The U.S.-Central America-Dominican Republic Free Trade Agreement (CAFTA)

Issues, implications and lessons for the Smaller Economies of Latin America and the Caribbean

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Introduction

Regional Trade Agreements (RTAs, hereafter) have proliferated in the past two decades.[2] RTAs are recognized by the World Trade Organization (WTO) as long as they are consistent with Article XXIV of GATT and Article V of GATS. Article XXIV authorizes customs unions and free trade zones as an exception to the principle of non-discrimination. The regional agreements and free trade zones are expected to remove barriers to trade with respect to the essential of the trade, which originated in the constituting members of the customs union or free trade areas. [3]

In other words RTAs are consistent with the principles of multilateral trade as long as they are trade creating arrangements. The arguments are based on the theory of comparative advantage and on the tacit validity of Say's Law. Global free trade suppresses the discrimination between the existing sources of supply. Contrarily by granting preferential market access to its signatory members, RTAs shift the discrimination between the existing sources of supply.

Following this trend the United States has engaged into a series of negotiations leading to the signing of free trade agreements with Jordan (2002), Chile (2003), Mexico and Canada (NAFTA, 2004), Singapore (2003), and Australia (2004). Most recently the United States signed a free trade agreement with Central American countries and the Dominican Republic. Central America and the Dominican Republic represent the United States 14h largest overall export market or and the 2nd largest export market in Latin America.

From the point of view of the United States the free trade agreement between the United States and Central America and the Dominican Republic is meant to 'level the

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[2] Between 1958 and 1979 the number of notified RTA's in goods was equal to 16. Between 1980 and 2005, the number of notified RTA's in goods increased to 125. The total number of notified preferential agreements for goods and services is currently equal to 170. See, Jo-Ann Crawford and Roberto V, Fiorentino (2005).

[3] What is meant exactly by the essential of trade is not defined in the legal texts. In addition, Article XXIV also states that country members may maintain trade restriction among members of a trade agreement on the basis of GATT's articles XI, XII, XIII, XV and XX. Finally, Article XXIV seems concerned with avoiding the trade deviation effect of free trade areas or customs unions and explicitly states that in order to avoid trade deviation, tariff and/or other trade measures should be established at a level at a level, which in their aggregate, does not make these more restrictive than those previously imposed by the individual members.

playing field' for the United States. Indeed, the United States exhibits very low average tariffs applied on most imports while Central American and the Dominican Republic apply comparatively higher tariffs on imported goods from the United States. In addition Central America and the Dominican Republic benefit from special duty preference programmes such as he Caribbean Basin Initiative and the Generalized System of Preferences. CAFTA will allow the United States to trade on the same footing with Central American countries and the Dominican Republic.

A further and perhaps more important point is that the United States has a trade deficit that is for all purposes unsustainable. The country is forced to resort to foreign trade policy as the only way to reduce its external imbalance. According to official sources the entry into force of CAFTA will reduce the United States trade deficit by 756 millions US$.

In the case of Central America and the Dominican Republic, CAFTA will solidify in a more permanent manner the current market access temporary advantages that these countries receive in the from of special duty preference programmes. However, the tariff reductions that these countries will implement as a result of the implementation of CAFTA may have dire consequences for their external performance and for their domestic economy.

This paper analyses some of he key issues and implications of CAFTA for Central American countries and the Dominican Republic. The focus is on Central American countries. The paper is divided into eight sections.

The first section presents the arguments and assumptions underlying the benefits of regional integration agreements. The second and third section focuses on the trade policy of Central America and the Dominican Republic. The fourth section explains and summarizes the main provisions of CAFTA. The fifth section deals with the stylized facts of regional integration agreements. Building on these stylized facts, the sixth section ascertains the potential effects of CAFTA on Central American countries and the Dominican Republic on macroeconomic performance and on the environment.

The treatment of regional trading agreements in economic theory

According to mainstream economic theory free trade creates 'welfare gains by allowing consumers and firms to purchase from the cheapest source of supply ensuring that production is located according to comparative advantage.' In other words, free trade allows the operation of the principle of comparative advantage by suppressing the discrimination between the existing sources of supply.

The properties of the standard mainstream free trade model based on comparative advantage the Hecksher-Ohlin model or H-O-S model[4], are found in four well-known theorems: (i) the Hecksher-Ohlin theorem; (ii) the Stolper-Samuelson theorem ;(iii) the Rybczynski theorem; and (iv) the factor-price equalisation theorem.

The Hecksher-Ohlin theorem establishes a relationship between the factor scarcity and factor embodiment in a commodity such that countries export the commodity that intensively uses the abundant factor. It provides the basis for the gains from trade argument. These refer to the increase in output and real income for a given set of inputs or domestic resources that result from trade.

The Stolper-Samuelson theorem complements the above theorem by stating that the intensive use of a factor of production for export (i.e., the abundant factor) raises its rate of return above all other prices. In turn, the consequent increase in the supply of that factor of production will lead to an increase in the output of the commodity intensive in that factor of production (the Rybczynski theorem). Finally, the factor price-equalization theorem stating that trade equalizes commodity and factor prices across countries rounds up the case for free trade.[5]

Contrarily RTAs shift the discrimination between the existing sources of supply among trading partners by granting preferential market access to its signatory members. As a result these do not necessarily lead to the creation of welfare gains. The standard approach argues that RTAs are welfare enhancing when their trade creation capacity exceeds that of trade diversion. [6] The standard case is that of the customs union.

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[4] The Hecksher-Ohlin (H-O) model was renamed Hecksher-Ohlin-Samualeson (H-O-S) model as Samuelson formalized the basis properties of the H-O model.

[5] Under conditions of perfect competition trade in goods acts as a substitute to factor mobility. Under conditions of imperfect competition free trade does not result in the full equalization of commodity and factor prices. However, free trade reduces commodity and factor price differentials among countries and thus acts as a force of convergence.

[6] See, Jacob Viner (1950). In his seminal contribution he identified the conditions that if met by the RTA could improve its efficiency. These included, the geographical extension of the RTA, the level of the external tariff adopted by the members following the formation of the RTA relative to the previous tariff level, the degree of complementarity, differences in unit costs, and the level of tariffs prevailing outside the RTA. The greater the geographical extension, the greater are the opportunities for trade creation. A greater geographical extension means a greater extension of the market and thus a greater scope for trade specialization and the generation of economies of scale. Also a greater geographical area can also involve a greater stock of natural resources implying the possibility of a more diversified export base. Recent findings also indicate that at least in the case of the United States, population is a factor that can account for greater innovation. As put by Hernández-Murillo (March, 2003): 'Recently economists have found that densely populated areas are increasingly providing the best environment to facilitate the diffusion of new ideas, in addition to serving as the location for the production of goods. The reason is that the agglomeration of people and firms in urban areas promotes a faster exchange of information and ideas and this generates new technologies.' Finally a greater geographical area can help to reduce transaction costs, when these are defined to include 'transportation, communications, bureaucratic red tape and transshipment costs.' The reduction in transaction costs increases profits and thus the incentives to export. The relationship between the degree of complementarity and that of a trade diversion and trade creation of a RTA can be seen from different perspectives. A low degree of complementarity in the production structures of states forming as RTA reduces the scope for trade diversion. Notwithstanding the formation of the RTA, member states will continue to trade with the rest of the world. In the same way a high degree of

Trade creation refers to the substitution from a high-cost domestic source to a lower-cost source in a partner country.[7] Trade diversion results from the substitution away from a lower-cost producer outside the customs area to a higher cost supplier within the customs union area.

