

31st UNITAB Congress
Cáceres – October 15-16 2008
Situation and perspectives
for the EU tobacco sector

Orlando Astuti

Director - Fetratab

President and Managing Director - Deltafina SpA

**Queridos amigos y amigas,
Ladies and gentlemen,**

Two years have elapsed since my speech at your Congress in Mainz, and here I am (.....again! some of you may be thinking!), with the goal to try to pass to this very important audience my thoughts on the recent evolution of our tobacco world and to try to look together with you into our future.

Time really goes by fast, in particular for all of us who are working in the tobacco sector. Our activity used to be based on seasonal cycles, but the new market patterns and the new challenges of the political arena in Europe have strongly contributed to enlarge the scope of our activity: tobacco is still seasonal, but tobacco women and men are working all year round.

We have been meeting now for many years, in Congresses and Conventions around Europe. Sometimes it looked like the Congress would risk to be the last one, since tobacco in Europe was in danger. It looks like our industry, our farmers, our processors are stronger than somebody thought, since we keep on meeting to discuss about our future. The past has been at times brilliant, at times difficult; I'm sure the future will have the same traits: brilliant and difficult. But I bet we will have a future, and this is what is important.

But before entering the main theme of my speech, on where the European tobacco is at present and where it is heading to, I thought of some interest for all of you to update the set of statistics on the cigarettes and tobacco markets around the world and to comment upon them.

The market in which we all operate, as well as the down-stream market of smoking products, from which we totally depend from, are in fact global in scope. Cigarettes are produced and consumed in all corners of the world and tobacco is also a very adaptable plant.

It is therefore – in my opinion – of paramount interest to understand what is happening around the globe in the tobacco markets, since these trends influence directly our economic scenario, being – as we all know – the European tobacco production a small fraction of the tobacco produced in the world.

But let's now move fast – I promise – through the data, trying to draw your attention to the features that most interest European tobacco.

The cigarette market

World cigarette production increased in 2007 by about 127 billion sticks, or 2.1 percent. World cigarette production grew by 1.6 percent on a compound annual basis between 2002 and 2007. Longer term world cigarette production growth has been lower, with a compound annual growth rate of 0.8 percent over the period 1997-2007.

As in the past several years, in 2007 the increase was mostly due to China, which increased cigarette production by about 120 billion sticks, or 5.9 percent. For the period 2002-2007, cigarette production in China had a compounded annual growth of an astonishing 4.5%!

World production, excluding the PRC, increased by only about 8 billion sticks, or 0.2 percent, in 2007. For the period 2002-2007, cigarette production, excluding China, grew at a compound annual rate of 0.3 percent.

Significant increases or decreases by country and geographical region have taken place between 2006 and 2007.

We already mentioned China. Cigarette production grew strongly for the fifth consecutive year. China now represents 34.9 percent of world cigarette production.

Production in the Americas decreased significantly, as U.S., Brazilian, and Canadian production declined. U.S. cigarette production declined in 2007 for the eleventh straight year, decreasing by 34 billion sticks, or 7.0 percent.

Overall E.U. production increased in 2007 due to the inclusion in the 2007 figures of Bulgaria and Romania, which joined the European Union on January 1, 2007. If production in these two countries is removed, E.U. production would have declined again in 2007, by about 17 billion sticks, led by the United Kingdom. Production in Poland increased significantly for the third consecutive year. Production in the CIS countries increased by about 10 billion sticks, or 1.6 percent. Production in the Ukraine resumed its upward trend after remaining flat in 2006.

Production in Asia (excluding China) increased significantly in 2007, as a decline in Japan was more than offset by large increases in Vietnam, Indonesia, South Korea, and Thailand.

African production was flat, while Middle East/North Africa production was up in a number of countries.

Overall E.U. production increased in 2007 due to the inclusion in the 2007 figures of Bulgaria and Romania, which joined the European Union on January 1, 2007. If production in these two countries is removed, E.U. production would have declined again in 2007, by about 17 billion sticks, led by the United Kingdom. Production in Poland increased significantly for the third consecutive year. Production in the CIS countries increased by about 10 billion sticks, or 1.6 percent. Production in the Ukraine resumed its upward trend after remaining flat in 2006.

