CAFTA: CHALLENGES AND OPPORTUNITIES IN THE AGRICULTURAL AND AGRO-INDUSTRIAL SECTORS

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Context: The CAFTA negotiations

Since 1984, various trade liberalization reforms have increased trade flows with the US and revealed actual and potential comparative advantages of the Central American (CA) countries. Reforms include: those implemented unilaterally by CA countries; the US’s Caribbean Basin Initiative (CBI); CA adherence to the Uruguay Round (1986-1994); membership in the World Trade Organization (WTO); and Free Trade Agreements (FTAs) with Mexico from 1995, when Mexico joined NAFTA.

Yet protectionist pressures persist in CA and the US. In response to strong lobbying, some agricultural and agro-industrial products were excluded from existing FTA lists of goods subject to tariff reductions. Non-tariff barriers in the US still block imports of commodities for which CA possesses comparative advantages and high export potential. In CA and the US, reactions to new trade negotiations are likely from exporters of traditional (coffee, bananas, sugar, and beef) and non-traditional commodities and producers engaged in import substitution agriculture or non-tradable goods.

World Bank Analysis of CAFTA Challenges and Opportunities

A Central America Free Trade Area (CAFTA) has been under negotiation since January 2003. A World Bank report, “Opportunities and Challenges for the Agricultural and Agroindustrial Sectors of Central America from a Free Trade Agreement with the United States of America” examines how a FTA between the US and CA countries might affect the agricultural and agro-industrial sectors of Costa Rica, El Salvador, Guatemala, Honduras and Nicaragua. Two main questions are addressed: (i) how to guarantee better US market access for CA’s agricultural and agro-industrial exports, and (ii) how to promote greater openness to imports from the US of food products that are “sensitive” in each CA domestic market.

The authors analyze the structure of agricultural and agro-industrial exports and patterns of revealed comparative advantages in CA, and tariff and non-tariff barriers (NTBs) these exports face in the US. The report suggests that the CAFTA negotiations consider (i) lessons from Mexico’s entry into NAFTA, (ii) existing protectionism in the US, and (iii) specific features of each CA country. It recommends domestic policy reforms to improve the competitiveness of CA producers of “sensitive” and new export goods.

Central American Trade with the United States

The US is CA’s main trade partner. The share of total exports to the US ranged from 23 percent (El Salvador) to 53 percent (Honduras); the share of total imports coming from the United States ranged from 24 percent (Nicaragua) to 51 percent (Costa Rica).
CA economies show high but diverse degrees of openness. In 2000, exports ranged from 10 percent (El Salvador) to 34 percent (Costa Rica) of GDP and imports from 27 percent (Guatemala) to 72 percent (Nicaragua) of GDP. The trade openness index [(exports+imports)/GDP] was 0.39 (El Salvador) and 0.41 (Guatemala) at the lower end, and 0.71 (Honduras), 0.72 (Costa Rica) and 0.98 (Nicaragua) at the higher end.

The share of primary commodities in total exports declines with development. This share was highest (85 percent) in Nicaragua, and lowest (33 percent) in Costa Rica where manufactured goods exports expanded rapidly from the mid-1980s and investments in human capital and institutional infrastructure have recently attracted foreign-owned high-technology firms (e.g., INTEL). In 2001, Costa Rica’s exports (US$ 5,043 million) were over five times greater than in 1985 (US$ 976 million).

All CA countries (except El Salvador) are net exporters of agricultural and agro-industrial products to the world and to the US. The US is the main destination – shares range from 36 percent (El Salvador) to 63 percent (Honduras). In absolute value, Costa Rica is by far the largest exporter of primary products to the US. The US is also a key source of CA food imports; shares range from 29 percent (Nicaragua) to 46 percent (Costa Rica). Simply put, the US market matters for Central America.

The Caribbean Basin Initiative

The US unilaterally enacted the Caribbean Basin Economic Recovery Act (1983), granting preferential tariff treatment to most imports from CA. Intended to last 12 years (through 1995), it was extended through 2008, with approval of the Trade and Development Law HR1594 (NAFTA parity) in 2000.

The CBI and NAFTA parity granted most goods produced in CA duty-free access to the United States, when: (i) goods are cultivated or manufactured in one or more CBI countries; (ii) imported raw materials undergo substantial transformation; (iii) local value added accounts for 35 percent or more of total production costs, and (iv) if raw materials from the United States are used, and national or regional value added is at least 20 percent. Before NAFTA parity, the CBI excluded canned tuna. The CBI also established tariff-free quotas for meat, dairy products, sugar, peanuts, tobacco and cotton, and most-favored-nation tariff for over-quota imports, although the US can adopt safeguards when massive imports cause proven harm to US domestic producers.

