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

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Summary

On December 17, 2003, the United States concluded negotiations on a U.S.-Central America Free Trade Agreement (CAFTA) with four of the five Central American Common Market (CACM) countries (Guatemala, Honduras, El Salvador, and Nicaragua). Costa Rica has not agreed to CAFTA pending further discussion on a few sensitive issues, which began on January 5, 2004. The CAFTA text will not be released until January 2004 at the earliest, but summaries indicate that a comprehensive agreement was reached. As defined in the Trade Promotion Authority (TPA) legislation, President Bush must notify Congress 90 days in advance of his intention to sign CAFTA, which he is expected to do in January 2004. After that, he must forward to Congress detailed documentation, including the draft implementing bill. This report provides background and analysis on CAFTA in support of Congress and will be updated periodically.

Under CAFTA, more than 80% of U.S. consumer and industrial exports would become duty-free immediately, with all tariffs removed within 10 years. Tariffs would go to zero on information technology products, agricultural and construction equipment, paper products, chemicals, and medical/scientific equipment, among others. Over half of current U.S. farm exports to Central America would become duty free immediately, including "high quality" cuts of beef, cotton, wheat, soybeans, certain fruits, and vegetables, processed food products, and wine. At the same time, the U.S. conceded to slight increases in sugar quotas for the four Central American countries. Advances were also made in other areas important to the United States including services trade, intellectual property rights, and government procurement. For Central America, benefits received under the Caribbean Basin Trade Partnership Act (CBTPA) would become permanent.

CAFTA, however, is not complete and faces political uncertainty. Work continues on the environment portion of the agreement and details reportedly must be clarified in other areas as well. Issues with Costa Rica must be settled expeditiously if it is to accept the agreement early in 2004. In the United States, groups oppose liberalizing trade rules for Central America's major exports, apparel and agricultural goods, and there is also considerable resistence to the agreement from labor groups.

For the U.S. Congress, reconciling diverse interests remains a standard, but challenging, task in consideration of any FTA. This task is complicated by the competing nature of the negotiating goals. Relaxing trade rules governing agriculture and textiles, for example, may support trade growth and development in Central America, but runs contrary to some strong interests in the United States. Labor advocates argue that CAFTA perpetuates exploitation in Central America, but proponents assert that U.S. protectionism works against Central America growth and development and hurts U.S. consumers and exporters. Balancing these perspectives may prove particularly vexing during a presidential election year. Although CAFTA has broached new ground in some areas, it is unclear whether it has achieved such a balance.

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

On December 17, 2003, after a year of intensive meetings, the United States concluded negotiations on the U.S.-Central America Free Trade Agreement (CAFTA) with four of the five Central American Common Market (CACM) countries (Guatemala, Honduras, El Salvador, and Nicaragua). Costa Rica has not agreed to CAFTA pending further discussion on a few sensitive issues, which began on January 5, 2004 (see section on the Status of Trade Negotiations). President George W. Bush promoted CAFTA as an ambitious agreement that would "strengthen the economic ties we already have with these nations...reinforce their progress toward economic, political, and social reform...and take another step toward completing the Free Trade Area of the Americas."[1]

Despite these bold promises, support by Members of Congress for CAFTA is far from certain given the diverse constituent interests that they represent. The congressional debate will likely intensify when CAFTA implementing legislation is referred from the White House for consideration. As defined in the Trade Promotion Authority (TPA) legislation, President Bush must notify Congress 90 days in advance of his intention to sign CAFTA, which he is expected to do in January 2004. After that, he must forward to Congress detailed documentation, including the draft implementing bill (see **Appendix 1** for a Chronology of CAFTA Negotiations). This report provides background and analysis on CAFTA in support of Congress and will be updated periodically.

Why Trade More Freely?

Countries trade because it is in their national economic interest to do so, a proposition that is supported by both theory and practice. Comparative advantage has been recognized for nearly 200 years as a core principle explaining the efficiency gains that can come from trade among countries by virtue of their fundamental differences. 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. Intra-industry trade is the other major insight that explains trade patterns. Larger markets allow for benefits from exchange among countries to occur based on specialized production, product differentiation, and economies of scale and many

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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.

Latin American countries have liberalized trade policies recognizing the contribution that trade (and related investment) can have on economic growth and development. As an important caveat, trade is at best only part of a broad development agenda, which must also include promotion of political freedom, macroeconomic stability, sound institutions, and adequate levels of savings and investment, among many other factors.[2]

Comparative advantage and perhaps intra-industry trade provide the rationale for U.S.-Central American trade. Comparative advantage is at the heart of exchange between developing and industrialized countries, such as Central America trading fruit and coffee for U.S. grains, cereals, and capital goods. Intra-industry trade (e.g. goods within the same harmonized tariff system (HTS) code number) is based on specialized production, but in this case relies in large part on differences in wages, skills, and productivity.[3] Certain specialized jobs have developed in Central America (and other developing countries), where they frequently reside in production sharing (maquiladora) facilities. Economists have come to refer to such specialized production as "breaking up the value added chain" and it accounts for why products (and particularly parts thereof) as diverse as automobiles, computers, and apparel are often made or assembled in Central America and other countries in partnership with U.S. firms.[4] This relationship, discussed in more detail later, provides the basis for much of the labor policy debate on CAFTA, and FTAs more generally.[5]

Measuring the benefits of freer trade is another difficult issue. 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 benefits from imports, where the

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[2] The role of trade is summarized well in: Rodrik, Dani. *The New Global Economy and Developing Countries: Making Openness Work*. The Overseas Development Council, Washington, D.C. 1999. p. 137 and Bouzas, Roberto and Saul Keifman. Making Trade Liberalization Work. *After the Washington Consensus: Restarting Growth and Reform in Latin America*. Kuczynski, Pedro-Pablo and John Williamson, eds. Institution for International Economics. Washington, D.C. March, 2003. pp. 158, 165-67.

[3] This case differs from the standard intra-industry case between two developed countries in which goods, such as automobiles, are exchanged based on product differentiation and economies of scale and where differences in wages levels are not a central factor.

[4] 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.

[5] Note that this trend has not been a driving force in the aggregate unemployment rate of the United States, but does affect the distribution of employment among sectors of the economy. It is also important to emphasize here that wage levels are only part of the issue. Lower wages correlate closely with lower productivity, hence 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.

gains from trade are better understood by their contribution to increased consumer selection, lower priced goods, and improved productivity. For example, high-tech intermediate goods imported from developed countries are the basis for future, more sophisticated, production in developing countries. In developed countries, imports from developing countries, whether final goods for consumers or inputs for manufacturing enterprises, reduce costs and contribute to productivity and economic welfare. For all countries, exports are the means for paying for these imports and their attendant benefits.