Customs Union and in general RTAs exemplify cases where the principle of comparative advantage operates within a confined geographical area when trade creation is greater than trade diversion.[8] In this sense according to neo-classical theory customs unions and RTAs are an approximation, and thus a special case, of a full-fledged, global, free trade situation.[9]

The introduction of dynamic factors such as the existence of spillover effects does not alter the validity of the basic analysis. Indeed, it can be shown that if knowledge is freely mobile and equally accessible among countries, patterns of specialization are determined by comparative advantage. [10] That is, by construction in mainstream theory, static and dynamic trade theories are one and the same thing when free trade (implying laissez-faire and laissez-passer) prevails.

The standard approach to analyzing the effects of a reduction in tariffs on trade is that of trade creation and trade diversion. In its origins the analysis of trade creation and trade diversion referred to the formation of a customs union. However the current trade literature uses both concepts to analyze the static welfare creation and diversion effects of the formation of a free trade area or to estimate the impact of tariff reductions.

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complementarity may enhance intraregional trade widening the possibilities for trade diversion. Contrarily it may also be stated that countries with a low degree of complementarity are also more vulnerable to asymmetric shocks reducing thus the possibilities for trade.

[7] This case assumes a discriminatory tariff reduction giving a member of the RTA a comparative cost advantage over a non-member by reducing its production costs. As a result the member increases its production efficiency over the non-member.

[8] RTAs maximise welfare when their number equals one, that is, when the geographical area of the RTA coincides with that of the world.

[9] In the limit when a given geographical area coincides with that of the world there is only scope for trade creation. Using a very simple model where the world is divided into regional blocs (i.e., customs unions) Krugman (1995, pp.75-78) shows that welfare is maximized when the number of blocs is reduced to one and the world has achieved free trade.

[10] See Helpman (2004) and Grossman and Helpman (1996).

Trade creation can be enhanced when an RTA member faces high tariffs from the rest of the world in products where it has decreasing costs or when due to size considerations the scale of production is too small to yield an optimum scale of production. The existence of economies of scales can lead to trade creation through a production, consumption and cost reduction effects. The production effect allows the transfer of production to the lower cost trade partner. The consumption effect refers to the gain in the consumer surplus due to a decline in price. The cost reduction effect denotes a change to cheaper sources of supply. Recently, Dunn and Muti (2000) identify three effects that can increase the efficiency of a free trade area: (i) a shift in output, where price is greater than average cost; (ii) a scale effect, where firms' average costs of production fall when output expands; (iii) increase in trade allows for the expansion of in the variety of final goods and intermediate inputs that are traded.

Trade policies of Central American Countries

Central American countries have followed a three-tiered trade policy strategy consisting in: (i) the slow but steady consolidation of their intraregional trade integration policy; (ii) the maintenance of existing trade preferences and an emerging tendency to participate in preferential trade agreements; and (iii) their adhesion and increasing compliance with the multilateral agreements.

The regional integration process which has produced an increase in intraregional trade (See Tables 1 and 2 below) was originally guided by the Central American countries' objective to seek the conformation of a Central American Common Market. This objective was adopted in 1960 following a series of attempts to increase the existing level of integration among these economies. These attempts included the formation of a customs and monetary union. Initially as it was delineated the Central America Common External Market strategy sought to integrate the countries commercially with the long term view of pursuing the more complex goal of economic integration.

Although Central American countries made some progress especially during the 1980's in the reduction of internal and external trade barriers commercial integration among its member states remained a distant and according to some an impossible goal to attain.

Table 1

Central American Isthmus: Intraregional exports (Millions of USD)

	1995	1996	1997	1998	1999	2000	2001 a/	2002 b/
Central American Isthmus	1,832	1,972	2,272	2,535	2,682	2,862	3,131	2,955
MCCA	1,748	1,896	2,172	2,424	2,578	2,751	3,008	2,831
Costa Rica	428	471	497	573	638	663	676	615
El Salvador	442	480	604	642	674	776	771	766
Guatemala	602	624	726	816	854	870	1,103	969
Honduras	183	217	217	268	260	267	270	260
Nicaragua	93	104	128	124	152	175	188	221
Panama	83	77	101	111	104	112	123	124

a/ Preliminary data; b/ Estimated data
Source: ECLAC (2003)

Table 2
Central American Isthmus
Intra-regional exports as a percentage of the total
1995-2002

	1995	1996	1997	1998	1999	2000	2001 a/	2002 b/
Central American Isthmus	12	13	12	13	14	14	16	16
MCCA	19	19	18	18	18	19	22	21
Costa Rica	12	12	12	10	10	11	14	12
El Salvador	27	27	25	26	27	26	27	26
Guatemala	28	28	28	29	31	28	39	35
Honduras	13	13	12	13	15	13	14	13
Nicaragua	19	20	20	19	25	24	27	32
Panama	1	1	2	2	2	2	2	2

a/ Preliminary data; b/Estimated data.
Source: ECLAC (2003).

For one thing the high levels of economic growth that the region experienced in the 1960's and 1970's came to a halt. At the same time social and political discontent planted the seeds of a political crisis that is marked by the assassination of Joaquín Chamorro (January, 1978).[11] Both Nicaragua (1978-1979) and El Salvador (1980-1985) were to some extent ravaged by the effects of civil war while Guatemala struggled with civil and military strife brought about partly by the complex ethnic composition of the country. For their part Honduras and Costa Rica did not suffer domestic armed conflict but the latter was a center for anti-sandinista operations. Costa Rica, does not have a standing army since 1954, and has always considered itself to be an exception to the problems faced by other Central American countries. This has often materialized into a status of exception and indeed of exclusion by choice that has in addition not been necessarily beneficial to the Central American integration process.

Low growth, high levels of indebtedness and the internal situation of Central America shifted the whole integration process to a low gear and indeed it became a 'second rank' priority goal. The 1990's saw a renewed impetus to advance towards a Central American unity. It was the product of the efforts of Guatemala and especially El Salvador.

This initiative was not unexpected. Throughout Central America history, El Salvador has often played the role of 'leader,' 'initiator,' and '*avant-garde*,' member state. El Salvador was the first country to implement the Central American Common External tariff parameters, the first Central American country to adopt market oriented economic policies, to engage and also to applaud initiatives such as the one engineered by Michael Porter of creating competitive clusters in Central America.

[11] Joaquín Chamorro was the owner of a well known Nicaraguan free press newspaper

While in some cases this attitude has proved to be a positive attribute of a country as it endows it with a certain dynamism and vision for the future, it has also led to the adoption of 'radical' measures. Two such radical measures have been the proposal of the adoption of a zero tariff rate on inputs which is part of the Central American parameters of the Common External Tariff and the decision to dollarize the economy in 2001. The 0% tariff rate did create some opposition from the entrepreneurial class. The most fundamental argument was that it deprived them of any negotiating leverage. The arguments sustaining the decision to dollarize were never clearly stated. The main consequence of this radicalism has been to pull the rest of Central America countries in that direction. In some cases it has united Central American countries while in some others it has created friction at the regional level.

The 1990's push for integration led by El Salvador and Guatemala focused mainly on the implementation of the Central American Common Market tariff parameters. The aim of a more complete commercial and eventually economic integration remained in the country's agendas but only and in most cases at the formal level. Commercial and economic integration other than the common external tariff became part of the regular political speeches and in many cases the main subject of the Central American heads of government meetings.

Table 3
Degree of convergence criteria compliance for Central American Countries

Country	1997	1998	1999	2000	Average
Costa Rica	63	63	38	38	55
El Salvador	63	63	63	63	63
Guatemala	63	63	25	50	50
Honduras	38	25	38	50	34
Nicaragua	50	25	50	50	42
Central America	55	48	42	50	49

Source: Consejo Monetario Centroamericano (2001)[12]

The most that this attempt at a deeper level of integration accomplished was the gradual adoption of legal texts aiming at the harmonization of trade legislation among Central American countries and to comply with multilateral trade obligations. These legal texts include the Central American Agreement on normalization measures, metrology and proceedings (1999); the agreement of sanitary and phytosanitary measures and proceedings (1999); the Central American agreement on safeguard measures (1996); and the Protocol to the Central American Agreement for the Protection of industrial Property (1999) It also has led to the regular computation of convergence indicators (See Table 3 above).

