Trade Disputes in an Unsettled Industry: Mexican Sugar

One of the outstanding trade disputes between Mexico and the United States revolves around the market for sweeteners. This, of course, should come as no surprise since around the world sugar is a highly politicized crop. In the Mexican - U.S. case the dispute moves beyond sugar involving high fructose corn syrup (HFCS) and is wrapped in the last minute wheeling and dealing to get the North American Free Trade Agreement (NAFTA) approved by the U.S. Congress. It also brings into the dispute corn policies, which are important to both countries.

In an attempt to put the trade dispute in perspective, this paper will focus on the Mexican sugar industry. Two distinct groups, growers and mill owners characterize the industry. Historical circumstances and legal issues have separated these two over time preventing the development of an integrated sugar sector. In fact, the relationship between these two groups can be characterized as, at best, antagonistic. At the same time, the industry has been characterized by a series policies and direct government intervention that left the industry in a state of confusion and disarray.

The first section of this paper will review the history of the sugar industry through the first years of the NAFTA. The second part of the paper will look at the NAFTA agreement and the subsequent disagreements regarding both the sugar quota and HFCS dumping demand. The final section of the paper will look at recent events in the Mexican market, including the expropriation of approximately half of the production capacity and the tax on the use of HFCS in soft drinks.

A troubled background

To understand the industry, its politics and the trade disputes, it is important to recognize its importance both economically and socially within Mexico. Sugar production in Mexico is mostly destined for domestic consumption as opposed to other countries that rely on the international market. Mexico has consumed on average more than 85% of its production domestically. Important Mexican industries, such as the soft drink industry, strongly rely on Mexican sugar production. The Mexican Sugar Industry generates 0.7% of Mexico's GDP, and some 400,000 direct jobs (in the fields), and 700,000 indirect jobs, affecting between 4 and 5 million people in Mexico. Therefore, the government has a strong commitment towards this industry for social and political reasons. This commitment has manifested itself through a series of polices that have attempted to regulate the market and protect cane producers and mill workers. At times this has led to direct management and expropriation of the sugar mill.

Private management and government intervention: Prior to 1970 Mexico's sugar mills were essential in private hands. Production had been growing at rates even above that of the population. In part production was a response to favorable prices and U.S. sugar policy. Sugar production was stimulated during World War II by high prices and again in the early 1960's after the U.S. canceled Cuba's sugar quota and distributed it among a number of sugar producing nations, including Mexico.

The fact that the sugar mills were in private hands did not mean that the government had left the sugar industry to the forces of the market. Going back as far as the 1930's the government, in conjunction with the private sector attempted to regulate the domestic sugar market through the *Comisión Estabilizadora del Mercado de Azucar*. In 1943 *Financiera Industrial Azucarera*, S.A. was created to finance the sugar industry. This became the *Financiera Nacional Azucarera* (FINASA) in 1953 and in 1966 the Federal Government formally took control of FINASA in order to assure that financing reached the industry at preferential rates.

The government's control over the industry even extended to farmers. In 1944 the government issued a decree (Sugar Cane Growers Decree) which required farms, whether they be *ejido* or private farms which operated within the sugar mills areas of influence to exclusively produce sugar cane, and required that the mills buy the sugar cane. As a result the area dedicated to sugar production practically tripled.

Although government programs impacted on the sugar industry at several levels, essentially the policy objective was to a stable supply of sugar to consumers at affordable prices. In practical terms this meant price controls at the consumer level while letting prices rise at the producer level to stimulate sugar cane production.

The government takes over the mills: Being squeezed at both ends the sugar mills bordered on bankruptcy. The government's answer to this impending crisis was to rescue the troubled mills, taking over the control through the *Operadora Nacional de Ingenios* (ONISA). In 1971 when ONISA was formed the government had control of 19 mills. By the end of the decade they controlled 49 of the 66 mills in the country.

To coordinate sugar policy the government, in 1970, set up the *Comisión Nacional de la Industria Azucarera* (CNIA). Eventually CNIA took over ONISA's functions.

