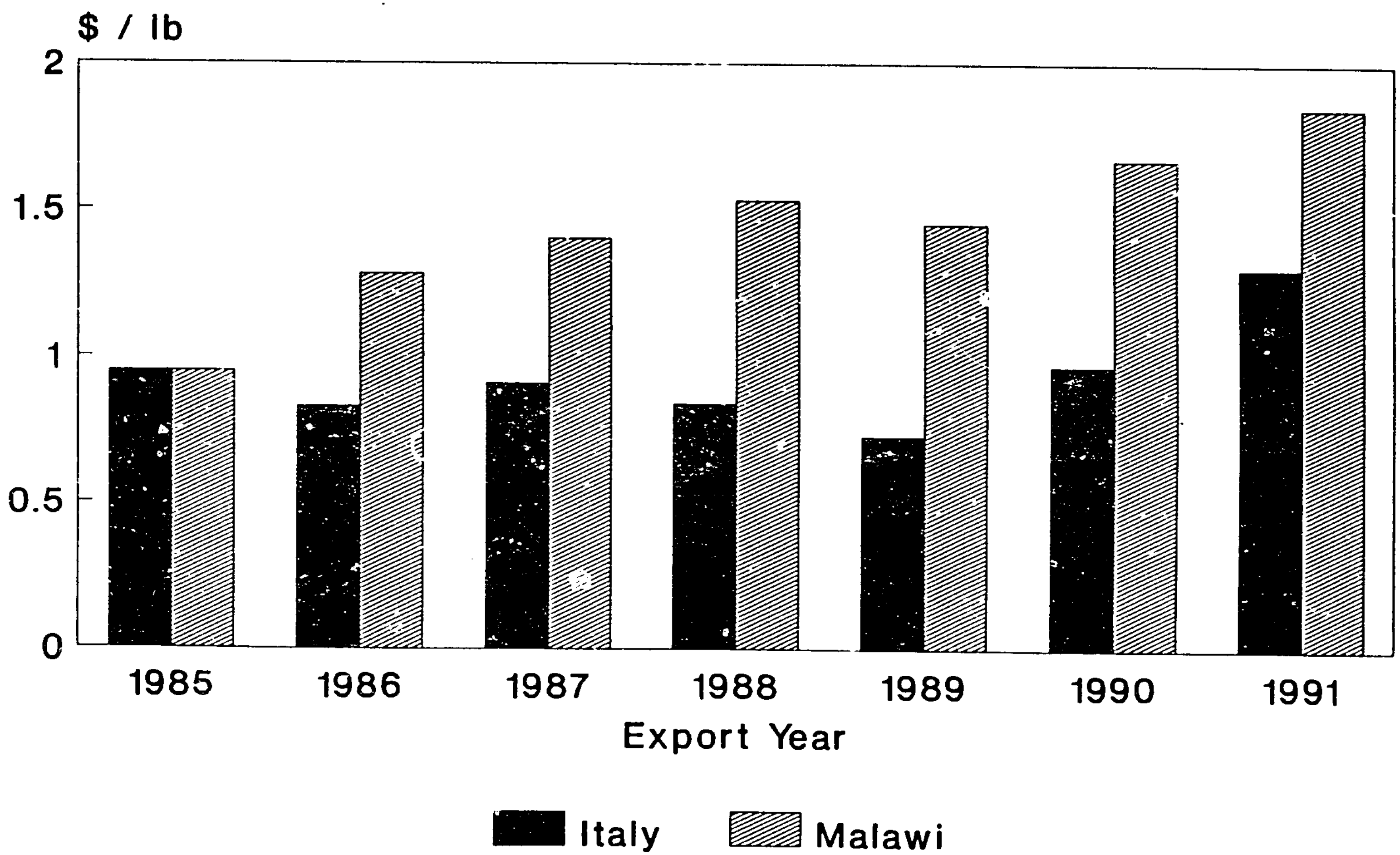

REAL PRICES EXPRESSED IN 1980 KWACHA
1992-SUBJECT TO REVISION, 1993-FORECAST

# Malawi vs. US
## Average Burley Export Values



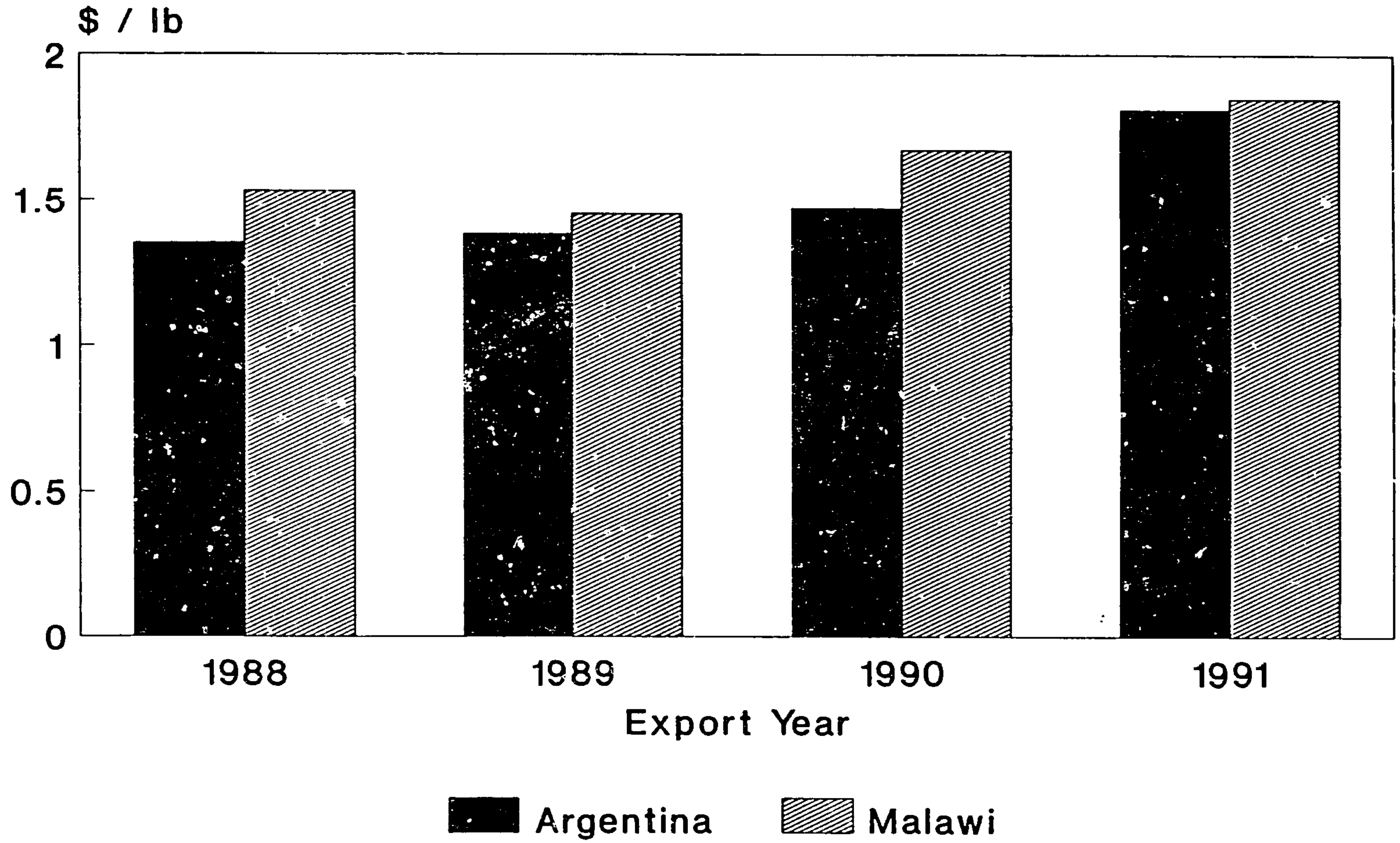

Source: FAS & Abt Associates

