

# Textile Industry versus Apparel Industry: The Case of Renegotiation of the North American Free Trade Agreement<sup>1</sup>

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## Abstract

In August 2017, the Trump administration announced to renegotiate the North American Free Trade Agreement (NAFTA). Although, the U.S. textile and apparel (T&A) industry is a critical stakeholder of the potential policy change to NAFTA, how to update the T&A specific rules of origin in the agreement has raised heated debate among different segments of the industry.

On the one hand, U.S. fashion brands and apparel retailers along with their counterparts in Canada are pushing hard for liberalizing the restrictive NAFTA T&A rules of origin commonly known as the “yarn-forward” to increase their flexibility in sourcing. On the other hand, U.S. textile manufacturers are firmly opposed to the idea of abandoning the “yarn-forward” rules of origin in NAFTA. Instead, they lobby strongly for eliminating the exceptions to the “yarn-forward” rule, such as the tariff preference level (TPL), to strengthen the NAFTA regional T&A production further.

Robert Lighthizer, US Trade Representative, had to weigh the arguments from both sides to make a careful decision. Robert knows that the outcomes of the NAFTA renegotiation, especially the rules of origin will shape the future landscape of the U.S. textile and apparel industry.

## Introduction

Since its coming into effect in 1994, the North American Free Trade Agreement (NAFTA), a trilateral trade deal between the United States, Mexico, and Canada, has raised heated debate regarding its impacts on the U.S. economy (Villarreal & Fergusson, 2018). Particularly, in the belief that NAFTA has affected the U.S. manufacturing sector negatively, the newly elected U.S. President Trump called the agreement “THE worst trade deal ever” and moved to renegotiate NAFTA in August 2017 (USTR, 2018a). As of June 2018, nine rounds of NAFTA renegotiations have taken place, which covered issues ranging from intellectual property right protection, market access for manufactured and agricultural goods to updating the rules of origin provisions (USTR, 2018b). However, because of the competing commercial interests of the three negotiating parties on these issues and the involvement of several sensitive political factors, such as the Mexican presidential election and the U.S. mid-term election in 2018, the NAFTA renegotiation has been moving slowly, with no sign of reaching an agreement anytime soon. Meanwhile, President Trump constantly threatens that he may seek to withdraw the United States from this 24-years old trade agreement should outcomes of the renegotiation fail to meet his expectation (Villarreal & Fergusson, 2018).

The U.S. textile and apparel (T&A) industry is a critical stakeholder of the NAFTA renegotiation (NCTO, 2017; AAFA, 2017a). Through a regional T&A supply chain facilitated by the agreement over the past 24 years, the NAFTA region has grown into the single largest export market for U.S. T&A products as well as a major apparel sourcing base

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for U.S. fashion brands and retailers (Lu, 2017). In 2017, as much as half of U.S. T&A exports went to the NAFTA region, totaling \$11.3 billion and U.S. apparel imports from Mexico and Canada exceeded \$4.97 billion (OTEXA, 2018).

Specifically for the T&A sector under the NAFTA renegotiation, trade negotiators have spent their time almost entirely on the issue of rules of origin (RoO). RoO is criteria used to determine the “nationality” of a product in international trade. When U.S. companies import T&A from Mexico or Canada, only products that meet the NAFTA RoO are eligible for the preferential tariff treatment under the agreement (Platzer, 2017).

Both the U.S. textile industry, which includes yarn and fabric mills and U.S. fashion brands and retailers support the NAFTA strongly. However, they split over on how to update the textile and apparel-specific RoO in the agreement. While listening to the competing arguments from both sides, Robert Lighthizer, the U.S. trade representative, who is responsible for the NAFTA renegotiation, has a tough job of finding a balanced solution.

### **Business Problem**

#### ***NAFTA and the U.S. T&A Industry***

While T&A is often treated as one single industry, textile manufacturing and apparel manufacturing are heterogeneous (Dickerson, 1999). In general, textile manufacturing, which mainly involves the spinning, weaving and fabric finishing processes, is primarily based on sophisticated machinery for production. Usually, a country won't be able to make textiles, especially man-made fiber products, until its national economy reaches a certain development stage with sufficient cumulation of capital and technology. In comparison, apparel manufacturing, which includes the cloth cutting and sewing operations, primarily relies on labor inputs (Lu & Dickerson, 2012).