Production in Asia (excluding the PRC) increased significantly in 2007, as a decline in Japan was more than offset by large increases in Vietnam, Indonesia, South Korea, and Thailand. African production was flat, while Middle East/North Africa production was up in a number of countries.

We can state that the production is slowly shifting away from industrialized countries into new areas, which is not a surprise, since it follows the same geographical shift as consumption. On top of this trend, there is a growing shift, within each region, towards lower cost countries, such as Poland in the E.U. or Mexico in America.

Another interesting indication comes from the development in the last few years of the breakdown of cigarettes production, among the three large groups of Manufacturers: the five larger Multinationals (Philip Morris BAT, Japan Tobacco plus Gallaher, Imperial Group); CNTC (i.e. the Chinese Monopoly); all the others (including the few Monopolies surviving in the world, accounting for about one third of this category).

Cigarette production in 2007 by the major manufacturers represented 44.8 percent of total world production, down from 45.4 percent of world production in 2006, as the growth of the Chinese Monopoly in 2007 far surpassed that of the major manufacturers group.

Chinese production grew also as a percent of overall world production, from 33.6 percent of world production in 2006 to 34.9 percent in 2007.

Estimated production by the other, smaller manufacturers decreased by 0.9 percent in 2007. As a percentage of total world production, other manufacturers' production decreased to 20.3 percent in 2007, due a decrease in smaller manufacturers' production, along with strong growth in China. Total production by this group of other, smaller manufacturers is expected to continue to decline in the future, due to acquisitions by the major manufacturers of smaller manufacturers (such as the recent acquisition of the Turkish Monopoly Tekel by BAT), and also some organic volume loss on the part of the smaller manufacturers to the major manufacturers group.

It is clear that these developments represent, at the same time, positive and critical news for the European tobacco.

Let's see why.

First of all – contrary to what the experts (whatever this means) of the EU Commission have kept preaching – an important portion (that I estimate around two-thirds) of the tobacco grown in the EU is manufactured within the EU or is exported to other industrialized countries. This means that our tobacco is appreciated by the Major Multinationals that dominate these same markets. If they grow their market share, we can hope to grow together with them.

But, from another angle, the slow but – by now – evident delocalization of these Manufacturers production centres means that we may progressively lose the logistic advantage we have enjoyed, of being relatively closer to the cigarette plants where our tobacco is used. Moreover, they are entering new markets and therefore need to be even more cost aggressive than normal.

I cannot but add just a few lines of warning, in connection to the recent world financial crisis: when in the mid-nineties a financial crisis hit Russia and the Asian economies, the tobacco industry felt the impact, in terms of reduced consumption and request for cheaper products. We all survived, by increasing the efficiency in all stages and re-adapting to different consumers' request. Let us be prepared to face something of even greater magnitude, in the next crops.

The tobacco global market

It is now time, following a tradition that started in the UNITAB Lisbon Congress, to give you some background data on the recent quantitative evolutions of cigarette tobacco in total and of the three main varieties.

After the two peaks of world production in 1992-93 and in 1997, with production exceeding respectively 6.3 million tons and 6.6 million tons, the tobacco market has experienced a number of smaller but more frequent adjustments.

After one of these peaks in 2005 (with a total production of 5.2 million tons), the two following crops (2006 and 2007) have shown a significant trend downwards, reaching 4.7 million tons, which is the lowest production since the crisis of 1994.

The indication for crop 2008 indicate a trend that again goes up, and the preliminary indications for crop 2009 do confirm an expected over-all production of around 5.1 million tons, that is back to where this mini-cycle started in crop 2005.

But we need to go deeper at least in the two main varieties, to better understand the trends, what has happened and what we can expect from the future.

The Flue Cured market

As we all know, the production of Flue Cured represents the most important component and in fact sets the trend of world production. It was Flue Cured that peaked in 1992-93 and again in 1997. And it is Flue Cured that is now setting the pace for the current trends.