Between 1970 and 1989, when the mills were under government administration, sugar production grew from 2.2 million MT in 1970 to 3.49 million MT in 1989. Most of this growth came from bringing new land under cultivation. During that period sugar cane area grew by 35% while average yields increased by only 7.7%.

At same time the number of sugar cane growers grew by 56%. The disproportionate relationship between the growth in the number of producers and sugar cane area contributed to the contraction in the average size holding to only 4.1 hectares. In other words, sugar cane production is characterized by a predominance of *minifundios*. For example, in 1990, only 5% of the sugar cane area was harvested mechanically[1].

Sugar mills did not fare much better under government control. The number of workers grew by 37%. Plant productivity increased by only 5%.

Sugar consumption, helped by falling real prices, grew by 103%. By the 1980's Mexico had gone from being a net exporter to being a net importer of sugar.

What kept the industry afloat during those years were growing subsidies. Garcia Chavez calculates that between 1983 and 1990 government transfers to the sugar industry reached some 933.9 billion pesos. In fact, in 1988 subsidies to the sugar industry represented a quarter of the Secretary of Agriculture's total budget.

The government sells the mills: During the de la Madrid Administration Mexican economy policy moved away for direct state control and intervention in the economy towards one taking more of a market orientation. Among the sectors marked for a reduction in the government's participation was the sugar sector.

Initially, the government had intended to only reduce its participation in the industry from around 75% to 50%. However, the recurrent economic crises and budgetary limitations the government decided to withdraw completely from running sugar mills.

Selling the government's participation in the sugar mills was easier said than done. Potential buyers were aware of the problems inherent in the acquisition of the sugar mills: 1) low levels of investment in

[1] The low level of mechanization was also related to reluctance on the part of the government to stimulate mechanical harvesting since it was seen as a labor displacing technology.

technology; 2) difficult labor situations in the mills; 3) organizational problems with sugar cane producers; and 4) high dependence on government subsidies.

In response to the difficulties the government designed schemes for purchasing the mills what allowed for buyers to put up only 20% of the purchase price at the time of sale, with concessions on the terms of the remaining 80%. In other words the mills were privatized in highly leveraged operations.

Even with these terms one could question the feasibility of business venture. It should be remembered that at that time imports of sugar were tightly controlled. There was the implicit understanding that imports would remain under tight controls in order to maintain domestic sugar prices. This was not to be. Between 1989 and 1991 grew exponentially reaching over one million metric tons.

Between 1990 and 1992, according to the National Sugar Chamber (*Cámara Nacional de la Industrial Azucarera y Alcoholera*) net losses for milling industry reached 1.77 billion pesos. In 1991 the debt of the privatized mills was restructured. In 1993 the government had to extend credit to the mills on the order of 900 million pesos in order to liquidate the debt that they had with sugar cane growers.

As would be expected with the growing financial difficulties a number of mills changed hands after the privatization. This resulted in an increased concentration in the industry. At the same time a number of companies initiated programs to restructure production processes. As a result area planted in sugar cane grew while at the same time yields (tons of sugar cane per hectare) also increased. At the same time the yields in the mills also improved (tons of sugar per tons of cane).

Coming into 1994 the outlook for the sugar industry was mixed. However, any thoughts of optimism disappeared at the end of the year. While much has been made of the economic crisis in terms of the devaluation of the peso and subsequent contraction of the economy, for the sugar industry the rise in interest rates proved most harmful. Average interest rates rose from 13.9% in 1994 to 48.6% in 1995. For the already highly leveraged mills this added debt burden was unsustainable. FINA had to carry the debts on their books. This reached over 12 billion dollars in 1996.

The Free Trade Agreement

Much has already been written about the North American Free Trade Agreement, including one prepared for the Sixth Agricultural and Food Policy Information Workshop. What stands out, however, is that out of what should be a straightforward agreement there should be so much disagreement over what was actually said and meant. In part, this may be due to the negotiating objectives of the different parties. For Mexican negotiators, the Free Trade Agreement was part of the policy of structural reform that characterized the Administration's economic policy. In fact, the NAFTA would guarantee the continuance of structural reform beyond the normal 6-year political cycle. For the U.S., and Canadian negotiators this was "one more" trade agreement. As such they tended to respond more to the interests of their clientele producers than did the Mexican negotiators.

