

2006 Beltwide Cotton Conferences, San Antonio, Texas - January 3 - 6, 2006
CAFTA-US TEXTILE AND COTTON TRADE PROSPECTS: THE CHINA EFFECT

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Abstract

The Central American Free Trade Agreement (CAFTA) will be enacted in 2006 and is expected to benefit U.S. cotton producers by ensuring a market for cotton materials. Almost 50% of U.S. cotton fabrics and yarns were exported to CAFTA countries in 2004, and CAFTA countries comprised almost 10% of all textile and apparel imports to the U.S. Concurrently, WTO agreements have disallowed the existence of quotas amongst members. This impacts trade with China especially, as China holds a competitive advantage in textile apparel products over CAFTA countries. By analyzing the current U.S. quota safeguard import status, prospects of disaggregated textile and apparel categories are predicted for CAFTA countries. This comparison shows that it is likely that the full expected benefits from US-CAFTA-DR relations won't materialize due to China's increased competition.

Introduction

Globalization trends and free trade agreements have resulted in significant changes in the U.S. textile and cotton industries over the last decade. Over a third of the textile industry production has already left the U.S. in the past five years, suggesting that global competition is making it very difficult for U.S. textile mills to remain profitable. Just in August 2005, the U.S. signed a free trade agreement with Central American countries (CAFTA-DR) that is expected to impact the cotton and textile industries in all areas involved.

The US-CAFTA-DR includes seven countries: the U.S., Costa Rica, Dominican Republic, El Salvador, Guatemala, Honduras, and Nicaragua. With the agreement, the U.S. is expected to gain through increased exports of cotton and cotton products to CAFTA countries. CAFTA countries, on the other hand, are then expected to benefit by using this cheaper U.S. cotton fiber and textiles to produce apparel products to export to the U.S. at lower prices, increasing U.S. import demand. However, China's overall textile and apparel exports to the U.S. have been growing rapidly, especially during 2004 and 2005 despite U.S. quotas that limited China's most competitive U.S. imports of items such as cotton trousers, shirts, and underwear. This trend proposes the possibility that China's competitive advantage may negate the potential benefits to the U.S-CAFTA-DR agreement by usurping the U.S. textile import supply and diminishing U.S. textile imports from CAFTA countries.

These CAFTA impacts on the market and changing growth trends, combined with the lifting of all quotas previously held on Chinese textile/clothing imports in the U.S. due to WTO ruling, are greatly changing the textile industry worldwide. Members of the WTO agreed to full integration of textiles and textile apparel into WTO regulations beginning January 1, 2005 as a result of the Uruguay Round Agreement on Textiles and Clothing (ATC). Therefore, after that date all textile and apparel manufactured in a WTO country should no longer be subject to quota restrictions. CAFTA countries may no longer be able to compete with certain Chinese textile and apparel categories for the U.S. market when China is able to export as many textile products to the U.S. as the U.S. will demand. The U.S. cotton and textile export supply would be affected by CAFTA's reduced textile and apparel exports to the U.S. if CAFTA's textile and apparel exports are affected by competing Chinese industries. The purpose of this paper is to illustrate how reduced barriers to Chinese imports of textiles and apparel in the U.S. may ultimately affect the proposed symbiotic relationship between the United States and CAFTA member countries. By analyzing the current U.S. quota safeguard import status, prospects of disaggregated textile and apparel categories are predicted for CAFTA countries.

