TRADE DISPUTES IN AN UNSETTLED INDUSTRY: MEXICAN SUGAR

Kenneth Shwedel and Alejandro Ampudia[1]

INTRODUCTION

One of the outstanding trade disputes between Mexico and the United States revolves around the market for sweeteners. This, of course, should come as no surprise since around the world sugar is a highly politicized commodity. In the Mexican/U.S. case the dispute moves beyond sugar into the sweetener market involving high fructose corn syrup (HFCS). The dispute is also wrapped in the last minute wheeling and dealing that was necessary to get the North American Free Trade Agreement (NAFTA) approved by the U.S. Congress. It also brings into the dispute corn policies, which are important to both countries.[2]

In an attempt to put the trade dispute in perspective, this paper will focus on the Mexican sugar industry. Two distinct groups, growers and

[1] The opinions and conclusions expressed in this paper are those of the authors and not necessarily Rabobank.
[2] Corn, which is a stable in the Mexican diet, is the most widely grown crop in Mexico. Only a small portion of the domestic crop, which is predominately white corn, goes into animal feed and industrial use. The importance of corn both for its impact on rural incomes and consumption makes it a highly politicized crop in Mexico.

mill owners characterize the industry. Historical circumstances and legal issues have separated these two groups over time preventing the development of an integrated sugar sector. In fact, the relationship between these two groups can be characterized as, at best, antagonistic. At the same time, the industry has been characterized by a series of policies and direct government interventions that left the industry in a state of confusion and disarray.

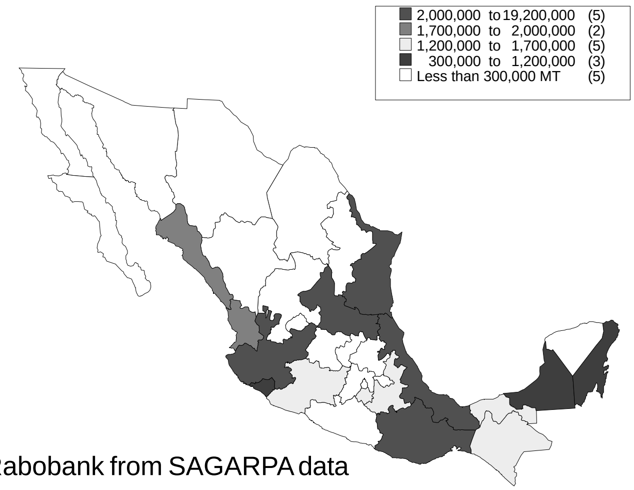
This paper has four sections:

- the first will review the troubled background and history of the sugar industry through the first years of the NAFTA;
- the second section will look at the NAFTA agreement and subsequent disagreements regarding both sugar quota and the HFCS dumping demand;
- the third section looks at recent events in the Mexican market, including expropriation of approximately half of the production capacity, Mexico's acceptance of NAFTA, WTO panel findings regarding the HFCS, and the subsequent decision to link the HFCS imports to the level of duty free exports of sugar accepted by the United States; and
- the final section discusses facing the future.

A TROUBLED BACKGROUND

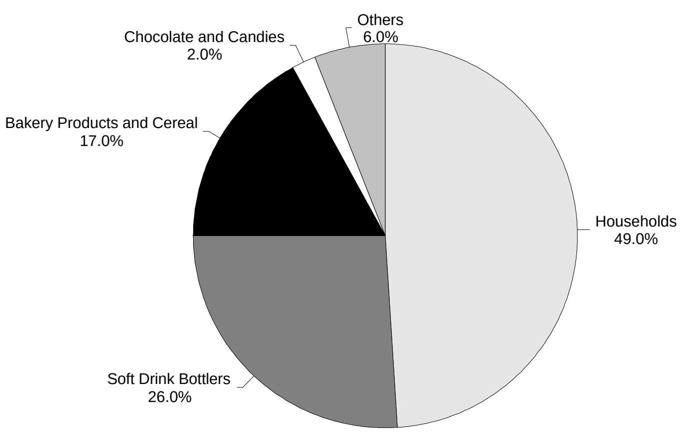
To understand the industry, its politics and the trade disputes, it is important to recognize its importance both economically and socially within Mexico. Sugar cane production tends to be is concentrated in the poor tropical areas of Mexico. This concentration implies that policy decisions have an important social impact in rural Mexico (Figure 1). Sugar production in Mexico is destined mostly for domestic consumption as opposed to other countries that rely on the international market. Mexico has consumed on average more than 85 percent of its production domestically. Major Mexican industries, such as the soft drink industry, strongly rely on Mexican sugar production (Figure 2). The Mexican sugar industry generates 0.7 percent of Mexico's GDP, and some 400,000 direct jobs (in the fields) and 700,000 indirect jobs, affecting between four and five million people

Figure 1: Sugar Cane Production is Concentrated in the Warmer Areas of Central Mexico.



