March 19, 2004

The Honorable Robert B. Zoellick
U.S. Trade Representative
600 17th Street, NW
Washington, DC 20508

Dear Ambassador Zoellick:

Pursuant to Section 2104 (e) of the Trade Act of 2002 and Section 135 (e) of the Trade Act of 1974, as amended, I am pleased to transmit the report of the Industry Sector Advisory Committee on Wholesaling and Retailing for Trade Policy Matters (ISAC 17) on the U.S. Central America Free Trade Agreement (CAFTA), reflecting consensus advisory opinions on the proposed Agreement.

Sincerely,

Francis X. Kelly
Chair
ISAC 17

The U.S.-Central America Free Trade Agreement (CAFTA)

Report of the
Industry Sector Advisory Committee on Wholesaling and Retailing for Trade Policy Matters (ISAC 17)

March 2004

March 19, 2004

Industry Sector Advisory Committee on Wholesaling and Retailing for Trade Policy Matters (ISAC 17)

Advisory Committee Report to the President, the Congress and the United States Trade Representative on the U.S.-Central America Free Trade Agreement

Pursuant to Section 2104 (e) of the Trade Act of 2002 and Section 135 (e) of the Trade Act of 1974, as amended, the Industry Sector Advisory Committee on Wholesaling and Retailing for Trade Policy Matters (ISAC 17) submits the following report on the substance of the U.S.-Central America Free Trade Agreement (CAFTA).

V. Advisory Committee Opinion on Agreement

The members of ISAC 17 have supported previous FTAs, and have voiced strong support for a commercially-viable CAFTA. Among other things, the Agreement will disciplines the use of dealer protection regimes, eliminating thereby significant barriers to distribution in the region. Subject to the issues and concerns discussed below, it is the committee's consensus that the CAFTA will, on balance, promote the economic interests of the United States, largely achieve the applicable overall and principle negotiating objectives, and provide for general equity and reciprocity within the distribution services.

Distribution Services: Dealer Protection Regimes

For the first time ever in a trade agreement, this Agreement addresses restrictions on distribution in Central America created through restrictive dealer protection regimes. Such regimes have placed substantial burdens on the distribution of U.S. exports to the region by locking U.S. companies into inefficient, exclusive and effectively permanent relationships, oftentimes regardless of the performance of the local dealer. The Agreement addresses these issues in each of the countries where dealer distribution issues arose - Costa Rica, El Salvador, Guatemala and Honduras. In general, the Agreement requires these countries to allow the parties to a dealer distribution agreement to terminate such agreements at the end of the contract period or renewal period without indemnification. The Agreement also provides for the calculation of actual damages based on general contract law in the case of an early termination of such an agreement (rather than a statutory formula that bore little relation to the commercial relationship), that exclusivity may only be required if written into the contract, and that arbitration should be a preferred method to resolve disputes. The Committee welcomes the innovative approach to dealer protection regimes adopted in this Agreement and believes that these provisions will

substantially help promote more efficient and improved distribution for U.S. companies within the region.

Textile and Apparel Rules of Origin

In past comments on preferential rules of origin for textile and apparel products, ISAC 17 has argued for flexible, commercially-viable rules that reflect the realities of global production and sourcing and actually promote new trade and investment. In the view of ISAC 17, the U.S.-Israel FTA rule of origin for textiles and apparel (substantial transformation), the U.S.-Jordan FTA rules of origin for apparel (Breaux-Cardin), and the pre-Breaux-Cardin rules of origin for textiles meet these criteria and have been advanced as models during various FTA negotiations, including those with the five Central American countries. The argument for adopting these rules of origin is made more compelling by the fact that they are consistent with the rules governing origin for other manufactured products – i.e., origin is determined according to the most significant production processes performed in an FTA partner country.

Achieving a CAFTA with flexible, commercially-viable rules governing textile and apparel trade is especially critical for the CAFTA countries, including the United States, for several reasons. First, the economic development of several of the countries in the region is highly dependent on building strong textile and apparel sectors, which, in the case of Honduras, accounts for nearly half of their total exports. Second, the CAFTA region figures importantly into the production and sourcing strategies of U.S. apparel manufacturers and retailers, due to the close proximity of the region to the U.S. market and the need to find avoid over-reliance on Asian production. Third, the U.S. fiber and textile industries desperately need export markets to assure their future viability, and Central America has traditionally been a major purchaser of U.S. textile inputs for apparel production. Fourth, Central America could serve as the base upon which to build a Western Hemisphere production platform for textiles and apparel that could compete with manufacturers in Asia.

