



The Dominican Republic-Central America-United States Free Trade Agreement (CAFTA-DR): Developments in Trade and Investment

J. F. Hornbeck

Specialist in International Trade and Finance

April 9, 2012

Congressional Research Service

7-5700

www.crs.gov

R42468

CRS Report for Congress

Prepared for Members and Committees of Congress

Summary

On August 5, 2004, the United States entered into the Dominican Republic-Central America-United States Free Trade Agreement (CAFTA-DR). Congress passed the implementing bill on July 28, 2005 (P.L. 109-53) and CAFTA-DR entered into force with El Salvador, Honduras, Nicaragua, and Guatemala by July 1, 2006, the Dominican Republic on March 1, 2007, and Costa Rica on January 1, 2009. This permanent, comprehensive, and reciprocal trade agreement eliminates tariff and non-tariff barriers to two-way trade, building on unilateral trade preferences begun under the 1983 Caribbean Basin Initiative (CBI). It enhances rules and other standards for services, intellectual property rights, government procurement, and investment, and other disciplines. It also reinforces Congress's historical support for trade as a foundation of broader foreign economic, political, and security policies in the region. This report supports congressional interest with an analysis of the trade and investment trends since CAFTA-DR entered into force.

CAFTA-DR reinforces trade and investment trends that have been emerging at least over the past decade. The United States remains the region's dominant trade partner, but its share of total trade has begun to decline. Intra-Central America trade and trade with China have seen the largest growth. Still, the United States (1) has vibrant trade in intermediate goods reflecting increasingly integrated production with the region; (2) provides the largest portion of foreign direct investment to the region; and, (3) remains the largest market for high-technology content exports. Because U.S. tariffs were already relatively low, the United States International Trade Commission model predicted that U.S. exports would rise slightly faster than imports, which so far has been the case.

One important indicator is the change in composition of trade. The United States has seen strong growth in exports of mineral fuels, machinery, cereals, yarns, and fabrics. Historically, the CAFTA-DR region has exported agricultural products and later apparel and other assembled goods to the United States. For over the past decade, more sophisticated and higher-value exports have grown, including specialized machinery goods (e.g., small aviation motors), electrical goods (e.g., integrated circuits), and medical equipment, while exports of light manufactures such as apparel have stagnated, or in some cases, declined. Agricultural trade has increased moderately and remains a combination of traditional exports (e.g., coffee and bananas) with little growth in higher value nontraditional goods (e.g., pineapple and sweet peppers).

These aggregate trends, however, mask important country differences. As examples of moving up the value chain, Costa Rica has increased nontraditional production in both its manufacturing and agricultural sectors, and so has experienced the largest growth in exports. Similarly, Nicaragua has begun to enter the assembly manufacturing sector and so experienced the second highest rate of trade growth. The other four countries have seen their exports stagnate or decline for multiple reasons, including dependence on the highly competitive apparel trade, lower levels of investment, public security problems, and broader governance and policy concerns.

CAFTA-DR reinforces the idea that growth in trade correlates closely with policies that promote economic stability, private investment in production, public investment in education, infrastructure, logistics, and good governance in general. Countries with worsening security and governance problems face additional problems in benefitting from CAFTA-DR. It is also important to promote productivity in part by avoiding delays in making necessary adjustments to trade liberalization, focusing public and private resources on trade facilitation, developing strategies for trade diversification, and examining CAFTA-DR trade rules (especially for textiles and apparel) that have perhaps inadvertently hindered trade growth expected from the accord.

Contents

Introduction.....	1
Background and Rationale for CAFTA-DR.....	1
CAFTA-DR Trade Rules	3
Apparel Rules.....	4
Agriculture Rules.....	4
Trends in CAFTA-DR Merchandise Trade.....	5
CAFTA-DR Direction of Trade.....	5
U.S.-CAFTA-DR Bilateral Trade	7
U.S. Exports by Country	8
U.S. Imports by Country	9
Composition of U.S.-CAFTA-DR Trade.....	10
Textiles and Apparel.....	12
Machinery and Other Manufacturing.....	12
Agriculture	13
Foreign Direct Investment in CAFTA-DR Countries.....	14
An Analysis of Trade and Investment Trends.....	15
Macroeconomic Factors	17
Microeconomic Factors	17
Doing Business Indicators.....	17
Logistics Performance Index.....	18
Security, Governance, Corruption, and Economic Freedom.....	19
Outlook and Issues for Congress	20

Figures

Figure 1. Map of Central America and the Caribbean.....	2
Figure 2. U.S.-CAFTA-DR Merchandise Trade, 2000-2011	7
Figure 3. U.S. Merchandise Exports to CAFTA-DR Countries (2000-2011).....	8
Figure 4. U.S. Merchandise Imports from CAFTA-DR Countries (2000-2011)	9
Figure 5. Direction of U.S.-CAFTA-DR Trade	10
Figure 6. Composition of U.S.-CAFTA-DR Trade.....	11
Figure 7. CAFTA-DR Countries: Net Foreign Direct Investment (2000-2011).....	15

Tables

Table 1. CAFTA-DR Direction of Trade	6
Table 2. Top U.S. Imports by CAFTA-DR Country and Sector, 2011.....	11
Table 3. CAFTA-DR Countries: Ease of Doing Business Rankings	18
Table 4. CAFTA-DR Countries: Logistics Performance Index (LPI) Ranking, 2010	19

Table 5. CAFTA-DR Countries: Rankings for Index of Economic Freedom, 2011 and
Corruption Perceptions Index, 2010 20

Table A-1. Real GDP Growth (%) 23

Table A-2. GDP Per Capita (PPP)..... 23

Table A-3. Inflation (%)..... 24

Table A-4. Current Account Balance (% of GDP)..... 24

Table A-5. Unemployment Rate (%) 25

Table A-6. Doing Business Indicators, 2011..... 25

Table A-7. U.S. Merchandise Exports to CAFTA-DR Countries, 2000-2011 25

Table A-8. U.S. Merchandise Imports from CAFTA-DR Countries, 2000-2011 26

Table A-9. Top U.S.-CAFTA-DR Trade Categories 26

Table A-10. International Hourly Wage Rates 27

Appendixes

Appendix. CAFTA-DR Country Economic Data 23

Contacts

Author Contact Information..... 27

Introduction

On August 5, 2004, the United States entered into the Dominican Republic-Central America-United States Free Trade Agreement (CAFTA-DR) with Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua, and the Dominican Republic (hereafter the CAFTA-DR countries). Congress engaged in a full year of debate before narrowly passing the implementing bill.¹ On July 28, 2005, after assurances from Bush Administration officials on many issues, the House approved it by a two-vote margin (217 to 215), followed by passage in the Senate (55-45), clearing the measure for presidential signature on August 2, 2005 (P.L. 109-53).² Implementing the agreement proved equally challenging and occurred on a rolling basis after each country made legal, regulatory, and rule changes to comply with the accord's obligations. CAFTA-DR entered into force with El Salvador, Honduras, Nicaragua, and Guatemala by July 1, 2006, the Dominican Republic on March 1, 2007, and Costa Rica on January 1, 2009.

This report follows up on congressional interest by providing an analysis of the trends in trade and investment since CAFTA-DR entered into force six years ago. Changes in rules governing issues such as intellectual property rights, government procurement, services, labor and others are not easily measured and will require a longer-time frame to evaluate. The report concentrates on trends in all countries, with close attention paid to the CAFTA-DR partner economies. The marginal effects on the U.S. economy are expected to be small by comparison because the CAFTA-DR countries are economically about the size of the Denver metropolitan area, and they already had duty-free access to the U.S. market under various unilateral preference programs.³

Background and Rationale for CAFTA-DR

Historically, the United States has entered into free trade agreements (FTAs) and unilateral trade preference programs with developing countries in the pursuit of both economic and foreign policy goals. In 1983, the U.S. Congress passed the Caribbean Basin Initiative (CBI—formally the Caribbean Basin Economic Recovery Act—P.L. 98-67) to support political and economic stability in the Caribbean at a particularly vulnerable time (see **Figure 1**, Map of Central America and the Caribbean). The CBI included limited unilateral trade preferences, which required periodic congressional reauthorization. CAFTA-DR builds on this precedent, but makes preferential access comprehensive, reciprocal, and permanent while also enhancing rules and other disciplines on trade. It is intended to strengthen economic relations as a way to stimulate growth, to foster stability, and, in the words of Congress, “to lay the foundation for further cooperation.”⁴

¹ U.S. Congress, House Ways and Means, *Dominican Republic-Central America-United States Free Trade Agreement Implementation Act*, Report together with Additional and Dissenting Views, 109th Cong., 1st sess., July 25, 2005, H.Rept. 109-182 (Washington: GPO, 2005), pp. 26-27 and 46-52.

² “Central American Trade Accord Just Squeaks Through,” *Congressional Quarterly Almanac Plus 2005*, vol. LXI (2005), pp. 17-3 through 17-5.

³ Irena Asmundson, Thomas Dorsey, Armine Khachatryan, Ioana Niculcea, and Mika Saito, *Trade and Trade Finance in the 2008-09 Financial Crisis*, International Monetary Fund, IMF Working Paper WP/11/16, Washington, D.C., January 2011, pp. 4, 29-30.

⁴ 119 Stat. 463. The Dominican Republic-Central America-United States Free Trade Agreement Implementation Act, sec. 2(4).

Figure I. Map of Central America and the Caribbean



Source: CRS.

The economic rationale rests on preferential access for agricultural and manufactured goods produced in the region. By removing regional barriers to trade, CAFTA-DR encouraged the development of specialized co-production in assembly manufacturing between the United States and CAFTA-DR countries based on comparative advantage and economies of scale. This strategy has increased the productivity (a major benefit of trade) of firms in all countries. Firm competitiveness rests on value-added supply chain relationships, particularly in the area of apparel manufacturing, later extended to automobile parts, medical equipment, integrated circuits, and other products. Tariff preferences under CAFTA-DR (and CBI previously) have helped firms remain marginally competitive with Asian and other low-cost global producers.⁵

By moving from limited unilateral trade preferences to comprehensive bilateral free trade under CAFTA-DR, U.S. exporters also stood to benefit from reduced trade barriers, both for final goods and the increasingly large intermediate goods trade characteristic of the supply chain model. Market access, therefore, was central to the FTA negotiations. Equally important for the United States were enhanced rules covering multiple disciplines including trade in services, intellectual property rights, sanitary and phytosanitary regulations, investment, government procurement, labor, and environment, among others. From the Central American and Dominican perspectives, permanently reducing barriers to the U.S. market was the core objective, assuring investors that exports would have permanent duty-free access to the large U.S. market, while ensuring lower-cost imports (including capital and intermediate goods) for consumers and producers alike.

