IICA



# CHALLENGES AND PROSPECTS FOR CENTRAL AMERICA IN A CONTEXT OF GLOBAL TRADE

Juan Manuel Villasuso



PROGRAM I
AGRICULTURAL POLICY ANALYSIS AND PLANNING

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The Inter-American Institute for Cooperation on Agriculture (IICA) is the specialized agency for agriculture of the inter-American system. The Institute was founded on October 7, 1942 when the Council of Directors of the Pan American Union approved the creation of the Inter-American Institute of Agricultural Sciences.

IICA was founded as an institution for agricultural research and graduate training in tropical agriculture. In response to changing needs in the hemisphere, the Institute gradually evolved into an agency for technical cooperation and institutional strengthening in the field of agriculture. These changes were officially recognized through the ratification of a new Convention on December 8, 1980. The Institute's purposes under the new Convention are to encourage, facilitate and support cooperation among its 33 Member States, so as to better promote agricultural development and rural well-being.

With its broader and more flexible mandate and a new structure to facilitate direct participation by the Member States in activities of the Inter-American Board of Agriculture (IABA) and the Executive Committee, the Institute now has a geographic reach that allows it to respond to needs for technical cooperation in all of its Member States.

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## Introduction

There have been major changes in Central America in the last decade. Economic crisis, stabilization programs and structural transformation have characterized the recent economic history of this region Social and political transformations were also profound. At this point in time, however, new options and possibilities have opened up in terms of development strategies and participation in international markets. Some of them seem to be promising, some should be examined in more detail, and others would probably have adverse effects both in the short and the long run. The purpose of this paper is to analyze current events and policies in Central America, to discuss these new options and initiatives, and to examine the impact they could have in terms of economic growth, regional integration and trade expansion for the region.

## Evolution of the Central American scenario

For several decades, Central American countries followed the import substitution model (ISM), which generated growing rates of production and economic activity while also creating a new social group: the manufacturing sector. At the same time, the State was given a major role in the provision of services and the generation of employment.

However, because of political reasons and technical and administrative limitations, only the first phase (easy substitution) of the import substitution scheme was applied and practically no instruments were developed to conquer new markets, strengthen linkages in the production structure, and put in practice a gradual process of tariff reduction in order to attain a more efficient allocation of resources and increased international competitiveness.

Rosenthal (1991) also mentions the lack of leadership promoting competition within the Central American Common Market (CACM), the constraints imposed by an insufficient and imperfect infrastructure, and the limitations emerging from the social and political contexts as causes negatively affecting application of the ISM.

These shortcomings of the model (or perhaps mistakes in the implementation of the model), added to other elements such as growing public deficits, and the international events at the end of the 1970s and beginning of the 1980s (the external debt crisis, the turbulence of international financial markets, and the second oil shock), created an economic crisis scenario accompanied by deterioration of political and social conditions in the Central American isthmus.

Zuvekas (1992) summarized the origins of the crisis in Central America in the following manner: "Most authors recognize that the crisis is attributable to a combination of three factors: external events beyond the control of the Central American countries; flawed domestic and regional policies that did not permit flexible responses to changing international events; and civil war and other political conflicts that affected all countries in the region directly or indirectly."

Thus, in the early 1980s Central American countries faced a profound economic and political crisis. Guatemala and El Salvador had virtual civil war; the "Sandinistas" were in power in Nicaragua and fighting against the U.S.-armed "Contras;" Panama was under the control of General Noriega; Honduras was preparing to end a long period of military rule in the face of a faltering economy. Only Costa Rica had a democratically elected government at the beginning of the decade.

The economies of the region were reeling under the impact of the oil crisis and subsequent recession. It is estimated that at least US$1.5 billion in capital left Central America between 1980 and 1983. Public and private debt skyrocketed to over US$10 billion. Income declined 12% in three years. High inflation, rising unemployment rates, significant deficits in the trade balances and public budgets, and massive devaluations also characterized this period.

Later in the 1980s important changes occurred in Central America, both internally and externally. These changes gave rise to two well-defined stages in the evolution of Central American countries: stabilization and structural reform.