Three caveats related to negotiating FTAs are important. First, the discussion of costs and benefits generally assumes that FTAs are executed and implemented in a multilateral setting. In fact, given the slow pace of World Trade Organization (WTO) negotiations, many countries are pursuing preferential arrangements, that is, regional and bilateral agreements like the proposed CAFTA. Latin America is full of them and depending on how they are defined, they may actually be trade distorting if they promote trade diversion. This occurs when trade is redirected to countries within a limited agreement that does not take into account countries outside the agreement, some of which may be more efficient producers. Preferential trade agreements are also cumbersome to manage, requiring extensive rules of origin, and economists disagree over whether FTAs help or hinder the movement toward greater multilateral trade liberalization.[6]

Second, trade, much like technology, is a force that changes economies. It increases opportunities for internationally competitive sectors and challenges import competing firms to become more efficient or do something else. This fact gives rise to the policy debate over adjustment strategies, because while consumers and export sector workers benefit, some industries, workers, and communities are hurt. 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.[7] Because trade agreements raise difficult political choices for legislators in all countries, many of whom represent both potential winners and losers, FTA provisions are typically limited in scope (so continue to protect partially or completely certain products, industries, or sectors) and are phased in over time (typically up to 15 years for very sensitive products).

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[6] 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 can have a countervailing influence on the others. Adding the many Latin American FTAs only makes the situation more confusing.

[7] Importantly, 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 U.S. consumer. This can be significant for low-wage workers in the United States. The same idea holds true for industrial products and business consumers. So, there is a "trade off" in the trade policy decision between keeping certain jobs through protection and losing the income gains, or keeping the income gains and losing certain jobs. One public policy response has been to pass trade adjustment assistance legislation to help firms and workers transition more quickly to new opportunities.

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 over which they would be able to exert little or no leverage. Both agreements deal little with trade remedies (e.g. antidumping and subsidies) and resolving agriculture issues also has been limited, given the politically sensitive nature of this issue.

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 was made for Central America as well, which has trade agreements with Mexico, Canada, and other countries. The apparent impasse or delay of WTO and possibly the Free Trade Area of the Americas (FTAA) negotiations only reinforces this attitude.

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 an 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 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. Third, the promise of social, economic, 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.[8]

Economic fundamentals have shaped Central American trade relations. From the early days of independence, agricultural exports were the centerpiece of Central American economic growth. The British controlled primary export production (coffee, bananas, sugar, and beef) until about 1850, when U.S. interests won over. This continued until the 1980s when passage of the Caribbean Basin Economic Recovery Act (CBERA — P.L. 98-67) began to transform the Central American economies. By becoming eligible for unilateral preferential tariff treatment as part

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[8] 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.

of the Caribbean Basin Initiative (CBI), U.S. investment fostered growth in light manufacturing, primarily apparel.[9]

The U.S.-Central American economic relationship changed dramatically under the CBI, creating an environment in which businesses forged strategic partnerships in the increasingly complex world of textile and garment manufacturing. From 1974 until 1995, rules restricting trade in apparel between developed and developing countries (mostly quotas) were set out in the Multifiber Arrangement (MFA). Its successor, the WTO sponsored Agreement on Textiles and Clothing (ATC) serves as a transitional agreement that oversees the reduction and elimination of quotas by January 1, 2005.[10] The preferential arrangements offered under the CBI programs were defined in this system, which the United States created to help foster Caribbean economic development, as well as to assist U.S. industry in responding to competition from similar production-sharing arrangements in Asia that were taking a toll on U.S. production and employment in the textile and apparel industries.

Both U.S. textile and apparel industries have been hit hard by foreign competition. The textile industry (e.g., cloth, yarns, thread) has lost jobs, but has remained marginally competitive internationally through more sophisticated use of production technologies. The apparel manufacturing industry (e.g., shirts, pants, undergarments) by contrast, is highly labor intensive, and in striving to reduce costs, has moved production offshore to lower wage countries, with significant U.S. job loss in that sector. As part of this process, and with the added incentive of CBI benefits, U.S. firms invested in Central American and Caribbean countries to develop assembly businesses that used mostly U.S. textiles as inputs. Although created as a mutually beneficial pact, it was a controversial move because of the reliance on foreign low-wage workers to the detriment of some U.S. employment. Many economists argue, however, that the alternative was even greater loss of textile and garment jobs to Asian countries that use no U.S. inputs.[11]

Low-cost labor, however, is not the only, or even the most important, factor driving competitiveness. Studies suggest that the economic and social networks that developed between U.S. and Central American firms effectively created a comparative advantage for the region in apparel exporting that has held up even with the entry of China in the market.[12] The key global challenge to this system comes

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[9] This legislation was amended twice, most recently by the Caribbean Basin Trade Partnership Act (CBTPA — P.L. 106-200, Title II), which further loosened restrictions on apparel imports from the Central American countries.

[10] See: CRS Report RL31723, *Textile and Apparel Trade Issues*, by Bernard A. Gelb.

[11] Chacón, Francisco. International Trade in Textile and Garments: Global Restructuring of Sources of Supply in the United States in the 1990s. *Integration and Trade*, Vol. 4, No. 11, May-August 2000. Inter-American Development Bank, Washington, D.C.

[12] A more subtle distinction made by one economist notes that, "How comparative advantage is created matters. Low-wage foreign competition arising from an abundance of workers is different from competition that is created by foreign labor practices that violate norms at home. Low wages that result from demography or history are very different from low wages that result from government repression of unions." See: Rodrik, Dani. "Sense and (continued...)

after 2004 when quotas are scheduled to end on textiles and apparel. Whether the U.S.-Central American production relationship can withstand the expected increased competition from large low-cost producers, such as China, is unclear, but CAFTA is seen by some as a logical policy extension of a model intended to do so.[13]

Broader geopolitical and strategic concerns also sparked interest by all parties in pursuing CAFTA. For example, proponents expect CAFTA 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. CAFTA may also be a way to expand support for U.S. 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.

Critics of CAFTA point to equally broad themes, such as the pervasive social and economic inequality in much of Central America, and so support labor and environment provisions as important negotiating objectives. 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 to materialize unless there is some credible promise of accelerated social development, even if this is much to ask of 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 commercially from the detailed agreement that has emerged. 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, although a distant third from Mexico. Still, 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, especially in the maquiladora trade.

