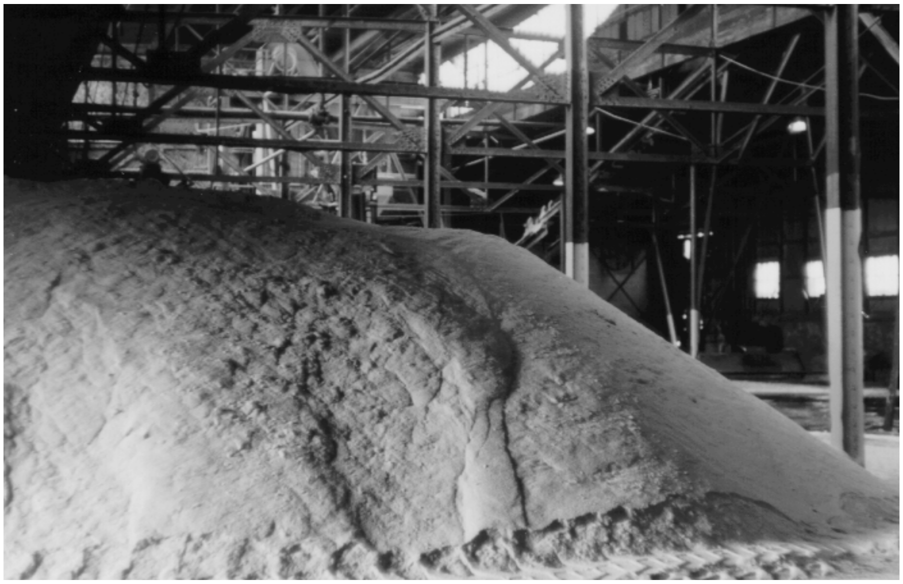

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U.S.-Mexico Sweetener Trade Mired in Dispute

Disagreement persists among the U.S. and Mexican sugar industries and the U.S. high-fructose corn syrup (HFCS) industry over interpretation of the North American Free Trade Agreement (NAFTA). Trade in sweeteners between Mexico and the U.S. is addressed directly by provisions of NAFTA, as well as other trade agreements, but as these industries have grown, pressure on trade agreements has increased, leaving the future of U.S.-Mexico sweetener trade uncertain.

The Changing Mexican Sugar & U.S. HFCS Industries

Behind the Mexican sugar industry's interest in this dispute is the remarkable rebound in Mexican sugar production since implementation of NAFTA. As recently as the November-October marketing year 1994, Mexico produced only 3.8 million MTRV (metric tons, raw value) of sugar. By marketing-year 1998, Mexico produced a record of nearly 5.5 million. Although USDA forecasts a decrease to 5.04 million for marketing-year 1999, the year's production would still be the second highest on record. USDA projections for marketing-year 2000 put production at 5.15 million MTRV.

A combination of increased sugarcane area harvested and recently instituted technological and producer incentive measures is behind growth in Mexican sugar production. Harvested area had reached a low in 1992 of under 482,000 hectares, about 18 percent lower than 1987. By 1997, producers increased harvested hectares to the 1987 level, but sugar production was 22 percent higher than the 1987 level. New technologies have increased sugar recovery rates—the percent of cane recovered as sugar—from 9.08 percent in 1992 to 10.77 percent in 1997, and the effective milling season expanded from 130 to 175 days. Competition arising from increased efficiencies in the sector has apparently led to severe financial problems for some sugar companies, but many have been able to adapt their production processes to more modern methods.

The Mexican government, by providing several different forms of support, enables the domestic sugar industry to maintain both high domestic prices and high production levels. A government-controlled development bank for the sugar industry, the Financiera Nacional Azucarera SA (FINASA), is estimated to hold over US$1.3 billion of the Mexican sugar industry's debt. FINASA has provided extensive restructuring assistance to troubled sugar companies with high debt loads.

Since 1997 the government has coordinated the amount of sugar that can be marketed domestically, which effectively establishes the quantity of sugar that must be exported or held in stocks. The export total is divided among sugar companies on a pro rata basis. A penalty system discourages companies from selling their assigned exports on the domestic market. In addition, the government has subsidized domestic stockholding, helping to keep 600,000 MTRV out of the domestic market.

The government also provides support to the industry by controlling sugar imports. It currently maintains tariff rates of 39.586 cents per kg, high enough to prevent imports of world-price sugar that would undercut domestic prices. Under NAFTA, however, Mexico is required by the sixth year, 2000, to adapt a tariff-rate quota (TRQ) system with rates applied to third countries that match the tariff levels maintained by the U.S.

