104. **Notwithstanding the benefits of free trade agreements, the risks of trade diversion need to be acknowledged.** Although these agreements will promote trade with some trading partners,[61] the risks of trade diversion increase with the relative preferences given to a group of countries. Reducing the differential in relative preferences will therefore help the country fully benefit from trade liberalization. Priority should be given to removing non-tariff barriers for all trading partners, as these barriers are high and their elimination bears no fiscal costs (see above). Lowering the level of customs tariffs for all trading partners (on a Most Favored Nation basis) in parallel with the implementation of the preferential agreement with the EU and Turkey would help reduce the preferential gap and facilitate competitive access to efficient import goods, while taking into account possible fiscal costs.

G. Conclusion

105. **Trade reform has just started. Syria's trade regime is relatively restrictive and a concerted effort will be needed if the authorities are to fulfill their objective of joining the** WTO.[62] Eliminating key non-tariff barriers should be the first priority and will signal the authorities' determination to address the trade agenda. Implementing the regulatory measures provided for in the Association Agreement with the EU will bode well for the future and help Syria progress toward observing WTO rules and disciplines. **As these reforms are implemented,** Syria will gain credibility as a full-fledged trading partner, establish a solid track record in shifting toward an open economy, and boost its potential for a much-needed insertion into the global economy.

[61] Arab and EU countries accounted in recent years respectively for roughly 15 and 20 percent of imports and 10 and 60 percent of exports.

[62] Syria's request (sent in 2001 and reiterated in 2004–05) needs approval by the WTO's General Council to start negotiations.

V. Could the Textile Sector Be a Main Driver of Non-oil Export Growth?[63]

A. Introduction

106. **The textile sector plays a key role in the Syrian economy.** Cotton is the second most important cash crop (after cereals) and employs 2.7 million farmers and their dependents (about 15 percent of the population), while the textile industry accounts for about 20 percent of production and employment in the industrial sector. Until recently, the sector has been heavily protected and local production has mainly targeted the domestic market.[64]

107. **In a bold move in early 2006, the authorities opened the textile sector to international competition.** The ban on garment imports was abolished, along with most of the restrictions applied to cotton fabric imports.[65]

108. **This chapter analyzes the ability of Syria's textile sector to respond to the challenges from greater international competition** and sets out some policy recommendations on supporting measures to turn the challenge into an opportunity for the sector to become a main driver of non-oil export growth.

109. **This chapter contains four sections.** Following this brief introduction, the next **section** analyses the upstream sector of cotton. Section C discusses the textile sector. Section D draws some policy recommendations.

B. The Cotton Sector[66]

Production, domestic sales, and exports

110. **Over the last five years, raw cotton production has ranged between 700 thousands and 1 million tons** (Table 1). These fluctuations reflect in part sensitivity to weather conditions. Syria was the tenth-largest cotton producer in the world in 2005. Cotton varieties include high quality types that are used to produce fine fibers.

111. **The production is likely to peak at about 1 million tons.** The land appears to be intensively used. The yield per unit of cultivation area increased to 4.3 tons in 2004, which is the highest level in the world after Australia. Furthermore, the limited supply of water prevents expansion to new fields. The government licenses farmers to produce cotton in

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[63] Prepared by Stephane Cossé.

[64] On average, the sector has been a net importer.

[65] However, customs duties will remain high at 47.5 percent for most goods. Furthermore, the tariff on machinery and equipment for the industry is low, thereby raising the effective level of protection.

[66] Upstream activities are defined as the production of raw and ginned cotton.

designated areas in order to regulate the use of water and ensure an adequate water supply for the entire agricultural sector.

112. **Syria's ginning capacity is now high enough to absorb the annual crop, following substantial capacity investment in the early 2000s.** The ginning process is handled by 14 government-owned plants under the aegis of the Cotton Marketing Organization (CMO), based in Aleppo. The full annual production was ginned in 2005, yielding 328,000 tons

113. **With a ban on the import of cotton, the government has so far considered it of strategic importance that CMO meets the demand of the local industry before any surplus is exported.** Under these marketing obligations, the CMO has exported between one- and two-thirds of the production. One-fourth was to the European Union in 2004, one-fourth to neighboring countries (GAFTA and Turkey), and the remaining half to textile manufacturing countries (such as China, Pakistan, India, and Bangladesh).

Table 1: Production and Exports of Cotton, 2000–05

	2000	2001	2002	2003	2004	2005
Cotton production (unginned) (thousand of tons)	1047	974	713	796	1005	992
Area (thousand of ha)	270.3	257.1	199.8	205.4	234.2	237.0
Yield (ton/ha)	3.9	3.8	3.6	3.9	4.3	4.2
Cotton production (ginned) (thousand of tons)	346	315	235	270	333	328
of which: exports	218	246	80	104	114	145

Source: Ministry of Agriculture; CMO; and Fund staff estimates.