Probably one of best examples of the differences in attitude is seen in the sugar negotiations. In essence, the original agreement was rewritten at the last moment in the form of two side letters that redefined the conditions for Mexico's duty free access to the U.S. market. The two main differences related to the formula for determining Mexico's status as a surplus producer and the quota size for duty free sugar.

In the original agreement Mexico was to be considered as a surplus producer if domestic sugar production exceeded domestic consumption of sugar for two consecutive years. As a surplus producer, Mexico would have the right to export all surplus production into the US market. The side letters introduced high fructose corn syrup (HFCP). Now to be considered as a surplus producer Mexico domestic sugar production had to be greater than domestic consumption of both sugar and HFCS.

It should be pointed out that in the side letter in English signed by the USTR it makes specific reference to the "consumption" of HFCS, while the Spanish version, signed by the Mexican Secretary of Commerce only says that HFCS will be used for calculating net surplus. This leaves open the possibility for domestic production of HFCS to be included along with domestic production of sugar.

Simultaneously, the quota for Mexico during years 7 – 14 of the Agreement the quota was raised from 150,000 MT to 250,000 MT[2]. While this seems to be rather straightforward, there have been differences on interpretation. Mexico understands that that gives them access to 250,000 MT, i.e. they can export duty free up to that level. The U.S. understands that that is the upside limit, however, Mexico does not automatically have access to the entire 250,000 MT. Mexico called for a NAFTA panel to challenge the U.S. interpretation and subsequent actions.

In light of the controversy that has ensued, it is interesting to reflect that in 1994 Mexico was a net importer of sugar and that imports of HFCS were minimal.

The side letters have been subject to much controversy in Mexico. In general the feeling in Mexico is that this gives the baby away with the bath water, and has left many doubting the commitment of the U.S. to free trade.

HFCS: The U.S. was investing heavily in HFCS production capacity. As *Kennedy and Petrolia* pointed out at the Sixth Agricultural and Food Policy Information Workshop, increases in consumption of HFCS in the U.S. lagged behind growth in production capacity (pp. 239-240). Mexico, which is the world's second largest consumer of soda pop, was the logical market for the excess capacity. Exports grew, displacing sugar. Finally in 1997 the National Sugar Chamber (*Cámara Nacional de la Industrial Azucarera y Alcoholera*) formally accused the U.S. industry of dumping HFCS in Mexico.

Following an investigation, the Mexican Commerce Secretariat (SECOFI) ruled in favor of the Mexican sugar producers, recognizing that not only had dumping occurred, but that it also harm Mexican sugar producers. As a result Mexico imposed countervailing duties on imports from the U.S. companies involved in exporting to Mexico.

The response from the U.S. said was to ask for both a NAFTA panel and a WTO dispute settlement panel. In all cases Mexico the panels have ruled against Mexico. In spite of the panel rulings Mexico has been able to put offer reversing the countervailing duties. And now, after what is supposed to be the final ruling, late last year Mexico entered into negotiations with the U.S. looking to solve both the differences on the interpretation of the side letters and the dumping resolution.

In a bungled attempt to resolve Mexican sugar producers' problems, the SECOFI requested the soft drink industry to limit its use of HFCS. Following the adverse reaction from the U.S. to the SECOFI press release on the "request" to the soft drink industry, SECOFI denied that this had taken place. Interestingly enough, a number of bottlers purchased sugar mills during the privatization process.

Following the dumping resolution imports of HFCS have slowed down, from 374,000 MT in 1999 to 283,000 MT last year. This, however, does not mean that the consumption of HFCS has contracted. Domestic production of HFCS has grown. In 2001, Mexican production of HFCS reached 350,000 MT. Only two companies are involved: Arancia Corn Products, which is a joint venture with CPI, produces 300,000 MT and Almidones Mexicanos, which is a joint venture between ADM and Tate&Lyle, produces the other 50,000 MT.

