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The U.S.-Central America Free Trade Agreement (CAFTA): Challenges for Sub-Regional Integration

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Summary

On January 27, 2003, negotiations began on the U.S.-Central America Free Trade Agreement (CAFTA). Nine meetings are scheduled for 2003 between the United States and the five Central American Common Market countries: Guatemala; Honduras; El Salvador; Nicaragua; and Costa Rica, with all parties having expressed confidence that the agreement can be completed by year-end. This report provides background and analysis on the proposed CAFTA and will be updated periodically.

U.S. interests in CAFTA are broad, but the dollar value of U.S. trade with Central America represents less than 1% of U.S. foreign commerce. Thus, CAFTA may expand trade at the margin, but the effects will be small on a macroeconomic level, although no doubt important to those firms affected by the regional trade. For the United States, market access (especially for agricultural products) is a key issue. U.S. business interests generally want equal or better treatment than that afforded to exports from Canada and Mexico under their own free trade agreements with Central America. As highlighted in recent negotiations with Chile, a bilateral agreement also affords the United States a chance to delve into other issues of commercial importance such as intellectual property rights, government procurement, foreign investment, e-commerce, and services, particularly financial services.

From the Central American perspective, reducing barriers (especially for textile and agricultural products) to their largest export market and attracting foreign direct investment are cause enough to proceed. This point is directed specifically at improving and making permanent the trade benefits Central America currently enjoys under the Caribbean Basin Initiative (CBI) programs, but which require periodic reauthorization by Congress. CAFTA also would potentially increase U.S. foreign direct investment, which has been instrumental in the creation of the production sharing (maquiladora) manufacturing industries in the region. In short, CAFTA fits into Central America's strategy of developing economically through increased trade and investment.

CAFTA supporters highlight the long-term U.S.-Central American trade relationship. From the early days of independence, agricultural export promotion has been key to Central American economic growth and since 1984, the Central American nations have enjoyed a preferential trading position with the United States as beneficiaries of the CBI. More recently, U.S. trade and investment interests have turned to apparel manufacturing in maquiladoras. Geopolitical and strategic concerns are also important; CAFTA may reinforce stability by providing institutional structures that will undergird gains made in democracy, the rule of law, and efforts to fight terrorism, organized crime, and drug trafficking. CAFTA may also be a way for the United States to garner support for the Free Trade Area of the Americas. CAFTA doubters point to equally broad themes, such as the pervasive social and economic inequality perpetuated by existing economic systems, and question whether CAFTA will perpetuate or perhaps worsen the status quo. For this reason, the labor and environment provisions will be important negotiating areas to follow. U.S. firms competing with Central American imports have also registered concern.

Contents

List of Figures

List of Tables

The U.S.-Central America Free Trade Agreement (CAFTA): Challenges for Sub-Regional Integration

On January 27, 2003, negotiations began on the U.S.-Central America Free Trade Agreement (CAFTA). Nine meetings are scheduled for 2003 between the United States and the five Central American Common Market countries: Guatemala, Honduras, El Salvador, Nicaragua, and Costa Rica, with all parties optimistic that the agreement can be completed by year-end. President George W. Bush summarized the goals of CAFTA as being no less ambitious than to "strengthen the economic ties we already have with these nations...to reinforce their progress toward economic, political, and social reform...and to take another step toward completing the Free Trade Area of the Americas."[1]

This report provides background and analysis on CAFTA in support of Congress and its role in the trade negotiation process. Congress has defined trade negotiating objectives and the executive branch trade consultation process in Trade Promotion Authority legislation (Title XXI of P.L. 107-210). It ultimately also has responsibility for final acceptance of any trade agreement via passage of trade implementing legislation. This report will be updated periodically.

Why Trade More Freely?

Countries trade because it is in their national economic interest to do so, a proposition supported by theory and practice. Comparative advantage remains the core principle explaining the efficiency gains that can come from trade, which have now been recognized for over 200 years. It states that countries can improve their overall economic welfare by producing those goods at which they are relatively more efficient, while trading for the rest. Empirical evidence since the close of the Second World War supports this claim; countries that have adopted relatively more open trading regimes generally experienced higher levels of economic growth and development, other things equal.

Measuring and understanding the benefits of freer trade are often not straight forward processes. There is a tendency to count exports, imports, and the oft-misrepresented importance of the trade balance as indicators of the fruits of trade. This approach tends to give undue weight to exports at the expense of understanding

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[1] Office of the United States Trade Representative. *Proposed U.S.-Central America Free Trade Agreement Fact Sheet*. Washington, D.C. January 17, 2002. It is customary to refer to the agreement simply as CAFTA.

the benefits from imports. More importantly, the true gains from trade are better understood through the increases in consumer selection, prices, and productivity that trade can bring. Comparative advantage, scale economies, and competition lead to specialized production that drives these gains and forms the basis for why most countries want to trade more freely. As developing and industrialized countries began to trade more, various issues related to these concepts may come into play. Because of lower wage levels, low-skilled, labor-intensive jobs have migrated to developing countries, where they frequently reside in production sharing (maquiladora) facilities.[2] Economists have come to refer to such specialized production as "breaking up the value added chain" and it accounts for why products as diverse as automobiles, computers, and apparel are often made or assembled in Latin America and Asia in partnership with U.S. firms.[3]

Three factors regarding the discussion of the rationalization of international trade are important. First, the discussion generally assumes that trade and free trade agreements (FTAs) are executed and implemented in a multilateral setting. In fact, given the slow process by which the World Trade Organization (WTO) negotiation rounds proceed, countries have often opted for preferential arrangements, that is regional and bilateral agreements like CAFTA. Latin America is full of them and economists are still debating the extent to which they can be trade distorting through trade diversion. This occurs when trade is redirected to countries within a limited agreement that does not take into account countries outside the agreement, which may in fact be even more efficient producers. Preferential trade agreements are also cumbersome to manage, requiring extensive rules of origin, among other administrative complexities. Finally, there is a debate whether FTAs will help move the world toward multilateral trade liberalization, as some claim.[4]

The second factor is that the benefits of trade flow broadly to all participating countries, but not all sectors of an economy are affected equally. While consumers benefit, for example, some industries and workers may actually be hurt from the adjustments to freer trade and some communities may be disproportionally affected by changes in trade rules if their economies are heavily dependent on an import-

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[2] Note that this trend has not been a driving force in the aggregate unemployment rate of the United States. It is also important to emphasize here that wage levels are only part of the issue. Competitiveness comes from overall productivity, so lower wages and an abundance of low-skilled (low productivity) workers attracts these types of jobs. For a recent overview of the methodology of measuring the effects of changes in trade policy, see: Rivera, Sandra A. Key Methods for Quantifying the Effects of Trade Liberalization. *International Economic Review*. United States International Trade Commission. January/February 2003.