[12] Véase Consejo Monetario Centroamericano. Informe Económico Regional 2000. San José, Costa Rica: febrero de 2001.

The Central American Common External Tariff was perfected between 1992 and 1996. It consisted of a tariff floor (0%) for capital goods and a ceiling applied to final consumer goods (15%) (See Table 4 below). It also distinguishes between inputs and final goods. All Central American countries have adopted with different tariff reduction calendars the parameters of the Central American Common Market (0% and 15%). The last Central American country to adopt it was Honduras in 2001.

On the one hand, the tariff structure is 'protectionist' as final goods are taxed at higher rates than inputs. The evidence on effective rates of protection shows that the implementation of the common external tariff parameters reduced slightly the overall rate of effective protection (See Table 5) and increased the rate of effective protection for some sectors.

On the other the tariff structure does not necessarily favor the development of intra-regional trade because inputs imported from the Central American region are taxed at rates that exceed those inputs that are produced outside Central America. Intra-regional capital goods had to pay a tariff (5%-10%) whereas extra-regional capital goods paid a nominal tariff rate of 0%.

Table 4
Central America
The common external tariff parameters and the average tariff rate (percentages)

	Costa Rica	El Salvador	Guatemala	Honduras	Nicaragua
Capital goods	0	0	0	1	0
Raw materials	0	0	0	1	0
Intermediate goods	5-10	5-10	5-10	5-10	5
Final goods	15	15	15	15	15
Average simple tariff rate	7.0	7.4	7.0	7.1	5.9

Note: 0% applies to capital goods and raw materials produced outside the Central American region. 5% applies to raw materials produced in Central America. 10% applies to intermediate inputs produced in Central America. 15% applies to final goods.

Table 5
Mean average effective protection rate and dispersion for the Central American Common External tariff

Country	Average rate of protection		Dispersion	
Costa Rica	10.8	8.7	14.2	11.0
El Salvador	9.6	8.2	8.7	7.3
Guatemala	12.9	10.1	10.6	9.3
Nicaragua	8.3	6.9	6.4	5.8

Source: ECLAC (1997)

The Common External Tariff has also a number of exceptions. Most of them are contained under the so-called list A. Presently the list A includes a two products sugar cane and coffee not roasted whose trade restrictions apply to all Central American countries and a series of bilateral restrictions. The latter are summarized in Table 6 below)

Table 6
Bilateral country restrictions
2003

Country imposing restrictions	Partner country	Partner country	Product
Guatemala	Honduras	Costa Rica	Roasted Coffee
El Salvador	Honduras	Guatemala	Roasted Coffee
Honduras	Nicaragua	Costa Rica	Roasted Coffee
Nicaragua	Costa Rica	……	Roasted Coffee
Guatemala	El Salvador	Costa Rica	Ethylic Alcohol
El Salvador	Honduras	Costa Rica	Ethylic Alcohol
Honduras	Costa Rica	……	Ethylic Alcohol
Nicaragua	Costa Rica	……	Ethylic Alcohol
Honduras	Guatemala	El Salvador	Petroleum Derivatives
Honduras	Nicaragua	Costa Rica	Petroleum Derivatives
Honduras	Guatemala	El Salvador	Alcoholic distilled beverages
Honduras	Nicaragua	Costa Rica	Alcoholic distilled beverages

Source: SIECA (March 2003)

Other exceptions not included in list A but agreed upon by the Central American countries include tires, footwear, and textiles and apparel. The push for intra-regional free trade was accompanied by regulations concerning safeguard clauses and rules of origin. Most of these were eliminated because they were used as means to target the development of specific firms and industries. In addition Central American countries have a tendency to impose *ad hoc* trade restrictions often as a result of political retaliation or pressure and political lobby of a specific group of producers pertaining to a given activity. Central American countries decided to publish periodically these restrictions as an attempt to increase the transparency of the Central American integration process. The Ministry of Commerce of Costa Rica used to publish in its Web Page the list of restrictions. The list of restrictions is now available to the general public in SIECA's web page. The last edition shows that there are 12 reported and identified obstacles to intraregional trade. The obstacles include non-tariff and tax barriers (sanitary and phytosanitary measures), compensatory tax measures and other arbitrary charges.

More recently the discourse of integration has changed and Central American Countries refer to the process of integration as a Customs Union and not a Common Market. However, in spite of the adoption of similar tariff parameters and the adoption of a more realistic integration goal, the Customs Unions, not all tariff items have been harmonized. According to SIECA (2003) 77% of all tariff lines have in fact been

harmonized. This corresponds to part I of the Central American Tariff Schedule. Part II and III do not have the same tariff code, nomenclature and import tariff. However, according to the WTO in 2001,

In 2001, the WTO claimed that Central American countries used different tariff codes which in fact invalidated the common external tariff. The report stated that Guatemala used the CAUCA III (1999), Costa Rica and Nicaragua used the CAUCA II (1993) and Honduras applied the domestic legislation. More recently Central American countries have undertaken efforts to harmonize their customs legislation and approved the New Uniform Central American Code in 2002 (CAUCA, 2002) which is currently being implemented in El Salvador, Guatemala and Nicaragua. Costa Rica and Honduras are in the process of adoption of this new piece of legislation.

Table 7
Central American Countries
Nominal tariff rates (2001)

	Costa Rica	El Salvador	Guatemala	Nicaragua
Total	7.0	7.4	7.0	5.9
Agricultural products	14.8	12.0	10.2	8.7
Live animals; animal products	29.9	21.9	12.4	
Dairy produce	67.4	26.9	13.2	11.0
Coffee and tea	12.5	12.7		
Fruit and vegetables	14.8	13.4	13.4	13.5
Cereals	11.0	12.0		
Beverages and spirits	13.6	19.1	24.8	9.4
Tobacco	11.2	7.9		10.0
Non-agricultural products	5.6	6.7	6.4	
Fish and fish products	10.4	9.8		
Textiles and clothing	10.3	17.8	16.0	12.2
Transport equipment		8.6		

Central American Preferential trading arrangements and Free Trade Agreements

At the same time that Central American have re-shaped their integration efforts they have also sought to solidify existing preferential trade agreements and to engage into bilateral free trade agreements.

Central American countries benefit from unilateral trade preferences within from the United States and Europe within the framework of the System of Generalized Preferences, of the Caribbean Basin Initiative and its most recent modification, the Law of Commerce and Development that expands the preferences granted to Central

American countries among others to products such as footwear and textiles that had been originally excluded from the Caribbean Basin Initiative.[13]

The Caribbean Basin Initiative (1983) gave a preferential access to a gamut of export products form Caribbean and Central American countries to enhance the development and growth of these economies. Initially the Caribbean Basin Initiative was set for a period of twelve years ending in September 1995. The law excluded textiles and Garments, leather products, canned tuna, petroleum and its derivatives.

Due to the disadvantage in the competitive positioning of Caribbean and Latin American countries after the entry into force of the North American Free Trade Agreement (1994) and the adverse consequences of Hurricane Mitch for Central American countries, the Caribbean Basin Initiative was expanded in May 2000 to include the products that had been excluded in the previous legislation. The new legislation titled the Law of Commerce and Development that entered in force on October 2000 provides an equal tariff treatment to canned tuna, leather footwear to that received by Mexico. In the case of textiles the situation is more complex.