The Flue Cured market situation, from our European perspective, is more interesting if we examine separately the data of exporting countries, segregating the production of China and of other minor countries, whose tobacco is almost entirely consumed domestically. Of course our European Flue Cured is competing with the exporting countries, though China has an indirect impact: because of the increasing demand in that market, due to ever growing cigarette production, China has become a net importer of tobacco. Therefore, China has absorbed growing volumes from exporting countries, reducing the over-all availability to the other Manufacturers, who are the main users of European Flue Cured.

Exporters had increased their production in 2004-2005 to a record 1.8 million tons: not even in the record crop year of 1997, exporting countries the Flue Cured production in exporting countries was so high.

2006 volumes were instead down to 1.65 million tons, a reduction driven by many different factors. First of all there has been a reduction in Brazil, following the sharp increases of the previous crops. At the same time, there has been an increase of US marketings, though almost entirely dedicated to the domestic market, following the readjustment in market prices after the quota buy-outs.

Another important factor was the decrease in Africa, where the additional drop in Zimbabwe was not been compensated (but aggravated) by the drop in most of the other African origins.

Finally, the disappearance of the Greek crop, driven by the political decision of total decoupling, has contributed to the reduction of Flue Cured production by exporting countries.

Crop 2007 production was slightly higher, as a result of higher productions in India and the US. But in 2008, the total production is again heading downwards.

The decrease in exporters' production in 2008 was led by Brazil, where production declined by 35 million kg, or 5.4 percent, to 608 million kg. The crop size represents the smallest Brazilian crop since 2003, prior to the build up to larger crop sizes that began in 2004.

Production in the nine main African flue-cured exporting countries as a group (Zimbabwe, Malawi, Tanzania, Zambia, Uganda, Mozambique, South Africa, Kenya, and Democratic Republic of Congo) declined by about 23 million kg in 2008, or 10.9 percent, due mainly to Zimbabwe and Zambia.

Production increased in a few of the major exporting countries. In the US, production increased strongly by about 11 million kg, or 5.1 percent, to 231 million kg, as export demand increased. This marked the third consecutive year of increasing production in the US.

In India, the 2008 crop size increased by about 11 million kg, or 4.1 percent, to a total of 270 million kg. In recent years, India has become a strong competitor to other major filler tobacco producers, such as the European Union, Tanzania, and China.

As one could have expected, worldwide unsold stocks have gone down steadily, reaching in June 2008 the level of 72 million kg (which is approximately less than 10% of the exporters yearly production).

But we need to give a look to China, as well, for the reason that we have indicated before. China has announced a production in crop 2008 of a record 2,300 million kg, up 350 million kg from crop 2007 (that is almost three times the total European production!).

Should this come true, the total production of Flue Cured in crop 2008 will reach a new record.

My impression is that all this will lead the market to a balance, since the low level of stocks will play the role of a cushion, in case production exceeds the yearly consumption.

In crop 2009, the preliminary data seem to indicate a reduction of the Chinese volume, while exporting countries shall again increase their production: the combined effect is in any case a reduction of the over-all tobacco available.

Before we move on to Burley, I would like to share with the opinion – just an opinion, not substantiated by data – that perhaps the demand of Flue Cured has also been growing: the increase in cigarette production is concentrated in a country (China) that smokes Virginia type cigarettes and in other Asian countries where consumption is probably also growing (but where possibly statistics do not yet show this trend).

We may therefore be heading towards a situation in which Flue Cured production may become again unbalanced, with a shortage of supply.

The Burley market

The Burley market used to be much more stable than the Flue Cured market, being concentrated in a lower number of countries, most of which are traditional exporters.

After the peak of crop 1997 (production of 932 million kg), production slowly slipped down to a minimum of 771 million in crop 2001. It went up slightly in crop 2002 and dropped again in crop 2003.

But Burley production then significantly increased in crop 2004, by 110 million kg, or 14%, reaching 880 million kg. But 2005 and 2006 crops have been smaller in size, in the range of the traditional level of 770 million. But the dramatic change occurred in crop 2007, where the Burley production dropped by almost 105 million kg. (- 15%).

All main producing countries were hit: from Argentina (- 15 million) to Brazil (- 28 million), from Mozambique (- 13) to Zambia (- 13), but in particular Malawi lost almost 37 million kg, compared to crop 2006.