⁵ Alejandro Izquierdo and Ernesto Talvi, *One Region, Two Speeds? Challenges of the New Global Economic Order for Latin America and the Caribbean*, Inter-American Development Bank, Washington, D.C., March 2011, pp. 42-44.

Increased trade can raise a country's long-term growth rate through multiple channels including increased market size, production specialization, scale economies, transfer of technology and managerial/worker expertise, more efficient resource use, and increased investment.⁶ With these factors in mind, the agreement takes on an added importance given the dominant role of the U.S. economy for the CAFTA-DR countries.

Market access in a reciprocal trade agreement works both ways, however, so countries also face certain challenges. In the United States, CAFTA-DR raised concerns over negative effects on import-competing firms. This is often part of the cost inherent in a free trade agreement, though it is expected to be small relative to the U.S. economy as a whole. For CAFTA-DR countries, U.S. agricultural exports, including staples such as corn and rice, increasingly compete with local production of basic grains. A transition period was built in with an extended tariff phase-out schedule and safeguards as a partial response to this concern. As a matter of development policy, however, CAFTA-DR countries also envision diversifying agricultural sectors into higher value nontraditional exports, and integrating rural economies more deeply with other sectors. CAFTA-DR's success will in part be judged by how well this transition is made, and so far, results have not been uniform among the six countries.

CAFTA-DR Trade Rules

Market access is at the center of free trade agreements and refers to provisions that govern barriers to trade such as tariffs and quotas. Rules of origin determine which goods are eligible for tariff preferences based on their regional content, and are particularly relevant for textile and apparel trade. CAFTA-DR requires that each country accord national and most favored nation treatment (non-discrimination) to all parties. The FTA also replaces and consolidates in a permanent bilateral agreement trade preferences formerly extended unilaterally under the Generalized System of Preferences (GSP), the Caribbean Basin Economic Recovery Act (CBERA), and the Caribbean Basin Trade Partnership Act (CBTPA).⁷

CAFTA-DR calls for the progressive elimination of nearly all customs duties. Each country negotiated a list of its most sensitive products for which duty-free treatment is delayed, including separate provisions for certain apparel and agricultural products. For non-textile manufactured goods, duties on 80% of U.S. exports were eliminated immediately, with the rest phased out over a period of up to 10 years.⁸ For agricultural goods, duties on over 50% of U.S. exports were eliminated immediately, with the rest phased out over a period of up to 20 years. In some cases, duty-free treatment is "back loaded," meaning it will not begin for 7 years or more after the agreement takes effect. For the CAFTA-DR countries, 100% of non-textile and non-agricultural goods began to enter the United States duty free upon implementation. Safeguards are retained for certain agriculture and textile goods over the period of duty phaseout, but antidumping and

⁶ Cesar Calderona and Virginia Poggio, *Trade and Economic Growth: Evidence on the Role of Complementarities for CAFTA-DR Countries*, The World Bank, Policy Research Working Paper 5426, Washington, D.C., September 2010, pp. 3-5.

⁷ The CAFTA-DR countries have been reclassified as non-beneficiary countries for purposes of these trade preference programs, as set out in the Dominican Republic-Central America-United States Free Trade Agreement Implementation Act (P.L. 109-53).

⁸ U.S. International Trade Commission, *U.S.-Central America-Dominican Republic Free Trade Agreement: Potential Economywide and Selected Sectoral Effects*, Publication 3717, Washington, D.C., August 2004, p. 25.

countervailing duties were not addressed in the CAFTA-DR, leaving all U.S. and other country trade remedy laws fully enforceable under the World Trade Organization (WTO).

Apparel Rules

CAFTA-DR apparel enters the United States under a “yarn forward rule,” with some exceptions, building on the standard developed for the region under the CBTPA in 2001. Yarn production and all operations that follow, from fabric production through cutting and apparel assembly, must be done in either the United States or a CAFTA-DR country, if the good is to qualify for duty-free treatment.⁹ From 2008 to 2011, 82% of qualifying textile and apparel imports from CAFTA-DR countries entered the United States under this rule.¹⁰

There are numerous exceptions including the “cut and assemble” rule, which allows for use of third country inputs (typically lower-cost Asian yarns and fabrics) for certain specified goods provided they are cut and assembled in a CAFTA-DR country. A de minimis rule permits duty-free entry of goods in which up to 10% of the weight of the fibers and yarns may come from third country sources. Separate rules (tariff preference levels—TPLs) for Nicaragua and Costa Rica allow for specified quantities of duty-free apparel imports that may be assembled from limited amounts of third country materials. A “short supply” list allows for use of fibers, yarns, and fabrics from third countries when not available in commercial quantities in the region, and CAFTA-DR allows for “cumulation” or the use of inputs from the various countries within the region, with limitations on the use of Mexican yarns and fabrics for wool, denim, cotton, and man-made fiber. Other exceptions exist for hand-loomed fabric of a cottage industry, folklore handicrafts, and other products. A “fabric-forward” rule allows for wool yarn from third countries to be used in certain textile and apparel goods and more detailed rules exist for specific cases of apparel manufacturing. Another 15% of qualifying imports entered duty free under these rules.¹¹

Agriculture Rules

Under agriculture, domestic support programs are not addressed in the CAFTA-DR, which focuses instead on reducing tariffs and defining quota levels, the most costly trade-distorting policies. Average applied tariffs on agricultural goods by most CAFTA-DR countries range from 7% to 23%. Most agricultural imports face no tariff in the United States. But for select products in all countries, the pressing challenge was negotiating tariff rate quotas (TRQs—see below), or limits on the quantity of imports that can enter the United States before higher tariffs are applied. Tariffs for sensitive agricultural products have the most generous phase-out schedules, with up to 20 years for some products (e.g., rice and dairy). This approach acknowledges that the agricultural sectors bear most of the trade adjustment costs and so are given more time to make the transition to freer trade.¹²

⁹ U.S. Department of Commerce, International Trade Administration, Office of Textiles and Apparel, *Free Trade Agreements: Summary of the U.S.-Dominican Republic-Central America Free Trade Agreement (CAFTA-DR)*. <http://web.ita.doc.gov>.

¹⁰ Non-qualifying (dutiabale) goods comprised 22% of apparel and textile imports in 2008 and fell to 14% in 2011.

¹¹ U.S. Department of Commerce, International Trade Administration, Office of Textiles and Apparel, *Free Trade Agreements: Summary of the U.S.-Dominican Republic-Central America Free Trade Agreement (CAFTA-DR)*. <http://web.ita.doc.gov>.

¹² Salazar-Xirinachs, Jose M. and Jaime Granados. *The US-Central America Free Trade Agreement: Opportunities and (continued...)*

All agricultural trade eventually becomes duty-free except for sugar imported by the United States, fresh potatoes and onions imported by Costa Rica, and white corn imported by the other Central American countries. These goods will continue to be subject to quotas that will decrease by approximately 2% each year in perpetuity, with no decrease in the size of the above-quota tariff.¹³ Over half of current U.S. farm exports to Central America became duty free upon implementation, including cotton, wheat, soybeans, certain fruits and vegetables, processed food products, wine, and high quality cuts of beef.

Trends in CAFTA-DR Merchandise Trade

Following is a discussion of the major trends in merchandise trade from 2000 to 2011. For comparative purposes, this encompasses a period of time before and after the agreement entered into force. It is a starting point for raising questions over the possible effects of CAFTA-DR.

CAFTA-DR Direction of Trade

There have been three major changes in the direction of CAFTA-DR trade over the last decade, including the period of time the agreement has been in force:

- first, although the United States remains the CAFTA-DR countries' dominant trade partner, U.S. trade has fallen relative to other countries;
- second, trade with China and Mexico has increased; and
- third, intra-Central America trade and integration has increased and deepened.¹⁴

As seen in **Table 1**, in 2000, the United States accounted for 73% of CAFTA-DR exports and 55% of its imports. By 2010 (latest available data), these figures had fallen to 43% and 46%, respectively, the decline occurring in all CAFTA-DR countries. From 2000 to 2010, exports to China rose from near zero to 6% of CAFTA-DR exports, and the import share increased from 2% to 7%. Intra-Central America trade rose from 2% to 11% of the region's exports, with imports climbing similarly, making Central America, in the words of one analysis, the hemisphere's "region that trades the most with itself."¹⁵

CAFTA-DR plays a supporting, rather than leading, role in these evolving trade patterns. The rise in exports to China, for example, is accounted for entirely by Costa Rican semiconductor exports. Increased intra-Central American resulted from a long-sought effort to deepen subregional integration. In addition to CAFTA-DR, the effort came to fruition with the signing of the Mexico-Central America Free Trade Agreement on November 22, 2011.¹⁶ The deepening integration

(...continued)

Challenges, In: Schott, Jeffrey J. ed. *Free Trade Agreements: US Strategies and Priorities*, Washington, D.C. Institute for International Economics, 2004, pp. 245-46.

¹³ See CRS Report RL32110, *Agriculture in the U.S.-Dominican Republic-Central American Free Trade Agreement (DR-CAFTA)*, by Remy Jurenas.

¹⁴ There is little trade between the Dominican Republic and Central America.

¹⁵ International Monetary Fund, *Regional Economic Outlook: Western Hemisphere - Watching Out for Overheating*, Washington, D.C., April 2011, p. 20.

¹⁶ Revista Summa, "Firma de TLC Único entre México y Centroamérica Busca Potenciar Comercio e Inversión," (continued...)

resulted in a nearly four-fold increase in Mexico-Central America trade over the past decade that is in part supported by the supply chain relationships that U.S. and other firms have developed in the Caribbean, Central America, and Mexican economies (particularly in automobile, apparel, and computer electronics industries).¹⁷

Table I. CAFTA-DR Direction of Trade
(in percent)

	2000	2005	2010	2000	2005	2010
	CAFTA-DR Exports			CAFTA-DR Imports		
United States	73.3	53.0	42.6	54.5	44.0	45.5
European Union	17.2	16.4	18.3	12.3	9.8	7.8
CAFTA-DR	1.5	11.6	10.9	2.6	11.7	12.5
Mexico	1.6	4.5	5.4	7.7	7.5	8.4
China	0.0	3.2	6.1	1.8	3.7	6.8
Asia (excluding China)	3.6	5.2	8.8	13.1	8.7	7.5
Other	2.8	6.1	7.9	8.0	14.6	11.5
Total	100.0	100.0	100.0	100.0	100.0	100.0

Source: CRS calculations based on U.S. Department of Commerce data reported in Global Trade Atlas. 2010 is the most recent data available for this series.

CAFTA-DR reinforces regional integration with rules of origin that allow greater cumulation of production between Central American and Mexican producers using U.S. inputs. With increased harmonized rules of origin, the region becomes globally more competitive by increasing co-production relationships, reducing delays at the border, and allowing for greater economies of scale in production. New cumulation rules also allow for U.S. duty-free treatment of imports assembled from inputs produced in Central America or Mexico.

