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Back to Perspectives

Wednesday, March 03, 2010

# CAFTA Five Years: Seal of Approval for FDI

**CAFTA has not been a panacea, but it has provided a seal of approval for foreign direct investment and democracy.**

**CHRONICLE SPECIAL**

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**MAKING HISTORY:** Trade ministers from CAFTA sign the historic agreement in 2005. (Photo: SEIC)

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When the Central America Free Trade Agreement (CAFTA) squeaked through the U.S. Congress in 2005, the U.S. business community rejoiced.

By providing duty preferences for imports from the countries of that nearby region, CAFTA would lower the cost of importing from the five countries of Central America as well as the Dominican Republic, and cushion their corporate supply chains from overdependence on China at a time when U.S.-China tensions threatened to erupt in a succession of anti-dumping, countervailing duty and other trade measures against allegedly predatory Chinese trade practices. U.S. manufacturers of apparel and other low-cost manufactured goods would take increasing advantage of lower transportation costs from Central America to build “demand-driven” supply chains that would be more cost-effective than those anchored in Asia, and more responsive to sudden changes in U.S. consumer tastes.

Supporters of CAFTA crowed that the free-trade pact would create the third-largest U.S. export market in Latin America, behind only Mexico and Brazil, and the 14th largest U.S. export market in the world. Nearly 32 percent of total exports from Central America went to the United States in 2008, while the region sourced 33 percent of its total imports from the United States.

Over its first few years, U.S. companies reaped significant benefits. Between 2005 and 2008, U.S. exports to the region increased by around 48 percent to reach $24.3 billion, while U.S. imports from the region increased by 10 percent to $14.4 billion. Inward foreign direct investment as a percentage of region’s GDP rose from 3.4 percent in 2005 to almost 5 percent in 2008, and

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higher remittance inflows and tourism from the United States helped lift per capita income. "Before the recession, the countries of the region all increased their exports by double-digit rates," says David Lewis, vice-president of Manchester Trade, a Washington, D.C., trade consultancy. "They were very aggressive about taking advantage of new opportunities in agri-industry, agricultural products, and textiles. [CAFTA] was a shot in the arm for them." For example, El Salvador increased its exports of agricultural products to distribution networks in the U.S. Hispanic market, to little fanfare in the U.S.

More recently, the global economic downturn has taken a major toll on the region's economic growth, foreign direct investment and trade volumes. In 2009, all five Central American members of CAFTA – Costa Rica, El Salvador, Guatemala, Honduras and Nicaragua – suffered declining GDP. The biggest loser was Honduras (minus 4.4 percent), hit hard not just by declining demand for its apparel exports but by the disruption in the uncertainties that emerged last summer when left-leaning President Manuel Zelaya was arrested by the Honduran military, acting on an arrest order issued by the Honduran Supreme Court. (The democratic election of Porfirio Lobo Sosa as president of Honduras last November has since restored stability to trade with Honduras.)

Even Costa Rica, the region's most developed economy, saw its GDP slip by 4 percent in 2009, after growing by 2.9 percent in 2008. It is barely more than a year since Costa Rica became the final country to join CAFTA but its exports to the U.S. fell by 15 percent in 2009, and its imports from the U.S. dropped by 30 percent. Its unemployment rate rose to 7.8 percent in 2009 from 4.8 percent in 2008. Between 2005 and 2008, in-coming FDI in Costa Rica had risen 134 percent to $2 billion, before dropping last year by an estimated 30 percent as a result of the impact of the recessions in both the United States and Spain, the country's two largest sources of FDI.

