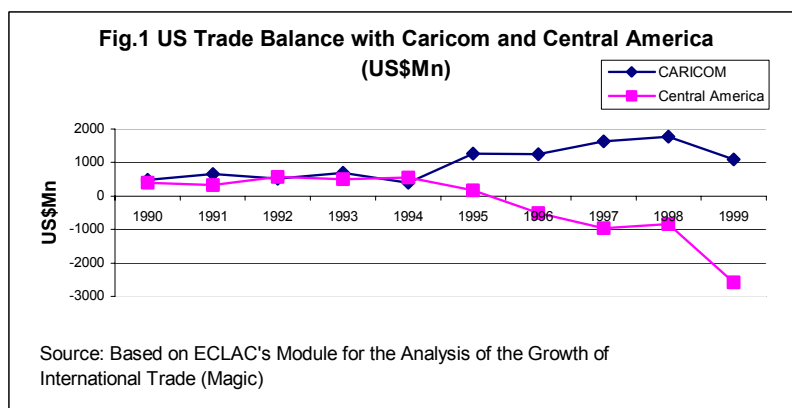


Should the Caribbean seek a US-CARICOM Free Trade Agreement?

This question is of interest in light of the proposed free trade agreement (FTA) between the United States (US) and the five member countries of the Central American Economic Integration System (hereinafter referred to as Central America)¹. The Dominican Republic has also expressed interest in a free trade arrangement with the US.² Negotiations for a United States-Central America Free Trade Agreement (US-CAFTA) were officially launched between the US and the countries of Central America in January 2003. There has been a mutual interest in establishing a FTA between the two parties. Central America wants enhanced access to the US market in light of the perceived benefits to Mexico from the North America Free Trade Area (NAFTA). The US wants enhanced access to Central America’s market in light of: (1) the significant decline in its trade balance with the region since 1994, the year NAFTA went into effect (Fig.1); and (2) its perception of a competitive disadvantage in the region due to the free trade agreements that Central America has concluded with other countries, notably Canada, Chile and Mexico³.

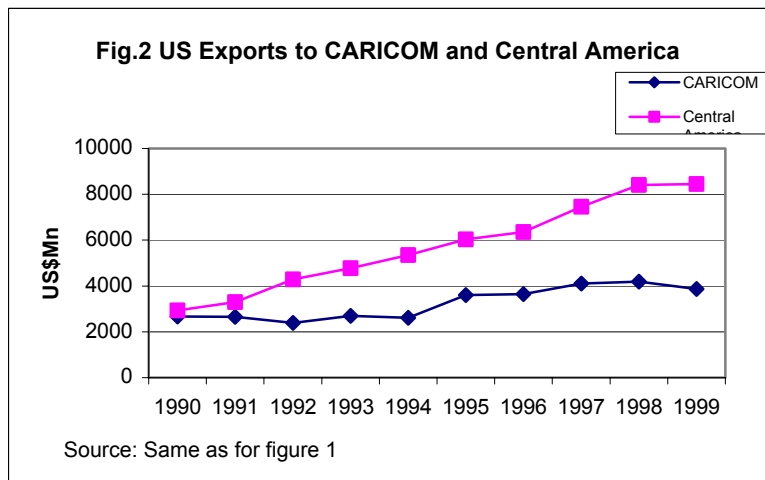


¹ The 5 countries are Costa Rica, El Salvador, Guatemala, Honduras and Nicaragua.