Production and Consumption of Sugar in Mexico

Mexico					
Period	**Production**	**Consumption**	**Surplus/Deficit**	**Consumption / Production**	**Exports / Production**
91/92	3,577	4,329	(752)	121%	-17%

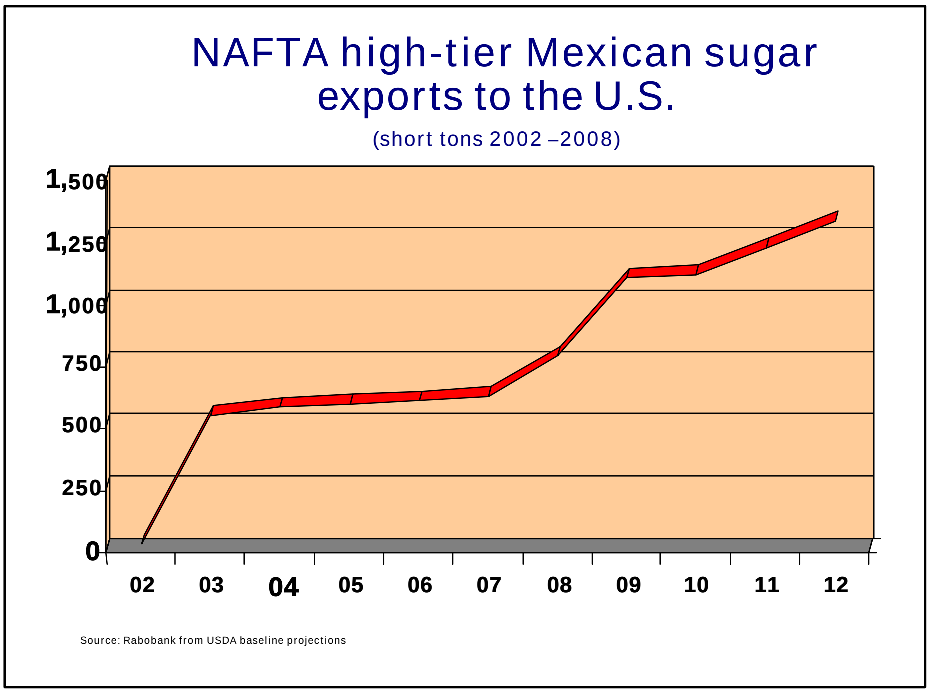
[2] The quota for years 1 through 7 remained unchanged.

92/93	4,431	4,459	(28)	101%	-1%
93/94	4,010	4,404	(394)	110%	-9%
94/95	4,650	4,397	253	95%	6%
95/96	4,685	4,443	242	95%	5%
96/97	4,822	4,100	722	85%	18%
97/98	5,490	4,179	1,311	76%	31%
98/99	5,147	4,160	987	81%	24%
99/00	4,696	4,195	501	89%	12%
00/01*	4,912	4,300	612	88%	14%

* Preliminary results

High-tier tariffs: While much of the attention and tension has focused on the dispute surround the duty free tariffs (also known as the "low-tier Tariffs"), the NAFTA also put into place a declining tariff schedule for sugar.[3] "For calendar year 2002 the raw sugar tariff is 9.07 cents a pound and the refined sugar tariff is 9.61 cents a pound. The raw sugar tariff drops around 1.5 cents each, and the refined sugar tariff drops about 1.6 cents a year. Both rates reach zero in 2008."[4]

The combination of low world sugar prices and the falling high-tier tariff rates would suggest that Mexico would eventually find it profitable to redirect its sugar exports from the world market into the high-tier U.S. market. USDA baseline data projections show a jump in Mexican exports to the U.S. in 2003 taking advantage of the falling tariff rates.



WTO commitment[5]*:* The U.S., during the Uruguay Round, committed to importing a minimum 1.256 million tons of raw and refined sugar, raw value (STRV). Of this amount at least 24,251 STRV has to be

[3] Besides sugar the NAFTA also incorporated a number of declining tariff schedules for over-tariff exports, including those for U.S. shipments of corn, and poultry, among others, into Mexico.
[4] USDA, *USDA Baseline Projections*, February 2002, p.45.
[5] This section is based on *USDA Baseline Projections*, February 2002, p.45.

refined sugar. This commitment was rolled over into the World Trade Organization when it replaced the GATT.