CBI preferences and trade policy reforms resulted in substantially increased trade flows. Costa Rica’s non-traditional exports grew 31 percent per year and the share going to the US increased from 37 percent (1982) to 55 percent (1988). Costa Rica enjoyed early-learning advantages, and has taken the greatest advantage of CBI preferential treatment for agricultural imports, followed closely by Guatemala and Nicaragua. From 1989 to 2001, Costa Rica’s agricultural exports to the U.S. grew from US$ 517 million to US$ 1,063 million (6.2 percent average annual increase), Guatemala’s from US$ 454 to US$ 731 million, and Nicaragua’s, from almost nothing to US$ 205. In contrast, Honduran agricultural exports to the US stagnated, El Salvador’s declined. The coffee crisis exacerbated these outcomes.

Determinants of Export Success

Although no formal studies have been conducted, numerous circumstances may explain Costa Rica and Guatemala’s relative success in taking advantage of the CBI. Impressive human capital and institutional infrastructure increased Costa Rica’s readiness. Trade policy reforms, including export subsidy schemes, paid off. Guatemala relied less on subsidies and more on domestic policies and programs to support the export drive.

Agricultural protectionism

Exports of 48 agricultural commodities from CA to the US encounter tariff peaks ranging from 21 to 121 percent. Despite CBI and other preferences, the US maintains tariffs and NTBs against imports of US domestically “sensitive” goods. Clark and Zarrilli (1994) found that 48 percent (Costa Rica), 68 percent (El Salvador), and 45 percent (Guatemala and Honduras) of the value of CA exports faced some NTB in the US. The US applied import quotas and seasonal tariffs according to Section 22 of the 1993 Farm Law. For Costa Rica, it applied tariff-rate quotas on chocolate and other processed foods, automatic licensing procedures on meat and preparations made of meat, antidumping duties on flowers, increased tariffs on ethyl alcohol and seasonal tariffs on imports of a large variety of fruits and vegetables. El Salvador, Guatemala and Honduras faced automatic licensing for meat and preparations made of meat and quotas on cheese.

In CA countries, “sensitive products”—key agricultural commodities for domestic consumption (e.g., dairy products, yellow corn, rice, beans, sugar, beef, pork and poultry)—enjoy some form of protection. Effective rates of protection vary greatly across products and countries. Products excluded from recent FTAs differ across countries. There are arguments for trade liberalization in these commodities across CA. Trade restrictions are not an appropriate tool to deal with the problems and lack of competitiveness associated with these products. The paper suggests alternative mechanisms to enhance competitiveness, guided by Mexico’s successes and failures.
Domestic Subsidies to Agriculture

Direct subsidies to agricultural production abroad—which depress world prices and increase their volatility—affect 42 percent of CA exports and 8 percent of imports. Trade barriers, which are more harmful to developing country exports, may further protect domestic production of subsidized goods.

For CA, reducing tariffs and NTBs should take precedence over reducing US domestic production subsidies in CAFTA negotiations. A 50-percent reduction in WTO-country tariffs would increase CA agricultural exports between 14.6 percent (Costa Rica) and 3.4 percent (El Salvador) and CA imports between 4.5 percent (El Salvador) and 2.9 percent (Nicaragua). A 50-percent reduction in WTO-country production subsidies would increase CA exports only 1.7 percent (Costa Rica) to 1.0 percent (El Salvador) and leave imports almost unchanged. Lower trade barriers would also have more impact on CA countries’ terms of trade and welfare levels (following Hoekman et al., 2002). Costa Rica gains more than other CA countries because of higher price elasticity of its exports supply, so is better prepared to take advantage of greater market access.

Revealed Comparative Advantage of CA Countries

The main contribution of the document is the identification of shopping lists for each CA country, based on their revealed comparative advantages and the corresponding barriers to access in the U.S. market. Using data for 1998-1999-2000, revealed comparative advantage indexes (RCAI) were computed for each country (following Balassa, 1967). The RCAI compares a given country’s share (e.g., for El Salvador) in exports of a given commodity (e.g., coffee), to the same destination (e.g., the United States), by a group of Central American countries, with the country’s share in the total exports of a set of commodities (e.g., agricultural goods) by the same group of countries. If the ratio is higher than 1, the country possesses a comparative advantage in this commodity, as revealed by its relative success in exporting it (see Table 1).

Any FTA negotiation should focus on these commodities, when there are entry barriers in the U.S. market. For each CA country, RCAIs were computed both for the United States and the world. A presumption of barriers to trade in US market emerges when the RCAIs for the world are equal or higher than 1 but not for the US. This presumption was then verified by looking at the existence of domestic production subsidies and tariffs and NTBs in the United States and at the possibility that the U.S. is a pure net exporter of those commodities.

At the 8-digit level, Costa Rica possesses revealed comparative advantages in the world for 267 line items, with average exports of $1,536 million, but this is not the case for 136 line items in its exports to the U.S. market. That is, for about one-half of the line items for which Costa Rica has been a successful exporter to the world, it has not had the same relative success in the U.S market and there is unused export potential. In the majority of these cases (83 percent of the 136 line items), there are exports to the world but none to the United States, mostly because of some barrier. Thus, excluding a few commodities for which the United States is a pure net exporter, this constitutes Costa Rica’s shopping list. It includes some dairy products, edible plants and fruits, seeds, preparations with meat and fish, processed sugar and others.