The first stage took place between 1983 and 1986. At that time, macroeconomic adjustment was emphasized. Given that all main indicators in the monetary, fiscal and commercial fields showed important disequilibria, priority was assigned to diminishing these unbalances. Traditional stabilization instruments were used. In the fiscal area, there were reductions in public expenditures, as well as overall deficit shrinking using both budgetary cutting and tax increases. Regarding prices, monetary supply was tightened and credit programs were diminished. In the external sector, Central Banks established exchange rate controls.

In recent years a second stage, portrayed as structural change, has been emerging. This stage is identified with the structural adjustment programs promoted by the World Bank and other international organizations. The program applied includes, in addition to strong monetary and fiscal adjustment: (i) trade liberalization, especially elimination of quantitative restrictions and reduction of tariffs; (ii) real exchange rate depreciation; (iii) freeing prices; (iv) reduced State participation in production, by privatizing public enterprises; and (v) reduction of government regulations on the market.

This orthodox program does not differ substantially from those implemented in other Latin American countries (CEPAL 1990) and represents a 180- degree turn from the previous ISM. Nevertheless it is important to recognize that not only the ISM, but also the State, as it was structured, oriented and managed, was not able to meet the challenges of the future. A new development model, with a different set of macroeconomic policies and a new relationship between the public sector and the rest of the society, was needed.

## Policy reforms and institutional changes

The orthodox approach pursues an "outward-oriented structural adjustment strategy." In most Central American countries, it is felt that economic adjustment will require: (i) a sufficient rise in productivity to support a firm increase in the rate of domestic saving, in order to finance higher levels of domestic investment while continuing to service the external debt; and (ii) a rapid expansion in exports, in order to convert domestic savings into foreign exchange payments (Villasuso 1992).

As Bhagwati (1985) argues, "Productivity is often impaired by distorted factor and market prices, by inefficient public sector enterprises and by a structure of incentives that has helped create inward-looking, non-competitive industries." Economic liberalization, therefore, is seen as the key to increasing productivity and exports and, consequently, to more output, more employment and more foreign exchange to service the foreign debt.

The new strategy rests on an effective reorganization of the productive process based upon a macroeconomic policy frame that: (i) promotes international insertion on an environment of greater competitivity by a greater commercial opening; (ii) an austere monetary-credit policy for the money supply that does not put pressure on price level; (iii) a fiscal policy centered on the reduction of public finance imbalances; (iv) a foreign trade policy that includes depreciation of exchange rates as a mean to achieve international competitiveness; (v) a policy for the reorganization of the Central American Common Market (CACM) within the framework of the Economic Action Plan for Central America (PAECA); and (vi) a political decision to gradually integrate LAC markets to the United States and Mexican markets, within the framework of the Enterprise for the Americas.

In concrete terms, there are four areas in which the countries have modified their previous economic policies: the financial sector, the foreign exchange rate, the fiscal sector, and the trade sector (Butari 1992)

*Financial Sector.* All countries have liberalized their interest rates to some extent. The trend is toward reducing reliance on direct credit lines and subsidized credit. All countries seek to strengthen the regulation and supervision of financial institutions, particularly commercial banks.

*Foreign Exchange.* Though countries have moved in the general direction of market-based systems, they have tended to follow a rather circuitous, muddled route. With the exception of Costa Rica, the prevailing pattern has been one of allowing parallel (or inter-bank) markets where, for authorized transactions, the exchange rate was negotiated among buyers and sellers.

*Fiscal Sector.* Although all countries have attempted to gain more effective control over expenses, strengthen tax administration, reduce tax avoidance and the number and kind of exemptions, raise rates of public utilities, and decrease transfers, the most significant impact on the deficit has been achieved by reducing capital expenditures.

*Trade Sector.* The governments have stimulated measures on two somewhat inconsistent fronts. On the one hand, they have actively promoted exports through fiscal incentives, have expanded free-trade zones, and have set up institutions that service exporters and reduce the transaction costs of exporting. On the other hand, they have modernized tariff nomenclatures, converted specific to ad valorem rates, reduced quantitative barriers and exemptions to tariffs, and have adopted time-phased programs to reduce the levels and dispersion of tariff protection.