Mexico's duty free exports of sugar to the United States have been included in the U.S.'s WTO commitment. As indicated above, the quota assigned to Mexico has been a source of trade friction. Into the future as Mexico's exports to the U.S. grow, they will take an increasingly larger share of the WTO quota. Once the U.S. market for Mexican sugar opens completely under the NAFTA, the USDA baseline projections have exports growing to the point where in 2011 they will equal the entire WTO quota commitment.

Recent events

The Mexican government was and is still very much involved in attempting to regulate the sugar market, since many of the sugar mills continued to face serious financial problems, even with the countervailing duties on HFCS.

Mexican sugar producers face a number of structural inefficiencies. Of these, two are directly related to the legal structure that applies specifically to the sugar industry:

> *Decreto Cañero* (Cane growers decree): The decree, as mentioned above guarantees the supply of sugar cane to the mills from the growers in their area of influence. While this assures a supply of sugar cane, at the same time it requires that the mills purchase all the sugar cane that is grown by the producers. This limits the mills ability to adjust purchasing to market conditions. The decree also sets forth a pricing formula for the sugar cane. One of the elements of the formula relates the price of sugar cane to the previous year's sugar prices. When sugar prices are rising this is favorable to millers since they pay last crop's prices (lower) to cane growers. Likewise, when sugar prices are falling the millers pay above market prices for sugar cane. Taken all together, the *Decreto Cañero* separates the sugar industry from the market.
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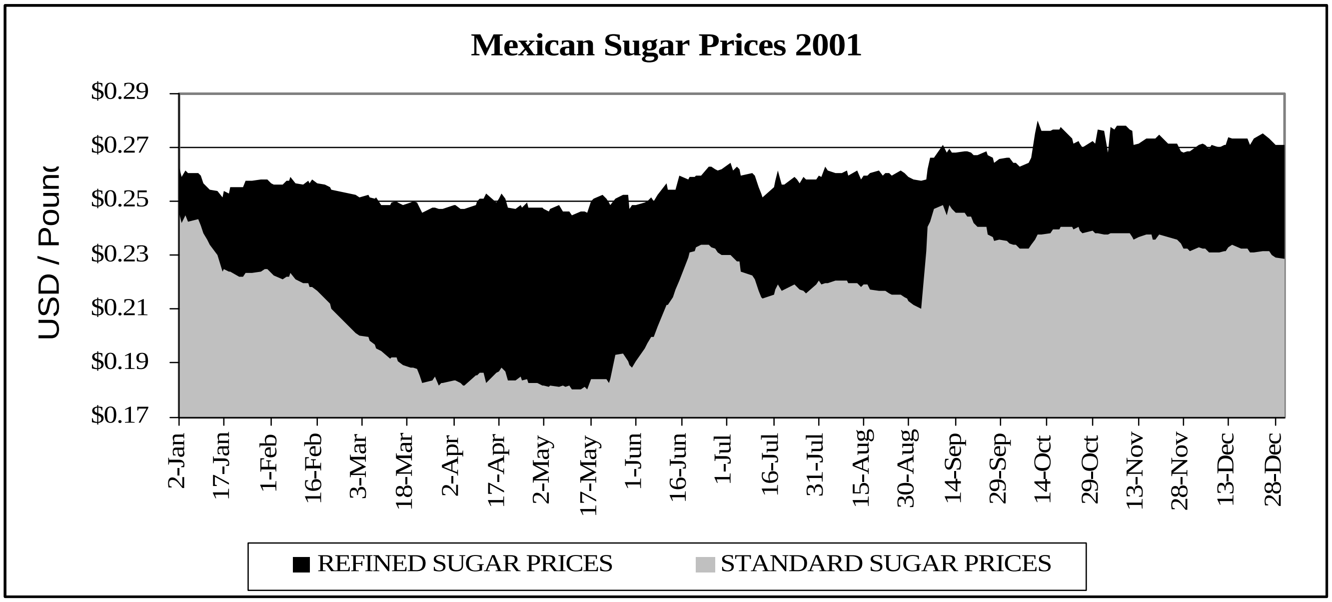
> *Contrato Ley* (Legal contract): Sugar mills legal obligations to their workers are more rigorous than those of other industries in Mexico. Dating back to when mills were located in relatively isolated areas, they were required to provide such services as housing, schooling, etc. for their workers and their families. Even now when the State is able to provide these services, and taxes companies for these purposes, yet the *Contrato Ley* obliges the mills to continue providing these services. Mill owners charge that when the mills were under government control the size of the labor force was padded, which after privatization has made the *Contrato Ley* burden even more onerous.