# Malawi vs. Italy
## Average Burley Export Values ($ / lb)

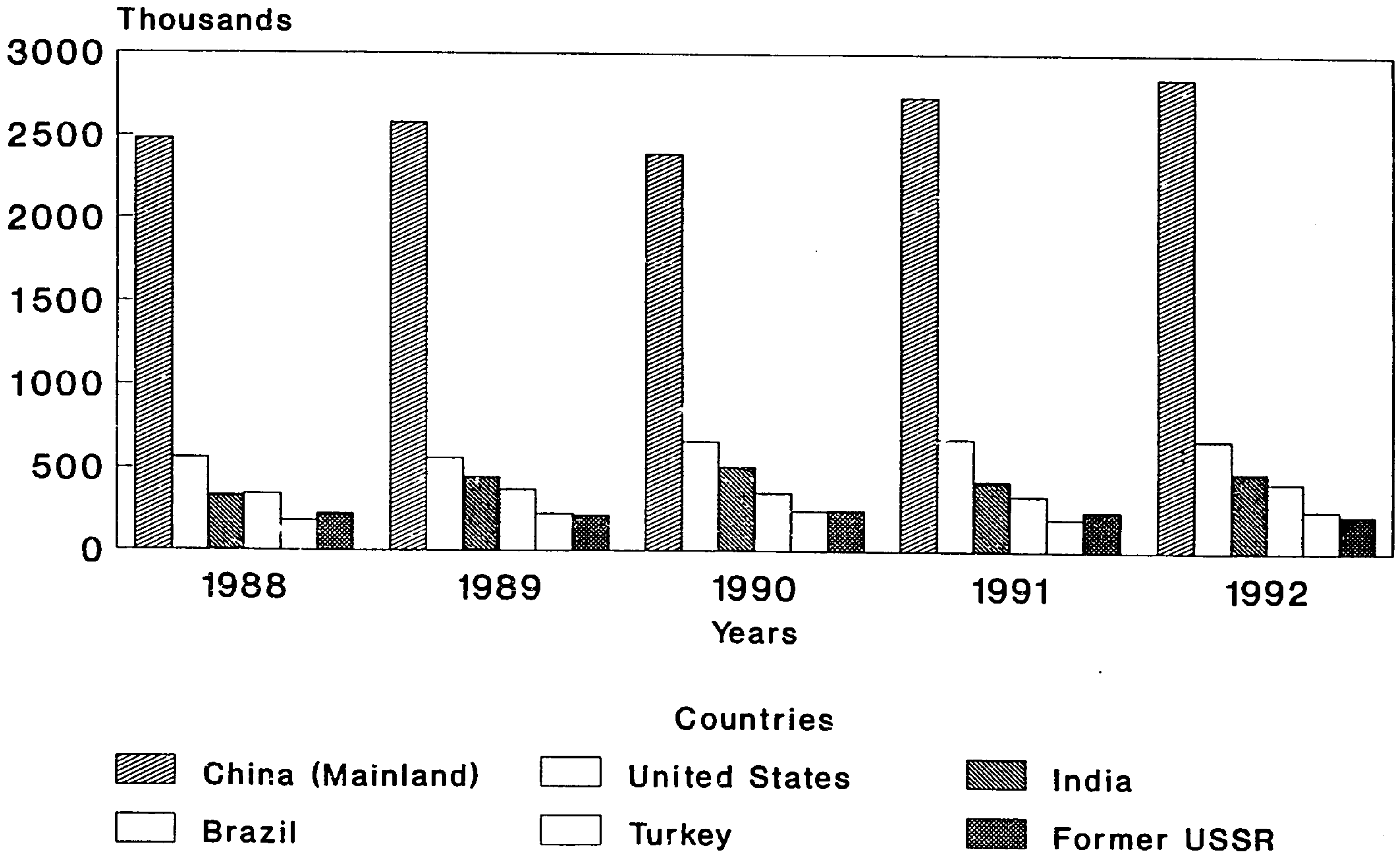



96

# Malawi vs. Argentina
## Average Burley Export Values ($ / lb)



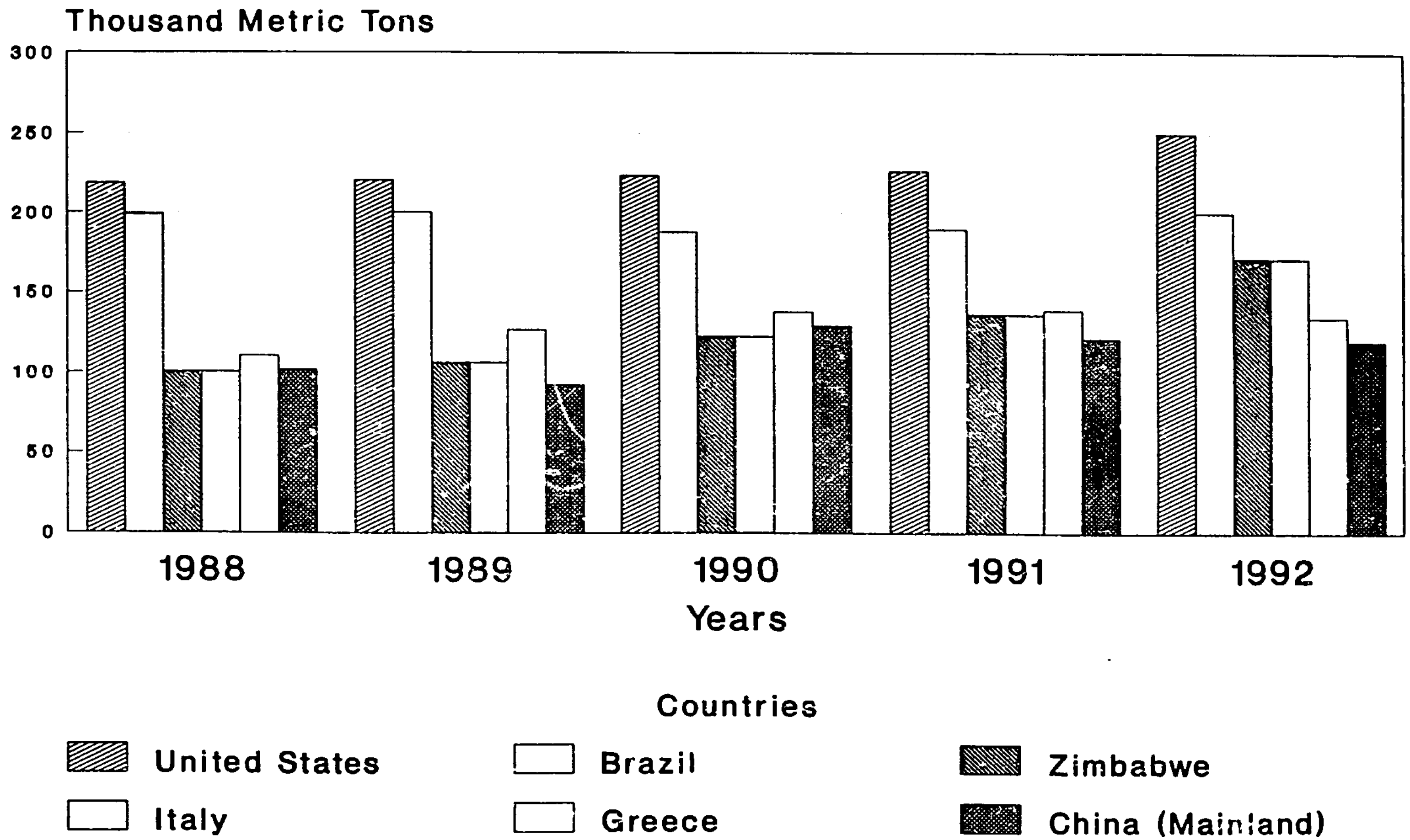
# World Unmanufactured Tobacco Production
## 1988 - 1992




