

Agricultural Outlook Forum 2003

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TRADE POLICY DEVELOPMENTS AFFECTING COTTON

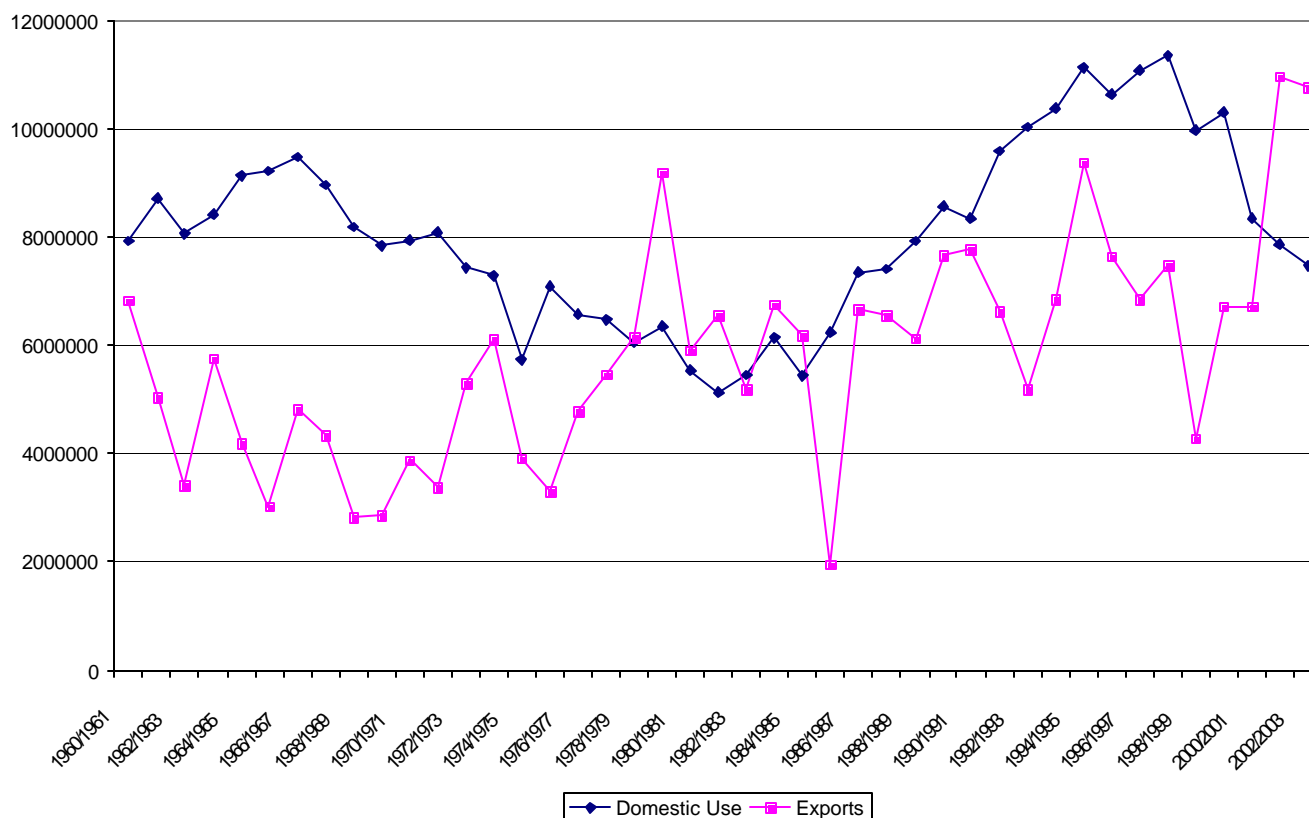
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Introduction

