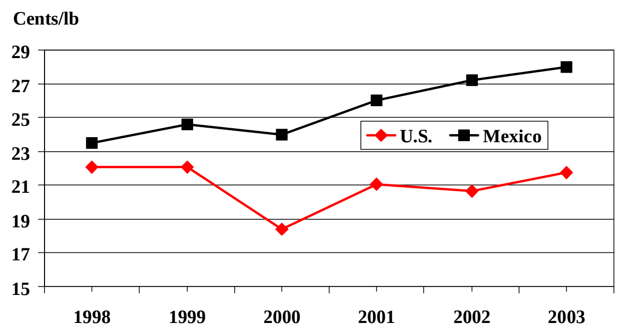
Mexico and Sugar: Historical Perspective

The viability of the Mexican sugar industry is a political imperative. Sugar is Mexico's largest agricultural industry. Sugar cane is the fifth largest cultivated crop, supplying raw material to over 60 mills located in 15 of the country's poorest 35 states. The industry as a whole accounts for more than 300,000 jobs, including cane cutters, seasonal field workers, and factory workers. Consequently, over 2.2 million people depend on the Mexican sugar industry for a living. There are 158,000 cane growers averaging nearly 4 hectares per growers delivering about 300 tons of cane. This compares to Queensland, Australia where output is about the same but the number of growers is 6,500 working an average of 85 hectares. This comparison demonstrates the current inefficiency of the Mexican industry.

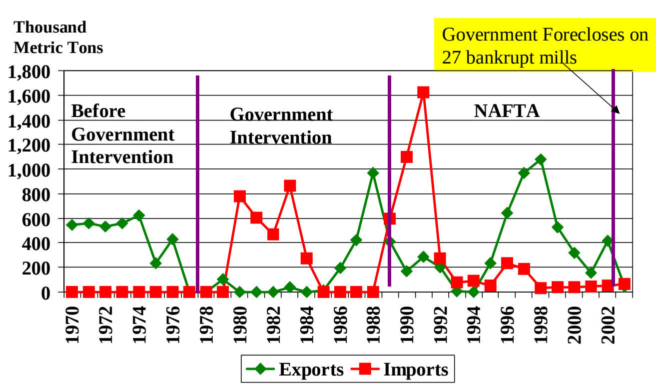
U.S. vs. Mexico Domestic Price Comparison
Yearly Average Refined Sugar



Source; U.S. price #14 duty fee paid NY; Mexico Servicio Nacional de Informacion de Mercados

Perhaps the lack of mobility and alternative employment keep people growing sugarcane, but government-controlled prices, which over the last few years have been between $28 and $32 per ton, also help keep people on the farm. Mexico controls domestic prices through a system of marketing allotments. Domestic supplies are limited by the legal requirement that millers supply no more than a pre-determined allocation of sugar each year. Any production over these allocations must be held over as stocks, sold for non-food uses, or exported. This policy constrains supplies ensuring high domestic prices. Mexican import tariffs help defend these price levels. The Mexican sugarcane price is higher than the U.S. price; almost double the price in Guatemala and three times the price of Brazilian sugarcane. Consequently, the income per hectare from sugar cane is well above that of rice, cotton, or corn.

Mexican Sugar Trade 1970 to 2003



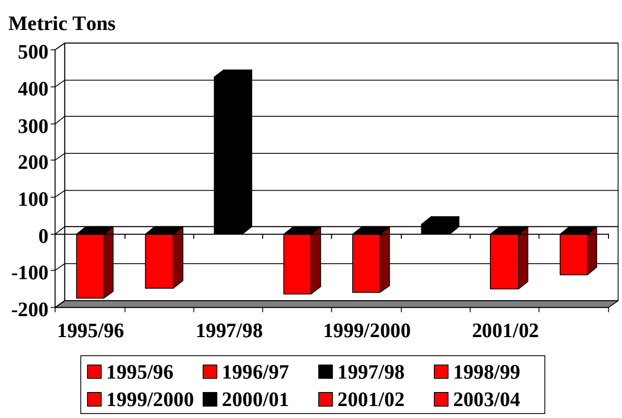
Over the last 40 years the Mexican sugar industry has experienced a progression of government interventions, motivated to provide inexpensive sugar to consumers, but resulting in bankruptcy and technological stagnation. The mandated marketing prices forced mill operators to postpone maintenance and depend upon government-supported loans for operating expenses. Eventually, the debts exceeded the mills asset values forcing the mills into government receivership. Instead of annually exporting half a million tons of sugar, Mexico became a substantial importer.