The government has looked to support the sugar industry by keeping domestic prices above world prices, by limiting the amount of sugar that is sold on the domestic market. To this, the government estimates the domestic demand and the sugar harvest. Based on this information, the government assigns the NAFTA duty free export quota among the mills and an export quota to the non-duty free NATFA market. The mills are required to comply with the government assigned export quotas. Essentially, therefore, Mexican sugar producers deal with three prices. The U.S. price, for the sugar exported under the NAFTA/sugar quota, the low world price, and the Mexican price.

Bankruptcy to expropriation: In spite of the government's attempts to support the domestic price the debt burden proved too much for many mills. In some cases, for example, they raided pension funds. In others, they delayed payment to cane growers. There have also been charges that some sugar that was suppose to be exported illegally found its way back into the Mexican market. This had the effect of depressing domestic prices, further exacerbating the worsening financial situation for some mills.



In May 2000, GAM, the second largest company in the industry filed for "suspension of payments", an equivalent to a Mexican Chapter 11. Although the company restructured and paid most of its short-term debt, it was unable to reach an agreement regarding its long term debt.

Into 2001 the domestic market was in disarray. Due to the seasonal nature of sugar prices[6] mills usually obtain sugar inventory financing during the production period (from November to August), and repay the loans from August to December each year. In 2001, however, after years of difficulties companies such as Escorpion (CAZE), Santos, Machado, and GAM were negatively affected by their lack of short term inventory financing. This inability to monetize inventories provoked the accelerated sales of sugar in order to obtain funds to cover operating expenses (mainly payments to cane growers). As a result, in May 2001 standard sugar prices reached its lowest level in the previous three years. Extremely low prices were affecting profitability of the entire industry. Sugar cane growers demonstrated for payment closing SAGARPA's offices. The mill workers were threatening to go on strike. Looking for a way out of the immediate crises, the government implemented a program to finance inventories and pay the sugar cane growers. In the sort run, the crisis was diffused. With the inventory financing implemented by the government for distressed mills, standard sugar prices increased 28% between June and August. This measure was effective and assisted not only distressed mills, but also those mills with regular access to credit who were also impacted by low market prices.

With the new harvest just around the corner and no real solution in sight, on September 3, 2001, the government expropriated 27 out of the 61 mills in the country. These mills represent approximately 55% of the total sugar production. The mills belonged to four companies: GAM (6 mills), Escorpion (9 mills), Machado (4 mills), Santos (6 mills) and 2 independent mills. Machado kept three of their seven mills. For the other companies the expropriation represented their entire operations.

[6] Seasonal movements of sugar prices in Mexico are characterized by three different stages:

a) From January to May sugar prices drop as a result of excess supply on the market. This period corresponds to the main months of the sugar harvest.
b) From May to August sugar prices increase as the harvest winds down. This period when sugar producers usually would obtain financing for sugar inventories; therefore supply is lower than demand and prices increase.
c) From August to December, when mills usually undergo maintenance and there is no production, sugar prices increase. At the same time, demand grows at year's end.

Following the expropriation, with the expectation that the government would be able to enforce the domestic marketing quotas, sugar prices reacted upwards. This measure increased standard sugar prices by 10% in just one day and by 20% in the following 15 days. Since that date, prices have remained relatively stable, partly due to seasonal price effects and the government's ability – now that they control just over half of the country's sugar production -- to manage the amount of sugar on the domestic market.

Seeing that the regulation of the supply of sugar on the domestic market was an essential element to their sugar program, in February 2002 the government announced the creation of a sugar exporting company, owned jointly by the public and private sectors.

The government established a special agency to manage and eventually sell the mills. They have said that the mills will be privatized within 18 to 24 months. Most analysts see this timeframe as highly optimistic.