El Salvador possesses revealed comparative advantages in the world for 200 line items, with average exports of $542 million, but this is not the case for 116 line items in exports to the U.S. market. That is, for over one-half of the items for which E.S. has been a successful exporter to the world, it has not had the same success in the U.S. market. In 94 percent of these cases there are exports to the world but none to the United States, mostly because of similar barriers as those faced by Costa Rica. Excluding commodities for which the US is a pure net exporter, this constitutes El Salvador’s shopping list.

Guatemala possesses revealed comparative advantages in the world for 261 line items, with average exports of $1,236 million, but this is not the case for 184 line items in exports to the U.S. market. For 70 percent of the items for which Guatemala has been a successful exporter to the world, it has not had the same success in the U.S. market. In 89 percent of these cases, there are exports to the world but none to the United States. Excluding commodities for which the United States is a pure net exporter, this constitutes Guatemala’s shopping list.

Honduras possesses revealed comparative advantages in the world for 312 line items, with average exports of $494 million, but this is not the case for 75 line items in exports to the U.S. market. That is, for over one-half of the items for which Honduras has been a successful exporter to the world,
it has not had the same success in the U.S. market. In 85 percent of the cases, there are exports to the world but none to the United States. Excluding commodities for which the United States is a pure net exporter, this constitutes Honduras’ shopping list.

Nicaragua possesses revealed comparative advantages in the world for 140 line items, with average exports of $401 million, but this is not the case for 82 line items in exports to the U.S. market. That is, for over one-half of the items for which Nicaragua has been a successful exporter to the world, it has not had the same success in the U.S. market. In 81 percent of the cases, there are exports to the world but none to the United States, mostly because of trade barriers. Excluding commodities for which the United States is a pure net exporter, this constitutes Nicaragua’s shopping list.

Thus, despite the CBI, there is still a long list of CA agricultural and agro-industrial products (over one-half of goods exported to the world but not the United States) that face important barriers in the U.S. market. Indeed, most of these goods were excluded from the CBI. There are differences in the shopping lists of the various countries.

### Sensitive Products

A number of key agricultural commodities for domestic consumption (e.g., dairy products, yellow corn, rice, beans, sugar, beef, pork and poultry) enjoy some form of protection in the CA countries, designated here as sensitive products. Effective rates of protection are highly dispersed across products and across countries. Products excluded from recent FTAs differ across countries. There are arguments; moreover, for the liberalization of trade in these commodities across CA. Trade restrictions are not an appropriate tool to deal with the problems and lack of competitiveness associated with these products. The paper suggests alternative mechanisms to enhance competitiveness in these areas. The successes and failures of the Mexican experience are reported as a guide for these exercises.


**The World Bank and CAFTA**

As Central American countries engage in free trade negotiations with the United States, the World Bank has designed a support strategy to ensure that an agreement would fulfill its potential to reduce poverty and spur growth in the region. The Bank’s assistance strategy includes loans, analytical and advisory support, as well as grant funds.

A key element of the Bank’s strategy is the support offered through a portfolio of **$41.3 million in ongoing loans to enhance the competitiveness of firms in Nicaragua, Guatemala and El Salvador**. These loans are currently being adapted to focus more directly on the immediate challenges posed by CAFTA. Additionally, a new competitiveness project for Honduras will be presented to the Bank’s board in 2003. For more information on these projects please go to [http://www.worldbank.org/projects](http://www.worldbank.org/projects)

Beyond financing, the Bank is responding to Central American Governments’ requests for analytical and advisory support through studies of strategic CAFTA-related issues, that emerged in consultations held across the region in December 2002. These efforts build on the “Lessons from NAFTA” studies recently published by the Latin America Chief Economist Office. See [http://www.worldbank.org/laceconomist](http://www.worldbank.org/laceconomist)

The Bank obtained **grant resources to strengthen the institutional capacity** of the Central American governments to facilitate policy implementation related to the CAFTA. Potential areas of support include systems development and training of government officials, among others.

### About the Authors

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### See Also

#### Lessons from NAFTA and other Free Trade Agreements

The purpose of this study (available at [http://www.worldbank.org/laceconomist](http://www.worldbank.org/laceconomist)) was to derive lessons for policy makers in the region regarding the likely design and economic effects of future free trade agreements (FTAs) with the United States. This in turn involves a triple objective: (1) an assessment of the Mexican experience with NAFTA, to evaluate what countries can expect from such FTAs, especially in terms of speeding up convergence with the U.S., and how that may depend on their institutional and policy framework; (2) an evaluation of how key features of NAFTA, likely to be replicated by future FTAs with the U.S., would affect other countries in the region choosing to join in but starting from initial conditions possibly very different from Mexico’s; and (3) an assessment of the impact of NAFTA on excluded LCR countries, to gain a regional perspective on the impact of NAFTA beyond Mexico, as well as to inform policymakers about the issues that would arise from the inclusion or exclusion of countries during the transition towards the Free Trade Area of the Americas (FTAA).

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