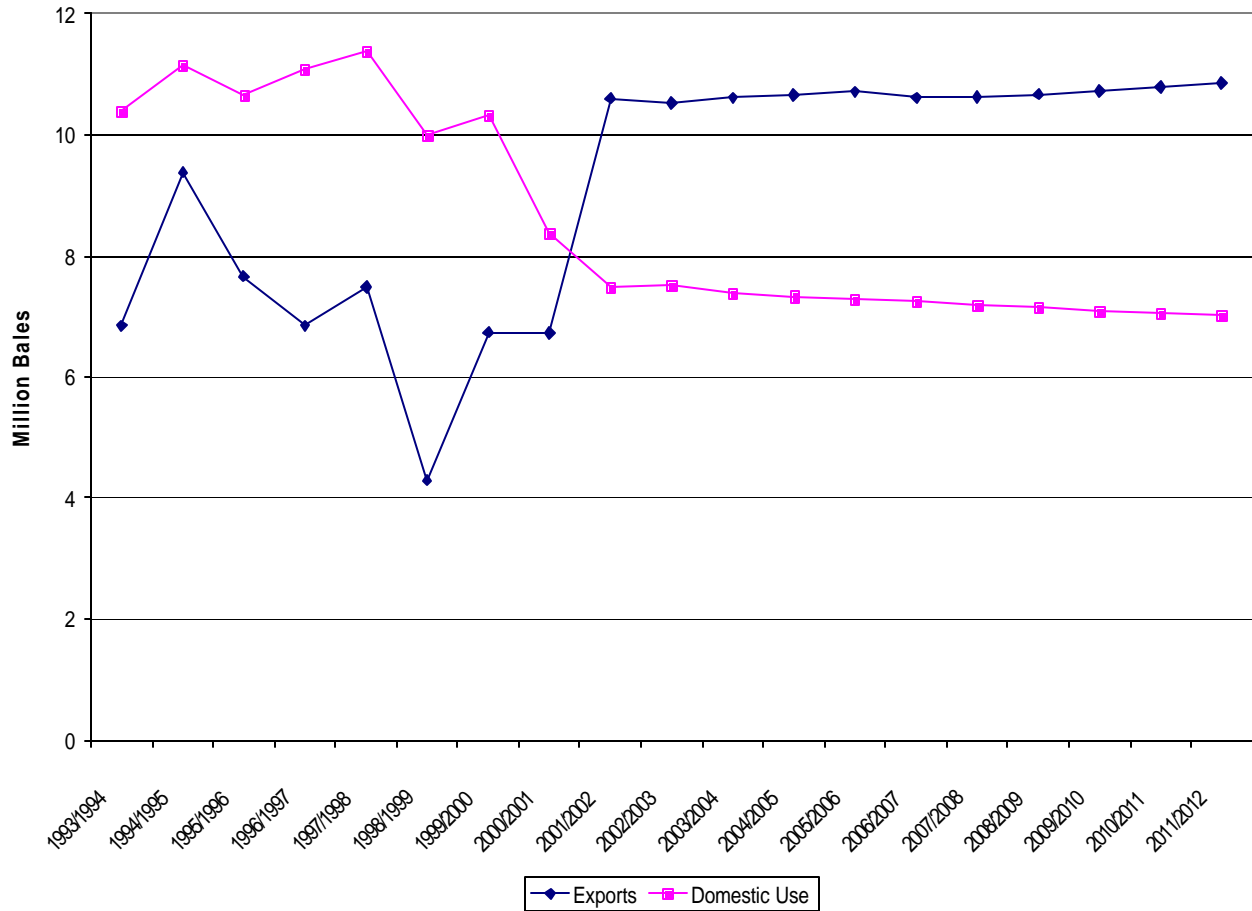
The topic I have been asked to address today is in keeping with the theme of this year's Forum "Competing in the 21st Century". The U.S. cotton industry is increasingly dependent on foreign markets and being able to successfully compete in those markets in the 21st century will be the key to the industry's health, if not long-run survival. A look at the historic use pattern for U.S. cotton shows that after a resurgence in domestic use beginning in the mid 1980s a rather rapid decline has taken place since around 1997 (Figure 1).