HFCS tax: As part of the reforms that the new Fox Administration tried to put into place as a fiscal reform package. Over the course of the year, the reform package got bogged down in Congress. As the year came to an end, the Administration and the Congress faced a deadline for the new budget. As part of the wheeling and dealing that characterized the final days of 2001 – with Congress flexing its muscle – a special tax on the use of HFCS for soft drinks was passed.

The tax initiative did not initiate with the Administration, rather it came from Congressmen related to the sugar growers union. They were apparently were dissatisfied with the Administration's apparent willingness to negotiate a settlement to the HFCS dumping case.

Interestingly enough, the reaction from the U.S. seems to blame the Administration for the special tax, accusing the government of going back on its word when they agreed to negotiations. Beside the pressure from the U.S. government, the Administration is also under pressure from the companies producing HFCS in Mexico.

Caught between a rock and a hard place, the Administration temporarily suspended the HFCS tax in March 2002. The temporary suspension runs through September 30, 2002. That is the end of the U.S. government's fiscal year. The timing most likely reflects a balancing act among the different interest groups, and the government's expectations to have reached an agreement the U.S. on the HFCS and sugar quota issues by that date.

Facing the future

It is clear that the recent expropriation gives the government a one-time opportunity to comprehensively restructure the sugar industry, including the level of inventories, price, the *Decreto cañero, Contrato Ley*, and industrial rationalization. However, part of the future of the sugar industry will also depend on the trade situation and negotiations under the NAFTA.

Within the Mexican sugar industry there are those who doubt that in 2008 the U.S. will allow for the free entry of Mexican sugar into their market.

For the U.S. to allow free and unlimited access of Mexican sugar two basic scenarios emerge:

Under the first scenario, the U.S. would abandon all together their sugar support program. Access to the U.S. market would stimulate Mexican production, the result of both Mexican and foreign investment. With Mexican sugar production more efficient than U.S. beet production, sugar from Mexico would be more attractive. Prices on the U.S. market, while still above world prices, would be depressed, driving beet producers out of the market. At one point in time U.S. policy makers would come to realize that the sugar program resulted in a transfer payment to Mexican producers. Once the U.S. abandons their sugar program they would be willing to open the market. This would drive down prices to world levels to the detriment of those Mexican sugar producers who are unable to compete at international price levels.

This scenario is not seen as highly probable. The political costs on both sides of the border would be high, and it is doubtful as to whether policy markers would be will to confront the social consequences.

More likely is the second scenario. As Mexican exports to the U.S. market grow, the U.S. adjusts its quota program to continue protecting the U.S. market. A basic assumption here is that the U.S. is willing to abandon the sugar quota as an instrument of foreign policy. What will emerge is a common North American sweetener market. HFCS will flow south and sugar will flow north. There are already companies who are considering investment strategies based on this scenario.

With the second scenario considered more probable, what happens over the next five years will determine where the market goes. With most of the attention, due obviously to the trade disputes, focused on the duty free exports, it is easy to forget that the NAFTA calls for over-the-quota tariffs on Mexican sugar. Estimates are that with the reduced tariffs this year, exports to the U.S. are near the breakeven point with exports to the world market. Next year the U.S. will become a more attractive alternative to the world market. This suggests that Mexican exports to the U.S. market will grow significantly over the next 5 years, and the over-the-quota tariff rate falls. This may push the U.S. to a policy decision even before 2008.

The spoilers: Looking ahead two issues stand out. The first is post-Castro Cuba. The obvious question is how will the U.S. treat Cuban sugar?

The second issue relates to the Free Trade of the Americas initiative. As this moves forward it is safe to assume that the negotiations will look to the NAFTA as a model. This would suggest that sometime into the future there will be a regional sweetener market. Right now, neither the Mexican nor the U.S. industries are competitive with those of other countries in the Americas region.

For the U.S. one could predict the end of domestic sugar production. For Mexico the longer it takes for the regional market to come about, the more time it will have to develop and restructure its industry. The real question is will Mexico take the hard decisions needed to turn its sugar industry into a world class competitive sugar producer?

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