1992 World Production 7.3 million MT

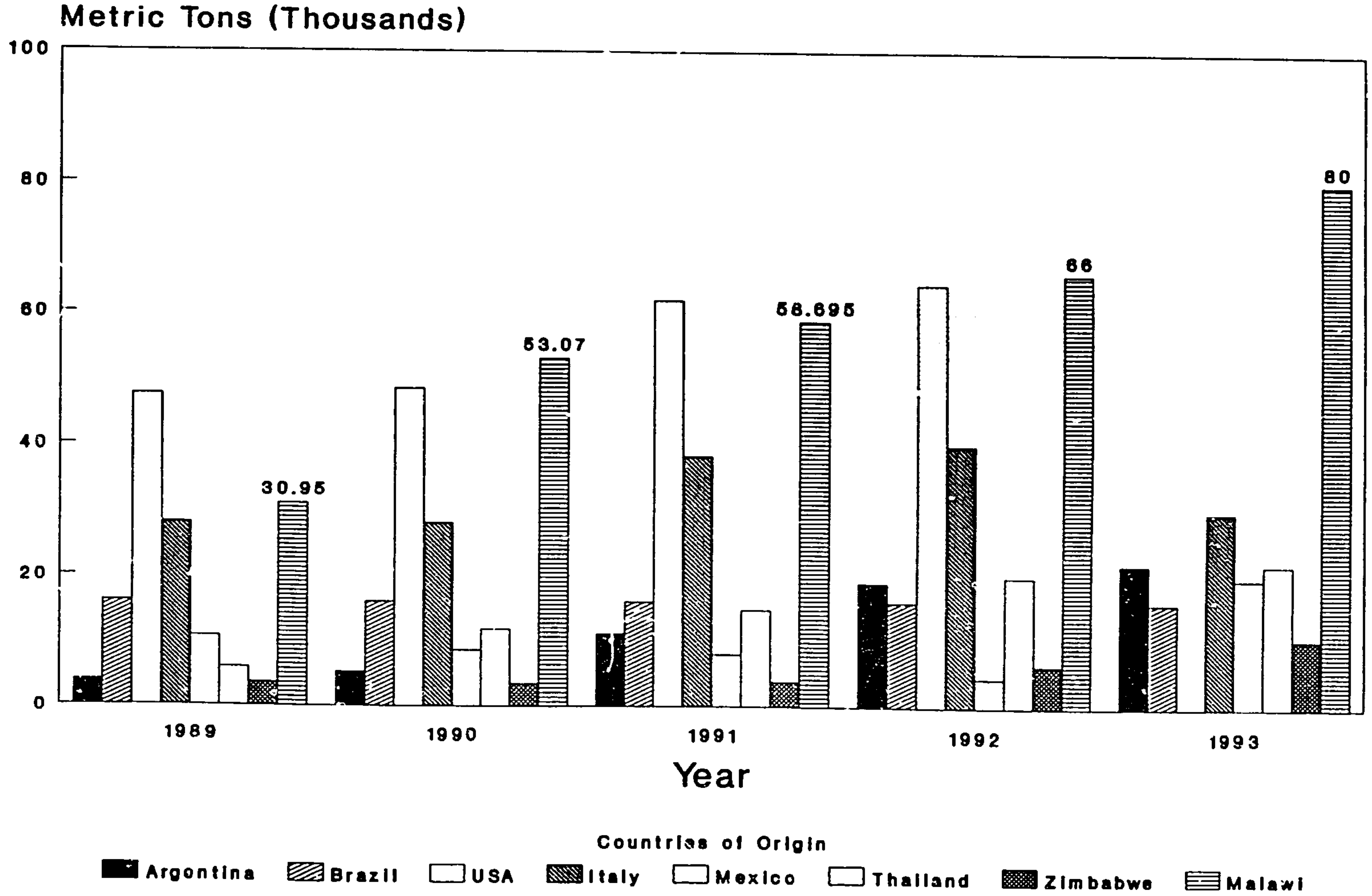
Source: USDA/FAS/TCSD and Abt Associates