This relationship is evident in the production of integrated circuits, automobile parts, and apparel, in which the United States ships parts from all these industries to the region for further processing. For example, Mexico imports integrated circuits from Costa Rica, apparel from Guatemala, and wire harness sets for automobiles from Nicaragua, all transformed from U.S. inputs. These goods are used for assembly of computers, apparel, and automobiles for export to the United States and elsewhere in Latin America. Similarly, fabric produced in the United States, the Dominican Republic, Honduras, and Guatemala is used in apparel production in many of the CAFTA-DR countries, with final goods receiving duty-free treatment when they enter the United States. So unlike previous commodity-driven export growth, much of region's trade reflects global supply chain manufacturing related to U.S. production and global consumption.

(...continued)

November 22, 2011, <http://www.revistasumma.com>. And Inter-American Development Bank, "Progress in Central American Domestic and Foreign Integration Agendas," *INTAL Monthly Newsletter 169*, September 2010.

¹⁷ United States International Trade Commission, "Chapter 3: Global Supply Chains," in *The Economic Effects of Significant U.S. Import Restraints*, Washington, D.C. 2011, p. 12.

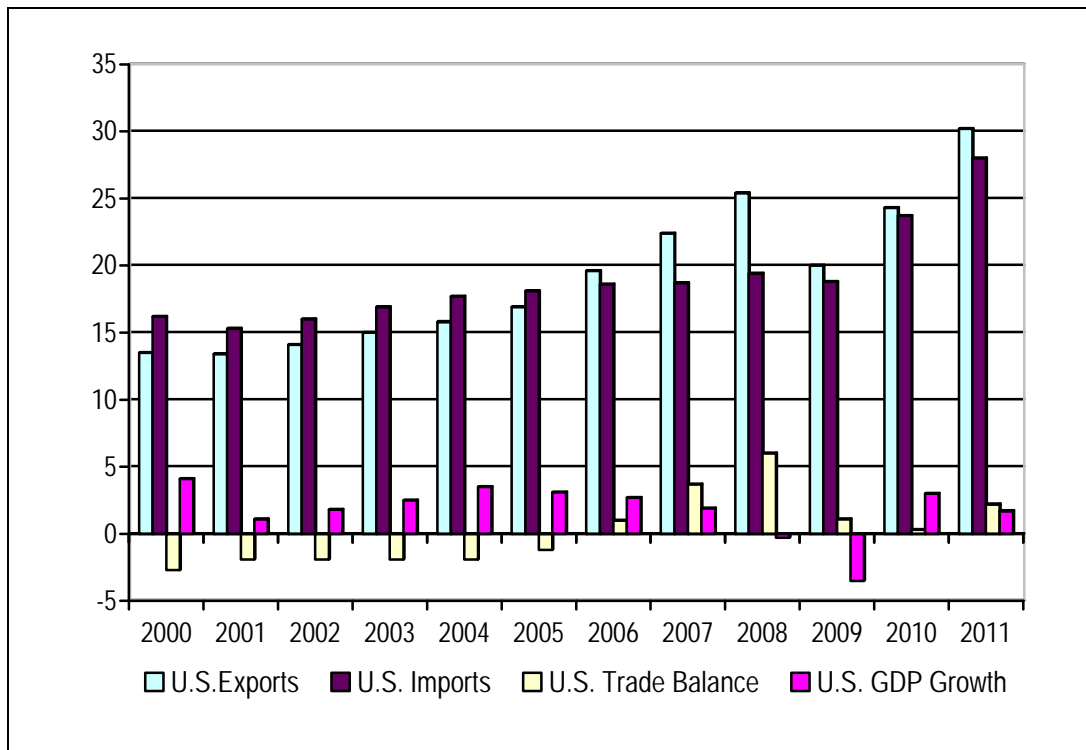
In addition, analysis of the technology content of CAFTA-DR country exports suggests that the agreement supports the trend of the United States being the largest market for technology-enhanced exports, ranging from low-technology apparel to high-technology medical equipment and integrated circuits. Exports from Costa Rica and the Dominican Republic have the highest concentration of technology intensiveness, Guatemala and Nicaragua the lowest. The potential for future benefit from technology-enhanced exports is uncertain, however, given the need for CAFTA-DR countries to increase productivity and adopt complementary policies to become more globally competitive and take fuller advantage of the trade agreement.¹⁸

U.S.-CAFTA-DR Bilateral Trade

Aggregate U.S.-CAFTA-DR bilateral trade is presented in **Figure 2**. Two trends dominate:

Figure 2. U.S.-CAFTA-DR Merchandise Trade, 2000-2011

(in U.S. \$ billions)



Source: CRS from U.S. Department of Commerce data.

- Trade and U.S. economic growth trend together, reflecting only modest growth for much of the decade until the 2010 recovery from the global recession; and,

¹⁸ Paolo Giordano, *Desarrollo Exportador y Tecnológico: el aprovechamiento del RD-CAFTA*, Inter-American Development Bank, Washington, D.C., 2010 and Kevin Casas-Zamora, *The Travails of Development and Democratic Governance in Central America*, The Brookings Institution, Policy Paper Number 28, Washington, D.C., June 2011, pp. 10-12.

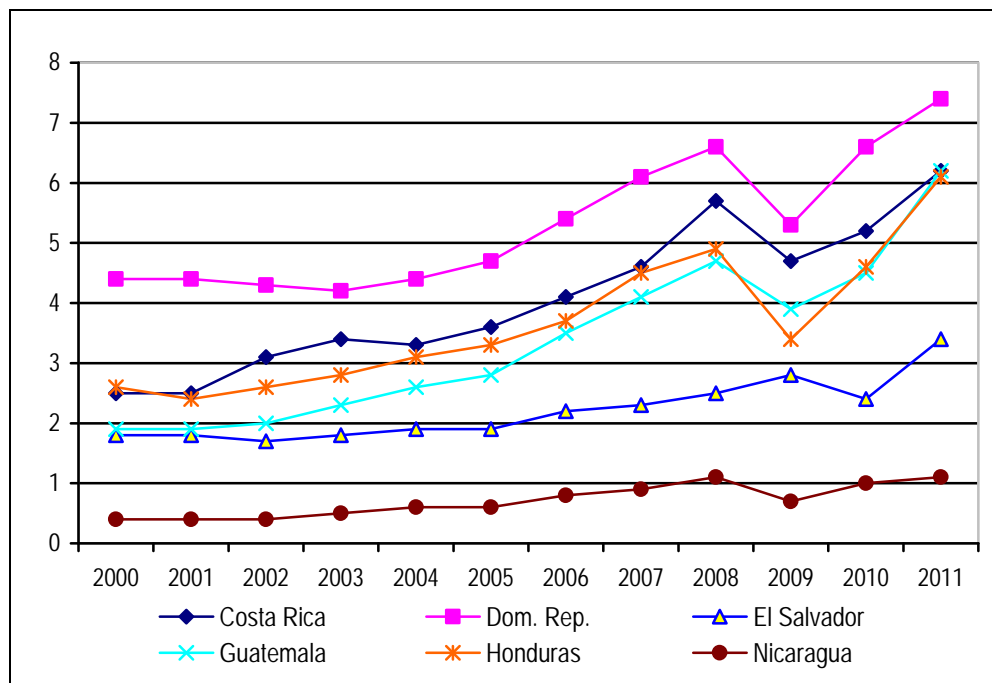
- Growth in U.S. exports has outpaced U.S. imports, resulting in a U.S. trade surplus each year since CAFTA-DR entered into force.

U.S. demand is a key factor defining trade growth, influencing both imports and exports because of significant intra-industry trade.¹⁹ Also, because a large portion of CAFTA-DR exports entered the United States duty free prior to implementation of the agreement, the United States International Trade Commission (USITC) model predicted that the marginal trade effects of the accord would be a relatively larger increase in U.S. exports, as appears to be the case, so far.

U.S. Exports by Country

Figure 3 shows the value of U.S. exports by country, reflecting a modest, but upward trend for all countries except during the 2008-2009 global recession. In recent years, the trend in U.S. export growth has been skewed by the rise in price and volume of refined petroleum products, which on a value basis increased from 3.2% of total exports to the region in 2000 to 23.7% in 2011.

Figure 3. U.S. Merchandise Exports to CAFTA-DR Countries (2000-2011)
(in U.S. \$ billions)



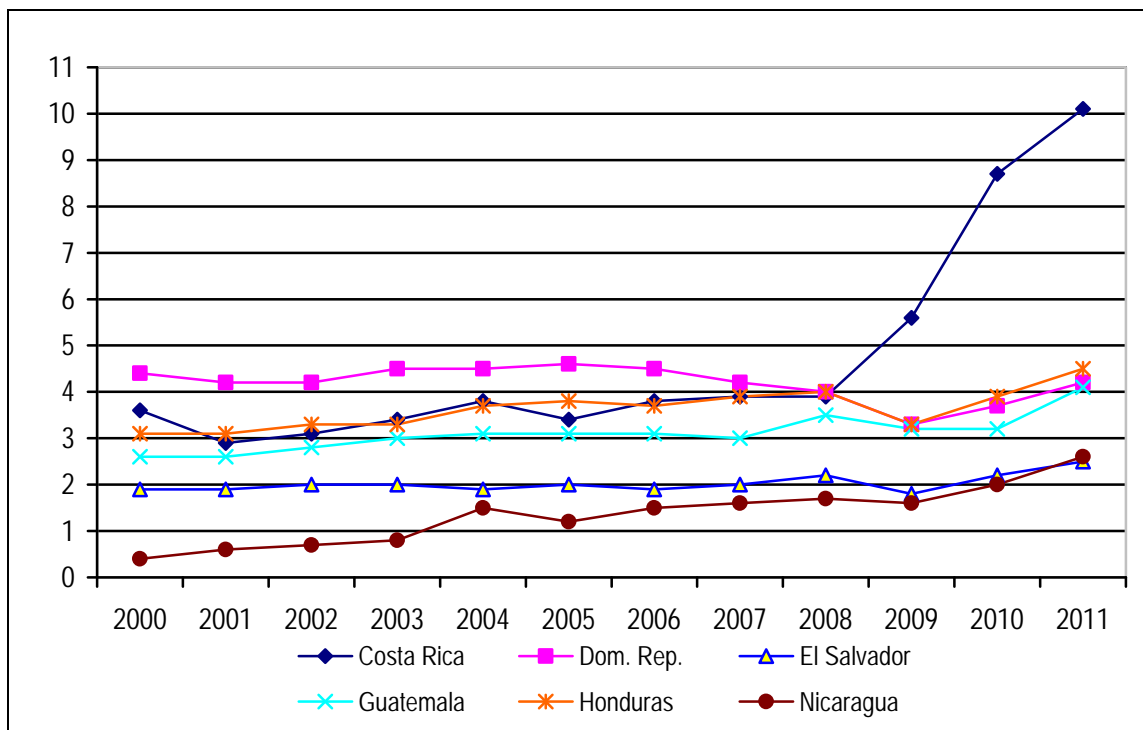
Source: CRS from Global Trade Atlas data.