For the United States, an FTA is a more balanced trade arrangement than the unilateral preferences provided in the CBI. Market access (e.g., tariff rates, rules of origin) was 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 their FTAs with Central American countries. Permanent and clarified trade rules would also support the joint production arrangements already in place between Central American and U.S. firms. Finally, as highlighted in the negotiations with Chile, a bilateral agreement offers the United States a chance to address other trade

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[12] (...continued)
Nonsense in the Globalization Debate." *Foreign Policy*. Summer 1997. p. 28.

[13] Gereffi, Gary. The Transformation of the North American Apparel Industry: Is NAFTA a Curse or a Blessing? *Integration and Trade*. Vol. 4, No. 11. May -August 2000. Inter-American Development Bank. Washington, D.C. pp. 56-57.

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, and services.

From the Central American perspective, reducing barriers to the large U.S. market (especially for textile and agricultural products) and increasing foreign investment were cause enough to proceed. This point is directed specifically at making permanent the benefits Central America currently enjoys under the CBI legislation, but which requires periodic reauthorization by Congress. This could increase U.S. foreign direct investment (FDI) that developed the maquiladora relationship in the first place and which supports Central America's export driven development strategy. The Central American countries also face important vulnerabilities, such as the possibility that U.S. agricultural exports of key staples, such as corn and rice, might overwhelm their small markets, causing huge displacement issues. Sensitivity to these and other key industry sectors had to be considered.

Finally, two factors pointed to significant negotiation challenges. The first was the need for better Central American integration. Individually, the Central American countries may be too small to justify a U.S. bilateral agreement by themselves, and also trade has been hampered within the subregion by cumbersome customs and other rules. For CAFTA to work well, the United States needed some assurance that goods could flow efficiently within the region. Second, much was made of the difference in negotiating capacity between Central America and the United States. U.S. and multilateral offers to assist these countries in developing such capacity were viewed as generous, but also a little self-serving, which required a sensitive approach to the whole negotiation process.

The Quest for Central American Integration

Because the Central American countries had to develop a single negotiating position, cooperation was paramount. This is no small technical point; although the Central American Common Market (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. The fact that Costa Rica did not agree to CAFTA, despite some expectations that it eventually will, makes the point.[14]

Since the Spanish colonial period, Central America has been an agricultural exporting area, which by the modern period became concentrated in five major commodities: bananas; coffee; sugar; beef; and cotton. The socioeconomic balance that emerged from this trade regime was far from egalitarian. 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 colonial Central

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

American society, the modern, foreign-dominated agricultural export model did little to change this reality. The resulting highly stratified socioeconomic structure fostered social discontent and political unrest, leading directly, and perhaps unavoidably, to the turbulent 1970s and 1980s (see **Appendix 2** for a comparison of economic data among the five countries).[15]

There are important implications of this development pattern for regional integration. The emphasis Central American leaders placed on economic integration rested largely on expectations that the gains from economic growth and development would be shared, at least among countries, if not within them. In the first two decades of the CACM, economic analysis pointed to both static and dynamic gains from trade. The CACM lowered and equalized external tariffs, expanded the internal market, and helped diversify production and modernize economic activity. Benefits arose from more open domestic policies as well as foreign investment and technology transfer that accompanied trade. One study found that 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 economies, presumably without introducing new distortions in trade relations.[16]

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. 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 economic growth in Honduras continued to lag behind the rest, it pressured the common market members to find a policy solution to the growing disparity in economic performance.[17]

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

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[15] 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.

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

[17] 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.

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.[18]

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, 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. Over time Central America moved away from low value-added primary-goods exports, and through this diversification process, there emerged a renewed sense that the region would be served better by engaging the world as a bloc, rather than 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 2**). A revived 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.

Table 1. Central American Exports as % 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.

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

[18] 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.

foundation of flexibility that has served to unify the member countries by recognizing their varying abilities to implement the agreement's provisions.[19]

This flexibility has been useful in CACM's trade agreement negotiation process as well. The CACM has initiated negotiations for FTAs with both Chile and 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.[20]

Such a concern has not been 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.[21] Although it is unclear how soon all these goals can be reached, the continuing commitment to regional integration remains alive.

U.S.-Central American Trade Relations

Because of its huge size and geographical proximity, the U.S. market has been a natural destination for Central American exports. Merchandise trade with the United States has dominated Central America's foreign commerce for 150 years, 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 57% of its exports and 41% of its imports. The rest of Latin America collectively is the next largest trading partner, accounting for 19% of Central America's exports and 28% of its imports. The European Union and Asia together accounted for about 17% of Central American exports and 19% of imports.

This distribution is not uniform throughout the region. Honduras, for example, exports 70% of its merchandise goods to the United States, compared to 45% for Costa Rica. Honduras also has the highest import percentage from the United States at 55% compared to Nicaragua's 24%, 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.

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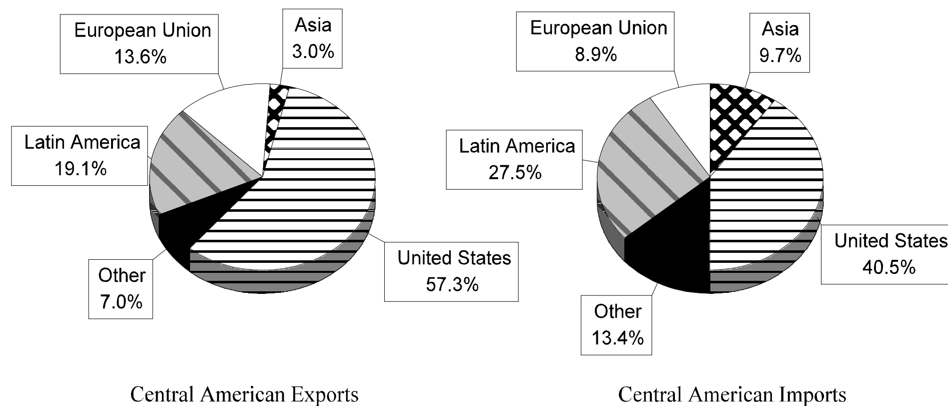
[19] Inter-American Development Bank. *Integration and Trade in the Americas: Periodic Note*. Washington, D.C. December 2000. pp. 34-35.

