Fair Trade or Free Trade? Understanding CAFTA

Central American Development: the Impact of Trade Liberalization in the 1990s

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Trade Liberalization is already occurring in Central America. Tariff levels have dropped and imports have surged dramatically in the 1990s. In the region's poorest country, Nicaragua, the average tariff has dropped from 43.2% to 5% in less than a decade. But has development followed? This is a question we must ask in light of the negotiations for CAFTA, which promises to codify and accelerate the process of liberalization.

- **Export Growth –** Exports more than doubled in the 1990s (from $5 to $15 billion), but imports rose even faster. An increased reliance on remittances and migration is required to finance the Central American trade deficit.

- **Economic Growth –** Growth has been relatively stagnant, compared to the 1970's growth rate of 6% (2.7% per capita). In the "lost decade" of the 1980s growth averaged only 1%; in the 1990s growth rose to 4.1% (1.8 % per capita), but has been flat since 1997 and well below the East Asian average of 7% for last three decades (IDB 2002).

- **Foreign Direct Investment (FDI) –** On average, Central American countries have seen an increase in FDI of $375 million per year (1998-2000). However, this investment was driven largely by privatization and was biased toward construction rather than productive fixed investment and domestic savings, which remain far below levels necessary for sustainable development. Few forward and backward economic linkages were created. The use of local inputs remains minimal in export oriented investment (i.e. in *Maquilas*).

- **Productivity –** Total factor productivity rates have actually fallen in Central America over the past decade, especially in the agricultural sector (IDB Research Dept, 2002). Total Factor Productivity Growth 1991-2000 has been disappointing for Costa Rica (+0.2%), Guatemala (- 0.5%), El Salvador (- 0.85%), Nicaragua (-1.6%) and Honduras (- 1.95%).

- **Competitiveness –** Central American countries rank close to last on the World Economic Forum's Growth Competitiveness Index (High: Costa Rica = 43; Low: Honduras = 76, out of 80 countries.)

In sum, increased dynamism and diversification in Central American exports in the 1990s have not jumpstarted the Central American economies. Growth, in turn, has not increased fast enough to significantly reduce poverty and inequality, create jobs, or stem environmental degradation. Liberalization has instead been associated with rising levels of criminal violence, social and political instability and the hollowing out of democracy.

- **Poverty –** Trade liberalization has failed to lower poverty - the principal Millennium Development Goal. Relative poverty in the region is 55%; 2 of every 3 Central Americans in rural areas are poor.

- **Inequality** – Trade liberalization has increased income inequality in the region, even in Costa Rica. Central America has sustained one of the highest levels of income inequality in the world, with a Gini coefficient of 0.55. Trade has also failed to diminish the gap between Central America and the North, or between rural and urban areas. Central America, in terms of GDP per capita, lost ground relative to the U.S. over the past 25 years.

- **Jobs** – 600,000 Central American jobs have been permanently lost to the coffee crisis out of a rural labor force of 5 million. The *maquila* sector has leveled off at 400,000 jobs. The only increase in employment has been in the informal sector.

- **Hunger –** In Central America, indices of malnutrition -- measured by average weight and height -- have increased in Nicaragua, Honduras and Costa Rica. The World Food Program 2002 Report states that 8.6 million Central Americans (1 in 4) continue to suffer from hunger or food insecurity.

- **The Downsizing of the Central American State –** In the view of the IDB (2002), the shrinking state has crippled its capacity to carry out its basic functions, such as enforcing the rule of law, collecting taxes and promoting the health and education of people entering the work force.

- **Weak State Fiscal Authority** – Central American capacity to collect taxes remains far below expected levels relative to similarly developed countries. The IDB shows that Central Americans should be collecting about 15% of their GDP in taxes, while the actual level is about 10% of GDP. Despite a decade of reforms, the 1990s have seen public investment levels remain well below (-25 to –60%) expected levels.

- **Debt –** Massive bailouts of a failing financial sector and rising internal and external debt have wiped out the HIPC debt forgiveness gains in Nicaragua and Honduras. After a decade of capital accounts liberalization, Central America has accumulated nearly $10 billion in unsustainable, additional debt.

- **Education not Growing Fast Enough** – Central America continues to underinvest in education, spending about 2.4% of its GDP on education, while the IDB estimates that the region should be spending at least 4%. As a result, the education gap between Central America and the rest of the world is growing.

- **Weak Rule of Law, Crime and Violence –** Social Violence has reached epidemic proportions, now approximating the worst political violence of the civil war years in several countries.[1]

- **Hollowing out of Democracy** -- The fragile process of democratization is threatened by the non-democratic formulation of development policies (like trade liberalization) and the lack of any perceived economic payoff after nearly a decade of reforms. *Latinobarometer* surveys of Central America report an alarming deterioration in support for recent political and economic reforms.
  - 58% are unsatisfied with the performance of their respective market economies
  - 68% say that privatization has been a bad idea
  - 80% believe that corruption has increased
  - 50% say that democracy does not function in the region
  - 85% of Central Americans have little or no confidence in their political parties

- **Migration & Remittances:** Recent studies have shown that increased labor mobility would generate greater financial benefits for poor countries than free trade. Four of the five countries increasingly rely on migration and remittances as a *de facto* social policy and to cover an expanding trade deficit with the U.S. The primary export for Central America has become labor. Some 200,000 – 300,000 Central Americas attempt to migrate to the U.S. through legal and illegal means every year. Macroeconomic stability is now and will continue to be dependent upon the $5 billion sent home annually from the U.S.

[1] Juan Luis Londono, Alejandro Gaviria, and Rodrigo Guerrero (2000) *Asalto al Desarollo: Violencia en America Latin*a. IDB; Latinobarometer, 2002

Sources:
IDB & World Bank Country Strategies, Program Evaluations; Agosin, Manuel, Roberto Machado and Paulino Nazal (November 2002) "The Economies of Central America and the Dominican Republic: Evolution and Long Term Challenges," IDB Sector Study RE2-02-001; World Bank Development Indicators (2003); Latinobarometer (2002); Salazar-Xirinachs José M. and Jaime Granados (May 2003) "The United States-Central America Free Trade Agreement: Opportunities and Challenges"