Source: Rabobank from SAGARPA data

Figure 2: Consumption of sugar by major use categories, 2000.



in Mexico. Therefore, the government has a strong commitment to this industry for social and political reasons. This commitment has manifested itself through a series of polices that have attempted to regulate the market for the benefit of mill owners as well as to protect cane producers and mill workers. At times this commitment has led to direct management and expropriation of the sugar mills.

Private Management and Government Intervention

Prior to 1970, Mexico's sugar mills were essentially in private hands. Production had been growing at rates even above that of the population. In part this growth was a response to favorable prices and changes in the U.S. sugar policy. Sugar production was stimulated during World War II by high prices and again in the early 1960s after the United States canceled Cuba's sugar quota, which was distributed among a number of sugar producing nations, including Mexico. The fact that the sugar mills were in private hands did not mean that the government had left the sugar industry to the forces of the market. Going back as far as the 1930s, the government in conjunction with the private sector attempted to regulate the domestic sugar market through the *Comisión Estabilizadora del Mercado de Azucar* (Commission to Stabilize the Sugar Market). In 1943 *Financiera Industrial Azucarera, S.A.* was created to finance the sugar industry. It became the *Financiera Nacional Azucarera* (FINASA) in 1953, and in 1966 the Federal Government formally took control of FINASA in order to assure that financing reached the industry at preferential rates.

The government's control over the industry went beyond the milling and marketing of sugar into the production of sugar cane. Two legal measures, which are still in effect today, contributed to the structural inefficiencies that characterize the industry. In 1944 the government issued a decree *Decreto Cañero* (Sugar Cane Growers Decree) that required farms, whether they be *ejido*[3] or private farms, that operated within the sugar mills areas of influence to produce exclusively sugar cane. The decree, in turn, required that the mills buy all the sugar cane produced in their area of influence. This requirement assured a market for farmers' cane and jobs for rural laborers. As a result the area dedicated to sugar production almost tripled.

[3] The term *ejido* refers to a specific land tenure structure, whereby the use rights over a tract of land is given to a group of farmers, *ejidatarios*, in perpetuity as long as they continue to work the land. They may work the land in individual units, as a co-operative or in a collective-type scheme.

The decree limits the mills' ability to adjust purchasing to market conditions. The decree also sets forth a pricing formula for the sugar cane. One of the elements of the formula relates the price of sugar cane to the previous year's sugar prices. When sugar prices are rising, the formula is favorable to millers since they pay last crop's prices (lower) to cane growers. Likewise, when sugar prices are falling the millers pay above market prices for sugar cane. Taken all together, the Decreto Cañero separates the sugar industry from the market.

In addition to the Decreto Cañero, the government also imposed a set of contractual obligations, the *Contrato Ley*, on the relations between mill owners and their workers in the mill. Dating back to when mills were located in relatively isolated areas, mill owners were required to provide such services as housing, schooling, etc. for their workers and their families. As a result the millers' legal obligations to their workers were, and still are, more rigorous than those of other industries that compete for financial capital in Mexico. Even today when the government is able to provide these services, and taxes companies for these purposes, the Contrato Ley obliges the mills to continue providing these services.[4]

Although government programs impacted on the sugar industry at several levels, essentially the policy objective was to assure a stable supply of sugar to consumers at affordable prices. In practical terms this meant price controls at the consumer level while letting prices rise at the producer level to stimulate sugar cane production.

The Government Take-Over of Mills (1970–1988)

Being squeezed at both ends, the sugar mills bordered on bankruptcy. The government's answer to this impending crisis was to rescue the troubled mills, taking over the control through the Operadora Nacional de Ingenios (ONISA). In 1971 when ONISA was formed the government had control of 19 mills. By the end of the decade they controlled 49 of the

[4] Mill owners charge that when the mills were under government control, the size of the labor force was padded, which after privatization has made the Contrato Ley burden even more onerous.

66 mills in the country. To co-ordinate the sugar policy, the government set up the *Comisión Nacional de la Industria Azucarera* (CNIA) in 1970. Eventually CNIA took over ONISA's functions.

Between 1970 and 1989, when the mills were under government administration, sugar production grew from 2.2 million metric tons (mt) in 1970, to 3.49 million mt in 1989 . Most of this growth came from bringing new land under cultivation. The sugar cane area increased by 35 percent while average yields increased by only 7.7 percent. At the same time the number of sugar cane growers increased 56 percent. The disproportionate relationship between the growth in the number of producers and sugar cane area contributed to the contraction in the average size holding to only 4.1 hectares. In other words, sugar cane production is characterized by a predominance of small scale agricultural units or *minifundios*. By 1990, for example, only 5 percent of the sugar cane area was harvested mechanically.[5] Sugar mills did not fare much better under government control. The number of workers increased 37 percent. Plant productivity increased by only 5 percent.

