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The US–Central America Free Trade Agreement: Opportunities and Challenges

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In a speech in Washington at the Organization of American States (OAS) on January 16, 2002, President George W. Bush announced his administration's objective to explore a free trade agreement (FTA) with the five countries that are members of the Central American Common Market in the following terms:

> Today I announce that the United States will explore a free trade agreement with the countries of Central America. My administration will work closely with Congress toward this goal. Our purpose is to strengthen the economic ties we already have with these nations; to reinforce their progress toward economic and political and social reform; and to take another step toward completing the Free Trade Area of the Americas [FTAA].

Earlier, in April 2001, US Trade Representative Robert Zoellick had initiated dialogue with the Central Americans on this possibility; and following President Bush's announcement, a number of technical meetings and consultations took place during 2002, leading to formal initiation of the negotiations on January 8, 2003.

The idea of an FTA between the United States and Central America is not new, however. In fact, Central Americans had been making the case

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for a free trade agreement with the United States for a number of years, but a window of opportunity had not opened before. Despite the broad access to the US market that began in 1984 with passage of the Caribbean Basin Economic Partnership Act, the North American Free Trade Agreement (NAFTA) has evoked concerns among the Central Americans about the possible effects of this agreement on trade and investment diversion. After NAFTA entered into force in January 1994, Central American and other Caribbean Basin Initiative (CBI) countries lobbied strongly for "NAFTA parity"—that is, for leveling the playing field by providing them the same conditions of access to the US market that Mexico obtained in NAFTA. By 1996–97 there was a sense of frustration with the failure to obtain NAFTA parity and this, coupled with the shortcomings of unilateral preferences and the fact that Central America was already deeply engaged in and quite committed to the FTAA negotiations, led to a rethinking of the trade relationship with the United States.

During President Clinton's visit to Costa Rica in May 1997, the Central American governments made the first formal proposal for a reciprocal free trade agreement between Central America and the United States. The Central American presidents proposed two main trade policy actions: enhanced CBI, or "NAFTA parity," in the short term, and initiation of negotiations for a full-fledged free trade agreement in the long term.[1] Clinton declined, in part due to his lack of fast track trade negotiating authority. The initiative was put on a back burner.

The purpose of this chapter is to analyze the opportunities and benefits as well as the costs and risks—in both economic and political terms—that a prospective FTA with the United States presents to the countries involved. In the following sections, we review some of the asymmetries between the parties, review the objectives and motivations of each party, discuss the main negotiating issues and challenges, comment on the politics in Central America of the Central American Free Trade Agreement (CAFTA), and outline the main policy challenges for Central America. Before our concluding remarks, we briefly consider the importance of capacity building for CAFTA to succeed.

The Parties at a Glance: Basic Economic Indicators and Asymmetries

Although the large asymmetries between the United States and the Central American countries are obvious enough, it is nonetheless important to review them briefly. It is possible to distinguish three types of asymme-

1. See "Gobierno insistirá en TLC con EE.UU." *La Nación* (Costa Rica), April 20, 1997; "Discreto avance comercial," *La Nación*, May 8, 1997; "Socios y amigos," *La Nación*, May 9, 1997, www.nacion.com.

tries: those related to the economy, to institutions, and to objectives and motivations. The main economic ones are as follows (see table 9.1):

- The population of the five Central American countries (33.2 million) is 11.7 percent of that of the United States.
- The territory of Central America is 4.5 percent that of the United States.
- The combined GDP of Central America is only 0.5 percent of the US GDP.
- The per capita income of Central America in 2000 was on average $1,822—that is, 1/19th that of the United States ($34,637).
- There is significant variation in per capita income between the Central American countries themselves: Costa Rica has the highest ($3,940), and Nicaragua the lowest ($473). While agriculture contributes only 2 percent to the GDP of the United States, it contributes on average 17 percent to the GDP in Central America, ranging from a relatively low 9 percent in Costa Rica and El Salvador to as high as 23 percent in Guatemala and 32 percent in Nicaragua.
- Thirty-six percent of the labor force in Central America is employed in agricultural activities compared with only 2 percent in the United States.
- As for trade, 50 percent of Central American exports go to the United States, and 45 percent of imports originate in the United States; in contrast, Central America as a whole accounts for only around 1 percent of US exports and imports (table 9.2).
- The United States ranks first in the 2002 Growth Competitiveness Index calculated by the Global Competitiveness Report; Costa Rica ranks 43rd, El Salvador 57th, and Guatemala, Nicaragua, and Honduras occupy places 70, 75, and 76, respectively.
- The US ranks sixth in the world in terms of the Human Development Index calculated by the UN Development Program, while Costa Rica is 43rd and the other Central American countries rank below the hundredth position.

These figures suggest that there are not only abysmal economic asymmetries between the United States and Central American countries but some important differences among the Central American countries themselves. These differences can also be appreciated by looking at the readiness indicators calculated by Jeffrey Schott (2001).

There are also significant institutional asymmetries. Some of them pertain to the capabilities of trade-related institutions such as those in charge

Table 9.1 Central America and the United States: Fundamental economic indicators

Country	Population (millions)	Area (thousands of square kilometers)	2001 GDP (millions of US dollars)	Average 1990–2000 GDP growth (percent)	2000 per capita income (US dollars)	2001 Structure of production (percent of GDP)			2000		Inflation average (percent annual)		2000 HDI[b]		2002 GCI[c]		2002 NRI[d]	
						Agri-culture	Indus-try	Ser-vices[a]	Imports from world (millions of US dollars)	Exports to world (millions of US dollars)	1990–2002	2001	Index	Rank	Index	Rank	Index	Rank
Costa Rica	4.0	51	16,108	5.3	3,940	9	29	62	7,304	7,651	16.3	10.9	0.8	43	4.19	43	3.57	49
El Salvador	6.4	21	13,739	4.7	2,104	9	22	59	5,642	3,646	9.9	1.4	0.7	104	3.85	57	3.17	63
Guatemala	11.7	109	20,496	4.1	1,668	23	19	58	5,294	3,801	14.0	8.9	0.6	120	3.20	70	2.63	73
Honduras	6.6	112	6,386	3.2	924	14	32	55	3,344	2,512	16.6	8.8	0.6	116	2.98	76	2.37	81
Nicaragua*	5.2	130	2,529	3.5	473	32	23	45	1,945	962	13.3	4.6	0.6	118	2.99	75	2.44	79
Central America average/total	33.9	423	59,258	4.16	1,822	17	25	56	23,529	18,572	14	3	—	—	—	—	—	—
United States	285.3	9,364	10,065,265	3.5	34,637	2	25	73	1,238,200	771,991	3	3	0.9	6	5.93	1	5.79	2

* Excludes years 1990 and 1991.

HDI = Human Development Index
GCI = Growth Competitiveness Index
NRI = Networked Readiness Index

a. For Nicaragua, figures for 2000.
b. Total of 173 countries ranked.
c. Total of 80 countries ranked.
d. Total of 82 countries ranked.

Sources: World Bank *World Development Indicators* 2002 and 2003; UNDP *Human Development Report*, 2002; *Global Competitiveness Report* 2002–2003; World Economic Forum, *The Global Information Technology Report 2002–2003;* Boletín Estadístico SIECA, 2002.

Table 9.2 Relative importance of CAFTA countries for each other as trading partners, 2000 (percent share)

Country	Share of total US exports	Share of total US imports	US share of total exports	US share of total imports
Costa Rica	0.3	0.3	50.9	49.1
El Salvador	0.2	0.2	34.2	23.7
Guatemala	0.2	0.2	39.6	36.0
Honduras	0.3	0.3	46.6	55.4
Nicaragua	0.0	0.0	24.2	37.8
Central America	1.2	1.0	41.7	42.9

Sources: US International Trade Administration, *US Foreign Trade Highlights* (August 27, 2002); IDB, Data INTAL.

of negotiations, customs, technical standards, sanitary and phytosanitary issues, intellectual property, government procurement, financial-sector supervision, and also labor and environmental issues. Perhaps even more important are differences in institutions such as the branches of government that protect property rights, the rule of law, and democracy. One of the most important conclusions of development economics in the 1990s was the recognition that institutions play a crucial role in growth and development. In this light, institutional asymmetries have two implications for CAFTA. First, one of the main benefits of CAFTA will be to promote a "second generation of reforms" in Central America to improve institutions in all these areas, so that their quality may gradually approach that of institutions in developed countries. Second, as long as many of these institutional deficiencies remain they will continue to constitute an important obstacle to attracting investment, promoting business, and benefiting from the agreement. As stressed below in the discussion of policy challenges, doing its homework in terms of institutional upgrading must be one of Central America's priorities if its countries are to benefit from CAFTA.

The asymmetries of the third kind, related to the objectives and motivations of the parties, merit discussion at greater length.

Opportunities and Benefits: Objectives and Motivations

US Motivations: The Case for CAFTA from a US Perspective

US motivations and objectives in CAFTA are a complex mix of economic, trade policy, security, and political and strategic objectives, as summarized in box 9.1. Some of these objectives are direct and explicit, while others are more implicit and indirect. First and foremost, CAFTA is part of

Box 9.1 US objectives, motivations, and benefits in CAFTA

Trade policy related

- take a positive step toward completing the FTAA
- signal US commitment to free trade
- create a "success case" of an FTA with smaller economies

National security related

- strengthen efforts to control drug traffic
- curb money laundering and prevent terrorism
- reduce immigration

Political and strategic

- promote economic, political, and social reform in Central America
- promote political stability and democracy in the region
- signal US commitment to Latin America

Economic

- increase US exports to the region
- improve global competitiveness in key sectors

the broader US strategy of "competitive liberalization" as well as of supporting democratic developments in the Western Hemisphere and building economic alliances with countries crucial to US national security (see Zoellick 2002).

Trade Policy–Related Objectives

CAFTA is not only a building block to the FTAA but also an example of USTR Zoellick's "competitive liberalization" strategy of pursuing trade negotiations at the multilateral, regional, and bilateral levels under this three-tiered approach. If the World Trade Organization (WTO) or even the FTAA does not make progress, the United States is determined to move forward by other paths. This openness to negotiate bilaterally radically changes the structure of incentives for other countries and regions: it opens up new scenarios, raising the possibility that certain countries will be excluded or be the last to enjoy the benefits of a trade agreement with the United States. The US administration has argued that this tends to increase the incentives to complete the FTAA and has conceived this strategy as a key element in providing an alternate route, if one proves necessary, to complete the FTAA.[2]

2. There is no doubt that from a US perspective the strategy of competitive liberalization increases leverage. However, from a Latin American perspective the strategy lessens the scope of coalitions negotiating the FTAA and puts tremendous stress on the remaining countries to get in line after Chile and Central America.

In the initial months of his tenure as USTR, Ambassador Zoellick referred on numerous occasions to the impasse in US trade policy after NAFTA while bilateral agreements proliferated in Latin America and the world, and the negative implications of this situation.[3] Coming just after the agreement with Chile, the negotiation with Central America sends an important signal of US willingness and ability to move forward in trade—particularly at a time when this ability has been put in doubt by a number of negative developments, including measures to protect US steel, the 2002 Farm Bill, and some of the conditions included in recent trade promotion authority (TPA) legislation.

Finalizing an agreement with the Central American economies could set a positive precedent by showing how smaller economies can reach a modern trade agreement with the United States and benefit from such integration.[4] However, there are also risks in this precedent-setting approach, which will be discussed below.

National Security

Efforts to block drug traffic in other countries of Latin America had the unintended consequence during the 1990s of encouraging drug trafficking operations in Central American countries increased. The closer economic and political partnership with Central America promoted by CAFTA will facilitate collective efforts to control the trade in drugs. Similarly, closer economic and political partnership between the United States and Central America will help to strengthen collective efforts to curb money laundering and prevent Central American countries from being used by international terrorist networks.

The number of legal immigrants from Central America increased from 134,640 in the period 1971–80 to 468,088 in 1981–90 and then to 526,915 in 1991–2000.[5] During that last decade, as many immigrants entered the

3. As Zoellick wrote in a *New York Times* op-ed piece, "Each agreement without us may set new rules for intellectual property, emerging high-tech sectors, agriculture standards, customs procedures or countless other areas of the modern, integrated global economy—rules that will be made without taking account of American interests. The price for inaction will eventually be paid by American workers and consumers" ("Falling Behind on Free Trade," April 14, 2002).