## Recent developments in Central American integration

After a decade of political turmoil, during which the main objective in the region was to achieve peace and democratic stability, the Central American presidents met in an historic event in Antigua, Guatemala, in June 1990 to discuss not only political and military issues but also economic development for the area. This meeting was the beginning of a series of workshops, seminars and diplomatic and technical reunions to give new life to the Central American integration process in order to improve economic and social conditions in the region.

### (a) Antigua Summit (June 1990)

In the Antigua Summit, the presidents of Central America reiterated a political commitment to restructure, strengthen and reactivate the integration process. The ultimate goal was defined as the establishment of the Central American Economic Community, as an instrument for the improvement of Central America's position in the world economy.

Broad objectives were set in the Antigua Summit: (i) the development of stable and democratic societies; (ii) the achievement of broad-based sustainable economic growth; and (iii) the attainment of effective regional cooperation.

There were seven basic points in the Declaration signed by all Central American Presidents:

i) *Agricultural development.* Policy coordination (food security, price policies, stability). Trade liberalization.

ii) *Role of the government.* Review and modernize the public sector in order to increase its efficiency and its austerity.

iii) *Role of the private sector.* The private sector has to play the central role in the transformation of the economies and the development of the integration process.

iv) *Protection of natural resources and environment.* Support to regional organizations such as the Comision Centroamericana de

**Ambiente y Desarrollo**. Support for all national initiatives in this area and look for new mechanisms to protect the ecosystems.

v) *External support.* To study the different instruments of external cooperation, as well as other initiatives to coordinate and optimize such cooperation in consequence with regional needs.

vi) *External debt and financial cooperation.* Find new formulas for the solution of the external debt problem. Support the Central American Integration Bank (CABEI) as a very important financial institution that will actively promote development projects. Creation of the **Comision Economica y Financiera** (at the ministry level) in charge of coordination and follow up of the PAECA programs.

vii) *External coordination.* Strengthen the negotiational capacity of the various Central American official groups, particularly with the international organizations and in the international conferences.

**(b) Central American Economic Action Plan (PAECA)**

During the Antigua Summit, the Presidents adopted the Central American Economic Action Plan, which includes the following commitments and guidelines:

- To establish a new legal and operative framework, adequate to the new strategies. Specific points included the establishment of a new regional payment system; compliance with a scheduled program for the elimination of intra-regional trade barriers; and the establishment of a common external tariff.

- To promote a physical infrastructure, construction and reconstruction program in support of commercial integration, with a view to comprehensive inward-looking and outward-looking development.

- To tighten regional coordination of external trade, foreign investment and tourism, including coordinated action for joining and participating in the GATT.

- To promote dynamic and comprehensive procedures for consensus-building, consultation and participation processes between governments and different social sectors.

- To promote industrial restructuring and productive transformation policies, geared towards achieving a competitive and regionally integrated production structure.

- To support the transformation of State enterprises, encouraging broad-based stock ownership and economic democratization.

- To formulate and apply a coordinated agricultural policy.

- To formulate and apply a regional S&T policy.

- To promote the coordination of macroeconomic adjustment process.

- To promote social compensation programs for economic adjustment.

- To establish a consultation and coordination forum on foreign debt.

**(c) San Salvador Summit (July 1991)**

A later meeting of the Central American presidents took place in El Salvador in July 1991. The basic purpose was to establish the main institutional criteria in order to support the integration process. The agreement includes the political, economic and social spheres.

In the political field, it was agreed to continue with the "Esquipulas Plan" for the pacification and democratization of Central America, to support free election processes and reiterate their rejection to all violent acts and terrorist actions. The presidents also agreed to activate the **Organizacion de Estados Centroamericanos** (ODECA) as the regional institutional system.