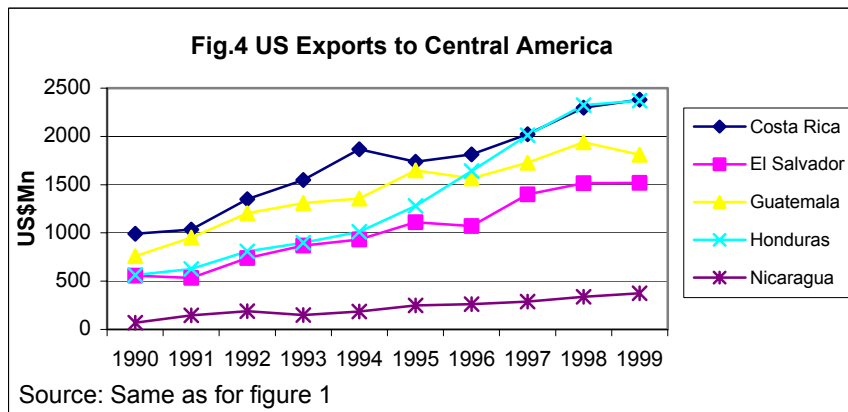
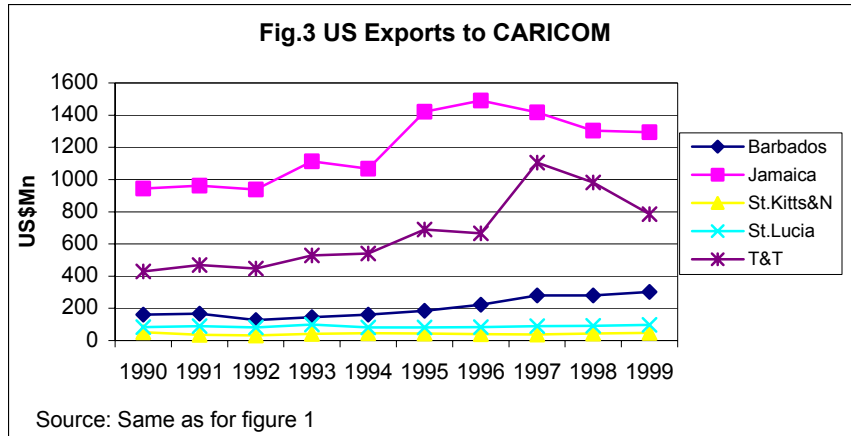
² The US expressed its willingness to consider the option of docking the Dominican Republic to the US-CAFTA, www.ustr.gov.

³ See United States Trade Representative, “Free Trade with Central America”, www.ustr.gov.

Countries in the Caribbean Community (CARICOM) region would be interested in a FTA with the US in order to obtain more favourable access to the US market. The US, on the other hand, would have a greater interest in a FTA with Central America than with CARICOM. To the US, Central America represents a market of 31.6 million whereas CARICOM represents a market of 14.4 million or just less than half that of Central America. Exports from the US to Central America increased significantly over the 1990s whereas exports to CARICOM increased only between 1995 and 1997 (Fig.2). Despite this increase, the US trade balance with Central America became increasingly negative after 1994. Imports from the US remained more or less constant during the 1990s – from 46% of total imports in 1990 to 45% in 1999. On the other hand, the US market became more significant for exports from Central America; exports to the US represented about 42% of total exports in 1990 and about 59% in 1999. These factors - the size of the Central American market, the declining US trade balance with the region and the import behaviour of the Central American countries are key factors in the US interest in a FTA with Central America.

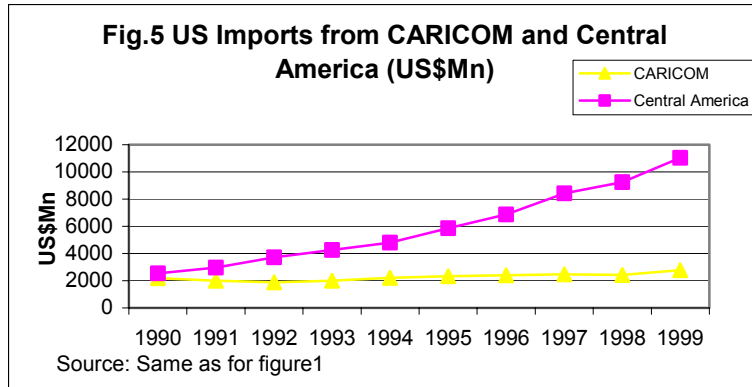


On the basis of these factors, CARICOM countries would seem to hold little interest to the US for negotiating a FTA. The CARICOM market represents only about half of the Central American market. Exports to the US represent less than 40% (37% in 1990 and 36% in 1999) of total exports whereas imports from the US represent over 50% (50% in 1990 and 53% in 1999) of total CARICOM imports during the 1990s. The US trade balance with the region was increasingly positive over the period. In terms of individual countries, Jamaica is the most significant market for US imports in the region. Nevertheless, the level of imports is comparable only to El Salvador, which is the fourth market in descending order of significance in Central America (Figs.3 & 4).