Prices

114. **Cotton is bought from farmers and private cooperatives at an administered price set by the ministry of agriculture**. The purchase price is adjusted downward during the crop season to encourage early collection. It is based on an assessment of the production costs, which include the cost of inputs and workforce. Following a decline in 2001–02 to LS/kg 27-28, the price increased to LS/kg 29–31 in 2003–05. This is due in particular to rising labor costs in the last 3 years, owing to an increased demand for farm workers during the crop season as the production of other seasonal crops (such as olives and other fruits) has been expanding. The price also includes a profit margin of LS/kg 2 to provide social support to cotton producers.

115. **Thus, the setting of the purchase price does not take into account world cotton price levels and fluctuations.** The authorities implicitly recognize that the world price equivalent to be paid to farmers would be much lower, and probably no more than half of what is actually paid to them.[67] The difference is equivalent to a producer price subsidy.

116. **The government bears the cost of the subsidy through the government-owned Agricultural Bank.** There is no pass-through of the cost to the CMO. The CMO purchases cotton in cash directly from producers at the administered price, but receives compensation from the government through the Agricultural Bank. At the beginning of the season, the Agricultural Bank lends the CMO the cash needed to purchase cotton for a specific volume at an administered price. However, the CMO reimburses the loan at the lower price reflecting the world price level. The Agricultural Bank bears the cost of the nonreimbursed share, that is, the difference between the outstanding loan and the actual repayment, which is not booked in the CMO's account. Estimates point to a subsidy that could amount to 1.3 percent of GDP in 2004 and 1.1 percent in 2005.[68]

Table 2: Cotton Prices and Subsidy, 2000–05
(In Syrian pounds/kg)

	2000	2001	2002	2003	2004	2005
Purchase price to farmers 1/	30.75	27.90	26.80	30.75	30.75	29.30
Price effectively paid by CMO 2/	n.a.	n.a.	n.a.	n.a.	15.00	15.00
Implicit subsidy (in billion of LS) 3/	...	...	...	...	15.8	14.2
In percent of GDP	...	...	...	...	1.3	1.1

Source: CMO; and Fund staff estimates.

1/ Between the beginning of the season and mid-November. Preliminary for 2005.
2/ The difference between the price paid to farmers and that effectively paid by CMO is covered by the Agricultural Bank.
3/ Calculated as the difference between the price paid to the farmers and that effectively paid by CMO multiplied by the annual production.

117. **The authorities justify the need to subsidize cotton farmers for economic and social reasons.** They consider the cotton supply critical for the textile industry, one of Syria's largest industrial sectors. If cotton-generated incomes are lower, output levels and product quality could decline, while farmers and cooperatives could shift toward more profitable

[67] There is no single benchmark for a world purchase price to farmers. Syria's price of US$/kg 0.3 (LS/kg 15) set in 2004–05 is roughly close to average production costs in sub-Saharan Africa. The purchase price paid to farmers in Sahelian countries averaged US$/kg 0.35-0.4 during the same period.

[68] At the start of the season, the Agricultural Bank also provides loans in kind and in cash (40-60 percent, respectively) at concesional rates to farmers and cooperatives for an amount equivalent to 0.1 percent of GDP. One-third of the loans are estimated to be nonperforming.

agricultural products.[69] Furthermore, the authorities argue that cotton production remains the main cash resource in a number of rural areas and is subsidized in many producing countries. They stress that although they support the need for a subsidy, they would be reluctant to support an increase in production given the potential environmental costs this could generate.

118. **Since 2001, ginned cotton is sold to the local textile industry at world prices.** Cotton imports are banned in Syria, which implies that domestic manufacturers in the textile sector have to purchase cotton exclusively from the CMO. Before 2001, the CMO's prices were set by the Ministry of Industry above world prices, but since then prices are set directly by the CMO (under the supervision of the government) consistent with world levels (Table 3). (Syria is a price taker in the world market.)

Table 3: Syrian Export and World Cotton Prices, 2000–2005
(In US$/kg)

	2000	2001	2002	2003	2004	2005
Average sales price by CMO	1.12	0.76	1.13	1.30	1.05	1.22
Average world price (Liverpool Index)	1.30	1.06	1.02	1.40	1.36	1.21

Sources: CMO; and IMF's World Economic Outlook

C. Textile Industry[70]

119. **Textile manufacturing is one of the largest industrial sectors, but supplies mostly the domestic market.** It is the second largest sector following agro-industries and excluding oil-related activities, accounting for about 20 percent of industrial production. The share of public sector production represents about 25 percent **of the total, but only 10 percent** of the fabric and garment sub-sectors. Garments and most cotton fabric could not be imported until this year. As a result, the industry remained mostly inward-looking and found little incentive to look for markets abroad. Domestic manufacturers increased output to meet the needs of a fast-growing population, with exports amounting to only 15-20 percent of the production.