Regarding the economy of the region, the presidents celebrated the signing of the "Transitory Multilateral Agreement of Free Trade between the Governments of Guatemala, El Salvador, Nicaragua and Costa Rica." At the same time, within the regional integration strategy, they agreed and adopted the Action Plan for the Central

American Agriculture (PAC). The purpose of the PAC is to "incentivate agricultural production, intra-regional trade of agricultural products and guaranty food security". According to the PAC, free trade of agricultural products will be in place by June 1992. For a period of six months, there will be a price band in order to give some additional time for some products to adapt to the new situation.

With respect to the "common external tariff" for Central America, it was agreed that by December 31, 1992 there will be a reduced tariff in effect; the ceiling for final goods will be 20% and the fiscal floor for raw materials, intermediate goods and capital goods will be 5%. However, the presidents agreed on a list of basic goods that will receive special treatment. They also agreed on a list of products that could have a tariff higher than 20%.

Concerning the social component of the San Salvador Summit, the presidents met later in Honduras, Costa Rica and Nicaragua with the purpose of defining and supporting a "Regional Program for Poverty Alleviation." This program must take into account "economic adjustment with human face." Several regional institutions are now working to set the parameters of this program.

**(d) Agricultural commitment**

The most recent meeting of the Central American presidents (December 1992) in Panama was devoted to the modernization of the agricultural sector in the region. It was noted that:

- Agricultural production generates 20% of GDP, 50% of total employment, and 70% of export revenues.
- Regional development must guarantee food security in its broadest sense.
- Discriminatory and protectionist policies in some countries negatively affect the access of Central American products to those markets.
- Several measures and actions have been implemented in the region in order to harmonize agricultural policies and liberalize trade of grains and other primary goods.

The presidents agreed to establish specific commitments that must be implemented both by the Council of Agricultural Ministers

(COMACA) and the Economic Cabinets of the six nations. The most important are the following:

**(i) Regional strategy for agricultural and agroindustrial exports**

- Support "universal tariffs" *(tarificacion universal)* included in the Dunkel proposal presented at the Uruguay Round (GATT).

- Request the U.S. government to suppress Section 509 of the "Foreign Assistance Law" that prohibits the use of USAID funds to promote investment in Central America.

- Express dissagrement with ECC policies that negatively affect LAC exports and urge that those policies be modified in order to fulfill GATT principles. This applies specifically to banana exports. Also express concern regarding Mexico's restrictions on beef and sugar exports from the region.

**(ii) Improve regional trade of agricultural products**

- Support the COMACA initiative to create the Central American Information System on Agricultural and Agroindustrial Trade.

- Establish a concrete procedure in order to incorporate Panama into the Central American system of free trade in agricultural products.

- Request from Central American ministers of agriculture and economics a proposal to abolish the Central American Protocol on Grain Trade *(Protocolo de Limon)*.

**(iii) Reconversion and modernization of the productive sectors**

- Request from the Central American economic cabinets a proposal to create a "Regional Fund for the Modernization and Reconversion of the Agricultural Sector." Vertical integration and productive reconversion of the small —and medium— sized producer would be the main objectives of the Fund.

- Request from the Central American economic cabinets the improvement and development of new mechanisms in order to broaden access to credit for small—and medium—sized producers; and technical and financial support to prepare studies and projects to increase efficiency and competitiveness in the agricultural sector.

**(iv) Private sector participation in the process of development, integration and trade liberalization**

- Include representatives of the agricultural private sector not only in the definition of trade policies but also as members of national and regional negotiation teams.

- Support the private sector in its organizational efforts at the regional level and its willingness to participate in the design and implementation of agricultural policies in Central America.

## Initiatives for the Central American countries

There are at the present time several initiatives for the Central American region (Villasuso 1993). Some of them come from within the region, such as the PAECA and the PAC. Other initiatives have been developed outside the region by international organizations and some foreign nations, mainly the United States and the European Community.

One of the earliest economic initiatives for the Central American and Caribbean countries that produced concrete results was the Caribbean Basin Initiative (CBI). Proposed by President Reagan in 1981 and approved by the U.S. Congress a year later, it had, as the main objective, collaborating with the democratic governments of the region. In the frame work of the CBI, the United States government eliminated unilaterally most of the import tariffs for goods and services produced by the countries. Some products were excluded such as textiles and leather. For political reasons, Nicaragua, was excluded.