[3] For the theoretical foundation, see: Krugman, Paul. Growing World Trade: Causes and Consequences, in *Brookings Papers on Economic Activity (1)*, William C. Brainard and George L Perry, eds. 1995. pp. 327-76 and for the case in Central America, see: Hufbauer, Gary, Barbara Kotschwar, and John Wilson. *Trade and Standards: A Look at Central America*. Institute for International Economics and the World Bank. 2002. pp. 992-96.

[4] U.S. businesses operating in Latin America have had to interpret a difficult road map when dealing with multiple arrangements such as the Caribbean Basin Initiative, the Andean Trade Preference Act, and the North American Free Trade Agreement. Each distorts investment decisions in the region and has a countervailing influence on the others. Adding the many Latin American FTAs only makes the situation more confusing.

competing industry. Economists generally argue that it is far less costly for society to rely on various types of trade adjustment assistance than opt for selective protectionism, the frequent and forcefully argued choice of trade-affected industries. The public policy difficulty is that both options have costs and benefits, but result in different distributional outcomes.[5]

Third, there are clearly implications in the trade negotiation process for smaller countries' bargaining leverage when they choose to negotiate with a large country in a bilateral rather than multilateral setting. Both Chile and the Central American countries realized early in the process that there were negotiating issues with which they would have little or no leverage. Neither agreement will have a trade remedies (e.g. antidumping) chapter and resolving agriculture issues will also be limited, particularly in light of ongoing WTO agricultural talks.

The Impetus for a CAFTA

It is clear that the United States has decided to move ahead with preferential trading agreements. In part, this decision has been influenced by external events, as well as broader strategic interests. With the proliferation of regional agreements around the world, trade negotiations for some countries have become a tactical issue of picking off gains where they are perceived relative to what other countries are doing. In response to this, it was repeatedly argued by the U.S. business community that the U.S.-Chile agreement, for example, was necessary to equalize treatment of U.S. businesses competing with Canadian firms that already enjoyed preferential treatment with Chile. The case is made for Central America as well, which has trade agreements with Mexico, Canada, and other countries.

In the context of sub-regional trade agreements, history, geographic proximity, and economic complementarities also combine to make the formal deepening of trade relations between Central America and the United States an apparently logical step. At least three cautionary notes, however, bear keeping in mind. First, because of a historical pattern of U.S. political, military and corporate intervention in the region, a sense of disparity in power between the two partners lingers, which has carried over to the trade negotiations themselves. Second, intra-Central American squabbles and instability have at times disrupted regional integration and especially foreign trade relations.[6] Third, the promise of social and political reform alluded to by President Bush's statement at the outset of this report has proven difficult to achieve in Central America, perhaps propelling expectations beyond CAFTA's ability to deliver.

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[5] It is worth noting that when a staple, such as underwear, is produced abroad and sold in the United States as a lower-priced import compared to a domestically produced good, it is equivalent to an increase in real income for the consumer. This can be significant for low-wage workers. The same idea holds true for industrial products and consumers as well. The possible need for trade adjustment assistance to help U.S. firms who compete with imports is the other side of the policy issue.

[6] For an excellent economic history of the region, see: Woodward, Ralph Lee Jr. *Central America: A Nation Divided.* New York: Oxford University Press, third edition, 1999.

Economic fundamentals have shaped Central American trade relations. From the early days of independence, agricultural export promotion was the centerpiece of Central American economic growth. The British first dominated Central America's natural primary export capacity based on products such as coffee, bananas, sugar, and beef, but U.S. interests became predominant after 1850. The region's primary exports to the United States now rely on jointly produced goods, mostly apparel, with U.S. firms. This lengthy and deepening relationship may have helped propel CAFTA ahead of the FTAA as a U.S. priority. Other factors contributed, including the FTAA's relatively slow progress, the less complex nature of negotiations with Central America compared to those with the South American countries that will dominate the FTAA debate, and the U.S. preferential trade arrangement already in place since 1984 with Central America via the Caribbean Basin Initiative (CBI). Hence, CAFTA may be considered a logical extension and consolidation of a long-standing arrangement.

Geopolitical and strategic concerns also sparked interest by all parties in pursuing CAFTA. For example, CAFTA is expected to reinforce stability in general by providing institutional structures that will undergird gains made in democracy, the rule of law, and efforts to fight terrorism, organized crime, and drug trafficking. The United States also sees CAFTA as a way to expand support for its positions in the FTAA, and in the event that the FTAA is delayed beyond its 2005 deadline, help rationalize the system of disparate preferential trade agreements that currently define Central American trade relations.

Those who question the wisdom of negotiating CAFTA point to equally broad themes, such as the pervasive social and economic inequality in much of Central America, causing some to support the inclusion of specific goals in the agreement itself, making the labor and environment provisions important negotiating areas. There is concern, for example, over the adequacy of working conditions and basic labor rights and whether CAFTA can help change the situation, a reflection of the whole issue of "civil society's" role in the trade agreement that developed early in the negotiation process. The broadest possible support for CAFTA is unlikely unless there is some credible promise of accelerated social development, even if this may be a heavy burden to place on the proposed trade agreement.

Strategic justifications may have helped get the process going, but ultimately it is fair to ask what each side expects to gain specifically from the detailed agreement that may emerge. The dollar value of U.S. trade with Central America makes the region the United States' third largest Latin American trading partner; right behind Brazil, but a distant third from Mexico. It represents less than 1% of U.S. foreign commerce so CAFTA may expand trade at the margin, but the U.S. effects will be small on a macroeconomic level, although no doubt important to those industries affected by regional trade trends.