Benefits of CAFTA

Once enacted, CAFTA will create the largest export market for the U.S. in Latin America, behind only Mexico (Export). More than 80% of U.S. exports of consumer and industrial goods will become duty-free in the Central American countries and the Dominican Republic when CAFTA is enforced. Almost \$16 billion in goods were shipped to the CAFTA countries in 2004, amounting to a 16% growth since 2000 (Export). Most of the CAFTA countries have benefited from low U.S. import tariffs since the induction of the Caribbean Basin Initiative (CBI). However, agricultural tariffs that are charged to U.S. exports by individual CAFTA countries are currently as high as 60% in Nicaragua and 49% in Guatemala. All of these tariffs in CAFTA member countries will be phased out

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according to specific schedules negotiated on a product and country-specific basis. Thus, CAFTA will reciprocally reduce tariffs for U.S. exports in the region, resulting in lowering overall textile and cotton tariffs on U.S. exports. One key note of interest is that the U.S. will only use safeguards on dairy, peanuts, and peanut butter (FAS). This means textile and clothing will become open to reduced TRQs and tariffs quickly. But, CAFTA contains a special textile safeguard which allows the U.S. to re-impose tariffs on apparel if damage occurs due to import surges. This is the only product-specific safeguard in the entire CAFTA Agreement.

Cotton Implications

As for cotton, the tariff schedule under CAFTA implements a phase-out schedule over 15 years, except where duty-free access already exists under CBI policy. There is a tariff of 1 percent in Costa Rica for cotton, which will be immediately dropped to zero. Other CAFTA countries may hold tariffs as high as 60% on cotton under WTO regulations, but have been importing cotton duty-free in the past. CAFTA countries account for approximately 50% of all U.S. cotton textile exports. In return, CAFTA textile and apparel exports to the U.S. comprised almost 5% of the combined CAFTA countries' GDP in 2004. This means that not only are U.S. cotton textile producers highly dependent on CAFTA countries for their exports, but the CAFTA region is very dependent on the U.S. textile and apparel demand for economic stability. CAFTA will ensure these countries will continue to import U.S. raw cotton and textile products duty-free, but will also shelter growth of U.S. increases in demand for textiles from CAFTA. This would create a synergistic relationship benefiting all involved countries. The U.S. would benefit from securing an export market for U.S. cotton production, while Central American countries would gain by securing an export market for textiles and apparel. In addition, the agreement also includes an allowance for using NAFTA fabric for duty-free apparel, which also favors U.S. cotton exports (FAS).

According to the USTR, upon passage of CAFTA, more than 90 percent of all apparel made in the region will be sewn from fabric and yarn made in the United States. Right now, 71% of apparel from CAFTA countries enters the United States using U.S. yarns and fabrics, while only one-tenth of 1% of apparel from China enters the United States using U.S. yarn or fabric (USTR). This statistic shows that while the U.S. is able to receive textile and apparel imports from China, Chinese textile manufacturers do not impact U.S. cotton demand nearly as much as CAFTA textile manufacturers. That is, while U.S. cotton producers benefit under CAFTA by exporting more cotton and yarn to Central America, there isn't as large of a benefit to U.S. cotton producers when China increases its production of textiles and apparel. Thus, the U.S. cotton industry does not necessarily gain through increased imports of Chinese textiles and apparel as much as it would if imports come from CAFTA.

Economic Model

Using a simplified three country trade model, assuming completely free trade amongst all three areas, excess supply would equal excess demand. There would be only one world price, which all countries would share. The equilibrium price in China would be lower than that of CAFTA because of China's labor abundance, and textiles and clothing are labor-intensive commodities. This case is shown in Figure 1. Over time, China's domestic price will rise so that the prices in both countries are more similar as the cost of wages increase in China.