The results of the CBI have been positive for some of the countries. For others, exports to the United States have not increased significantly. The report prepared by the U.S. General Accounting Office (GAO, 1988) is illustrative: "In the countries it reviewed, the GAO found that the CBI has fostered trade and investment opportunities, and established a basis for improved economic performance. To date, however, the resulting trade and investment have not been sufficient to generate broadly based economic growth, alleviate debt-servicing problems, or create lasting employment."

A second initiative from the United States for all developing nations is the Brady Plan. It was designed to reduce external debt. Costa Rica has been the only Central American country that has used the "debt buy-back" mechanism contemplated in the Brady Plan. The fact that Costa Rica had a "stand-by agreement" with the International Monetary Fund and a "structural adjustment loan (SAL)" with the World Bank was an important advantage to be considered in this debt renegotiation program.

The latest U.S. initiative is the Enterprise for the Americas (EAI). The EAI was launched on 27 June 1990 by President Bush and is designed to bolster the democratic and market-oriented transition throughout Latin American by focusing on trade, investment and debt reduction.

The trade element of the EAI includes a long-term goal of a hemisphere-wide free trade area. The first step is the negotiation of basic agreements. The investment initiative proposes to unlock the potential for domestic and foreign investment and encourage capital flows. A third EAI pillar provides additional support for debt and debt-service reduction in Latin America and the Caribbean. The benefits of debt reduction will be available to countries that have undertaken reform measures, such as IMF or World Bank programs.

By the end of 1991 all Central American countries had signed basic agreements *(tratados marco)* with the United States and are taking serious steps toward more specific agreements. However, it seems that the U.S. government is not moving ahead with other countries until NAFTA is into effect. Additionally, it seems that the U.S. prefers a regional agreement with the Central American nations, even though no definitive decision has yet been made.

Another U.S. initiative for Central America is the Partnership for Democracy and Development (PDD). It proposes broad multilateral support for the region, and encourages support from the international community for regional democratization and development. It will also provide a forum for fostering international support for regional economic policies and integration efforts, strengthened democratic institutions, and a coordinated approach to bilateral and multilateral assistance to the region.

Regarding support from the United States Agency for International Development (USAID) to Central America, the strategy for economic assistance has focused on three main objectives (USAID 1991):

• Political: Free and open national and local elections will be the norm. Administrative and financial authority of local governments will be reinforced. Legislatures will function effectively and cooperate more through a Central American Parliament. Judiciaries will increase respect for the rule of law and human rights. The military's role in the political process will be reduced. Civilian participation in democratic process will increase. The press and other media will be freer and more responsible.

• Economic: Per capita GDP will grow between 2.5% and 3.0% per year. Private investment, as a percentage of GDP, will increase substantially. Non-traditional exports will maintain their brisk growth rate. Unfettered intra-regional trade and capital movements will be concentrated in: (i) basic infrastructure for economic growth, (ii) the development of human resources, and (iii) the conservation of the natural resource base.

• Social: Infant mortality, malnutrition in children under five, and population growth rates will continue to decline substantially. Vaccination coverage and primary school enrollments will increase.

Another important initiative in the free trade process is the Central America / Mexico Agreement. This framework treaty signed in August 1992 constitutes an important step toward the integration of the region with one of its larger neighbor countries. Even though the agreement is very general and the process of negotiation is not yet concluded, it seems that the possibility of establishing a free trade area with a new and important partner is rather promising.

An additional possibility to consider is the extension of the NAFTA so as to include the Central American countries. This possibility is especially interesting. Nevertheless, no concrete steps have been taken in this direction and there seem to be several obstacles that must be overcome, particularly in terms of policy harmonization and legal and institutional compatibilization.

Finally, the San Jose Conference of Ministers of Foreign Affairs of the European Community (EC), the *Contadora* Group (Mexico, Venezuela, Colombia and Panama) and the Central America countries, in September 1984, established a new relationship between the CACM and Europe. During the follow-up meeting in Luxemburg a year later, an agreement was signed between the two regions in order "to contribute to the peace process and support economic and social development in Central America."