For the United States, market access (e.g., tariff rates, rules of origin) will be a core negotiating area. Although Central American tariffs are already relatively low, they can be reduced further. In particular, U.S. business interests want equal or better treatment than that afforded to exports from Canada and Mexico based on FTAs already signed with Central American countries. Permanent and clarified trade rules will also support the joint production arrangements already in place between Central

American and U.S. firms. Finally, as highlighted in recent negotiations with Chile, a bilateral agreement offers the United States a chance to delve into many other trade barriers that affect some of its most competitive industries. This includes clarifying rules for the treatment of intellectual property, foreign investment, government procurement, e-commerce, financial services, and other non-tariff issues.

From the Central American perspective, reducing barriers to the large U.S. market (especially for textile and agricultural products) and increasing the potential for foreign investment are cause enough to proceed. This point is directed specifically at making permanent the benefits Central America currently enjoys under the CBI programs, but which require periodic reauthorization by Congress. This could potentially increase U.S. foreign direct investment (FDI) that developed the maquiladora relationship in the first place and could support Central America's export driven development strategy.

Two other factors point to significant initial challenges. The first is the need for better Central American integration, a sentiment expressed by both the United States and the European Union, which is also in the very early stages of trade negotiations with Central America. Individually, the Central American countries are too small to justify a U.S. bilateral agreement by themselves. Yet, trade has been hampered within the subregion by cumbersome customs and other rules. For CAFTA to work well, the United States needs some assurance that goods can flow efficiently within the region, which means making the Central American Common Market (CACM), created in 1960 as the beginning of the subregion's integration effort, work better. It also means that unlike other "bilateral" negotiations, the five Central American nations, of necessity, have agreed to present a single negotiating position.

Second, much has been made of the difference in negotiating capacity between Central America and the United States. U.S. offers and arrangements with multilateral organizations to assist these countries in developing such capacity may be viewed as generous, but perhaps also a little self-serving, which could tap into the historical power disparity issues and leave some Latin American leaders leery of the process.

The Quest for Central American Integration

Because the five Central American countries will need to develop a single negotiating position, cooperation is paramount.[7] This is no small technical point; although the CACM has been in place for four decades, historically the member countries have struggled to define unified positions in trade, a natural consequence of trying to reconcile diverse national interests and economic capabilities.

Since the Spanish colonial period, Central America has been an agricultural exporting area, which by the modern period became concentrated in five major

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[7] This is not to suggest that all five countries will strike the exact same bargain with the United States in all cases, but that there will be agreement among them regarding how the final agreement will be defined.

commodities: bananas; coffee; sugar; beef; and cotton. The socioeconomic balance that emerged from this trade regime was far from egalitarian. In fact, the economic gains have been uneven. Concentrated land ownership led to highly skewed patterns of income and wealth. Although underlying inequality was an inherent part of Central American society prior to the modern period, the foreign-dominated agricultural export model has done little to change this reality. The resulting highly stratified socioeconomic structure has fostered social discontent and political unrest, leading directly, and perhaps unavoidably, to the turbulent 1970s and 1980s (see **Appendix 1** for a comparison of economic data among the five countries).[8]

There are important implications of this development pattern for regional integration. The emphasis Central American leaders have placed on economic integration rested largely on expectations that economic growth, development, and resulting welfare gains would be shared, at least among countries, if not within them. In the first two decades of the CACM, economic analysis suggested that indeed, both static and dynamic gains from trade were measurable and significant. The CACM succeeded in expanding the internal market, lowering and equalizing external tariffs, and diversifying and modernizing economic activity. Benefits from more open domestic policies as well as foreign investment and technology transfer that accompanied trade were clear. Some of these gains were shared broadly, as seen in lower prices and a greater selection of goods. Economic integration, however, was not realistically expected to change the underlying social and economic stratification that had dominated for centuries. What the CACM did accomplish was to address, in part, the lack of opportunity that defined small closed domestic economies, presumably without creating distortions in trade relations.[9]

These gains were widely applauded in the first decade and *intraregional* trade grew eight-fold from 1960 to 1968, when it peaked at 24% of total Central American trade with the world. After that, the CACM struggled as a unifying force for the region. Unequal growth and development patterns eventually undermined the common market, largely because of disappointment over efforts to achieve its unwritten, but widely accepted goal of "balanced development." Historical inequalities among the five countries (most evident between the two extremes of a relatively wealthy Costa Rica and a far poorer Honduras) gave rise to chronic balance of payments problems. As Honduran economic growth continued to lag behind the rest, it pressured the common market members to find a policy solution to the growing disparity in economic performance.[10]

Unequal economic performance gave way to heated political debate and eventually military conflict. The "Soccer War" between El Salvador and Honduras

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[8]An excellent discussion on the effects of the agricultural export model from a historical basis may be found in: Brockett, Charles D. *Land, Power, and Poverty: Agrarian Transformation and Political Conflict in Central America*. Boulder. Westview Press, second edition, 1998. See especially pp. 93-94.

[9] Cline, William R. and Enrique Delgado, eds. *Economic Integration in Central America*. Washington, D.C. The Brookings Institution, 1978. pp. 405-10.

[10] Ibid., pp. 30-45 and Carl, Beverly M. *Trade and the Developing World in the 21st Century*. New York, Transnational Publishers, Inc, 2001. p. 106.

begun during the 1969 World Cup playoffs was a major setback for the CACM because the heart of this conflict was economic, arising out of long-term tensions over land disputes and immigration pressures. The hostilities, although short-lived, had lasting economic effects, with Honduras pulling out of the CACM and suspending trade with El Salvador for over a decade. Despite these setbacks, economic analysis strongly suggested that where reduced restrictions to trade were allowed to operate, net welfare gains could be found for all countries, even if not shared equally.[11]

The 1980s led off with the fall of the Somoza dictatorship in Nicaragua, civil war in El Salvador, the 1982 Latin American debt crisis, and military repression in other parts of Central America. Between a growing political mistrust and the collapse of economic fundamentals, intraregional trade was halved by 1986 in dollar terms, falling to 15% of total trade. Policies meant to correct foreign debt buildup and balance of payments problems resulted in increased non-tariff barriers, reducing trade growth throughout the region. To move out of the low value-added primary-goods export trap, Central America made some limited attempts at diversifying into non-traditional exports. As a result of this effort, there was a growing sense that the region would be served best by engaging the world as a bloc, rather than attempting to negotiate individually.