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

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

Figure 1. Central America's Direction of Merchandise Trade, 2002



Data Source: IMF, *Direction of Trade Statistics*, September 2003.

Trade volume with the United States varies among countries, but in most cases the trend has been one of growth 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 17.0%, compared to 1.6% with the world and 4.8% with Latin America as a whole (see **Appendix 3** for the data). U.S. imports from Central America increased by 28.2% over the same time period, compared to 27.6% for the world and 40.9% 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 9.4%. 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% in 2002, compared to 7% for the Central American countries, all of which experienced growth in the U.S. market over the last year.[22]

U.S. Imports

The major U.S. imports from Central America fall into three main categories: fruit (mostly bananas) and coffee; apparel; and integrated circuits. These three

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[22] Calculations are made from trade data compiled by the U.S. Department of Commerce. Merchandise trade data have 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.

distinct categories are not traded uniformly by the five countries (see **Table 2**). First, Central America has traditionally exported bananas and coffee, which is dominated by Costa Rica and Guatemala. Coffee has actually declined for all countries except Costa Rica and constitutes only 3.2% of U.S. imports from the region. This reflects the competitive nature of trade in coffee, which is grown in vast quantities by Brazil, Colombia, and countries in Africa as well. Banana trade has also declined in importance and accounts for only 5.4% of U.S. imports from Central America.

Table 2. Top Eight U.S. Imports from CAFTA Countries, 2002

($ millions)

Product and HTS Number	CAFTA	Costa Rica	Hon	Guat	El Sal	Nic
Total U.S. Imports	11,861	3,142	3,261	2,796	1,982	680
Knit Apparel (61)	4,534	365	1,801	978	1,259	131
Woven Apparel (62)	2,463	363	700	681	417	302
Edible Fruit & Nuts (08) Bananas (0803)	987 (636)	484 (250)	154 (120)	338 (258)	1 (0)	10 (9)
Electrical Machinery (85) Integrated circuits (8542)	723 (447)	618 (447)	73 (0)	0	28 (0)	4 (0)
Spices, Coffee, Tea (09) Coffee (0901)	387 (378)	122 (121)	29 (27)	173 (168)	32 (32)	31 (30)
Optical/Med. Equip. (90)	369	366	0	3	0	0
Fish and Seafood (03)	325	81	133	19	8	84
Mineral Fuel, Oil	180	12	0	168	0	0
Other	1,893	731	2,890	436	237	118
Top 8 Imports as % of Total	84.0	76.7	88.6	84.4	88.0	82.6

Data Source: U.S. Department of Commerce.
#HTS = Harmonized Tariff Schedule

Second, apparel has become the primary export good for all countries except Costa Rica and accounted for nearly 60% of total U.S. imports from Central America in 2002. As discussed above, the United States has encouraged this trade since including the Central American countries as beneficiaries under the CBI program in 1984. 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 CBI 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 U.S. 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%.[23]

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

Third, 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. This investment was augmented by an additional $110 million in October 2003 for the production line of "chipsets" for personal computers. In 2002, U.S. imports of integrated circuit exports grew by 37% on a dollar-value basis and constituted 14% of total imports from Costa Rica. Similar growth may also be seen in imports of Costa Rica's medical equipment, 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 was the leading advocate of CAFTA.[24] (Note, there is also a small amount of crude oil imported mostly from Guatemala in the top eight imports.)

Many non-apparel items that the United States imports from Central America face minimal or no tariffs. Bananas, coffee, oil, most fish products, and Costa Rica's integrated circuits and medical equipment enter duty free. Some enter the United States under preferential arrangements, but the majority is free of duty under normal (most favored nation) tariff rates. Apparel was technically excluded from preferential treatment under CBI, but under a special access program (SAP), eligible Central American apparel exports receive 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.[25]

U.S. Exports

The major U.S. exports to Central America include: electrical machinery; apparel; plastic; yarns; and fabric (see **table 3**). 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 exports to Central America is integrated circuits going to Costa Rica for processing and re-export. The same may be said for fabric and yarns that are exported to all five countries, sewn and otherwise assembled, and re-exported back to the United States. Some of these goods are consumed in the CAFTA countries along with capital goods (machinery and parts) and agricultural products.

The same distinctions seen in U.S. import trade are evident in U.S. exports. Some 70% of yarn exports goes to Guatemala and Honduras and between 85% and 90% of apparel and knit fabric is sent to Honduras and El Salvador. These three countries are the heart of the maquiladora relationship. Although the United States exports machinery and parts to all five countries, electrical machinery and particularly integrated circuits, are sent to Costa Rica. All five countries import U.S.

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

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

cereals and some, such as corn and rice, are among the more import sensitive products that the Central American countries would like to continue protecting.[26]

Table 3. Top Eight U.S. Exports to CAFTA Countries, 2002
($ millions)

Product and HTS Number[#]	CAFTA	Costa Rica	Hon	Guat	El Sal	Nic
Total U.S. Exports	9,833	3,117	2,571	2,044	1,664	437
Elec Machinery (85)	1,411	1,023	86	161	114	28
Integrated circuits (8542)	(823)	(821)	(0)	(1)	(1)	(0)
Knit Apparel (61)	954	102	521	30	293	8
Machinery (84)	940	332	179	240	131	58
Office Mach. Parts (8473)	(171)	(69)	(18)	(52)	(19)	(13)
Computer Parts (8471)	(137)	(51)	(12)	(29)	(24)	(19)
Woven Apparel (62)	597	214	261	30	56	36
Plastic (39)	526	208	90	154	66	8
Cotton Yarn (52)	467	16	207	169	70	5
Knit/Crocheted Fabric (60)	446	30	244	16	153	3
Cereals (10)	400	97	73	117	74	39
Corn (1005)	(175)	(51)	(24)	(59)	(34)	(7)
Wheat and Meslin (1001)	(147)	(31)	(32)	(48)	(24)	(12)
Rice (1006)	(76)	(16)	(16)	(10)	(15)	(19)
Other	4,092	1,095	910	1,127	707	252
Top 8 Exports as % of Total	58.4	64.8	64.6	44.8	57.5	42.3

Data Source: U.S. Department of Commerce.
[#]HTS = Harmonized Tariff Schedule

The significant aspects of this trade structure are that it reflects: 1) growing U.S. direct investment; 2) a deepening economic integration; and 3) the continued historical trend of regional dependence on the large U.S. market as an important aspect of trade and development policy.