The law allows free of tariff market access and quotas to garments, which are elaborated in the region with United States fabric and string. It also permits the free market access for garments which are cut in the countries that benefit form the CBI but that have United States fabric and strings. Furthermore, it allows free market access to the United States of 250 million squared meters of knitted garments made with fabric from the region and but with United States strings. Finally, it allows the free market access of 4.2 million squared meters of knitted shirts elaborated with regional fabric and United States strings. The quotas of 250 and 4.2 million squared meters were distributed among Central American and Caribbean economies as shown in Table 8 below.

Table 8
Market share of quota distribution of 250 million knitted garments and 4.2 squared meters of knitted shirts among CBI beneficiary countries

Country or regional block	Market share of 250 million knitted garments	Market share of 4.2 million squared meters of knitted shirts.
CARICOM	4.9	5
Costa Rica	7.5	1.5
El Salvador	21.3	20.8
Guatemala	19.4	11.2
Honduras	25.2	42
Nicaragua	2.0	4

[13] The Generalized System of Preferences (GSP) was adopted in 1974 and grants trade preferences to manufactured and semi-manufactured goods and to some agricultural products. Textiles are excluded for the SGP. There are 16 different GSP schemes granted by 28 developed countries.

Panama	1.5	1
Dominican Republic	18.1	10
Total	100	100
Note: On the basis of official data.		

The Law of commerce and development extends the categories of garments that have preferential access to the United States import market. The other categories are "807 plus", guaranteed access level and specific limit. The category "807 plus" includes products elaborated with United States fabric and strings and which have to pay tariff upon entry in the United States territory on only the value added but with no quota restrictions. The guaranteed access level category includes those textile products that elaborate with fabric made and cut in the United States. Exports that fall under the category of guaranteed access levels are subject to quota restrictions and tariffs on their value added. Finally, specific limit export products are those textile products elaborated with fabric from any country. This category also includes products that are imported by the United States from a third country and which may be re-exported after undergoing a transformation process. The precise impact of the extended CBI initiative on the export and the performance of the beneficiary countries remain uncertain and will depend on the unit price of garments, on their export capacity and their potential to fully use the assigned quotas to enter the United States market.

The efforts of Central American to obtain extended CBI preferences reflect these countries' dependency on their textile exports. The free trade zone regime grants income tax exemption (See Table 2 above). At the Doha Ministerial Meeting (November 2001), member countries agreed to extend the right of countries to maintain the free trade zone regime until the year 2007. Free trade zone activities are a major foreign currency earner, represent on average for Central America more than 65% of total exports and are labor intensive (See Table 3 below) but generate little value added. Estimations for Central America undertaken by ECLAC show that free trade zones contribute at most 2% to total value added. Costa Rica is one of the least competitive exporters in the free trade zones.

In the case of Central America the apparel and textile became during the 1990's decade the main export product. At the country level, it represented in 1999, 21%, 55%, 81% and 83% of the total exported to the United States for Costa Rica, Guatemala, Honduras and El Salvador, respectively. Central American countries, as well as the Dominican Republic, and some other CARICOM economies, have granted export subsidies in the form of tax holidays to further promote the development of free trade zone exports to the United States. The exemptions include the exoneration from the obligation to pay income taxes which depending on the cases may be granted for a specific or an indefinite period of time (See Table 9, below).[14]

[14] The World Trade Organization considers this preferential fiscal treatment an export subsidy and according to the WTO-GATT texts forbids it under Articles 1 and 3 of the Agreement on Subsidies and Countervailing Measures (WTO, 1999c, pp.231-233 and pp.265-267). However due to the granting of longer periods for implementing obligations to developing countries, these had until the year 2003 to dismantle these subsidies. The exception was the group of countries whose GNP was below 1 000 US$ per capita (see, the Agreement on Subsidies and Countervailing Measures, Annex VII, WTO, 1999c, p. 274).

Table 9
Central America
Main export products as a percentage of the total
1990 – 1999

Countries	Products	Years			
		1990	1993	1996	1999
Costa Rica	Machinery	4.6	5.7	8.1	43.9
	Fruits and nuts	22.8	22.4	20.0	13.0
	Textiles and apparel	**37.4**	41.2	35.5	**20.8**
	Subtotal	64.8	69.3	63.6	77.7
El Salvador	Textiles and apparel	**22.8**	51.5	67.2	**82.8**
	Coffee and tea	36.1	20.2	4.9	4.2
	Electrical machinery	10.3	6.5	3.1	1.9
	Fish and mollusks	5.2	4.3	3.7	1.7
	Subtotal	74.4	82.5	78.9	90.6
Guatemala	Textiles and apparel	**24**.0	45.8	47.7	**54.9**
	Coffee	23.7	12.9	15.6	13.4
	Fruits and nuts	15.3	11.6	10.8	8.6
	Fossil fuels	2.9	2.0	3.6	4.2
	Subtotal	65.9	72.3	77.7	81.1
Honduras	Textiles and apparel	**22.9**	55.6	69.0	**80.9**
	Fish and mollusks	12.6	9.9	5.7	4.0
	Fruits and nuts	12.0	14.6	10.9	1.9
	Coffee and tea	9.5	3.2	2.2	1.9
	Subtotal	57.0	83.3	87.8	88.7

Source: MAGIC (2001)

Table 10
Latin America and the Caribbean: income tax exemption for firms operating in free trade zones (2000)

Country	Percentage of income tax exoneration	Years of exemption
Costa Rica	100/50	8-12/4-6
El Salvador	100	Indefinite
Guatemala	100	5-15

The Doha Ministerial Conference (November, 2001) extended the time derogations and the per capita threshold. These developments indicate the degree to which developing countries have become dependent on this foreign exchange earning activity. In fact, it is market based policies at the national level that ultimately create and accentuate this dependency while at the same time their implementation at the international level demand their banishment in order to comply with WTO free trade rules.

Honduras	100	Indefinite
Nicaragua	100/60	10/11
Dominican Republic	100	15-20
Brazil	100	3-10
Chile	0	0
Mexico	0	0

Table 11
Competitiveness Indicators for the textile and apparel sector in Central America (2000)

	Number of free trade zones by country	Minimum wage per hour (US dollars)	Transport costs to Miami per tone (Container) US dollars	Domestic gasoline prices (dollars per gallon)	Average prices of electricity Cents by kilowatt hour	Average rental rate in the free trade zones U.S dollars per foot per year
Costa Rica	6	1.26	1250	1.58	7.7	5.02
El Salvador	8	0.60	1610	1.36	11.1	3.63
Guatemala	6	0.39	1119	1.35	8.2	4.52
Honduras	14	0.50	1165	1.58	9	5.00
Nicaragua	6	0.35	2320	1.81	11.3	3.67

Source: On the basis of official information

Table 12
Central America
Share of SGP exports as a percentage of the total
1995 – 1999

	1995	1996	1997	1998	1999
Costa Rica	41	37	26	20	15
El Salvador	24	21	24	16	11
Guatemala	34.0	32.7	33.5	29.8	28.2
Nicaragua	….	…..	…..	22	28.5

Note: … denotes not available.
Source: Ministerio de Comercio Exterior de Costa Rica; Ministerio de Economía de Guatemala; Ministerio de Economía del El Salvador; Ministerio de Comercio Industria y Comercio de Nicaragua.

Table 13
Number of firms and employment in the textile sector in Central America

Country	Number of firms		Number of employees Thousands	
	1998	1999	1998	1999
Costa Rica	104	102	36	-----
El Salvador	218	230	60	60
Guatemala	268	286	71	85
Honduras	184	216	96	111
Nicaragua	36	42	16	23

Source: On the basis of official information

Besides these general preferential agreements Central American countries have signed trade agreements with Chile, Mexico, Panama, the Dominican Republic, Canada, Trinidad and Tobago and more recently have started negotiations tending to a free trade agreement with the United States. The annex provides a sample of these free trade agreements briefly describing their content and main characteristics.