This production pattern has diminished the unsold inventories detained by trade, that are practically down to zero.

What is going to happen in the future to the Burley crops?

The figures for crop 2008 indicate that Burley will be up again – over and above the 2006 volumes – with huge increases in particular in the filler, low nicotine Burley (Malawi alone has grown from 87 to 175 million kg). Further increases are expected in the crop 2009.

All this seems to indicate that the Burley market is rapidly evolving from a very tight market situation to a more balanced one, though likely the marginality of stocks may cause again unbalances, in case some of the expected volume increases do not materialize.

The threats to world tobacco production

I hope to have fulfilled with my presentation so far the request of your Congress, to have an over-all, hopefully precise, but necessarily synthetic view of the tobacco market worldwide.

We all very well know how deeply interconnected this market is, and how much and how fast what happens around the world affects our activity, our profitability, our future.

I would also like to share with you some opinions on the current political situation on tobacco subsidies.

But before going into European politics, I would also like to share with you – after so many numbers – also my opinions on some qualitative aspects of the tobacco market that possibly will affect European tobacco.

I see two main threats for the long term future of tobacco farming around the world. One comes for the economy, the second from politics.

Let's first discuss how recent economic trends may affect tobacco production around the world (though the even more recent financial crisis may completely over-run what I will state to you in a moment!).

Once a farmer gets out of labour intensive tobacco production, there is a good chance he will not return. We are currently in a period of rapidly rising input costs and experiencing increasing competition from alternative crops.

Never before the tobacco industry has been confronted with the possibility that less labour intensive food crops might yield more money per hectare to farmers.

This basically means that never before there has been such a sudden and dramatic change in volumes and prices.

This also means that all the players in our market, that is – let's never forget this – a world-wide market, should receive the right incentive to sustain tobacco production: an incentive that must have the form of monetary compensation, but also of stability income and of technical assistance.

We must not forget that this economic change is occurring at a time when the World Health Organization, within the activities of the Framework Convention for Tobacco Control (FCTC) is actively soliciting countries to encourage alternatives to tobacco farming.

This is the political threat I was referring to: I am not afraid or I do not oppose in principle this exercise.

On the contrary, I definitely support the efforts in this field of our friends of the ITGA (International Tobacco Growers' Associations), represented here today by their valorous Secretary General, my friend Antonio Abrunhosa: ITGA has confirmed the interest of the tobacco growers in the less favoured countries to introduce alternative crops as a complement to main production of tobacco, as a mean to increase family income.

But we must be aware that the Study Group of WHO on tobacco alternatives has a very peculiar approach. On one side they have literally declared the following: *"There was consensus that tobacco is a cash crop that active industry intervention has made attractive to farmers."* In another document the Study Group openly declares: *"The working group first defined the factors facilitating tobacco growing. Those include the price stability of tobacco, the credit facility and technical support provided to tobacco farmers, particularly by the tobacco industry, the high revenue from tobacco per hectare even from small farms, and the low cost of labour provided by the families of farmers. The existence of integrated market support systems and management provided by the tobacco companies from the growing phase to the marketing phase is also a very important factor facilitating, and sometimes encouraging, tobacco growing."*

But after having said all that, they insist that alternatives to tobacco farming should be found, and since these are not easily available, since tobacco farming is – by their own admission – economically interesting for the farmers, they are now proposing to introduce subsidies to support the change!

I strongly believe that tobacco farmers, processors and the industry must be aware of these two threats; that must address them, on one side, by supporting an equitable distribution of what I called the “right incentive” and, on the other, by defending with their Governments the right to keep this vital source of income and employment, against the biased position of bureaucrats and self-appointed economic experts, who go around the world to hold meetings and discuss about the future of millions of people, with no knowledge and no serious approach.

I took some time in describing these two issues, though they may seem far away from the specific interests of the European tobacco sector, because I am sincerely convinced of the opposite, that these world-wide problems have an impact on our business.

First of all, the costs increases have also severely affected the European tobacco, in labour, energies, fertilizers and interests. Therefore we are all very much aware that the “right incentive” is an open issue in Europe, as much as in the rest of the world.