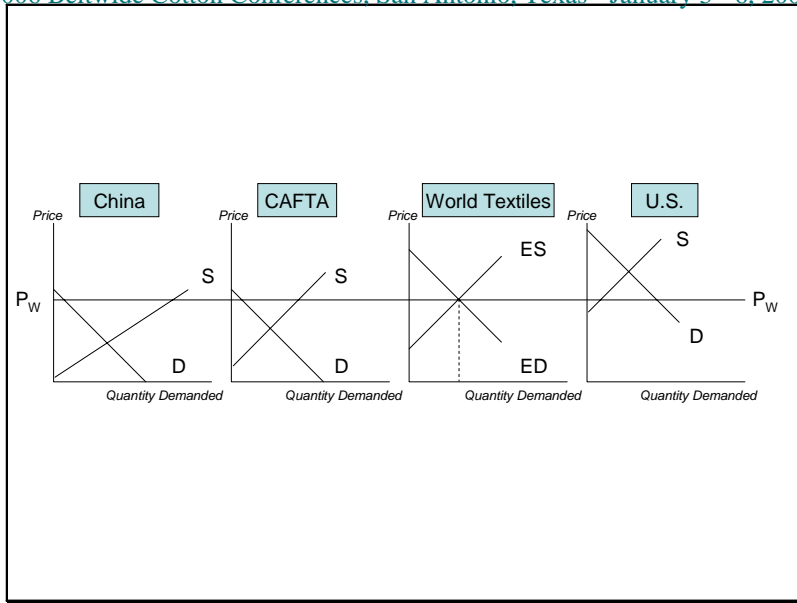


Figure 1. Free Trade Equilibrium – 3 country model

If the actual quotas and tariffs imposed on Chinese goods imported into the U.S. are taken into account, a trade model like Figure 2 would exist. The excess demand curve for the world market, in China’s perspective, has been shifted inward to represent the smaller demand in the U.S. for Chinese goods resulting from the tariffs and quotas that raise their prices. This has caused the world market to reach a new equilibrium point at which U.S. trade has been decreased, and the U.S. price for Chinese goods has been lower than would exist with free trade.

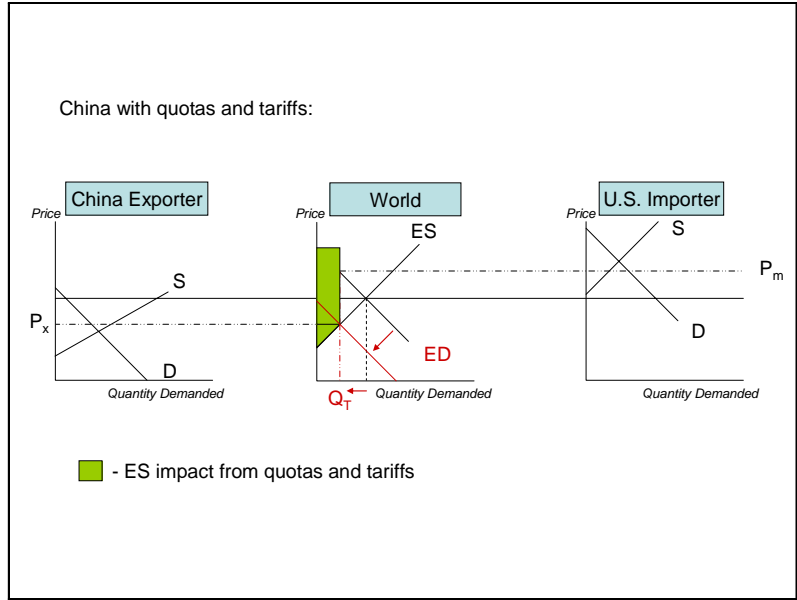


Figure 2. The world market from China’s perspective

CAFTA has been willing to export extra goods to the U.S. at a price higher than China’s domestic price, but lower than the U.S.’ price for Chinese goods after the tariffs and quotas are included, as seen in Figure 3. In this case, China’s equilibrium domestic price for textiles is lower than CAFTA’s, so a quota with a tariff has negatively impacted the U.S. with decreased trade and increased prices.

