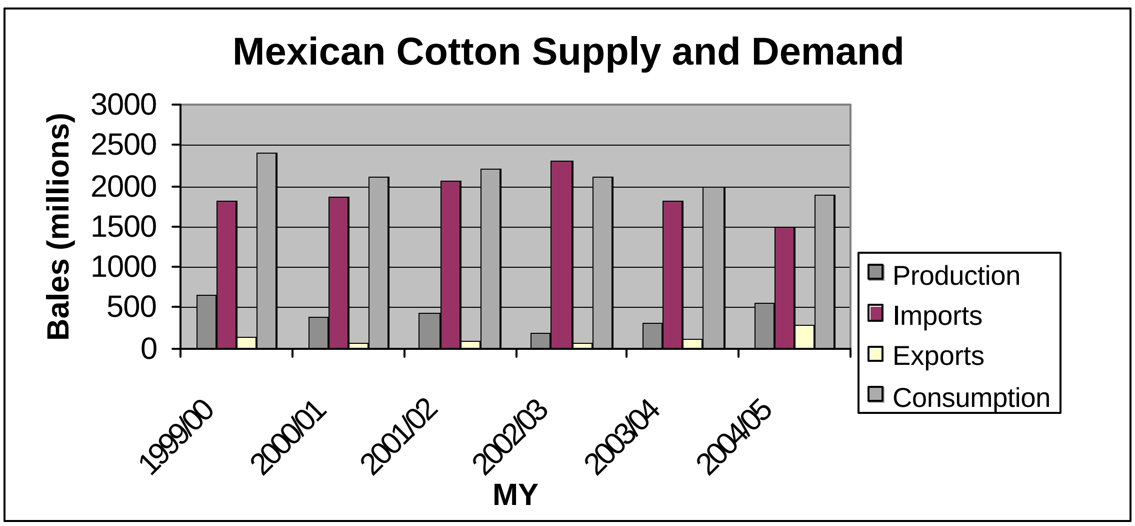
August, 2004

FAS TRIP REPORT
The Cotton Situation in Mexico

The Mexican apparel and textile industry is scrambling as the Multi-Fiber Arrangement quotas are set to expire on December 31 2004. Mexico's cotton production is also set to increase 54 percent in marketing year 2004/05. These situations are likely to have a negative impact on future U.S. cotton exports to Mexico.

Mexico had been the largest importer of U.S. cotton in recent years until marketing year 2003/04, when China became the top destination for U.S. cotton due to China's weather related crop damage. The United States is the largest export market for Mexican apparel and textile products. Mexico is already losing market share to China in the U.S. market before the Multi-Fiber Arrangement (MFA) quotas expire. The Mexican apparel and textile industry is concerned that their overall output will decline further once the MFA quotas are removed. These developments could further reduce U.S. cotton exports to Mexico.



Factors Affecting Consumption

Mexico's apparel and textile industry flourished as a result of the implementation of NAFTA in 1994 becoming the largest supplier of apparel and textiles in the United States. However, the benefits to the industry have been eroding in recent years as Mexico faces competition from lower cost countries, such as China and the countries of the Caribbean Basin.

Mexico's cotton consumption is being impacted on two fronts. First, Mexico's apparel and textile exports are losing market share in the U.S. to low cost countries. This situation will likely continue to worsen with the removal of the MFA quotas at the end of 2004. Secondly, the Mexican industry faces competition in the domestic market from illegal imports (contraband). Trade sources indicate that 60-70 percent of apparel purchased in the Mexican market is contraband. The Government is directing resources towards the apparel and textile industry in order to assist it, particularly illegal transshipments. However, admittedly, the GOM is focusing more of its resources on higher value-added industries, such as the software and aerospace industries. Although the Mexican Government has recently instituted measures to help curtail the contraband issues, the industry reports that more enforcement is needed.