# World Unmanufactured Tobacco Exports
## 1988 - 1992

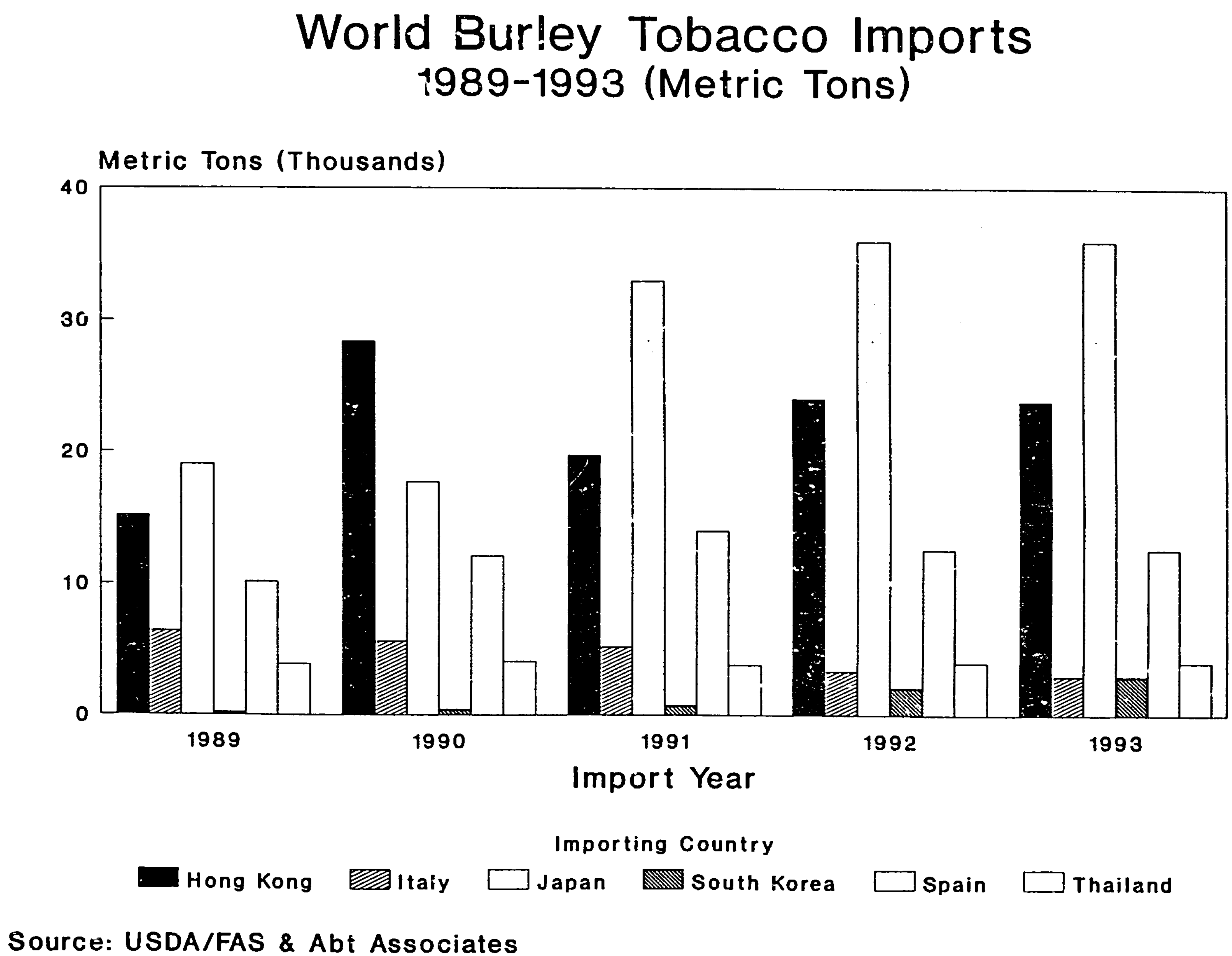



Source: USDA/FAS/TCSD and Abt Associates

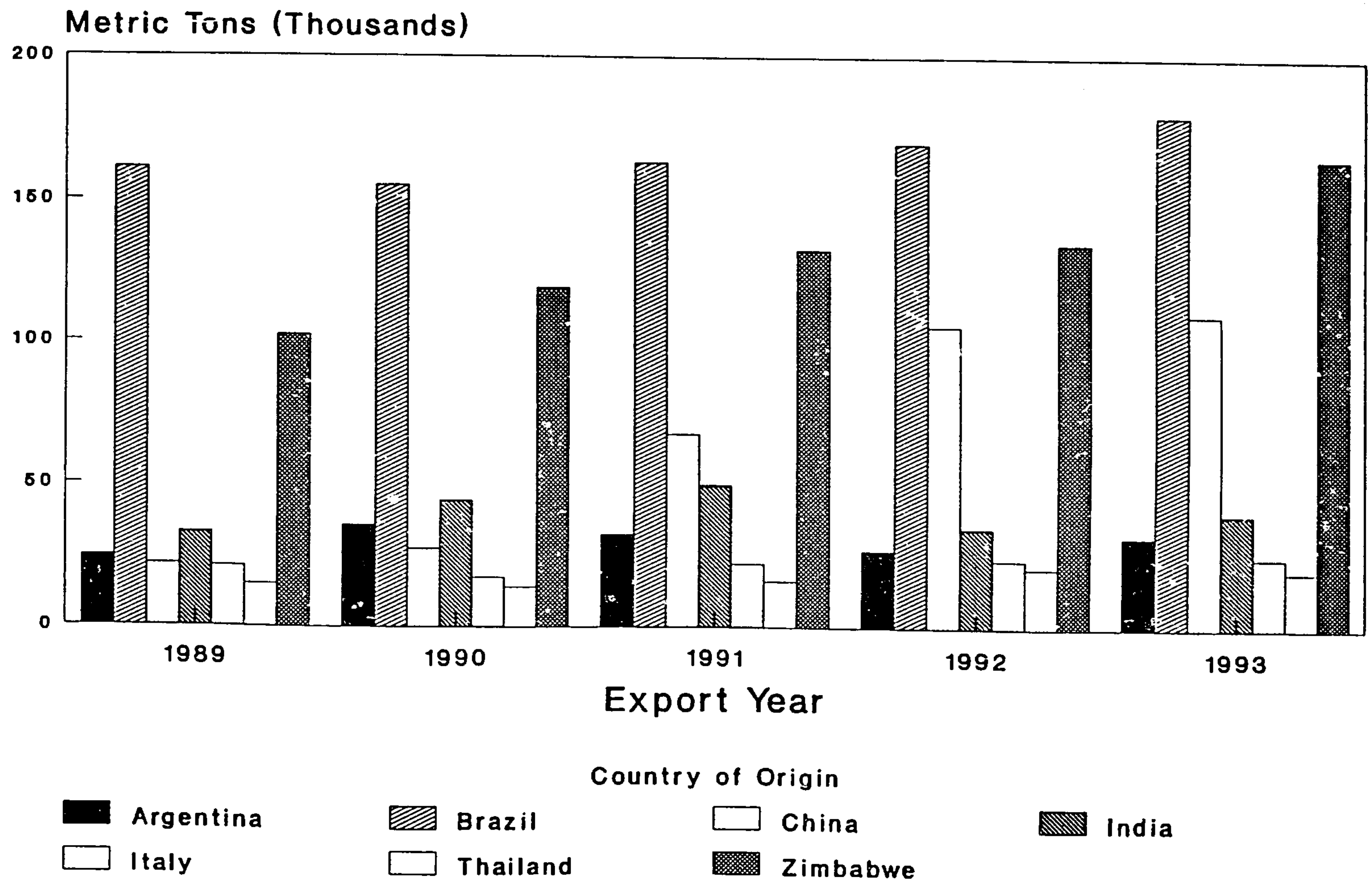
# World Burley Exports
## 1989 - 1993 (est.)




Source: USDA/FAS & Abt Associates (1/93)

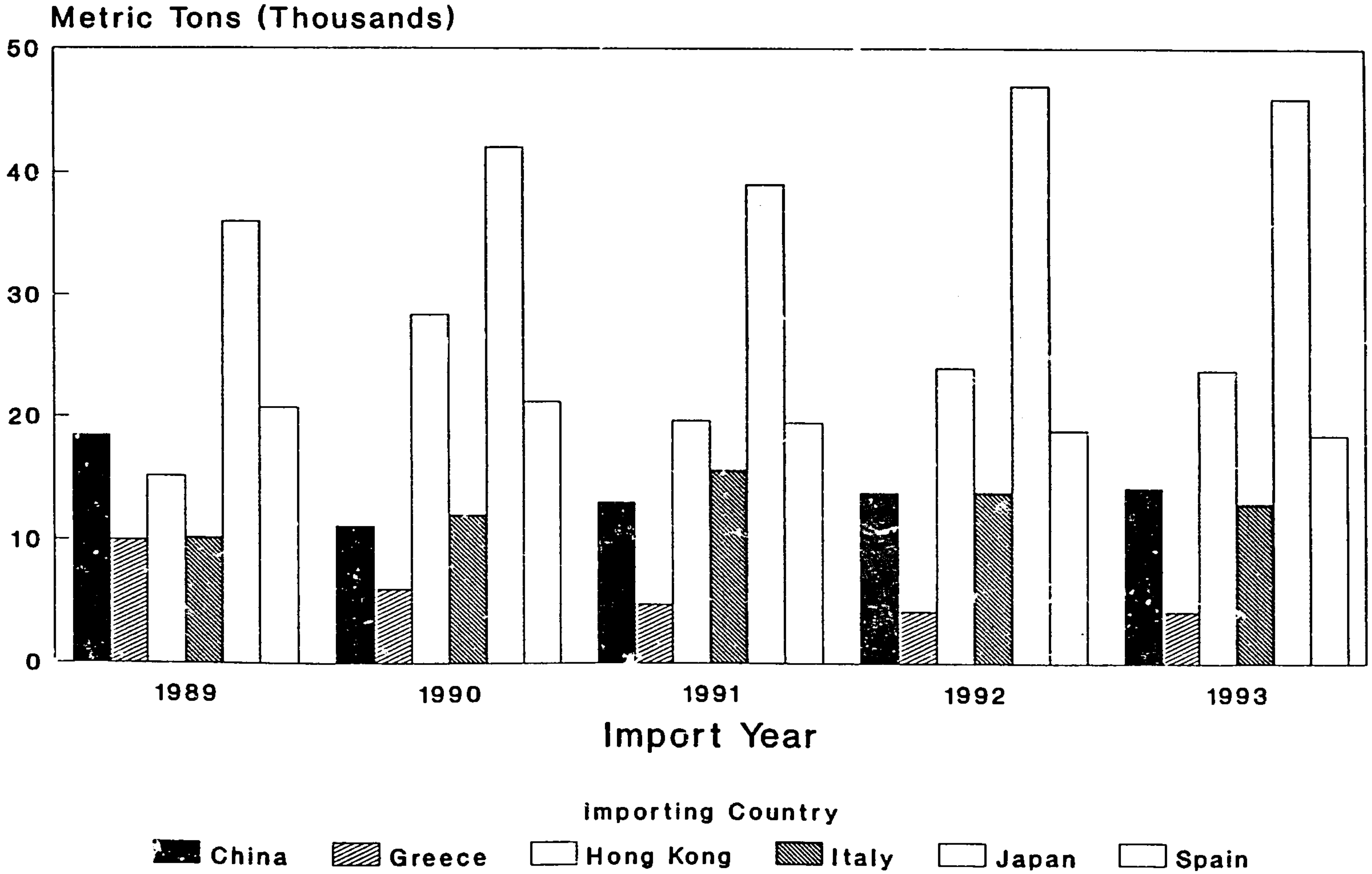

World Burley Tobacco Imports
1989-1993 (Metric Tons)
Metric Tons (Thousands)
40
30
20
10
0
1989
1990
1991
1992
1993
Import Year
Importing Country
Hong Kong
Italy
Japan
South Korea
Spain
Thailand
Source: USDA/FAS & Abt Associates