Despite government assistance, Mexican sugar companies face an uncertain future. In addition to the high debt loads of many companies, productivity gains have not been shared among all 61 sugar mills, and marketing expertise is also unevenly distributed. Although domestic sale prices are high at about 20 cents per pound in June and July, exports are currently being sold at much lower world prices of 5-7 cents per pound.

NAFTA has allowed for some duty-free access to higher priced U.S. markets in recent years. Under NAFTA, Mexico's projected net surplus production of sugar for fiscal year 1997 gave it a duty-free quota of 25,000 MTRV to be shipped as either raw or refined sugar. Since then, Mexico has qualified as a net surplus producer in both FY1998 and FY1999 and thus has qualified each year for NAFTA duty-free exports up to 25,000 MTRV.

The U.S. HFCS industry's interest in the sweetener dispute stems from expectations that the NAFTA provisions regarding HFCS might provide another market

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for U.S.-produced HFCS. The U.S. industry has been plagued with excess capacity—the larger HFCS companies have added significant production capacity, and several new plants have opened. Some experts have estimated that HFCS annual production capacity may have grown by 3.5 million tons (dry basis) between 1994 and 1997.

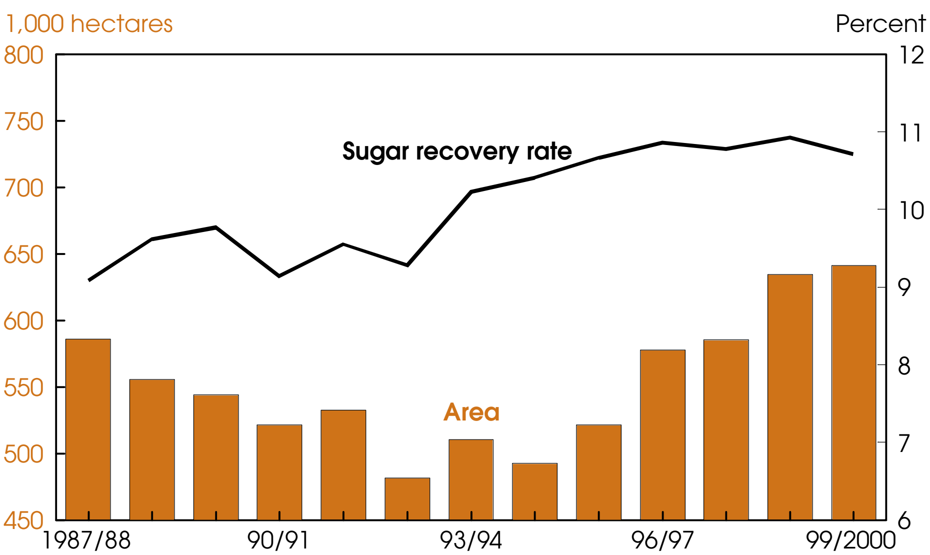
Although domestic HFCS sales have increased by more than 13 percent during this period, the increases have not been sufficient to absorb increases in capacity. Prices have declined as supply outstrips demand. The ratio of the HFCS-42 spot price to the beet-sugar wholesale price began to fall below 0.60 in the fourth quarter of 1995, averaged 0.40 for both 1997 and 1998, then rose to 0.42 in the first quarter of 1999. HFCS-42 (42 percent fructose) is used mostly in confections and other processed foods and in beverages. The Bureau of Labor Statistics producer price index for the HFCS industry (June 1985=100) fell from 117.6 in the last 3 months of 1995 to an average of 77.6 in 1998, a 34-percent reduction. As a result, the sector faced tough adjustments, with some smaller operations leaving the business and others selling to or attracting investors from among larger companies.

Increased HFCS-55 exports to Mexico raised expectations during this period. HFCS-55 (55 percent fructose) is used primarily in soft drinks. Estimates place sugar use by the Mexican soft drink industry in the neighborhood of 1.4 million tons in the late 1990's, offering a close natural outlet for excess U.S. HFCS productive capacity. The U.S. Customs Service reports that HFCS-55 syrup and solids exports to Mexico rose from nearly 52,000 metric tons in 1995 to over 179,000 mt in 1997 and over 207,000 metric tons in 1998. The Mexican government reports substantially higher levels of U.S. exports—338,500 metric tons for 1997 and 285,500 for 1998.

NAFTA Sugar Provisions Remain in Dispute . . .

U.S. sugar producers closely monitor the potential impacts of the sweetener trade disagreements under NAFTA. The original NAFTA document, in effect since January 1994, contained provisions related to trade in sugar that were opposed by many U.S. sugar producers. They feared NAFTA provisions allowing increased HFCS exports to Mexico would lead to the substitution of HFCS for sugar in Mexico, which in turn would lead to a Mexican sugar surplus that could be exported to the U.S. In order to secure support for NAFTA in Congress, the U.S. and Mexican governments exchanged side-letters that altered the sugar provisions of the original NAFTA text. Since implementation of NAFTA, however, there has been a trade dispute between Mexico and the U.S. centering on interpretation of the content and validity of the side-letter agreement.