Several meetings have taken place since that time and concrete initiatives, projects and activities are already under way. The agreement reached between the EC and the Central America Monetary Council to reactivate the Regional Payment System (1989) is a good example. Support to CADESCA (Action Committee for the Development of Central America) for the food security program is another example of the European involvement in the region.

However, Bulmer-Thomas (1990) considers that the EC should play a more active and relevant role in the shaping of a more "socially just and economically prosperous CACM." This idea is shared by Ruben and Van Oord (1991), who detail socioeconomic areas in which the European cooperation should be increased: poverty alleviation, rural development, environment, refugees, and the informal sector.

## The road to free trade in Central America

Political and economic authorities in the Central American countries perceive that the decade of the 90s holds great promise for expanded hemispheric trade through a growing network of free trade arrangements, leading ultimately to a free trade area that will encompass the entire Western hemisphere.

According to this vision, Central America needs to be a part of this process in order to attract new investment and new technology, and in order to develop new markets for the increasingly diverse array of goods and services that it produces.

The U.S. market is viewed, because of size, proximity and historical nexus, as the "logical" market for the region. However, the road to establishing a free trade agreement between the Central American countries and the United States and/or NAFTA members is not an easy one.

United States trade representative Carla A. Hills (1991) detailed eight provisions as basic components of a free trade agreement between CA and the USA, recognizing that there may need to be some tailoring to fit individual country circumstances:

i) Elimination, according to a specified schedule, of all tariffs on trade between the parties on products originating in the customs territories of the parties. This is a prerequisite for GATT compatibility.

ii) Analogous phase-out of non-tariff barriers, such as quotas.

iii) Broad-scale market access for services, which are becoming increasingly important in international trade.

iv) Standards for treatment of investment, guaranteeing investors in the parties to the agreement national treatment in the country of the other contracting party. This means that export performance requirements and mandates for local content would be outlawed.

v) Guarantees that investors' and traders' intellectual property will be protected.

vi) Special provisions may be necessary to deal with trade and investment in natural resources and resource-based products in light of the extensive state regulation and involvement in this area.

vii) Operational and technical rules, such as rules of origin, public health and safety exceptions, safeguards, dispute settlement provisions, and mechanisms for adding future free trade agreements will be necessary.

viii) Provisions will be needed to restrain government action that could undermine the agreement, such as subsidies, state trading, restraints justified on balance of payment grounds, and the use of foreign exchange restrictions and controls.

In addition to the Hills provisions, the issues discussed in NAFTA also provide a basis for a plausible agenda to negotiate a Central American free trade agreement with the United States. These issues include: market access, rules of origin, domestic trade remedies, mechanisms for dispute settlement, trade-related investment measures, trade-related intellectual property rights, the environment, labor, and the role and perspectives of business throughout the region.

• Market Access: The key issue in this process is how to maximize the benefits of liberalization and minimize the cost of adjustment of sensitive sectors. In agriculture this implies anticipating which commodities would be included and which would remain off-limits. Manufacturing industries such as textiles and leather may require special analysis. Safeguards, a time-frame for implementation, and preferential status for financial services, insurance and telecommunications seems to be relevant.

• Rules of origin: These regulations have decisive repercussions on trade relations between members and non-members, and on trade creation and diversion, as well as on investment flows. There are several ways to formulate the rules, as well as differences of opinion as to the best methodology. Agreement on these rules can be very difficult.

• Domestic Trade Remedies: The bulk of these unilateral decisions are often referred to as safeguard mechanisms ("escape clauses," antidumping and countervailing duties, extended unemployment benefits, and capital adjustment incentives) which should facilitate the trade liberalization adjustment process. A dilemma has to be resolved on safeguards. On the one hand, stringent safeguards will help ensure domestic political support. On the other, limiting the application of safeguards may provoke the use of more onerous forms of protection.

• Dispute Settlement: The issue of trade remedies makes evident the need to arbitrate disputes via concerted mechanisms. The study of such mechanisms is imperative in any dialogue on the establishment of a US-CA Free Trade Area. It should focus on precedents, the coexistence of different legal and administrative systems, and the design of a system for settlement of disputes.

