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TAMRC REPORT

THE U.S.-MEXICO FREE TRADE AGREEMENT: ISSUES AND IMPLICATIONS FOR THE U.S AND TEXAS COTTON INDUSTRY

Merritt J. Taylor*

U.S.-Mexico Free Trade Issue Paper Series
TAMRC International Market Research Report No. IM-6-91
April 1991

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U.S-MEXICO FREE TRADE AGREEMENT: ISSUES AND IMPLICATIONS FOR THE U.S. AND TEXAS COTTON INDUSTRY

Texas Agricultural Market Research Center (TAMRC) U.S.-Mexico Free Trade Issue Paper Series, TAMRC International Market Research Report No. IM-6-91, by Dr. Merritt J. Taylor, Texas Agricultural Market Research Center, Department of Agricultural Economics, Texas A&M University.

ABSTRACT: This report considers the likely implications of U.S.-Mexico FTA in an attempt to assist strategic decisionmaking in the U.S. and Texas cotton industry. The information is also being used in ongoing research to quantify magnitudes of potential impacts of freer trade between the two countries. First, some background information is provided on Mexican raw cotton and textile production, prices, cost of production, trade policies, and historical imports and exports between the two countries according to available data. The potential effects of a U.S.-Mexico FTA for the U.S. and Texas cotton industry are then outlined followed by a discussion of the priority issues for the negotiations likely to be of concern to the industry.

The **Texas Agricultural Market Research Center (TAMRC)** *has been providing timely, unique, and professional research on a wide range of issues relating to agricultural markets and commodities of importance to Texas and the nation for more than two decades.* **TAMRC** *is a market research service of the Texas Agricultural Experiment Station and the Texas Agricultural Extension Service. The main* **TAMRC** *objective is to conduct research leading to expanded and more efficient markets for Texas and U.S. agricultural products. Major* **TAMRC** *research divisions include International Market Research, Consumer and Product Market Research, Commodity Market Research, and Contemporary Market Issues Research.*

THE U.S.-MEXICO FREE TRADE AGREEMENT: ISSUES AND IMPLICATIONS FOR THE U.S. AND TEXAS COTTON INDUSTRY

EXECUTIVE SUMMARY

A U.S.-Mexico free trade agreement (FTA) with Mexico seeks to expand the flow of trade between the U.S. and Mexico through comprehensive elimination of tariffs and non-tariff barriers. This paper examines issues and implications of an FTA with Mexico for the cotton industry in the U.S. and Texas. The following summarizes essential points of this paper.

- The Mexican cotton situation has changed significantly since the 1970s. The land area dedicated to cotton production in Mexico has declined somewhat erratically but nonetheless continually to about 24% of 1964 cotton acreage. Reduced profitability, competition from commodities covered by price supports or special subsidies, and weather and related problems combined to induce Mexican farmers to switch out of cotton production particularly in 1975 and again in 1982, 1986, and 1989. Once the second largest cotton producer in Latin America, Mexico now ranks fourth behind Argentina, Paraguay, and Brazil.

- With freer Mexican access to the U.S. cotton market, there could be pressure for Mexican farmers to increase cotton acreage. The extent and magnitude of the production increase, however, would depend crucially on the impact of an FTA on the relative profitability of alternative enterprises in Mexico. While the profitability of cotton production may rise, the profitability of other crops such as fruits and vegetables may rise more. Other factors determining the impact of an FTA with Mexico and the competitiveness of the Mexican cotton industry include water and other production constraints, the ability of Mexico to efficiently market their cotton and cotton products to U.S. consumers, the availability of investment capital to expand production capacity and technology and to improve the transportation and marketing infrastructure in Mexico as well as changes in the dollar/peso exchange rate, and the particular provisions of the free trade agreement.

- If Mexican cotton production increased near the U.S. border as a result of a U.S.-Mexico FTA, there would be an increased demand for water, although the amount of water that could be used is determined by treaty with the U.S. Unless negotiations on an FTA with Mexico made changes in water allotments between the U.S. and Mexico, one consequence of increased Mexican production would likely be higher Mexican costs for the relatively fixed supply of available water. Increasing demands by Texas municipalities for the region's only water supply (the Rio Grande) has placed South Texas agriculture in a precarious position. Additional water demands by Mexico could create unbearable water problems for area cities and agriculture.

- Water quality is an issue of increasing importance in the Rio Grande Valley. Increasing population growth on both sides of the river is already impacting water quality. Growth in irrigated cotton acres in Northern Mexico could further increase this strain. Drainage problems in Mexico, for example, could adversely impact the quality of water in the Rio Grande River if irrigated cotton production in Mexico increased.

- Pest problems in cotton are of major concern to producers along the Rio Grande River. Coordinating control measures, such as plow up deadlines, and research and extension activities need to be considered in the negotiations.