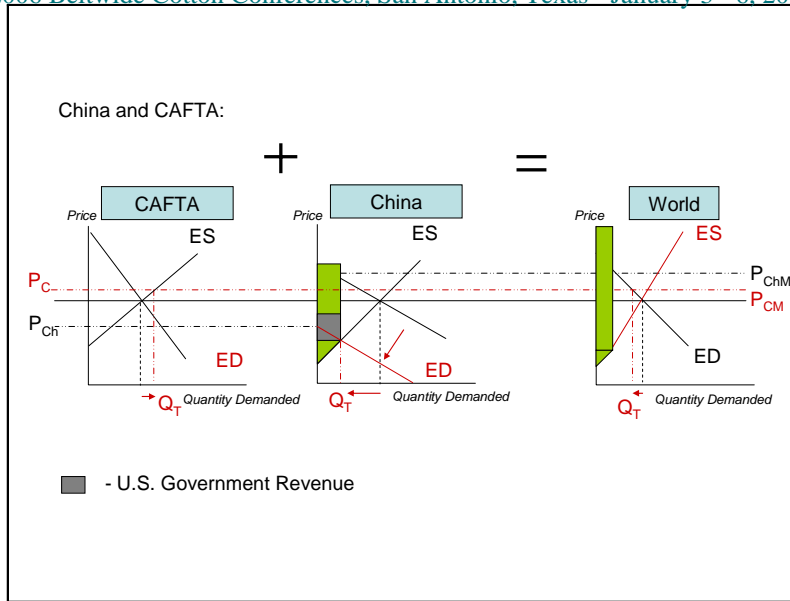


Figure 3. World Textile Trade Compiled of Components from China and CAFTA

As both CAFTA and China are considered large countries, they both affect world trade. It is assumed for this model that CAFTA will not impose any tariffs or quotas large enough to affect exports to the U.S. Thus, neither excess supply nor excess demand shift for CAFTA, but the quotas and tariffs do cause China's excess demand to shift inward. This has resulted in a decrease in trade for China, but an increase for CAFTA. Combining both effects together, a bent excess supply curve results with the apex of the curve at the point where the Chinese quotas and tariffs are limited.

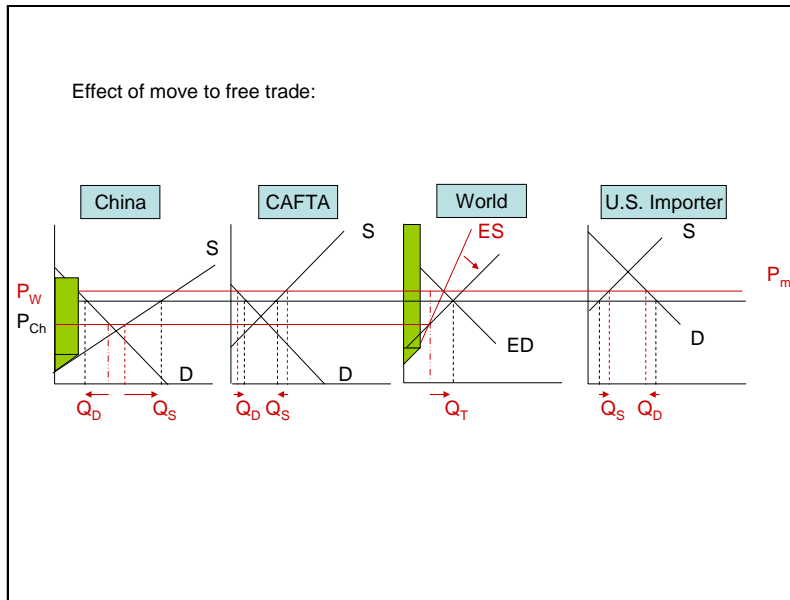


Figure 4. World Textile and Clothing Trade Effects

The effects seen in Figure 4 show the change from U.S. trade barriers against Chinese goods (red) to the move to free trade (black). China's domestic market will be affected by a decrease in quantity demanded because of its resulting higher domestic price. Domestic quantities supplied will increase, resulting in higher trade exports, because producers are willing to produce more at the new higher domestic price.

CAFTA's domestic price will fall though, because increased competition with China will force CAFTA producers to accept lower profits from the U.S. market. As a result, producers will decrease quantities supplied and consumers will increase quantities demanded. This will decrease trade for CAFTA with the U.S.