Competitive Disadvantages

Mexico is no longer considered the cheapest source of labor in the region. This honor now belongs to the countries in the Caribbean. The Government of Mexico acknowledges that the standard of living has increased in Mexico, in large part, as a result of NAFTA and other FTAs. The GOM understands that apparel and textile production will move to Central America where labor is cheaper. The industry, on the other hand, is lobbying the government to make other changes that might enhance their competitiveness. These changes include: a) a temporary exemption on the 2 percent tax on equipment. This tax has to be paid on equipment whether or not it is being used. The industry would like a two-year exemption through 2006. This would allow enough time to make the needed adjustments due to the pending MFA quota removal; and b) a reduction in the high taxes paid on electricity usage.

The Mexican industry is aware that it needs current and future investments in order to increase its competitiveness. However, trying to attract this investment is difficult considering the high-risk environment of the textile sector. The industry wants to move into more value-added services. Given the advantages that Mexico already has, such as its close proximity to the U.S., it believes that if it is able to differentiate its products and move more into niche markets then it will be able to maintain its production levels. The goal is to keep cotton consumption at current levels, roughly 2 million bales a year. However, opinions varied widely on the likely impacts of the end of the MFA quotas on domestic cotton consumption. Several contacts suggested that cotton consumption would be unaffected by the quota removal and would remain at approximately 2 million bales, while others insisted that consumption would systematically decline over a several year period before leveling off at approximately 1 million bales. Since U.S. cotton is the primary source of cotton fiber used in the Mexican industry, this situation needs to be monitored carefully in the coming months/years in order to assess the impacts on U.S. cotton exports to Mexico.

The Mexican apparel and textile industry are also attempting to work with the U.S. industry to form a regional apparel and textile agreement, but without much success to date. Industry officials state that this is the only way that the apparel and textile industries in the Western Hemisphere can protect themselves from further decline after the MFA quotas are removed. Several industry representatives suggested that relaxing the NAFTA "rules of origin" would allow the Mexican industry to remain competitive with the Asian industries. The Mexican industry indicated that they are losing market share in the U.S. partially due to other trade agreements that the U.S. has entered into, particularly the Andean Trade Preference and Drug Eradication Act and the CBI (Caribbean Basin Initiative), which will worsen when the Central American Free Trade Agreement becomes effective. The textile association, Camara Nacional de la Industria Textil (CANIANTEX), however, stated that it is pleased that the CAFTA includes a cumulation clause with Mexico, but stated that the initial quantity allowed (100 SME) is not enough to assist the industry over the long term. Production aimed for domestic consumption may also be impacted negatively due to a reciprocity clause in CAFTA. This clause will allow a limited quantity of apparel made in CAFTA countries into Mexico duty-free. In other words, the Mexican textile industry will benefit somewhat because of the cumulation clause, while the apparel industry will be pressured by apparel and textile imports from CAFTA countries.

Mexican Cotton Production

Mexico's cotton production is currently on track to increase 54 percent this marketing year, increasing from 357,000 bales in MY 2003/04 to 550,000 bales in MY 2004/05. The cotton producers' goal is to eventually produce 1 million bales a year, but some in the industry believe that this is unrealistic. The main reason for this increase in cotton production next year is government subsidies. The Mexican Government's assistance to growers used to be solely aimed towards various grain growers and now they are assisting cotton growers as well. Producers insist that they would not be able to produce and expand cotton production without this aid.

Cotton production is located mostly in northwest Mexico, where the crops require irrigation. Generally costs are greater in Mexico than in the U.S. However, in some growing areas, the increased use of BT cotton seed will help offset some costs.

It is reportedly cheaper to ship cotton from Texas to the Mexican textile mills than it is to ship cotton grown in Mexico. A cotton trader indicated that 40 percent of next year's cotton crop will be exported and 60 percent will be used in domestic mills. Mexican cotton quality is generally poor and inconsistent. Even though there exists an abundance of gins, many of them are older which tends to damage the cotton during the ginning process. Attempts are being made to improve the quality, but plans do not exist for the use of USDA's High Volume Instrument (HVI) systems for classing cotton qualities. Mostly smaller mills use Mexican cotton with products aimed toward the domestic market. Larger mills generally use U.S. cotton in its production processes because U.S. cotton is better qualityu and more consistent.

The current outlook for future U.S. cotton exports to Mexico does not appear to be very promising. As the Mexican apparel and textile industry struggles to regain its competitiveness and with Mexican cotton production growing, U.S. cotton exports appear to be headed for a decline.

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