4. Even though by many indicators Chile's economy is small in comparison to that of the United States, in terms of income per capita, several indicators of size, level of development, and social conditions the Central American economies are in a different category—much closer to those in the Caribbean (though also different from them in significant ways).

5. US Department of Justice, Immigration and Naturalization Service, 2001 Statistical Yearbook of the *Immigration and Naturalization Service* (available at www.immigration.gov). To put these figures in a broader perspective: 9.1 million people came to the United States from all countries in the world in that decade, of whom 50 percent (4.5 million) came from the Americas. In turn, of this number, 2.3 million people came from Mexico, nearly 1 million from all the Caribbean, slightly over half a million from Central America, and another half million from South America.

United States from a region with a total population of only 33 million people as from all the South American countries combined, whose total population exceeds 200 million. To the extent that CAFTA generates growth and employment opportunities in Central America, it would tend to reduce the region's contribution to the total immigration flows into the United States. That the Central American country whose economic performance in the past two decades has been relatively strong, Costa Rica, is the one whose contribution to immigration is by far the smallest clearly indicates the close link between higher economic growth and standards of living and lower rates of emigration.

Political and Strategic Objectives

Promoting progress in Central America toward economic, political, and social reform was one of the objectives mentioned by President Bush in his OAS speech announcing CAFTA. NAFTA showed the importance of free trade agreements not just to lock in economic reforms but also to promote democracy. The democracy promotion effects of an FTA with Central America can be very significant. Because of their deep reach into domestic regulation in areas such as competition policy, government procurement, customs, and administrative transparency, FTAs are important mechanisms to improve political as well as market fundamentals. The FTA with Central America can be a powerful instrument to bring prosperity to the region and prevent scenarios of increased poverty and instability that would threaten US security interests.

During 2001 and 2002, concerns grew over the worsening economic and political conditions in Latin America and the Caribbean—starkly highlighted by the crisis in Argentina, which was at its worst in 2001. There were widespread perceptions that the US response to the crisis in Argentina had not been forthcoming enough. More generally, the high hopes for continued progress toward more democratic politics, higher growth and employment, and reduced poverty had gradually dissipated in Latin America (Hakim 2001; Shifter 2003). In addition, after September 11, 2001, Latin Americans feared that more urgent worries elsewhere and the new focus on fighting terrorism would lead the United States to indifference toward and disengagement from their region. In this context, sending a strong message that the Bush administration has not abandoned its policy of partnership with Latin America and that backsliding in the area of economic reforms should be avoided was useful and timely.[6]

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6. It is no coincidence that President Bush's speech at the OAS on January 16, 2002, combined comments on the situation in Argentina with the announcement of the desire to explore an FTA with Central America. This speech and Ambassador Zoellick's presentation—also at the OAS, in February 2002—concretely reassert US policy toward and commitment to Latin America. In his speech, President Bush restated the Summit of the Americas vision that "The future of this hemisphere depends on the strength of three commitments: democracy, security, and market-based development," and that "These commitments are inseparable."

Economic Objectives

Although the combined GDP of Central America totals $56 billion, slightly lower than that of Chile alone, Central America is not an insignificant market for the United States. US exports to the region amounted to nearly $10 billion in 2002, making the region the third most important market for US exports in Latin America, after Mexico and Brazil.[7] Given Central American countries' propensity to import from the United States, and given that the region has higher tariffs on US exports than vice versa, CAFTA has the potential to increase US exports to a degree that is significant relative to the size of the economies of the region.

The investment side of the equation is perhaps more interesting. Investments in Central America are key for the global competitiveness and global sourcing efforts of some US industries, including mostly textiles and apparel but increasingly many others. For instance, investments by Procter and Gamble, Abbott Laboratories, and a number of high-tech firms in Costa Rica tellingly demonstrate that the mutual benefits of US involvement in the region include but can go well beyond unskilled-labor-intensive activities; with ever greater frequency, they incorporate higher levels of skills and participation in more sophisticated manufacturing processes.[8]

Even though for a number of US business sectors CAFTA is a "commercially significant" agreement, the economic importance of Central America in the broader picture of US business and trade should not be overstated. Therefore, it is reasonable to think that from the US public-policy perspective of "competitive negotiations," geopolitical and security objectives and motivations dominate for this particular agreement. But the politics of CAFTA in the United States is a complex subject that lies beyond the scope of this chapter.

Central American Motivations: The Case for CAFTA from a Central American Perspective

Central American governments, business leaders, academics, and others that favor CAFTA have pointed out a number of potential economic, developmental, trade policy, and political benefits the agreement might bring, summarized in box 9.2 and examined in greater detail below.

7. This figure is larger than the sales to Russia, India, and Indonesia combined. Or within the Americas, it is as much as the exports to Chile, Colombia, and Argentina combined, and not far behind the exports to Brazil of $15.8 billion in 2001.

8. For the case for CAFTA from a US business perspective, see Emergency Committee for American Trade (2003), particularly the November 19, 2002, testimony of Jerry Cook, vice president of international trade, Sara Lee Knit Branded Apparel, on behalf of the Business Coalition for US-Central America Trade.

Box 9.2 Central American objectives, motivations, and benefits in CAFTA

Trade policy related

- reduce uncertainty by locking in market access to its main trading partner and largest market in the world
- insure against the risks of a protracted FTAA negotiation

Economic and developmental

- promote exports
- attract investment
- diversify imports, with benefits for both consumers and productivity
- improve institutions and market economy fundamentals
- promote policy reform
- increase bilateral and multilateral aid flows

Political

- improve social conditions and democracy
- overcome local resistance to further economic and political reform

Trade Policy–Related Objectives

In the realm of trade policy, a key motivation is to seek to protect market access from the uncertainties inherent in unilateral programs such as CBI, a worry exacerbated by recent protectionist pressures in the United States. The reality of this threat was underlined in the recent TPA negotiations when political pressures led to commitments to remove the access to the United States for textile and apparel products dyed and finished in the region—access granted to Central America under the Caribbean Basin Trade Partnership Act (CBTPA) of 2000—by hardening the applicable rule of origin. Under CAFTA, such actions would be much more difficult to undertake, a change that would benefit investors and exporters from Central America by removing uncertainty regarding access rules and conditions in the US market.

The number of players and the accompanying proliferation of sensitivities ensure that the FTAA is an ambitious and complex negotiation, and its precise outcome remains uncertain. Some doubt that the FTAA will be concluded by the target date of January 2005. CAFTA will bring the Central American countries enhanced and more secure access to the market of their principal trade partner, without their having to wait for the conclusion of the FTAA negotiations and its entry into force.

Economic and Developmental Benefits

The fundamental objective of CAFTA is to develop the Central American engines for economic growth. Given the limited size of the regional mar-

Table 9.3 Share of the main 5, 10, and 15 CAFTA products exported to the United States (percent)

Country	Year	5	10	15
Costa Rica	2001	19.93	29.56	30.78
El Salvador	2000	23.49	31.42	35.70
Guatemala	2000	26.17	29.09	30.98
Honduras	2000	38.65	42.25	44.76
Nicaragua	2001	18.03	22.33	38.82

Source: IDB, Hemispheric Database, 2003.

ket and the near exhaustion of import substitution opportunities during 30 years of trying this strategy, Central Americans realize that these engines will be fueled by increased and more diversified exports and by investment resulting from integration with the largest markets in the world. As table 9.3 shows, despite some export diversification in the 1990s, Central American countries still present an export portfolio dominated by a relatively small number of product lines. (See appendix 9.1 for the detailed list of products for each country.)

A free trade agreement with the United States has the potential to boost growth in all the areas in which Central America does business with the world, and with the United States in particular. Simplifying somewhat, these include

- Traditional exports such as coffee, beef, bananas, and sugar.
- Nontraditional agricultural exports such as ornamental plants, melons, pineapples, shrimp, gourmet coffee, and many other products.
- Exports of industrial parts and components. This is one of the most promising lines of business expansion, which will mutually benefit the US and the Central American economies. For instance, Central America is a very attractive location for electronic assembly and manufacturing, such as that done at the Intel plant in Costa Rica. As the case of Intel demonstrates, these types of investments have a very large positive impact on host countries, raising the general level of training, developing local suppliers, and providing both a model for other investments and a nucleus around which they can cluster (see Rodriguez-Clare 2001).
- Services exports from tourism to call centers and from educational to medical services. The increased presence of US service providers in Central American economies will also be a major force in promoting the region's modernization and increased international competitiveness.
- Textile and apparel trade has long been at the center of trade policy concerns between Central America and the United States and may

provide large benefits in addition to those conferred by the CBTPA of 2000.

A fundamental point to stress is that despite the importance of the textile and apparel sectors in the short to medium term, in the longer term CAFTA has the potential to promote growth and development in Central America by creating incentives that go well beyond the labor-intensive, relatively low-skilled processes that the Central American countries have until now undertaken in that sector. CAFTA represents an extraordinary opportunity for Central America to climb the ladder of comparative advantage by developing activities that demand higher levels of skills and greater value added and by allowing its mostly small and medium-sized enterprises to increasingly participate more actively in global sourcing networks.

Recent studies have found that access to a wide range of imports at internationally competitive prices can have a large positive impact on economywide productivity. This is so in part because of the economywide production and organizational efficiencies induced by competitive pressures and by the incorporation of best practices, and in part because of the role of imports as a vehicle to access new technologies, including computers, information and telecommunications technologies, automated production lines, and other capital equipment and intermediate goods (Stiglitz and Yusuf 2001).

One of the main conclusions of development economics in the 1990s was the recognition of the crucial role of institutions in growth and development.[9] It can be argued that one of the major benefits of an FTA with the United States will be to trigger a second generation of reforms in Central American countries by upgrading a wide array of institutions, from those most obviously and directly related to trade and globalization (such as customs, standards, and certification-setting bodies; regulatory agencies for the financial and other sectors; competition policy agencies; government procurement processes; etc.) to institutions related to labor markets and environmental policies. In addition, CAFTA will create incentives and a sense of urgency for countries to accelerate policy reform in a number of key areas (to address price distortions and service-sector inefficiencies, for instance), as well as to improve such market economy fundamentals as property rights, the rule of law, and the judicial system.

The likelihood of achieving several of the main economic and developmental benefits discussed above will increase to the extent that the co-

9. See Kuczynski and Williamson (2003, 11). Easterly and Levine (2002) conclude that the level of institutional development is the only variable that reliably predicts how developed a country is. According to these results, institutions trump policies in explaining cross-country differences in income per capita.

operation exercise being carried out in parallel with the negotiations succeeds in mobilizing sufficient human and financial resources to the region, thereby providing a benefit in and of itself. During 2002, even before the negotiations were officially launched, Central American governments and the US government agreed to put in place a trade-related cooperation exercise to accompany the negotiations. With the support of the Inter-American Development Bank (IDB), the OAS, the Economic Commission for Latin America and the Caribbean (ECLAC), and the United States Agency for International Development (USAID), each country prepared a National Trade Capacity Building Action Plan to define, articulate, and prioritize needs grouped in three major areas: preparation for negotiations, implementation of the agreement, and transition to free trade and competitiveness.[10] Since January 2003, when negotiations formally started, each negotiating round has involved (in addition to the five negotiating groups) the Group on Cooperation, where donors meet multilaterally and bilaterally with countries so that they can respond to the needs identified by countries and better coordinate their giving. It is too early to tell what additional mobilization of resources this exercise will achieve. So far, it has certainly helped to focus and prioritize needs and to set an agenda for the mix of trade and other developmental homework that countries should undertake to implement and benefit from CAFTA. Putting together the trade and aid components is one of the innovative aspects of CAFTA, which recognizes the close and complex relationship between free trade, the challenges of implementation, and the broader developmental challenges posed by an FTA between such unequal trade partners.

Political Benefits

Finally, many Central Americans believe that an FTA with the United States may have positive political and social impacts. Clearly, however, there are some well-justified fears that if the transition is not gradual, if concessions by Central America are not matched by significant additional access to the US market in key sectors in which Central America has comparative advantage, and if Central American societies do not do their homework in setting up social policies and safety nets, then the economic, social, and political systems of the region could be put under extreme stress by this agreement.