As with most of Latin America, it took more than a decade for Central America to recover economically from the 1980s downturn (see **appendix 1**). A renewed commitment to deeper integration was codified in the 1991 Protocol of Tegucigalpa that established the Central American Integration System, which operates as a regional umbrella organization and includes Panama. Since then, most Central American countries have experienced noticeable increases in trade as a percentage of economic activity (see **table 1**), although at levels that still leave much room for growth, especially for countries with small internal markets. In 1993, the Protocol of Guatemala modified commitments of the original CACM treaty, calling for deeper economic and political cooperation. This took form in policies such as establishing a new common external tariff (CET) with a floor of zero and a cap of 15%. This and other rules, however, were phased in at the discretion of each country, so the prospects for deeper integration rests on a foundation of flexibility that has served to unify the member countries by recognizing their varying abilities to implement the agreement's provisions.[12]

This flexibility has proved useful in CACM's trade agreement negotiation process as well. The CACM has initiated negotiations for FTAs with both Chile and

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[11] Cline and Delgado, op.cit., pp. 22-23, 39-41, 110-15, and 296-300. Honduras actually raised its tariffs for all CACM members and then proceeded to negotiate more limited bilateral agreements with individual CACM countries, with the exception of El Salvador. The Central American Bank for Economic Integration took responsibility for providing resources to address uneven development issues. Interestingly, Honduras had the highest level of outstanding loans (relative to total economic output) in the first two decades, but this had failed to keep hostilities at bay.

[12] Inter-American Development Bank. *Integration and Trade in the Americas: Periodic Note*. Washington, D.C. December 2000. pp. 34-35.

the Dominican Republic, among others, setting a precedent for intra-regional cooperation in trade negotiations. Individual countries, however, are also pursuing bilateral agreements with various Latin American countries, again pointing to the fluid nature of the CACM, but also blurring the distinction between the CACM operating as a free trade area rather than a customs union with a well-defined and fully observed common external tariff, to which the member states are legally bound. This system raises a number of potential legal confusions for international firms wishing to trade or operate in one or more of the Central American countries.[13]

Table 1. Central American Exports (% of GDP)

Country	1991 Exports/GDP	2001 Exports/GDP
Costa Rica	22.8	31.0
El Salvador	11.3	20.8
Guatemala	12.8	14.2
Honduras	26.7	31.7
Nicaragua	21.4	32.6

Data Source: IMF, *International Financial Statistics*, and Central Banks of Costa Rica, El Salvador, Guatemala, Honduras, and Nicaragua.

Such a concern is not lost on the CACM countries. On March 24, 2002, they signed a plan of action to move forward on integration issues including tariff harmonization, reducing non-tariff barriers, finalizing dispute settlement procedures, and developing a common foreign trade policy.[14] Although it is unclear how soon all these goals can be reached, the continuing commitment to regional integration remains alive, which may facilitate the CAFTA negotiations.

U.S.-Central American Trade Relations

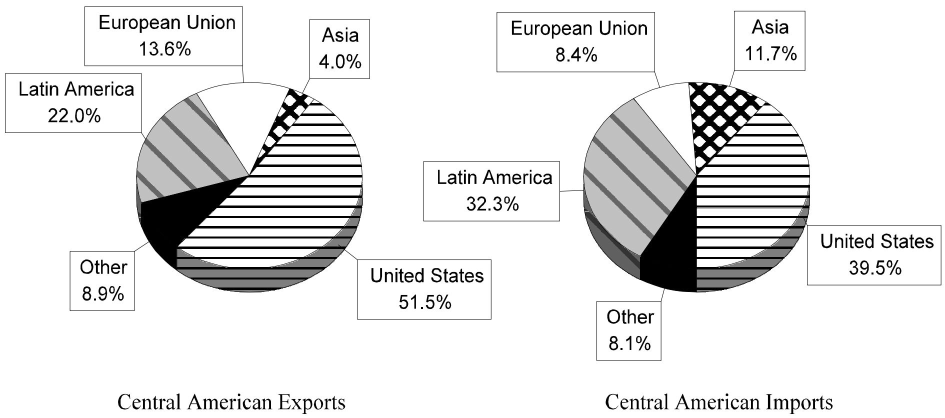
In large part because of geographical proximity and the huge U.S. market, Central America early in its history developed a strong trade and investment relationship with its northern neighbor. U.S. merchandise trade has dominated Central America's foreign commerce and as seen in **figure 1**, remains in that dominant role today. The United States is by far the largest of Central America's trading partners, accounting for some 52% of its exports and 40% of its imports. The rest of Latin America collectively is the next largest trading partner, accounting for 22% of Central America's exports and 32% of its imports. The European Union and Asia together accounted for about 14% of Central American exports and 20% of imports.

[13] Ibid., p. 35-36 and Carl, op. cit., pp. 110-11.

[14] Inter-American Development Bank. *Institute for Integration of Latin America and the Caribbean. Monthly Newsletter*. April 2002.

This distribution is not uniform throughout the region. Honduras, for example, exports 70% of its merchandise goods to the United States, compared to only 20% for El Salvador. Honduras also has the highest import percentage from the United States at 58% compared to Nicaragua's 25%, which is the lowest. Total trade (exports plus imports) with the United States is also somewhat uneven country by country. Costa Rica accounts for one-third of total Central American trade with the United States, whereas Nicaragua amounts to only 7% of the total. Guatemala, Honduras, and El Salvador account for 25%, 22%, and 12% respectively.

Figure 1. Central America's Direction of Merchandise Trade, 2001



Data Source: IMF, *Direction of Trade Statistics*.

Although the trade volume with the United States varies among countries, in most cases the trend has been one of growth and at a rate higher than the average for U.S. trade with the world. Over the past five years, U.S. exports to Central America grew by 17.1%, compared to 1.6% with the world and 4.9% with Latin America as a whole (see **appendix 2** for the data). U.S. imports from Central America increased by 28.3% over the same time period, compared to 27.6% for the world and 41.0% for Latin America. Although trade varied among the five countries, in all cases except U.S. imports from Costa Rica, it was significantly higher than the world average. More recent data support this trend as well. In 2002, U.S. merchandise exports to the world declined by 5%, whereas to Central America they grew by 9.5%. This reflects declines of 5% and 1% with El Salvador and Nicaragua, respectively, and increases of 6%, 9%, and 25% with Honduras, Guatemala, and Costa Rica, respectively. U.S. imports from the world advanced by 2% over the last year, compared to 7% for the

Central American countries, all of which experienced growth in the U.S. market over the last year.[15]

The major U.S. imports from Central America, reflecting a structural shift away from the pure agricultural model, include: apparel; fruit (mostly bananas); coffee, and integrated circuits. The disparity in trade growth, with Costa Rica standing out from the rest, can be explained in part by the type of merchandise trade in which each country specializes. Traditionally, Central America is known for exporting bananas and coffee. Coffee has actually declined for all countries except Costa Rica and constitutes only 5.4% of U.S. imports from the region. This may reflect the competitive nature of coffee trade, which is grown in vast quantities by Brazil, Colombia, and countries in Africa as well. Bananas are also less important than at one time and export growth has moderated to the point that they account for only 3.2% of U.S. imports. Costa Rica and Guatemala are the largest exporters, but bananas account for only about 8% of total exports sent to the United States.