The heterogeneity of textile and apparel production and the nature of U.S. economy had led to the adoption of different restructuring strategies by the U.S. textile and apparel industries in response to the new business environment under NAFTA. On the one hand, the U.S. textile industry was a strong supporter of NAFTA at the beginning and regarded the agreement critical to its long-term survival (Robert, 2000). Notably, NAFTA's unique textile and apparel-specific RoO and the limited textile manufacturing capacity in Mexico and Canada created a lucrative and almost guaranteed export market for U.S.-made yarns and fabrics in the NAFTA region (Freund, 2011). Just four years after the implementation of the agreement, the value of U.S. yarns and fabrics exports to the NAFTA region surged by 64.8% (OTEXA, 2018). Over time, the NAFTA region had grown into the single largest export market for the U.S. textile industry, accounting for 50.0% of the industry's total exports in 2017, up from 36.3% in 1992 (OTEXA, 2018). Further, exports to the NAFTA region provided critical support to textiles “Made in the USA,” especially since most U.S. apparel firms moved their productions overseas and the U.S. domestic demand for textile inputs fell substantially. In 2016, as much as 24.2% of U.S. textile industry's gross output ended up sold in the NAFTA region, much higher than only 7.2% in 1994 (BEA, 2017).

Compared with the U.S. textile industry, however, U.S. apparel producers had a more difficult time struggling with increased imports from Mexico and Canada caused by the substantial removal of trade barriers under NAFTA (Minchin, 2012). Just four years after the implementation of the agreement, the total U.S. apparel imports from Mexico and Canada surged by 262.6% between 1994 and 1998. Meanwhile, the value of the output of U.S. domestic apparel manufacturing fell sharply by 16.4% over the same period (BEA, 2017). In

2016, the value of U.S. apparel manufacturing broke a record low of \$10.1 billion, which was only 36.1% of the size in 1994 (BEA, 2017).

Recognizing the cost disadvantage in making garments in the United States, most U.S. apparel firms have chosen to offshore production and shift their businesses to non-manufacturing functions such as apparel design, product development, branding and marketing (Dickerson, 1999). As a reflection of U.S. apparel firms' heavy reliance on global sourcing today, as much as 97.3 percent of apparel sold in the U.S. market was imported in 2016 (AAFA, 2017b). Lu (2017) also found that U.S. fashion brands and apparel retailers adopt truly global supply chains today: of the 34 firms surveyed between April and May 2017, 58 percent reported sourcing from more than ten different countries or regions in 2017, and around 54 percent expect their sourcing base would become even more diversified through 2019. The study further shows that "China Plus Vietnam Plus Many" has become the most popular sourcing model among respondents: typically, China accounts for about 30-50 percent of a firm' total sourcing value or volume, 11-30 percent from Vietnam and each additional country, including NAFTA members, accounts for less than 10 percent. As some respondents put it, it is becoming increasingly important that U.S. fashion brands and apparel retailers use a mixed bag of sourcing destinations to balance the needs of cost, speed, flexibility, and risk control.

### ***The Yarn-forward Rules of Origin under NAFTA***

When U.S. fashion brands and apparel retailers import apparel from the NAFTA region, only those products that meet the NAFTA RoO can enjoy the preferential tariff treatment (Gelb, 2003). The textile and apparel-specific RoO for apparel goods under NAFTA is known as the nickname "yarn forward." The "yarn-forward" RoO means that fibers may be produced anywhere, but each component starting with the yarn used to make the apparel garments must be formed within the free trade area, i.e., by NAFTA members (Platzer, 2017). The "yarn-forward" rule sometimes is also called "triple transformation," as it requires that spinning of the yarn or thread, weaving or knitting of the fabric, and assembly of the final apparel garments all occur within the free trade area.

The U.S. textile industry sees the "yarn-forward" RoO a key driver for an integrated textile and apparel regional supply chain that has developed among the three NAFTA countries (NCTO, 2017). U.S. textile producers, in particular, regard the "yarn-forward" RoO a critical means to encourage Mexican and Canadian apparel manufacturers to use more U.S.-made yarns and fabrics instead of textile inputs from Asia and Europe (Minchin, 2012). U.S. textile mills also believe that requiring the "yarn-forward" RoO in free trade agreements is about fairness— similar to club membership, the benefits of preferential tariff treatment under NAFTA should be kept to producers in the region rather than their competitors from non-NAFTA member countries.

In contrast, U.S. fashion brands and apparel retailers see the "yarn-forward" RoO too restrictive to use and argue that it fails to recognize the global nature of today's apparel supply chain (AAFA, 2017). U.S. fashion brands and apparel retailers say that the "yarn-forward" RoO prevents them from fully enjoying the preferential tariff treatment under NAFTA since not always fabrics and yarns in need to make apparel are available in the NAFTA region or can be much more expensive than similar textile inputs made in Asia (USFIA, 2017). Reflecting the difficulty of meeting the "yarn-forward" RoO in sourcing, data from the U.S. Department of Commerce shows that of the total \$4,133 million U.S.

apparel imports from the NAFTA region in 2017, only 67.8% (or \$2,803 million) claimed the duty-free benefits by complying with the “yarn-forward” rule (OTEXA, 2018).