¹⁹ Estimates of the co-movement between business cycles are tested econometrically in Dominique Desruelle and Alfred Schipke, *Central America: Economic Progress and Reforms*, International Monetary Fund, Washington, D.C., 2008, pp. 34-35 and 49-52. In fact, the correlation is even stronger when CAFTA-DR growth is compared to U.S. industrial production, which depends even more than the U.S. economy as a whole on imported (intermediate) goods. See, Andrew Swiston, *Spillovers to Central America in Light of the Crisis: What a Difference a Year Makes*, International Monetary Fund, Working Paper WP/10/35, Washington, D.C., February 2010, pp. 4, 14, 25-28, and 32.

U.S. Imports by Country

U.S. imports from CAFTA-DR countries reflect demonstrably different trends since 2000. As seen in **Figure 4**, there has been little real growth in U.S. imports from the region in most cases. Interestingly, in percentage terms, U.S. imports have also grown the most from Costa Rica and Nicaragua, the richest and poorest CAFTA-DR countries, respectively, whereas U.S. imports from the other four countries have shown much slower growth, with the Dominican Republic actually registering a decline.

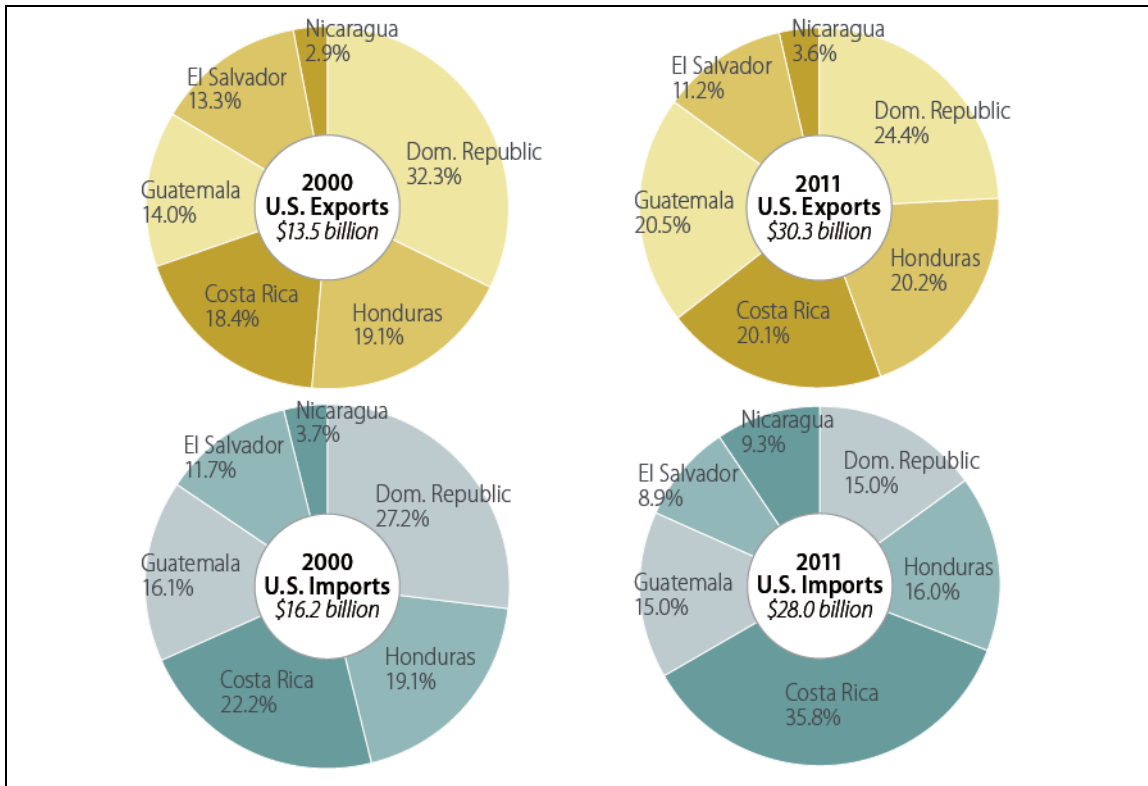
Figure 4. U.S. Merchandise Imports from CAFTA-DR Countries (2000-2011)
(in U.S. \$ billions)



Source: CRS from Global Trade Atlas data.

These trends are also seen in **Figure 5**, which compares the relative position of each CAFTA-DR country with respect to U.S. imports and exports in 2000 and 2011. As may be seen, most countries that experienced a relative increase or decline in U.S. exports between these two years also experienced a similar increase or decline in U.S. imports (another indication of importance of intra-industry trade common in the manufacturing sector). Costa Rica accounted for 36% of U.S. imports from the region in 2011, up from 22% in 2000 and Nicaragua's portion rose from 4% to over 9%. The remaining four countries experienced a counterbalancing decline in their share of U.S. imports, particularly the Dominican Republic.

Figure 5. Direction of U.S.-CAFTA-DR Trade
(in percent)



Source: CRS from U.S. Department of Commerce data as presented in Global Trade Atlas.

Composition of U.S.-CAFTA-DR Trade

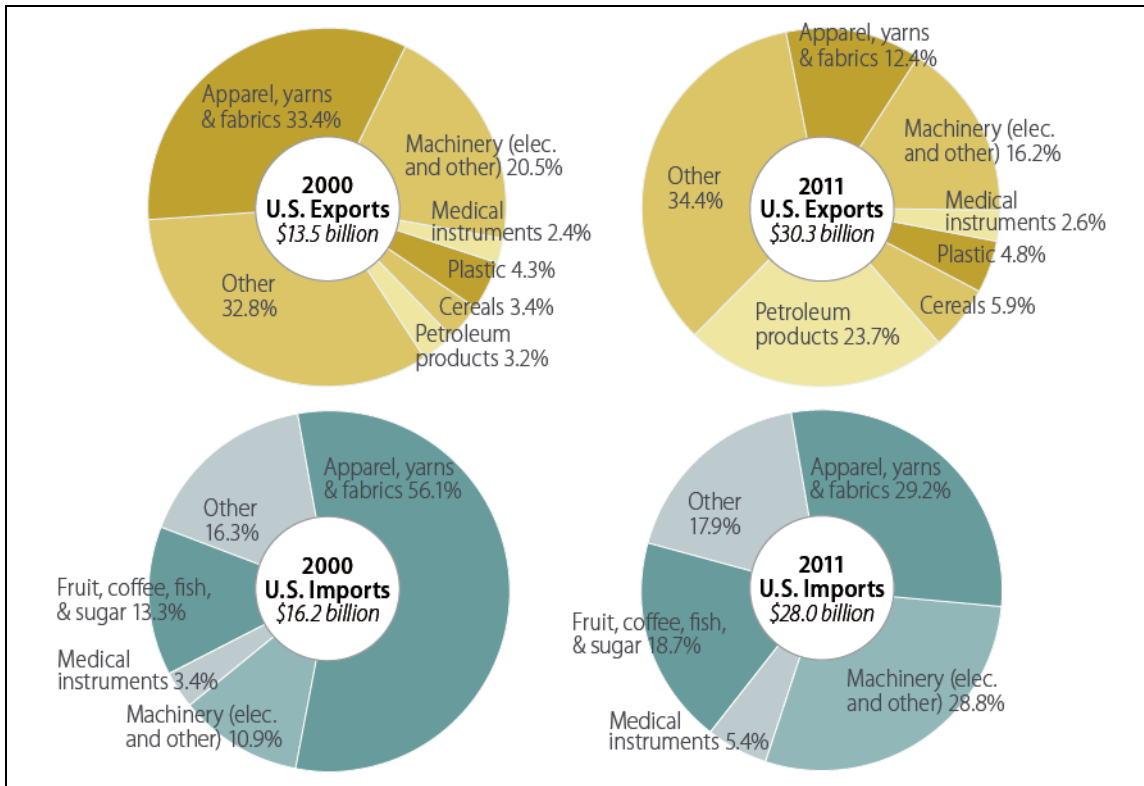
Examining the trade data at the product level provides shows changes in the composition of U.S. trade among these countries. This focus also points to the possible development aspects of trade liberalization to the extent that the value added of a country’s exports increases by transitioning away from traditional to nontraditional, and from low-tech to high-tech intensive products.

Figure 6 compares the composition of U.S.-CAFTA-DR trade for the years 2000 and 2011. Product groups have been combined by Harmonized Tariff System (HTS) codes to provide an indication of broad trends in trade composition. The first category is defined as apparel, yarns, and fabrics. It includes knit, woven, and footwear goods plus yarns and fabrics (HTS 52, 55, 60, 61, 62, 63, and 64). The second category comprises electrical and non-electrical machinery products (HTS 85 and 84). The third category constitutes agriculture products such as fish, vegetables, fruit, coffee, sugar, and tobacco (HTS 03,07, 08, 09, 17, and 24). Finally, optical and medical equipment capture imports of HTS 90.

Key trends from **Figure 6** and **Table 2** include:

- the structure of U.S. exports has not shifted dramatically, with the notable rise in the value of petroleum products;
- U.S. imports have shifted from apparel to higher value-added manufactures;

Figure 6. Composition of U.S.-CAFTA-DR Trade
(in percent)



Source: CRS from U.S. Department of Commerce data as presented in Global Trade Atlas.

- Costa Rica stands alone as a non-apparel, high tech exporter;
- Honduras, El Salvador, and Nicaragua export large amounts of low tech apparel;
- Guatemala splits major exports between agriculture and apparel; and,
- the Dominican Republic has the most diversified export structure with medical manufactures, mining, apparel, and processed agricultural goods.

Table 2. Top U.S. Imports by CAFTA-DR Country and Sector, 2011
(as percent of total U.S. imports from each country)

Sector	Costa Rica	Dominican Republic	El Salvador	Guatemala	Honduras	Nicaragua
Textiles/Apparel	1.6%	20.5%	70.7%	32.0%	60.0%	52.8%
Elec./other machinery	66.2%	12.8%	1.1%	0.3%	10.0%	13.5%
Optical/Med. Equip.	8.8%	14.2%	0.0%	0.2%	0.0%	0.0%
Agriculture	12.7%	14.1%	12.9%	41.7%	17.5%	18.3%
Precious Metals	0.9%	12.9%	3.9%	8.8%	4.6%	2.9%

Source: Analysis by CRS. Data from U.S. Department of Commerce in Global Trade Atlas.