# World Flue-cured Tobacco Exports
## Selected Countries, 1989-1993 (est.)




Source: USDA/FAS & Abt Associates

# World Flue-cured Tobacco Imports
## 1989-1993 (Metric Tons)




Source: USDA/FAS & Abt Associates

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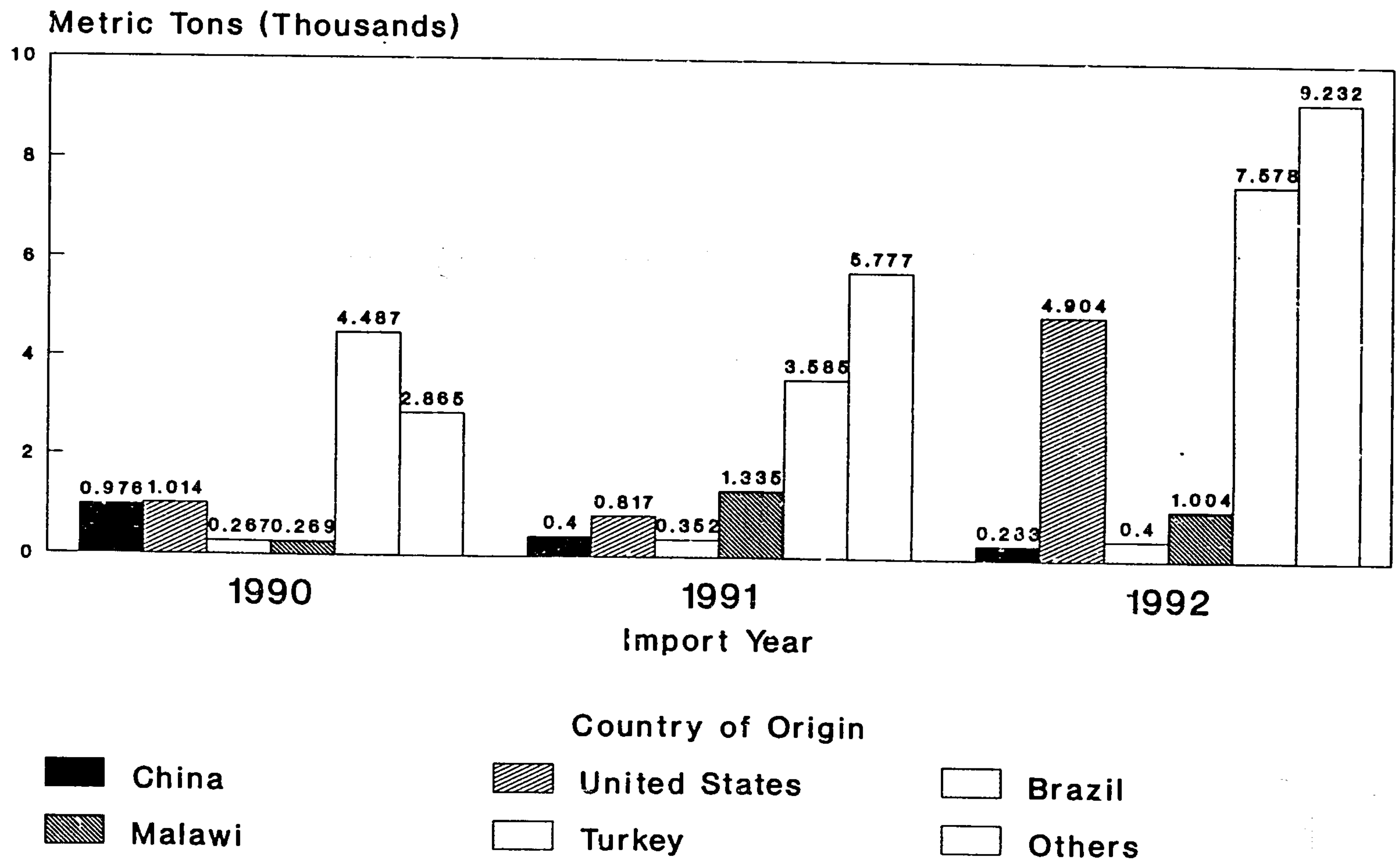
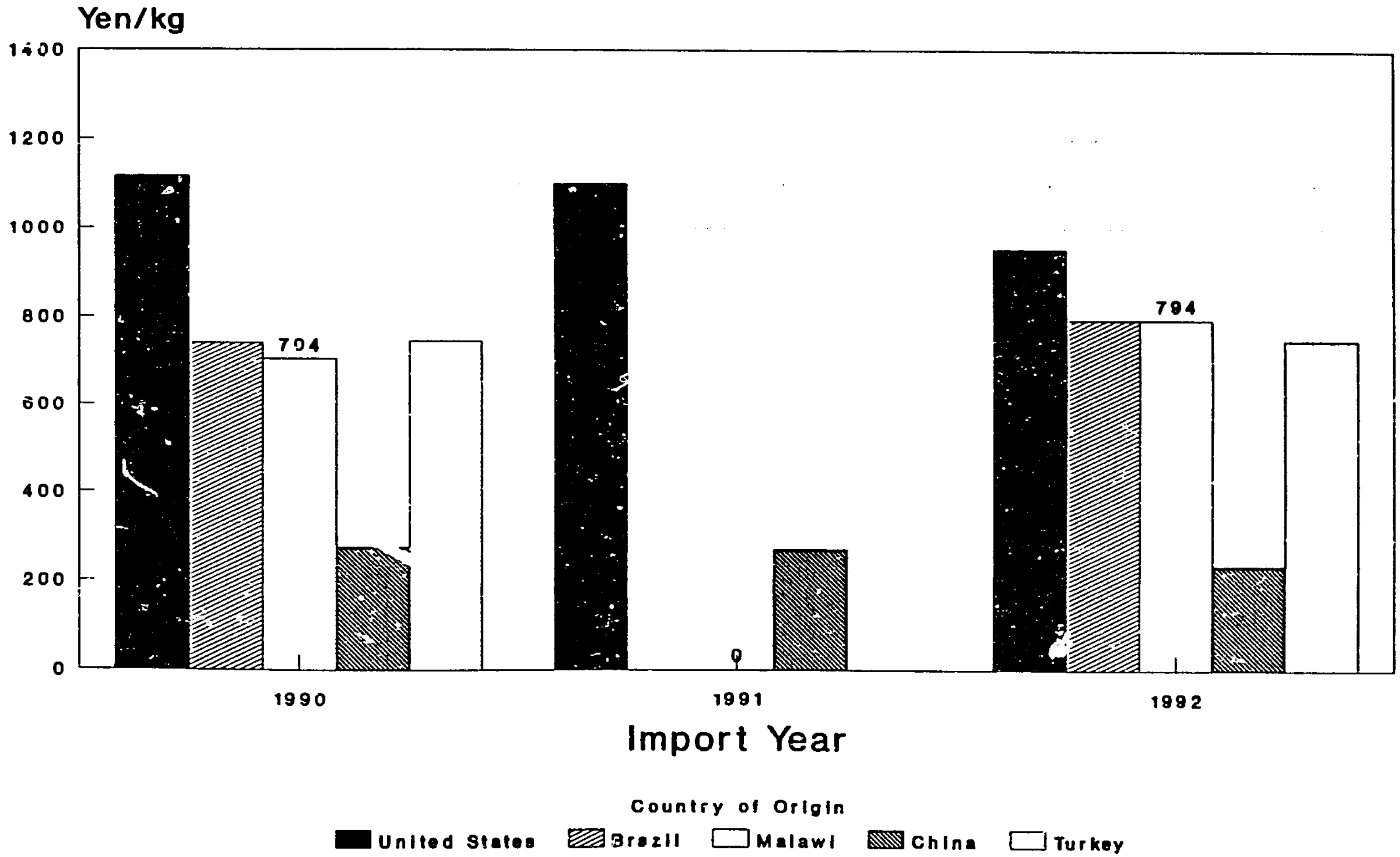
# Japanese Flue-cured Tobacco Imports
## By Supplier (Unstripped) -- 1990 - 1992