### **Debate on the Tariff-Preference Level (TPL) in the NAFTA Renegotiation**

Ideally, U.S. fashion brands and apparel retailers would like to see the “yarn-forward” RoO abandoned and replaced by a less restrictive one in NAFTA (Lu, 2017). However, because of the strong political influence of the U.S. textile industry, U.S. trade policymakers decide not to change the “yarn-forward” rule in the agreement (USTR, 2017). Nevertheless, the U.S. textile industry and U.S. fashion and apparel retailers find a new battlefield in the NAFTA renegotiation: the exception to the “yarn-forward” RoO.

One major exception to the “yarn-forward” RoO in NAFTA is the so-called tariff preference level (TPL). TPL allows NAFTA members to export a certain amount of T&A to each other’s market duty-free despite using non-NAFTA originating textile inputs (Gelb, 2003). For example, under TPL, each year Mexico and Canada respectively can export up to 45 million and 88 million square meter equivalents (SME) of apparel that contain non-NAFTA originating yarns and fabrics to the United States duty-free. However, beyond these quota limits, any additional apparel exports from Mexico and Canada to the United States have to meet the “yarn-forward” RoO to enjoy the preferential tariff treatment under NAFTA.

For a long time, the U.S. textile industry has regarded TPL as a damaging loophole (Platzer, 2017). In its testimony before U.S. trade negotiators, the National Council of Textile Organizations (NCTO), which represents U.S. yarn and fabric producers, strongly called for complete elimination of TPL in the NAFTA renegotiation. According to NCTO, TPL “circumvents the yarn-forward rules of origin and directly undermine benefits for NAFTA regional textile manufacturers. Worse yet is the fact that TPL transfers lucrative benefits to non-signatory countries, such as China.” (NCTO, 2017). Further, NCTO argues that eliminating TPL will incentivize more textile and apparel production in the NAFTA region and promote the expansion of textile production in the United States particularly.

Not surprisingly, NCTO’s proposal to eliminate TPL in the NAFTA renegotiation meets strong opposition from U.S. fashion brands and apparel retailers, represented by industry associations such as the American Apparel and Footwear Association (AAFA) and the United States Fashion Industry Association (USFIA). According to these industry groups, eliminating TPL will disrupt supply chains in the NAFTA region that have been in place for more than two decades. Particularly, AAFA, and USFIA don’t think that eliminating TPL will move production back to the United States, but rather would further incentivize U.S. fashion brands and apparel retailers to source from outside the NAFTA region and eventually put textile and apparel factories in the NAFTA region out of business (AAFA, 2017; USFIA, 2017).

Trade statistics support AAFA and USFIA’s arguments: in the U.S. import market, apparel from the NAFTA region compete with similar products from Asia directly. For example, almost all top categories of Mexico’s apparel exports to the United States are non-fashion-sensitive basic items, such as cotton men’s trousers, knit shirts and knit skirts, which not only are highly price-sensitive but also are supplied in larger quantity by price-competitive Asian countries such as China, Vietnam and Bangladesh in the U.S. market (OTEXA, 2018). Without the TPL, U.S. fashion brands and apparel retailers would opt to produce and source apparel products in the least expensive way possible, likely outside the NAFTA region, and ship items into North America despite being hit with higher tariffs.

On the other side, apparel producers in Canada oppose NCTO's proposal to eliminate TPL from NAFTA as well (Canadian Apparel Federation, 2018). The TPL mechanism has played a critical role in facilitating the export of Canada's wool suits to the United States and the U.S. cotton or man-made fiber apparel to Canada. Statistics show that in 2016 more than 70% of the value of Canada's apparel exports to the United States under NAFTA utilized the TPL provision, including almost all wool apparel products. Over the same period, the TPL fulfillment rate for U.S. cotton or man-made fiber apparel exports to Canada reached 100%, suggesting a high utilization of the TPL mechanism by U.S. apparel firms too (Global Affairs Canada, 2018). Several studies suggest that without the TPL mechanism, the U.S.-Canada bilateral T&A trade volume could be in a much smaller scale (USITC, 2016).