120. **Accordingly, the textile export performance is somewhat mixed, accounting for 13 percent of non-oil exports in 2004** (8 percent excluding yarn).[71] Syria's export strength has been geographically limited so far, reflecting a good knowledge of local customs and the distribution structures of Arab markets but difficulties in meeting industry standards, and the time-sensitive delivery requirements of western markets. Products with higher added value are exported mostly to GAFTA countries and Turkey (75 percent for fabric and 60 percent

[69] No study is available on whether production would be resilient to a fall in the purchase price (in particular, no data are available to estimate the marginal costs of producing cotton in Syria).

[70] Downstream activities are defined here as the production of yarn, fabric, and garments.

[71] Latest available data. Source:UNCTAD.

for garments in 2004). Exports of fabric and garments to the EU accounted for respectively 10 percent and 23 percent,[72] amounting to a marginal share of the EU's imports.[73]

121. **As the industry is mostly directed toward local consumption, Syria has been a net textile importer.** In particular, local companies rely on imports of synthetic and blended yarns and machinery for their manufacturing (Table 4).

Table 4: Imports and Exports of Textile Products, 2000-2004
(in million of U.S. dollars)

	2000	2001	2002	2003	2004
Imports					
Textile - Yarn	286	185	174	188	208
Textiles - Fabric	113	73	91	152	126
Textiles - Garments	-	-	-	1	-
Textile - Machinery and Parts	107	34	80	81	103
Total	506	292	344	421	437
Exports					
Textile - Yarn	95	50	70	140	92
Textiles - Fabric	60	19	3	96	92
Textiles - Garments	113	32	140	120	90
Textile - Machinery and Parts	-	-	-	3	-
Total	268	100	214	358	274
Net trade (imports-exports)	237	192	130	62	162
excl. machinery and parts	131	158	51	(18)	59

Source: UNCTAD .

122. **In a bold move, the authorities opened the textile sector to external competition in 2006 by removing the ban on the imports of garments and most cotton fabrics, but a number of government restrictions remain.** The production of cotton yarn remains a government monopoly and imports are prohibited, thereby increasing the risks of higher supply costs for domestic manufacturers. Synthetic and blended yarns can be imported, but fees and insurance costs must be paid to the government agency managing the production of cotton yarn.[74]

[72] However, 65 percent of the yarn produced was exported to the EU in 2004.

[73] Given the relatively small level of textile exports to the EU out of Syria's total exports (about 3 percent), the country could only be marginally affected by the removal of the quotas under the Multi-Fiber Agreement.

[74] The agency states that the authorities have requested since 2004 that yarn be sold at the world price level (the agency is also pressured in this respect by lower synthetic-based material prices, an apparent increase in informal imports, and the emergence of private micro-producers).

D. Policy Recommendations

123. **The period ahead constitutes a challenge for the competitiveness of Syria's textile sector.** The removal of a key protection for the local industry (i.e., the ban on imports of garments and some fabric) should, in principle, encourage local companies to reduce their costs to be competitive. This is likely to affect primarily the less efficient government-owned companies. For the private sector, the response is still uncertain as discussed above, but a positive scenario is conceivable. Because of their comparative advantage, the most profitable companies may shift against increasing competition in the local market to products for which their marginal costs are the lowest and their external competitiveness the highest. This is likely to include the niche products exported to Arab markets. But, given low labor costs, direct domestic access to cotton varieties, and the long-standing manufacturing tradition in this sector, the industry might be able, during this process, to gain shares on other markets.

124. **A number of supportive measures could turn these challenges into an opportunity for the textile sector to become a main source of non-oil exports.**

- In the short run, it is critical that the prices of ginned cotton and yarn, which are still subject to public monopolies, truly reflect world prices to level off domestic and external competition.

- In the near to medium term, the ban on cotton imports, as well as marketing obligations to local suppliers, should be removed to improve supply choices and cost effectiveness. For the same reasons, the monopoly on the production of yarns and the related ban on imports would need to be rescinded, along with the administrative planning regulating the annual share of yarns that should be sold to the local market. Given that Syria produces cotton locally, the domestic production of yarns benefits from a natural advantage. Furthermore, half of the yarn is already exported, reflecting an external demand for Syrian specific yarns.[75] Syrian final goods manufacturers (fabric and garments) should be able to choose Syrian cotton and yarn only because of economic and financial reasons, such as lower costs (limited freight and insurance costs), trustworthy distribution networks, and product quality.

- The authorities would need to restructure/liquidate the non-profitable public companies to encourage a resource shift across the sector to the most profitable companies.

- The authorities' ongoing efforts to improve the business environment and reduce red tape would need to be strengthened to boost the industry's competitiveness.

[75] The CMO has indicated that they could withstand the implications of lifting the ban on cotton imports and the removal of the domestic supply obligations as they are confident the sector is competitive.