• Trade-related Investment Measures (TRIMS): The most restrictive rules pertain to local-content requirements (some minimum percentage of inputs of the foreign company must be purchased locally), export performance (some percentage of the foreign company's product must be exported), and foreign exchange generation (foreign companies may have to provide foreign exchange themselves via exporting).

• Trade-related Intellectual Property Rights (TRIPS): Many US producers complain that their intellectual property rights (such as trademarks and patents) are violated in foreign markets, particularly in developing countries. Central American businessmen could be obtaining benefits from lax laws. This issue is not an easy one, mainly because it requires legal changes and the political climate might not be propitious.

• Environment and Trade: There is a need to shed light on existing mechanisms in international law and ongoing trade negotiations that can minimize environmental conflicts. There is also a need to assess the potential environmental effects of trade liberalization, and to ascertain the position and possible role of environmental groups.

• Labor: Labor issues related to trade have been growing in importance in trade negotiations. The reason stems in large part from the differences in wages between the United States and the other countries. Worker health and safety standards, child labor laws, and worker rights, such as the establishment of unions, will also require consideration.

• Business: It should prove enlightening to analyze the roles and perspectives of business groups and organizations, since their participation is crucial in the implementation of any trade liberalization process.

## NAFTA and Central America

From a theoretical point of view the establishment of the Canada-United States-Mexico free trade area could be examined using Viner's concept of trade creation and trade diversion. In the conventional static approach, the formation of a preferential arrangement generates a once-and-for-all reallocation of factors of production among the members of the agreement, in response to the interplay of trade-creating and trade-diverting effects. In this scenario, the usual assumption is that when trade creation exceeds trade diversion, the preferential arrangement will improve the welfare of its participants.

For non-members, the implications of the arrangement are to be found mostly in the trade diversion effect. Non-members could also be affected by a deterioration of their terms of trade if the countries in the preferential area are major players in the world economy. A more direct impact may occur if the free trade agreement generates an immediate increase in the level of protection against outsiders. In this scenario, direct trade suppression would add to the trade diversion impact.

From a pragmatic point of view, Central American countries could benefit from economic growth generated by NAFTA in Canada, Mexico and the United States through increased demand for regional products. However, NAFTA could have negative effects on certain sectors, particularly because of the fact that the Central American nations are participating countries of the Caribbean Basin Initiative (CBI).

For many years to come, the United States is likely to remain Central America's major market. Therefore, for the foreseable future it seems that increased competition in the U.S. market resulting from NAFTA is likely to far outweigh any benefits for Central America deriving from increased trade with Mexico and Latin America.

Mexico already competes very successfully with Central America for U.S. trade and investment. NAFTA benefits will increase this advantage. Mexican minimum wages are currently lower than the more competitive Central American countries (Costa Rica and Guatemala). Mexican transportation costs are cheaper. Despite progress being made in structural reform in Central American countries, Mexico has a significant head start. Mexican restrictions on investment are being liberalized faster than in Central America. Finally, given its size and history, Central America is not perceived as having as stable a political climate as Mexico.

According to FEDEPRICAP (1991) two categories of Central American exports to the United States are likely to be particularly impacted by NAFTA: (i) products that are currently excluded from CBI (textiles and apparel) or products which only benefit from small preferences (footwear and leather products and canned tuna), and (ii) products in which CBI countries have gained a competitive edge due to duty preferences whose margin will be reduced and eventually eliminated by NAFTA.

A second major non-traditional export from CBI countries has been horticultural products. Given that these products are normally subject to high duty rates (melons are subject to 20-35% duties and frozen vegetables to a 17.5% duty rate), CBI duty-free treatment has probably spurred the growth of this trade. With NAFTA this duty advantage will progressively be reduced and eventually eliminated.

Also according to FEDEPRICAP, "the immediate effect of NAFTA provisions could be to put sixty percent of CBI imports at a competitive disadvantage. This results from the fact that fifteen percent of CBI imports which enter the United States duty free under CBI and/or GSP are also on the GSP list. For the forty-five percent of CBI sensitive products entering under MFN duty rate, even if NAFTA concessions are implemented slowly, investors will know that NAFTA will probably benefit from small duty preferences immediately with the preferences increasing progressively over time."