Likewise, Nicaragua, the poorest country in Central America, suffered a GDP decline of 3.1 percent in 2009, after growth of 3.2 percent in 2008; El Salvador's GDP dropped 2 percent, compared with 2.6 percent growth in 2008; and Guatemala's GDP dropped by 2 percent, compared with 4 percent growth in 2008, according to the Economist Intelligence Unit. The only CAFTA member that experienced any positive growth last year was Dominican Republic, which expanded by a mere 1.5 percent, down from 5.3 percent in 2008. CAFTA itself is not to blame for those declines, says Lewis. "Last year was marred not by how CAFTA did in and of itself, but really the fact that because of the fall in the U.S. market, no exporter in the CAFTA region did well at all," he says.

**DAMAGED APPAREL**

The damage has been particularly severe in the labor-intensive apparel sector. There, about 20,000 jobs in the region have been lost in free-trade zones where contract manufacturers make low-value garments for U.S. apparel makers. The problem, Lewis said, is that "it is easy to close plants in free trade zones because they run on contracts." The challenge now is how to regain those jobs at a time when the U.S. economy is weak and

to regain those jobs at a time when the U.S. economy is weak, and unemployment in the U.S. is high, dampening demand for many imported apparel products. “Until the jobs come back in the U.S., orders for apparel in the region won’t grow again,” Lewis says. “Growth in other areas of the economy won’t provide the number and quality of jobs that you had in apparel. At the end of the day, there is no silver bullet to replace those jobs” despite Central America’s continued strength in niche agribusiness markets and its proximity to the United States.

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Notwithstanding the preferences CAFTA provides, China has continued to consolidate its position as the top foreign supplier of apparel to the United States. In 2009, overall U.S. imports of apparel dropped by 6 percent to $22.6 billion, yet U.S. imports of apparel from China increased by 10.71 percent to $8.62 billion, a market share of nearly 40 percent. China was the number-one source for apparel and home furnishings that use textiles as well as the leading source of imported footwear and fashion accessories, says Julia K. Hughes, senior vice-president at the United States Association of Importers of Textiles and Apparel. Meanwhile, imports from the CAFTA countries, which ranked second collectively after China, dropped during 2009. Apparel imports from Costa Rica plunged by 43.4 percent; from the Dominican Republic by 33.36 percent; from Honduras by 24.4 percent; from El Salvador by 22.6 percent; from Guatemala by 14.7 percent; and from Nicaragua, by 6.94 percent. Only three out of the top ten apparel suppliers to the U.S. worldwide belong to any U.S. free trade agreement. Following China, at the top of the list of apparel suppliers are Vietnam, Indonesia and Bangladesh; not one of those countries belongs to a free-trade pact with the United States. So much for the magic of free-trade pacts, critics say, when it comes to stemming China’s rise in the sector.

**ADDING COMPLICATIONS**

A key reason CAFTA hasn’t done more to cushion the region from recession, say its critics, is that CAFTA – like other recent U.S. free-trade agreements – does not yield its benefits easily. Rather than simplify or eliminate trade rules (as many people imagine free-trade pacts do), CAFTA makes importing from Central America a more complicated process than importing from China and many other countries that are not parties to any U.S. free-trade pact. Jonathan M. Fee, a partner at the U.S.-based Alston & Bird law firm, says, “CAFTA isn’t for the faint-hearted.” According to Kim Glas, deputy assistant secretary, textiles and apparel at the U.S. Department of Commerce, “Textile and apparel goods must be produced starting at the yarn stage in the CAFTA countries in order to access the full benefits of the agreement.” U.S. importers from CAFTA countries must also continually share information about their CAFTA shipments with U.S. Customs, and conduct regular factory visits to their foreign suppliers’ manufacturing locations to make sure that the goods for which they claim trade preferences are legitimately entitled to them. In contrast, U.S. importers who buy from China can benefit from that country’s low costs and high productivity without having to meet such requirements, since they’re not applying for any trade-pact preferences.