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Overall for the U.S., trade will increase and prices will decrease when the world is free of trade barriers. The shifted excess supply curve resulting from the lifting of China’s quotas and tariffs will raise the world price back to equilibrium. This creates an efficient economy that is void of dead weight loss. With free trade in the U.S., producers will pay the cost for lower domestic prices, but U.S. consumers will gain even more. The U.S. as a whole will be better off with free trade. Independent textile and clothing categories won’t all benefit from free trade though; independent categories may suffer and have to leave the U.S. market. To analyze which categories will suffer or benefit most, each one has to be analyzed separately.

Methodology

To compare which commodities are the most important to CAFTA countries, the dollar value of each import was compared to the value of China’s imports as seen in Figure 5. By evaluating the commodities that produce the highest income for CAFTA countries, we see where CAFTA’s textile and clothing market trade will be most affected by the elimination of China’s quotas. If CAFTA’s highly-valued categories can’t maintain a competitive edge with China under free trade, CAFTA’s imports to the U.S. will dramatically decrease. Category 339, knit shirts and blouses made of cotton, is worth \$1435.617 million, a total of 17.55% of all U.S. textile and clothing imports from CAFTA.

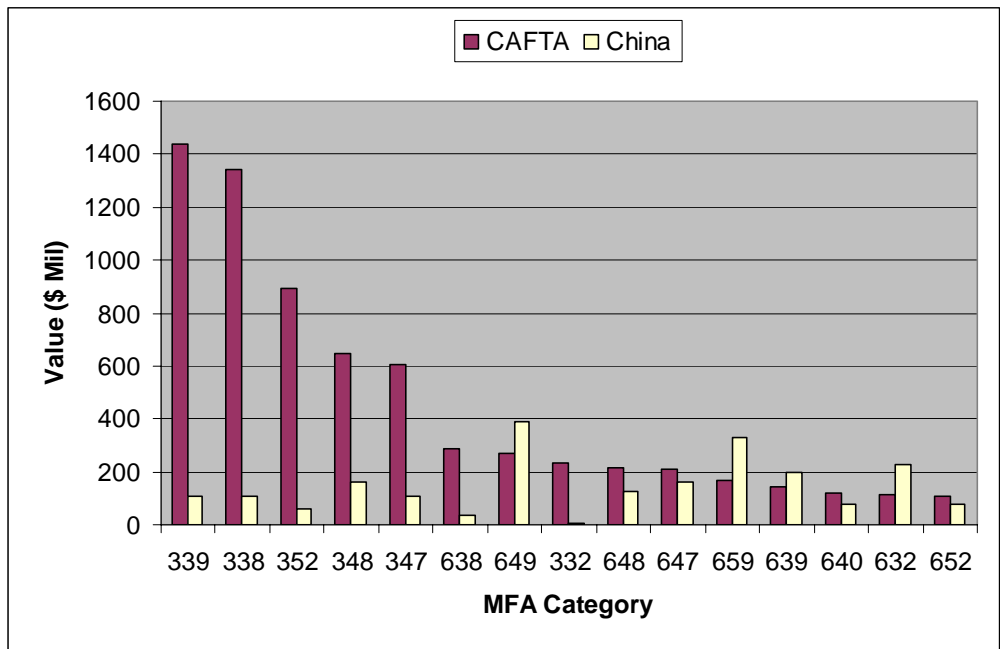


Figure 5. 2004 Dollar Value of U.S. Imports by Commodity
 Source: International Trade Administration - Office of Textiles and Apparel

Based on these values, the percent of U.S. market share that CAFTA and China each hold was calculated for the top 15 categories and compared between the two countries, as seen in Figure 6. These top 15 categories that CAFTA exports to the U.S. makes up 83% of the total textile and clothing exports to the U.S. To show the growth trend within the last year, the CAFTA year-to-date percentage change was overlapped for each category. The year-to-date percentage change exposes which commodities have been impacted most by WTO’s quota elimination that occurred January 1, 2005 and was only in effect for a couple of months. These couple of months allowed China to flood the U.S. market with its stored inventories of textiles and clothing. This quota-free trade was short-lived however, as safeguards were filed against China and temporary quotas have since been established for the categories shown in the figures. It is still a good indicator of which categories China will be able to grow in and take over a large market share once free trade is re-established. Figures 5, 6, and 7 all contain the same order of categories on the X-axis for reference.