- Because of lower Mexican labor costs, Mexican cotton producers may have a slight absolute cost advantage over U.S. producers. However, labor constitutes only 5% of total costs of cotton production in Mexico providing little relative advantage to Mexico.

- Removal of U.S. tariffs and quotas and the resolution of current phytosanitary constraints could likely increase U.S. cotton imports from Mexico. The consequence could be lower Texas producer prices and returns which will subsequently reduce employment in Texas cotton input and marketing sectors. U.S. consumers might experience lower cotton prices but Mexican consumers would pay higher prices. Returns to Mexican agricultural producers would also be enhanced.

- Removal of Mexican trade barriers would have only a modest positive effect on U.S. cotton exports to that country. A relatively strong dollar and low per capita incomes currently restrict additional exports and are expected to continue to do so into the foreseeable future.

- Issues for trade negotiation include the imbalance of trade between the two countries, the lack of accurate market information for Mexico, indirect subsidies to Mexican producers, harmonization of phytosanitary requirements, pesticide use and residues and similar regulations, dispute settlement procedures, consistency of FTA provisions with the GATT, the impact of the participation of Canada in the negotiations, third country access (rules of origin), the outdated Mexican infrastructure, labor issues, and competitiveness.

U.S.-MEXICO FREE TRADE AGREEMENT: ISSUES AND IMPLICATIONS FOR THE U.S. AND TEXAS COTTON INDUSTRY

In June 1990, the Presidents of the United States and Mexico issued a joint statement on negotiation of a bilateral free trade agreement (FTA). The statement calls for a discussion on tariffs, non-tariff barriers such as quotas and licenses, individual property rights, dispute settlement procedures, and expansion of commerce and investment. In September 1990, President Bush notified the Senate Finance committee of his Administration's intent to enter trade negotiations with Mexico. If "fast-track" authority (currently set to expire at the end of May 1991) is extended as President Bush has requested, formal talks between the two countries could begin soon thereafter and would likely last for a couple of years (Sek).

In general, negotiations on an FTA with Mexico would seek for a way to improve and expand the U.S.-Mexico flow of goods, services, and investment. A U.S.-Mexico FTA would look toward the gradual and comprehensive elimination of import tariffs and the elimination to the fullest extent of non-tariff barriers such as import quotas, licenses, and technical barriers to trade. Such an agreement with Mexico would likely have positive effects for both countries on average but with uneven distribution of the benefits among the various agricultural producer groups in both countries (USITC). U.S. corn and soybean producers, for example, would likely benefit from lower Mexican import duties on their exports to Mexico. U.S. agricultural jobs, however, particularly in the horticulture, would likely be lost if U.S. tariffs on Mexican imports were eliminated or reduced below current levels. Mexico may have a labor cost advantage and has less demanding environmental and labor safety regulations.

This report considers the likely implications of U.S.-Mexico FTA to assist strategic decision making in the U.S. and Texas cotton industry. The information is also being used in ongoing research to quantify magnitudes of potential impacts of freer trade between the two countries. First, some background information is provided on Mexican raw cotton and textile production, prices, cost of production, trade policies, and historical imports and exports between the U.S. and Mexico according to available data. The potential effects of a U.S.-Mexico FTA for the U.S. and Texas cotton industry are then outlined followed by a discussion of the priority issues for the negotiations likely to be of concern to the industry.

BACKGROUND

The likely impacts and issues for the U.S. and Texas cotton industry relating to a U.S.-Mexico FTA must be considered in the context of the current market situation in Mexico and current trade linkages between the two countries. Consequently, this section provides an overview of the Mexican cotton market situation and outlines U.S.-Mexico cotton trade flows and related trade issues.

Mexican Cotton Market Situation

Several dimensions of the Mexican cotton market are discussed in this section, including the current supply and demand situation in Mexico, Mexican foreign trade, and Mexican agricultural and trade policy relating to cotton.

Mexican Cotton Supply and Demand Situation

Since the 1970s, the Mexican cotton industry has changed significantly. The land area dedicated to cotton production in Mexico has declined somewhat erratically but nonetheless continually to about 24% of 1964 cotton acreage (Table 1). Reduced profitability, competition from commodities covered by price supports or special subsidies, and weather and related problems combined to induce Mexican farmers to switch out of cotton production particularly in 1975, 1982, 1986, and 1989 (USDA, 1989). Once the second largest Latin American cotton producer, Mexico now ranks fourth behind Argentina, Paraguay, and Brazil.