Given both the large effort at unilateral trade liberalization and policy reform undertaken by Central America in the past decade and the current economic and social conditions, the next stage of policy reform in the re-

10. These action plans are publicly available at the Web sites of the US Trade Representative (www.ustr.gov) and the OAS Trade Unit's Foreign Trade Information System (www.sice.org), as well as those of each Ministry of Trade of the individual Central American countries.

gion will be facilitated under a reciprocal negotiation with a major trading partner or partners that will end with clearly identified winners whose gains from additional market access granted by those trading partners will offset the resistance of local losers hurt by increased imports and competition. For CAFTA to provide an incentive for change, the negotiation will have to lead to clear mercantilist gains. This benefit goes to the heart of the negotiating and political economy challenges discussed in later sections.

What can be concluded from these different profiles of priority objectives and motivations? How will the asymmetries in economic structures, on the one hand, and in political objectives, on the other, interact to enable the parties to arrive at not only a mutually satisfactory CAFTA agreement in the short term but also an economic relationship that all consider fully satisfactory in the longer term?

These are not questions that are easily answered. However, it seems important for both parties to reflect on the following propositions:

- For the United States, CAFTA is first and foremost a means to achieve "competitive negotiations," in accordance with its geopolitical and security objectives. Its commercial interest in CAFTA, while not negligible, is relatively modest. For Central America, in contrast, the objectives of CAFTA are overwhelmingly economic and developmental.
- The achievement of the US geopolitical and security objectives depends critically on Central Americans achieving their economic objectives, a task that in turn requires significant and balanced progress in both trade and aid. If the economic and developmental benefits expected by Central Americans fail to materialize, if the transition costs are too high, and if the stress on the Central American economic and political systems proves to be excessive, then emigration to the United States could increase instead of diminish, popular resistance during the implementation of CAFTA could destabilize instead of consolidate the fragile Central American democracies, and CAFTA will certainly not become a model that others in Latin America and the Caribbean will wish to emulate. In the light of these considerations, a US policy of quickly extracting the maximum number of concessions could even backfire.
- On the other hand, Central Americans must consider that the economic and developmental benefits of CAFTA will not be achieved if many sectors or areas are excluded from high levels of trade discipline and, most important, if the countries of the region do not do the type of economic and social policy homework discussed below.

We will come back to these fundamental issues after commenting briefly on the main challenges in each of the relevant negotiating areas.

Key Negotiating Issues and Challenges

Space constraints allow us to discuss only the most salient issues and challenges posed by the CAFTA trade negotiations, and in general terms.

Market Access: Tariffs and Nontariff Measures

Tariff profiles of the six countries show some similarities and some divergences (table 9.4). The US nominal average tariff is much lower than that of any Central American country, but the Central American tariffs are not very high. The US import tariff applied to Central American exports is 0 percent for all products that qualify for CBI or other preferential treatment. On average, 61 percent of Central American exports actually enter the US duty-free under these unilateral programs; however, there are important differences among the countries.[11] After having undergone trade reform in the 1980s and 1990s, the Central American countries do not, broadly speaking, provide very high levels of tariff protection, at least when compared with historical levels (especially during the peak of the import substitution industrialization phase in the 1960s and 1970s). There are sectors in which each party in this agreement shows comparative advantages and comparative disadvantages.[12] The challenge in this negotiation, as in many trade negotiations, is to maximize opportunities for market access at the lowest possible internal political cost. Both the United States and Central America have tariff peaks in agricultural products that are not only politically very sensitive but also in areas of mutual interest for gaining market access (table 9.5), giving rise to deep underlying tensions in these negotiations.

It is very likely that the tariff elimination programs will result in a series of baskets accommodating the goods according to political, commercial, and fiscal criteria, probably in that order of importance. In this regard, Central American negotiators should have no major difficulties in securing US recognition of the clear economic asymmetries that pervade this agreement. Since most Central American exports enter duty-free to the United States while US exports to Central America pay customs tariffs, the expected tariff elimination scheme will necessarily imply a higher burden of liberalization for Central America, thereby following the typical pattern in North-South agreements. Notwithstanding any built-in asymmetric reciprocity and whatever the possible political importance of longer tariff transition periods, in the case of Central America such longer

11. By country, the proportions of duty-free imports are Costa Rica, 84 percent; Honduras, 67 percent; El Salvador, 58 percent; Guatemala, 50 percent; Nicaragua, 47 percent (USTR 2001).

12. For an analysis of opportunities and challenges in agriculture and agribusiness in Costa Rica and El Salvador, see Monge, González, and Monge (2002).

Table 9.4 CAFTA countries' tariffs by Harmonized System section, 2000

		Costa Rica			El Salvador		
	Section and description	Average MFN	Maximum	Imports	Average MFN	Maximum	Imports
I.	Live animals; animal products	19.6	162.0	44,443	12.1	40.0	118,674
II.	Vegetable products	9.7	49.0	234,613	9.8	40.0	193,055
III.	Animal or vegetable fats and oils and their cleavage products; prepared edible fats; animal or vegetable waxes	8.3	30.0	10,645	7.7	15.0	70,687
IV.	Prepared foodstuffs; beverages; spirits and vinegar; tobacco and manufactured tobacco substitutes	15.2	162.0	174,599	14.3	40.0	239,158
V.	Mineral products	4.1	49.0	512,241	2.9	15.0	611,530
VI.	Products of the chemical or allied industries	1.4	14.0	686,256	1.9	15.0	468,472
VII.	Plastics and articles thereof; rubber and articles thereof	5.0	14.0	437,487	4.5	15.0	232,273
VIII.	Raw hides and skins, leather, fur skins, and articles thereof; saddlery and harness; travel goods; handbags and similar containers; articles of animal gut (other than silkworm gut)	8.9	14.0	25,598	9.1	15.0	13,459
IX.	Wood and articles of wood; wood charcoal; cork and articles of cork; manufactures of straw; basketware and wickerwork	8.3	14.0	23,803	7.3	15.0	26,286
X.	Pulp wood or other fibrous cellulosic material; recovered (waste and scrap) paper or paperboard	4.6	14.0	329,778	4.5	15.0	189,631
XI.	Textiles and textile articles	9.2	49.0	768,195	17.8	25.0	1,008,743
XII.	Footwear, headgear, umbrellas, walking sticks, whips, riding crops, and parts thereof; prepared feathers and articles made thereof	11.2	14.0	41,755	15.0	20.0	37,643
XIII.	Articles of stone, plaster, cement, asbestos, mica, or similar materials; ceramic products; glass and glassware	6.7	14.0	78,103	6.5	15.0	76,689
XIV.	Natural or cultured pearls, precious or semiprecious stones, precious metals, metals clad with precious metal; imitation jewelry	7.4	14.0	29,787	8.2	20.0	4,182
XV.	Base metals and articles of base metal	3.4	14.0	427,998	3.3	15.0	252,653
XVI.	Machinery and mechanical appliances; electrical equipment; sound recorders and reproducers, television image and sound recorders; accessories of such articles	2.2	14.0	1,936,046	2.3	15.0	755,384
XVII.	Vehicles, aircraft, vessels, and associated transport equipment	4.6	14.0	376,477	6.2	30.0	251,065
XVIII.	Optical, photographic, cinematographic, measuring, checking, precision, medical, or surgical instruments	3.1	14.0	131,704	4.2	25.0	71,568
XIX.	Arms and ammunition; parts and accessories thereof	9.6	14.0	705	30.0	30.0	2,930
XX.	Miscellaneous manufactured articles	10.6	14.0	100,818	10.9	30.0	80,335
XXI.	Works of art, collectors' pieces, and antiques	4.0	9.0	862	20.0	30.0	206

a. Tariff year for Honduras is 1999.

Source: IDB, Hemispheric Database.

Table 9.5 United States and Central America: Tariff peaks (by Harmonized System chapter)

Chapter number	Description	Most favored nation	Maximum	Imports	Country
US tariff peaks more than 50 percent					
4	Dairy produce; birds' eggs; natural honey; edible products of animal origin, not elsewhere specified or included	21.3	116.6	1,035,394	
12	Oil seeds and oleaginous fruits; miscellaneous grains, seeds, and fruit; industrial or medicinal plants; straw and fodder	6.4	163.8	822,860	
17	Sugars and sugar confectionery	16.6	159.3	1,489,288	
18	Cocoa and cocoa preparations	13.8	108.9	1,404,323	
19	Preparations of cereals, flour, starch, or milk; pastry cooks' products	18.1	253.5	1,775,215	
20	Preparations of vegetables, fruit, nuts or other parts of plants	8.9	131.8	2,604,900	
21	Miscellaneous edible preparations	14.5	102.4	1,240,015	
22	Beverages, spirits, and vinegar	3.7	57.1	8,027,408	
23	Residues and waste from the food industries; prepared animal fodder	4.7	98.0	615,516	
24	Tobacco and manufactured tobacco substitutes	51.0	350.0	1,129,986	
64	Footwear, gaiters, and the like; parts of such articles	17.4	58.8	14,855,456	
Central American tariff peaks more than 50 percent					
2	Meat and edible meat offal	16	180	3,563	Nicaragua
4	Dairy produce; birds' eggs; natural honey; edible products of animal origin, not elsewhere specified or included	53	88	17,307	Costa Rica
10	Cereals	20	55	36,260	Nicaragua
16	Preparations of meat, of fish or of crustaceans, molluscs or other aquatic invertebrates	29	162	4,984	Costa Rica
17	Sugars and sugar confectionery	19	55	8,144	Nicaragua
21	Miscellaneous edible preparations	14	88	39,038	Costa Rica
24	Tobacco and manufactured tobacco substitutes	10	55	30,453	Nicaragua

Source: IDB, Hemispheric Database, 2003.

transition periods by themselves will be insufficient for structural adjustment: they must be accompanied by other internal measures. We will comment further on this issue below.

That Central America has maintained a common external tariff (CET) during the past 10 years benefits both parties, procedurally and substantially, in a negotiation such as this. By the same token, any imperfections in the CET suggest complications in the negotiations. The problem here is that in the Central American CET, as in every CET in the Western Hemisphere, there are many imperfections; these are linked to different sources in each of the five Central American countries. Such sources include fiscal problems, the need for faster unilateral liberalization, the imposition of temporary protective tariffs, Uruguay Round tariffication resulting in different tariff levels in key agricultural commodities, intraregional acts of political retaliation, and so forth (see Granados 2001). Regardless of the legal, political, or economic justifications for these imperfections, the fact is that they make it difficult for the Central American delegations to define a common negotiating position, while at the same time creating strategic opportunities for US negotiators. Many of the features of the resulting tariff elimination programs will take shape as a function of these problems.

Another source of potential concern for both US and Central American negotiators is the issue of export-processing zones (EPZs). It has been the policy of the United States that some tax and fiscal incentives typically found in EPZs, such as tariff deferrals or exemptions, be phased out either on entrance into force of the free trade agreement or within a specific period.[13] Among other things, this serves to avoid trade deflection. The challenge here is that a considerable amount of the total exports from Central American countries come from EPZs.[14] Therefore, any provision to this effect in CAFTA would have an important impact on Central America. Furthermore, if WTO provisions banning export subsidies by 2008 are factored into the picture, we must conclude that EPZs, as they are known today in Central America, are likely to change substantially in the next 5 to 10 years.[15]

13. NAFTA Article 303, for example, mandates that Mexico introduce important changes into its *maquila* regime by 2001—that is, seven years after the entry into force of the agreement. Basically, Mexico can no longer engage in duty-free importation of inputs from third countries that are to be incorporated in goods to be further exported duty-free to the other NAFTA countries. In the US-Chile FTA (USTR 2003), Article 3.8 grants Chile eight years to adopt somewhat similar obligations.

14. In the year 2000, the specific percentages, by country, were Honduras, 55 percent; Costa Rica, 51.1 percent; El Salvador, 48.8 percent; Nicaragua, 21.8 percent; and Guatemala, 6.5 percent (figures from Zonas Francas of the Americas Committee).