Sugar consumption, helped by falling real prices, increased 103 percent. By the 1980s Mexico had gone from being a net exporter to being a net importer of sugar. What kept the industry afloat during those years were growing subsidies. Garcia Chavez (1996) calculates that between 1983 and 1990 government transfers to the sugar industry reached about 934 billion pesos. In fact, in 1988 subsidies to the sugar industry represented one quarter of the Secretary of Agriculture's total budget, about US$988 million.

Government Sale of the Mills (1988–1992)

During the de la Madrid Administration (1982–1988), Mexican economic policy moved away from direct state control and intervention in the economy toward favoring more market orientation. Among the sectors marked for a reduction in the government's participation was the sugar

[5] The low level of mechanization was also related to reluctance on the part of the government to stimulate mechanical harvesting since it was seen as a labor displacing technology.

sector. Initially, the government had intended to reduce only its participation in the industry from around 75 percent to 50 percent. However, because of the recurrent economic crises and budgetary limitations, the government decided to withdraw completely from running sugar mills.

Selling the government's interests in the sugar mills was easier said than done. Potential buyers were aware of four problems inherent in the acquisition of the sugar mills:

- low levels of investment in technology;
- difficult labor situations in the mills;
- organizational problems with sugar cane producers; and
- high dependence on government subsidies.

In response to these problems, the government designed schemes for purchasing the mills that allowed for buyers to put up a small portion of the purchase price[6] at the time of sale, with concessions on the terms of the remaining amount. In other words the mills were privatized in highly leveraged operations. Interestingly enough, a number of bottlers of carbonated beverages purchased sugar mills during the privatization process, vertically integrating an important part of Mexico's beverage industry.

Even with these terms one could question the feasibility of the business venture. It should be remembered that at that time imports of sugar were tightly controlled. There was the implicit understanding that imports would remain under tight controls to maintain domestic sugar prices. This was not to be. Between 1989 and 1991 imports grew exponentially reaching over one million metric tons.

Between 1990 and 1992, according to the *Cámara Nacional de la Industrial Azucarera y Alcoholera* (National Sugar Chamber) net losses for the milling industry reached 1.77 billion pesos. In 1991 the debt of the privatized mills was restructured. In 1993 the government had to extend credit to the mills on the order of 900 million pesos in order to liquidate the debt that they had with sugar cane growers.

[6] Some reports say that it was as low as 20 percent.

As might be expected with the growing financial difficulties, a number of mills changed hands after the privatization, creating increased concentration in the industry. At the same time a number of companies initiated programs to restructure production processes. As a consequence the area planted in sugar cane increased concurrently, production yields (tons of sugar cane per hectare) increased. At the same time, processing yields (tons of sugar per tons of cane) in the mills improved.

Going into 1994, the outlook for the sugar industry was mixed. Any thoughts of optimism, however, disappeared at the end of the year. While much has been made of the economic crisis in terms of the devaluation of the peso and subsequent contraction of the economy, for the sugar industry the rise in interest rates proved most damaging. Average interest rates increased from 13.9 percent in 1994 to 48.6 percent in 1995. For the already highly leveraged mills, this added debt burden was unsustainable. FINA had to carry the debts on their books, about $1.2 billion in 1996 and $2.0 billion in 2001.

THE NORTH AMERICAN FREE TRADE AGREEMENT

Much has already been written about sugar and the NAFTA including one paper prepared for the Sixth PDIC Workshop (Kennedy and Petrolia, 2001). What stands out in the literature is that for what appears to be a straightforward agreement, there is so much disagreement over what was actually said and what was meant. In part, the disagreement may be due to the negotiating objectives of the different parties. For Mexican negotiators, NAFTA was part of the policy of structural reform that characterized the de la Madrid and Salinas Administrations' economic policy. In fact, Mexican policy-makers and -negotiators saw NAFTA as a mechanism that would keep structural reform policies in place beyond the normal six-year political cycle. For the U.S. and Canadian negotiators, by way of contrast, NAFTA was "one more" trade agreement. As such they tended to respond more to the interests of their clientele (producers) than did the Mexican negotiators.

Likewise there were important differences in the way Mexico and the United States approached the negotiations. Mexico saw and consequently negotiated NAFTA in the limited terms of their domestic sugar policy needs. The United States on the other hand, took a broader view, focusing on sugar in the context of the wider sweetener market and policy. In essence at the insistence of the United States, the original agreement was rewritten at the last moment in the form of two side letters that redefined the conditions for Mexico's duty free access to the U.S. market, incorporating HFCS into the equation. The two main differences related to the formula for determining Mexico's status as a surplus producer and the quota size for duty free sugar.