Mexican Cotton Market

There are ten main cotton growing areas in Mexico, including Laguana/Delicias (28% of the total), Mexicali (24%), Sonora (19%), Juarez (11%), and Sinaloa (8%). The Central and Southern regions of Mexico produce only about 10% of the cotton crop. Mexico produces 80% of its cotton under irrigation. *Ejidatarios* (low income producers) grow the majority of Mexican cotton (75%) on *ejidos* (government-owned communal land). The remainder is grown by *colono* farmers with their own machinery on their own the land. Average yield is 4.5 to 5.0 bales/ha (480 lb bales). Yields on the *ejidos*, however, is considerably lower (generally less than 4 bales/ha). A typical *ejido* averages 5 to 10 ha. The most common cotton variety produced is Deltapine (DLP) 80, except in Juarez, where the most common variety is Acala (USDA, 1989).

The production cost increase in 1989 for Mexican cotton exceeded the official inflation rate of 25%. The cost of borrowing (interest) accounts for 15% to 17% of production costs (Table 3). Although interest rates to farmers have recently decreased, loan rates are still high in real terms. *Ejidatarios* are offered loans at a subsidized interest rate of 48%. The commercial rate is 52.25%. Other major costs incurred by Mexican cotton producers are harvesting (25%), insurance (16%), and chemicals (15.4%) (USDA, 1989). Because of lower Mexican labor costs, Mexican producers may have a slight absolute cost advantage over U.S. producers. However, labor constitutes only 5% of total costs of cotton production in Mexico providing little relative advantage to Mexico.

The Mexican cotton industry has also been affected by government efforts to stimulate domestic food production by offering relatively more favorable support prices for food than nonfood crops. Farmers have responded by shifting away from producing nonfood crops like cotton. An inadequate water supply has also hampered cotton and agriculture in general in Mexico. Widespread droughts have tended to occur in 4 out of every 10 years. Additionally, industrialization and urban migration have also put more demands on the water supply normally used for agriculture.

Even though improvement in the Mexican economy and a strong market for Mexican cotton in the Asian and European markets could encourage producers to grow more cotton for export, a number of problems may make that difficult to achieve. First, the handling of seed is not controlled resulting in poor germination. Cotton seeding rates in Mexico are about 120 lb/ha compared to 48 lbs/ha in the Texas Lower Rio Grande Valley. Many producers use the same seed varieties or mix seed varieties every year, resulting in diminished crop quality over time. Because most producers do not own the land they farm, they have little incentive to invest in land improvement. Furthermore, the size of their plots are not large enough to benefit from economies of scale. However, the Salinas administration is committed to controlling inflation, improving the standard of living in rural areas and in general strengthening all areas of the Mexican economy including the agriculture sector. Yet it is doubtful that Mexico will not regain its former status as a major cotton producer.

Mexican Textile Industry

The great majority of the Mexican textile industry is controlled by family-owned companies with only 2% owned by foreigners. The fully unionized labor force in Mexico includes about 180,000 workers. Textile workers typically receive wages about 25% higher than their counterparts in other industries (USDA, 1989). Low productivity in Mexican industries in recent years has been blamed on labor unions. The family structure of Mexican industrial workers and numerous holidays also contribute to low worker productivity. Mexican workers typically receive about twice as many holidays as workers in most developed countries. Other factors contributing to inefficiencies in the textile industry are outdated technology, low quality inputs and factory under-utilization (about 75% of capacity). As a result, costs of textile production are about 25% to 150% higher than in the U.S. (USITC).

Due to rising synthetic fiber prices, demand has shifted more toward clothing made from cotton. As a result, the cotton share of total fiber increased from 27% in 1987 to 35% in 1988. Of the 1988 per capita textile consumption in Mexico, 35% was made from cotton, 64% from manmade fibers, and 1% from wool. Although the share of cotton in the Mexican textile industry has increased, an open import policy on textiles has dampened domestic cotton textile growth. The Mexican textile industry has had to compete with mostly poor quality and low-priced imported goods since entering the General Agreement on Tariffs and Trade (GATT) in August of 1986 (USDA, 1989).

Mexican textile producers view the current trade relationship with the U.S. as unfair because of inequitable tariff barriers. Mexican charges a 13% *ad valorem* duty on textile imports while the U.S. charges 15% *ad valorem*. The Mexican textile producers argue that numerous trade agreements have stripped them of import protection while other countries continue to impose restrictions on textile imports from Mexico. They are concerned that a U.S.-Mexico FTA may simply add to that inequity. The recent expansion of the *Maquiladoras*, i.e., factories in Mexico using American inputs and re-exporting the output to the U.S duty-free, has allowed the U.S. textile industry to substantially lower labor cost and better compete with Far East textiles. Consequently, the Mexican textile industry is less competitive than the U.S. textile industry in both the U.S. and foreign markets (USDA, 1989).