Figure 1. U.S. Cotton Use in 480 Lb. Bales



A look at the most recent long-range projections for U.S. upland cotton utilization from the University of Missouri, Food and Agricultural Policy Research Institute reveals that the evolution of the industry from a supplier for the domestic textile industry to one dominated by exports may be the picture of the future (Figure 2).

Figure 2. FAPRI U.S. Cotton Use Projections



While the U.S. cotton industry has always been one whose fate was linked to global events the decline in domestic mill use is making that link even more important. Accordingly developments in the policies that govern trade will have a great influence on the U.S. cotton industry. In the time we have today I would like to discuss three trade policy issues that will play a role in defining the outlook for the U.S. cotton industry in the near and long-term. The first issue, and the subject of the majority of this brief talk, is the recent Brazilian complaint to the WTO concerning the detrimental effects of the U.S. cotton program. Next I will touch briefly on the issues of China's performance relative to its commitments on cotton market liberalization as a new member of the WTO. I will conclude with a few thoughts on the effects of the Uruguay Round's Agreement on Textiles and Clothing (ATC) which brings to an end the Multifiber Arrangement (MFA), a regime governing, in large part, global trade in textiles for the past 30 years.

Consultations with Brazil

On September 27, 2002 the Government of Brazil (GOB) formally requested consultations with the Government of the United States concerning elements of the U.S. cotton program that the GOB considers to be causing adverse effects, i.e. serious prejudice, to the interest of Brazil. Like most things having to do with the WTO dispute settlement process, this begins a lengthy and involved theater where the characters are almost always played by expensive industry consultants and highly paid international trade

lawyers. And also like many of the agricultural issues facing the WTO the resolution of the problems will fall ultimately on the backs of producers with little influence on the outcome of the process.

In an attempt to simplify the nature of the GOB complaint it is helpful to understand the WTO concept of “serious prejudice”. Under the Agreement on Subsidies and Countervailing Measures (SCM Agreement), serious prejudice may arise in any case where one or several of the following conditions apply: 1. a subsidy results in the displacement or impedes the imports of a like product of another Member into the market of the subsidizing Member; 2. a subsidy results in the displacement or impedes the exports of a like product of another Member from a third country; 3. the effect of a subsidy is a significant price undercutting by the subsidized product as compared with the price of a like product of another Member in the same market or significant price suppression, price depression or lost sales in the same market; or 4. the effect of the subsidy is an increase in the world market share of the subsidizing Member in a particular product as compared to the average share during the previous three years **and** this increase follows a consistent trend over a period when subsidies have been granted.

If a Member is found to be maintaining a subsidy that causes serious prejudice, that Member “shall take appropriate steps to remove the adverse effects of the subsidy or shall withdraw the subsidy.”

The Brazilian case is troublesome for many reasons, not the least of which is the timing. Article 13 of the WTO Agreement on Agriculture (UAA), known as the “Peace Clause”, precludes most WTO dispute settlement challenges against a country that is complying with the Agreement’s liberalization commitments until January 1, 2004, when the Peace Clause will expire. In the case of Amber and Blue Box domestic support measures subsidies may be subject to dispute settlement actions if the level of support exceeds that of the 1992 marketing year. It is curious, therefore, that Brazil decided to take action when the expiration of the Peace Clause is close at hand.

Another troublesome, but not surprising, aspect of the Brazilian complaint is the broad categorization of programs that they maintain are prohibited and actionable subsidies. The programs include all forms of support currently in place for upland cotton producers and for the marketing of upland cotton, many of which are applicable to other commodities as well. For example in the initial Brazilian request for consultation points to domestic support during marketing years 1999-2002; export subsidies during marketing year 1999-2002; all programs applicable under the Farm Security and Rural Investment Act of 2002 (FSRIA); and provisions of the export credit guarantee programs GSM-102 and GSM-103. Many of the questions regarding the nature of these and other farm supports are the very substance of the current WTO negotiations. Decisions on the fate of these and other programs are historically decided in a multilateral setting. With the current Doha round of negotiations underway it seems, to paraphrase one high level USDA official, Brazil is dealing with the past, while we are focused on the future.