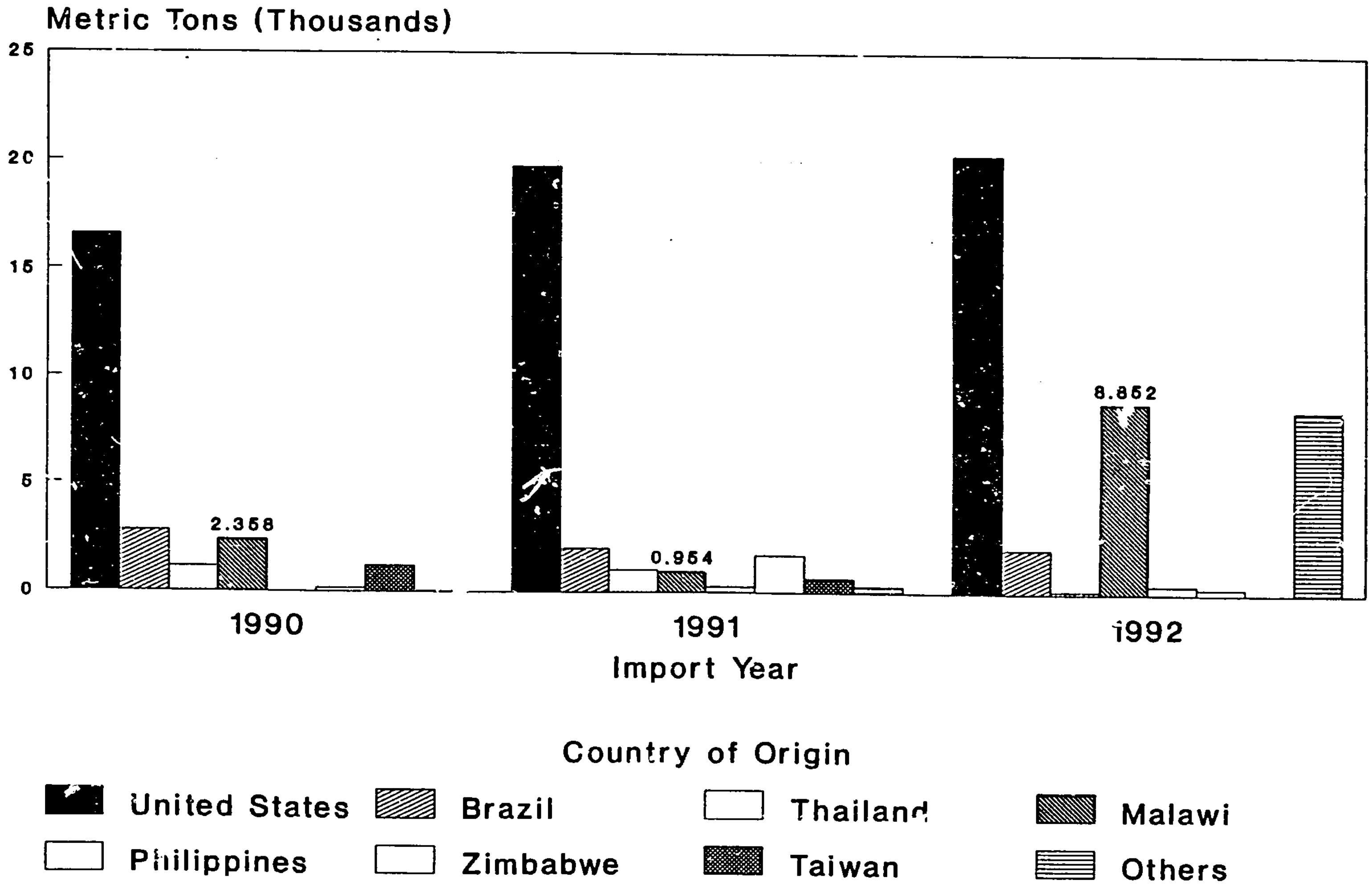

Source: USDA/FAS & Abt Associates, 1993.

# Price of Japanese Flue-cured Tobacco
## By Supplier, 1990-1992 (Yen/kg, CIF)
## (Unstripped)




Source: USDA/FAS & Abt Associates

# Japanese Flue-cured Tobacco Imports
## By Supplier (Stripped) -- 1990 - 1992

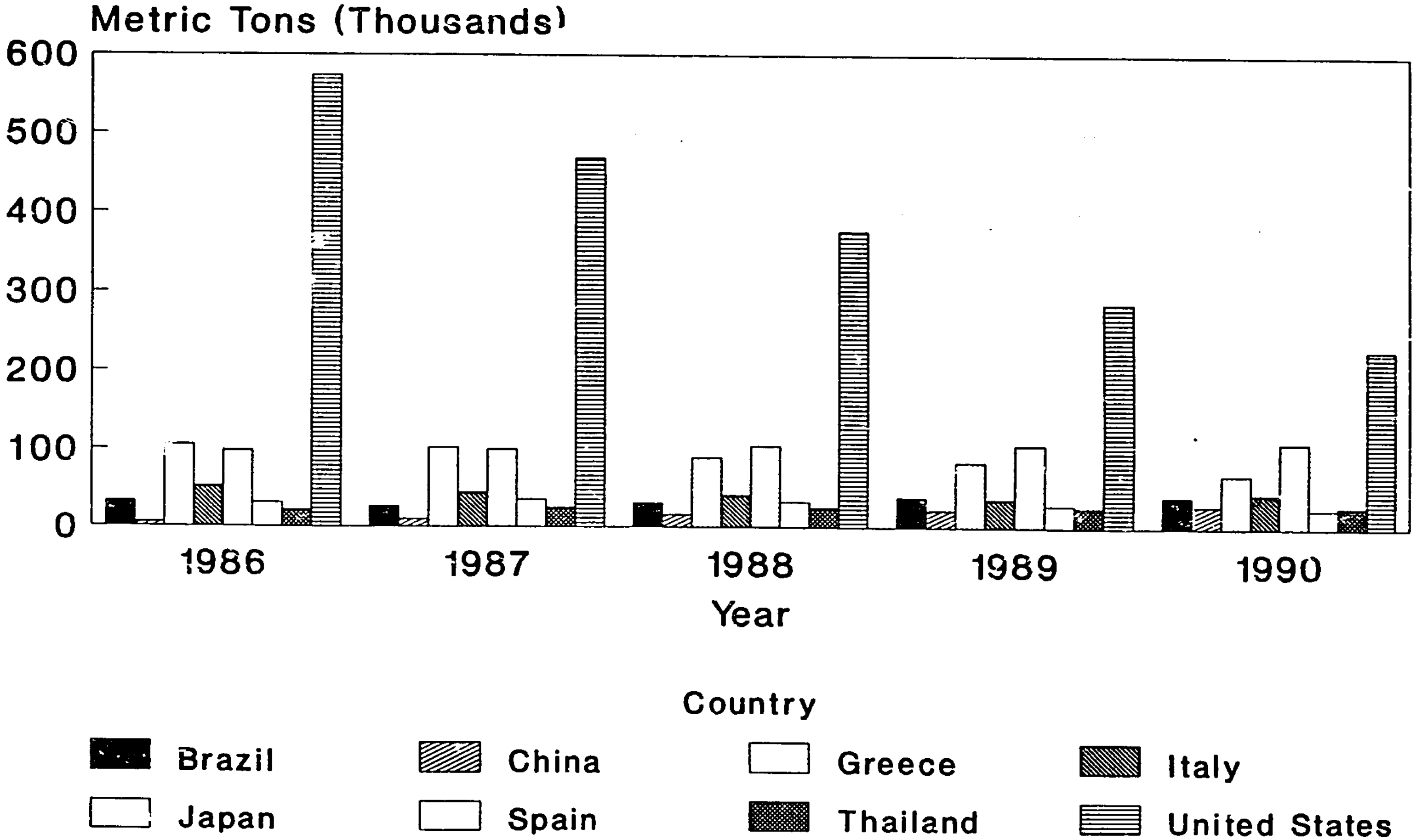



Source: USDA/FAS & Abt Associates, 1993.