Status of Trade Negotiations and Policy Issues

The ninth and final round of negotiations concluded on December 17, 2003 in Washington, D.C. Although certain details still need to be worked out, the CAFTA was agreed to by the United States, Guatemala, Honduras, El Salvador, and Nicaragua. Costa Rica declined to accept the agreement at that time pending resolution of a few key sensitive issues. As set out in Trade Promotion Authority (TPA) legislation, President Bush must provide Congress with at least a 90-day formal notification of his intention to sign the agreement. Within 60 days of signing the agreement, the President must submit to Congress a description of changes in

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[26] USITC, Production-Sharing Update: Developments in 2001. *Industry Trade and Technology Review*. July 2002. pp. 39-42, B1-4

existing laws that may be needed for the United States to comply with the agreement. The President must also submit a draft implementing bill, statement of administrative action, and supporting information that explains, among other things, how the agreement meets congressionally mandated objectives and goals. TPA also requires that within 90 days of signing the agreement, the President submit a report by the U.S. International Trade Commission (USITC) assessing the likely effects of the agreement on the U.S. economy.[27]

Although the CAFTA text will not be released until January 2004 at the earliest, summaries indicate that a comprehensive agreement was reached. A detailed discussion of the issues follows, organized topically by the five working groups, including capacity building, with first an introductory focus on the Costa Rica.[28] Importantly, any reference to details of the proposed CAFTA are contingent upon acceptance of the agreement by Congress.

Costa Rica and Unresolved Issues

The United States and Costa Rica agreed that there were a number of unique issues that could not be resolved by the December 2003 deadline, leading to Costa Rica's early withdrawal from the last round of negotiations. In the meantime, Costa Rica has reiterated its strong preference to be part of CAFTA and plans to hold two bilateral meetings with the United States to discuss unresolved issues. The first began on January 5, 2004 and is addressing nonagricultural issues. The second meeting is scheduled to begin January 19, 2005 and will take on agriculture and all other unresolved issues. Both sides hope the second meeting will complete discussions on CAFTA. Any agreement struck between the United States and Costa Rica will not likely apply to the other four Central American countries.[29]

The key unresolved issue was Costa Rica's resistence to opening its state-run insurance and telecommunications industries to competition. Unlike the other four countries, doing so would constitute a major structural adjustment for the Costa Rican economy, which combined with its politically sensitive nature, would be difficult for the Costa Rican Congress to support without concrete tradeoffs. Costa Rica also complained that the U.S. insurance offer was presented too late in the round for Costa Rica to respond in time. After regrouping, Costa Rica appears prepared to concede to opening these industries, but would need greater flexibility from the

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[27] 116 STAT. 1013 and 116 STAT. 1012.

[28] Bowing to Central America's limited resources and desire to consolidate negotiations, the United States agreed to establish only five working groups 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 supporting 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.

[29] This summary is based on news accounts and discussions with representatives of the Costa Rican government. See: Government of Costa Rica. Ministry of Foreign Trade. *Press Release: Central America – U.S. Free Trade Negotiations*. December 18, 2003.

United States on agriculture and textile issues. In agriculture, Costa Rica is pressing for a "significant" sugar quota, a response to its ethanol proposal, and improved access for beef and poultry. It would also like to extend the tariff phase-out period to 18 years for some of its most sensitive products, such as pork, rice, onions, and potatoes.

In textiles, the issue is use of third country fabrics in goods to be exported to the Untied States. This would require more generous treatment in rules of origin and short supply provisions (see Market Access section). Costa Rica would also like easier rules governing future additions to the short supply list. Costa Rica has argued that because it does not rely on low-wage labor like other Central American countries, the cost of materials, such as fabrics, is a more important factor and therefore it needs greater flexibility to use alternatives to high-cost U.S. fabrics. There are other issues, such as intellectual property rights, to be addressed that may be less controversial. The traditionally difficult issues of labor and environment are not a problem for Costa Rica, which generally has more advanced standards than many Latin American countries.

Although a general optimism appears to be present regarding the prospects of Costa Rica and the United States coming to an agreement, the tradeoff between Costa Rican telecom/insurance and U.S. textiles/agriculture pits four of the most sensitive sectors against each other in the trade discussions. Given resistence in both countries to concessions already made in these areas, striking a balance agreeable to both countries and their respective congresses may be difficult.

Market Access

This working group focused on the key issues determining the tariff structures and rules that will govern the movement of goods. The Central American countries had two important goals. First, consolidate access to the U.S. market, which meant clarifying, making permanent, and improving on preferential tariff treatment currently applied to many of their major exports under the Caribbean Basin Trade Partnership Act (CBTPA) and the Generalized System of Preferences (GSP). Second, increase opportunities for export goods protected by the United States and specify safeguards to limit the effect on select (mostly) agricultural products of potentially large increases in U.S. imports. For the United States, seeking equal or better treatment than what other countries receive (especially Canada and Mexico) under their FTAs with Central America was a basic goal, including obtaining access for sensitive agricultural products. Specifically, negotiators had to agree on the list of goods to be covered, the schedule under which tariffs would be phased out, and the rules of origin that would apply, all thorny and complicated issues in FTAs.

Upon CAFTA's entry into force, more than 80% of U.S. consumer and industrial exports would become duty-free immediately, with all tariffs removed within 10 years. Tariffs would go to zero on many product categories including information technology products, agricultural and construction equipment, paper products, chemicals, and medical/scientific equipment. For the Central American countries, benefits received under the Caribbean Basin Trade Partnership Act

(CBTPA) would become permanent, allowing most consumer and industrial products from Central America to enter the United States duty free immediately.[30]

The most difficult market access issues involved Central America's major exports, apparel and agricultural goods. Protection of agriculture includes use of tariffs, tariff rate quotas, safeguards, and sanitary and phytosanitary regulations.[31] Under CAFTA, tariffs on agricultural goods would be phased out based on a schedule placing most agricultural products in one of four categories or "buckets" in which tariff elimination occurs: 1) immediately; 2) in five years; 3) in ten years; and 4) in 12-15 years. All products were addressed, but some required special treatment such as extended tariff rate quotas, special safeguards, or lengthier tariff protection. Over half of current U.S. farm exports to Central America would become duty free immediately, including "high quality" cuts of beef, cotton, wheat, soybeans, certain fruits, and vegetables, processed food products, and wine. At the same time, the U.S. conceded to slight increases in sugar quotas for the four Central American countries, which is being challenged by U.S. sugar interests.[32]

Apparel trade was the other major market access complication, pitting U.S. domestic industries competing directly with Central American products against Central American producers who work with U.S. textile manufacturers in production-sharing arrangements and U.S. importers/distributers of apparel products. Consumers, no doubt, should also be mentioned as a constituent group (as with agriculture products). Reconciling these competing interests was a delicate process and required negotiators to define treatment for every product and material involved in the manufacture of garments.