15. For a more thorough analysis of these issues, see Granados (2003). During the Doha Ministerial Conference in November 2001, the ministers decided in essence to sympathetically consider requests from certain developing countries to possibly allow export incentives typically found in EPZs to extend five years beyond the 2003 deadline originally negotiated during the Uruguay Round, a decision that will benefit Central American countries.

Broadly speaking, Central American countries have eliminated most nontariff measures (NTMs), either because they are meeting conditions set by international financial institutions or because they are following WTO disciplines. There are no quotas (except in the case of tariff rate quotas, or TRQs, resulting from the Uruguay Round Agreement on Agriculture in some countries, notably Costa Rica), and they apply only ad valorem duties. The range of measures that typically are labeled nontariff is larger in the case of the United States, many of them so designed in response to tremendous internal lobbying pressures. As a result, there are quotas for a vast array of products that the Central American countries are interested in exporting, such as textiles and clothing, dairy products, sugar, beef, peanuts, tobacco, and cotton.[16] Many products are subject to specific tariffs as well. In addition, in practice the technical and sanitary procedures at best make market access cumbersome and at worst turn into access barriers.[17] Finally, Central American traders face the difficult challenge of dealing with US distribution channels, which is the private dimension of international trade relations.

A set of transparent and clear rules of origin should be negotiated in this agreement. Central American countries have experience with NAFTA-like rules of origin, since they have negotiated similar disciplines with other trading partners such as Mexico and Canada. As a result, many of the approaches that the United States will seek in the CAFTA origin regime will be familiar and acceptable to Central American countries. The substantial question here is whether those rules will take into account the particularities of the Central American region or simply replicate the structure of US industrial protection. Central American countries are generally not well endowed with rich sources of raw materials. Their levels of value added tend to be low. Therefore, for CAFTA to be a meaningful source of trade opportunities for Central American countries, flexible and softer rules of origin will be required in many sectors, such as textiles and clothing. The rules of origin should not be crafted so as to neutralize concessions made to gain market access.

It is not at all unreasonable to suggest that the agreement should have an adequate mechanism to ensure safeguards. Again, Central American–US asymmetries in industry and agriculture are so wide that Central American producers and industrialists are likely to require clear and transparent safeguard rules to guarantee them adequate opportunities to adjust. The ability to impose safeguards should be maintained during the transition period at least. A public hearing to listen to consumers and other downstream users of the imported good should also be part of the disciplines.

16. Agricultural products with TRQs account for 24 percent of US tariff lines. See Gibson et al. (2001).

17. For an analysis of these issues, including perceived technical and sanitary barriers in the United States and other countries, see Roberts, Josling, and Orden (1999).

Table 9.6 Employment in agriculture in CAFTA countries
(in thousands, and percent of workforce)

	1990		1995		2000	
	Number	**Share of workforce** (percent)	**Number**	**Share of workforce** (percent)	**Number**	**Share of workforce** (percent)
Costa Rica	264	26	252	22	252	17
El Salvador	620	40	801	41	912	40
Guatemala	942	39	1,334[a]	44	1,727[a]	48
Honduras	688	47	766	43	853	38
Nicaragua	442	39	497	40	712	43
Central America	2,956	38	3,650	38	4,456	38
United States	3,429	3	3,592	3	3,457	2

CAFTA = Central American Free Trade Agreement

a. Estimate.

Sources: ILO, Laborsta; World Bank, *World Development Indicators, 2002–2001;* Comisión Económica para América Latina, Información Básica del Sector Agropecuario, Subregión Norte de América Latina y el Caribe, 1990–2001, LC/MEX/L.549, December 2002.

Agriculture

As table 9.6 shows, in 2000 on average 38 percent of the labor force in Central America (some 4.5 million people) was employed in and making a living from agriculture, in comparison to only 2 percent in the United States (3.5 million). If the linkages and indirect effects of agricultural activities with other commercial and industrial activities are taken into account, it is clear that a very significant part of the economic activity of Central America is connected to agriculture.

As in many developing economies, this large agricultural sector in Central America is characterized by an important degree of dualism. A number of modern, mostly export-oriented, dynamic, and internationally competitive agribusiness clusters, with significant participation of foreign capital, coexist with large segments of highly protected agricultural activities oriented toward the domestic food markets. The latter in turn contain some relatively modern agricultural clusters (dairy, poultry) as well as a large number of small and subsistence farmers (maize, beans, rice, and other products). The modern sectors and clusters are not threatened by CAFTA; on the contrary, they will tend to be winners if they gain additional access to the US market. The traditional, domestic market–oriented sectors represent a major social, political, and developmental challenge, particularly in the transition to free trade, because economically they are very sensitive to international competition, and politically they are as a rule highly organized and proactive.

As development proceeds, the long-term trend is clearly that part of the rural population becomes increasingly engaged in nonfarm activities. Experience elsewhere in the world shows that the process of economic development involves a structural change toward manufacturing and tertiary activities, as the demand for food grows at a slower rate than the demand for nonfood goods and services, and as economies diversify away from their concentration on natural resource–based activities into more productive knowledge- and skill-intensive activities. It is also in the interest of countries to promote this change because over time agricultural commodity prices tend to decrease.

This process is not painless, however, and it has taken decades to complete in many now-developed countries. One of the most difficult policy challenges is thus how to influence and manage this transformation. If adjustment is too fast, inducing rural-urban migration, and if the new high-productivity jobs in manufacturing or services cannot absorb the influx, then the agricultural transition will increase unemployment and expand the ranks of the poor working in the informal sector.

Policies on two fronts will influence the speed, costs, and benefits of the agricultural adjustment process. On the external front are the transition periods negotiated for specific sectors and products and the treatment given to the agricultural sensitivities. On the internal front, the process of agricultural transformation induced by trade liberalization needs to be carefully managed; such management includes making the necessary investments in rural development, education, communications, transportation infrastructure, export diversification, and sanitary and phytosanitary measures to protect the safety of food. Ultimately, each country must find the right balance and pace for its rural transformation process, facing the challenge of increasing modernization via new investments in large, highly integrated agribusinesses while preserving a space for the small and medium-sized producers, including family farms, engaged in production for both export and the domestic food market.

Given this asymmetry in the importance and role of the agricultural sectors in the economies of the United States and Central America, the agricultural negotiations are viewed very differently by the parties involved. For the United States, they mostly remain a trade negotiation, with relatively little potential to influence domestic production and employment structures—and even so the subject is highly sensitive. For the Central American countries, these negotiations have the potential to affect their production, employment, and development in fundamental ways over the next few years.

In the United States, agricultural trade has been made subject to special treatment by TPA legislation. Consultation and coordination channels between the USTR and Congress have gained a higher profile. More precise deadlines, procedures, and requirements have been established when agricultural goods are the focus of negotiations. These changes, of course, will give Congress—and by implication farm lobbying groups—a better chance to influence policy outcomes in ongoing trade negotiations.

US farm policy has historically been to provide intensive support to farmers, aiding both production and exportation. US farmers have a wide set of benefits at their disposal, many of which are decoupled measures—that is, they provide no incentive to increase production and therefore have a less distorting impact on trade. Many observers argue, however, that a number of these measures are indeed trade distorting. The recently approved Farm Bill of 2002 not only maintained but in some respects enlarged some of the existing benefits.[18] US support concerned with export competition (that is, excluding other programs focused on commodities, crops, and conservation) includes direct export subsidies, export credit, food aid, generic market development programs, market access programs, and other programs using foreign currency (Hathaway forthcoming). Central American farmers enjoy far fewer benefits, if any. There is therefore a striking difference between farm programs in the United States and those in Central American countries.

The US administration has given indications that in fact many of these programs, especially those with trade-distorting effects, may be negotiated down.[19] This by itself demonstrates a very positive attitude. But for the United States the preferred venue for such bargaining is the WTO Doha Development Agenda and not regional FTA negotiations. The reason for this preference is understandable: because the European Union and Japan—the two major world agriculture subsidizers—are absent from regional negotiations, the United States is reluctant to negotiate away domestic support, export subsidies, and, in general, any instrument of agricultural policy that may distort trade.

Here new difficulties arise in attempting to strike a balanced CAFTA agreement. If this agreement does not address the thorny aspects of domestic support and export subsidies (the US-Chile FTA did not address these issues either), is Central America going to liberalize its tariff protection for agricultural products without having any guarantees as to the direction, depth, and scope of the WTO exercise regarding domestic support and export subsidies? Is there going to be any relationship between the Central American tariff phaseout calendars for agricultural goods and any likely dismantling of US domestic support and other export subsidies on commodities relevant for Central American countries? Does the timing of the two negotiations lend itself to the kind of synchronicity needed for the Central American countries to reach a reasonable comfort zone? It is doubtful that the Doha Round will finish before the US CAFTA negotiations. Therefore, the governments of Central America should be prepared to address many of these issues with utmost political care and technical

18. For a summary of the provisions, see Farm Bill Conference Summary (2002).

19. See US position regarding agricultural negotiations in the WTO as presented on the USTR Web site, www.ustr.gov.

creativity. Since not all of the US programs will have an impact on Central American agriculture, as they may be geared toward products that are not of interest to Central American countries or are not trade distorting, Central American authorities should try to focus their attention on issues of real relevance to their task at hand. They should avoid discussions based on broad principles, many of which may not be relevant for the dynamics of trade between the United States and Central America.

It is interesting to reflect on the likely outcome of this negotiation and its broader implications. From the US standpoint, the size of the Central American economies and their agricultural sectors may make the size of the concessions needed to please the countries in the region fairly negligible. At the same time, those countries also have their own internal political difficulties when it comes to liberalizing agriculture and ensuring that adequate conditions for the adjustment, including safety nets, are in place. Long phaseout periods and transitional TRQs in many sensitive products may be part of a solution. In addition, adjustment assistance should be part of the deal, not only because it will be needed for the transition to free trade but also, more immediately, because it will be needed to secure smoother passage for the agreement through Central American congresses.

One relevant question is what kind of precedent any CAFTA agricultural package might set for other negotiations, such as the FTAA or WTO.[20] For one thing, it would signal US willingness to achieve genuine free trade in agricultural products, at least in the long run. This is very positive—but perhaps it is not as strong a signal as it first appears. Although Chile and Central America are important producers of certain farm products, broadly speaking they do not represent the kind of threat to US producers posed by other, much larger partners inside and outside the Western Hemisphere; thus the real test for the United States is yet to come. A related question is whether US farm groups will voice opposition to the US-Chile FTA or to CAFTA as a matter of principle, viewing the agreements as precedent setting, or will save their political capital for negotiations that may present a more direct danger to them.

In essence, there are still too many questions not yet answered. Agriculture will be a difficult issue in CAFTA. For some Central American countries—not all—agriculture may be a deal breaker. Judging by the US-Chile FTA, the United States seems willing to phase out agricultural tariffs in the long run. Except for progress in export subsidies, not much is to be expected regarding domestic support and other measures that may have an effect equivalent to export subsidies. Not all US programs

20. In a groundbreaking negotiation, the United States and Chile were able to agree to total free trade in agricultural products, phased in over 12 years. There are TRQs in the transition period. (Sugar is an issue resolved by what resembles the NAFTA solution rather than crystal-clear free trade.) See USTR (2003); see also informational documents from Chilean trade authorities at www.direcon.cl.

will have an impact on Central American agricultural production and trade. Nevertheless, those programs that do should be carefully looked at in the negotiations in order to engineer appropriate mechanisms to achieve the right balance between the United States and Central America. Finally, given the lack of synchronicity between CAFTA and the WTO, there seems to be limited opportunity for fruitful cross-fertilization between these two forums.

Services

As table 9.1 shows, services are a key component of the six CAFTA economies. Of course, from an export point of view, they are more important still to the United States. The United States clearly enjoys a comparative advantage in tradable services in areas such as telecommunications, finance, transportation, various professions, and entertainment. Central American countries may lack comparative advantage in almost all of these sectors but they do have comparative advantages in others, including tourism, software programming, telemarketing, bilingual call centers, and those professional services for which the consumer may travel to the country of the provider (especially in some areas of health care, such as dentistry, plastic surgery, and ophthalmology).[21]

With few exceptions, Central American countries are relatively open to foreign service providers, as they see the competitive provision of services as key to achieving nationwide systemic competitiveness and a sound regulatory environment.[22] However, both sides maintain restrictions on a number of service activities, some of which are politically very sensitive—for example, professional services and maritime transportation in the United States, telecommunications and insurance services in Costa Rica, and professional services in all of the Central American countries.