. A key feature of some of these trade agreements is the incorporation of asymmetric clauses (i.e., special and differential treatment). The specification of these asymmetric clauses follows WTO principles and includes:

- A differential tariff rate base as the starting point of the tariff phase-out.
- Longer periods for the implementation of tariff phase-out
- Special treatment provided to key sectors (agriculture, textiles, and pharmaceutical products).
- Wider application of the zero-tariff rate in the case of the more developed country.
- Tables 14 to 19 below provide examples of asymmetrical treatment in the cases of the Free Trade Agreements between Nicaragua and Mexico; Chile-Nicaragua; Costa Rica-Chile; Costa Rica-Canada and Mexico and the Northern Triangle.

Table 14
Free trade agreement between Nicaragua and Mexico
Tariff reduction schedule for the textile and agricultural sectors

Time extensions for tariff phase-out	Nicaragua Number of tariff lines	Share of the total	Mexico Number of tariff lines	Share in total
Immediate	3,594	58.54	8,268	72.73
Within 5 years	1,430	23.29	1,564	13.76
Within 10 years	979	15.95	1,469	12.92
Within 15 years	40	0.65	43	0.38
Negative list	23	0.37	17	0.15
Sugar	4	0.07	7	0.06
Total	6,139	99	11,368	100

Table 15

Tariff reduction schedule contemplated in the free trade agreement between Chile-Nicaragua

Time extensions for tariff phase-out	Nicaragua Number of tariff lines	Percentages	Chile Number of tariff lines	Percentages
A – immediate phase-out with tariff rates equal to 0%.	2946	47	21	0
A- Immediate with tariff rates different than 0%	581	9	4514	77
B (3 years for Nicaragua and immediate phase-out for Chile)	1253	20	------	----
B+ (5 years for Nicaragua and immediate phase-out for Chile)	41	1		
C (10 years for Nicaragua y 8 years for Chile)	1152	18	1044	18
C 16 (Sixteen years for Chile and Nicaragua)	3	0	8	0
D (10 years for Nicaragua and 8 years for Chile five years after the entry into force of the free trade agreement)	45	1	17	0
DC (3 years for Chile five years after the entry into force of the free trade agreement).	----	----	2	0
Special treatment for bovine products	6	1	6	0
Excluded from the agreement	256	4	224	0
Total	6139	100	5854	100

Source: On the basis of official information.

Table 16

Free Trade agreement Costa Rica – Chile Tariff reduction schedule		
Time extensions for tariff phase-out	Costa Rica	Chile
Immediate Share of tariff lines with a tariff rate of 0% Share of tariff lines with a tariff rate different than 0%	73.4% 48.1% 25.3%	94.6% 0.4% 94.2%
Tariff phase-out within a five-year period.	9.0%	0.3%
Tariff phase-out within a twelve-year period.	12.8%	0.2%
Tariff phase-out within a sixteen-year period.	0.9%	0.7%
Preferential treatment for bovine meat	0.1%	0.1%
Products excluded	3.8%	3.8%
Total	100%	100%
Source: On the basis of official information		

Table 17 Free trade agreement Costa Rica – Canada Tariff phase-out program		
Time extensions for tariff-phase out	Costa Rica	Canada
Chapters 1 to 97		
Immediate	65%	86%
Medium term	19% (Seven years)	1% (Four years)
Long term	15% (Fourteen years)	1% (Eight years)
Agricultural Sector		
Immediate	45%	87%
Medium term	8% (Seven years)	0
Long term	36% (Fourteen years)	1% (Eight years)
Industrial sector		
Immediate	68%	86%
Medium term	21% (Seven years)	1% (Four years)
Long term	11% (Fourteen years)	13%(Eight years)
Source: On the basis of official information		

Table 18

Asymmetric treatment in market access

An example in the case of the free trade agreement between Mexico and the Northern Triangle		
Tariff phase-out applied by the Northern Triangle	Asymmetric Treatment applied by Mexico	Calculation method
3%	2%	3 – 3 (0.30) = 2
5%	3.5%	5 – 5(0.30) = 3.5
10%	7%	10 – 10(0.30) = 7
15%	10.5%	15-15(0.30) = 10.5
20%	14%	20 – 20(0.30) = 14
25%	17.5%	25 – 25(0.30) = 17.5

Table 19
Free trade agreement between Mexico and the Central American Northern triangle
(El Salvador, Guatemala and Costa Rica)
Proportion of tariff lines subject to immediate tariff phase out in agriculture and industry

Immediate phase out for Central American countries			
	El Salvador	Honduras	Guatemala
Agriculture	32.4	32.8	33.6
Industry	59.4	57.9	58.6
Immediate phase out by Mexico			
	El Salvador	Honduras	Guatemala
Agriculture	31.8	32.8	31.2
Industry	71.0	70.6	77.3

Source: On the basis of official information

The economic rationale underlying these free trade agreements and negotiations, with the exception of the negotiations with the United States, are unclear. Most of these countries account for small share of Central America's imports and exports and are not thus a priority for these countries. Also these are not countries that provide crucial or fundamental inputs or products for the economy of Central American countries. At most it can be speculated that Central American countries have entered into these trade negotiations in the belief that a policy of free trade enhances welfare and is conducive to growth or have political reasons for undertaking these agreements.

Main features of the CAFTA-DR-USA Free Trade Agreement

The agreement comprises twenty-two chapters dealing with trade in goods, in particular agriculture, textiles and apparel and services, investment, labor and environment.

Trade in goods is governed by the principle of non-discrimination and provides for the phasing out of and elimination of tariffs between the signatory countries. While most of the tariffs were programmed to be eliminated when the agreement entered into force, the text also contemplates the phasing out for some products over a period of ten or more years.

In the case of agriculture the text allows tariff phase out periods according to different products and countries and ranging from immediate to 20 years time. In some cases the phase out period will be provided through the implementation and expansion of existing tariff-rate quotas. According to the text of he agreement tariff rate-quotas will be administered "in a manner that is transparent, non-discriminatory, responsive to market conditions and minimally burdensome on trade and allows importers to fully utilize import quotas."

The agreement does not allow signatory member countries to apply export subsidies but it permits the imposition of safeguards. In fact chapter 3 of the agreement allows the imposition of a 'transitional agricultural safeguard mechanism' allowing a country to impose a temporary additional duty on specified agricultural products if imports exceed an established volume 'trigger.' That is safeguards are applied when the imports of a given products experience import surges. The safeguard cannot be applied for a period exceeding four years and can be used once during the transition period.

In the particular case of sugar, the text of the agreement provides greater market access for Central American countries and the Dominican Republic. Indeed the agreement contemplates an increase in the zero-tariff import quotas of sugar from Central American countries from 99,000 to 140,000 metric tonnes in the first fifteen years of the agreement.

In the manufacturing sector, the agreement contemplates the elimination of most tariffs lines upon the entry into force of the agreement. Still, the agreement allows for asymmetrical treatment as the United States liberalizes close to 100% of its manufacturing products while Central America liberalizes close to 80% of its manufacturing products. As in the agricultural section a safeguard clause is introduced to protect Central America and the Dominican Republic from import surges.

For textiles and manufacturing the text provisions grant duty free treatment to apparel using yarn and fabric from the United States, Central America and the Dominican Republic. In this regard the DR-CAFTA agreement expands the CBI legislation, which in its most recent form allowed duty and quota free treatment for apparel and textile products assembled in Central America from United States inputs.

The treaty also contemplates that the provision of reciprocal duty free access for all goods should be retroactive to January 1, 2004. This retroactive provision will benefit every company doing business in Central America and the Dominican Republic. It also includes a cumulation rule whereby a limited amount of inputs from Mexico and Canada will qualify for duty free treatment. The cumulation rule is subject to a 100 million annual dollar cap, which can expand to 200 million dollar.

