Memorandum for the Secretary of Commerce and the United States Trade Representative

From the Industry Trade Advisory Committee on Distribution Services (ITAC 5)

July 14, 2004

Regarding the Proposed Free Trade Agreement with the Kingdom of Bahrain

The members of ITAC 5 and its predecessor committee, ISAC 17, have supported previous FTAs. While it is the view of this committee that the economic benefits to the U.S. economy of a free trade agreement between the United States and Bahrain are likely to be modest, it is the committee's consensus that in broad terms agreement with Bahrain 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 sector. However, when we examine certain details of this agreement, the Committee believes the Bahrain FTA falls well short of the mark. Specifically, like other FTAs before it, the Bahrain FTA contains serious deficiencies that will result in little benefit for trade in certain consumer products, in particular textiles and apparel, which are sold at retail in the United States.

With a rank 48th among apparel exporters to the United States, Bahrain is not a major supplier of clothing to the U.S. market. Nonetheless, Bahrain did export $163.7 million of apparel to the United States in 2003 – a not insignificant sum for a small country. The Bahrain FTA could have provided additional opportunities for trade and investment in this sector and allow Bahraini producers to enhance their competitive position for the post-quota world of January 1, 2005.

In past comments on preferential rules of origin for textile and apparel products, ISAC 17, the predecessor committee to ITAC 5, argued for flexible, commercially-viable rules that reflect the realities of global production and sourcing, actually promote new trade and investment, and provide genuine benefits to American consumers. We have suggested that 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 should serve as the model for all FTA negotiations, including with Bahrain. The argument for these rules of origin is more compelling in 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.

As with previous FTAs, the Bahrain FTA contains rules of origin that do not meet the objectives enumerated above. The agreement with Bahrain has incorporated the so-called "yarn forward" rule of origin for textiles and apparel, which determines origin according to where the inputs used to make the final product are produced. Under this rule, only apparel made from yarn and fabric originating in Bahrain or the United States can qualify for duty-free treatment. This rule 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. Since Bahrain has no yarn or fabric production, this rule essentially requires the use of U.S. yarn and fabric in the production of qualifying apparel. The net result is that the yarn forward rule in this FTA will retard, rather than promote textile and apparel trade.

As noted in other comments by the predecessor to this committee, a survey of major apparel retailers conducted by the National Retail Federation confirms the deficiencies of the yarn forward rule of origin. It was the unanimous view of survey respondents that a yarn forward rule 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. Although 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, experience shows that such a rule has the opposite effect and has resulted in an accelerated shift of apparel sourcing to China.

To complicate matters further, the committee believes the Bahrain FTA provides insufficient additional flexibility to use non-originating inputs. Such flexibility is essential, as apparel manufacturing has evolved from the old "cut-and-sew" model to the so-called "full package" production. Due to these significant changes in production, those producers who have access to the widest range of yarns and fabrics will be the most competitive. Some additional flexibility can be achieved through a cumulation provision for inputs from other FTA partner countries, revised short supply procedures, a list of products deemed in short supply, or workable tariff preference levels (TPLs), that might ameliorate the inherent deficiencies of the yarn forward rule of origin under current production models, provide sufficient incentives to protect current levels of trade, and perhaps generate new trade and investment.

The agreement with Bahrain does include a tariff preference level (TPL) of 65 million square meter equivalents that provides benefits under the FTA for 10 year to products made from third country yarn and fabric. The committee acknowledges that this TPL will provide some additional flexibility. However, with textile and apparel exports from Bahrain to the United States totaling nearly 75 million square meter equivalents (SMEs) in 2003, this TPL allows for no real growth in trade and investment. Moreover, with elimination of the TPL after 10 years, without additional flexibilities, the committee believes that there will be little interest among American apparel retailers to take advantage of the preferences under the agreement. In particular, with FTAs currently in place or planned for other countries in the Middle East, the ability to cumulate inputs from other FTA partner countries would have been a valuable addition to the Bahrain FTA and would be a major stepping stone toward the creation of a Middle East Free Trade Agreement. In comments on other FTAs, this committee has 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. Without cumulation, opportunities for retailers to source from Bahrain under this agreement will be significantly diminished and U.S. trade policy goals for the Middle East as a whole are compromised.

The Bahrain FTA also fails to address recognized deficiencies in the system under which yarns and fabrics that are unavailable in commercial quantities may be used in qualifying apparel production. Unlike the U.S.-Central American FTA (CAFTA), there is no list of products deemed to be in short supply. Also, the committee urges clarification regarding how affirmative

short supply determinations under other FTA or preferential trade regimes would apply to the Bahrain FTA. In our view, it makes little sense for U.S. companies and government bodies to jump through the hoop of a separate administrative short supply procedure under the Bahrain FTA with respect to products already confirmed to be in short supply under other FTAs or preference programs.

The Bahrain FTA also contains a de minimis rule for the use of some foreign yarns of up to 7 percent of total weight of the component. However, the CAFTA contains a more generous 10 percent de minimis rule. There is no reason why the Bahrain FTA should contain a more restrictive rule than under the CAFTA.

ITAC 5 is also concerned that, in this and other FTA negotiations, U.S. negotiators have focused too much on simply ensuring that existing trade levels for textiles and apparel are maintained, rather than trying to fashion an agreement that will promote trade and investment and allow our FTA partners to build more viable textile and apparel industries. Besides the disturbing mercantilist philosophy underpinning this approach, the curious aspect of this strategy is that it ends up subjecting existing trade to more onerous compliance requirements in order to claim duty free treatment. However, as pointed out above, the costs of compliance in these situations are often greater than the duty-free benefit, with a net result of a decline in trade.

That said, ITAC 5 acknowledges that most qualifying textile and apparel products from Bahrain will be duty free upon implementation of the agreement. One additional positive note in the Bahrain FTA that ITAC 5 would like to recognize is the retention of duty drawback for textile and apparel products. The members of ITAC 5 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.

In sum, it is disturbing to this committee that the United States has continued to insist on overly restrictive rules on textiles and apparel even for countries, such as Bahrain, which is a comparatively small supplier to the United States. Such restrictions are usually employed to protect vulnerable domestic industries from significant import competition. It is evident that Bahrain poses no threat whatsoever to domestic textile manufacturers and restrictive rules of origin are unwarranted. Indeed, by insisting upon such restrictions, the U.S. textile industry has ensured that it will see little or no economic benefit from our system of FTAs. If the rules of origin act to stifle trade in textiles and apparel, another group that will see few benefits from our system of FTAs is American consumers.

We have no additional comments on matters relating to distribution services within the Kingdom but do ask that the negotiators are vigilant in defending the interests of retailers, direct sellers and others who would operate distribution services businesses within the Kingdom

Respectfully submitted,
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Chair