Mexico's Sugarcane Area and Sugar Recovery Rate Are Up



Sugar recovery rate = Ratio of raw sugar tonnage to sugarcane tonnage.
Harvested area. 1 hectare = 2.471 acres. Marketing year beginning in November. 2000 forecast.
Source: Fideicomiso Para El Mercado de Azucar FORMA.
Economic Research Service, USDA

The original provisions of NAFTA subjected Mexican sugar exports to the U.S. to several conditions. During the 15-year NAFTA transition period, Mexican exports were to be limited to no more than Mexico's projected net production surplus of sugar—sugar production less domestic sugar consumption—but at minimum, Mexico was allowed to ship 7,258 metric tons of raw sugar duty-free. For the first 6 years of NAFTA, duty-free access was limited to no more than 25,000 MTRV. In year 7, the maximum duty-free access quantity was to become 150,000 MTRV, and in each subsequent year, the maximum duty-free quantity was to increase by 10 percent. These maximums could be exceeded, however, if Mexico had achieved net production surplus status for 2 consecutive marketing years.

But the side-letter agreement changed key NAFTA sugar provisions. Under the side agreement, projected Mexican sugar production will have to exceed Mexican consumption of both sugar and HFCS for Mexico to be considered a net surplus producer, making it less likely that Mexican sugar would qualify for duty-free access. In addition, the side letter provided for an annual limit on duty-free access of 250,000 metric tons from 2001 to 2007, eliminating the possibility of unlimited duty-free access should Mexico become a net surplus producer for 2 consecutive years.

The Mexican government has disputed the validity of the side letter. Moreover, Mexico maintains that its version of the side letter does not count HFCS consumption in the formula that defines net surplus producer status, nor limit exports to 250,000 metric tons per annum during 2001-07. Based on its interpretation of the NAFTA agreement, Mexico is entitled to export total net surplus production to the

U.S. on a duty-free basis beginning in October 2000.

On March 12, 1998, the Mexican Secretariat of Commerce and Industrial Development (SECOFI) asked for consultations with the U.S. on the validity of the disputed side letter under NAFTA. No agreement was forthcoming, so on November 15, 1998, Mexico formally requested a NAFTA Commission to resolve the issue, although no Commission meeting has yet been held, by agreement with Mexico. The Commission has several options for resolution, none of which are binding unless both parties agree. If the Commission cannot resolve the dispute within 30 days after it has convened (or another time period agreed to by both parties), either party may request an arbitration panel to adjudicate the issue. Some observers expect a negotiated settlement will be reached, but it is difficult to project the outcome of the dispute.

Tariffs on U.S. Sugar Imports from Mexico Are Being Phased Out

	High-tier tariff*			
	Most countries		Mexico	
	Raw cane	Refined	Raw cane	Refined
	¢ per lb.			
Base	**18.08**	**19.08**	**16.00**	**16.95**
1995	17.62	18.60	15.20	16.11
1996	17.17	18.12	14.80	15.69
1997	16.72	17.65	14.40	15.26
1998	16.27	17.17	14.00	14.84
1999	15.82	16.69	13.60	14.42
2000	15.36	16.21	12.09	12.81
2001	15.36	16.21	10.58	11.21
2002	15.36	16.21	9.07	9.61
2003	15.36	16.21	7.56	8.01
2004	15.36	16.21	6.04	6.41
2005	15.36	16.21	4.53	4.81
2006	15.36	16.21	3.02	3.20
2007	15.36	16.21	1.51	1.60
2008	15.36	16.21	0.00	0.00

*Mexican sugar imports exceeding a predetermined volume are subject to a high-tier tariff. The low-tier tariff rate is zero.

Economic Research Service, USDA

. . . And HFCS Provisions Fare No Better

A series of investigations and counter-investigations has also developed from the surge in Mexican imports of U.S.-produced HFCS. NAFTA provides for duty reductions on Mexican HFCS imports from the U.S. The base tariff was 15 percent and is scheduled to reach zero by 2004, with 1.5-percent yearly reductions over a 10-year adjustment period. In December 1996, however, the Mexican government announced increases in import duties on HFCS-42, HFCS-55, and crystalline fructose to 12.5 percent, above the then-current scheduled rate of 10.5 percent, to compensate for damage to Mexico when the U.S. raised tariffs on Mexican broomcorn brooms. In December 1998, the U.S. dropped the tariff increase, and as a result, Mexico dropped its retaliatory duties on U.S. HFCS imports. The 12.5-percent *ad-valorem* duty was reduced to the NAFTA-specified rate—6 percent by the end of 1998.