In the original agreement, Mexico was to be considered as a surplus producer if domestic sugar production exceeded domestic consumption of sugar for two consecutive years. As a surplus producer, Mexico would have the right to export all surplus production into the U.S. market. In response to concerns from U.S. producers, the side letters introduced HFCS into the formula for calculating the surplus status. After the exchange of the side letters, to be considered as a surplus producer, Mexico domestic sugar production had to be greater than domestic consumption of both sugar and HFCS.

For the United States this difference was crucial. Historically, the United States has been a surplus producer of livestock feed corn, while it has maintained a deficit position in the sweetener market. Both of these markets have been the objective of government subsidies. The growth of the HFCS industry appeared to take up part of the corn surplus while it reduced the sweetener deficit. Yet the growth of HFCS posed the possibility of depressing the U.S. sweetener market. Maintaining exports of HFCS is crucial to the U.S. sweetener policy.

An additional element of confusion and uncertainty comes from what appears to be two different versions of the side letter. The English version signed by the U.S. Trade Representative makes specific reference to the "consumption" of HFCS, while the Spanish version, signed by the Mexican Secretary of Commerce, says only that HFCS will be used for calculating net surplus. This discrepancy in wording leaves open the possibility for the Mexican production of HFCS to be included along with domestic production of sugar.[7]

The other area of controversy relates to the quota for Mexican sugar. According to the agreement, during years seven to fourteen of NAFTA, the quota was raised from 150,000 mt to 250,000 mt.[8] While this seems to be rather straightforward, there have been differences on interpretation. Mexico understands that this gives them access to 250,000 mt, i.e. they can export duty free up to that level. The United States understands that level to be the upside limit, i.e. Mexico does not automatically have access to the entire 250,000 mt. Mexico called for a NAFTA panel to challenge the U.S. interpretation and subsequent actions. In light of the controversy that has ensued, it is interesting to reflect that in 1994 Mexico was a net importer of sugar and that imports of HFCS were minimal.

The side letters have been subject to much controversy in Mexico. In general the feeling in Mexico is that the baby was given away with the bath water. At the same time the situation has left many Mexicans doubting the commitment of the United States to free trade.

High Fructose Corn Syrup

In the United States there has been heavy investment in HFCS production capacity. The main market for HFCS is for carbonated beverages. The switch-over from sugar to HFCS in the United States was relatively fast and easy since the carbonated beverage industry used liquefied sugar. Not only was it used in the production of carbonated beverages, but it was also transported and stored in liquid form. Yet even with the switch-over in the carbonated beverage industry, the HFCS industry continued to face excess capacity. Kennedy and Petrolia (2001, pp.239-240) pointed out that increases in consumption of HFCS in the United States lagged behind

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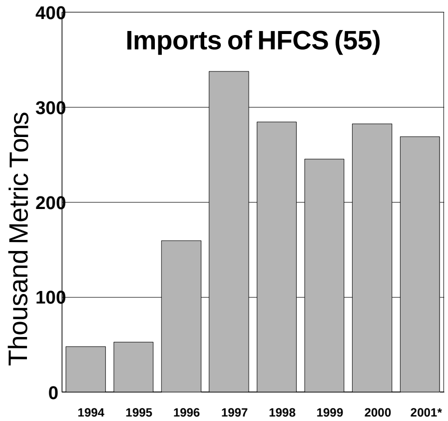
[7] If this discrepancy were not enough, the Mexican Senate never officially approved the side letter. This omission has allowed the Mexican government to argue that it never agreed to the side letter. As such, it has no validity and does not supercede the original agreement.

[8] The quota for years one to seven remained unchanged.

Figure 3: Mexico's Imports of HFCS, 1994-2000.



Total Fructose Mexican Imports.

	United States	*Other Countries*	*Total*
1994	74,092	26	74,118
1995	57,758	1	57,759
1996	198,918	91	199,009
1997	347,799	3	347,802
1998	295,923	5	295,928
1999	344,910	1	344,911
2000	295,016	15,243	310,259

Source: Rabobank with data from the Secretaria de Economia

growth in production capacity. Mexico, which is the world's second largest consumer of carbonated beverages, was the logical market for the excess capacity (Figure 3). Exports from the United States of HFCS increased, displacing sugar.[9] Finally, in 1997 the *Cámara Nacional de la Industrial Azucarera y Alcoholera* (National Sugar and Alcohol Chamber) formally accused the U.S. industry of dumping HFCS in Mexico.