U.S. Domestic Price-Support, Production and Consumption

U.S. Government programs have attempted to support cotton prices and adjust acreage since the 1930s to insure adequate income to farmers and adequate and steady supply of cotton to meet market needs. Under normal market conditions, cotton comber waste and other cotton wastes are not directly covered by the U.S. cotton support program. Farmers are assured a certain minimum price through nonrecourse loans and several types of direct payments. Farmers may receive loans from the Commodity Credit Corporation (CCC) at the beginning of the planting season to cover costs of planting, cultivating, and harvesting the crop. Direct payments can be made under provisions covering target prices and acreage diversion. Because of the differing market conditions for upland cotton and for extra-long-staple (ELS) cotton, the government has separate program provisions for each cotton type. A farmer may receive benefits under more than one provision of the program. The program for upland cotton accounts for about 98% of annual U.S. cotton production.

A marketing loan for cotton is available to U.S. producers and provides a loan repayment plan if the loan rate is not competitive on world markets. If the price of cotton, as determined by the Secretary of Agriculture, is below the loan rate, one of two loan repayment plans must be implemented which are designed to allow the farmers to sell their crop at a more competitive price. The concept of the marketing loan was an attempt to retain the basic cotton loan program yet keep U.S. cotton competitive in world markets.

U.S. mill use of cotton increased from 7.4 million bales in 1986/87 to 8.7 million bales in 1988/89 largely as a result of the increasing consumer demand for cotton in apparel and household uses which overwhelmed a slight decline in industrial use of cotton (USDA, 1991).

Mexican Foreign Cotton Trade

Mexico was one of the world's top five cotton exporters until the mid-1970's, exporting more than half of domestic production. Mexico is still a net exporter of cotton even though area planted to cotton has declined. Mexico imported about 22,000 metric tons (mt) of cotton in 1989 while exporting 103,000 mt, about 59% of Mexican production that year (USDA, 1989)

The drastic reduction in Mexican cotton output since the mid-1970s has led to a continual decline in Mexican exports. Exports have averaged under 400,000 bales since 1989 while consumption has remained relatively stable at about 750,000 bales. Imports, on the other hand, have been increasing in order to keep up with the demands of the domestic textile industry. Mexico imported 180,000 bales in 1986, 60% of which come from the United States. Mexico imported around 100,000 bales in 1989.

Mexican Agricultural and Trade Policy for Cotton

The Mexican Revolution of 1910 was the impetus for land reforms which commenced in 1915. The original law allowed for the expropriation of land within a seven kilometer radius of a village. The term *ejido* was adopted for expropriated lands on the outskirts of villages and the people living on these lands became known as *ejidatarios*. Mexican cotton farmers are comprised of *ejidatarios, colonos*, and large farmers. The size of farms is limited by law with the maximum for *ejidatarios* being 10 hectares, *colonos* 20 hectares, and large farms at 100 hectares. Since the *ejidatarios* farm small plots of land which they are not allowed to own, they have had considerable difficulty in acquiring financing needed to adopt improved farming practices.

Cotton producers in Mexico do not receive direct price subsidies for their products but are aided by government investment in irrigation facilities, subsidized interest rates, subsidies for energy and fertilizer, and exemption from import taxes. Devaluation of the Mexican peso since 1982 has also encouraged growth of the cotton export industry.

The Mexican government has attempted to sell many of its State-owned enterprises involved with agriculture in recent years in an effort to reduce public deficit spending (USDA, 1989). The Mexico Commercial Cotton Company, one of the four largest cotton traders in Mexico, was sold to the private sector in March of 1989. In addition, the Government's rural credit bank (Banrural) was restructured to eliminate inefficiencies in the banking system. High-income farmers will now be serviced by commercial banks rather than by Banrural which will now focus on the lower income farmers. Interest rates are set by the government and will be lowered to reinvigorate the agricultural sector through increased input use and an increase in yields and planted area. Interest rates are expected to fall an average of 20%. Subsidies for low-income producers, therefore, will be reduced as well as loan rates for fixed assets.

Mexico has liberalized its trade policy since joining GATT in the early 1980s and has subsequently made considerable progress on tariff reform. Currently, Mexico offers some protection to their domestic producers through the use of tariffs, import licensing requirements, and phytosanitary regulations (USITC, October 1990).

The volume of Mexican cotton lint exports or imports is not directly controlled. Mexican exporters must declare all earned dollars and are required to convert foreign exchange earnings at the official U.S. dollar exchange rate. Import tariffs were raised from 5% to 10% in January of 1989. Imports of cotton yarn are taxed at 15%. Phytosanitary permits apply to all cotton imports. Wage and price controls have been in effect since 1987 but have recently been changed. A wage increase of 10% was implemented on December 1 of 1990, along with a 5% increase in energy costs. In addition, fertilizer prices, which had been frozen since 1987, have now been increased.