A recent study by Perez (1992) evaluates possible effects of NAFTA on agricultural exports from Central America to the United States. His results are less pesimistic than those of FEDEPRICAP regarding agricultural goods.

The author considers three groups of products: (i) those for which Mexico already has a zero tariff and for which NAFTA will not improve market access; (ii) those which will show an immediate improvement in their trade situation; and (iii) those that will improve their situation in the medium term.

Considering the export value of Central American agricultural exports to the U.S., the first group includes 82% of total value and 73% of all tariff items. This means that four fifths of regional exports will continue competing with Mexican products after NAFTA comes into effect. The second group represents 6% of total export value, and the last category amounts to 12%.

On the average, Perez's analysis shows that the "loss in preference" for the second and third groups could be considered "moderate." For the 40 most important products in these two categories "preference average margin" at the present time is 6.2%

It is also concluded in this study that for three specific products (cucumbers, pineapples, and cantaloupes) there is a high risk that Mexican production will replace Central American exports in the U.S. market due to NAFTA aproval. Other fruits and vegetables for which Mexico has obtained important tariff reductions, such as tomatoes, onions, lettuce, mangos, avocados, and honey, are not being exported by Central America to the U.S. at the present time.

Saborio (1992) also expŕesses concern about the future of Central American countries once NAFTA comes into effect: "The establishment of a North American Free Trade Area encompassing the USA, Mexico and Canada, poses some thorny questions for Central America...; given that Mexico is a competitor on practically all items exported by Central America to the United States, the inclusion of Mexico in NAFTA would result in the erosion of some of the preferences these countries currently enjoy in terms of access to the US market under the CBI."

However, investment diversion seems to be a more serious problem than trade diversion *per se* for Central America. Even with preferential access to the U.S. market and generous incentives for investment in export-oriented activities, these countries have had a hard time attracting direct investment from the USA and elsewhere (USITC 1991).

With Mexico now becoming a springboard for unrestricted entry into the United States and Canada, whatever locational advantage Central America had as an investment site to serve the North American market will disappear or will be severely diminished. To be placed at such competitive disadvantage at a time of global capital scarcity should be a matter of great concern to the region.

Primo-Braga (1992) also poses some warnings regarding the effect of NAFTA, not only upon the Central American countries, but upon the rest of the world: "There is the danger that NAFTA will become more a managed trade initiative (emphasizing the discriminatory administration of rules-of-origin and quotas) than one designed to liberalize trade on a preferential basis. In this scenario, the NAFTA may have significant negative implications both for member and non-member countries."

## Final remarks

Central American countries are moving toward free trade. Their macroeconomic policy is coherent with this objective. However, it is not yet clear which scenario will play. Neither it is clear whether all nations in the sub-region will move at the same time. Some of them may try to take the first step alone.

So far, there has been no quantitative evaluation of the costs and benefits of establishing a free trade area between Central America and the USA or between Central America and other NAFTA members. There have been no studies to determine the advantages for Central America of strengthening its own integration process and isolating itself from other economic blocs.

Nevertheless, it seems, according to Weintraub (1991) that a sounder approach for development would be to encourage a sub-regional integration movement. In due course, these region-to-region agreements could lead to a hemisphere-wide free trade area. This suggests the need to restore the Central American Common Market (CACM).

However, it is indisputable that a revival of the CACM need not depend on a return to the biased incentive structure of the 1960s and 1970s. On the contrary, a necessary condition for the reconstruction of the CACM is a recovery in extra-regional exports and regional growth rates; that is, the expansion of the integration scheme will follow overall growth, not lead it.

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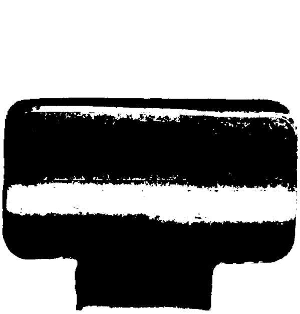

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