Following the formal investigation, the Mexican Commerce Secretariat (SECOFI) ruled in favor of the Mexican sugar producers. SECOFI found that dumping had occurred and that it had caused damage to the Mexican sugar industry. Mexico imposed countervailing duties on imports from those U.S. companies involved in exporting to Mexico. The response from the United States was to ask for both a NAFTA panel and a WTO dispute settlement panel. In all cases the panels have ruled against Mexico. In spite of these panel rulings, Mexico had been able to put off reversing the countervailing duties. After what was the final ruling in late 2001, Mexico entered into negotiations with the United States looking to solve both the

[9] Because of differences in flavor, the Mexican industry continued to use sugar along with the HFCS, with some bottlers favoring a 50-50 formula of HFCS and sugar.

differences on the interpretation of the side letters and the dumping resolution.

In a bungled attempt to resolve Mexican sugar producers' problems, the SECOFI requested the soft drink industry to limit its use of HFCS. Following the adverse reaction from the United States to the SECOFI press release on the "request" to the soft drink industry, SECOFI denied that this request had taken place.

Following the dumping resolution, imports of HFCS fell from 374,000 mt in 1999 to 283,000 mt in 2001. This drop, however, does not mean that the consumption of HFCS has fallen because domestic production of HFCS has grown. In 2001, Mexican production of HFCS reached 350,000 mt. Only two companies are involved: Arancia Corn Products, a joint venture with Corn Products International (CPI), produces 300,000 mt, and Almidones Mexicanos, a joint venture between ADM and Tate and Lyle, produces the other 50,000 mt.

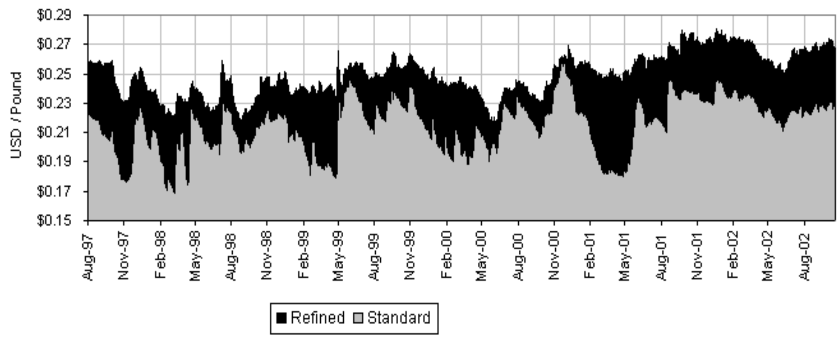
High-Tier Tariffs

While much of the attention and tension has focused on the dispute surround the duty free tariffs (also known as the "low-tier tariffs"), NAFTA also put into place a declining tariff schedule for sugar.[10] "For calendar year 2002 the raw sugar tariff is 9.07 cents a pound and the refined sugar tariff is 9.61 cents a pound. The raw sugar tariff drops around 1.5 cents each year, and the refined sugar tariff drops about 1.6 cents a year. Both rates reach zero in 2008."[11]

The combination of low world sugar prices and the falling high-tier tariff rates would suggest that Mexico would eventually find it profitable to redirect its sugar exports from the world market into the high-tier U.S. market (Figure 4). USDA baseline data projections show a jump in

[10] Besides sugar, NAFTA also incorporated a number of declining tariff schedules for over-tariff exports, including those for U.S. shipments of corn and poultry, among others into Mexico.
[11] USDA, "USDA Baseline Projections," February 2002, p.45.

Figure 4: Mexico Standard and Refined Historical Sugar Prices, 1997-2002.



Source: Rabobank from Fidiecomiso para el Mercado de Azucár (FORMA) data.

Mexican exports to the United States in 2003 taking advantage of the falling tariff rates.

WTO Commitment

The United States during the Uruguay Round, committed to importing a minimum of 1.256 million mt of raw and refined sugar, raw value.[12] Of this amount at least 24,251 mt has to be refined sugar. This commitment was rolled over into the WTO when it replaced GATT.

Mexico's duty free exports of sugar to the United States have been included in the U.S.'s WTO commitment. As indicated above, the quota assigned to Mexico has been a source of trade friction. Into the future as Mexico's exports to the U.S. increase, they will take an increasingly larger share of the WTO quota. The USDA baseline projections indicate that once the U.S. market for Mexican sugar opens completely under NAFTA, exports will increase to the point where in 2011 they will equal the entire WTO quota commitment.

[12] This section is based on "USDA Baseline Projections," February 2002, p.45.

RECENT EVENTS

Following the government's sale of the sugar mills and, in part, in anticipation of access to the United States market, sugar production increased in Mexico (Table 1). With consumption flat, increased production moved the industry into a surplus position. Over time the already precarious financial situation of the industry was worsened. The Mexican government was, and is still, very much involved in attempting to regulate the sugar market, since many of the sugar mills continue to face serious financial problems, even with the countervailing duties on the HFCS.