The U.S.-Mexico Trade Linkage For Cotton

The U.S. both exports and imports cotton from Mexico. After reviewing the U.S.-Mexico import and export picture for cotton, this section discusses the factors the competitiveness of Mexican cotton production and marketing and trade policies imposed by both Mexico and the U.S. affecting the flow of cotton across the U.S.-Mexico border in both directions.

U.S. Exports of Cotton

The U.S. leads the world in cotton exports accounting for over one-fourth of the world trade. Major foreign competitors in the world export market include the Soviet Union (14% of world exports), Pakistan (10%), Australia (6%), and China (3%). The U.S. cotton industry depends on the export market for about half of its offtake. The leading markets for U.S. cotton exports are the Far East (Japan, Korea, Taiwan, Indonesia, and Thailand) and Europe (West Germany and Italy). Mexico is a minor market for U.S. cotton, accounting for only about 1.6% of U.S. cotton exports in 1989. Much of the world's trade in cotton is subject to restrictions such as the U.S. import quota and export controls in some of the major producing countries. Trade in textiles and other cotton products is subject to the import controls imposed under authority of the Multi-fiber Arrangement.

U.S. Imports of Cotton

All imports of cotton except harsh or rough cotton having a staple length under 28.575 mm (3/4") are subject to quota limitations pursuant to section 22 of the Agricultural Adjustment Act. Under the same authority, imports of card strips from cotton having a staple length 1-3/16" or more, cotton comber waste, lap waste, roving waste, and cotton that has been processed but not spun are also subject to quotas. These quotas were established to prevent imports from interfering with the operations of the U.S. Department of Agriculture (USDA) price-support programs for cotton. The U.S. imported only 435 mt of cotton in 1989/90, of which nearly 60% came from Mexico. The U.S. market accounts for only a small portion of total Mexican exports of cotton.

The annual global quotas for raw cotton are applicable to cotton in accordance with the staple length of the cotton fibers as follows:

	Quota (kg)
• Cotton, staple length under 28.575 mm (1 1/8") except harsh or rough cotton of staple length under 19.05 mm (3/4")	584,428
• Harsh or rough cotton white in color and having a staple length 29.36875 mm (1-5/32") or more but under 34.925 mm (1-3/8")	680,388

- Other cotton having a staple length 28.575 mm (1-1/8") or more but under 34.935 mm (1-1/8") 2,070,940

- Cotton having a staple length 34.925 (1-3/8") or more 17,958,074

The quota amount shown for the first item (raw cotton under 28.575 mm in length) is the sum of 19 country-specific quotas. Of these, the quota for Mexico accounts for 61% of the total.

Most imports of cotton are subject to quota limitations under section 22 of the Agricultural Adjustment Act. Imports did not exceed 3,000 bales annually during 1986-89. During 1979-88 cotton imports averaged 25,500 bales annually. The relatively low imports during 1986-88 occurred because global cotton prices were close to U.S. prices. World prices were lower than U.S prices during most of the 1980s, however, making imports more competitive.

U.S. imports of cotton yarn and fabric have an indirect but substantial impact on the U.S cotton market. Such imports totaled $1 billion in 1988, of which fabric accounted for 98%. Domestically produced yarn and fabric compete not only against imported yarn and fabric but against imported apparel, since the apparel industry is the principal consumer of yarn and fabric. Trade in textile products is regulated by the Multi-fiber Arrangement, a program under the protection of the General Agreement on Tariffs and Trade (GATT), under which bilateral agreements are made to limit trade in textiles and apparel.

Mexican Competitiveness in Cotton Production and Marketing

The subtropical climate and low latitude of the Lower Rio Grande Valley enables South Texas producers to have the first U.S. cotton ready for sale at the start of each season. Consequently contracts for South Texas cotton tend to indicate the pricing tendencies for the new season. The competitiveness of Mexico as a cotton producer, however, is influenced production cost and by ginning and handling expenses, brokerage fees, and transportation costs to foreign markets. It has been shown in other crops that the share of transport and marketing costs in the total cost or sale price of Mexican products in the United States is high. For example, about 50% of the total cost of marketing Mexican fresh vegetables in the United States is attributable to production, harvesting and handling, about 30% to internal transport and marketing in Mexico, and the remainder to transport and handling in the United States. Since much less labor is required for cotton production per unit sold it would be expected that marketing and transportation costs would play an important role in determining the unit cost of cotton.

The Mexican infrastructure involves a network of highways and railroads linking all major urban areas and most rural areas to major seaports and United States border crossings. Nonetheless, the Mexican transportation infrastructure is generally inadequate and adversely affects Mexican competitiveness in cotton. Roads and highways are in chronically poor condition suffering from overuse and neglect. The government-owned railroad is characterized by outdated infrastructure, equipment, and operating procedures resulting in long delays and slow turn-around times.