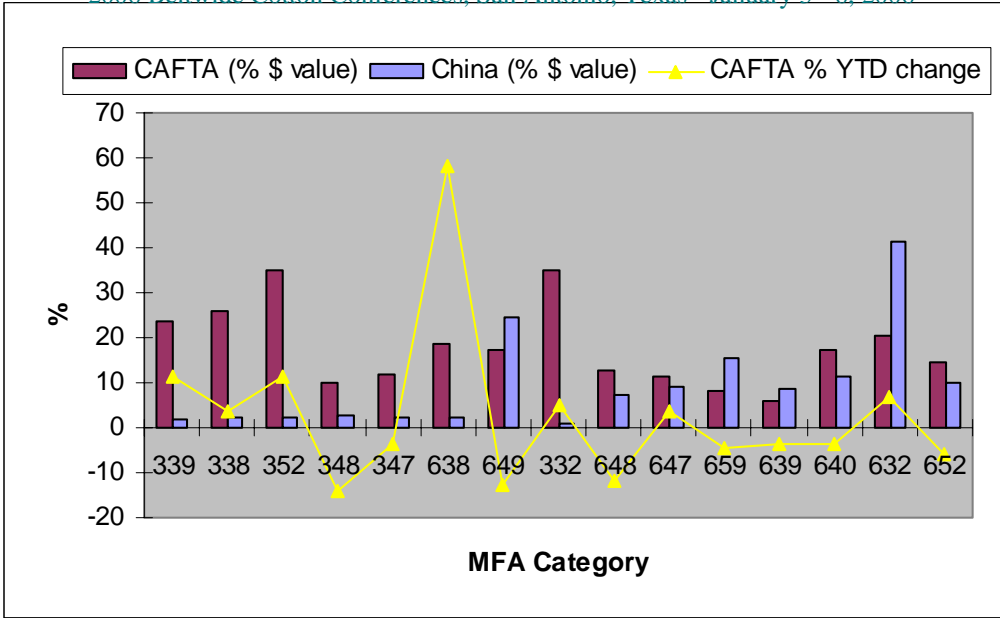


Figure 6. 2004 U.S. Market Shares of Categorized Commodities and 2004-2005 YTD CAFTA Growth Rate
 Source: International Trade Administration - Office of Textiles and Apparel

Though some categories are growing in size for CAFTA, many are shrinking in U.S. market share since China has had the opportunity to fully enter the market. This is a poor indicator of CAFTA’s competitiveness with China and gives a bleak outlook on future U.S.-CAFTA trade. To show this, CAFTA’s 2004-2005 year-to-date percent change has been compared to China’s 2004-2005 year-to-date percent change on the commodities most valuable to CAFTA’s textile and clothing industry. In most cases, China has the advantage and dwarfs CAFTA’s growth, as seen in Figure 7.