The government has attempted to support the sugar industry by keeping domestic prices above world prices, through limiting the amount of sugar that is sold on the domestic market. The government does this by estimating the domestic demand and the sugar harvest. Based on this information, the government assigns an export quota to the mills divided into NAFTA duty free and NATFA non-duty free market components. The mills are required to comply with the government assigned export quotas. Essentially, therefore, Mexican sugar producers deal with three prices: the U.S. price for the sugar exported under the NAFTA/sugar quota, the low world price, and the Mexican price.

From Bankruptcy To Expropriation

In spite of the government's attempts to support the domestic price, the debt burden proved too much for many mills. In some cases, for example, they raided pension funds. In others, they delayed payment to cane growers. There have also been charges of fraud, with sugar that was said to have been exported actually being sold on the domestic market. This sugar had the effect of depressing domestic prices, further exacerbating the worsening financial situation for some mills. In May 2000, GAM, the second largest company in the industry filed for "suspension of payments," an equivalent to a Mexican Chapter 11. Although the company restructured and paid most of its short-term debt, it was unable to reach an agreement regarding its long-term debt.

Table 1: Production and Consumption of Sugar in Mexico, 1991- 2002.

Period	*Production*	*Consumption*	*Surplus/ Deficit*	*Consumption/ Production*	*Exports/ Production*
1991/92	3,577	4,329	(752)	121%	-17%
1992/93	4,431	4,459	(28)	101%	-1%
1993/94	4,010	4,404	(394)	110%	-9%
1994/95	4,650	4,397	253	95%	6%
1995/96	4,685	4,443	242	95%	5%
1996/97	4,822	4,100	722	85%	18%
1997/98	5,490	4,179	1,311	76%	31%
1998/99	5,147	4,160	987	81%	24%
1999/00	4,696	4,195	501	89%	12%
2000/01	4,924	4,500	424	91%	9%
2001/02	4,872	NA	NA	NA	NA

Source: Fidiecomiso para el Mercado de Azucár (FORMA)

Into 2001 the domestic market was in disarray. Due to the seasonal nature of sugar prices,[13] mills usually obtain sugar inventory financing during the production period (November-August), and repay the loans August-December each year. In 2001 however, after years of difficulties, companies such as Escorpion (CAZE), Santos, Machado, and GAM were negatively affected by their lack of short-term inventory financing. This inability to monetize inventories pushed millers to accelerate sales of sugar in order to obtain funds to cover operating expenses (mainly payments to cane growers). By May 2001 standard sugar prices reached their lowest level in the previous three years, impacting negatively on cash flow and profits. The effect was felt throughout the entire industry. Sugar cane growers demonstrated for payments, closing SAGARPA's offices. The mill workers were threatening to go on strike. Looking for a way out of the immediate crises, the government implemented a program to finance inventories and

[13] Seasonal movements of sugar prices in Mexico are characterized by three different stages:

- January–May sugar prices drop as a result of an excess supply on the market. This period corresponds to the main months of the sugar harvest.
- May–August sugar prices increase as the harvest winds down. This period occurs when sugar producers usually would obtain financing for sugar inventories; therefore supply is lower than demand and prices increase.
- August–December, when mills usually undergo maintenance. There is no production, sugar prices increase, and demand grows at year's end.

to pay the sugar cane growers. In the short run, the crisis was diffused. With the inventory financing implemented by the government for distressed mills, standard sugar prices increased 28 percent between June and August. This measure was effective and assisted not only distressed mills, but also those mills with regular access to credit who were also affected by low market prices.

With the new harvest just around the corner and no real solution in sight, on September 3, 2001, the government expropriated 27 out of the 61 mills in the country. These mills represent approximately 55 percent of the total sugar production. The mills belonged to four companies: GAM (6 mills), Escorpion (9 mills), Machado (4 mills), Santos (6 mills) and 2 independent mills. Machado kept three of their seven mills. For the other companies the expropriation represented their entire operations. After the expropriation, the government established a special agency to manage and eventually to sell the mills. They originally said that the mills will be privatized within 18 to 24 months. Most analysts saw this time frame as highly optimistic. With mill owners challenging the expropriation in the country's courts it could be years before they exhaust their legal options, postponing indefinitely the re-privatization of the mills.

Since the government's expropriation of the 27 mills on September 2001, at least five fundamental factors are at work to the structure and performance of the industry as follows.

Price Stability. Immediately after the expropriation, prices increased by 20 percent, and have remained stable through June 2002. Although in the first half of the year, sugar prices were expected to drop based on supplies generally being larger than demand, prices have remained at attractive high levels. For instance, in May 2001 prices for a 50-kg bag of standard sugar ranged from 175 to 180 pesos. In May 2002, prices ranged from 230 to 240 pesos. Prices have remained at seasonably high levels because the government now controls the milling groups that had previously dumped sugar into the market to raise working capital. It is clearly in the government's best interest to have a stable, orderly and less volatile sugar market to facilitate these sales and to maximize value.