The CAFTA text contains provisions on services derived from the WTO General Agreement on Trade in Services and NAFTA. The provisions include a chapter on general measures pertaining to cross border trade in services and specific chapters on financial services, telecommunications and electronic commerce. The services provisions require the granting of national and most favored nation treatment (i.e., non-discriminatory treatment) to service suppliers of contracting parties. It also 'prohibits the parties from requiring firms to establish a local presence as a condition for supplying a service on a cross-border basis'. Finally it bars specific types of market access restrictions to the supply of services.

In contrast to other free trade agreements the CAFTA text contains chapters on labor and the environment (chapters sixteen and seventeen).

According to the general principles of the labour chapter, the signatory parties agree to recognize and protect the labor principles contained in the ILO declaration. The parties recognize and accept each other's right to establish their own laws and to implement fair, equitable and transparent procedures in the enforcement of their own laws.

The labor provisions establish mechanism for dispute settlement and a Labor Affairs council to oversee the Chapter's implementation and to provide a forum for consultations and cooperation on labor matters. Cooperation priorities and financing are discussed in a separate annex to the chapter.

The environmental chapter is based on the North American Agreement on Environmental Cooperation as well as the environmental provisions of other free trade agreements signed by the United States including those signed with Jordan, Chile, Singapore, Australia and Morocco. However, the CAFTA text provides in addition a 'process for public submissions on environmental enforcement matters.'

According to the general principles of the chapter on environment, the parties must ensure that their laws provide the adequate environmental protection. Environmental protection can also be guaranteed through voluntary and market based mechanisms.

Each party has the right to establish its own environmental laws, exercise discretion in regulatory, prosecutorial and compliance matters; and allocate enforcement resources. In terms of procedural matters the text establishes that judicial administrative proceedings should be available to sanction or remedy the violations of its environmental

laws and that such proceedings are to be fair, equitable, transparent and open to the public.

As in the case of labor, the CAFTA text establishes an Environmental Affairs Council to oversee the implementation and operation of the environmental provisions. The text contemplates a public submissions process, which is a way to guarantee the inclusion of the points of view of the civil society, on matters related to environment.

Finally the chapter "envisions the benchmarking of environmental cooperation activities and inputs from international organizations in evaluating progress and makes explicit reference to the right of member countries to protect and conserve genetic resources.'

The major stylized facts of regional trade agreements

There are currently seven stylized facts that capture the current state of our knowledge of regional trade agreements in Latin America and the Caribbean. These will provide the basis on which to assess the potential effects of CAFTA on Central American countries and he Dominican Republic.

First, there is a coexistence of different regional trading arrangements corresponding to two demarcated orientations in regionalism: the first and second regionalisms. The former includes groupings such as LAFTA later to be renamed LAIA (1980), the CARIFTA later to be CARICOM (1973) and the Central American Common External Market (1960).

The first regionalism flourished in the 1960's and 1970's decades and its objective was the creation of a regional market large enough to overcome the constraints imposed by the small size of its individual members. The first regionalism is associated in some instances with protectionism and import substitution.

The second regionalism was propelled by the adhesion of the United States to GATT's article XXIV, focused initially on developed economies and is associated with outward orientation and with the process of using regional agreements as building blocks to make effective multilateral agreements such as the WTO. Trade agreements corresponding to the Second Regionalism include NAFTA (1992), the G-3 (Colombia, Mexico and Venezuela, 1993) and to a lesser extent Mercosur (1991) and the Andean Community (1996).

Second independently of the type of orientation followed regional schemes have achieved at most a level of integration corresponding to an imperfect customs union and a less than full fledged free trade area. Deeper integration efforts, including the intentions of forming an economic and political union, which in some cases have been voiced for decades have not fructified. Two examples, the CACM and CARICOM, illustrate this point.

Both the CACM and CARICOM were formed with the ultimate intention of arriving at an economic union. In the former case Central American countries agreed on the implementation of a common external tariff only forty years after the Central American

Treaty of Integration was signed and still more than 30% of all tariff lines are not yet harmonized. In the case of case of CARICOM two members have not yet implemented the fourth phase of the Common External Tariff. In both schemes there are exceptions to the application of the Common External Tariff that are not clearly specified. In addition tariff and non-tariff trade barriers continue

Third, independently of the data set used, in the greater majority of cases regional integration agreements have witnessed an increase in intra-regional trade. In the case of CARICOM, the CARICOM Secretariat (2003) reported an increase in intraregional exports from 10% to 20% between 1980 and 2001. According to ECLAC (2002) intraregional imports have also risen during the same period accounting for 7% and 11% of the total between 1985 and 2000. Finally for UNCTAD (2002) intraregional exports have increased from 5% to 13% of the total between 1980 and 2001 (See Table 20 below).

Fourth, the increase in intraregional trade responds to conditions that are specific to each regional agreement. In the case of CARICOM the economic development of Trinidad and Tobago, the provision for ineligibility for duty exemptions, and the structure of the common external tariff have played an important part in the expansion of intraregional trade. In the case of Mercosur the intraregional protection afforded to selected goods as acted as a stimulant to intraregional trade. In the case of NAFTA, the processes of privatization in Mexico and the importance of Mexican in-bond industries have played a similar role.

Table 20
Intra-regional trade by trade block (Intraregional exports as percentage of the total)
1990 – 2001

	1980	1990	1995	2000	2001
NAFTA	33.6	41.4	46.2	55.7	54.8
CACM	24.4	15.4	21.7	13.7	15.0
CARICOM	5.3	8.1	12.1	14.6	13.4
FTAA	43.4	46.6	52.5	60.8	60.1
MERCOSUR	11.6	8.9	20.6	20.7	20.8
LAIA	13.9	11.6	17.3	12.9	14.5
OECS	9.0	8.1	12.6	10.0	5.6

Source: UNCTA(2002); ECLAC (2003)

Fifth, the increase in intraregional trade has been accompanied in some cases by a loss in extraregioinal competitiveness. The case of CARICOM is the most clear. CARICOM has lost market share in two of its major export markets, NAFTA and the European Union. In this particular case it can be said that intra-regional trade has acted as a buffer stock of extra-regional market share loss.

Sixth, the increase in intraregional trade does not imply that there has been trade creation or trade diversion. In general the increase in intraregional trade has been

accompanied by an increasing process of specialization and in some cases of concentration. Again CARICOM provides a clear illustration of this trend.