Apparel has become the dominant export good for all countries except Costa Rica. This trend reflects a broader pattern of low-wage apparel production being shifted to developing countries. The United States encouraged this type of trade when it included the Central American countries as beneficiaries under the Caribbean Basin Economic Recovery Expansion Act (CBERA) in 1984. Apparel is technically excluded from preferential treatment under CBERA, but under a special access program (SAP), eligible apparel exports received preferential treatment under production sharing arrangements (Chapter 98 of the Harmonized Tariff System–HTS). This arrangement was extended under the Caribbean Basin Trade Partnership Act (CBTPA) in October 2000 (P.L. 106-200), which allows duty-free and quota-free treatment of apparel imports if assembled in the Central American countries from fabrics made in the United States made of U.S. yarns, whether the fabrics were cut to shape in the United States or Central America.[16]

In 2001, Central America accounted for approximately 15% of U.S. production sharing imports from developing countries. Most of these imports were apparel, which amounted to 71% of total apparel imports from CBTPA-eligible countries in 2001, led by Honduras with 25% of the total, followed by El Salvador and Guatemala each with 17%, Costa Rica with 8%, and Nicaragua with 4%. U.S. content amounted to 61% of the total value of production-sharing imports from Central America, significantly higher than from production sharing arrangements in Asia and Europe. In 2002, knit apparel imports from CAFTA countries increased by an average 10%, whereas woven apparel imports declined by 5%.[17]

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[15] Calculations are made from trade data compiled by the U.S. Department of Commerce. Merchandise trade data has a two-month lag time from the time the goods enter the country until they are reported. Services trade data have a much longer lag time and are not readily available for small U.S. trading partners, such as the Central American countries.

[16] For the technical details of this arrangement, see: CRS Issue Brief IB95050, *Caribbean Basin Interim Trade Program: CBI/NAFTA Parity*, by Vladimir N. Pregelj.

[17] United States International Trade Commission. Production-Sharing Update: Developments in 2001. *Industry Trade and Technology Review*. July 2002. pp. 39-42, B1-4.

Costa Rica stands alone in having attracted $500 million in foreign direct investment to construct a computer chip plant, which has become its major export generator. In the past year, integrated circuit exports grew by 25% on a dollar-value basis and constitute 20% of the country's exports to the United States. Similar growth may also be seen in Costa Rica's medical equipment exports, another indicator of its relatively sophisticated production capabilities. Costa Rica is the fastest growing and most diversified trader in Central America, which explains in part why it has outpaced its neighbors on the development path and is the leading advocate of CAFTA.[18]

The major U.S. exports to Central America include: electrical machinery, apparel, plastic, yarns, and fabric. Many of these goods are processed in some form and re-exported back to the United States under production sharing arrangements. For example, nearly 60% of electrical machinery is integrated circuits going to Costa Rica for processing and re-export. The same may be said for apparel, fabric, and yarns that are exported to all five countries. These categories of goods also include those that remain in these countries for consumption.

The significant aspect of the structure of this trade is that it reflects growing U.S. direct investment, a deepening economic integration, and yet continues the historical trend of the region's dependence on the massive U.S. market as an important aspect of development policy. This reality will color the framework of negotiations, suggesting that the U.S. policy to provide technical assistance to bolster Central America's trade negotiating capacities may be critical in providing the comfort level necessary for an agreement to move forward.

Review of Trade Negotiations and Policy Issues

Bowing to Central America's limited resources and desire to consolidate negotiations, the United States agreed to establish only five working groups. They are responsible for: 1) market access (including agriculture); 2) investment and services; 3) government procurement and intellectual property; 4) labor and environment; and 5) dispute settlement and other institutional issues. In addition, there is a non-negotiating multi-agency effort responsible for trade capacity building (TCB). By contrast, the U.S.-Chile negotiations used 17 working groups and the FTAA negotiations utilize nine, plus three non-negotiating support groups. The major negotiation issues are summarized below according to the working group in which each negotiation is being conducted, including trade capacity building. As with all trade negotiations, in addition to differences between negotiating countries, for any issue there will be interest groups in the United States with diametrically opposing views, depending on how they perceive the costs and benefits of CAFTA.[19]

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[18] Hufbauer, Kotschwar, and Wilson, op. cit., p. 1003.

[19] In addition to testimony before the USTR's Trade Policy Committee, useful information on a country basis may be found in: Office of the United States Trade Representative. *2003 National Trade Estimate Report on Foreign Trade Barriers*. Washington, D.C.

Trade Capacity Building

Even before detailed discussions began on the CAFTA, the Central American countries expressed a strong apprehension that they would be overwhelmed by the resources and experience that the United States could muster in negotiating and eventually complying with liberalized trade rules. For this reason, the United States advocated assisting the Central American countries. Each Central American country prepared a National Action Plan based on a review of its "trade-related" needs. Assistance is being provided by the United States ($47 million requested in fiscal 2003 budget), private groups (corporate and non-government organizations–NGOs), and five international organizations (the Inter-American Development Bank–IDB, Central American Bank for Economic Integration–CABEI, United Nations Economic Commission on Latin America and the Caribbean–ECLAC, Organization of American States–OAS, and the World Bank).