Controlled Exports And Domestic Sales. The government has granted to an international trader a mandate to manage all sugar exports (from the expropriated mills) both under NAFTA and into international markets. At the same time, the government and the private companies have created a company to control all the exported sugar. Another international trader has been granted a mandate to market all the domestic sugar produced by the 27 expropriated mills.

Social Stability. All cane growers at the expropriated mills are being paid according to the industry payment terms. Full payment to cane growers must be done by the end of July 2002 or according to terms specifically negotiated with each mill. The risk of previous years' strikes or warehouse blockages by unpaid cane growers has virtually been eliminated.

Legal Structure. The government continues to evaluate the law that regulates payments to sugar cane growers and the labor law governing mill workers. Details have not been revealed, but changes are expected to make the industry more competitive in the world market (which should facilitate the privatization of the expropriated mills).

NAFTA. Negotiations continue with the United States to resolve disputes under NAFTA relating to Mexican sugar's access to the United States (currently limited to 125,000 metric tons). The new quota was not announced in October. Negotiations between the two countries continue. In addition to the sugar quota and HFCS issue, the United States is said to be looking for a commitment to restrict second-tier tariff exports from Mexico.

Seeking HFCS Solutions

In February 2002 the government announced its *Política Nacional Azucarera* (National Sugar Policy) 2002–2006. It sets forth the policy objective of bringing about order in the market and modernizing the sugar industry. To accomplish this objective, among other aspects, it talks about export credit and credit facilities for inventory finance. It hints at revision of the Contrato Ley. In addition, since the regulation of the supply of sugar on the domestic market was an essential element to their sugar program, as part of the policy measures, the government announced the creation of a sugar exporting company, owned jointly by the public and private sectors.

HFCS Tax

The HFCS tax was introduced as part of the reforms that the new Fox Administration tried to put into place as a fiscal reform package. Over the course of the year, the reform package got bogged down in Congress. As the year came to an end, the Administration and the Congress faced a deadline for the new budget. As part of the wheeling and dealing that characterized the final days of 2001- -with Congress flexing its muscle- -a special tax on the use of HFCS for soft drinks was passed. As a result, all soft drink bottlers quickly eliminated HFCS from their recipes and converted to all-sugar formulas. This conversion is expected to increase domestic consumption by 400,000 mt per year.

The tax initiative did not begin with the Administration, rather it came from Congressmen related to the sugar growers union. They were dissatisfied with the Administration's apparent willingness to negotiate a settlement to the HFCS dumping case. Interestingly enough, the reaction from the United States appeared to blame the Administration for the special tax, accusing the government of going back on its word when they agreed to negotiations on the HFCS issue. Besides the pressure from the U.S. government, the Administration is also under pressure from the companies producing HFCS in Mexico.

Caught between a rock and a hard place, the Administration temporarily suspended the HFCS tax in March 2002.[14] Subsequently in July 2002, the Mexican Supreme Court declared the suspension unconstitutional. Nevertheless, even before the Supreme Court ruling, bottlers were not expected to switch back to HFCS in the interim given the short-term nature of the moratorium and the uncertainties surrounding this tax. The temporary suspension ran through September 30, 2002, reflecting a bal-

[14] The temporary suspension did allow for the delivery of a number of contracts that were in place when Congress enacted the HFCS tax.

ancing act among the different interest groups, and the government's expectations to have reached an agreement with the U.S. on the HFCS and sugar quota issues by that date. That is the end of the U.S. government's fiscal year.

In April the government decided to formally recognize the NAFTA panel and a WTO dispute settlement panel ruling, eliminating the countervailing duties on HFCS. In an attempt to link the HFCS and NAFTA sugar quota issues, the Mexican government set a duty free quota of 148,000 mt for HFCS, applying a 210 percent tariff on imports of HFCS over the duty free quota amount. This amount is equal to the quantity of duty-free Mexican sugar allowed into the United States.

FACING THE FUTURE

It is clear that the recent expropriation gives the government a one-time opportunity to comprehensively restructure the sugar industry, including the level of inventories, price, the Decreto Cañero, Contrato Ley, and industrial rationalization. However, part of the future of the sugar industry will also depend on the trade situation and negotiations under NAFTA. Within the Mexican sugar industry there are those who doubt that in 2008 the United States will allow for the free entry of Mexican sugar, or, for that matter, any other country's sugar cane sugar, into the U.S. market. The USDA in their baseline projections apparently sets the stage for a challenge to Mexican sugar imports, especially the high-tier imports. Stating that production costs of Mexican sugar are higher than world prices, they raise the possibility that to export competitively to the United States under the high-tier quotas, Mexican exports would have to involve dumping practices.[15]

[15] In conversations with one of the authors, representatives of the USDA/ERS said that this was not their intention. Nevertheless, a high official at the U.S. Embassy in Mexico said that the United States would not hesitate to initiate a dumping demand if they thought that high-tier imports would damage the U.S. sugar industry.