About 82% of Mexican intracountry transportation is serviced by motor carriers. The largest portion of commerce between the United States and Mexico is also carried by truck. Until deregulation in 1989, the trucking industry in Mexico was heavily regulated by government. Mexican industry has welcomed deregulation since the regulated structure generally offered inadequate capacity and extracted monopolistic returns. The deregulation decree calls for measures that would make the transportation industry more efficient and competitive such as updating and modernizing institutions and regulatory mechanisms. The government still issues permits for entry but the process has been streamlined. Truckers now have the freedom to load, move, and unload any type of cargo.

A ceiling is still imposed on trucking rates, but carriers are allowed to negotiate special rates with customers. Mexican officials hope that by allowing more freedom in setting rates, the resulting competitiveness will reduce the excessive profit margins of carrier oligopolies. Supposedly, a more competitive environment will lead to the renovation of Mexico's obsolete trucking fleet. Mexican exporters have been pressing for improved transportation infrastructure to facilitate exports.

U.S. Trade Policies Affecting U.S./Mexico Trade

The major U.S. trade policies affecting imports of Mexican cotton include tariffs, quotas, and phytosanitary restrictions. The U.S. also maintains strict sanitary requirements on agricultural imports. In general, most Mexican agricultural exports to the United States meet these requirements. A major issue that affects Mexican access to the U.S. market is pesticide residues in food products (USGAO). Seed cotton imported into the United States whose seed is processed into cotton seed oil for human consumption would be subject to the above restrictions if the raw cotton were permitted to be imported.

Other impediments affecting agricultural trade between the U.S. and Mexico include lengthy and unpredictable administrative procedures, lack of market knowledge by potential U.S. exporters, and limited availability of financing.

Related Trade Issues

Related to U.S./Mexico cotton trade policy are issues dealing with labor, water, land, and transportation. Mexican agricultural workers receive low daily wages. There are no minimum wage laws, health or safety programs, or non-wage benefits such as insurance, workman's compensation, social security or unemployment insurance which is mandatory for U.S. employees.

If Mexico were to increase cotton production near the U.S. border, there would be an increased demand for water, although the amount of water that could be used is determined by treaty with the U.S. Unless negotiations on an FTA with Mexico made changes in water allotments between the U.S. and Mexico, one consequence of increased Mexican production of cotton would likely be higher Mexican prices for the relatively fixed supply of available water. Increasing demands by Texas municipalities for the region's only water supply (the Rio Grande) has placed South Texas agriculture in a precarious position. Additional water demands by Mexico could create unbearable water problems for area cities and agriculture. Water quality is also an issue of increasing importance in the Rio Grande Valley. Increasing population growth on both sides of the river is already impacting water quality. Growth in irrigated cotton acres in Northern Mexico would further increase this strain. Drainage problems in Mexico, for example, could adversely impact the quality of water in the Rio Grande River if irrigated cotton production in Mexico increased.

Pest problems in cotton are also of major concern to producers along the Rio Grande River. Coordinating control measures, such as plow up deadlines, and research and extension activities need to be considered in the negotiations.

Many Mexican cotton producers are *ejidatarios*, who have the right to use state-owned land. Consequently, their land resource is free so that, in essence, *ejidatarios* receive a government subsidy in the form of free rent. Finally, if efficient intercountry trade is to be facilitated, motor carrier regulations will need to be altered. While Mexican motor carriers are permitted access to U.S. commercial zones, U.S. carriers are not allowed to enter Mexico. Further, motor carrier weight and safety standards must be harmonized to achieve efficient movements between countries.

POTENTIAL EFFECT OF A U.S./MEXICO AGRICULTURAL FTA

Complete removal of U.S. tariffs and quotas in combination with the resolution of current phytosanitary constraints could increase U.S imports of cotton from Mexico. Clearly, this could have an unfavorable effect on domestic producer prices. The possible increase in Mexican cotton imports into the U.S. as a result of a U.S.-Mexico FTA, however, are not likely to amount to a significant percentage of the U.S. cotton supply. If U.S. demand for Mexican cotton is fairly responsive to price changes, imports could increase significantly with the removal of trade barriers. In the long-run, Texas and U.S. cotton production could decline as would returns to domestic cotton producers. This would unfavorably affect suppliers who provide inputs to area cotton producers. In the short-run, imported cotton and cotton products would be transshipped through existing border facilities. In the longer run, however, there may be an incentive to ship directly from Mexican locations to U.S. markets, bypassing transshipment at Texas/Mexico border locations. To facilitate direct truck shipments from Mexico to U.S. markets, however, constraints on intercountry motor carrier travel would need to be removed and additional capital invested in the Mexican cotton marketing infrastructure.