Rather than speculate on the motive and timing of Brazil’s action it is possible to review a few of the facts in the case to determine if there is any basis for the claim of serious prejudice. The first element in the argument concerns the level of U.S. subsidies to cotton relative to the 1992 Peace Clause trigger. The Peace Clause provides limited immunity from actions by Member countries against the policies of another member. If the conditions of the Peace Clause are not complied with the offending country loses that immunity. The recent level of support to U.S. agriculture in general, and cotton specifically, appear to clearly be above the level of outlays in 1992. There can of course be some disagreement about by how much. Information concerning U.S. government expenditures is most readily available in terms of Fiscal year outlays, not marketing years, even though WTO accounting is done on a marketing year basis. The USDA reports 1992 fiscal year expenditures for agriculture to have been \$9.738 billion, with cotton accounting for \$1.443 billion. For 2002 USDA reports fiscal year outlays of \$18.683 billion with \$3.685 going for cotton related programs. Even adjusting for fiscal vs. marketing year accounting it appears that

Brazil may have a point. But this just gets Brazil over the technical hurdle of proving that the U.S. has lost its immunity to a “serious injury” claim. Brazil still needs to prove that U.S. programs have caused Brazil “serious prejudice”.

Regarding the element of market share, the numbers may not be so clear. In an attempt to demonstrate extreme prejudice, the offending country must be shown to increased market share compared to average over previous three years and that this part of a consistent trend. If one looks at the history of U.S. world market share it appears that there has been an increase in U.S. market share. Is it a trend? If we refer back to the FAPRI projections, the industry would apparently hope so. Is it caused by U.S. farm programs? A question that will not easily be resolved.

Figure 3.



2002 estimated.
Source: USDA.

With regard to the issues of U.S. cotton programs having the effect of depressing world cotton prices and/or displacing potential sales of Brazilian cotton in selected markets, etc. the case will be much more difficult for Brazil to prove. As pointed out by leaders of the U.S. cotton industry, there are many reasons for the precipitous decline in world cotton prices in recent years. Cotton industry leaders suggest that the effects of the U.S. cotton program on world cotton prices are minute when compared to the aggregate effect of other factors such as: the Asian financial crisis; a faltering global economy; currency manipulations; a tripling of world production capacity for textile polyester; and revenue and tax policies of other governments. Clearly there will be disagreement over these issues should the dispute move to a formal WTO panel. As Robert Hudec has said, “In the hands of a clever advocate, there is always some

alternative explanation for events that have occurred". I have faith the USDA, USTR, the US Cotton Industry and the GOB have more than their fair share of clever advocates.

Obviously there are many more details surrounding the legal issues of the Brazilian case and they deserve a more complete hearing than we have time for today. What is also obvious is that the Brazilian action against U.S. cotton is the tip of the iceberg of potential stumbling blocks facing the current trade negotiations. In the cotton sector, for example, the fact that countries like India, Zimbabwe and Argentina also want to participate in the Brazilian complaint and the Oxfam report on the U.S. cotton program's effect on African cotton producers are other examples of what I see as complicating themes for the current negotiations. The developing country members of the WTO are going to have a much stronger voice in these negotiations. The target of these complaints will center on the agricultural programs, both domestic and trade related, of the developed members and the need to achieve some form of special consideration for their effects, real or perceived, on their economies.

In short what we will likely see develop are arguments where the developed countries maintain that correlation is not necessarily the same as causality while the developing countries argue that their observations are reality. In the end it does not appear that this provides the environment necessary for a speedy and/or successful conclusion to the new round of agricultural trade negotiations or helps to improve the profitability of any particular industry sector except perhaps trade lawyers.