CAFTA textile provisions would be retroactive to January 1, 2004, apparently to encourage U.S. businesses to use Central America sources for apparel, and would cover three basic issues of central importance. First, Central American apparel has been entering the United States duty free provided it is assembled from U.S. materials under the so-called "yarn forward" rule. This rule has been relaxed in some cases, and would be further relaxed under CAFTA "short supply" and "rules of origin" provisions. The Central American countries, and particularly Costa Rica, wanted as much flexibility as possible to use fabrics from third countries. The compromise appears to be that garments made from materials originating in either Central America or the United States would enter the United States duty free immediately. For certain products (e.g., nightwear, boxer shorts), third country material would be allowed, provided the garments are assembled in Central America.

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[30] Office of United States Trade Representative. *Free Trade with Central America: Summary of the U.S.-Central America Free Trade Agreement*. p. 1. Hereafter cited as the *CAFTA Summary*. It may be found at: [http://www.ustr.gov]

[31] For more details, see: CRS Report No. RL32110, *Agricultural Trade in a U.S.-Central American Free Trade Agreement (CAFTA)*, by Remy Jurenas.

[32] U.S. Sugar Industry Group. *Press Release: Mexican and US Sugar Industries Jointly Oppose CAFTA Sugar Provisions*. December 18, 2003.

This is one of apparently many controversial rules of origin and some U.S. textile interests have raised objections to CAFTA because of it.[33]

Second, under the "accumulation of origin" rule, selected apparel made from NAFTA partner fabrics would also receive duty-free treatment. The Central American countries wanted to extend the rule to fabrics from other countries, and apparently there is some room for select use of third country material outside NAFTA.[34] This is a precedent-setting rule and controversial. It effectively would promote further integration of the textile and garment industries of Mexico and Central America, which compete for U.S. investment and market access, as well as, against U.S. fabric producers.

Third, there was considerable debate over the "short-supply" list, or duty-free access of goods made from a specific list of fabrics that are determined to be in "short supply" in the United States. A list of some 47 materials was agreed to, but this also remains a serious point of contention with U.S. textile manufacturers, because it would be another way for textile exporting countries outside the agreement, such as China, to sell more material that enters the United States free.[35]

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), or nearly half of total FDI in the region. Over half of U.S. FDI went to Costa Rica. The United States has advocated clear and enforceable rules for foreign investment in all trade agreements. In the past, as with the U.S.-Chile FTA, this has included limiting restrictions on capital flows, as well as, defining specific recourse that individual investors would have should they face any restrictions. In general terms, CAFTA would protect all forms of U.S. investment in Central America and U.S. investors would receive the same treatment as local investors "in almost all circumstances," except where specifically stated. Transparent and impartial dispute settlement procedures would provide recourse to U.S. investors.

Services trade presented a number of hurdles given that the Central American countries have adopted few commitments of 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; local partner requirements in some financial services in Nicaragua; and numerous services monopolies in Costa Rica (insurance and telecommunications—see previous section on Costa Rica).[36] CAFTA would provide broad market access for most industries including

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[33] Inside U.S. Trade. *CAFTA Textile Rules Pave Way for Increase in Foreign Fabric Use.* December 19, 2003 and Press Release. *NTA Denounces CAFTA as Threat to U.S. Textile Industry*. December 18, 2003.

[34] Ibid.

[35] USTR, CAFTA Summary, p. 1.

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

telecommunications, financial services, distribution services, computer and business technology services, tourism, and many others. Banks and insurance firms would have full rights to establish subsidiaries, joint ventures, and branches. Regulation of service industries is required to be transparent and applied on an equal basis.[37]

Government Procurement and Intellectual Property Rights

These two areas were also of particular interest to the United States. CAFTA was seen as 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.[38]

CAFTA would grant non-discriminatory rights to bid on contracts from Central American ministries, agencies, and departments, with the exception of "low-value contracts." It would also call for procurement procedures to be transparent and fair, including clear advance notices of purchases and effective review. CAFTA would also make clear that bribery is a criminal offense under the laws of all countries.[39]

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 have simply not adopted reforms that many U.S. industries (e.g., sound and video recordings, pharmaceuticals, book publishing, computer software) consider necessary to protect their intellectual property. 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, covering print, electronic, and other media.[40]

The IPR provisions in CAFTA would provide that U.S. and Central American businesses receive equal treatment in all areas. Trademarks would benefit from a transparent on-line registration process and special system to resolve disputes over internet domain issues, among other benefits. Copyright provisions would clarify use of digital materials including rights over temporary copies of works on computers (music, videos, software, text), sole author rights for making their work available on-line, extended terms of protection for copyrighted materials, strong anti-circumvention provisions to prohibit tampering with technologies, the requirement

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[37] USTR, *CAFTA Summary*, p. 2-3.

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

[39] USTR, *CAFTA Summary*, p. 5.

[40] Ibid.

that governments use only legitimate computer software, the prohibition of unauthorized receipt or distribution of encrypted satellite signals, and rules for liability of internet service providers for copyright infringement. Patents and trade secrets rules would conform more closely with U.S. norms. End-user piracy would be criminalized and all parties would be required to authorize the seizure, forfeiture, and destruction of counterfeit and pirated goods. CAFTA would also mandate statutory damages for copyrighted material.[41]

Labor and Environment

Perhaps the greatest challenge to CAFTA comes from the environment and labor advocacy groups. These issues are complicated because trade agreements have gone beyond purely commercial interests and now influence domestic social policy, despite arguments by some that: 1) such worthwhile goals are too much to expect from trade agreements and are better handled directly; 2) that trade can enhance the economic welfare of countries even if broad social change does not follow immediately; or 3) that in some cases, the capacity to meet developed country standards is simply not immediately available to developing countries.

Labor and environment advocates in the United States argue that developing countries may have an "unfair" competitive advantage because their lower standards are the basis for their lower costs, which in turn are reflected in lower prices for goods that compete with those produced in developed countries.[42] Over time, the argument goes, the difference in costs leads to U.S. investment and jobs moving abroad. On the other hand, some studies suggest that these costs are usually not high enough to determine business location alone, and that productivity remains the primary deciding factor.[43] In addition, developing countries have expressed concern over loss of national sovereignty if FTAs define specific standards and that such provisions may also be used as a disguised form of protectionism.