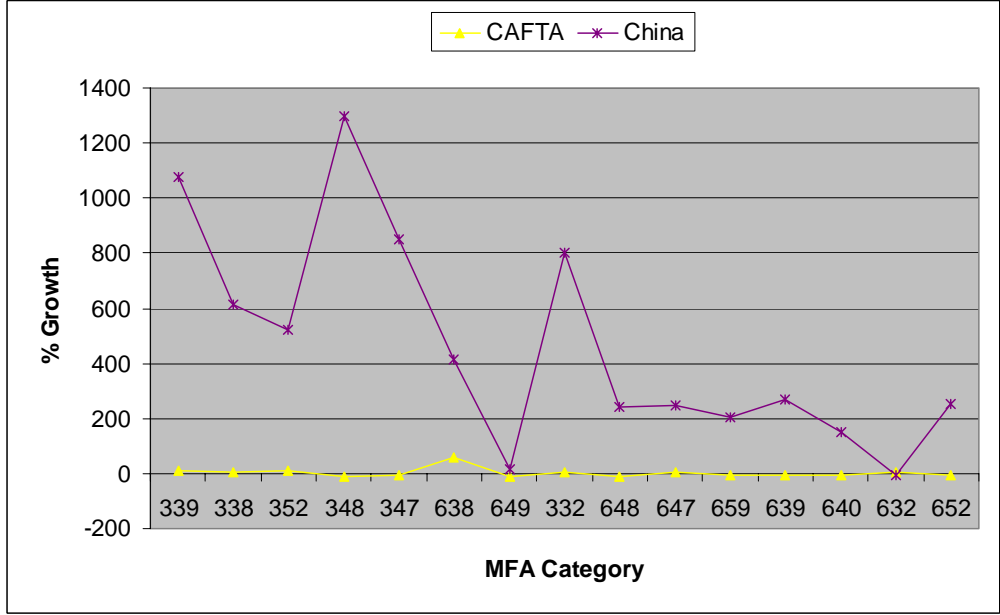


Figure 7. Growth Comparison of Top Valued Categories
 Source: International Trade Administration - Office of Textiles and Apparel

China’s Barriers to Trade

The problem that makes China difficult to compare to CAFTA is the different tariff rates associated with particular commodities within each category. Categories are determined by the U.S. Textile and Apparel Category System. These 3-digit categories label groups of similar items and are used for setting quota safeguards. Within each of

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these 3-digit categories are correlated 10-digit Harmonized Tariff Schedule (HTS) codes. HTS codes are based upon the international Harmonized Commodity Description and Coding System (HS) that was developed by the World Customs Organization, which are international 4- and 6-digit product categories used in most countries, including the WTO. The U.S. has subdivided these HS codes into HTS 8-digit unique rate lines and 10-digit non-legal statistical reporting categories for further clarification of imports and exports. HTS codes are used to set tariffs on individual textile imports.

The most highly valued CAFTA category, 339 – knit shirts and blouses made of cotton, is shown in Table 1 as an example. Though CAFTA countries enjoy duty-free exports to the U.S., China pays U.S. import tariffs and has still been able to increase its market share.

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Table 1. Tariff Example of Category 339

Category 339	China 2005 YTD % change =	CAFTA 2005 YTD % change =
	413.09	58.15
	WTO (China) Tariff	CBI Tariff
6104.22.0060	*	-
6104.29.2049	*	0
6106.10.0010	19.7	-
6106.90.2510	19.7	0
6106.90.3010	5.6	0
6109.10.0040	4.7	-
6109.10.0045	16.5	-
6109.10.0060	16.5	-
6109.10.0065	16.5	-
6109.10.0070	16.5	-
6110.20.1030	5	-
6110.20.2045	16.5	-
6110.20.2075	16.5	-
6110.90.9070	6	0
6112.11.0040	14.9	-
6114.20.0010	10.8	-
6117.90.9020	14.6	0
	* individually based per item	- same as WTO

Source: U.S. International Trade Commission, Office of the U.S. Trade Representative

Despite these barriers, China has succeeded in increasing exports to the U.S. by fulfilling most of the quotas set by the safeguards. This is indicative of China's readiness to capture a large share of the U.S. market, as seen in Table 2. It was estimated that the textile and clothing products that were being 'implemented' in response to ATC ruling from 1995-2005 were not high-value products. High-value products were being kept out of the implementation of lower quotas until the end of 2005 (Malaga and Mohanty). It is reasonable to assume that this is why the products with safeguards currently in place against China are mainly high-value items. Most of the safeguard limits are for a 5-month period, but most were fulfilled within 2 months. The main groups that appear to possess the strongest competition for CAFTA at this time are categories 638 and 632, men's man-made fiber knit shirts and hosiery, respectively. CAFTA managed to grow 58.15% since 2004 and keep an 18.65% share of the U.S. market for 638, creating exports worth \$326.120 million. For 632, exports grew 6.4% and the market share was 20.42% in 2004, worth \$113.279 million.