A very important question in this negotiation is whether the agreement, in complying with the General Agreement on Trade in Services (GATS), Article V, will seek only to consolidate the legal status quo in substantially all service sectors, thereby temporarily freezing opportunities for market access for US providers at their current level, or whether the United States will in addition try to open up some of the most entrenched existing market access barriers in areas of US interest. Here the United States will have to make a decision—one that, again, will be carefully scrutinized by negotiators from other countries for its precedent-setting implications for the FTAA as well as for other "competitive liberalization" sequences. It is

21. Other cross-border services, such as Spanish-English translation services making use of the Internet, are also on the rise in Central America.

22. For some interesting opinions on financial services in Central America in light of free trade negotiations with the United States, see Camacho (2003).

very likely that any final chapter on services will base its market access disciplines on a negative list approach, and that many reservations and exceptions will be insisted on both by the United States and by Central American countries.

For some countries, a difficult negotiating issue is the extent and intensity with which the United States may seek to open up state monopolies in areas of interest. This is a particularly sensitive topic for Costa Rica, where insurance and telecommunications services remain state monopolies and where previous attempts at deregulation have failed (Monge 2000). CAFTA confronts this country with a tough choice: to give in to majority public opinion and to powerful domestic groups that have a history of fighting fiercely for keeping those monopolies (most notably, but not exclusively, trade unions), or to embrace CAFTA as an opportunity to move toward a more open and competitive provision of telecommunications and insurance services. The latter would certainly help to overcome one of the most intractable developmental bottlenecks facing the country as it attempts to move fully into the information age and the knowledge-based economy.[23] Costa Rica has expressed its intention to avoid liberalization commitments in CAFTA in these areas.[24] While this decision avoids a domestic political confrontation,[25] it also misses an opportunity to address an important area where modernization is needed; moreover, to succeed in holding this position Costa Rica may be forced to pay a high price in concessions in other negotiating areas and objectives of interest.

Investment

Investment is, to a large extent, a win-win area in this agreement, as it may be in the FTAA. The US interest is to furnish US investors with a set of rules that provide stability and predictability, guarantees for nondiscriminatory treatment, an effective and expeditious dispute settlement mechanism, and a liberal environment for repatriating capital and profits. For Central American countries, the main interest is also to furnish those conditions to attract US investors. In fact, Central American countries ex-

23. Modernization of telecommunications infrastructure has been diagnosed as one of the main challenges for sustainable human development in Costa Rica. See Estado de la Nación (2001). See also the ranking of Central American countries in the Networked Readiness Index (NRI), as calculated by the World Economic Forum and reproduced in table 9.1.

24. See Costa Rican position in Costa Rica, Ministry of Foreign Trade (2003, 23, 26).

25. This issue is very divisive. Polls indicate that the majority of the people do not support privatization or competition. Others blame the rent-seeking behavior of trade unions and bureaucrats coupled with popular misconceptions and ignorance about the challenges posed by new technologies (e.g., broadband Internet) and complacency born of having benefited for many years from no-longer-sustainable welfare policies in a paternalistic state.

pect that one of the main benefits of CAFTA will be precisely increased foreign direct investment, mostly from the United States.

As explained further in a later section, it is important for Central American policymakers and leaders to realize that these expectations will materialize only if extensive internal efforts—which typically fall outside the scope of an FTA—are made in many other areas of their economies, institutions, and regulatory systems, such as improving physical infrastructure, raising levels of education, strengthening the rule of law, defending property rights, reducing poverty, increasing flexibility in the labor market, putting in place adequate taxation systems, and protecting the environment. Cooperation in building trade capacity can be enormously helpful for Central American countries seeking to make progress in all these areas.

In CAFTA the United States may seek changes to its traditional investment agreement model, epitomized by NAFTA's Chapter XI. Chief among those aspects possibly open to revision are the questions of the settlement of disputes between investors and states, indirect expropriation ("tantamount to expropriation"), and procedural amendments to allow more participation of civil society in the dispute settlement process. For years, nongovernmental organizations and other interests—not only in the United States but also in Central America (see, e.g., Gitli and Murillo 2001)—have argued against NAFTA-type provisions, sometimes overstating their point. In the United States these groups were successful in shaping the policy preferences in the TPA. As a result, the US-Chile FTA sets new guidelines for handling these issues. On the controversial topic of indirect expropriation, for example, that agreement develops a careful understanding as to how to interpret the question in the light of overriding public policy objectives. It is highly likely that a similar approach will be suggested by the United States in the CAFTA negotiations.

Of interest in the investment talks will be whether the Central American countries are able to negotiate disciplines to prevent the most negative effects of speculative investment flows. Traditionally, the United States has been active in promoting a regulatory framework in which portfolio capital can freely flow in and out of the partner country. As will be discussed in more detail below, recent literature expresses concerns that such an approach may prevent developing countries from reacting promptly and effectively in the face of sudden, destabilizing flows of speculative capital. Attention in the investment negotiations should be devoted to this issue.

Intellectual Property

As in any North-South trade negotiation, matters of intellectual property (IP) are likely to prove complex and controversial. During the past 10 years, Central American countries have signed on to several intellectual property agreements of varying kinds: not only to the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPs)—the current multilateral standard—but to NAFTA-type rules in the agreements negotiated with Mexico and Canada. CAFTA, however, is bound to go beyond these standards, since it is very unlikely that the United States will be satisfied with simply replicating them. On the contrary, the United States is seeking to adopt IP rules in different trade forums that take into account new technologies and US interests. The US-Chile text, for instance, provides evidence for the emergence of a new US-led standard. This text will probably be the US road map for CAFTA and for the FTAA; it is therefore taken as the basis for the comments in this section.

The US-Chile FTA contains several interesting features. It extends IP protection into new areas not included in North-South trade agreements currently in effect, enforced by a strong dispute settlement mechanism. The text mandates that the two countries will adhere to certain international IP conventions in specified time frames and that they will make efforts to conform to others.[26] The text develops further the obligations existing in TRIPs and NAFTA regarding transparency and cooperation; it also provides protection in cutting-edge areas such as domain names on the Web and limitations on liability for Internet service providers. The US-Chile agreement expands many of the obligations existing in NAFTA or TRIPs related to patents, trademarks, well-known marks, copyrights and related rights, satellite signals, and border measures. Many of these provisions can be found in US law and in World Intellectual Property Organization treaties and recommendations, but not under trade agreements subject to strong dispute settlement provisions.

Establishing a suitable legal and institutional domestic framework to make possible adequate enforcement of new rules such as these is not at all easy in the Central American countries. That difficulty has been recognized in the US-Chile FTA agreement, which allows Chile to implement many of the obligations over periods of two, four, and five years (see USTR 2003, Article 17.12). If this is the approach adopted in the case of Chile—a country widely recognized as exemplary in its public policies and institutional development—could something less be expected in the case of CAFTA? The answer in our view is no. The Central American countries can be reasonably sure that the United States will request the

26. International IP conventions are now adhered to by CAFTA countries as follows: Patent Cooperation Treaty (Costa Rica, Nicaragua, United States), International Convention for the Protection of New Varieties of Plants (Nicaragua, United States), Trademark Law Treaty (United States), Convention Relating to the Distribution of Program-Carrying Signals Transmitted by Satellite (Costa Rica, Nicaragua, United States), Patent Law Treaty (none), Hague Agreement Concerning the International Deposit of Industrial Designs (none), and Protocol Relating to the Madrid Agreement Concerning the International Registration of Marks (none).

same substantial level of obligation, particularly in the new context of competitive negotiations and the associated precedent-setting logic. Longer transition periods and more efforts at capacity building and cooperation may be agreed on and definitely needed in Central America, given that the United States can be expected to try to raise the bar high.

Government Procurement

Government procurement (GP) is an area in which finding an internal balance of concessions is quite challenging. On the one hand, with a few exceptions Central American countries are very open and nondiscriminating regarding the foreign origin of the goods and services procured by government entities.[27] On the other hand, the ability to compete effectively in US procurement markets is limited by several factors, including distance, language, culture, lack of specific knowledge of US procedures, and lack of competitiveness of potential suppliers vis-à-vis US suppliers.

If GP obligations in existing trade agreements are any predictor for CAFTA, the prospects in this area do not look very encouraging for Central American countries from the narrow mercantilist viewpoint of trade negotiators. Again, it is highly probable that the US-Chile FTA shows the shape of what the United States will seek in CAFTA: relatively high thresholds, exclusions of state- and county-level procurement opportunities, and exceptions for the set-aside programs for small and minority businesses. In brief, it may block the niches where potential Central American suppliers might have an opportunity of ever winning a bid. The US-Chile agreement may be a groundbreaking exercise insofar as it enhances the material scope of the concessions—it may be Government Procurement Agreement (GPA) plus, or NAFTA plus—but a CAFTA agreement along similar lines does not necessarily ensure any benefits to potential Central American suppliers, who suffer from a tremendous supply-side asymmetry.

Perhaps the analysis of GP issues should focus not on mercantilist expectations but rather on the institutional development aspects of this set of disciplines. Bringing about more transparent, predictable, and nondiscriminating GP rules may ultimately (at least in theory) deliver economic benefits and competitiveness to the Central American countries. In addition, exposing public-sector markets to the forces of free trade may also generate considerable gains in a group of countries chronically affected by fiscal deficits, thereby benefiting the public at large. Finally, as a positive externality, this set of rules may generate momentum for creating truly regional procurement markets in Central America—an alien concept so far, but one with great potential to facilitate growth and business, particularly for the small and medium-sized Central American suppliers.

27. For the exceptions, see IDB (2003).

Labor and the Environment

Labor and environmental issues have always been divisive topics in trade negotiations, and CAFTA is no exception. Mostly because of its domestic politics, the United States has been pressing for their incorporation in trade agreements since NAFTA. While it has had little success in the multilateral context, the United States has managed to include these issues in FTAs with small partners: Jordan, Chile, and Singapore. In the WTO, only matters pertaining to the environment will be on the table (and then only some aspects of it); responsibility for the global governance of labor issues was explicitly assigned to the International Labor Organization (ILO). In negotiations for the FTAA, Latin American and Caribbean countries have, in protracted discussions, systematically rejected the introduction of language on either environmental or labor issues.[28]

There are important differences in the approaches, procedures, and dispute settlement mechanisms in US trade agreements with Mexico, Canada, Chile, Jordan, and Singapore. But TPA requirements instituted in 2002 prescribe a series of policy guidelines for addressing the issues in US trade agreements. In very broad terms, the two most important questions are whether the labor and environmental provisions will be contained in the agreements proper or in "side agreements" and whether any breach of the obligations will trigger trade, monetary, or other sanctions. The answers suggested by the US-Chile agreement (which by law has to follow TPA guidelines) are that labor and environmental provisions will be within the agreement and subject to dispute settlement procedures equivalent to those applicable to the core trade disciplines, with the potential of having both monetary and (very subtle and implicit) trade sanctions.[29]

The issues are difficult for Central American countries—not because they would "race to the bottom" in labor or environmental standards to promote trade or attract investment, but because of the complex problems normally associated with low levels of development and the lack of strong domestic institutions and of law enforcement capacities. Everything seems to indicate that to comply with TPA guidelines, CAFTA is very likely to include labor and environmental provisions similar to those found in the US-Chile FTA. If so, the most important (but certainly not the only) issues are to determine the nature of the institutions established for labor and environmental cooperation and to allocate resources to build capacity and to domestically enforce labor and environmental laws.

NAFTA's environmental institutions have been partly responsible for the deepening of technical cooperation on environmental protection be-

28. For a description and analysis of the arguments in favor of and against introducing labor provisions into trade agreements, see Salazar-Xirinachs and Martinez-Piva (2003).