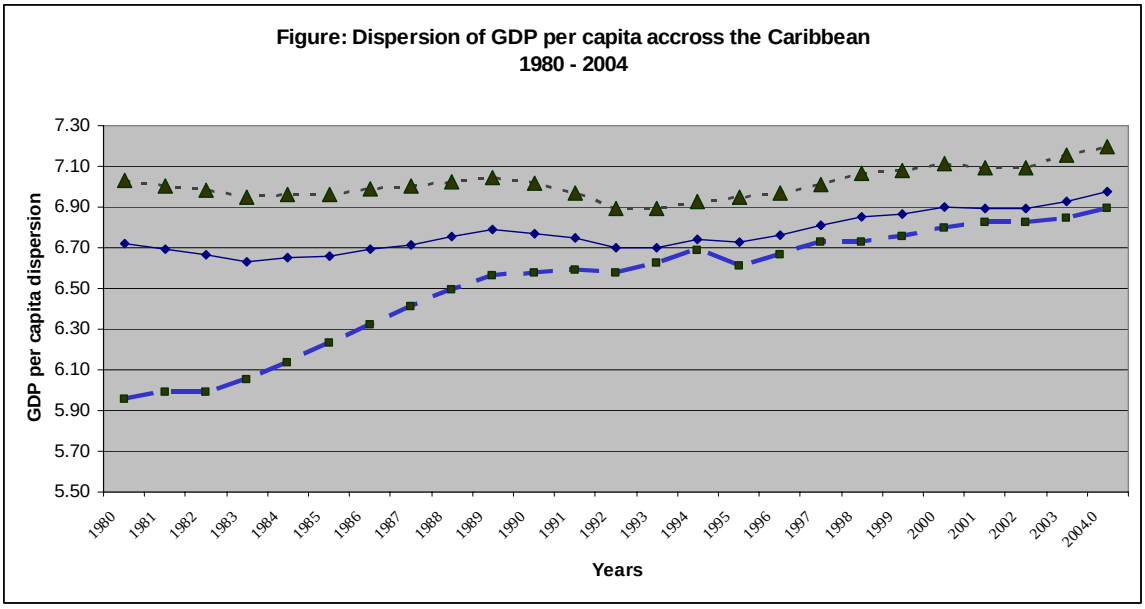
In terms of specialization, in the case of CARICOM, intraregional trade is still dominated by agricultural products. Using a United Nations Conference on Trade and Development (UNCTAD) classification intraregional imports were classified into four categories: primary commodities; labor-intensive and resource-based manufactures, manufactures with low skill and technology intensity, manufactures with medium skill and technology intensity, manufactures with high skill and technology intensity. Primary commodities represented 47% of the total. Labor intensive and resource-based manufactures accounted for 22% of the total. For their part, manufactures with low, medium and high skill and technology intensity signified 5%, 7% and 17% of total intraregional imports

For CARICOM intraregional trade is not only concentrated at the country level but also at the product level. At the country level Trinidad and Tobago accounts for more than half of all intraregional imports, while other countries contribute a minimal amount to trade flows.

At the product level the provision for ineligibility for duty exemptions protects the most important products and producers, and the major traded commodities in CARICOM. The items falling under that provision comprise those traded goods for which regional output can supply a minimum of 75% of regional demand. In addition, these main export products have, with a few exceptions, a market structure that is non-competitive.

This has partly led to the formation of national and regional monopolies with the concomitant associated costs. Examples of monopolies include flat-coated zinc, paints (Antigua and Barbuda), soaps and toothpaste (Dominica), concentrated orange, orange juice, sugar cane (Belize), cement and cigarettes (Trinidad and Tobago), rice (Guyana), carton box (OECS), and wheat and flour (St. Vincent and the Grenadines). There are thus empirical grounds for sustaining that the lack of competition has underpinned the export dynamics for these products.

Seven, regional agreements have not led to a process of convergence. In at least two cases that of CARICOM and that of Central American economies there is evidence of divergence in terms of GDP per capita.



The effects and implications of CAFTA for Central American countries and the Dominican Republic

CAFTA will have two main effects on Central American countries and the Dominican Republic.

On the one hand it will solidify the preferences that they currently receive from the United States on a more permanent basis. That is the free trade agreement will guarantee on a more permanent basis their current market access conditions.

These provisions have shaped and solidified a static export specialization pattern that is, with a few exceptions, highly concentrated in its direction and its composition, and based on a comparative advantage depending on natural resources and low labor costs. [15]

This export specialization pattern does not necessarily correspond with the evolution and direction in the composition of external demand. In both the United States and European markets, natural resources have lost market share and manufacturing

[15] In the 1990s Trinidad and Tobago represents the exception for the Caribbean region, a producing oil country, switched its productive structure from oil to natural gas and other manufacturing products. This change in its production structure was accompanied by a change in its export pattern. Between 1985 and 1999, petroleum and fuel oils lost substantial market share in the European market decreasing from 21% of total CARICOM exports to 4%. At the same time methanol exports, a recent successful Trinidadian product, increased by 100% in volume terms between 1995 and 1999. Trinidad and Tobago was the only country in the CARICOM region (besides Guyana) that registered higher rates of GDP growth with lower GDP growth volatility in the decade of the 1990s relative to that of the 1980s See, IMF (2000). Itam S. et al. Development and Challenges in the Caribbean Region. International Monetary Fund. Washington D.C. Table 2. p. 7.

exports not based on natural resources that are of medium technology represent the most important component of their import market and have steadily increased.

In the case of Central American countries and taking into account two time periods 1990-1994 and 1994-1999, a brief survey of more than 3000 products at the 10 digit level exported by Central American countries to the United States shows that: i) showed that i) 30% of the total corresponded to products combining a declining Central American regional share in dynamic products (i.e., products increasing their United States import market share); ii) between both periods of time Central America has maintained the percentage of the products whose relative importance in the United States import market and in which the region's market share have increased; iii) the percentage of the products whose relative importance in United States import market and in which the region's share have decreased remained constant representing one third of the total.

In addition, to divorcing the export pattern from the orientation in external demand, the current market access provisions which will become permanent under CAFTA have contributed to weaken the link between exports and domestic production.

In the specific case of manufacturing the export specialization pattern is simply not tied to the production structure of the economies. Manufacturing free trade zones are export enclaves contributing little to output or growth. The value-added contributed to output comes from wages without exhibiting strong linkages or clustering to the rest of economic sectors.[16] Production activities are labor-intensive requiring low skilled labor. Inputs are for the most part imported and transactions are carried out in foreign currency.

More importantly, in the cases of both agriculture and manufacturing the export specialization pattern has not necessarily corresponded to the changes in the composition of production, which has shifted in favor of tertiary-sector activities.

The change in the composition of production is a direct result of the application of stabilization policies applied following the 'lost decade' based on the Monetary Approach to the Balance of Payments.[17] This approach combined demand restraint with free market policies that were implemented in the different spheres of economic activity (trade, financial and capital market and eventually in some cases the labor market).[18]

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[16] Initially free trade zone legislation defined a specific geographic area for their activity. However, there has been a recent tendency to increase their degree of flexibility in their operations. The notion of industrial park has tended to disappear allowing free trade zone operations in any geographical location of a national territory. Honduras and Nicaragua are cases in point.

[17] More specifically the explosion of the international debt crisis in 1982, which dried up the supply of external funds forced debtor developing countries to stabilize in order to avoid unsustainable external positions. The analysis of trade policy here presented postulates that the trade policy of a region or country cannot be analyzed independently of its general economic policy orientation (Deraniyagala and Fine, 2001).

[18] The MABP is the child of an empirical fact and an economic tradition. The empirical fact is the 1967 devaluation of the pound by British authorities leading to wage inflation and deflationary measures to improve the position of the balance of payments. Intellectually the MABP owes its development to the Chicago School of economics (Mundell, Johnson) and to Dutch economists (Koopmans and Polak). (Johnson, 1972, 1980b).

The available evidence indicates that the removal of trade barriers that accompanied stabilization policies stimulated import growth. This factor is mainly due to the high income-elasticity of imports, which tends to be especially high for small open developing economies. Exports responded to trade liberalization albeit at a much slower pace and export growth was overpowered by the expansion of import The rate of growth of imports increased from 0.2% to 7.7% between 1980 and 2000 for the smaller economies of Latin America.

Thus in practice the implementation of the MABP tightened the external constraint forcing countries to adopt restrictive measures.[19] These translated into a higher plateau of interest rates and lower wages, which in turn led to a process of substitution between foreign and domestic investment. Financial liberalization accentuated the increase in interest rates.

Higher interest rates discourage domestic investment at the private and the public level. [20] Higher interest rates mean a higher cost of borrowing but can also weaken the fiscal position of a country. Due to the fact that current expenditures are rigid downwards, fiscal adjustment is generally accomplished by contracting capital expenditures. This policy stance reinforces the negative effect of interest rates on domestic investment. [21]

At the same time high interest rates constitute a profitable outlet for foreign capital. Short run capital inflows respond immediately to variations in interest rates but long-term capital inflows also respond to the resulting higher margins of profitability.[22]

As a result, for Central American countries, while foreign direct investment inflows increased, gross domestic investment as a percentage of GDP remained constant at the regional level, and in many specific country cases it decreased. This provides an indication that, contrary to common belief foreign direct investment may not have acted

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[19] As stated by Johnson (1980b, p.92): " A continuing balance-of-payments surplus requires either repeated devaluation or continuing restraint on the rate of growth of domestic credit."