The North American Free Trade Agreement (NAFTA) appeared to be the vehicle to revitalize the Mexican sugar industry. Initially, it appeared that Mexico would be the exclusive beneficiary to export a substantial additional quantity to the high-priced U.S. sugar market. The Mexican government offered the old mills, then under receivership, for sale. The price for these mills was bid up by newly organized conglomerates looking for quick profits. However, last minute changes during the final negotiations of the treaty failed to open the U.S. as much as was expected.

With the advent of increased production, three factors contributed to crisis of 2001/02. First, the U.S. quota for Mexican sugar remained far below the additional 250,000-ton minimum they hoped to be negotiated; second, Mexican imports of HFCS from the U.S. rapidly increased, displacing domestic sugar used in soft drinks; and third, the government issued a large number of import permits thus allowing large quantities of lower price world sugar to enter the domestic market. All together these factors increased the quantity of Mexico's exportable surplus sugar.

Thus, the scene was set for the 2001 expropriation of 27 bankrupt mills and beginning a repeat of the pre-1980 period. Inefficient operators borrowed expensive money for operating capital and sold sugar destined for export into the domestic market at low prices. The owners fell behind in payments to cane growers and eventually mill employees. In the summer of 2001 the Ministry of Agriculture, Livestock, Rural Development, Fisheries and Food (SAGARPA) together with the Treasury Secretariat (SHCP) funded 1.2 billion pesos ($131.1 million) for liquidating mills production debts. The debts were backed by the mills with certificated deposits of sugar stocks. Later that summer, the government expropriated 27 mills to ensure against further mismanagement.

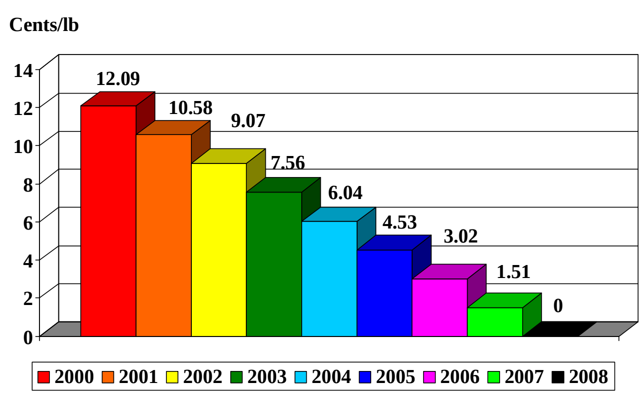
Mexico's Exportable Surplus Under NAFTA



Shortly after expropriating the mills, the government moved to reduce imports of HFCS and thus increase the demand for domestic sugar by industrial users. In January 1998, the government imposed a countervailing duty on the 250,000 tons HFCS imports from the United States. These duties effectively closed off imports and raised the domestic sugar price. Eventually both NAFTA and WTO panels ruled against these duties. However, these duties were replaced with a tariff rate quota of 148,000 tons in April 2002 which was preceded in January, with a tax of 20 percent on soft drinks not sweetened with sugar. This latter action negatively affected Mexico's producers of HFCS and reduced imports of U.S. corn destined for the manufacture of HFCS. It also eliminated Mexico's exportable surplus as defined by NAFTA.

Currently about 60 mills are operating in Mexico, Of the 27 expropriated by the government, four were returned to their owners and 13 are under government ownership. The remaining mills are under government supervision and on an indefinite track toward re-privatization. The industry should be restructured and downsized to be competitive. However, downsizing is not likely to take place. First, private capital, costing between 12 to 15 percent, is too expensive for a low priced commodity constrained by high cost government mandates. And second, the Mexican government is not likely to authorize investment for modernization and expansion.

NAFTA Staged Rates for Non Quota Duties for Sugar from Mexico



It is not clear how long the Mexican government will manage the 23 mills now under its direction, nor is it clear how long the tax on non sugar containing soft drinks will remain in place. However, in only four years, the United States staged tariff reduction on all sugar imported from Mexico will reach zero. There will be no U.S. barrier to sugar imports from Mexico. However, to compete in the U.S. market Mexican will have to be more price competitive. Currently the Mexican domestic price is above the U.S. domestic price so even if Mexico had an exportable surplus and a zero duty rate it would be more profitable to stay in the domestic market.

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