29. Regarding labor in the US-Chile FTA, see Elliott (forthcoming 2004).

tween the United States and Mexico (see Gilbreath 2003; Torres 2002). This experience strongly suggests that here institutional design, more than the threat of sanctions, is the key to achieving results. It is also clear that enforcement of environmental and labor laws is resource intensive. Therefore, Central American countries will need substantial technical and financial assistance to cope with the type of commitments they are about to undertake in these areas in CAFTA.

Meeting the agreement's labor standards may at first appear to be a less onerous task, as Central American countries have already agreed to many ILO conventions.[30] But the commitments they may be taking on in CAFTA obligate them to create better conditions to fully comply with core labor rights, under the threat posed by effective dispute settlement procedures. Achieving those conditions will in some cases require the attainment of a more advanced stage of economic and institutional development. The challenge for Central American countries will therefore be enormous.

Treatment of Asymmetries

The treatment of asymmetries in free trade agreements is a hotly debated topic. Central Americans are not talking about special and differential treatment as understood in the General Agreement on Tariffs and Trade (GATT)/WTO system. Instead, CAFTA will most likely take a number of different approaches to these asymmetries:

- The negotiations will lead to differential treatment in transition periods and to technically creative ways of dealing with specific issues on a country-by-country, sector-by-sector, and product-by-product basis.
- A major trade-related capacity-building exercise has already been begun in three main areas: preparation for negotiations, implementation of the agreement, and transition to free trade and competitiveness. It is too early to assess the extent of its benefits (see the section on capacity building, below).
- Most certainly other aspects of differential treatment will emerge from the negotiations over the rules and disciplines of the agreement.

Other Issues

Unfair Trade Practices

To date, Central American countries have been little affected by antidumping or countervailing duty actions in the United States. One reason

30. As of April 2003, Costa Rica has ratified 50 ILO conventions; El Salvador, 25; Guatemala, 72; Honduras, 22; Nicaragua, 59; and the United States, 14 (ILO 2003).

is that their levels of export subsidization are very low and progressively diminishing as a result of unilateral policies and WTO commitments. Second, Central American countries do not produce the kind of industrial commodities that are more likely to be involved in these proceedings, such as steel products and electronics and other high-technology goods. Third, the low volume of Central American exports to the United States relative to those from the rest of the world means that goods are not normally exported in such quantities as to cause or threaten to cause statutory injury to domestic production.

But there is no reason to believe that this situation is permanent. On the contrary, given the expected increases of exports to the United States, certain products such as garments will probably become subject to claims of dumping in that market. Therefore, it is in the best long-term interest of Central American countries to achieve better discipline regarding unfair trade practices, particularly dumping. But because these issues are very contentious in the United States, CAFTA, as the US-Chile FTA demonstrated, is very unlikely to be a forum for addressing and finding effective solutions to them. Some doubt that even the FTAA could make progress in negotiating better disciplines in this area. At the end of the day Central American countries may have to turn to the WTO, where the issues are currently being discussed, for a meaningful negotiation of trade remedy rules.

Dispute Settlement

The quality of dispute settlement procedures is also now key to any trade agreement. In general, it is expected that the CAFTA, like other recent agreements, will have strong and effective procedures for settling disputes among the parties. Meaningful trade commitments need a rules-based framework backed by clear, expeditious, and not too costly dispute settlement mechanisms. Such procedures are especially necessary for those Central American countries with less capacity to initiate actions or to defend themselves. It is worth observing that the dispute settlements that currently exist in the WTO, NAFTA, and other modern trade agreements, which rely exclusively on trade sanctions to retaliate and to restore the balance of rights and obligations, by their very nature are implicitly biased in favor of the more powerful party. Trade-based sanctions do not have the same economic effect on countries of different sizes. In other words, if the United States breaches its obligations under CAFTA and it does not want to modify its behavior, which country will suffer more from the retaliatory action prescribed in the agreement, the United States or the aggrieved Central American party? Perhaps some kind of monetary fines (a notoriously sensitive issue in the United States), appropriately designed to take into account asymmetries, would lead to a more balanced approach to enforcing agreements between large and small economies. This issue warrants further careful thought.

It can only be hoped that the six CAFTA countries fully realize the importance of designing fair rules and of following them in today´s interdependent world.

The CAFTA Endgame

Wrapping up the CAFTA negotiation presents the United States and Central America with fundamental problems.

For the United States the basic dilemma is the following: while textiles and apparel, clothing, footwear, leather, food, and agriculture are sectors particularly sensitive to being opened up, these are precisely the areas with the largest potential benefits for Central America. Moreover, as argued earlier, the United States' ability to accomplish its geopolitical and security objectives depends critically on Central American countries' achieving their economic objectives: only an agreement that creates additional access to the US market and concrete growth opportunities for Central America will manage to increase employment and standards of living, promote further economic and social reform, and consolidate the fragile democracies of the region.

If concessions to provide Central America market access prove to be politically impossible for the United States, the result will be not only to put at risk the United States' own geopolitical and security goals but also to present the Central Americans with a stark choice:

- On the one hand, they can keep insisting on a genuine mercantilist balance of reciprocal concessions, only to find that US reluctance leads to their gains and losses not adding up. Following this path would lead to frustration, protracted negotiations, and even potentially to the talks' derailment.
- On the other hand, they can internalize to some extent the political-economy restrictions of the United States, giving more weight to a logic of investment and growth that holds that even in the absence of attractive mercantilist concessions, other growth, investment, and policy-signaling effects tip the balance in favor of signing a less liberalizing, or less ambitious, agreement. But would simply turning the existing level of unilateral access to the US market into a reciprocal agreement be a sufficient payoff from this negotiation?

Central Americans must also realize that the reciprocal nature of this agreement makes it very likely that the price for recognition of their political sensitivities will be the United States' insistence on its own exclusions and reserves in areas of interest to Central America. It is here that the complex array of objectives and motivations of each party described above must be balanced to wrap up the CAFTA negotiation.

Table 9.7 Profiles of winners and losers in Central America

Winners: CAFTA supporters	Losers: CAFTA detractors
Consumers	Traditional or other specific agriculture and agribusiness activities (depending on the nature of the reciprocal agricultural liberalization schedules)
Exporters, including small and medium enterprises oriented toward exports	Traditional (import substitution) industrialists
Bankers and financial operators	Small and medium enterprises oriented toward the domestic market
Import traders	Agricultural subsistence and very low skilled workers
Tourism sector and tourism operators	Trade unions in some public enterprises
Large regional groups	
Highly skilled workers, women	
Low-skilled workers, women	
Nontraditional agriculture	
Traditional agriculture/agribusiness (depending on specific market access opportunities)	

Source: Adapted from Colburn and Sanchez (2000).

Winners, Losers, and the Politics of CAFTA in Central America

By its nature, any healthy process of economic modernization and transformation generates sectors and activities that grow (winners) and sectors and activities that decline or disappear (losers).[31] To ease the process of adjustment and reduce its costs, governments may establish mechanisms to compensate losers and may create incentives to smooth the transition.

One of the mechanisms by which CAFTA will promote modernization and increase productivity in the Central American economies is precisely an acceleration of the process of economic transformation. Table 9.7 identifies the main winners and losers from such transformation in Central American countries. Though its characterizations are general and thus tend to oversimplify a complex reality, it provides some insight into the

31. The biological metaphor is appropriate: just as a healthy living organism generates new cells to replace dying ones, so a healthy economic system generates new, more productive, more competitive activities and firms to replace uncompetitive, inefficient businesses and activities. Joseph Schumpeter called this engine of innovation and growth that drives capitalist competition the process of "creative destruction."

nature of the economic changes, and associated political challenges, that will be brought by CAFTA in Central American societies.

If CAFTA is comprehensive, winners would include the 33 million Central American consumers, who would benefit in multiple ways from lower prices and wider choice; exporters, including small and medium-sized enterprises (SMEs) linked to export operations; bankers and financial operators (although the increased competition in the financial sector might reduce profits and rents for some of the existing groups); import traders; tourism-sector businesses, where Central American countries have unique natural, ecological, and historical attractions and comparative advantages; large regional business groups able to enter into strategic alliances with US companies to penetrate the US market and to marginally service the Central American market; highly skilled workers, who will find expanded job opportunities with modern national and international business firms; low-skilled but semiliterate workers, particularly women, who could find jobs in labor-intensive manufacturing assembly operations that have expanded significantly with the CBI and most likely will experience a new wave of expansion with CAFTA; nontraditional agriculture in numerous product lines where Central American countries are quite competitive; and, finally, traditional agriculture and agribusiness activities (sugar, beef, poultry, and dairy), assuming that manages to open significant opportunities for market access in the United States. Most groups in the winners' column of table 9.7 see CAFTA as an opportunity; they believe that if the negotiations go reasonably well, the benefits as discussed above will overwhelmingly exceed the costs.

The list of potential losers includes traditional or other agricultural and agribusiness activities, if Central America liberalizes some of its own sensitive sectors in the face of continued US subsidization of agriculture while gaining no significant additional market access in the United States; traditional—that is, import substitution—industrial activities, many of which have already gone through substantial adjustment and rationalization with the trade liberalization of Central American economies so far, but which will not be able to survive the transition to full free trade with the United States; SMEs oriented toward the domestic market that either are in niches that will be hit by import competition or new competitive players, or do not manage to link up to expanded local and global sourcing networks; and agricultural subsistence and very low skilled workers who might not be able to take advantage of the new opportunities opened by modern economic activities, even in the labor-intensive manufacturing that requires a minimum of knowledge. Also in this list are some trade union leaders and members in a number of public enterprises that—probably wrongly—think that their jobs are threatened and thus perceive themselves as potential losers.

A number of dissenting voices in Central America have raised objections to or reservations about CAFTA. Those that perceive themselves as losers argue that the costs are higher than the benefits and that there is no way for many industrial and agricultural sectors to survive US competition. Others oppose CAFTA for ideological reasons; they fear that it will lead to greater concentration of economic activities in the hands of a few, mostly foreigners, with reduced opportunities for Central American nationals, or that it will erase or dilute Central American cultural traditions. Still others think that such an agreement is the way to go in the long term but assert that Central America is not yet ready in one or more areas, such as its infrastructure, competitive conditions, efficiency of public services, or entrepreneurship. Some believe strongly in "food security" and fear that the agricultural and rural way of life in Central America will be severely disrupted and threatened by CAFTA. In some countries, particularly Costa Rica, most of the population feels strongly that some "strategic" services should be produced and distributed by the public sector (e.g., telecommunications, energy, fuel, and drinking water) and would oppose CAFTA if its ratification would mean changing the status quo in these sectors.[32]

This profile of winners and benefits on the one hand, as well as of losers and objections on the other, explains why CAFTA was generally well received by many sectors of Central American society while others have expressed concerns or outright skepticism. The agreement's detractors include some very well organized and influential groups that pose a major political challenge to Central American governments and leaders. A more detailed analysis of the politics of CAFTA in Central America is beyond the scope of this chapter.

Central American governments are aware that these politics are very complex and that only a policy of transparency and participation, combined with a major investment in public education and debate as well as success in the negotiations, will make it possible to persuade doubters of the benefits of this agreement and to respond to their objections, fears, and concerns.

The Central American Policy Agenda to Fully Benefit from CAFTA

Since the Central American Common Market was launched, no project has had greater potential than CAFTA to promote growth, create employment, reduce poverty, and improve standards of living in Central America. But CAFTA will not achieve this transformation in and of itself. For its hopes and promises to materialize, Central American countries have a lot of homework to do, and they must see CAFTA as part of a much broader

32. For an inventory of these objections and some arguments in response, see Lizano and González (2003).

set of development policies. In other words, countries must "mainstream" CAFTA into their development strategies. This section presents a five-part policy agenda to summarize what we see as the policy challenges that must be a priority for Central America if it is to fully take advantage of the developmental opportunities opened up by CAFTA for higher growth, reduced poverty and better income distribution.