Despite its relatively small market, the region's purchasing power is significant given the high *per capita* income of a number of countries in the region. There are at least seven CARICOM countries⁴ compared with only one Central American country (Costa Rica) that have *per capita* GDP in excess of US\$3,000. Nevertheless, CARICOM would have to significantly increase its exports in order to sustain an increased level of imports. US imports from the region remained relatively flat during the 1990s (Fig.5).

⁴ These are Antigua & Barbuda, Bahamas, Barbados, Grenada, St. Lucia, St. Kitts & Nevis and Trinidad & Tobago.



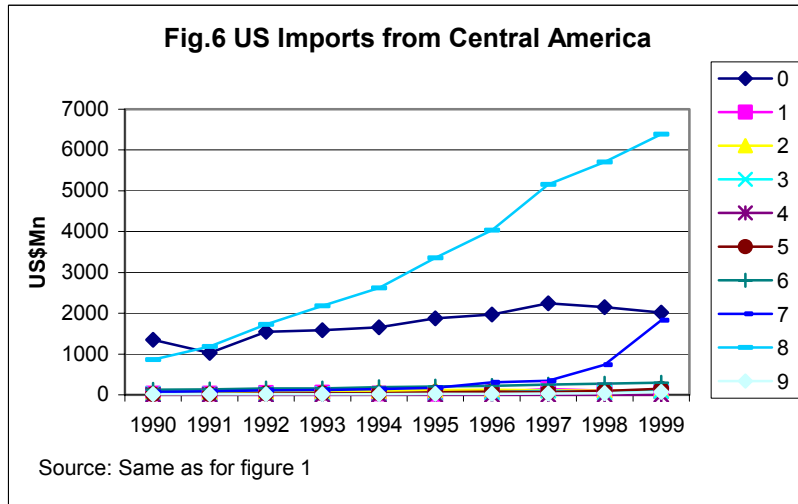
Central America is of greater interest to the US than CARICOM on account of existing barriers to trade and investment described by the US Trade Representative as “including high tariffs on agricultural goods, unjustified use of sanitary and phytosanitary measures, restrictive licensing practices, inadequate protection of intellectual property rights and limitation on access by service providers”⁵. Most CARICOM countries have eliminated non-tariff barriers to trade and significantly lowered tariffs during the 1990s. Central America is also of interest as the US seeks to eliminate labour and environmental practices that give Central American countries comparative trade advantage. Strong trade unionism in the Caribbean guards against exploitation of child labour and other adverse labour practices.

For Central American countries, the US represents a significant market to which these countries have been increasing their exports. Central American exports tend to be concentrated in the categories, machinery and equipment and miscellaneous manufactures (SITC 7 and 8).⁶ These are largely electrical and electronic equipment and apparel produced by “maquila” operations, which have benefited from enhanced Caribbean Basin access to the US market and have increased significantly since the 1990s (Fig.6). Nevertheless, exports of a number of products in the category food and live animals (0) such as fish, root vegetables (such as cassava or manioc), fruits and coffee increased significantly over the decade.

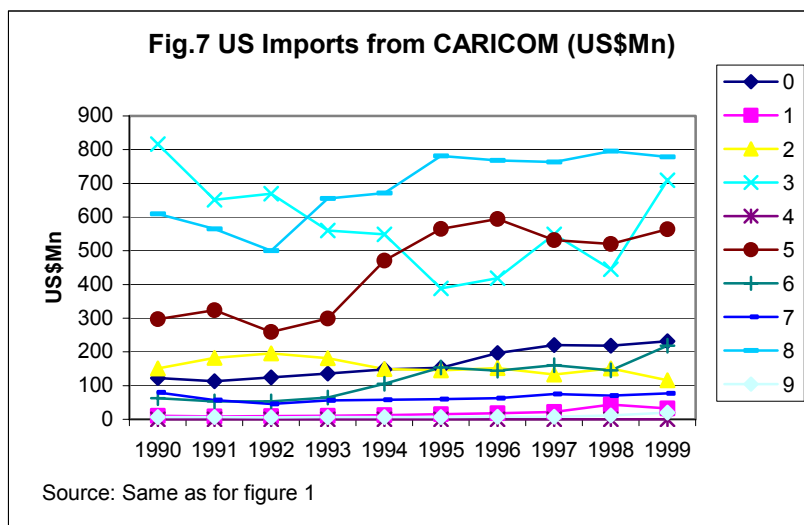
In the case of CARICOM countries, exports to the US have been a bit more diversified although three categories namely miscellaneous manufacture, petroleum products and chemicals (SITC 8, 3 and 5) were dominant over the decade (Fig.7). A closer look reveals increases during the second half of the 1990s in the categories food and live animals (0), beverages and tobacco (1) and manufactures classified mainly by materials (6). Decomposition of these categories indicates where US imports are concentrated. Most imports under SITC 0 from the CARICOM region are of fish and other seafood (crustaceans), sugar, root vegetables and fruit juices. However, it is only imports of fish and crustaceans and root vegetables that increased significantly during the 1990s. Under beverages and tobacco, beer and cigars are the products whose imports into the US increased significantly over the period. Under SITC 6, US imports of new tyres (rubber), refractory bricks and iron and steel bars and rods increased significantly during the decade.