Textiles and Apparel

From 2000 to 2011, aggregate U.S. exports of apparel, yarns, and fabrics declined from 33.4% to 12.4% of total U.S. exports to the CAFTA-DR countries. Although all categories declined, it was particularly steep for knit and woven apparel parts shipped for further assembly. Basic fibers, yarns, and fabrics declined as well, but less in relative terms. This relative shift away from apparel exports towards more yarn and fabric suggests that more of the production process (e.g., computerized design and cutting) is being done in the CAFTA-DR countries.

Similarly, although apparel is still the largest U.S. import sector in 2011, capturing 30.4% of total merchandise imports from the region, this is notably smaller than the 56.1% of 2000. Apparel rules under CAFTA-DR are intended to support trade from the region. To qualify for duty-free treatment, most apparel enters under a yarn forward rule. Nonetheless, the decline in apparel as a percentage of total U.S. imports from the region coincides with the growing U.S. import penetration from Asian and other low-cost producers, and may be seen in the slowed growth of U.S. imports from the major apparel producers: Honduras, El Salvador, and Guatemala. These countries are vulnerable to competition from lower-wage countries and without a shift in investment to higher value-added production, they may continue to see limited growth in their exports to the United States, despite preferential access accorded apparel under CAFTA-DR.

By contrast, U.S. imports in general from Costa Rica and Nicaragua have shifted for two very different reasons. With the exception of some specialty high-end products, Costa Rica, the most developed of the CAFTA-DR countries, has ceded the apparel trade to other countries. It has shifted to other higher value-added goods. Nicaragua, the poorest and least developed of the group, is expanding into apparel exports to the United States for two reasons in particular. First, it is the beneficiary of CAFTA-DR tariff preferences levels (TPLs), which allow Nicaragua to export apparel goods assembled from limited amounts of third country materials (e.g., less expensive Asian yarns). Second, relatively low wages in Nicaragua mean its firms are still competitive with those in Asian countries for the lower-skilled sector of the industry (see **Table A-10**, International Hourly Wage Rates, in the **Appendix**). The Dominican Republic appears to be in transition, moving away from apparel except for footwear, as seen in its diversified export structure.

Machinery and Other Manufacturing

Machinery and electrical machinery goods, by contrast, display a different pattern. U.S. exports in this group have declined from 20.5% to 16.2% as a percentage of total exports, from 2000 to 2011, but have continued to grow in dollar terms at a modest rate. U.S. imports, however, have grown dramatically, from 10.9% of total imports in 2000 to 28.8% in 2011. In addition, U.S. imports in the medical instruments category have also grown, the more technology-intensive products coming from Costa Rica and the Dominican Republic.

One key factor is Costa Rica's so-called "Intel Effect," as seen in the country's strong growth in exports despite the global recession. It points to the transformation of the Costa Rican economy away from not only traditional agricultural exports, but traditional apparel manufacturing as well. Costa Rica has moved toward more sophisticated manufacturing processes involving integrated circuits, medical equipment, and machine parts (e.g., specialized aviation motors) destined for the U.S. market and based on U.S. inputs. In addition, as a matter of policy, Costa Rica has identified

and encouraged the development of related industries, such as specialized packaging for electronics goods that previously had been contracted to foreign suppliers.²⁰

Although still dependent on agriculture, Nicaragua also deserves a special note for transitioning to assembly-type manufacturing, including wire harnesses for automobiles. Nicaragua is the poorest country in Central America, but appears to be undergoing economic transformation, moving into low-skilled assembly manufacturing even as Costa Rica exits the industry. In both cases, these are signs of economic development. U.S. import data for the Dominican Republic reflect a sharp decline in apparel, except for footwear, falling from 55% of total U.S. imports in 2000 to 17% in 2011 (data not shown). At the same time, there has been an increase in imports of medical equipment and other manufactures, perhaps indicating the country may also be undergoing transition in economic production.

Agriculture

The United States has experienced strong growth in agricultural exports since CAFTA-DR entered into force. Cereals account for only 6% of U.S. exports, but have increased from \$508 million in 2000 to \$768 million in 2005 and \$1,800 million in 2011. Corn represents over half of the cereals exports in 2011, followed by wheat and rice. Meat exports increased from \$60 million in 2000 to \$91 million in 2005 and \$290 million in 2011, a three-fold increase since the FTA was implemented. Agricultural exports may be expected to rise further as the phased-in tariff reductions continue to be implemented over time.

In the aggregate, U.S. imports of agriculture from the CAFTA-DR region have grown modestly from 2000 to 2011, rising from 10.9% to 15.5% of total U.S. imports. Costa Rica has experienced a decline in total agricultural exports to the United States, but has distinguished itself again in making the transition to more value-added, nontraditional agriculture exports, particularly pineapple. The Dominican Republic has seen little agricultural export growth except for sugar and tobacco, and Guatemala, Nicaragua, and Honduras have seen slight increases in fruit, fish, and specialized coffee exports, demonstrating some shift in production to nontraditional exports. A key problem has been the limited ability to make the transition to nontraditional exporting more fully, reflecting a need for further structural reforms and support for the sector in order for agriculture to take greater advantage of CAFTA-DR.²¹

There is an ongoing debate over CAFTA-DR's effects on small agricultural producers in the region. Early estimates suggested that overall increased agricultural trade could be an important source of rural development. In addition to increasing CAFTA-DR country agricultural exports, the majority of households are net consumers of agricultural goods and stand to gain from lower prices, the equivalent to an increase in family income. Because subsistence farmers' generally produce little for sale, they are unlikely to be greatly affected by changes in market prices.²²

²⁰ Discussion with officials in San José, Costa Rica, September 2010. This is a modern example of "backward linkages" in which export-led growth in one industry promotes new upstream and downstream industries when economies of scale encourage investment. For a discussion, see Dwight H. Perkins, Steven Radelet, and David L. Lindauer, *Economics of Development, Sixth Edition* (New York: W. W. Norton & Company, 2006), pp. 661-668.

²¹ USAID, *Optimizing the Economic Growth and Poverty Reductions Benefits of CAFTA-DR*.

²² Todd, Jessica, Paul Winters, and Diego Arias. *CAFTA and the Rural Economies of Central America: A Conceptual Framework for Policy and Program Recommendation*, Inter-American Development Bank. Washington, D.C. December 2004. pp. 43-50, Andrew D. Mason, "Chapter 5," in *Ensuring that the Poor Benefit from CAFTA: Policy* (continued...)

Still, some small producers of agricultural goods may be harmed,²³ and many economists argue that adjustment policies are necessary to increase productivity in this segment of agricultural producers. The tariff transition period is intended to provide space to do this. The alternative is to protect certain industry groups, by maintaining artificially high domestic prices, while delaying and making more difficult necessary competitive adjustment, a deficient strategy often associated with Mexico under the North American Free Trade Agreement (NAFTA).²⁴ It may be a problem for certain CAFTA-DR industries as well. Costa Rica, for example, supports domestic rice production with subsidies and price controls, delaying and perhaps eventually compounding the adjustment that will be needed as the tariff rate quotas for U.S. rice phase out over 20 years.

Foreign Direct Investment in CAFTA-DR Countries

FTAs are often considered as much about investment as trade, and foreign direct investment (FDI) is one measure of a country's foreign attractiveness. An FTA can encourage FDI through two channels. First, permanent preferential access to the U.S. market reassures potential investors that access to the largest market is more stable. Second, enhanced investment rules protect investors.²⁵ Investment is a critical component of a country's economic growth and development, and where domestic savings rates are low, or opportunities are readily apparent, FDI is one way to meet demand for capital. There are potentially many economic benefits to FDI, although their realization depends on where and how FDI is invested, and the policies governing its use. In general, however, there appears to be broad recognition that the benefits of FDI outweigh the costs in most cases for developing countries.²⁶

Trends in FDI vary among the six CAFTA-DR countries and total net foreign direct investment is shown in **Figure 7**, with the United States the largest investor in the region. Trends suggest that a formal investment agreement alone is not sufficient to guarantee uniform results. Three trends stand out:

(...continued)

Approaches to Managing the Economic Transition (Washington, D.C.: The World Bank, 2005), pp. 25-26, 35, and Arce, Carlos and Carlos Felipe Jaramillo. *El CAFTA y la Agricultura Centroamericana*. Paper presented at the World Bank Regional Conference on International Trade and Rural Economic Development, Guatemala. February 21-22, 2005. p. 17.

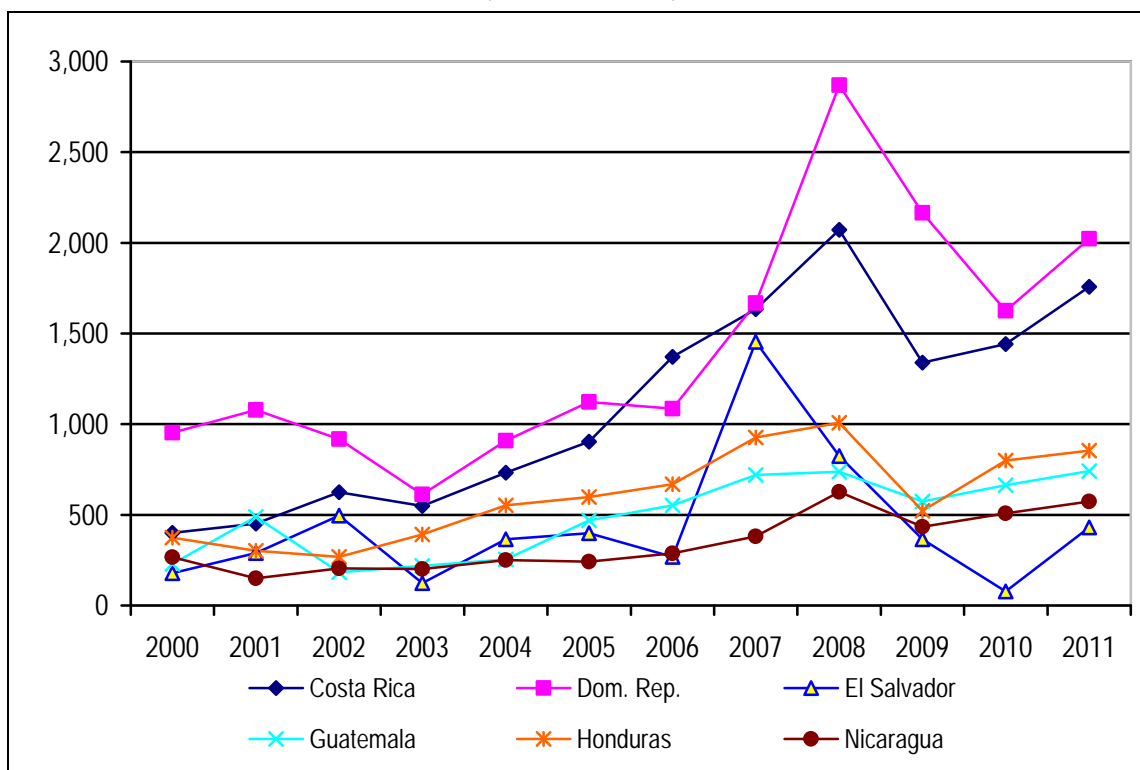
²³ Oxfam International, *A Raw Deal for Rice Under CAFTA-DR*. Briefing Paper #68, 2004.