If the U.S. were to allow free and unlimited access of Mexican sugar two basic scenarios emerge. Under the first scenario, the United States would abandon their sugar support program. Access to the U.S. market would stimulate Mexican production, the result of both Mexican and foreign investment. With Mexican sugar production more efficient than U.S. sugar cane or beet production, the price of sugar from Mexico would be more attractive. Prices on the U.S. market, while still above world prices, would be depressed, driving beet producers out of the market. At some point, U.S. policy makers would come to realize that the sugar program resulted in a transfer payment to Mexican producers. Once the United States abandoned their sugar program they would be willing to open the market. An open market would drive down prices to world levels to the detriment of those Mexican sugar producers who are unable to compete at international price levels.

This scenario is not seen as highly probable. The political costs on both sides of the border in both countries would be high, and it is doubtful as to whether policy makers would have the will to confront the social consequences. A variant of this scenario has the United States adapting mechanisms akin to those incorporated into the new Farm Bill for peanuts.[16] This approach would allow the opening of the border while providing income support to U.S. beet and cane growers. To the extent that this policy framework drove down prices in the U.S. market, it would also work against those Mexican sugar producers who are unable to compete at international price levels. Needless to say, this outcome would lead to further trade disputes between the two countries.

More likely is the second scenario. As Mexican exports to the U.S. market grow, the United States would adjust its quota program to continue protecting the U.S. market. A basic assumption here is that the United States is willing to abandon the sugar quota as an instrument of foreign

[16] In the case of peanuts the new Farm Bill does away with the production quota, offering growers two different “buy out options,” and establishes an acreage base for subsequent support. These changes bring the new peanut program in line with other major commodity programs through a marketing loan, direct payments and countercyclical payments.

policy. What would emerge is a common North American sweetener market. HFCS would flow south and sugar would flow north.[17] There are already companies considering investment strategies based on this scenario.

With the second scenario considered more probable, what happens over the next five years will determine where the market goes. With most of the attention, due obviously to the trade disputes, focused on the duty free exports, it is easy to forget that NAFTA calls for over-the-quota tariffs on Mexican sugar. Estimates are that with the reduced tariffs this year, exports to the United States are near the break-even point with exports to the world market. Next year the United States will become a more attractive alternative to the world market. This situation suggests that Mexican exports to the U.S. market will grow significantly over the next five years, and the over-the-quota tariff rate falls. The United States may be pushed to a policy decision even before 2008.

The Spoilers

As we look ahead, two issues stand out. The first is post-Castro Cuba. The obvious question is how will the United States treat Cuban sugar? Before the suspension of imports of Cuban sugar in 1960, Cuba was a favored source of sugar for the United States receiving 72 percent of the total U.S. import quota with a tariff rate 20 percent lower than that faced by other exporters.[18] By the late 1950s Cuba accounted for "about 35 percent of U.S. annual domestic consumption."[19] There is no reason to believe that in a post-Castro Cuba, especially one that has come to terms with the Cuban refugee population living in the United States, there will not be a move to extend favorable access for Cuban sugar to the U.S. market. Any

[17] Significant growth is not seen in the demand for HFCS in the U.S. market since it is already used extensively for sweetening carbonated beverages. The physical and organoleptic properties of HFSC suggest that there are limited options for its use as a sweetener for other food products. Sugar remains the sweetener of choice.

[18] Boughner, D.S., and Coleman, J.R. (2002). "Normalizing Trade Relations with Cuba: GATT-compliant Options for the Allocation of the U.S. Sugar Tariff-rate Quota." *The Estey Centre Journal of International Law and Trade Policy* 3, 1: p.48. Downloaded from www.esteyjournal.com.

[19] Ibid. p. 48.

favorable treatment for Cuba would reduce Mexican participation in the U.S. sugar market.[20]

The second issue relates to the Free Trade of the Americas initiative. As this initiative moves forward it is safe to assume that the negotiations will look to the NAFTA as a model, suggesting that some time into the future there will be a regional sweetener market. Right now, neither the Mexican nor the U.S. industries are competitive with those of other countries in the Americas' region.

For the United States one could predict the end of domestic sugar production. For Mexico the longer it takes for the regional market to come about, the more time it will have to develop and to restructure its industry. The real question is will Mexico take the hard decisions needed to turn its sugar industry into a world class competitive sugar producer?

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[20] Recently Cuba has taken steps to rationalize sugar production and increase efficiency. This initiative would suggest that, if successful, Cuba would be more competitive in the U.S. market in the event of a possible opening.

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