⁵ See Letter from USTR to the Speaker of the US House of Representatives, www.ustr.gov.

⁶ See definition of broad SITC categories at Annex.



It is useful to consider a potential US-CARICOM free trade arrangement with reference to the proposed US-CAFTA. Although the details of a US-CAFTA are still being negotiated, the countries involved in the proposed arrangement anticipate favourable market access for many of their products. The Caribbean Basin Economic Recovery Act (CBERA) of 1983 had accorded duty free access to 24 Caribbean Basin countries for a number of products. Textile and apparel products that were excluded from the list of eligible products were given special guaranteed access levels (including reduced duties) by the US government under the 807A programme. However, in 1994 Mexico was given duty free access for these products under the NAFTA. Caribbean Basin Initiative (CBI) countries lobbied for and got approval of the US-Caribbean Trade Partnership Act (CBPTA) in 2000. The CBPTA provided NAFTA-equivalent access for those products excluded by CBERA, including footwear, canned tuna, petroleum and textile and apparel products.



Despite the expansion of CBI provisions by CBPTA Central American countries have been negotiating for a free-trade arrangement with the US to, among other things, preserve as well as

expand the benefits of the CBI. The preference schemes are unilateral and must be renewed periodically, which means that they can be withdrawn by the US. In fact the CBPTA will end in 2008 or the date on which a free-trade arrangement (including the Free Area of the Americas - FTAA) comes into force between the US and any CBPTA beneficiary country. The advantage of a FTA over the one-way preferences is in securing, through negotiations, favourable market access for products of interest. In other words, countries can gain access for products that may be excluded from preference schemes by offering, in return, access to specific markets.

However, most of the products that are of interest to the Central American countries are among the most protected in the US. These include sugar and tropical fruits that grow abundantly in the five countries. The US cannot eliminate its subsidies to agricultural producers within the framework of free trade arrangements because of the advantage that would be gained by other countries that subsidise their producers, namely Europe and Japan. The US has instead put forward a proposal at the multilateral level for eliminating subsidies. In the case of tropical fruits from Central America, agricultural producers in the Southern US (Florida) are opposed to their entry into the US market. The barriers to entry are phytosanitary rules rather than tariffs and quotas.

Central American countries are, to a large extent, dependent on the textile and apparel sector. El Salvador and Honduras are the most dependent and Costa Rica the least dependent. Nevertheless, the countries all specialise in exports produced by “maquiladoras”. They tend to see “free zones” as the best example of success and therefore as the future direction of the economies.⁷ However, they face significant challenges in regional FTAs as well as at the multilateral level. The World Trade Organization (WTO) is not supportive of free-trade zones or “zonas francas” because they tend to distort the structure of incentives between exporters and producers. Canada also opposes the consideration of free-trade zones within free trade arrangements. Nevertheless, it seems that the WTO had agreed in November 2001 to extend the life of free zones until 2010.

Promotion of free zones has been aimed mainly at addressing unemployment problems in these countries as well as in the Caribbean. However, the value added in maquila operations is low given that it is based on relatively cheap labour. These countries would be best advised to diversify their production and exports towards higher valued added products. China is a significant competitor in labour-intensive exports such as textile and apparel and with the cessation of the Multi-Fibre Arrangement in 2005 will be an even more formidable competitor to Latin American and Caribbean countries. It is this possibility that has led the Central American countries to delineate their objectives for the textile and apparel sector within the US-CAFTA.