Secondly, the change in cost/price structure that has affected many tobacco producing countries will likely change the competitiveness positioning of European tobacco in the world arena.

Thirdly, European tobacco is produced in an environment that makes it potentially attractive, over and beyond the mere economic advantage: I refer to the social environment that has no comparison anywhere in the world (and that in itself justifies the subsidy support, that simply compensates the cost of the European welfare systems), as well as to the “cleanness” of our product, to the controlled application of the right agro-products.

Finally, the survival of a viable and significant production of tobacco in Europe is now more than ever before within the strategic interests of the final customers: while it is true that European tobacco is a small fraction of the tobacco produced in the world, our “big-leaf” (that is Flue Cured and Burley) represent almost 9% of the tobacco of these two varieties available for international trade.

EU subsidies: costs differential and efficiencies

In this third portion of my speech (before dedicating some more time – not much, I promise – to politics), I would like to add two short comments on subsidies in favour of tobacco.

The first comment concerns the reasons why we believe that subsidies in favour of tobacco are justified from a social and economic point of view: they are simply the tool to allow European tobacco to play a reasonable match with our international competitors. When the cost of labour and when the absolute enforcement of social best practices (in terms of welfare in the broadest sense) will be the same in the other countries where tobacco is produced, as they are in Europe, there will be no need for subsidies.

But I would like also to add a second thought that we should try to convey to the Institutions: subsidies are not an unearned income. They have been instrumental, after the introduction of partial decoupling, to stimulate the research of efficiencies.

Despite the fact that 40% of the subsidies have been decoupled, the tobacco sector in Europe has not disappeared; the system has been able to find the economic resources to substitute this portion of the farmers’ income that is not available any more to the tobacco balance.

This has been true in the fields, as well as in our factories. In all European producing countries, the prices of the processed tobacco have decreased in the last few crops or – better said – have increased much less than it would have been necessary to cover the increase in prices paid to farmers.

Therefore, I strongly believe that partially decoupled subsidies have been a winning tool for Common Agricultural Policy in tobacco. And I strongly believe that it is perfectly legitimate that our Governments request that this success story is not abruptly terminated, but is continued for a number of additional crops, in order to allow our tobacco to be able to survive with less and less support!

But if tobacco and partial decoupling seem to have become an example, what sense does it make to destroy all of this in 2010? To discriminate tobacco against all other sectors of the European agriculture?

The answer is clear: it does not make any sense, not only in the perspective of non-discrimination of some European farmers against the others, but in the more tangible perspective of not destroying one agricultural sector that – though relatively small – is crucial in some very defined areas of Europe, and one that is reasonably well surviving.

The final effort to win our battle

It will not take me much time, finally, to talk about politics, because I am sure that others are more qualified and expert than me, to talk about these issues from this stand.

I think that the idea that was elaborated by your Congress in Mainz two years ago, to form a close cooperation and coordination among farmers (UNITAB), processors (FETRATAB) and workers (EFFAT) was very appropriate and brilliant.

I promised you that the political section of my speech would not be long. So I want to add only one thing, from my perspective of dealer with activities (direct or indirect) in most of the European producing countries.

There is going to be a future for European tobacco; there must be a future for European tobacco.

This future is not only subject to our own actions, since it greatly depends from political decisions.

But it is our goal, UNITAB's and FETRATAB's and EFFAT's goal to fight the final battle for the future.

We know that we can count on the support of a qualified majority of the members of the European Parliament, as well as of the local Authorities in many tobacco producing regions. We know that our Governments are determined to use all their influence to change the position of the Agriculture Commissioner.

As long as FETRATAB is concerned as long as my Company as me personally are concerned, I can guarantee our full support and our availability to work together, as in the last few years, in the next few weeks to achieve what we have been working for in such a determined and coordinated way.

This basically means, dear friends, Ladies and Gentlemen, Mr. Chairman and Mr. Secretary General, that I expect to attend your next Congress to discuss together about the successful future of European tobacco.

Let's work together to make this happen!

Thank you for your attention.

HASTA LA VICTORIA, SIEMPRE!1