Major efforts are concentrated on resolving problems and upgrading deficiencies with information systems and regulatory practices (Humane Society of the United States, ECLAC, IDB), environmental issues (World Environment Center, IDB, OAS), worker conditions (Worldwide Responsible Apparel Production, IDB), small business technical assistance on trade and the U.S. market (Humane Society of the United States, IDB, OAS, World Bank), and trade negotiating capabilities (CABEI–$2.5 million grant). The U.S. government is providing assistance through the U.S. Agency for International Development (USAID), the office of the United States Trade Representative (USTR), Department of Commerce, and others in an interagency cooperative effort, which Central America is attempting to duplicate with a coordinating mechanism of its own. Assistance includes training, meeting with trade specialists, and trade data technical assistance and will deal with all trade affected areas: economic; social; and political. Specific topics include environmental and labor issues, outreach to civil society via trade advisory groups, E-business assistance for small businesses, and training negotiators, among others.[20]

Market Access

This working group will focus on the key issues that will determine which tariff structures and rules will govern the movement of goods between Central America and the United States. Tariff rates, rules of origin, customs rules and fees are addressed here. For the Central American countries, the key goal is to "consolidate access" to the U.S. market, which means clarifying, making permanent, and improving on reduced tariff rates for their major exports under rules that already exist under CBTPA and the Generalized System of Preferences (GSP). The United States is seeking equal or better treatment than what other countries receive (especially Canada and Mexico) under their FTAs with Central America. Specifically, negotiators will have to determine the list of goods to be covered, the schedule under which tariffs will be phased out, and the rules of origin that will apply, a thorny and complicated issue for FTAs.

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[20] Details of the program and the Central American National Action Plans may be found at the USTR website: [http://www.ustr.gov].

The most difficult issues will involve Central America's major exports, apparel and agricultural commodities, which receive special treatment in the WTO rules[21] and other U.S. bilateral agreements because they are protected industries in most countries. Both Central America and the United States protect certain agricultural sectors with tariffs and tariff rate quotas. According to the USTR, many of the CAFTA countries have tariffs on agriculture that exceed the 15% common external tariff (CET) of the CACM, particularly for dairy and poultry products. In the United States, sugar will be one of many important issues given that all five Central American countries produce sugar for export and are subject to U.S. tariff rate quotas. Central America is also concerned with U.S. subsidies and the effects lower tariffs on U.S. agricultural goods will have on their domestic markets, but no trade remedies chapter (antidumping/countervailing duties) is contemplated.

Apparel trade presents the other major complication. On the one side, there are U.S. domestic industries competing directly with Central American products. On the other are the Central American producers, often working in concert with U.S. manufacturers in production-sharing arrangements, and also with U.S. importers and distributers of apparel products that are less concerned over the national origin of products, or their component parts. Consumers, no doubt, should also be mentioned as a constituent group (as with agriculture products). There is a complexity in these competing interests, reflecting the delicacy with which negotiators will have to approach literally every product to be included in the agreement. U.S. apparel importers have called for the expedited elimination of all tariffs, a single rule of origin, and broader free use of local yarns and fabrics in Central American exports, particularly as the world heads towards quota-free textile trade on January 1, 2005 as outlined in the WTO Agreement on Textiles and Clothing (ATC). In addition, there are high tariffs on imports of apparel and fabrics in some of the CACM countries (especially El Salvador).

It is not clear how much progress can be made in apparel and agriculture negotiations. Agricultural issues may be a high-profile target, but given world subsidies for agriculture, it is well understood that the WTO is the place to resolve many of these issues.

Investment and Services

In 2001 the United States' stock of foreign direct investment (FDI) in Central America was $3.0 billion (down from nearly $4.0 billion the year before), which represented nearly half of total FDI in the region from all countries. Over half of U.S. FDI was in Costa Rica. The United States has strongly advocated clear and enforceable rules for foreign investment in any trade agreement. In the past, as with the U.S.-Chile FTA, this has included rules governing restrictions on capital flows, as well as specific recourse that individual investors would have. The former has been a problem because it impinges on a country's macroeconomic policy options, but the latter may be the bigger issue for Central America because in all countries the legal system has proven to be difficult to navigate, with charges of corruption in some cases, inhibiting recourse for investors. Therefore, Central America faces the

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[21] See testimony before the Trade Policy Committee.

potential for dealing with major structural reforms in attempting to come to an agreement in this area, yet also stands to gain in the long run if foreigners come to view the region as being a transparent, predictable, and reliable place to invest.

Services trade presents a number of hurdles given Central America has adopted few of the commitments to the WTO's General Agreement on Trade in Services (GATS). There are also many industry-specific barriers that exist, such as: barriers to foreign insurance companies in Guatemala; "heavy" regulation licensing of foreign professionals in Honduras; numerous services monopolies in Costa Rica; and local partner requirements in some financial services in Nicaragua.[22] U.S. firms are very competitive in services trade, particularly financial services.

Government Procurement and Intellectual Property Rights

These two areas are also of particular interest to the United States. CAFTA may be an opportunity to remedy many deficiencies and move toward strong enforcement of standardized practice in the region. None of the five Central American countries is a signatory to the WTO Agreement on Government Procurement and allegations against the various purchasing processes vary from dissatisfaction with less than transparent and cumbersome procedures in Costa Rica to outright corruption in Guatemala. El Salvador and Nicaragua passed new government procurement laws in 2000 and Honduras followed in 2001, and in general, there have been improvements in all countries in dealing with project bidding, although transparency issues remain.[23]

All Central American countries are revising, or have revised, their intellectual property rights (IPR) laws and some are closing in on complying with the WTO Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS). That said, all countries are subject to criticism for falling short on either clarifying or enforcing penalties for noncompliance and in some cases are simply not adopting reforms that many U.S. industries (e.g., sound and video recordings, pharmaceuticals, books, computer software) consider necessary to protect their intellectual property. Revenue losses from IPR infractions amount to millions of dollars each year. Piracy, incomplete or inadequate legal protection, and enforcement capacity remain problems and ongoing concerns exist across the range of IPR issues of patents, trademarks, and copyrights and covering print, electronic, and other media.[24]

Labor and Environment

The broadest challenges to the proposed trade agreement seem to come from the environment and labor advocacy groups. This reflects, among other things, that a variety of social issues related and unrelated to trade are being focused on in this working group. Trade agreements are now seen by many as one way to influence domestic social policy, despite arguments that: such worthwhile goals are too much

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[22] USTR. *2003 National Trade Estimate Report on Foreign Trade Barriers.*

[23] Ibid.