Macroeconomic Policy and "Crisis Proofing"

First, an appropriate macroeconomic policy framework is essential to reduce Central America's vulnerability to international shocks and crises. Reduced vulnerability and volatility are in turn essential elements for sustaining a reasonable rate of growth and for improving the distribution of income. To achieve such a framework, Central America should adopt most of the elements of "crisis proofing" recommended by Pedro-Pablo Kuczynski and John Williamson (2003). To do so:

- The chronic fiscal deficits and the high levels of domestic debt that characterize most countries in the region must be reduced.
- An exchange rate regime must be adopted that is sufficiently flexible to allow external competitiveness to be improved through currency depreciation when there is a sudden stop in capital inflows or other balance of payments difficulties. This system has indeed served Costa Rica very well since the early 1980s, and is a key element of the country's export success.
- Countries should also give serious thought to maintaining an instrument (such as a variation of the Chilean encaje) to avoid overvaluation if capital inflows threaten to become excessive. In El Salvador, remittances are a major contribution to foreign-exchange earnings, but they also represent a risk if they are allowed to support an artificially high exchange rate that would damage the competitiveness of Salvadoran exports.
- The flexible exchange rate regime should be complemented with a monetary policy based on targeting a low rate of inflation.
- Prudential supervision of the banking system should also be strengthened.
- Every effort should be made to increase domestic savings in both the public and private sector, by reforming domestic pension systems, developing the emerging capital markets, and taking other measures.

In addition, a very important policy issue is the fiscal impact of CAFTA and the tax reform that must accompany the agreement. As table 9.8

Table 9.8 Central America's reliance on taxes on trade (percent of current tax revenue)

Country	3-year average, 1999–2001
Costa Rica	6.4
El Salvador	10.2
Guatemala	12.7
Honduras	16.1
Nicaragua	10.3

Source: Schott and Kotschwar (2002).

shows, most countries in the region derive a substantial share of current revenues from taxes on international trade. Because imports from the United States represent around 50 percent of their total imports, CAFTA will erode between 3 percent and 8 percent of total tax revenue in these economies during the transition period to free trade. There is a great deal of work to be done by Central American countries on tax reform to replace this lost revenue.

Institutional Upgrading and Building

As stated above, one of the major benefits to Central American countries of an FTA with the United States will be to trigger a second generation of reforms by upgrading a wide array of institutions, from those most obviously and directly related to trade and globalization—such as customs, standards- and certification-setting bodies, regulatory agencies for the financial and other sectors, competition policy and government procurement agencies, and the like—to institutions related to labor markets and environmental policies.

Some of the institutional upgrading is directly linked to the requirements of implementing the CAFTA agreement itself. Michael Finger and Philip Schuler (2002) have estimated the costs of implementation of trade agreements in three areas (customs valuation, sanitary and phytosanitary standards, and intellectual property) using World Bank project data. They show that these investments require the purchasing of equipment and software, the hiring and training of specialized personnel, systems development, and other steps to upgrade the institutions and systems of developing countries to industrial-country standards. Depending on each country's existing capacities, the requisite investment may be on the order of tens of millions of dollars.

Improving compliance with international labor and environmental standards first and foremost needs substantive investments in institutional capacities and in a variety of specific projects. Even more broadly, depending on its specific situation, each Central American country needs to invest in improving market-economy fundamentals in areas such as property rights, the rule of law, the judicial system, and corporate governance and social responsibility. Only by working to improve the quality of all these institutions and of economic governance mechanisms will Central American countries manage to attract sufficient investment to grow and take full advantage of the new market access opened up by CAFTA.

The trade-cooperation nexus established during CAFTA's negotiation phase is a major opportunity for Central Americans to mobilize resources to upgrade and build the institutions they need to benefit from free trade with the world's largest market and most competitive economy. However, this exercise has resulted in too many initiatives too widely dispersed across many areas. Although many small incremental changes can make a significant contribution, it is possible that the Central Americans will seek, as part of the negotiation, that priority be placed on significant institution building and on the resources to finance them. And if they do, how will the United States respond to such a request?

The Challenge of Competitiveness and Productive Development

As is true of many small, developing economies, the economies of Central America are held together almost entirely by micro, small, and medium-sized enterprises and businesses. Most workers are found in the extremes: in microenterprises with fewer than 20 employees and in medium- to large-sized firms (by Central American standards) with more than 150 employees. This profile suggests a certain duality in the industrial structure of the region, where a modern sector coexists with many family and informal businesses (see Fedepricap 1996).

A number of studies have identified the main obstacles for the competitiveness of Central American SMEs. These include deficiencies in infrastructure (electricity, telephone, Internet, roads, ports, and airports); limited access to credit (high interest rates, bureaucratic procedures, collateral-based eligibility criteria in banking institutions, and lack of venture capital); insufficient knowledge of modern management, administrative, and marketing techniques; an insufficient degree of e-readiness, that is, of using information and telecommunications technologies for doing business; deficiencies in support services such as quality verification, specialized laboratories, diffusion of technological information, and product and process design; and scant investment in research and development. Factors such as these explain the low ranking of Central American countries in the competitiveness indices of the World Economic Forum (Fedepricap 1996, INCAE 1996, Monge and Céspedes 2002).

A competitive model that would enable the region to take advantage of CAFTA would necessarily have to incorporate SMEs, not just large businesses and groups, and apply appropriate policies to tackle these different weaknesses. Given the lessons from the "picking winners" type of industrial policies in Asia (Noland and Pack 2003) and the limits imposed by the WTO on the use of certain instruments (Pangestu 2002), the right approach for the region will be comprehensive rather than targeting specific sectors. Hence, the main elements of a productive modernization policy should include enhancing the efficiency of basic infrastructure and services, improving human capital, reducing procedural constraints to doing business, promoting the diffusion of technological information and the use of e-business, encouraging venture capital, and promoting a well-networked national and regional system of innovation based on a technologically supportive infrastructure that accelerates the introduction of best practices in the region. In some cases, these policies could converge in the context of facilitating the growth of industrial clusters à la Porter. Upgrading on all these different fronts is the key for Central America to make a successful transition from a reliance on natural resources and unskilled, labor-intensive activities to the knowledge economy.

Central American countries must overcome the so-called neoliberal or old Washington Consensus view that macroeconomic stabilization and trade liberalization are sufficient for development: they must recognize that establishing and strengthening such programs is not only a necessary but a legitimate role for government. Most Central American countries have a long way to go to establish or strengthen their institutional and human capacities to put such policies in place. In a positive step in this direction, the third part of the National Strategies for Trade Capacity Building (being developed as part of the cooperation exercise in parallel with the CAFTA negotiations) is adjusting to free trade and developing competitiveness. In the light of the discussion above, the importance of this parallel capacity-building initiative needs no further emphasis.

The agricultural sector requires special attention. As suggested above, the process of agricultural transformation that CAFTA will bring to Central America must be carefully considered and managed; such management includes making the necessary investments in rural development, education, communications, transportation infrastructure, export diversification, and sanitary and phytosanitary and food safety capacities.[33] This is by itself a huge challenge for Central American countries, given the current status of these areas.

33. For an analysis of NAFTA's implications for agriculture and the challenges of agricultural adjustment, particularly in Mexico, see Veeman, Veeman, and Hoskins (2002); Yunes-Naude (2002); and Appendini (2003).

Table 9.9 Central America: Poverty and indigence indicators, 1990–99

	1990	1994	1997	1999
Percent below poverty line				
Costa Rica	26.2	23.1	22.5	20.3
El Salvador	n.a.	54.2	55.5	49.8
Guatemala	69.1	n.a.	n.a.	60.5
Honduras	80.5	77.9	79.1	79.7
Nicaragua	n.a.	73.6	n.a.	69.9
Latin American average	48.3	45.7	43.5	43.8
Percent below indigence line				
Costa Rica	9.8	8.0	7.8	7.8
El Salvador	n.a.	21.7	23.3	21.9
Guatemala	41.8	n.a.	n.a.	34.1
Honduras	60.6	53.9	54.4	56.8
Nicaragua	n.a.	48.4	n.a.	44.6
Latin American average	22.5	20.8	19.0	18.5

n.a. = not available

Note: Two income-based indicators of poverty are included in this table—poverty line and indigence line. The poverty line for each country is estimated based on the cost of a basic basket of goods that includes the minimum to cover food and nutritional requirements as well as nonfood needs. The indigence line takes into account only food requirements. Indigents (or the extremely poor) are defined as those persons living in households whose incomes are so low that even if they use them entirely to buy food, they will not adequately satisfy the minimum nutritional requirements of all household members.

Source: UN, Economic Commission for Latin America and the Caribbean, *Social Panorama of Latin America, 2001–2002.*

Social Policy, Safety Nets, and Adjustment Assistance

As table 9.9 shows, during the 1990s all Central American countries experienced a slight reduction in poverty. However, with the exception of Costa Rica, the proportion of poor people continues to be extremely high, much higher than the Latin American average: in 1999, 79.7 percent in Honduras, 69.9 percent in Nicaragua, 60.5 percent in Guatemala, and 49.8 percent in El Salvador. The proportion of persons living under the indigence line is also extremely high. In addition, high rates of income inequality remain deeply entrenched in the region.

CAFTA represents an opportunity to boost growth and reduce poverty, but it may also make the social situation worse under two scenarios: in the short to medium term, if the costs of adjustment that attend trade liberalization are not matched by new investment and employment creation; and in the longer term, if the agreement accelerates the transition in some Central American economies away from their predominantly agrarian nature and increases rural-urban migration without creating enough new jobs in highly productive services and industries. Unlike in developed industrial economies, in Central America new jobs must be created not just to absorb workers displaced by trade-related adjustments but also, more fundamentally, to improve the acute poverty and unemployment already existing in the region.

Thus, for Central American economies, CAFTA poses both the familiar issue of trade adjustment assistance and the much more basic issue of using social policy to address underlying structural problems. Given the inability of economic reforms and social policies in the region so far to significantly reduce poverty and inequality, it seems obvious that this area requires some rethinking. Efforts will have to be renewed in the new stage of economic and social development, as new stresses are induced in the region by CAFTA.

It is beyond the scope of this chapter to delve more deeply into this important policy area. We wish only to signal the importance of social policies in the post-CAFTA stage of economic development in Central America.[34]

Deepening Regional Integration

What would be the impact of the FTA on regional integration in Central America? Despite years of economic integration, significant trade areas have not yet been negotiated by these countries. In this respect, CAFTA confronts Central Americans with a choice between a hub-and-spoke configuration—that is, the disciplines and the market access concessions of CAFTA would apply bilaterally between each Central American country and the United States, but not among Central American countries[35]—and a common generic agreement, in which the disciplines do not just apply bilaterally but also are binding for the Central American countries among themselves.

There are important reasons to prefer the generic route rather than the hub-and-spoke configuration:

- A hub-and-spoke pattern would tend to fragment and undermine the Central American Common Market (CACM), because there is the risk that Central American countries would apply some rules among themselves and a different set of rules with their principal trading partner.

34. Much has been learned about social policy in Latin America in the past decade. Birdsall and Székely (2003) provide a recent review of lessons learned and a persuasive rethinking of what needs to be done in the future. They propose an approach based on three main components: the mainstreaming of poverty reduction and the equity objective into the traditional macroeconomic and trade policies, so as to reduce volatility and protect poor people's assets; policies and programs to increase their assets (in addition to investing in education, health, and increased schooling, put greater emphasis on poor people's access to land, credit, and financial markets); and policies to increase the return on their assets, which is mainly their own labor.

35. Central Americans have negotiated such bilateral agreements with Mexico, Chile, and the Dominican Republic.

- A hub-and-spoke design for CAFTA would also entail the risk of making market access less secure among Central American countries than between them and the United States. For instance, in the recent past some Central American countries have raised tariffs against other Common Market members, in some cases for political and not economic reasons. Making CAFTA-like commitments binding among the members of the CACM would discipline such measures.
- Such commitments would give US and other multinationals as well as Central American companies the security of knowing that there will be no backsliding in the level of free trade among Central American countries in such areas as tariffs, nontariff barriers, and rules of origin, thereby encouraging trade and investment. This security is important if the region is to become a platform for operations and sourcing. A similar logic applies to investment protection. This would give an additional incentive to growth by improving the "investment quality" of the region as a whole, positioning it—rather than just individual countries—as a platform of operations for global sourcing and promoting freer trade and business facilitation regionwide.