However, these opportunities can only be realized if the agreement contains sufficient incentives for U.S. apparel and retail industries – the customers of U.S. textile manufacturers – to expand trade and investment in apparel within the CAFTA region. In addition, two counter trends are fundamentally reshaping the competitive landscape in the textile and apparel sectors, which, absent a commercially-viable CAFTA, threaten to undermine the future competitiveness of the region. The first is the end of the global system of textile and apparel quotas on January 1, 2005. Once quotas end and the cost of quota is no longer a factor in production and sourcing decisions, the most competitive producers in Asia will see a substantial cut in their costs.

The second event is a fundamental change over the past decade in the way apparel is manufactured, from the old "cut-and-sew" model to so-called "full package" production. Under this system, those apparel producers who have access to the widest range of yarns and fabrics will be the most competitive. Again, this situation favors manufacturers in Asia over those in Central America who have found themselves bound to the cut-and-sew

model and over-reliant on high-priced U.S. yarn and fabric as a result of the inflexible rules of origin under the Caribbean Basin Initiative and the Caribbean Basin Trade Partnership Act. The compliance costs created by these programs often negate the duty preference and have made it more difficult for Central American producers to compete effectively against Asian manufacturers.

It was with the aim of addressing these challenges, that ISAC 17 recommended avoiding the NAFTA approach, and instead adopting flexible rules of origin along the lines of the Israel FTA or the Jordan FTA. Notwithstanding our recommendations, U.S. negotiators insisted on inclusion of a so-called "yarn-forward rule" in the CAFTA, which determines origin according to where the inputs used to make the final product are produced. Under a strict application of this rule, as advocated by segments of the U.S. textile industry, only apparel made from yarn and fabric originating in the five Central American countries or the United States could qualify for duty-free treatment.

As a general principle, ISAC 17 is concerned that a yarn-forward rule has several negative consequences. First, it creates the anomalous situation where the effective amount of value added processing necessary for qualifying apparel is substantially higher than for all other products – in the range of 80 to 90 percent. Second, since the five Central American countries have limited yarn and fabric production, this rule would continue to keep them overly dependent on U.S. yarn and fabric in the production of qualifying apparel and would prevent them from developing an integrated industry necessary for full-package production. Third, a yarn forward rule of origin does not provide sufficient flexibility to allow access to the range of yarns and fabrics necessary to maintain a strong apparel sewing base in Central America. All these issues are central to the continued viability of the apparel industry in Central America in the post-quota world.

This conclusion is substantiated by a survey of major apparel retailers conducted by the National Retail Federation. It was the unanimous view of survey respondents that a yarn forward rule of origin is not cost effective and, results in a net increase in the cost of apparel production, even when the savings from the elimination of tariffs and quota charges are factored in. All retailers participating in the survey further reported that yarn forward rules of origin have affected their sourcing operations by accelerating the shift in apparel trade away from preferential trading partner countries, such as Mexico, that are subject to this rule to certain large Asian suppliers, notably China. Segments of the U.S. textile industry have strongly advocated a yarn-forward rule of origin in FTAs as necessary to protect domestic yarn and fabric production from Chinese competition. However, experience in Mexico and elsewhere shows that such a rule has the opposite effect and has resulted in an accelerated shift of apparel sourcing to China and other Asian producers.

In order to ameliorate the inherent deficiencies of the yarn forward rule of origin under current production models, provide sufficient incentives to retain at least the current level of trade, and help generate new trade and investment, ISAC 17 argued that the textile and apparel rules under the CAFTA should provide for additional flexibility to permit apparel manufacturers in Central America to use a wider selection of competitive yarns and fabrics. ISAC 17 argued that these flexibilities could be achieved through: (1) a

cumulation provision allowing for the use of inputs from other FTA partner countries; (2) revised short supply procedures; (3) a list of products deemed in short supply; and (4) workable tariff preference levels (TPLs).