²⁴ Bathrick, David D., *Optimizing the Economic Growth and Poverty Reduction Benefits of CAFTA-DR: Accelerating Trade-Led Agricultural Diversification, Executive Summary*, United States Agency for International Development, Washington, D.C., September 2008.

²⁵ It should also be noted that FDI is also supported by the strong degree of financial integration (e.g., large amounts of dollarized assets and remittances) between the United States and the CAFTA-DR countries. See Swiston, *Spillovers to Central America in Light of the Crisis: What a Difference a Year Makes*, pp. 9-12.

²⁶ Economists tend to emphasize the possibility for marginal increases in employment, firm specialization, access to world markets and global production chains, technology transfer, and human capital development (training and education), all building blocks for growth and development. On the other hand, there may be a loss of domestic policy control over investment and production, and negative effects on local firms from the very policies intended to entice FDI. In addition, studies testing for the effects of investment agreements on capital inflows offer a range of observations from weak to strong evidence of causal relationship. See, Perkins, Radelet, and Lindauer, *Economics of Development, Sixth Edition*, pp. 370 and 418-428 and Paul Alexander Haslam, "The Evolution of the Foreign Direct Investment Regime in the Americas," *Third World Quarterly*, vol. 31, no. 7 (2010), pp. 1183-1184, and 1194.

Figure 7. CAFTA-DR Countries: Net Foreign Direct Investment (2000-2011)
(in U.S. \$ millions)



Source: United Nations, Economic Commission on Latin America and the Caribbean, *Preliminary Overview of the Economies of Latin America and the Caribbean*, December 2011, p. 107.

Note: For small developing economies, spikes in FDI often reflect acquisitions in the financial sector. This is the case for El Salvador in 2007, for example, which reflects Citibank's purchase of Banco Cuscatlán.

- first, FDI increased in all CAFTA-DR countries immediately prior to and after the FTA entered into force, but magnitudes differed widely;
- second, investment is also influenced by macroeconomic conditions, as reflected in the decline following the 2007-08 global financial crisis; and,
- third, Costa Rica and the Dominican Republic outdistanced the rest of the countries in attracting new FDI. They have the highest labor rates (see **Table A-10** in the **Appendix**) and level of manufactured exports, indicating that investment is not necessarily drawn to low-cost producers, but rather to countries that have relatively higher levels of stability, education, and productivity.²⁷

An Analysis of Trade and Investment Trends

Both theoretical and empirical literature on trade presents differing viewpoints on the benefits of liberalizing commercial exchange in small developing countries. Trade can promote growth

²⁷ United Nations, Economic Commission for Latin America and Caribbean, "Foreign Direct Investment Rises by 54% in the First Half of 2011 in the Region," *CEPAL News*, October 2011.

through increased productivity, and firm-level studies corroborate the strong link between firm productivity and exporting, but they often argue that the benefit from trade comes from “facilitating the growth of high-productivity plants, not by increasing productivity growth at those plants.”²⁸ That is, productivity may increase trade more than the other way around, although both directions of influence are likely. Many economists also argue that trade liberalization can increase a country’s long-term growth rate through other channels including increased market size, production specialization, scale economies, transfer of technology and managerial/worker expertise, more efficient resource use, and increased investment.²⁹ Case studies, however, offer contradictory evidence, pointing up examples where growth has or has not followed trade opening.³⁰ Such seemingly irreconcilable outcomes raise fundamental questions over how and why the benefits of trade seem to be more robust in some cases, but not in others.

CAFTA-DR countries comprise an economically heterogeneous group and seem to mirror the disparate responses to trade liberalization found in the economic literature. Country- and product-specific trade and FDI trends vary significantly. Noticeable differences exist with respect to a number of variables that may affect a country’s ability to manage openness under an FTA. For the export model of development to succeed, productivity improvements are necessary, which in addition to private sector initiatives implies an important public sector role in creating a solid business environment. Failure to do so may be equivalent to restricting many of the CAFTA-DR countries to a diminished development model of trade in which they are locked into low-level manufacturing and low-value agricultural production, competing with the poorest countries of the world. In such a scenario, improving economic well-being will be a slow process.³¹

Managing openness implies encouraging macroeconomic stability, investment, and complementary policies to enhance economic growth directly, which can improve chances for reaping the benefits of trade liberalization.³² Stated otherwise, developing countries may respond less to trade liberalization because they are less invested in policies that, in and of themselves, promote growth more directly than trade. A non-exhaustive list includes support for private sector investment, infrastructure, education, and good governance, including an efficient and predictable regulatory framework. As discussed below, the fiscal commitment to accomplish these goals has been lacking, with the possible exception of Costa Rica. To the extent that these, and perhaps other non-trade policy areas, function to improve economic growth and efficiency, they can directly and indirectly support a country’s ability to take fuller advantage of trade liberalization.³³ Differences in growth of exports and FDI seem to correlate closely with similar trends in these variables.

²⁸ Andrew B. Bernard and J. Bradford Jensen, “Exporting and Productivity in the USA,” *Oxford Review of Economic Policy*, vol. 20, no. 2 (2004), pp. 344-345.

²⁹ Calderón and Poggio, *Trade and Economic Growth: Evidence on the Role of Complementarities for CAFTA-DR Countries*, pp. 3-5.

³⁰ For a collection of case studies, see: *Globalization and Poverty*, ed. Ann Harrison (Chicago: University of Chicago Press, 2007).

³¹ Kevin Casas-Zamora, *The Travails of Development and Democratic Governance in Central America*, pp. 11-12.

³² Dani Rodrik, *The New Global Economy and Developing Countries: Making Openness Work*, Overseas Development Council, Policy Essay No. 24, Washington, D.C., 1999.

³³ *Ibid.*, Calderón and Poggio, *op. cit.*, pp. 3-7, Harrison, *op. cit.*, pp. 16-18, and USAID, *Optimizing the Economic Growth and Poverty Reductions Benefits of CAFTA-DR*.

Macroeconomic Factors

Maintaining macroeconomic stability, particularly when an international economic crisis occurs, may be one of the most important goals to ensure long-term growth and higher benefits from trade liberalization.³⁴ Macroeconomic stability, in short, supports competitiveness. Over the last two decades, the CAFTA-DR countries reinforced this theme with their own reform agendas, which have contributed to relatively higher economic growth and stability, despite recent global volatility. They have experienced solid, but not spectacular economic growth since 2002 (see **Table A-1** in the **Appendix**). Costa Rica, Honduras, and the Dominican Republic show above average expansion for the region, while El Salvador and Nicaragua tend to lag. These economies have become increasingly open, particularly among themselves and with the United States, setting a sound development foundation to begin to utilize the opportunities of CAFTA-DR. The downside of this relationship is that as small, open economies, they are heavily dependent on the U.S. economy and susceptible to global shocks, particularly through price channels. The sharp fluctuations in commodity prices and global recession of 2008-2009, for example, disrupted growth trends in trade and output.

Microeconomic Factors

In addition to macroeconomic reforms and stability, so-called “second generations reforms” are essential for trade to become an engine of growth and development.³⁵ Since CAFTA-DR was first proposed, new microeconomic indicators have been developed to analyze the regulatory environment for business, a critical variable for assessing competitiveness or readiness to undertake the obligations and benefit from a U.S. reciprocal free trade agreement.

Doing Business Indicators

The World Bank calculates a series of measures referred to as Doing Business Indicators, which provide a comparative measure of the business regulatory environment. These metrics add an important dimension for assessing economic competitiveness, particularly for countries that have achieved other important goals such as peace and macroeconomic stability. These indicators compare the efficiency, accessibility, and implementation of a country’s regulations, a key consideration in evaluating a country’s ability to fulfill its CAFTA-DR obligations. In addition, having good rules, the World Bank argues, is a key to supporting small and medium-sized businesses, which are an important avenue for achieving income growth, equality, and social inclusion.³⁶

As shown in **Table 3**, the CAFTA-DR countries do not rank high on improving the business environment over time, and regulatory reform still tops the list of concerns for the region. Although strides have been made in regulatory reform in recent years, the CAFTA-DR countries have not kept pace with many other developing countries. Should businesses find operating in CAFTA-DR countries more difficult than others, the countries are in a relatively weaker position to take full advantage of the FTA, and evaluations of CAFTA-DR effectiveness will likely

³⁴ Rodrik, *The New Global Economy and Developing Countries: Making Openness Work*, pp. 17, 77, and 100.

³⁵ USAID, *Optimizing the Economic Growth and Poverty Reduction Benefits of CAFTA-DR*.

³⁶ The World Bank, *Doing Business 2010: Reforming through Difficult Times*, Washington, D.C., 2009, pp. v-ix.

understate its potential impact absent improvements in these indicators.³⁷ In general, trends in foreign direct investment shown in **Figure 7** are consistent with the relative Doing Business rankings in **Table 3**, with the exception of Costa Rica.

Table 3. CAFTA-DR Countries: Ease of Doing Business Rankings

Year	Costa Rica	Dom. Rep.	El Salvador	Guatemala	Honduras	Nicaragua
2006	89	103	76	109	112	59
2007	105	117	71	118	111	67
2008	115	99	69	114	121	93
2009	117	92	72	112	133	107
2010	121	86	84	110	141	117
2011	121	108	130	97	128	118

Source: The World Bank, *Doing Business*, years 2006-2011.

Notes: Ranking among 183 countries in 2011, with lower scores indicating greater “ease” of doing business. Countries are ranked on 10 measures: starting a business, dealing with construction permits, employing workers, registering property, obtaining credit, protecting investors, paying taxes, trading across borders, enforcing contracts, and closing a business. Because the criteria evolved slightly over time and countries were added each year, relative comparisons between years are inexact.

Logistics Performance Index

The World Bank has recently begun to produce a Logistics Performance Index (LPI), which summarizes performance in six areas: customs efficiency; trade and transport infrastructure; ease of arranging competitively-priced shipping; logistics services; tracking and tracing shipments; and frequency with which shipments reach destination on time. This information points to a critical factor in evaluating a country’s ability to trade efficiently and can be used to identify major supply-chain bottlenecks. The composite index might best be thought of as conveying an overall assessment of the “time and cost burdens of import and export transactions.”³⁸

Table 4 summarizes the rankings of composite LPI index for the CAFTA-DR countries. For the region, Costa Rica, the Dominican Republic, and Honduras all rank in the top half of the LPI midpoint. By contrast, El Salvador, Guatemala, and Nicaragua rank in the bottom half of the group. Differences among countries can be large, with Costa Rica clearly outperforming the group on logistics capabilities, while Nicaragua lags. This stark difference may reflect various issues including level of economic development and political decisions to support trade, in general, and CAFTA-DR in particular.