Countries are seeking access from duty and other restrictions for garments made from regional material; preferential treatment for garments made from non-regional inputs but transformed in the region resulting in a change in tariff classification; duty and quota free access for products for domestic use such as towels, sheets, etc.; increase in the level of tariff preferences for garments manufactured from non-originating material; and accumulation in fulfilling rules of origin based on recognition of garments made with inputs from countries that have free-trade arrangements

⁷ Maquiladores de C.A. y el Caribe analizan retos de globalización www.tribuna.com.

with the US⁸. If these objectives can be successfully negotiated in the FTA with the US then countries will have a breathing space for developing more viable textile and apparel industries.

The issue of services has not been as strongly debated as those regarding agriculture and the textile and apparel sectors. This could be because many areas of services such as telecommunications and petroleum refinement in Costa Rica, for example, are still controlled by the State. In addition, data limitation precludes detailed analysis of trade in services. However, interest in increased investment from the US would require focus on the opening of the services sector. Nevertheless, countries have different interests in and would benefit differently from a free trade arrangement. Determining factors include the resource base and production and export structures of the particular country.

There may be few benefits that would accrue to countries in the CARICOM region from a US-CARICOM free trade arrangement. Countries, with the exception of Haiti and Jamaica, do not have comparative advantage in producing labour-intensive goods for mass markets. Nevertheless, duty free access to the US market for textile and apparel goods with significant design and other local content could facilitate the development of a regional industry. However, whatever advantage countries obtain from the US may be of a short-term nature given that the Multi-fibre Arrangement is to be fully liberalised by 2005.

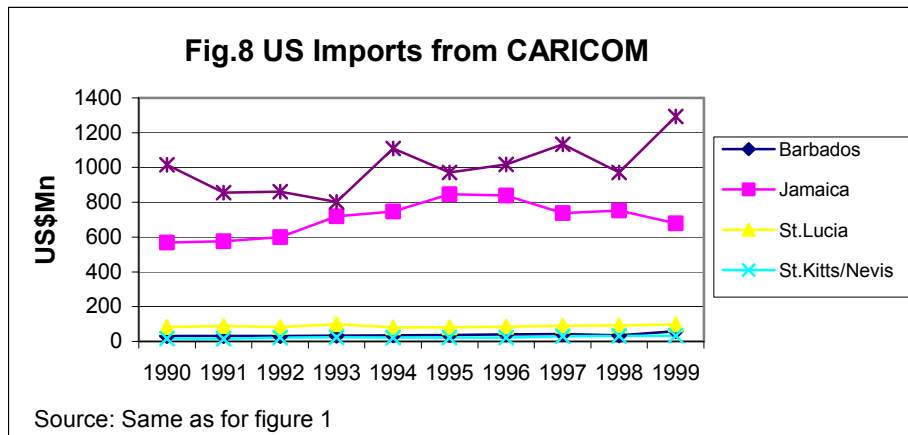
Caribbean countries would also not be able to compete with Central America in the export of sugar and bananas to the US. Cessation of preferences for Caribbean bananas in the European Union has already begun to adversely affect the economies of the Eastern Caribbean. However, access free from restrictions for other tropical products would boost supply and earnings in the agricultural sector. The issue of subsidies, as mentioned earlier, cannot be resolved within a US-FTA but must be negotiated at the level of the WTO. Nevertheless, parties to a free trade agreement would be expected to support the US in WTO and FTAA negotiations aimed at eliminating agricultural export subsidies.⁹

Many of the countries in the CARICOM region have service-based economies, notably Barbados and the countries that are members of the Organisation of Eastern Caribbean States (OECS). Their merchandise trade with the US is relatively insignificant compared with that of the resource-based economies of Jamaica and Trinidad and Tobago, for example (Fig.8). Nevertheless, all Caribbean countries would benefit from access for both skilled and unskilled service providers especially in areas such as construction and professional services. Securing advantage for export services in the US market would require, on the part of Caribbean countries, opening of what may be considered sensitive sectors such as education, distribution, health and transportation. It would also mean accepting the negative list approach to services liberalisation that markets are open unless a specific exception is made.¹⁰

⁸ Legislation, in the form of the Haiti Economic Recovery Opportunity Act of 2003, has been introduced in February 2003 to provide Haiti with duty-free access for apparel products assembled with inputs from countries in which the US has a free trade or regional agreement.

⁹ This is contained in the letter from the USTR to the US House of Representatives setting out the case for US-CAFTA www.ustr.gov.

¹⁰ Free Trade Area of the Americas www.ustr.gov.