China Cotton TRQ Administration

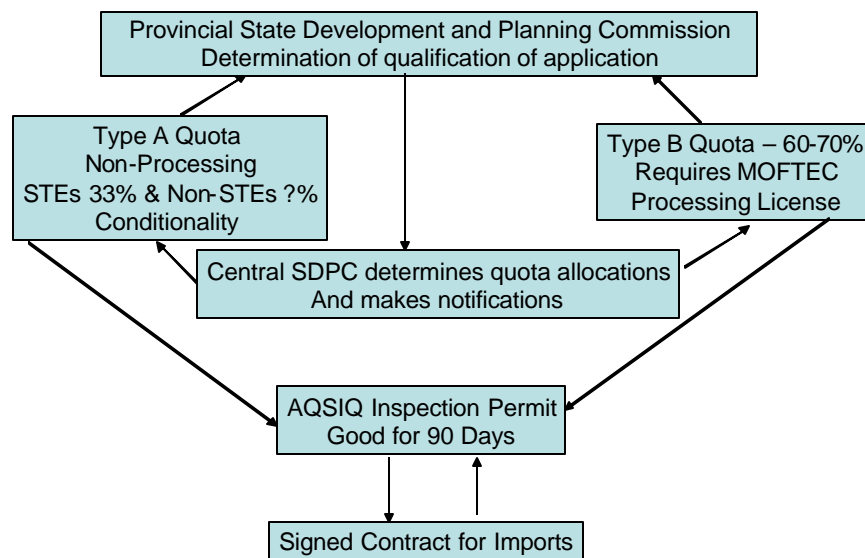
At the same time the U.S. cotton industry is facing challenges in the WTO, the excitement over potential increased market access expected to result from China's accession to the WTO is waning. In December there we calls for USTR to convey a message to Chinese officials that any grace period for implementing WTO commitments has expired and that a continuation of unfair restrictions would force the U.S. to initiate a WTO dispute settlement action. In the case of cotton these complaints focus primarily on the administration of the Chinese tariff-rate-quotas (TRQ).

As part of the WTO accession agreement signed in December, 2001, China agreed to introduce a TRQ system to govern cotton imports. Specifically the Chinese agreed to provide access for imports of around 3.8 million bales in 2002 increasing to around 4.1 million bales in 2004. Imports under the quota would be subject to a 1% tariff while above quota imports would be subject to an initial tariff of 76% declining to 40% in 2004. One third of the TRQ was to be reserved for state trading companies and the remaining two thirds to non-state trading companies. The excitement surrounding the TRQ for cotton is understandable because Chinese imports of cotton have not approached these levels since the mid 1990s. With world cotton trade around 27 million bales and cotton prices at historic lows an increase in Chinese imports of magnitudes approaching the TRQ would be welcome news indeed. So what's the problem?

Unfortunately the administration of the Chinese cotton TRQ system has not yielded the results many have hoped for. First of all, the Chinese were late in beginning to administer the TRQ process, with the first notifications taking place in March. Second the application process proved to be very burdensome requiring importers to apply to their regional State Development and Planning Commission (SDPC), who then forwarded qualified applications to the central SDPC in Beijing who ultimately notified the end users of their allocation (if approved). The quotas were allocated in a fashion reminiscent of the EU banana quota allocation scheme, that is to say less than completely transparent to the casual observer. In addition more than 60 percent of the 2002 quota allocation was apparently reserved for Chinese companies in the processing and re-export trade, increasing the competition for WTO members' processed goods in other export markets, such as the U.S. And finally the import quota is being treated like a pool to be drawn down over the course of the year rather than allocated at the beginning of the year as had been expected.

A diagram of the steps that a Chinese importer must follow to ultimately import cotton under the TRQ is provided in Figure 4. Of particular importance is the number of steps required before a formal import contract can be obtained. Chinese importers do not really have the green light to secure a contract for delivery until the final step of the process, obtaining an inspection certificate from the State Administration of Quality Supervision, Inspection and Quarantine (AQSIQ). Once obtaining the certificate, it is valid for only 90 days. Unless and until the process becomes more streamlined the promise of China's cotton imports will likely remain unfulfilled. Imports of cotton by China will continue to be guided by internal political decisions and supply/demand fundamentals allowing for imports when necessary. It should be remembered that the existence of a TRQ merely provides for the possibility of a given quantity of product to enter under tariff preference, not the obligation to import.