³⁷ Regulatory concerns were mentioned by numerous businesses in interviews conducted in El Salvador, Costa Rica, Nicaragua, and the Dominican Republic.

³⁸ The World Bank, *Connecting To Compete: Trade Logistics in the Global Economy*, Washington, D.C., 2010, p. 4.

Table 4. CAFTA-DR Countries: Logistics Performance Index (LPI) Ranking, 2010

Indicator	Costa Rica	Dom. Rep.	El Salvador	Guatemala	Honduras	Nicaragua
LPI (overall)	56	65	86	90	70	107
Customs	58	63	67	91	76	101
Infrastructure	67	90	77	84	93	102
Int. Shipment	105	107	148	150	101	106
Logistics	59	100	68	62	82	114
Tracking	54	48	87	84	74	107
Timeliness	51	38	55	61	41	92

Source: The World Bank, *Connecting to Compete Trade Logistics in the Global Economy*, 2010. Rankings have not been updated as of January 2012.

Notes: LPI is the composite ranking of the six indicators. Ranked from 155 countries, with lower scores indicating better logistics performance.

Security, Governance, Corruption, and Economic Freedom

Many CAFTA-DR countries suffer from structural problems in governance. First, tax systems in many countries are regressive and provide inadequate revenue to meet public needs, hindering development. The Costa Rican tax burden is roughly 23% of GDP, twice that of Guatemala, and significantly higher than the other countries except Nicaragua. Inadequate and regressive tax systems, combined with a general bureaucratic ineffectiveness, are incapable of helping make adjustments that might diminish the region's high levels of inequality. These deficiencies have been directly linked to the growing violence and crime, much related to drug trafficking, which threatens the social fabric of society.³⁹

The inability to counter the extreme violence and security violations in the northernmost countries of Central America has been costly—one estimate ranges between 7.5% to 8.0% of GDP.⁴⁰ The long-term cost lies in the region's inhibited development, persistent poverty, and inequality. In many areas, organized crime operates with virtual impunity, in part a result of weak national government bureaucracies and corruption. These broad problems diminish the business climate, inhibiting countries from taking full advantage of CAFTA-DR. The level of national insecurity, most prevalent in the "Northern Triangle" countries of Honduras, El Salvador, and Guatemala, appears highly correlated with low levels of FDI (see **Figure 7**).⁴¹ Business investment at the firm level provides corroborating evidence, with some business executives pointing to, for example, production shifts from violence-prone Mexico and Colombia to Costa Rica largely because of security concerns.⁴²

³⁹ Kevin Casas-Zamora, *The Travails of Development and Democratic Governance in Central America*, pp. 2-5 and United Nations Economic Commission on Latin America and the Caribbean, "Rising Tax Revenues: A Key to Economic Development in Latin American Countries," *CEPAL News*, February 2012.

⁴⁰ *Ibid.*, p. 18, and CRS Report R41731, *Central America Regional Security Initiative: Background and Policy Issues for Congress*, by Peter J. Meyer and Clare Ribando Seelke.

⁴¹ *Ibid.*, p. 4-5. CRS notes that the homicide rates in these three countries are 3-4 times that of Mexico, but with an increasing trends throughout the region.

⁴² Interviews in Costa Rica, September 2011.

Two indicators provide additional evidence of the problems. The Index of Economic Freedom, prepared by the Heritage Foundation and the Wall Street Journal, is a composite number reflecting 10 indicators.⁴³ The criteria provide a business perspective and the overall score gives a broad indication of how countries may rank (see **Table 5**), but should not be given too much weight without understanding how countries perform with the individual indicators. A summary of this performance suggests that the CAFTA-DR countries do reasonably well on macroeconomic and trade reform, but with the exception of Costa Rica, come up short on two important indicators: upholding property rights and dealing with corruption. Both these indicators point to traditionally weak judicial branches of government, among other problems.⁴⁴

Table 5. CAFTA-DR Countries: Rankings for Index of Economic Freedom, 2011 and Corruption Perceptions Index, 2010

Indicator	Costa Rica	Dom. Rep.	El Salvador	Guatemala	Honduras	Nicaragua
Economic Freedom	49	90	39	79	99	98
Corruption Perceptions	41	101	73	91	134	127

Source: The Heritage Foundation and Wall Street Journal, and Transparency International.

Notes: Economic Freedom ranked from 183 countries, Corruption Perceptions ranked from 178 countries. Countries with identical index numbers are also given identical rankings.

Transparency International produces the Corruption Perceptions Index.⁴⁵ It measures perceptions based on extensive survey work, and is the basis for the corruption indicator used in the Index of Economic Freedom. As may be seen in **Table 5**, some of the CAFTA-DR countries still rank low, suggesting corruption may be hindering the conduct of business and inhibiting progress on attracting investment, promoting development, and reducing poverty. The Office of the United States Trade Representative (USTR) corroborates concerns over corruption throughout the region, particularly for Honduras and Nicaragua.⁴⁶ These indicators seem to correlate closely with the CAFTA-DR countries' overall economic performance over the long run, and over time the worst performers may see investment and trade trends lag relative to their CAFTA-DR neighbors.

Outlook and Issues for Congress

Although it is still early to pass judgment on the success or failure of CAFTA-DR, the accord has provided enhanced incentives to deepen a trade partnership built on a model of trade preferences that stretches back nearly three decades. The crowning features of CAFTA-DR include transitioning to a reciprocal agreement, making tariff preferences permanent, creating more flexible rules of origin, liberalizing trade rules in new areas and commerce, and promoting institutional capacities in many areas to support the new trade and investment arrangement.

⁴³ The 10 indicators are: business freedom, trade freedom, fiscal freedom, government spending, monetary freedom, investment freedom, financial freedom, property rights, freedom for corruption, and labor freedom.

⁴⁴ <http://www.heritage.org/index/>.

⁴⁵ See, http://www.transparency.org/policy_research/surveys_indices/cpi/2009.

⁴⁶ Office of the United States Trade Representative, *2011 National Trade Estimates Report on Foreign Trade Barriers*, Washington, D.C., March 2011.

The data suggest that CAFTA-DR has supported a long-term trend in the region toward trade and investment liberalization, encouraging diversification into higher value-added, and in some cases, technology-enhanced goods. U.S. exports have grown, with gains in agriculture and more modest growth in manufactured goods. Part of this growth appears to be related to CAFTA-DR and will likely continue as the trade agreement is fully implemented over time.

There are two major challenges to CAFTA-DR operating better. First, the longer-term need for deeper structural transformation in the CAFTA-DR region may be hindering the development potential of the FTA. As suggested by the trends identified in this report, the level of transformative change varies dramatically among the six countries, and to a large extent appears to reflect national business climates and the degree to which national strategies and complementary policies are instituted to support productivity enhancements necessary to be competitive in a global market, a difficult and long-term proposition. Deteriorating security and governance capabilities in some countries further complicate the trade and investment environment. Over time, however, expectations of CAFTA-DR's success rely on policy changes that will improve chances for all countries to benefit more from this deepening and still evolving trade arrangement.

Second, there are a number of issues that are being addressed in the short term, and which Congress may wish to continue monitoring. At the top of the list is enhancing trade facilitation, which refers to improving the rules and capacity of firms and countries to apply them to take full advantage of a trade agreement. Officials in CAFTA-DR countries, and firms operating there, have identified numerous important obstacles to the full and effective implementation of the trade agreement:⁴⁷

- rules of origin, which can be highly complex for textile trade, are frequently the object of firm complaints. Many specific rules seek to protect U.S. producers from third country competition. For example, multiple cases have been identified in which U.S. producers are no longer capable or willing to supply the yarn or fabric covered by the rule, resulting in CAFTA-DR products having to use inputs that are subject to high tariffs or to forgo production entirely. In other cases, rules covering U.S. inputs do not match up clearly, causing delays at the U.S. border.
- customs determinations for these and other matters have caused delays at the U.S. and CAFTA-DR country borders. In order to meet production deadlines, U.S. importers have at times decided to pay tariffs rather than wait for determinations that would have likely been made in their favor. Also, in some cases, U.S. customs procedures and rules have not been well understood by CAFTA-DR exporters. In other cases, CAFTA-DR country customs modernization has been an issue. Assistance has been provided under USAID contracts to ensure U.S. exports are not delayed unnecessarily, but in some cases, further resources and dedication are needed to ensure a continuous smooth flow of U.S. goods.⁴⁸
- the short supply list is also intended to protect U.S. producers, but the “first come” rule for use of tariff rate quotas has been criticized as inequitable and

⁴⁷ Author's interviews in various CAFTA-DR countries.

⁴⁸ United States Agency for International Development, *CAFTA-DR Program Assessment: USAID Regional Assistance Programs for the Implementation of the CAFTA-DR Agreement*, Washington, D.C., September 2011.

complicating production planning. To the extent that these rules unnecessarily inhibit competitive trade, the agreement falls short of meeting its goals. Other challenges include interpretation and application of highly technical rules in areas such as intellectual property rights, sanitary and phytosanitary regulations, and telecommunications.

The complexities of the CAFTA-DR make for many operational challenges, with new ones emerging periodically. Over time, the trade data will likely reflect the extent to which the CAFTA-DR countries and the United States make use of the trade agreement, in part enhanced by addressing these and possibly other issues. It is still early to pass judgment on this FTA, but indicators to date suggest that both long- and short-term policy decisions may go a long way to improving the conditions that will allow CAFTA-DR to provide economic benefits for all participants.

Appendix. CAFTA-DR Country Economic Data

Table A-1. Real GDP Growth (%)
(actual and estimated)

	1992- 2001*	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Costa Rica	5.1	2.9	6.4	4.3	5.9	8.8	7.9	2.7	-1.3	4.2	4.0
Dom. Rep.	6.2	5.8	-0.3	1.3	9.3	10.7	8.5	5.3	3.5	7.8	4.5
El Salvador	4.4	2.3	2.3	1.9	3.6	3.9	3.8	1.3	-3.1	1.4	2.0
Guatemala	3.6	3.9	2.5	3.2	3.1	5.4	6.3	3.3	0.6	2.8	2.9
Honduras	3.2	3.8	4.6	6.2	6.1	6.7	6.2	4.1	-2.1	2.8	3.5
Nicaragua	3.9	0.8	2.5	5.3	4.3	4.2	3.7	2.8	-1.5	4.5	4.0
LAC*	3.0	0.3	2.1	6.0	4.7	5.6	5.8	4.3	-1.8	6.1	4.5
United States	3.5	1.8	2.5	3.6	3.1	2.7	1.9	0.3	-3.5	3.0	1.5

Source: International Monetary Fund, *World Economic Outlook data base*, September 2011.

* Average annual growth.

LAC = Latin American and Caribbean.