## Unmanufactured Tobacco Ending Stocks
(Metric Tons, Dry Weight)

| Ending Stocks | 1988 | 1989 | 1990 | 1991 | 1992 |
|---|---|---|---|---|---|
| WORLD | 6,364,218 | 6,498,924 | 6,489,291 | 6,550,258 | 7,037,172 |
| China (Mainland) | 1,209,295 | 1,602,262 | 1,776,621 | 1,958,736 | 2,329,102 |
| United States | 1,568,212 | 1,483,526 | 1,433,237 | 1,460,421 | 1,401,273 |
| Turkey | 275,634 | 297,625 | 339,281 | 300,904 | 402,549 |
| Japan | 439,656 | 410,813 | 393,292 | 364,873 | 374,153 |
| Italy | 247,689 | 281,098 | 304,800 | 308,631 | 298,394 |
| Brazil | 175,000 | 192,000 | 192,000 | 180,500 | 266,500 |

# World Stocks (Ending) Burley Tobacco 1986 - 1990




Source: FAS & Abt Associates

# World Stocks (Ending) Burley Tobacco
## 1986 - 1990

Metric Tons (Thousands)

| | 1986 | 1987 | 1988 | 1989 | 1990 |
|---|---|---|---|---|---|
| Brazil | 32 | 26 | 31 | 38 | 40 |
| China | 4.677 | 9.708 | 15.7 | 21.9 | 28.3 |
| Greece | 104.712 | 101.958 | 88.954 | 82.687 | 67.827 |
| Italy | 50.949 | 43.904 | 40.361 | 35.88 | 43.78 |
| Japan | 97.584 | 99.975 | 104.045 | 105.871 | 109.201 |
| Spain | 30.969 | 35.189 | 32.067 | 28.464 | 23.969 |
| Thailand | 20.709 | 25.033 | 24.52 | 25.433 | 27.298 |
| United States | 573.238 | 467.927 | 376.333 | 284.417 | 226.737 |

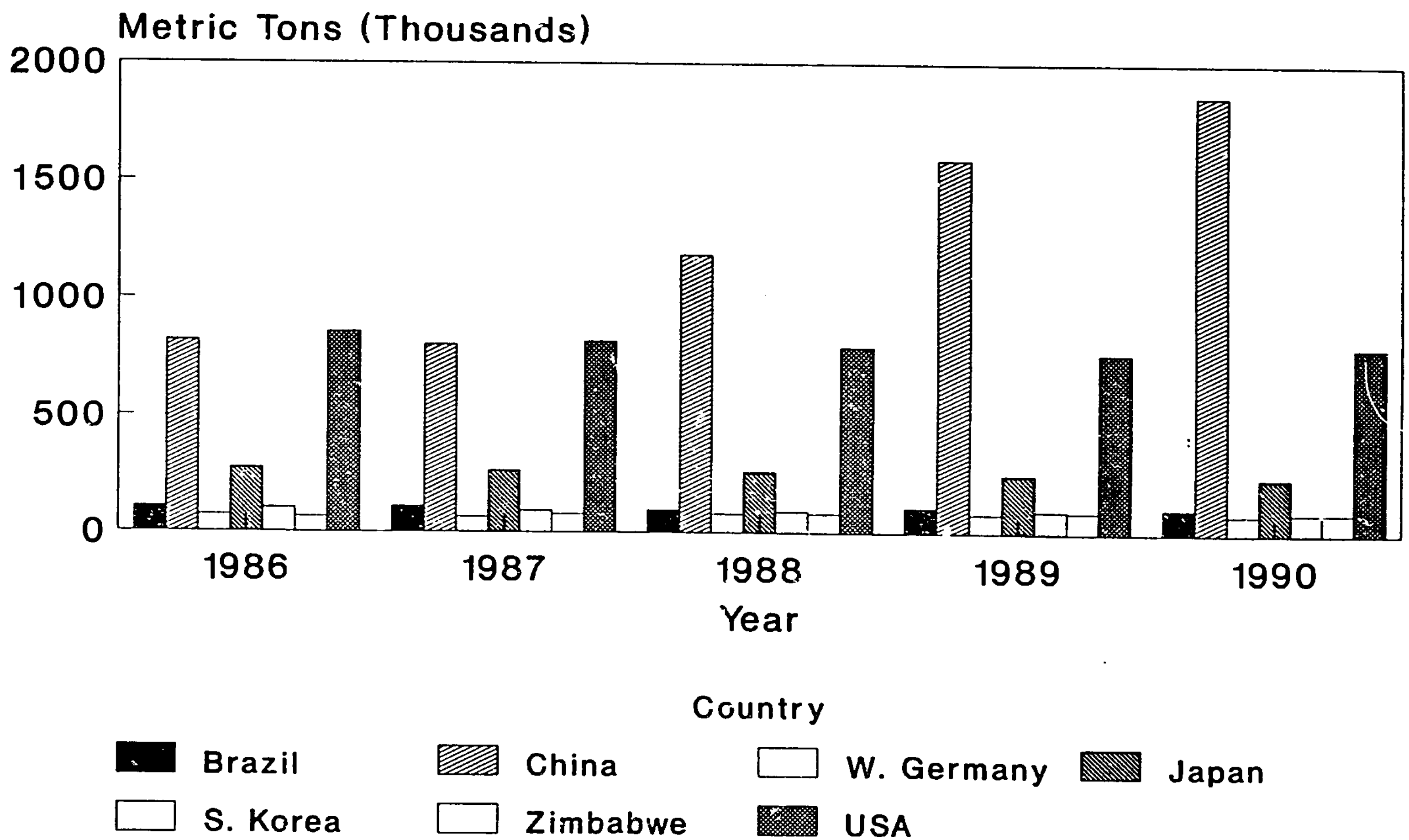
Year

Country

Brazil China Greece Italy
Japan Spain Thailand United States

Source: FAS & Abt Associates

# World Stocks (Ending) Flue-Cured Tobacco
## 1986 - 1990




Source: FAS & Abt Associates

# World Stocks (Ending) Flue-Cured Tobacco
# 1986 - 1990

Metric Tons (Thousands)

| | 1986 | 1987 | 1988 | 1989 | 1990 |
|---|---|---|---|---|---|
| Brazil | 106 | 108 | 96 | 106 | 105 |
| China | 818.3 | 800 | 1181.895 | 1588.193 | 1861.593 |
| W. Germany | 71.373 | 64.671 | 78.362 | 78.779 | 79.539 |
| Japan | 272.854 | 261.484 | 256.887 | 247.487 | 237.391 |
| S. Korea | 101.5 | 92.5 | 89.19 | 93.747 | 87.601 |
| Zimbabwe | 64.07 | 76.519 | 80.582 | 89.106 | 87 |
| USA | 856.354 | 814.353 | 791.522 | 764.656 | 794.072 |