Figure 4. China Cotton TRQ Administration



The outlook for a rapid improvement in the Chinese TRQ administration does not appear promising. Reports from government and trade sources suggest that China intends to implement its cotton TRQ in the same way in 2003. In the most recent USDA estimates, China is forecast to import 2.25 million bales, up substantially from last year but well below the TRQ level. Not surprisingly continued pressure from cotton interests in Congress has pushed USTR to the brink of requesting formal WTO consultations with China over the administration of their TRQ regime on cotton and other bulk commodities.

Agreement on Textiles and Clothing

From 1974 until the implementation of the Uruguay Round Agreement, trade in textile and apparel was governed primarily by the Multifiber Arrangement (MFA). The MFA was an international agreement permitting restrictions on textile and apparel trade that would otherwise have violated the rules of the GATT. The MFA evolved from a five-year agreement, beginning in 1957, to limit cotton textile imports to the United States from Japan. Increased imports from other countries and protectionist pressures in Europe led to the Short-term Arrangement on Cotton Textiles in 1961, followed by the Long-term

Arrangement regarding International Trade in Cotton Textiles which lasted from 1962-73. Increased importance of wool and synthetic fibers led to the establishment of the first MFA. Following numerous modifications and renewals the stage was set for the dismantling of the agreement with the conclusion of the Agreement on Textiles and Clothing (ATC). Under the ATC, the MFA restrictions were scheduled to be phased out over a ten year period ending in 2004.

With full implementation of the ATC effective January 1, 2005 there is increasing interests in the possible effects this policy change will have on the U.S. textile and apparel industry and subsequently the U.S. cotton industry. It is difficult to quantify what the likely effects will be. A study by USDA/ERS in 2001 estimated that U.S. apparel consumption would increase by about 7 percent as world prices fall, that the U.S. textile industry contracts by 2 percent as imports rise and that the U.S. apparel industry shrinks. With U.S. textile industry demand for cotton decreasing and foreign demand for cotton increasing, U.S. exports increase but not by enough to offset downward pressure on cotton production of about 1 percent.

There are reasons to anticipate that the effects of full implementation of the ATC may be more substantial, on both the domestic industry and textile and apparel exporting nations, at least in the short-run. First, the pace of adjustment in current import restrictions has been slow and focused on a limited number of low value-added import categories. According to the July 2002 report of the WTO Council for Trade in Goods, even at the end of the third stage of integration the number of quotas that remain in place would be as high as 701 out of 757 in the U.S. and 164 out of 219 in the case of European Union. As a result the industry may be in store for a sizeable increase in import competition as the remaining quotas on high-valued textile and apparel are removed (Figure 5).

Figure 5. Agreement on Textiles and Clothing Implementation Schedule

Four steps over 10 years
 The schedule for freeing textiles and garments products from import quotas (and returning them to GATT rules), and how fast remaining quotas should expand. This example is based on the commonly-used 6% annual expansion rate of the old Multifibre Arrangement. The actual rates used under the MFA varied from product to product.