[24] Ibid.

to expect from trade agreements and are better handled directly; that trade can enhance the welfare of countries even if broad social change does not follow; or that in some cases, the capacity to meet developed country standards is simply not available to developing countries. In short, trade negotiations and agreements are viewed as an opportunity for environmental and labor, as well as business groups, to exercise leverage and achieve their goals.

There are a variety of economic issues at play. Advocates of including labor and environment provisions in trade agreements argue that developing countries can enjoy an "unfair" competitive advantage because their lower standards translate into lower costs, which in turn are reflected in lower prices for goods that compete with those produced in developed countries.[25] Over time, the argument goes, the difference in standards leads to investment and jobs moving abroad to take advantage of the lower production costs. On the other hand, a number of studies suggest that these costs are usually not high enough to determine business location, and that productivity remains the primary deciding factor.[26]

For environmental advocates, major goals include protecting and assuring strong enforcement of existing domestic environmental standards, ensuring that multilateral environmental agreements are not undermined by trade rules, promoting strong environmental initiatives to evaluate and raise environmental performance, developing a systematic program of capacity-building assistance, and assuring that environmental provisions in trade agreements are subject to the same dispute resolution and enforcement mechanisms as are other aspects of the agreements.[27] Labor groups advocate ensuring that all workers can exercise freely their fundamental rights at work, requiring governments to respect and promote core International Labor Organization (ILO) standards, and using the same dispute resolution and enforcement provisions that apply to other provisions in an agreement.[28]

Some government officials and interest groups in developing countries have expressed two basic concerns with including environmental and labor provisions in trade agreements: that their sovereignty may be undermined if such agreements endorse higher standards, and that such provisions may be used as a disguised form

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[25] The difference is that the social costs associated with environmental degradation, pollution, poor working conditions, and low wages are not captured in the production process. Through legal and regulatory measures, developed countries require that businesses bear many of these costs, which are then reflected in the final (relatively higher) price of the good or service in the market place.

[26] See: CRS Report 98-742 E, *Trade with Developing Countries: Effects on U.S. Workers*, by J. F. Hornbeck. September 2, 1998, pp 11-13. Productivity and wage levels are, however, highly correlated. See: Rodrik, Dani. Sense and Nonsense in the Globalization Debate. *Foreign Policy*. Summer 1997, Number 107. pp. 30-33.

[27] See: [http://www.sierraclub.org/trade/fastrack/letter.asp], *Principles for Environmentally Responsible Trade.* Another important issue for the United States is ensuring that its higher environmental standards defined in law and regulation not be compromised by challenges of protectionism. See: CRS Report RS20904, *International Investor Protection: "Indirect Expropriation" Claims Under NAFTA Chapter 11*, by Robert Meltz. May 3, 2001.

[28] See: [http://www.aflcio.org], *Off the Fast Track–On the Right Track.*

of protectionism. A number of groups in the United States and other developed countries supporting free trade agreements have expressed similar sentiments in opposition to the inclusion of environmental and labor provisions.

In the Central American case, much attention is focused on income inequality and working conditions, particularly in the maquiladoras. One perspective notes that inequality remains the standard in Central America and that none of the countries "come close to meeting a minimum threshold of respect for the ILO's core labor standards." Further, systematic infractions at maquiladoras are provided as prominent examples, and it is argued that CAFTA "could dramatically and irreversibly weaken current labor rights conditions contained in the GSP and CBTPA," particularly if language goes no further than requiring countries to enforce their existing laws, which fall far short of ILO standards.[29] Other critics argue that neo-liberal economic ideas, including free trade, are a dismal failure in Central America and should be abandoned.[30]

Still other observers maintain that despite clear problems with inequality and workers' rights, they are complex issues that require multiple long-term policy responses that go far beyond trade policy. They emphasize that inequality and working conditions are the result of multiple factors, including cultural and historical circumstances, as discussed briefly above. Most economic literature suggests that restricting trade is an ineffective policy response for addressing social equality issues such as child labor and bargaining rights. Rather, much of the literature characterizes trade liberalization as a necessary part of long-term growth and development for all countries.[31]

A detailed survey of Honduran maquiladora workers and applicants suggests that the alternatives to maquiladora work offers no actual improvement. Although the Honduran maquiladora salaries were shown to be too low to move families out of poverty, the survey indicated they were 50% higher than minimum wage, or what the average applicant was making before working at the maquiladora. Maquiladoras did have a lower percentage of workers represented by unions than the applicants coming from other jobs, but the survey indicated the difference was small and that there had not been a strong call for more unionization. It was suggested that this might be due to Honduran workers' lack of trust in local unions given their history of corruption, as well as the pressure management put on workers not to support unionization. There was also some clear discrimination against women and perhaps higher health risks (not defined), but by and large, working conditions were seen as comparable to other lines of work, and workers surveyed said they were generally satisfied with their jobs. These conclusions raise an important overall question of

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[29] Lee, Thea M. Assistant Director for International Economics, AFL-CIO. *Comments on the Proposed U.S.-Central American Free Trade Agreement*, before the USTR Trade Policy Committee, November 19, 2002.

[30] Fosse, Farah. Voices From Central America: Behind the Trade Agreements. *Center Focus*. February/March 2003. pp. 10-12

[31] The literature is vast. For a good and easily digestible summary, see: Birdsall, Nancy. Life is Unfair: Inequality in the World. *Foreign Policy*, Summer, 1998. pp. 84-87.

determining what the measured standard should be to evaluate the social effects of maquiladora operations.[32]

Finally, in the past, dispute resolution has been one of the biggest stumbling blocks. Previous negotiations, including those involving NAFTA and the Canada-Chile bilateral FTA, relied on an intergovernmental consultation process and turned to the imposition of a "monetary enforcement assessment," effectively fines, to compel compliance. This remains the case for the U.S.-Chile agreement as well, but with further understanding that nonpayment of fines can lead to broad monetary assessments on a range of traded goods, eliminating the need to specify trade sanctions as an option, which was a very controversial topic. Negotiators may find this to be compelling language for CAFTA, as well.