[20] When as for some Caribbean countries consumption represents more than 40% of imports, MABP policies, in effect, stimulate private consumption at the expense of investment.

[21] The government budget constraint states that its operational deficit (the primary deficit (Gs -Gr) and the interest payments on its debt (rB)) is financed with an increase in its bond issues (gb) and commercial bank credit (gd). It can be expressed as follows,

(1) $(Gr/Y - Gs/Y) + gb = (r - gy)\, B/Y + gd$

where,

B = stock of government debt.

Gs = government expenditure.

Gr = government revenue.

r = rate of interest.

An increase in r has to be met by lower expenditures or higher taxes. Decreases in expenditures are the preferred tool since tax increases can negatively affect growth. Thus the logic of the MABP requires fiscal policy to respond to monetary policy in the same direction. It must, to avoid an unsustainable situation, behave pro-cyclically. Fiscal policy is subsumed and subjugated to the needs of monetary policy.

Obviously fiscal subsidies imply lost revenues and can also contribute to tighten the budget constraint.

[22] In addition the interest rate differential tends to more than compensate exchange rate risk.

as a catalyst for growth. In fact, it may simply act as a substitute for domestic investment. In other words, foreign investment may have crowded-out domestic investment.[23]

This revealed preference for foreign over domestic investment, encouraged by national economic policy, underpinned a pattern of productive specialization that in some cases, is reflected in the change in the composition of GDP in favor of those activities intensive in foreign direct investment and to the detriment of traditional economic sectors. This change is often viewed, perhaps erroneously, as a process of 'structural change' brought about by globalization when in fact it is a result of the policy options implemented.[24]

The lack of correspondence between the export specialization pattern and the composition of external demand and between the export specialization pattern and the domestic structure of production has hampered export performance and weakened the export base.

In the case of agricultural products, the specialization pattern shaped by special and differential treatment provisions, locks economies into producing goods responding to Engel's Law, and thus conducive to relative impoverishment over time. In the case of manufacturing goods, as pointed earlier, export industries are at the low end of the value chain, exhibit weak linkages with the rest of the economy and thus cannot act as a source of stimulus to export growth and diversification.

The underperformance of exports is visible in the difficulty countries face in meeting export commitments or undertaking re-structuring processes to enhance their competitiveness. A reflection of this underperformance is the incapacity of countries to meet existing quota levels assigned in trade preferential arrangements, which is most common in the case of the agricultural sector.

As Table 21 shows on average the utilization ratio of the quotas granted by the United States to these countries for their main textile export products was estimated at 67% in 2000.[25]

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[23] In the standard literature foreign investment is presented as a key component of a long-run growth strategy. It can be hypothesized that foreign investment when accompanied by a decline in real wages can act as a motor for growth. Preliminary evidence in this direction is available in the case of Mexico.

[24] Obviously the internal terms of trade have also moved in favor of service-based activities. Preliminary evidence for the Member countries of the Organization of Eastern Caribbean States (OECS) shows that the terms of trade between tourism and agriculture moved from 1 to 1.05 between 1992 and 2000.

[25] Fukasaku, op.cit., p.13, provides similar evidence for the export quotas granted by Canada, the European Union, Japan and the United States to GSP beneficiary countries between 1976-1996. In 1976, the utilization ratio (the ratio between the GSP imports received to GSP imports covered) was 43% and increased to 56% in 1996. Ironically, this is a main argument to question the usefulness and efficiency of special and differential treatment. In the Caribbean, the inability to fulfill existing quotas may be due to a series of factors including: the lack of managerial capacity, poor organization, weak institutions, a slow response to a changing environment, and the lack of technological capacity.

Table 21 Utilization ratio for guaranteed access level textile exports				
	Cotton trousers for men and women	Cotton and synthetic shirts	Undershirts of synthetic and cotton fabric	Cotton suits for men
Costa Rica	36	97	100	83
Guatemala	13	64	9	100
El Salvador	-------	77	93	-------
Average	25	79	67	92

An additional indication of poor export performance is the stagnant market share shown by the fact that Central America gained market share in its major export market, the United States, but by less than half a percentage point in fifteen years (See Table 22 below).

Table 22 Central America market share in regional trading blocks (In percentages) 1985-1999				
Regional block	1985	1990	1995	2000
Central America				
NAFTA	0.52	0.49	0.71	0.88
Western Europe	0.15	0.10	0.13	0.13
Andean Community	0.33	0.27	0.38	0.27
Mercosur	0.05	0.06	0.06	0.04
CACM	1.16	0.67	0.83	1.19
Source: Competitive Analysis of Nations (2001)				

Table 23 Share of Textiles and Apparel in the United States import market and share of Central American countries			
	1990	1995	1999
Chapter 61 of the harmonized code			
Costa Rica	1.13	1.94	1.61
El Salvador	0.17	2.11	3.95
Guatemala	0.45	1.03	2.2
Honduras	0.36	3.23	6.22
Nicaragua	0.0	0.13	0.24
Product Share	1.7	1.9	2.3
Chapter 62 of the harmonized code			
Costa Rica	1.9	2.2	1.5
El Salvador	0.27	1.3	1.37
Guatemala	1.06	2.4	2.5
Honduras	0.57	2.2	2.5
Nicaragua	0.0	0.25	2.5
Product Share	2.9	2.99	2.8
Source: MAGIC (2001)			

These trends which may become a permanent feature of the export patterns of Central American countries and may be aggravated by a second key feature of the agreement which is that their imports will increase as a result of lower trade barriers.

Thus ultimately export competitiveness will not improve and imports will increase. To the extent that the rate of growth is driven by the external sectors, CAFTA will not be favorable to the improvement of economic growth or welfare.

The effects of CAFTA on the environment

A key question regarding the potential effects of CAFTA is its effects on two of the issues that affect the involvement of civil society, labour and the environment. In the case of the environment the potential effects should analysed at the legal-provision level, the institutional level and the more economic level.

At the provision level, the measures enumerated in the text include the general principles, the effective enforcement, the procedural matters, the public submissions, dispute settlement, and the institutional arrangements and cooperation. Among these the most important are the effective enforcement and the dispute settlement. The effective enforcement is characterized by a duality between the objective ‘enforcement of environmental laws’ and the discretion afforded to countries in the establishment of its own laws, their implementation and the allocation of enforcement resources. The difference in environmental standards between the United States and the rest of the countries is also an issue that needs to be addressed.

At the institutional level the treaty contemplates the creation of an Environmental Affairs Council that oversees the implementation and operation of the chapter. However, the treaty does not specify the workings mechanism of the Council and how it will deal with the discretion afforded to the signatory countries. The dispute settlement is explicit but carries with it the cost, which in the case of less developed economies can be a significant financial burden.

The incorporation of public submissions and the creation of a environmental cooperation commission in case of a failure to enforce environmental laws is certainly important. The question remains as to the degree to which it can be an effective instrument. In the case of the North American Agreement on Environmental Cooperation the enforcement of rules has clashed against the discretionary power that countries generally have under such agreements.

Finally as pointed above the environmental effects should be understood as deriving from the general effects of the agreement. To the extent that CAFTA does not translate into greater levels of growth and welfare, to the extent that CAFTA helps to create fiscal imbalances, the environmental issues may take on a less important role and countries may dispose of fewer resources to confront environmental and mitigate environmental risk.

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