Step	Percentage of products to be brought under GATT (including removal of any quotas)	How fast remaining quotas should open up, if 1994 rate was 6%
Step 1 1 Jan 1995 to 31 Dec 1997	16% (minimum, taking 1990 imports as base)	6.96% per year
Step 2 1 Jan 1998 to 31 Dec 2001	17%	8.7% per year
Step 3 1 Jan 2002 to 31 Dec 2004	18%	11.05% per year
Step 4 1 Jan 2005 > Full integration into GATT (and final elimination of quotas). > Agreement on Textiles and Clothing terminates	49% (maximum)	No quotas left

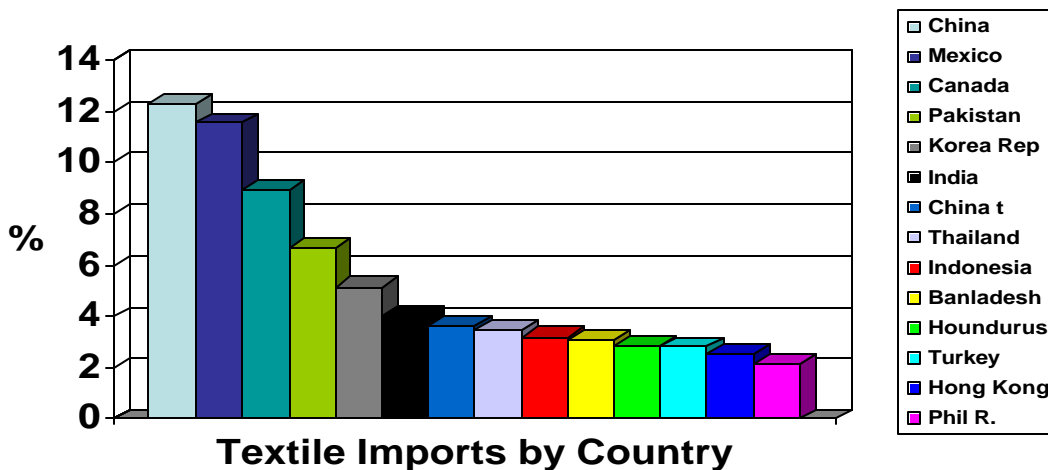
The actual formula for import growth under quotas is:
 by 0.16 x pre-1995 growth rate in the first step;
 0.25 x Step 1 growth rate in the second step; and
 0.27 x Step 2 growth rate in the third step.

The effects of full implementation of the ATC will also have a substantial impact on the exporters of textile and apparel. Currently exports of textiles and clothing from producing countries are constrained by the existence of quotas. When quotas are removed more intense competition from more efficient producers can be expected to the detriment of other exporters who have benefited from the preferential treatment afforded by import quota allocations. For example, U.S. imports of all MFA fibers originate from 102 different countries, however around 73 percent originate from 14 (Figure 6). In a recent report from the

U.S. Department of Commerce to the Congressional Textile Caucus major importers indicate that their current purchase of goods from as many as 40 to 60 countries could be quickly cut by one half to one third following full implementation of the ATC. These anticipated effects have led to efforts by the State Department diversification subgroup to encourage countries that are overly dependent on textile and apparel exports to diversity into other industrial sectors.

Figure 6. Imports of all MFA Fibers as of end 11/02

73%



102 Countries Export Textiles to the U.S.
Office of Textile Administration

Conclusions

It is apparent that the U.S. cotton industry is in transition to an export dependent industry. If the U.S. cotton industry is to survive and prosper it will have to maintain a competitive position in global markets. Currently a combination of export friendly farm programs contributes to the overall competitiveness of the industry. However, trade policy developments in the context of existing and future WTO obligations and domestic budget concerns cast doubt on the sustainability of those policies. Increased access to expanding world cotton markets will also be required for future success. Unfortunately promises of increased market access from trade liberalization can be unfulfilled when agreements are implemented under administrative rules that reduce their full potential as in the case of China's accession to the WTO. Stable domestic mill use would be a vital underpinning for the industry. With the full implementation of the ATC in 2005 the domestic textile industry is facing a balloon payment on removal of barriers to foreign imports. As a result the downward trend in U.S. mill use may accelerate.

The U.S. cotton industry is facing a challenging future in the 21st Century. It will take a coordinated industry approach to address the many difficult issues ahead. In addition it will likely take a continued public/private partnership to smooth the path of transition for cotton producers who continue to supply the basic product and must adjust to the end result of government policy decisions at all levels.

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