U.S. Customs has even made it a higher priority recently to enforce the complex requirements of CAFTA, says Janet Labuda, director, Textile/Apparel Policy and Programs Division, Office of International Trade at U.S. Customs and Border Protection. Labuda says importers who file for CAFTA preferences are subject to reviews of their prior claims, and if Customs can determine that a pattern of continued non-compliance exists, further penalties can be assessed against them. No wonder many U.S. apparel importers find it easier to source products in faraway China and other

productive, low-wage Asian countries, and spare themselves the headaches, Fee says. He adds that import specialists at many companies are not well-informed about CAFTA origin rules, and they need to spend precious time and money responding to requests made by U.S. Customs to validate their claims for trade preferences. This process is "inefficient and time-consuming," Fee says.

**"SPAGHETTI BOWL" OF AGREEMENTS**

Still another factor that makes it difficult for many newcomers: CAFTA is only one of numerous regional trade agreements involving the Americas that have been enacted in recent years, and CAFTA's peculiar complexities differ from the complex provisions of those other pacts, including some pacts that involve the U.S. "The proliferation of RTAs has created a veritable 'spaghetti bowl' of multiple and often overlapping agreements," assert economists Antoni Estevadeordal and Kati Suominen in a recent report from the Inter-American Development Bank, 'Bridging Regional Trade Agreements in the Americas.' "The various disciplines included in each RTA – such as tariff liberalization, rules of origin, standards, safeguards and investment rules – entangle the bowl further." On the other hand, at least those trade pacts that involve the U.S. have been getting a bit less complicated in recent years, the authors write. "The more recent Rules of Origin regimes based on the NAFTA model – namely, the U.S. Chile free trade agreement and CAFTA – incorporate simpler, more practical and less restrictive product-specific rules of origin than NAFTA," write Estevadeordal and Suominen. "This evinces a trend toward market-friendly rules of origin in the hemisphere."

For all that, the recent recovery in the global economy should provide a significant boost for exports from CAFTA countries. Roy Zuñiga, dean of the INCAE Business School, which operates campuses in Costa Rica and Nicaragua, says there is no doubt that the recession in the U.S. has had an impact on demand for Costa Rican products but that recent economic figures reveal that the U.S. economy is improving, and that Costa Rican exports to the U.S. are beginning to take off again. Zuñiga says that the conditions provided by CAFTA are "necessary but not sufficient" for Costa Rica to achieve its economic goals. However, CAFTA makes it easier for Costa Rica "diversify its risks and find niches and markets that competitively value" what Costa Rica can offer. Without CAFTA, the Costa Rican economy would have lost opportunities to continue growing in the U.S. "But that didn't happen, and now Costa Rica is better prepared to compete in international markets than it would have been without CAFTA."

As for the prospects for a rebound in Spanish foreign investment in Costa Rica, Zuñiga says, "The Spanish economy will be one of the most affected by the recession, apparently with a longer recovery period than in other countries whose growth was not based so strongly on the housing construction sector." He adds, "No longer investing in well-positioned countries [like Costa Rica] will cost [Spanish companies] more over the long term than over the short term, and some people already realize that this is the best time to commit to economies such as that of Costa Rica."

More broadly, free trade advocates also argue that it's all too easy to overlook the enormous progress that has been made in Central America, in part because of CAFTA. "You have to call CAFTA a success," says Dan Griswold, director of the Center for Trade Policy Studies at the Cato Institute, a Washington think tank. "CAFTA was never going to have a big impact on the U.S. economy; we are so much bigger than they are. The goal was to

deepen and strengthen our ties to Central American democracy, and trade with the region has picked up. Let's not forget that 25 years ago, Central America was a region in turmoil; it was on the front pages. While there are still bumps in the road – Nicaragua is [once again] led by Daniel Ortega, and Honduras has had its constitutional drama – democracy continues in that country" with the restoration of a democratically elected president. Although CAFTA hasn't worked miracles, says Griswold, "it is nevertheless an important tool; a cultural Good Housekeeping seal of approval that will help the region attract Foreign Direct Investment over the long run."

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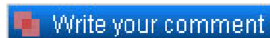


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