Year

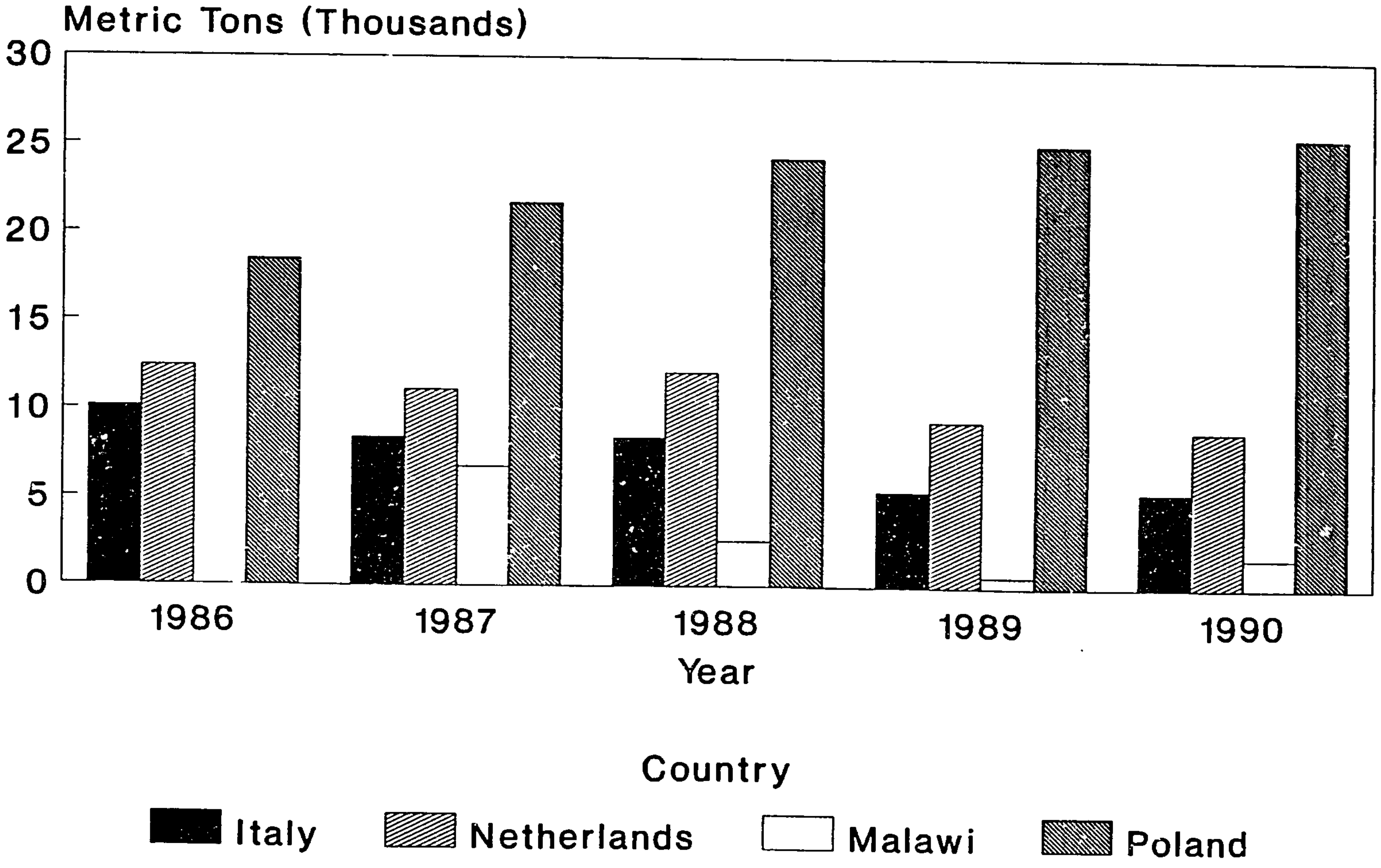
Country

Brazil China W. Germany Japan

S. Korea Zimbabwe USA

Source: FAS & Abt Associates

# World Stocks (Ending) Dark-Fire Cured Tobacco, 1986 - 1990




Source: FAS & Abt Associates

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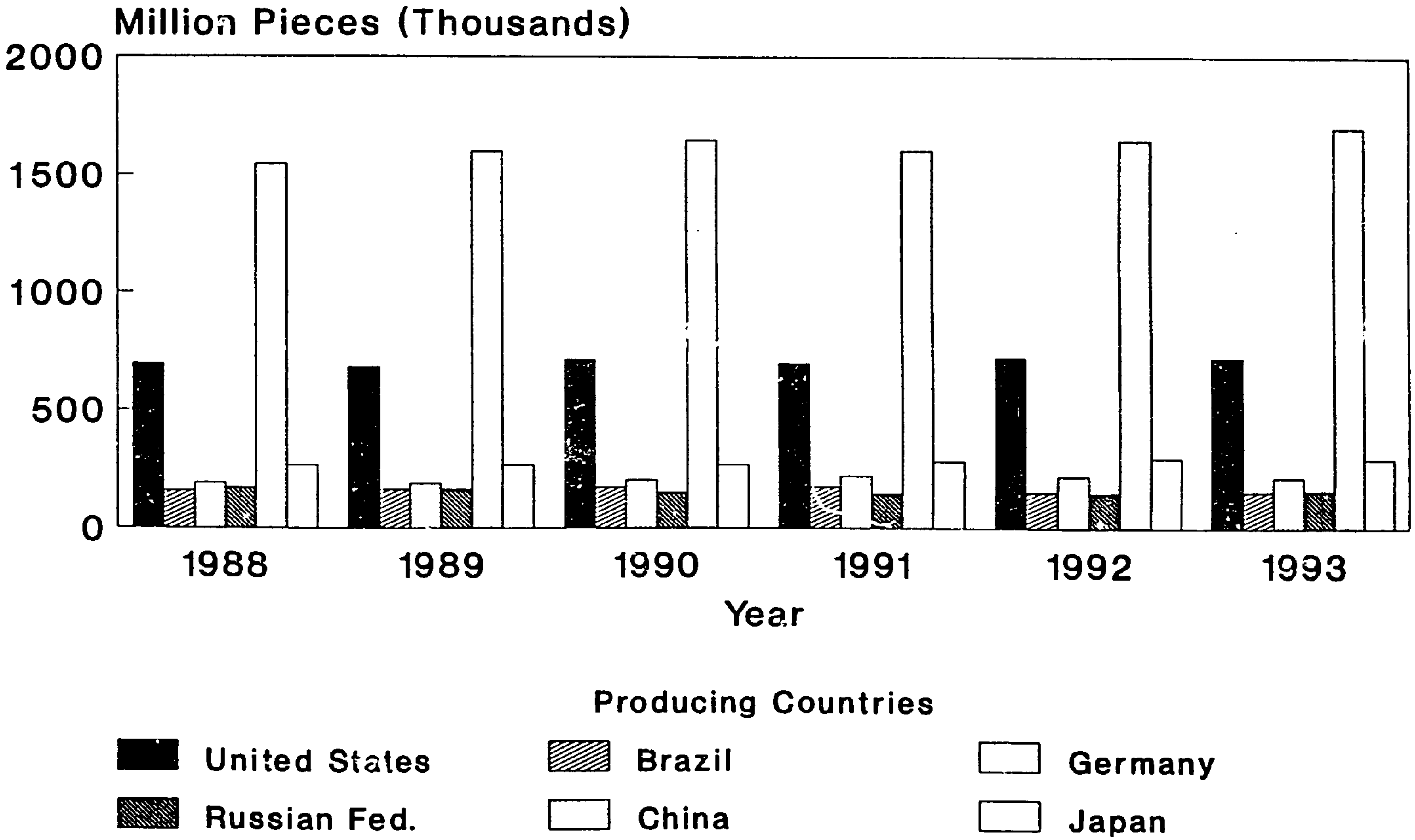
# World Cigarette Production
## Selected Countries, 1988 - 1993




Source: USDA/FAS & Abt Associates

# 1994 EC Tobacco Quotas (in Metric Tons)

| Country | Flue-cured | Light air-cured | Dark air-cured | Fire-cured | Sun-cured | Basmas | Katerina | Kaba Koulak | Total tons |
|---|---|---|---|---|---|---|---|---|---|
| Italy | 48,200 | 43,500 | 17,200 | 9,900 | 14,000 | -- | -- | -- | 132,800 |
| Greece | 26,100 | 12,300 | -- | -- | 19,300 | 26,500 | 22,500 | 20,000 | 126,700 |
| Spain | 25,000 | 4,000 | 13,300 | -- | -- | -- | -- | -- | 42,300 |
| France | 6,600 | 4,500 | 16,500 | -- | -- | -- | -- | -- | 27,600 |
| Germany | 2,500 | 6,000 | 3,500 | -- | -- | -- | -- | -- | 12,000 |
| Portugal | 5,500 | 1,200 | -- | -- | -- | -- | -- | -- | 6,700 |
| Belgium | -- | -- | 1,900 | -- | -- | -- | -- | -- | 1,900 |
| Total | 113,900 | 71,500 | 52,400 | 9,900 | 33,300 | 26,500 | 22,500 | 20,000 | 350,000 |