**Appendices** [not included in total word count]

Appendix 1 U.S. Textile and Apparel Trade with NAFTA Partners

Unit: \$million

Product/Year	1992	1994	1998	2000	2002	2005	2008	2012	2015	2016	<b>2016 vs 1994</b>
<b>Exports</b>											
Total	3,597	4,922	8,796	10,529	8,904	9,413	8,922	10,519	11,757	11,097	<b>125.5%</b>
Yarn	501	670	1,180	1,414	1,012	1,225	972	1,079	1,086	988	<b>47.3%</b>
Fabric	1,443	1,907	3,068	4,641	4,194	4,610	4,016	4,550	5,281	5,043	<b>164.5%</b>
Made-up textiles	656	770	1,204	1,343	1,176	1,526	1,815	2,166	2,219	2,246	<b>191.6%</b>
Apparel	997	1,575	3,344	3,132	2,523	2,053	2,119	2,725	3,172	2,821	<b>79.1%</b>
<b>Imports</b>											
Total	1,940	3,212	10,209	13,043	11,818	10,091	6,609	6,040	5,961	5,745	<b>78.9%</b>
Yarn	171	237	534	657	598	655	432	430	334	308	<b>30.2%</b>
Fabric	309	474	1,091	1,290	1,244	1,229	760	707	707	701	<b>48.0%</b>
Made-up textiles	207	319	669	937	942	855	704	693	769	785	<b>146.4%</b>
Apparel	1,254	2,183	7,915	10,159	9,034	7,352	4,713	4,211	4,151	3,951	<b>81.0%</b>
<b>Trade Balance (Value of Exports – Value of Imports)</b>											
Total	1,657	1,711	-1,413	-2,514	-2,914	-678	2,313	4,479	5,796	5,353	<b>212.9%</b>
Yarn	330	434	647	756	414	570	540	648	752	680	<b>56.7%</b>
Fabric	1,135	1,433	1,977	3,351	2,951	3,380	3,256	3,844	4,573	4,342	<b>202.9%</b>
Made-up textiles	450	452	535	407	234	671	1,111	1,473	1,450	1,461	<b>223.5%</b>
Apparel	-258	-608	-4,571	-7,028	-6,511	-5,299	-2,594	-1,486	-979	-1,130	<b>-85.5%</b>

Data source: OTEXA (2018)

Appendix 2: Top Categories of Mexico's Apparel Exports to the United States in 2016 (by value) and Market Competition

Rank	OTEXA code and product description	Share in Mexico's apparel exports to the United States	Competition in the U.S. import market		
			Mexico's rank (market shares)	Mexico's #1 competitor (market shares)	Mexico's #2 competitor (market shares)
1	347 (Men's trousers-cotton)	30.8%	<b>#3</b> (18.0%)	Bangladesh (23.7%)	China (18.6%)
2	338 (Men's knit shirts-cotton)	8.1%	<b>#10</b> (4.6%)	China (35.4%)	Vietnam (14.9%)
3	639 (Women's knit shirts-MMF)	7.7%	<b>#4</b> (5.3%)	China (29.7%)	Vietnam (19.6%)
4	638 (Men's knit shirts-MMF)	7.2%	<b>#6</b> (6.5%)	Honduras (14.3%)	Vietnam (13.2%)
5	659 (Other MMF apparel)	6.0%	<b>#3</b> (4.6%)	China (56.8%)	Vietnam (10.4%)
6	348 (Women's trousers-cotton)	5.5%	<b>#8</b> (3.1%)	China (35.4%)	Vietnam (14.9%)
7	647 (Men's trousers-MMF)	5.1%	<b>#2</b> (7.1%)	Vietnam (21.9%)	China (19.4%)
8	359 (Other cotton apparel)	3.2%	<b>#2</b> (10.7%)	China (48.9%)	Bangladesh (8.0%)

Source: Compiled based on data from OTEXA (2018)

Note: 1. MMF refers to "man-made fiber"; 2. Mexico's competitors were the top suppliers (by value) to the U.S. market in 2016 for respective product categories.

## Discussion Questions

1. How important is NAFTA to the U.S. textile and apparel industry? Overall, why or why not do you think the U.S. textile and apparel industry is a beneficiary of NAFTA over the past two decades?
2. Why does the U.S. textile industry want to keep the so-called "yarn-forward" rules of origin in NAFTA? Why do U.S. apparel brands and retailers dislike the "yarn-forward" rules?
3. In your view, why or why not the "yarn-forward" rules of origin are outdated in today's global-based textile and apparel supply chain?
4. What are the main arguments that support eliminating the tariff preference level (TPL) in NAFTA? What are the main arguments that oppose eliminating the TPL in NAFTA? If you were U.S. trade negotiators, why or why not will you eliminate TPL from the agreement?
5. Why are the textile-specific rules of origin under free trade agreements so complex? What potential issues do you think can arise because of the complexity of these rules?

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