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March 12, 2004

LIZ CLAIBORNE INC

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. Australia Free Trade Agreement (Australia FTA), reflecting consensus advisory opinions on the proposed Agreement.

Sincerely,

Francis X. Kelly
Chair
ISAC 17

The U.S.-Australia Free Trade Agreement (FTA)

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

March 2004

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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.-Australia 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.-Australia Free Trade Agreement (Australia FTA).

V. Advisory Committee Opinion on Agreement

The members of ISAC 17 have supported previous FTAs and it is the committee's consensus that the Australia FTA 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. Nonetheless, the committee wishes to voice serious concerns over certain aspects of this agreement that the committee members believe are major deficiencies and, therefore, should not serve as a model approach or precedent for future agreements.

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, actually promote new trade and investment, and provide genuine benefits to American consumers. 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 Australia. 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.

Unfortunately, the Australia FTA contains rules of origin and lengthy duty-phaseout schedules for textiles and apparel that do not meet these objectives and represent the most restrictive preferential trade agreement yet negotiated for these products. First, the Australia FTA 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 Australia or the United States can qualify for duty-free treatment. This rule has two immediate 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 Australia has no significant yarn or fabric production and imports most of its inputs from nearby producers in Southeast Asia, this rule essentially requires the use of U.S. yarn and fabric in the production of qualifying apparel. It is simply uneconomic to ship high-cost U.S. yarn and fabric halfway around the world to Australia to be made into apparel for export back to the United States. The net result is that the yarn forward rule will retard, rather than promote textile and apparel trade under this FTA.

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. 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 Australia FTA provides for no additional flexibility to use non-originating inputs as was done in NAFTA, and the FTAs with Central America, Singapore, and Chile. As apparel manufacturing has moved from the old "cut-and-sew" model to the so-called "full package" 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 retain at least the current level of trade, perhaps generate new trade and investment.

Indeed, as the U.S. commences negotiations on an FTA with Thailand, a major supplier of yarn and fabric to the Australian apparel industry, the ability to cumulate inputs from other FTA partner countries would have been a valuable addition to the Australia FTA. ISAC 17 has also 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 or any of the other added flexibilities, U.S. retailers have no additional incentive to source garments from Australia. As a result, Australian and American manufacturers will see no new opportunities under this agreement and there will likely be significant erosion in current trade levels.

To the extent that U.S. negotiators have shown any flexibility beyond the rigid yarn forward rule of origin in this and other FTA negotiations, the focus has been on ensuring that existing

trade levels can be maintained. Besides the disturbing mercantilist philosophy underpinning this approach, the curious aspect of this strategy is that it subjects existing trade to more onerous compliance requirements in order to claim duty free treatment. However, as pointed out above, the costs of compliance are often greater than the duty-free benefit, resulting in a decline in trade. This argument may be moot, however, as the Australia FTA does not even protect existing apparel trade between the U.S. and Australia. By some accounts, the rules of origin would exclude approximately 70 percent of existing trade.

ISAC 17 is also concerned about the overly long duty phaseouts scheduled for most textile and apparel products under the Australia FTA. Many products will not be duty free for 10 or 15 years. With the global quota system ending in less than a year, combined with the restrictive rules of origin under this agreement, we anticipate that apparel production in Australia will quickly migrate to Asia. Again, this outcome means that the Australia FTA will afford no business opportunities for Australian apparel manufacturers, U.S. apparel retailers, or U.S. apparel and textile manufacturers.

In sum, it is disturbing to this committee that the most restrictive rules on textiles and apparel should be applied against a country, such as Australia, which is not a major supplier to the United States. Such restrictions are usually employed to protect vulnerable domestic industries from significant import competition. Australia is not a significant supplier of textiles and apparel to the U.S. market and poses no threat whatsoever to domestic textile manufacturers. As such, there is simply no justification for such restrictive provisions as have been negotiated in this agreement. Indeed, by insisting upon such restrictions, the U.S. textile industry has ensured that it will see no economic benefit from this agreement. Another group that will see no benefit from the textile and apparel rules under this agreement is American consumers who must continue to pay substantial hidden taxes in the clothing they purchase from Australia as a result of high import duties that will be in place for another 10 to 15 years.

One positive note in the Australia FTA that ISAC 17 would like to recognize is the retention of duty drawback for textile and apparel 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.

Market Access for Sugar

Finally, ISAC 17 wishes to voice its serious concern over the exclusion of sugar from further trade liberalization under the Australia FTA. This result continues a policy of subsidizing the U.S. sugar industry, one of the most protected sectors in the U.S. economy, through restrictive quotas and high tariffs at the expense of U.S. consumers and manufacturers that use sugar products. Indeed, the high cost of maintaining barriers in the U.S. to imported sugar, largely equals the estimated economic gains that the U.S. would otherwise expect to realize from the Australia FTA.

More disturbingly, however, the decision on sugar represents the first time in the history of such negotiations, that the United States has insisted on the complete exclusion of a particular

sector from a free trade agreement. The unfortunate precedent that this result sets will make it more difficult for U.S. negotiators to resist political pressure from other import sensitive sectors, such as textiles, to be excluded in future trade negotiations. By elevating the interests of protected sectors in this manner, the ability for our negotiators to achieve high levels of market access for U.S. exporters is seriously compromised.

Sincerely,

Francis X. Kelly
Chair