The members of ISAC 17 are pleased that the U.S. and Central American negotiators recognized the validity of these arguments and included provisions in the CAFTA that incorporate all these elements into the agreement. In addition, the agreement provides for a range of other exceptions to the yarn-forward rule that, in our view, are very positive:

- Retaining the essential character concept from NAFTA;
- A single transformation rule for brassieres, boxer shorts, pajamas, nightwear, textile luggage, and umbrella fabric;
- Increasing the de minimis rule from 7 percent to 10 percent;
- Expanding the current 807 program to allow cutting in Central America, with duty assessed on only on the value added in Central America; and
- Listing in the agreement 43 products deemed to be in short supply, including those currently subject to AGOA, ATPDEA, CBTPA, NAFTA short supply and 401 items and a few additional products.

In addition, ISAC 17 is also pleased that qualifying textile and apparel products would be afforded immediate duty free treatment under the CAFTA, which would be retroactive to January 1, 2004. This provision is particularly important in providing assurances to U.S. textile and apparel manufacturers and retailers that they will receive benefits under the agreement as of a date certain even if there is a delay in Congressional consideration of the agreement. This element is especially important as retailers prepare to make their sourcing decisions for the end of 2004 and the beginning of 2005.

Notwithstanding these positive elements in the CAFTA, ISAC 17 is concerned that the provisions on cumulation, short supply, and TPLs are so restricted as to be of marginal benefit. Cumulation is limited in application only to Mexico and Canada, in scope only to wovens, and in quantity. As a result, the cumulation provision could benefit a limited set of producers and retailers of some apparel products, such as denim jeans, but would provide little benefit to producers and retailers of many other types of apparel.

ISAC 17 had advised that cumulation is necessary in order for U.S. companies to realize economies of scale and take full advantage of the U.S. preferential trade regime. With respect to the CAFTA, cumulation would be the first step in building a regional textile and apparel production capability. Accordingly, it makes no sense to limit cumulation to the extent it was done in this agreement.

Similarly, there appears to have been limited progress in making needed reforms to the procedures for adding and subtracting products from the short supply list. Therefore, there continues to be concern that the short supply process under CAFTA will prove to be largely unworkable especially if based on a so-called “order” approach as advocated by certain segments of the U.S. textile industry.

With the limited advances on cumulation and short supply, the need for workable TPLs was even more compelling. Therefore, we are also disappointed that further consideration was not given to TPLs beyond that provided to Nicaragua. Although we would expect to see an increase in trade with Nicaragua as a result of its fairly generous TPL, that trade may come at the expense of other regional producers and will eventually contract as the TPL is phased out.

On balance, it is uncertain, whether this agreement contains sufficient incentives to build a strong apparel sector serviced by regional textile production. If those incentives prove to be insufficient, trade will ultimately shift away from the region to Asia. This result will have an obvious adverse impact, not only on the economies of the region, but also on U.S. exports of various inputs – fiber, yarn, and fabric – used in apparel production.

Footwear Rules of Origin

ISAC 17 strongly supports the CAFTA provisions on market access for footwear and appreciates the efforts of negotiators to resolve a problem in the rules of origin for footwear that threatened to diminish substantially the economic benefits of the agreement in this sector. Specifically, in the agreement with the five Central American countries, Guatemalan negotiators had insisted on a tariff-shift rule of origin for footwear that would have operated at the six-digit, rather than eight-digit level, not to protect sensitive sectors, but rather for ease of administration.

With imports now accounting for over 95 percent of all footwear sold in the United States, there is a solid consensus in all segments of footwear manufacturing and retailing for complete and immediate duty-free treatment for all footwear under the CAFTA with the exception of 17 specified tariff lines of import-sensitive products, which would be subject to long duty-phaseout schedules. As a result of the Guatemalan position, however, the agreement would have effectively removed over 30 tariff lines from duty-free treatment and would have retained tariffs on footwear products that are not produced in the United States.

Fortunately, the Guatemalans modified their position and the provision was able to be amended during the negotiations to dock the Dominican Republic into the CAFTA. As a result, the ability to build trade and investment in the footwear sector in Central America has been substantially enhanced. The agreement will now support the diversification strategies of many retailers away from over-dependence on Asian production, provide substantial benefits to U.S. consumers, and pose no risk to U.S. footwear production.

Duty Drawback

Finally, ISAC 17 would strongly supports the retention in the CAFTA of duty drawback for textiles, apparel, and other products. The members of ISAC 17 believe that elimination of duty drawback may be appropriate among countries with a common

external tariff, but that it serves to undermine trade and investment objectives in free trade agreements. Accordingly, we would encourage the retention of duty drawback in future FTAs as well.

Sincerely,

Francis X. Kelly
Chair