Free access to the U.S. cotton market might provide an incentive for Mexican farmers to increase cotton acreage. The extent and magnitude of the production increase, however, would depend crucially on the impact of an FTA on the relative profitability of alternative enterprises in Mexico. While the profitability of cotton production may rise, the profitability of other crops such as fruits and vegetables may rise more. Other factors determining the impact of an FTA with Mexico and the competitiveness of the Mexican cotton industry include water and other production constraints, the ability of Mexico to efficiently market their cotton and cotton products to U.S. consumers, the availability of investment capital to expand production capacity and technology and to improve the transportation and marketing infrastructure in Mexico as well as changes in the dollar/peso exchange rate, and the particular provisions of the free trade agreement.

In general, Texas/U.S. cotton producers and the associated service industries could lose along with Mexican consumers who would pay higher cotton prices as a result of an FTA with Mexico. Conversely, Mexican cotton producers would likely gain from increased prices for expanded exports to the United States while U.S. cotton consumers would benefit from lower cotton prices.

PRIORITY ISSUES TO CLARIFY AND MONITOR DURING NEGOTIATIONS

Before a bilateral trade agreement is reached between the United States and Mexico several key issues related to the trade of raw cotton and textiles must be addressed. Some issues are not specific to cotton but have important implications for the U.S. and Texas production agriculture industries.

Issue 1: Imbalance of Trade

Presently, Mexico is a net exporter of cotton. Although the value of cotton lint exports declined from 14.2% of all Mexican agricultural exports in 1980 to 3.2% in 1987, 103,000 mt or 59%

of Mexican cotton production is exported to the United States. Mexico imports only 22,000 mt from the United States.

Issue 2: Water and Water Quality

If Mexican cotton production increased near the U.S. border as a result of a U.S.-Mexico FTA, there would be an increased demand for water. Because the amount of water that is available to Mexico from the Rio Grande is fixed by treaty with the U.S., there may be a push in Mexico to include water allotments and other water issues in the negotiations although the U.S. is not likely to allow water issues to be put on the table.

Water quality is an issue of increasing importance in the Rio Grande Valley. Increasing population growth on both sides of the river are already impacting water quality. Growth in irrigated cotton acres in Northern Mexico would further increase this strain. Drainage problems in Mexico, for example, could adversely impact the quality of water in the Rio Grande River if irrigated cotton production in Mexico increased.

Issue 3: Accurate Market Information

Mexican producers exporting cotton and cotton products into the U.S. have access to valuable U.S. market information from the U.S. Department of Agriculture and other U.S. sources regarding U.S. production, shipments, prices, etc. However, little if any timely information on Mexican markets is available to support U.S. producers interested in shipping products to Mexico. If a free trade agreement with Mexico opens export opportunities for U.S. producers and processors, the quality, timeliness, and scope of information available on Mexican markets will have to increase dramatically if the opportunities are to be fully realized. Monitoring Mexican compliance with all free trade agreement provisions will also require reliable, timely data on Mexican markets for a wide variety of products. Consequently, negotiations on free trade with Mexico will need to emphasize improved U.S. access to available Mexican market information, enhanced and more reliable data collection and reporting in Mexico, and coordination of agricultural data gathering and dissemination as well as market situation and analysis activities by USDA and the Mexican Ministry of Agriculture and Hydrologic Resources (SARH).

Issue 4: Indirect Subsidies in Mexico

Cotton producers in Mexico do not receive direct price subsidies but have been aided by government investment in irrigation facilities, lower interest rates, subsidies for energy and fertilizer, and exemption from export taxes. U.S. producers of raw cotton do not generally receive similar assistance. In order that a free trade agreement not provide Mexican producers with an unfair advantage, such indirect subsidies would need to be phased out along with trade barriers.

Issue 5: Harmonization of Regulations

The FTA must also address restrictions such as pesticide/chemical use and residue requirements, phytosanitary requirements, minimum wage laws, Social Security, workman's

compensation costs, Migrant and Seasonal Farm Worker Protection Act, housing and field sanitary regulations, occupational safety and health regulations, child labor laws, the 1986 Immigration Reform and Control Act, motor carrier safety laws, hazardous waste disposal laws, and various state and federal discrimination and Human Rights Acts. U.S. producers undergo considerable cost in complying with these regulations whereas Mexican counterparts do not at present. If these issues are not satisfactorily dealt with in an FTA with Mexico, U.S. producers would be at an unfair disadvantage compared to Mexican producers. Also, pest problems in cotton are of major concern to producers along the Rio Grande River. Coordinating control measures, such as plow up deadlines, and research and extension activities need to be considered in the negotiations.

Issue 6: Settlement/Snapback Procedures

Procedures to handle disputes concerning anti-dumping and countervailing duties must be identified. A snapback process to allow for quick imposition of tariffs in an emergency oversupply situation may also be included in the negotiations.