Labor and environmental issues have come to change the substance of trade negotiations compared to a decade ago. Advocates for these issues remain unsatisfied, but have produced some results. A key question is how much change can reasonably be expected from trade agreements, and how much will result from structural changes within each economy, as has been the case with the developed world.[33]

Dispute Resolution and Institutional Issues

This negotiation group will focus on numerous chapters that define how the trade agreement will operate. Dispute resolution will likely be modeled on previous FTAs, in which commercial disagreements are intended to be resolved cooperatively with some type of panel system, relying on suspension of tariff benefits (return to MFN treatment) if the dispute is not settled otherwise. Resolving labor and environmental disputes is trickier and may build on work done in the Chile agreement. This category of dispute is likely to be included as part of a single dispute resolution chapter and process, but with the stipulation of reliance on monetary assessments in cases of noncompliance with labor and environment commitments. These issues, however, are far from final. Administrative and other technical matters (e.g. transparency issues) of trade agreement implementation will also be outlined by this working group.

Outlook

The CAFTA negotiations have moved ahead quickly with three rounds of negotiations completed by April 2003. The U.S. bilateral trade negotiation process continues to evolve given the lessons learned from completing recent agreements

[32] Ver Beek, Kurt Alan. Maquiladoras: Exploitation or Emancipation? An Overview of the Situation of Maquiladora Workers in Honduras. *World Development*, 2001.

[33] In looking at the integration process of the CACM a quarter century ago, one study reinforced the influence of structural components, such as land distribution, in determining income distribution patterns, concluding that, "It would be naive in the extreme to suppose that alternative integration policies could have changed these basic structural factors substantially." Cline and Delgado, op. cit., p. 409.

with Singapore and Chile. CAFTA is an ambitious and innovative approach, especially for the Central American countries. They are learning quickly to assess their national priorities and capabilities, find ways to integrate the demands of civil society into the negotiation process, incorporate small business and rural agricultural diversification, and build on their basic capacities to trade such as improving customs procedures. The challenges to Central American institutions, both national and regional, are significant. For the potential benefits of CAFTA to materialize, the region must improve trade relations not only between the United States and Central America, but among the Central American countries.

For the United States, reconciling diverse interests remains a standard task of any FTA negotiation. Whereas progress already appears to have been made in areas where crossovers from the Chilean experience have been helpful, such as in services, intellectual property, government procurement, and e-commerce, resolution of the more difficult issues awaits further rounds of discussions. For example, dealing with the most sensitive agricultural products where tariffs and quotas are most prevalent will likely require lengthy negotiation. This is also true for defining the labor agreement in light of interests that want to make sure gains made through CBI are not in conflict with language in the TPA and also acceptable to the Central American countries. These issues lie ahead.

Although U.S. negotiators, in looking ahead to a completed CAFTA, may envision Central America with much of its trade capacity building well underway, it is also clear that there are limitations to what can be accomplished in the span of a few months. There may be delays and perhaps setbacks in implementing changes even if the negotiations proceed on schedule. Building on a relationship begun with the CBI, however, provides a basis to consider the possible merits and pitfalls of a CAFTA.

Appendix 1. Central America: Selected Economic Indicators

(year 2001 data, except where otherwise indicated)

	Costa Rica	El Salvador	Guatemala	Honduras	Nicaragua
GDP ($ billions)	15.7	13.0	19.6	5.9	2.5
GDP Growth (%)	1.1	2.0	1.9	2.6	3.3
GDP Growth 1980-1990 (%)*	3.0	0.2	0.8	2.7	-1.9
GDP Growth 1990-2001 (%)*	5.1	4.5	4.1	3.1	2.8
PPP Per Capita Gross National Income ($)**	9,260	5,160	4,380	2,760	2,080 (yr. 2000)
Inflation - CPI (%)	11.0	1.4	8.4	10.0	7.4
Current Account Balance (% of GDP)	-4.6	-1.3	-4.6	-4.9	-38.1
Pop. Below $1 per day (%)***	6.9	21.4	16.0	23.8	82.3
Human Development Index (HDI)#	43	104	120	116	118

Sources: World Bank, *World Development Indicators, 2003,* United Nations, *Human Development Report, 2002*, and IMF web site.
* Average annual percent growth.
** Gross national income (GNI) converted to international dollars using purchasing power parity rates. An international dollar has the same purchasing power over the GNI as a U.S. dollar has in the United States. GNI is a different, but similar measure as GDP.
*** Percentage of population living on $1 per day or less, most recent survey year.
# HDI is a composite measure (education, income, and life expectancy) of average achievement in human development. A lower ranking is better: e.g. United States (6), Italy (20), and South Korea (27).
na = not available.

Appendix 2. U.S. Merchandise Trade with Central America, 1998-2002

($ millions)

Country	1998	1999	2000	2001	2002	% Change 2001-2002	% Change 1998-2002
U.S. Exports							
Costa Rica	2,296	2,381	2,445	2,502	3,132	25.2%	36.4%
Honduras	2,318	2,370	2,575	2,416	2,565	6.2%	10.7%
Guatemala	1,938	1,812	1,895	1,870	2,042	9.2%	5.4%
El Salvador	1,514	1,519	1,775	1,760	1,665	-5.4%	10.0%
Nicaragua	336	374	379	443	437	-1.4%	30.1%
Total CAFTA	8,402	8,456	9,069	8,991	9,841	9.5%	17.1%
Latin America	142,168	142,062	170,632	159,453	149,173	-6.4%	4.9%
U.S. Imports							
Costa Rica	2,745	2,713	3,547	2,886	3,142	8.9%	14.5%
Honduras	2,544	3,968	3,090	3,127	3,264	4.4%	28.3%
Guatemala	2,072	2,265	2,605	2,589	2,800	8.2%	35.1%
El Salvador	1,438	1,605	1,933	1,880	1,982	5.4%	37.8%
Nicaragua	453	495	590	604	679	12.4%	49.9%
Total CAFTA	9,252	11,046	11,765	11,086	11,867	7.0%	28.3%
Latin America	144,895	168,185	209,274	198,708	204,276	2.8%	41.0%
U.S. Balance of Trade							
Costa Rica	-449	-332	-1,102	-384	-10		
Honduras	-226	-1,598	-515	-711	-699		
Guatemala	-134	-453	-710	-719	-758		
El Salvador	76	-86	-158	-120	-317		
Nicaragua	-117	-121	-211	-161	-242		
Total CAFTA	-850	-2,590	-2,696	-2,095	-2,026		
Latin America	-2,727	-26,124	-38,642	-39,256	-55,103		

Source: Table created by CRS from U.S. Department of Commerce data.