In January 1997, at about the same time that HFCS import duties were being increased in the broomcorn broom dispute, Mexico's National Chamber of Sugar and Alcohol Industries, the association of Mexico's sugar producers, charged that U.S. corn wet millers were exporting HFCS to Mexico at less than fair value. Mexico's SECOFI initiated an anti-dumping investigation in February, then imposed temporary tariffs on two grades of U.S. HFCS in June. The temporary tariffs applied to shipments from Cargill Inc., A. E. Staley Manufacturing Company, CPC International Inc., and Archer Daniels Midland Company. After further investigation, SECOFI made the duties permanent in January 1998, between $63.75 and $100.60 per ton for HFCS-42 and between $55.37 and $175.50 per ton for HFCS-55 (*AO* March 1998).

Also during 1998, SECOFI investigated a charge made by the Mexican sugar industry that HFCS-90 was being imported in order to avoid anti-dumping duties that had been imposed on HFCS-55. After a 7-month investigation, SECOFI imposed compensatory duties, effective September 8, 1998. Imports from A.E. Staley Manufacturing Company are charged $90.26 per metric ton, and imports from Archer Daniels Midland Company are charged $55.37 per metric ton.

In February 1998, the U.S. Corn Refiners' Association (CRA) asked for review of proceedings of Mexico's anti-dumping actions under Chapter 19 of NAFTA. A panel is being formed.

Parallel to these actions taken under NAFTA, the U.S. Trade Representative (USTR) announced its intention on May 8, 1998 to invoke a World Trade Organization (WTO) dispute proceeding to challenge Mexico's actions. The USTR made two formal requests for formation of a WTO panel (the first was blocked by Mexico). A preliminary ruling is expected by January 2000.

In May 1998, the USTR also initiated an investigation under section 302 of the U.S. Trade Act of 1974, as amended, in response to a petition by the CRA alleging that the government of Mexico had denied fair and equitable market opportunities to U.S. HFCS exporters. The CRA argued that the Mexican government had encouraged and supported an agreement between representatives of the Mexican sugar industry and the Mexican soft drink bottling industry to limit purchases of HFCS by the soft drink bottling industry to 350,000 tons per year in exchange for a 20-percent discount on sugar for soft drinks.

On May 15, 1999, the USTR concluded its formal investigation phase without determining that the Mexican government's alleged practices were actionable. However, the USTR noted that its investigation had raised enough questions about the actions of the Mexican government to warrant further examination and continued consultation with the government on issues related to trade in HFCS.

Falling World Sugar Prices May Increase U.S. High-Tier Imports

While ongoing disputes make liberalized sweetener trade between Mexico and the U.S. uncertain in the near future, recent effects of the falling world sugar price on the profitability of exporting Mexican sugar into the U.S. under high-tier tariffs have the potential to substantially increase the amount of Mexican sugar entering the U.S.

NAFTA established a declining tariff schedule for high-tier raw and refined sugar imported into the U.S. from Mexico. During the NAFTA adjustment period through 2008, the maximum world price at which it becomes profitable to ship Mexican sugar into the U.S. market increases annually. When the declining tariff schedule for raw sugar is compared to the world price level at which Mexican sugar is competitive with U.S. sugar (assuming marketing costs of 1.1 cents per pound for bringing Mexican sugar into the U.S., and a U.S. sugar price of 22 cents per pound), a world price below 7.3 cents per pound in 1999 would introduce the probability of high-tier imports from Mexico.

The world price (No. 14 New York contract) averaged 7.05 cents per pound in February 1999 and dropped to the 5.5-cents-per-pound range in April and May. Although U.S. raw sugar prices have been higher than 22 cents per pound through the first half of the year, they dropped to about 21.50 cents per pound recently.

Through April, USDA had not been forecasting significant high-tier Mexican sugar imports; only 184 STRV (short tons, raw value) had entered up to that point in the year. (A short ton, 2,000 pounds, is 0.91 metric ton.) During the first week of May, however, 15,432 STRV of Mexican high-tier raw sugar entered the U.S. At that point, the data became available to USDA indicating additional tonnage was awaiting entry that would bring the total to 120,000 STRV. USDA's projection from that data depended on whether the sugar would enter before the end of the fiscal year or be held in bond until the new calendar year, when the NAFTA high-tier tariff is scheduled to decrease from 13.6 to 12.09 cents per pound. The August 1999 projection for high-tier Mexican sugar imports stands at 70,000 STRV and is projected at 125,000 STRV for fiscal year 2000. AO

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