Issue 7: Consistency with GATT

The GATT allows a country to give preferential treatment to another country or countries in a free trade agreement as long as: (1) duties and other restrictions to most trade members of the agreement are removed, and (2) duties and other restrictions placed against non-agreement countries on the whole are not higher or more restrictive than pre-agreement levels.

Issue 8: Impact of Canadian Participation

Canada will likely participate in the trade talks between the U.S. and Mexico since U.S./Mexico trade policies can indirectly affect Canada. Since Canada is a cotton importer, Canadian involvement could complicate the negotiations. Instead of a trilateral free trade agreement among the three countries, it is likely that a series of bilateral agreements among them will be negotiated.

Issue 9: Third Country Access

U.S. textile manufacturers are concerned that a free trade agreement with Mexico would allow other countries either to transship to Mexico through the U.S to take advantage of possible expanded markets there or, worse, to transship through Mexico to the U.S. and enter the U.S. duty free. Negotiations on rules of origin will need to address this issue.

Issue 10: Mexican Infrastructure

Opportunity for improved access to major Mexican markets for U.S. producers may be enhanced by an FTA. The current communication and transportation systems in Mexico, however, are probably not sufficiently developed to handle large increases in U.S. exports to these markets.

Issue 11: Labor Issues

U.S. labor groups are among the strongest opponents of an FTA. Their position is that low-cost imports from Mexico would lead to job losses in the U.S. and that differences in labor costs, standards, and safety and environmental regulations would give unfair advantages to Mexican producers.

Issue 12: Competitiveness

In general, Mexican costs of production are estimated to be 40% to 80% of Texas production costs. Although this favors Mexican producers, the U.S. generally has greater water resources, a better transportation infrastructure, and a more diversified climate. Foreign investment in the Mexican processing industry has narrowed the technological gap between the two countries. Further foreign investment in the cotton processing and marketing infrastructure would make Mexico more competitive.

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Table 1: Mexico: Cotton Supply and Demand, Five Year Averages, 1960-1989

	1960-1964	1965-1969	1970-1974	1975-1979	1980-1984	1985-1989
Area Harvested (1,000 Ha)	827	678	479	321	272	202[a]
Imports (1,000 MT)	1	6	7	28	8	12[b]
Production (1,000 MT)	501	583	411	313	283	209[a]
Domestic Disapp.(1,000 MT)	147	178	209	190	183	150[b]
Exports (1,000 MT)	356	345	209	170	107	82[b]
Price (U.S.$/MT)	503	510	763	1,329	1,183	933[b]

[a] Four year average, 1985-1988.
[b] 1985 only.

Source: Hall and Livas-Hernandez.

TABLE 2: Mexican Cotton Yields and Production Periods by State, 1988/89

GROWING AREAS	PLANTING PERIOD	HARVESTING PERIOD	YIELDS BALES/ HA 1988/89
MEXICALI	Mar-Apr	Sep-Jan	5.0
LA PAZ	Feb-Apr	Aug-Dec	5.0
SONORA	Jan-Apr	Jul-Dec	4.5
SINALOA	Nov-Dec	Jun-Aug	3.9
JUAREZ	Mar-Apr	Oct-Dec	3.8
LAGUNA/DELICIAS	Mar-Apr	Sep-Dec	4.8
MATAMOROS	Jan-Apr	Jul-Sep	3.2
MANTE	Mar-Apr	Oct-Dec	2.3
TAPACHULA/CAMPECHE	May-Jul	Nov-Jan	3.0

Source: UDSA, 1991.

TABLE 3: MEXICAN COTTON COSTS OF PRODUCTION, 1988/89

CATEGORY	COSTS (U.S. $/ha)	
	Ejidos	Colonos
SOIL PREPARATION	99.28 (8.8%)	99.28 (8.5%)
PLANTING	45.61 (4.1%)	45.61 (3.9%)
FERTILIZATION	56.24 (5.0%)	56.24 (4.8%)
LABOR	57.59 (5.1%)	57.59 (4.9%)
WATER & DRAINAGE	61.71 (5.5%)	61.71 (5.3%)
PESTICIDES/INSECTICIDES	173.69 (15.4%)	173.69 (14.9%)
HARVESTING	281.29 (25.0%)	281.29 (24.1%)
INSURANCE	180.08 (16.0%)	184.75 (15.8%)
INTEREST (48.0, 52.25%)	170.02 (15.1%)	194.53 (16.7%)
SOCIAL SECURITY		2.86 (0.2%)
ADMINISTRATION		7.33 (0.6%)
TAXES		.93 (0.08%)
OTHER FEES		.57 (0.05%)
TOTAL	1,125.51 (100%)	1,166.38 (100%)
$ U.S./ACRE	455.67	472.22
U.S. CENTS/LB.	1.69	2.03

SOURCE: Government of Mexico, SARH
Converted from Pesos as: US $1.00=2,288.3 Pesos.