Determining whether it is desirable and feasible to apply this logic across the board would require further reflection, but there do seem to be important gains associated with having government procurement, technical barriers to trade, sanitary and phytosanitary standards, investment, and other key disciplines apply and be binding among Central American countries as well as bilaterally with the United States. Whether this should done as part of CAFTA or in parallel instruments among Central American countries is a major issue to be decided. Under this approach, of course, the CACM rules would still remain in place wherever they exceed CAFTA's standards. In essence, the CAFTA negotiations present a golden opportunity for Central American countries to deepen their own economic integration.

The Capacity-Building Pillar of Free Trade Between the United States and Central America

In the long term CAFTA will be judged, among other criteria, by whether its fostering greater economic integration with the United States will help Central American countries to reduce the large gaps in levels of income and standards of living between them and rich countries. In other words, it will be judged on whether this path to globalization will help in promoting "economic convergence."

The accelerated process of economic development that CAFTA will induce has a number of costs—or, more precisely, requires a big push in public goods and public investment: investment in capacity building to implement the agreement; investment to facilitate not only trade adjustment but, as suggested above, broader social policies; the costs of developing international competitiveness; and the costs of dealing with the financial implications of lowering tariffs. Of course, these are the main challenges of financing development in Central America over the next few years with or without CAFTA, but CAFTA will make them more urgent. In addition, as argued in the previous section, since free trade alone will not suffice to meet Central America's development challenges, Central Americans must avoid the risk of having CAFTA trigger priorities and policies that, in the absence of broader progress, might not be the "right" sequencing for development. Once CAFTA is approved, the rest of the development homework cannot be postponed.

A number of distinguished economists think that for economic convergence and integration to occur, these arrangements themselves or parallel efforts must incorporate substantial transfers of resources from the richer countries and regions to the poorer ones to close the gaps in infrastructure, education, institutions, and elsewhere.[36] This claim raises a number of important issues for CAFTA:

- Will the trade-cooperation nexus established in CAFTA be sufficient to mobilize the resource transfer to Central America necessary to do the homework outlined in the previous section?
- How will the resources mobilized by the United States, as a partner in this agreement, compare in magnitude to those mobilized by other bilateral donors and multilateral agencies?
- Given that NAFTA created a North American Development Bank, as well as a number of cooperation commissions in key areas, what institutions should be created to sustain aid and resource transfer efforts to Central America?
- Are Central Americans underestimating the challenge of financing the domestic tasks outlined in the previous section?

Given US and Central American objectives and asymmetries in size and level of economic development, the foundations for a win-win outcome from free trade must include both a world-class trade agreement and a no less impressive capacity-building component.

36. See Lopez-Calva and Lustig (forthcoming 2004) and literature cited therein. Of course, aid and international resource transfers will not do much good if the internal redistributive mechanisms (tax policy, social policy) are not working and if no social safety nets are in place.

Concluding Remarks

Only rarely do small economies have the opportunity to engage and sustain the interest of a large global power and economy in a modern trade negotiation. Many political, economic, and other circumstances must converge and synchronize for this to happen. Central Americans are aware that they have a window of opportunity that they must capitalize on.

A free trade agreement between the United States and Central America has the potential to generate significant benefits for both parties in the negotiation. The United States is motivated by a complex mix of economic, trade policy, security, and strategic objectives. CAFTA is part of the broader US strategy of "competitive liberalization," as well as of building economic alliances with countries that are critical to US national security and to promoting democracy in the Western Hemisphere.

From the point of view of Central America, CAFTA is a unique and extraordinary opportunity to boost growth and development. Indeed, it has the greatest potential for transformation of any project in recent history, both in terms of its benefits (growth, employment, poverty reduction, standards of living, institution building, modernization) and its costs (agricultural transition, rural-urban migration, job dislocation).

Given the large economic, social, and institutional asymmetries between the parties, the negotiation of CAFTA poses huge challenges for both parties.

A key negotiating challenge for the United States will be to strike a balance between the trade negotiators' basic mercantilist instincts to extract maximum concessions and set precedents in competitive liberalization and the broader interests of national security (drugs, terrorism, immigration), as well as political-strategic objectives of promoting political stability, democracy, and economic reform in the region. Yet, as noted above, for the United States to achieve these broader goals, Central Americans must achieve their economic objectives: a firm economic foundation is required for social and political reform and stability. The United States will do more than put at risk its own geopolitical and security objectives if it does not concede market access to Central America, for it will leave Central Americans an unattractive choice: either to continue to insist on genuine reciprocal concessions (thereby ensuring frustration and perhaps even leading to a breakdown in the talks) or accept a less liberalizing, less ambitious agreement—which may do little to further their economic objectives.

The key negotiating challenges facing Central Americans include the development of broad-based national consultations, regional coordination in defining common negotiating positions and strategies, and the need to maintain discipline in the midst of the heterogeneous conditions of the region, the differences in sensitivities, and the multiple pressures and trade-offs inherent to the broad and complex agenda of US-Central

American relations. Central Americans should also develop and fund an effective strategy to garner as much support as possible for their case in the United States.

For the hopes and promises of CAFTA to materialize, Central American countries have a lot of homework to do, and they must see CAFTA as part of a much broader set of development policies. In other words, countries must mainstream CAFTA into their development strategies. These broader policies include (1) an appropriate macroeconomic framework that reduces the vulnerability of Central American economies to international shocks and crisis; (2) a big push, supported by US and other bilateral and multilateral aid, for institutional upgrading and capacity building—the CAFTA trade-cooperation nexus must not be allowed to fail; (3) the putting in place of aggressive policies to promote productive modernization and competitiveness; (4) rethought and renewed efforts in the area of social policies not just to facilitate trade adjustment but to attack the underlying structure of poverty and inequality; and (5) the determination to design CAFTA or complementary commitments in such a way that not a hub-and-spoke configuration but rather a solid single-market economy is promoted in Central America, thereby turning the region into a competitive platform for regionwide investments, operations, and sourcing.

And for the hopes and promises of CAFTA to materialize, the United States also faces a challenge. It must deliver not only trade concessions but fresh aid and cooperation to Central Americans to make possible their big push to invest in public goods, build the necessary institutions, and apply the appropriate policies. If this happens, CAFTA will represent a new paradigm in North-South trade negotiations and governance, in which trade and aid complement each other in developmentally beneficial ways. This developmental bar must be placed high for CAFTA to be the road map for economic relationship between small developing and developed countries in the 21st century. Otherwise, in 10 years, we will be discussing why the revised new Washington Consensus failed to live up to its promise.

Appendix 9.1

List of the 15 main product lines exported from Central America to the United States

Chapter number	Description
Costa Rica	
8	Edible fruit and nuts; peel of citrus fruit or melons
84	Nuclear reactors, boilers, machinery, and mechanical appliances; parts thereof
62	Articles of apparel and clothing accessories, not knitted or crocheted
85	Electrical machinery and equipment and parts thereof; sound recorders and reproducers, television image and sound recorders and reproducers, and parts and accessories of such articles
61	Articles of apparel and clothing accessories, knitted or crocheted
90	Optical, photographic, cinematographic, measuring, checking, precision, medical, or surgical instruments and apparatus; parts and accessories thereof
3	Fish and crustaceans, molluscs and other aquatic invertebrates
9	Coffee, tea, maté, and spices
20	Preparations of vegetables, fruit, nuts, or other parts of plants
6	Live trees and other plants; bulbs, roots, and the like; cut flowers and ornamental foliage
7	Edible vegetables and certain roots and tubers
40	Rubber and articles thereof
71	Natural or cultured pearls, precious or semiprecious stones, precious metals, metals clad with precious metal, and articles thereof; imitation jewelry; coin
42	Articles of leather; saddlery and harness; travel goods, handbags, and similar containers; articles of animal gut (other than silkworm gut)
39	Plastics and articles thereof
El Salvador	
61	Articles of apparel and clothing accessories, knitted or crocheted
62	Articles of apparel and clothing accessories, not knitted or crocheted
9	Coffee, tea, maté, and spices
85	Electrical machinery and equipment and parts thereof; sound recorders and reproducers, television image and sound recorders and reproducers, and parts and accessories of such articles
63	Other made-up textile articles; sets; worn clothing and worn textile articles; rags
3	Fish and crustaceans, molluscs and other aquatic invertebrates
17	Sugars and sugar confectionery
27	Mineral fuels, mineral oils, and products of their distillation; bituminous substances; mineral waxes
22	Beverages, spirits, and vinegar
52	Cotton
64	Footwear, gaiters, and the like; parts of such articles
34	Soap, organic surface-active agents, washing preparations, lubricating preparations, artificial waxes, prepared waxes, polishing or scouring preparations, candles and similar articles, modeling pastes, "dental waxes" and dental preparations with a basis of plaster
48	Paper and paperboard; articles of paper pulp, of paper, or of paperboard
7	Edible vegetables and certain roots and tubers
76	Aluminum and articles thereof
Guatemala	
9	Coffee, tea, maté, and spices
8	Edible fruit and nuts; peel of citrus fruit or melons
27	Mineral fuels, mineral oils, and products of their distillation; bituminous substances; mineral waxes
34	Soap, organic surface-active agents, washing preparations, lubricating preparations, artificial waxes, prepared waxes, polishing or scouring preparations, candles and similar articles, modeling pastes, "dental waxes" and dental preparations with a basis of plaster

(Appendix continues on next page)

List of the 15 main product lines *(continued)*

Chapter number	Description
Guatemala *(continued)*	
7	Edible vegetables and certain roots and tubers
17	Sugars and sugar confectionery
6	Live trees and other plants; bulbs, roots, and the like; cut flowers and ornamental foliage
12	Oil seeds and oleaginous fruits; miscellaneous grains, seeds, and fruit; industrial or medicinal plants; straw and fodder
3	Fish and crustaceans, molluscs and other aquatic invertebrates
48	Paper and paperboard; articles of paper pulp, of paper, or of paperboard
24	Tobacco and manufactured tobacco substitutes
76	Aluminum and articles thereof
42	Articles of leather; saddlery and harness; travel goods, handbags, and similar containers; articles of animal gut (other than silkworm gut)
61	Articles of apparel and clothing accessories, knitted or crocheted
84	Nuclear reactors, boilers, machinery, and mechanical appliances; parts thereof
Honduras	
9	Coffee, tea, maté, and spices
49	Printed books, newspapers, pictures, and other products of the printing industry; manuscripts, typescripts, and plans
8	Edible fruit and nuts; peel of citrus fruit or melons
3	Fish and crustaceans, molluscs and other aquatic invertebrates
44	Wood and articles of wood; wood charcoal
24	Tobacco and manufactured tobacco substitutes
61	Articles of apparel and clothing accessories, knitted or crocheted
94	Furniture; bedding, mattresses, mattress supports, cushions, and similar stuffed furnishings; lamps and lighting fittings, not elsewhere specified or included; illuminated signs, illuminated nameplates, and the like; prefabricated buildings
26	Ores, slag, and ash
7	Edible vegetables and certain roots and tubers
62	Articles of apparel and clothing accessories, not knitted or crocheted
84	Nuclear reactors, boilers, machinery, and mechanical appliances; parts thereof
20	Preparations of vegetables, fruit, nuts, or other parts of plants
17	Sugars and sugar confectionery
71	Natural or cultured pearls, precious or semiprecious stones, precious metals, metals clad with precious metal, and articles thereof; imitation jewelry; coin
Nicaragua	
3	Fish and crustaceans, molluscs and other aquatic invertebrates
9	Coffee, tea, maté, and spices
2	Meat and edible meat offal
8	Edible fruit and nuts; peel of citrus fruit or melons
71	Natural or cultured pearls, precious or semiprecious stones, precious metals, metals clad with precious metal, and articles thereof; imitation jewelry; coin
69	Ceramic products
15	Animal or vegetable fats and oils and their cleavage products; prepared edible fats; animal or vegetable waxes
24	Tobacco and manufactured tobacco substitutes
38	Miscellaneous chemical products
7	Edible vegetables and certain roots and tubers
17	Sugars and sugar confectionery
44	Wood and articles of wood; wood charcoal
4	Dairy produce; birds' eggs; natural honey; edible products of animal origin, not elsewhere specified or included
76	Aluminum and articles thereof
21	Miscellaneous edible preparations

Note: The chapter numbers refer to the Harmonized Tariff Schedule; the categories are listed in order of volume of exports to the United States.

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