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 FTAs are subject to the same dispute resolution and

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[41] Ibid., p. 4-5.

[42] 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.

[43] 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, *Sense and Nonsense in the Globalization Debate*, pp. 30-33.

enforcement mechanisms as are other aspects of the agreements.[44] 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) principles, and using the same dispute resolution and enforcement provisions that apply to other provisions in an agreement.[45]

The USTR summary states that congressional objectives on environmental issues have been met fully in the proposed CAFTA agreement. It includes language requiring all countries to enforce their laws and regulations and also creates an environmental cooperation agreement that entails a framework for establishing a cooperation commission and a process to conduct capacity building. All parties agreed to commit to establishing high levels of environmental protection and open and transparent proceedings in the administration and enforcement of laws and regulations.

The Special Role of Labor Issues. Arguably, the most contentious issue of CAFTA will be the extent to which various parties are satisfied with the labor provisions. In the case of Central America, U.S. labor advocates have focused on income inequality and working conditions, charging 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 has been 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.[46]

Still others maintain that despite clear problems with inequality and workers' conditions, which actually vary among the five countries, these are complex issues resulting from many factors, including cultural and historical circumstances, requiring multiple long-term policy responses that go far beyond trade policy. A recent ILO study has documented the extent to which the five Central American countries have, to varying degrees, codified basic labor rights.[47] Although still criticized as inadequate and in many cases poorly enforced, there appears to be some recognition that change is necessary, and perhaps occurring. The results of one case

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[44] 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.

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

[46] 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.

[47] A recent review of the Central American labor laws found that all five countries basically address the four major categories of ILO rights and principles. This is not to say that enforcement or labor conditions are adequate, but that the laws appear to be in place. See: International Labor Organization. *Fundamental Principles and Rights at Work: A Labour Law Study: Costa Rica, el Salvador, Guatemala, Honduras, Nicaragua.* Geneva, 2003.

study in Honduras also raise the question of whether alternative employment to maquiladora work is largely available, better, or even preferred by job seekers.[48] Most economic literature also suggests that restricting trade is an ineffective policy response for addressing social inequality issues such as child labor and bargaining rights. Rather, much of the literature characterizes trade liberalization as playing a potentially constructive role in long-term growth and development, if combined with internal economic and social policy changes.[49]

CAFTA Provisions and the Congressional Debate. The USTR, in its summary of the CAFTA provisions, makes three important claims with respect to the agreement as concluded, that it:

- "fully meets the labor objectives set out by Congress in the Trade Promotion Act of 2002 and makes labor obligations a part of the core text of the trade agreement;"
- "includes unprecedented provisions that commit CAFTA countries to provide workers with improved access to procedures that protect their rights;"
- "goes beyond Chile and Singapore FTAs through a 3-part cooperative approach to improve working conditions by: 1) ensuring effective enforcement of existing labor laws; 2) working with the ILO to improve existing labor laws and enforcement; and 3) building local capacity to improve workers rights."

All three broad statements may be defensible, including meeting congressional objectives as defined in TPA.[50] A key issue, however, has been that the objectives, as carefully worded in TPA, do not fully satisfy the concerns of labor. Labor advocates argue that the provisions are a step backward from those agreed to in the U.S.-Jordan bilateral agreement, as well as, the Generalized System of Preferences, and Caribbean Basin Trade Partnership Act, which currently govern much of the U.S. trade with Latin America. Although failure to enforce domestic labor laws can be formally challenged in the dispute resolution, labor advocates have noted that provisions committing CAFTA countries to work with the ILO to improve existing labor laws and enforcement, and the U.S. commitment to help develop local capacity to improve worker rights with grant aid are not so enforceable, raising the issue of whether enforcement of ILO provisions should be the responsibility of FTAs.

This difference in treatment stems from similar treatment in the TPA language. Section 2102(b)(11) of the Trade Act of 2002 (TPA) states that among the principal labor negotiation objectives is the provision "*to ensure that a party* to a trade

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

[49] 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.

[50] Labor and environment trade negotiating objectives may be found in P.L. 107-210, sec. 2102, 116 STAT. 994, 116 STAT. 1000, 116 STAT. 1002, 116 STAT. 1003.

agreement with the United States *does not fail to effectively enforce* the environmental or *labor laws*." This may be contrasted with the apparently weaker objectives in the same Act "*to strengthen the capacity* of United States trading partners *to promote respect for core labor standards,*" and, in Sec. 2102(a)(1)(7) to "*strive to ensure* that *they do not weaken or reduce the protections afforded in* domestic environmental and *labor laws* as an encouragement for trade."

Therefore, the USTR argues that CAFTA meets congressional negotiating objectives and takes a new step toward providing direct input into the labor code and enforcement of U.S. trading partners that appears to go beyond commitments in the U.S.-Chile FTA, and hence, the claim to precedent-setting language. Whether these provisions strike the right balance to garner sufficient congressional support for the implementing legislation is another matter.

In addition, the dispute resolution process has been criticized as ineffective by relying on monetary assessments rather than trade sanctions or other measures to address noncompliance with FTA labor provisions. Details are not available yet to make a determination with respect to CAFTA, but the USTR summary suggests the enforcement mechanism has similar attributes for labor, environment, and commercial disputes.

Dispute Resolution and Institutional Issues

This negotiation group focused on numerous aspects that define how the trade agreement will operate. Dispute resolution appears to be modeled on previous FTAs, in which disagreements are intended to be resolved cooperatively with some type of consultative process, 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. Administrative and other technical matters (e.g. transparency issues) of trade agreement implementation were also addressed by this working group.

Trade Capacity Building

Even before detailed discussions began on the CAFTA, the Central American countries expressed a strong apprehension of being overwhelmed by the resources and experience that the United States could muster to negotiate and comply with liberalized trade rules. Hence, the need for trade capacity building, which, now that the negotiation process is effectively over, may be classified into three distinct areas beyond trade negotiation capabilities. First, the ability to identify priorities, including where the major adjustment costs (losers) are expected to be and how to respond to them. Second, the ability to develop resources to implement the agreement, including institutional, financial, and analytical resources. Third, the capacity to

benefit from CAFTA.[51] CAFTA provides for the creation of a permanent Committee on Trade Capacity Building to continue work begun in the negotiation process.