Table A-2. GDP Per Capita (PPP)
(actual and estimated)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Costa Rica	7,355	7,813	8,182	8,739	9,616	10,466	10,771	10,807	11,043	11,562
Dom. Rep.	5,805	5,808	5,686	6,197	6,955	7,626	8,060	8,276	8,860	9,289
El Salvador	5,593	5,802	6,013	6,375	6,792	7,208	7,410	7,204	7,340	7,595
Guatemala	3,933	4,017	4,112	4,375	4,438	4,737	4,880	4,838	4,907	5,033
Honduras	3,154	3,285	3,431	3,559	3,828	4,090	4,257	4,120	4,194	4,350
Nicaragua	na	na	na	2,554	2,712	2,856	2,962	2,910	3,037	3,185
LAC*	7,660	7,866	8,467	8,901	9,595	10,309	10,852	10,642	11,280	11,903
United States	36,950	38,325	40,401	42,629	44,750	46,468	46,900	45,349	46,860	48,147

Source: International Monetary Fund. *World Economic Outlook data base*, September 2011.

* Average

PPP = purchasing power parity basis. Income is measured in “international dollars,” which compares real income levels among countries, taking into account that market exchange rates do not fully capture differences in price levels among countries, particularly for non-traded goods. Since 1968, the United Nations has derived the value of an “international dollar” from conversion factors based on price surveys now conducted in 160 countries. GDP on a PPP basis expressed in per capita terms provides for a comparison of economic welfare.

LAC = Latin American and Caribbean.

Table A-3. Inflation (%)
(actual and projected change in average consumer prices)

	1992-2001*	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Costa Rica	14.2	9.2	9.5	12.3	13.8	11.5	9.4	13.4	7.8	5.7	5.3
Dom. Rep.	7.2	5.2	27.5	51.5	4.2	7.6	6.1	10.7	1.4	6.3	8.3
El Salvador	7.2	1.9	2.1	4.5	4.7	4.0	4.6	7.3	0.4	1.2	4.6
Guatemala	9.0	8.1	5.6	7.6	9.1	6.6	6.8	11.4	1.9	3.9	6.3
Honduras	15.9	7.7	7.7	8.1	8.9	5.6	6.9	11.5	8.7	4.7	7.9
Nicaragua	10.7	3.8	5.3	8.5	9.6	9.1	11.1	19.8	3.7	5.5	8.3
LAC*	51.9	8.6	10.4	6.6	6.3	5.3	5.4	7.9	6.0	6.0	6.7
United States	1.9	1.6	2.3	2.7	3.4	3.2	2.9	3.8	-0.3	1.7	3.0

Source: International Monetary Fund, *World Economic Outlook data base*, September 2011.

* Average annual change.

LAC = Latin American and Caribbean.

Table A-4. Current Account Balance (% of GDP)
(actual and projected)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Costa Rica	-5.1	-5.0	-4.3	-4.9	-4.5	-6.3	-9.3	-2.0	-4.0	-4.9
Dom. Rep.	-3.2	5.1	4.8	-1.4	-3.6	-5.3	-9.9	-5.0	-8.6	-8.1
El Salvador	-2.8	-4.7	-4.1	-3.6	-4.1	-6.1	-7.2	-1.5	-2.3	-3.8
Guatemala	-6.1	-4.7	-4.9	-4.6	-5.0	-5.2	-4.3	0.2	-2.0	-3.3
Honduras	-3.6	-6.8	-7.7	-3.0	-3.7	-9.0	-15.1	-3.7	-6.2	-6.4
Nicaragua	-18.3	-16.1	-14.5	-14.3	-13.5	-17.8	-23.8	-12.2	-14.5	-16.0
LAC*	-0.9	0.5	1.0	1.4	1.6	0.4	-0.7	-0.6	-1.2	-1.4
United States	-4.3	-4.7	-5.3	-5.9	-6.0	-5.1	-4.7	-2.7	-3.2	-3.1

Source: International Monetary Fund, *World Economic Outlook data base*, September 2011.

LAC = Latin American and Caribbean.

Table A-5. Unemployment Rate (%)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Costa Rica	6.4	6.7	6.5	6.6	6.0	4.6	4.9	8.4	6.9	6.5
Dom. Rep.	16.1	16.7	18.4	17.9	16.0	15.5	14.2	14.9	14.0	13.5
El Salvador	6.2	6.9	6.8	7.2	6.6	6.3	5.9	8.1	5.8	5.5
Guatemala	na	na	na	na	na	na	na	na	na	na
Honduras	3.8	5.1	5.9	4.0	4.0	3.9	3.9	4.4	4.6	4.4
Nicaragua	10.7	11.7	11.0	5.6	5.2	5.9	6.4	8.2	7.8	7.8

Source: International Monetary Fund, *World Economic Outlook data base*, September 2011.

* Annual average.

na= not available.

Table A-6. Doing Business Indicators, 2011

(in ranked order among 183 countries)

	Ease*	Starting Business	Const. Permits	Getting Electricity	Register Property	Credit	Protecting Investors	Paying Taxes	Trade	Enforcing Contracts	Closing Business
Costa Rica	121	122	141	43	46	98	166	138	73	129	121
Dom. Rep.	108	140	105	123	105	78	65	94	45	83	154
El Salvador	130	164	91	128	75	48	166	88	123	100	139
Guatemala	97	165	151	30	23	8	133	124	119	97	101
Honduras	128	150	70	114	94	30	166	140	103	177	131
Nicaragua	118	130	150	136	122	98	97	155	83	52	78

Source: The World Bank, *Doing Business*, years 2006-2011.

* Overall ease of doing business.

Table A-7. U.S. Merchandise Exports to CAFTA-DR Countries, 2000-2011

(US \$ billions)

Country	2000	2002	2004	2006	2008	2010	2011	% Change 2010-11	% Change 2000-2011
Costa Rica	2.5	3.1	3.3	4.1	5.7	5.2	6.1	17.3	144.0
Dom. Rep.	4.4	4.3	4.4	5.4	6.6	6.6	7.4	12.1	68.2
El Salvador	1.8	1.7	1.9	2.2	2.5	2.4	3.4	41.7	88.9
Guatemala	1.9	2.0	2.6	3.5	4.7	4.5	6.2	38.8	226.3
Honduras	2.6	2.6	3.1	3.7	4.9	4.6	6.1	32.6	134.6
Nicaragua	0.4	0.4	0.6	0.8	1.1	1.0	1.1	10.0	175.0
CAFTA-DR	13.5	14.1	15.8	19.6	25.4	24.3	30.2	24.3	123.7
Latin Amer	171.0	149.2	172.3	222.1	289.4	301.3	364.6	21.0	113.2
World	780.4	693.1	814.9	1,626.0	1,287.4	1,278.3	1,480.6	15.8	89.7

Source: Table created by CRS from U.S. Department of Commerce data.

Table A-8. U.S. Merchandise Imports from CAFTA-DR Countries, 2000-2011
(U.S. \$ billions)

Country	2000	2002	2004	2006	2008	2010	2011	% Change 2010-11	% Change 2000-11
Costa Rica	3.6	3.1	3.3	3.8	3.9	8.7	10.1	16.1	180.5
Dom. Rep.	4.4	4.2	4.5	4.5	4.0	3.7	4.2	13.5	-4.5
El Salvador	1.9	2.0	2.1	1.9	2.2	2.2	2.5	13.6	31.6
Guatemala	2.6	2.8	3.2	3.1	3.5	3.2	4.1	28.1	57.7
Honduras	3.1	3.3	3.6	3.7	4.0	3.9	4.5	15.4	45.2
Nicaragua	0.6	0.7	1.0	1.5	1.7	2.0	2.6	30.0	333.3
CAFTA-DR	16.2	16.0	17.7	18.5	19.4	23.7	28.0	18.1	46.3
Latin Amer	209.2	204.3	254.6	331.9	375.9	360.8	435.4	20.7	108.1
World	1,216.9	1,161.4	1,469.7	1,853.9	2,103.6	1,913.2	2,206.9	15.4	81.4

Source: Table created by CRS from U.S. Department of Commerce data presented in Global Trade Atlas.

Table A-9. Top U.S.-CAFTA-DR Trade Categories
(in millions of U.S. dollars and percentage, 2011)

Country	Top U.S. Imports	Value	Percent of Total	Top U.S. Exports	Value	Percent of Total
Costa Rica	(1) Electrical Machinery	\$6,462	64 %	(1) Petroleum Products	\$1,510	25 %
	(2) Optical/Med. Instruments	\$893	9 %	(2) Electrical Machinery	\$1,154	19 %
	(3) Edible Fruit	\$833	8 %	(3) Machinery	\$540	9 %
Dom. Rep.	(1) Optical/Med. Instruments	\$595	14 %	(1) Petroleum Products	\$1,330	18 %
	(2) Precious Stones	\$540	13 %	(2) Electrical Machinery	\$563	8 %
	(3) Electrical Machinery	\$417	10%	(3) Machinery	\$51915	7 %
El Salvador	(1) Knit Apparel	\$1,505	61 %	(1) Petroleum Products	\$705	21 %
	(2) Woven Apparel	\$233	9 %	(2) Machinery	\$246	7 %
	(3) Coffee	\$202	8 %	(3) Cotton, Yarn, Fabric	\$242	7 %
Guatemala	(1) Knit Apparel	\$991	24 %	(1) Petroleum Products	\$2,044	33 %
	(2) Edible Fruit	\$802	19 %	(2) Machinery	\$498	8 %
	(3) Coffee	\$593	14 %	(3) Electrical Machinery	\$286	5 %
Honduras	(1) Knit Apparel	\$2,223	49 %	(1) Petroleum Products	\$1,548	25 %
	(2) Woven Apparel	\$471	11 %	(2) Cotton, yarn, fabric	\$1,008	16 %
	(3) Electrical Machinery	\$450	10%	(3) Electrical Machinery	\$414	7 %
Nicaragua	(1) Knitted Apparel	\$978	38 %	(1) Machinery	\$148	14 %
	(2) Woven Apparel	\$379	15 %	(2) Cereals	\$127	12 %
	(3) Electrical Machinery	\$350	14 %	(3) Electrical Machinery	\$56	5 %

Source: Analysis by CRS. Data from U.S. Department of Commerce presented in Global Trade Atlas.

Table A-10. International Hourly Wage Rates
(PPP \$)

Country	Wage Rate
Costa Rica	2.56
Dominican Republic	1.50
El Salvador	1.07
Honduras	0.87
Nicaragua	0.59
Malaysia	3.21
China	1.38
Indonesia	0.87
Vietnam	0.65
Cambodia	0.43
Bangladesh	0.36

Source: World Development Indicators Database, published December 10, 2010.

Author Contact Information

J. F. Hornbeck
Specialist in International Trade and Finance
jhornbeck@crs.loc.gov, 7-7782