Table 2. Chinese Quotas Filled

MFA Category	2004 % filled	2005 % filled
339	92.8	100
338	92.8	100
352	94.1	100
348	83.9	100
347	83.9	100
638	94.3	100
649	100	58.1
332	5.5	100
648	89.2	100
647	89.7	100
659	87.2	no current quota
639	94.3	100
640	95	100
632	no quota set	100

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652	90.7	100
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Source: U.S. Customs and Border Protection

Conclusions

Though CAFTA has held on to a couple of markets, it is losing many more to the pressures of China. The categories most at stake are 348, 347, 649, and 648: cotton slacks, cotton trousers, cotton and man-made fiber brassieres and other body supporting garments, and man-made fiber slacks, respectively. CAFTA is losing market share to all of these categories, while China is experiencing exorbitant growth of up to 1297%. These four categories alone account for 24.59% of all CAFTA textile and clothing exports to the U.S. (OTEXA).

Though the US-CAFTA agreement is expected to increase CAFTA countries' demand for U.S. cotton and cotton textile products, reduced demand in the U.S. for CAFTA clothing may negate this benefit by decreasing the amount of CAFTA clothing produced. Unless CAFTA is able to find alternative markets to export clothing to, the outlook for the U.S. and CAFTA textile and clothing industries seem to be bleak.

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Appendix**Requests for China Textile Safeguard Action Filed with the Committee for the Implementation of Textile Agreements (CITA)**

Category	Description	Date Request Received by CITA	Requesters
363	Cotton terry and other pile towels	October 11, 2005	AMTAC NC TO NTA UNITE HERE
226	Cheesecloth, batistes, lawns/voiles	September 21, 2005	AMTAC NC TO NTA UNITE HERE
443	Men's and boys' wool suits		
619	Polyester filament fabric		
634/635	Other men's & boys' man-made fiber coats and women's and girls' man-made fiber coats		
338/339*	Cotton knit shirts and blouses	September 14, 2005	AMTAC NC TO NTA SEAMS UNITE HERE
340/640*	Men's and boys' cotton and man-made fiber woven shirts		
347/348*	Cotton trousers		
349/649*	Cotton and man-made fiber brassieres and other body supporting garments		
352/652*	Cotton and man-made fiber underwear		
638/639*	Man-made fiber knit shirts and blouses		
647/648*	Man-made fiber trousers		
301*	Combed cotton yarn		
620*	Other synthetic filament fabric		

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341/641	Women's & girls' cotton and man-made fiber woven shirts	July 11, 2005	AMTAC	NTA
342/642	Cotton and man-made fiber skirts	July 11, 2005	NCTO	UNITE
351/651	Cotton and man-made fiber nightwear	July 11, 2005		
359-S/659-S	Cotton and man-made fiber swimwear	July 11, 2005		
332/432 and 632(part)**	Cotton, wool and man-made fiber socks	July 8, 2005	DMC AMTAC	NCTO NTA
369(part)/666 (part)	Cotton and man-made fiber curtains and draperies	June 22, 2005	AMTAC	
340/640	Cotton and man-made fiber shirts, not knit	April 6, 2005	NCTO	
345/645/646	Men's & boys' and women's & girls' cotton and man-made fiber sweaters		NTA	UNITE HERE
349/649	Cotton and man-made fiber brassieres			
350/650	Cotton and man-made fiber dressing gowns, etc.			
620	Other synthetic filament fabric			
638/639	Men's & boys' and women's and girls' man-made fiber knit shirts and blouses			
647/648	Men's & boys' and women's and girls' man-made fiber trousers			

*Reapplication request. The quotas will terminate on December 31, 2005.

**Reapplication requests. The quota will terminate on October 28, 2005.

NOTE:

AMTAC = American Manufacturing Trade Action Coalition
 DMC = Domestic Manufacturers Committee of The Hosiery Association
 NCTO = National Council of Textile Organizations
 NTA = National Textile Association
 UNITE = UNITE HERE