The third category is arguably the most important. Also referred to as "supply side" capacity, it refers to the ability of a business to: compete in a larger market; learn how to export and use imports (as inputs) more to its advantage; tap into global finance; navigate customs and trade logistics problems; and in other ways make the transition from local producer to international player.[52] This will be a difficult challenge for many Central American firms, particularly if barriers to world trade are reduced outside the U.S.-Central American relationship (WTO/FTAA) putting increasing pressure on marginally productive businesses. The joint-production relationship already established in textiles and garments suggests that certain firms have already developed some expertise in meeting these challenges.

From the outset of negotiations, 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, 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).[53]

Outlook

The CAFTA negotiations moved quickly and met the anticipated year-end 2003 deadline, with the exception of Costa Rica. CAFTA was ambitious and innovative in melding the interests of the United States with those of five smaller countries that vary significantly among themselves. In so doing, one expectation is that CAFTA could improve trade relations not only between the United States and Central America, but within the isthmus as well. To the extent that the United States is able to open its markets further to the employment-generating sectors of the Central American economies (agriculture and textiles), CAFTA may assist with the development process.[54]

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[51] This typology of capacity issues was developed by Bernard Hoekman of the World Bank. Earlier versions of this report mentioned a fourth area, trade negotiation capacity.

[52] Ibid.

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

[54] Reducing rich-country protectionism is a critical goal set out by a study aimed at highlighting policies that may effect social development and equity in Latin America. See: Birdsall, Nancy, Augusto de la Torre, and Rachel Menezes. *Washington Contentious: Economic Policies for Social Equity in Latin America.* Carnegie Endowment for International Peace and Inter-American Dialogue. Washington, D.C. 2001. pp. 65-66.

CAFTA, however, is not complete and faces political uncertainty. Work continues on the environment portion of the agreement and details reportedly must be clarified in other areas as well. Issues with Costa Rica must be settled expeditiously if it is to accept the agreement early in 2004. The timetable calls for discussions to occur during the weeks of January 5 and 19, 2004. The Bush Administration has signaled its expectation to notify Congress of its intention to sign the agreement, a formal step that would have to be taken relatively soon if Congress is to act by mid year.

For the United States, reconciling diverse interests remains a standard, but challenging task in consideration of any FTA. This task is complicated by the competing nature of negotiating goals. Relaxing trade rules governing agriculture and textiles, for example, may support trade growth and development in Central America, but runs contrary to some strong interests in the United States. Labor advocates argue that CAFTA perpetuates exploitation in Central America, but proponents assert that U.S. protectionism works against Central America growth and development and hurts U.S. consumers and exporters. Balancing these perspectives may prove particularly vexing during a presidential election year. Although CAFTA has broached new ground in some areas, it is unclear whether it has achieved such a balance.

Appendix 1. Chronology of CAFTA Negotiations

Date	Milestone
January 16, 2002	President George W. Bush announces his intention to explore a free trade agreement (FTA) with Central America.
August 6, 2002	President Bush signs the Trade Act of 2002 (P.L.107-210), which includes Trade Promotion Authority (TPA).
October 1, 2002	President Bush, as required under TPA, formally notifies Congress of his intention to negotiate a U.S.-Central America Free Trade Agreement (CAFTA) with the five Central American Common Market (CACM) countries (Guatemala, El Salvador, Honduras, Costa Rica, and Nicaragua).
November 19, 2002	USTR holds public hearings, accepting written and oral testimony on CAFTA.
January 27, 2003	The first of nine negotiation rounds begins in San Jose, Costa Rica.
December 17, 2003	CAFTA negotiations concluded in Washington, D.C. Costa Rica decided not to accept the agreement at that time pending further discussion on insurance, telecommunications, and agriculture and textile market access issues.
January 5, 2004	Costa Rica and the United States begin bilateral discussions on CAFTA provisions.

Appendix 2. 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).

Appendix 3. 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	2,460	2,502	3,117	24.6%	35.8%
Honduras	2,318	2,370	2,584	2,416	2,571	6.4%	10.9%
Guatemala	1,938	1,812	1,901	1,870	2,044	9.3%	5.5%
El Salvador	1,514	1,519	1,780	1,760	1,665	-5.4%	10.0%
Nicaragua	336	374	379	443	437	-1.4%	30.1%
Total CAFTA	8,402	8,456	9,104	8,991	9,834	9.4%	17.0%
Mexico	78,772	86,909	111,349	101,296	97,470	-3.8%	23.7%
LAC*	63,396	55,153	59,283	58,157	51,551	-11.4%	-18.7%
Latin America	142,168	142,062	170,632	159,453	149,021	-6.5%	4.8%
World	682,138	695,797	781,918	729,100	693,103	-4.9%	1.6%
U.S. Imports							
Costa Rica	2,745	3,968	3,539	2,886	3,142	8.9%	14.5%
Honduras	2,544	2,713	3,090	3,127	3,261	4.3%	28.2%
Guatemala	2,072	2,265	2,607	2,589	2,796	8.0%	34.9%
El Salvador	1,438	1,605	1,933	1,880	1,982	5.4%	37.8%
Nicaragua	453	495	589	604	679	12.4%	49.9%
Total CAFTA	9,252	11,046	11,758	11,086	11,860	7.0%	28.2%
Mexico	94,629	109,721	135,926	131,338	134,616	2.5%	42.3%
LAC*	50,266	58,464	73,348	67,370	69,503	3.2%	38.3%
Latin America	144,895	168,185	209,274	198,708	204,119	2.7%	40.9%
World	911,896	10,024,618	1,218,022	1,140,999	1,161,366	1.8%	27.4%
U.S. Balance of Trade							
Costa Rica	-449	-1,587	-1,079	-384	-25		
Honduras	-226	-343	-506	-711	-690		
Guatemala	-134	-453	-706	-719	-752		
El Salvador	76	-86	-153	-120	-317		
Nicaragua	-117	-121	-210	-161	-242		
Total CAFTA	-850	-2,590	-2,654	-2,095	-2,026		
Mexico	-15,857	-22,812	-24,577	-30,042	-37,146		
LAC*	13,130	-3,311	-14,065	-9,213	-17,952		
Latin America	-2,727	-26,124	-38,642	-39,256	-55,103		
World	-229,758	-328,821	-436,104	-411,899	-468,263		

Source: Table created by CRS from U.S. Department of Commerce data.
* Latin America and the Caribbean, except Mexico.