Some of the disadvantages in entering into a free trade arrangement with the US lie in the non-trade issues that form part of the agreement as well as the possible adverse impact of lowering or eliminating tariffs. In Central America, Guatemala has encountered a major obstacle in its negotiations with the US on account of its de-certification by the US, at the beginning of 2003, as a cooperative partner in the anti-drug effort in the region. In its free trade negotiations with the US, Australia is likely to be pressured to allow the importation of genetically modified food as well as remove restrictions on foreign investment.¹¹ A more serious inclusion is the restriction on a country's use of capital controls. Chile and Singapore have reluctantly agreed to the inclusion of this restriction in their respective free trade agreements with the US. The Asian crisis of the late 1990s has taught developing countries to be careful in liberalising capital flows. The International Monetary Fund (IMF) is also cautious about encouraging such liberalisation.¹² But what is perhaps more alarming than the inclusion of the restriction is the consequence of imposing capital controls during a crisis even when such an imposition is approved by the IMF. In such a case, it is American investors that would have to be compensated by the country with damages determined by trade arbitrators who have in the past demonstrated little, if any, expertise in macroeconomic matters.¹³

A likely adverse impact of free trade with the US, or for that matter free trade generally, is the reduction of international trade taxes due to reduction of tariffs on imports from the US. Government revenues in Eastern Caribbean countries are significantly dependent on import tariffs. These taxes, for example, represented about 58% of tax revenues in St. Kitts and Nevis during the 1990s. Eastern Caribbean countries are in a less fortunate position than Central American countries such as El Salvador, which was able to unilaterally reduce its tariffs and institute measures to improve the efficiency of collection of taxes such as value added taxes. Income and value added taxes are absent in many Eastern Caribbean countries, which would make the process of tax reform difficult and politically sensitive.

¹¹ "Canberra hopeful on trade talks www.ft.com.

¹² See IMF, "The Effects of Financial Globalisation on Developing Countries: Some Empirical Evidence" www.imf.org.

¹³ "A ban on capital controls is a bad trade-off" by Jagdish Bhagwati and Daniel Tarullo www.ft.com.

Bilateral free trade agreements have not been considered as effective means of liberalisation but rather as distractions from pursuing more meaningful liberalisation at the multilateral level. Political more than economic motives have been attributed to their pursuit. The need for security and to overcome vulnerability as well as the fear of being left outside of groupings such as NAFTA are seen as factors influencing the move towards bilateral FTAs.¹⁴ Caribbean countries are already a part of the process of creating the hemispheric FTAA. They are also engaged in the process of creating economic partnership agreements (EPAs) with the European Union as well as in the multilateral negotiations at the WTO. These countries may be small and vulnerable but there would seem to be little basis for them to pursue a free trade agreement with the US for political or security reasons.

A free trade arrangement between groupings like CARICOM or Central America and the US would serve as a catalyst to deepen economic integration among the countries in the group. The five Central American countries negotiating the US-CAFTA have different degrees of restriction on trade with each other, some relating to tariff barriers and others to customs regulations. Despite some progress towards a single market and economy restrictions remain on the movement of goods, services, labour and capital. It is not only a free trade arrangement with the US that would require CARICOM countries to intensify their integration process. Negotiations to liberalise trade at the multilateral and hemispheric levels would be facilitated by a more integrated region. The recent initiative of some Caribbean leaders (Trinidad and Tobago and Saint Vincent and the Grenadines, for example) to move towards political integration is a positive step that would enhance the strength of the regional market and hence the negotiating position of CARICOM.

To obtain net benefits from free trade arrangements CARICOM countries need to not only strengthen their cohesiveness in terms of deeper integration but also to learn from the experience of other countries and groupings that have concluded free trade agreements with the US as well as with other countries such as Canada and other groupings such as the European Union.

¹⁴ See “The challenge for the multilateral trade system” www.ft.com.

Annex

Standard International Trade Classification (SITC)

- 0 Food and Live Animals
- 1 Beverage and Tobacco
- 2 Crude Materials inedible except fuels
- 3 Mineral Fuels, Lubricants and related materials
- 4 Animal and Vegetable Oils, Fats and Waxes
- 5 Chemicals
- 6 Manufactured Goods classified chiefly by materials
- 7 Machinery and Transport Equipment
- 8 Miscellaneous Manufactured Articles
- 9 Commodities and Transactions not elsewhere stated