

Why "Rebuilding the Caribbean" Requires NAFTA Parity for CBI Countries: Towards a "Win-Win" Strategy

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Summary

Hurricane Mitch has been the second big blow to the Caribbean region in the last five years after the North American Free Trade Agreement (NAFTA) tilted the balance of incentives away from the Caribbean Basin Initiative (CBI) countries and toward Mexico as a site for production, investment and trade. By the year 2005, the Multi-Fiber Agreement (MFA) will be completely phased-out, and Asian producers will compete on even terms with those in the Western Hemisphere. Much of the textile and apparel industries in the U.S. and Latin America are at risk from this development, unless new incentives encourage new investments forging strategic partnerships in the region with productivity gains that reinforce the inherent advantage of being close to the U.S. market.

This paper focuses on the reasons for extending NAFTA parity to the CBI countries which can be grouped into humanitarian, economic, and security arguments. The relative poverty of the CBI countries, with a few exceptions, is well documented. While the humanitarian reasons and security issues are important, the authors believe that sustaining arguments are clear, compelling and well understood and therefore focus more narrowly on the issue of how extending NAFTA parity to CBI countries will help the economies of both those countries and the United States.

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I. INTRODUCTION ¹

Hurricane Mitch blew through the Caribbean in late October of 1998. In addition to the human tragedy of over 10,000 deaths, damage to infrastructure (primarily roads and bridges) in the two hardest hit countries, Nicaragua and Honduras, alone was estimated at more than \$ 5 billion. Seventy percent of the growing crops were destroyed, causing massive unemployment (the fraction of the population in agriculture is three-fourths in Honduras and two-fifths in Nicaragua). How will the battered economies of the Caribbean

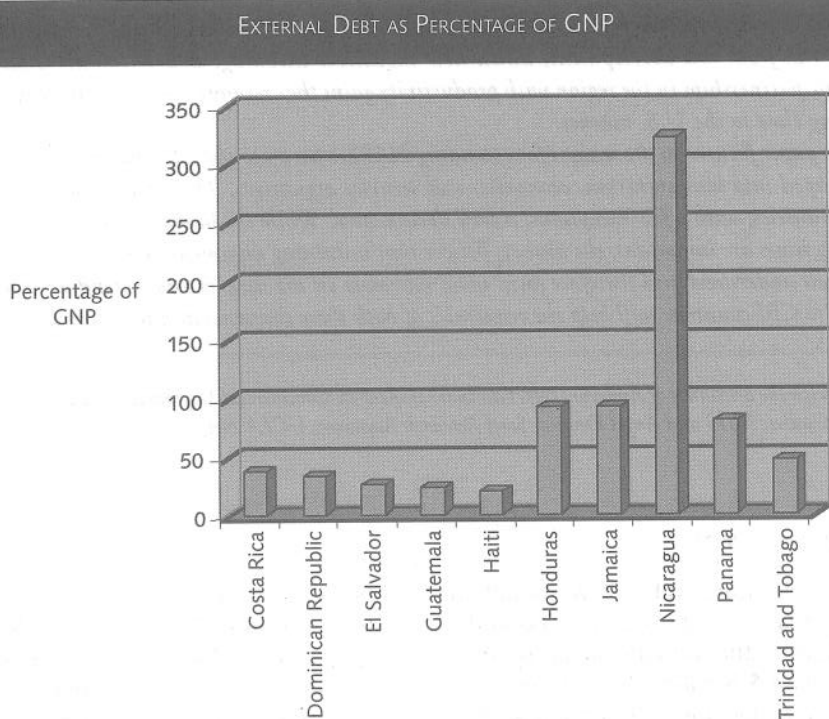
survive, much less continue to make payments on their international debts (over \$ 10 billion in Honduras and Nicaragua alone)? Beyond the limited resources of the Inter-American Development Bank and other multilateral organizations, what investors will gamble on locating factories and new infrastructure projects in the region now?

Mitch was actually the second big blow to the region in the last five years. The North American Free Trade Agreement (NAFTA) tilted the balance of incentives away from the CBI countries and toward Mexico as a site for production, investment and trade. The key difference, as we will explain in detail below, is that the CBI encourages assembly plants, while NAFTA has led to legitimate industrial integration and production sharing, creating more benefits for both the U.S. and Mexico.

Looming on the horizon is the third big blow, perhaps the knock-out blow for the region. By the year 2005, the MFA will be completely phased-out, and Asian producers will compete on even terms with those in the Western Hemisphere. Much of the textile and apparel industries in the U.S. and Latin America are at risk from this development, unless new incentives encourage new investments that forge strategic partnerships in the region, generating productivity gains that reinforce the inherent advantage of being close to the U.S. market.

Reasons for extending NAFTA parity to the CBI countries can be grouped into humanitarian, economic, and security arguments. The relative poverty of the CBI countries, with a few exceptions, is well documented. The Inter-American Development bank estimates that over 60 percent of the populations of Honduras and Guatemala live in poverty. Haiti and Nicaragua would undoubtedly match or exceed this poverty rate, if such detailed data were available. The picture becomes even more dramatic when the debt obligations of these countries are considered (see Figure 1, below).

Figure 1



The economic demands of servicing such large debts can take a dramatic toll on the ability of a nation to provide services to its people. Coupling the enormous debt service obligations with the potential trade diverting effects of NAFTA lends the case for NAFTA parity a sense of urgency for those who will be affected the most. Note that NAFTA parity and debt relief can potentially be mutually reinforcing for economic development in the CBI countries. Yet of all CBI countries, the current World Bank-IMF-US proposal includes debt relief only for tiny Guyana.²

Security issues are also rather straightforward, and detailed analyses are available from other sources. Originally, the CBI was introduced as an aid program, which would boost the economies of that strategic region. It was designed to give nations such as Haiti, the poorest in our hemisphere, a leg up. A boost in international trade was intended to translate into greater economic security for the Caribbean, and by extension, the U.S. as well. The security dimension can be extended to issues of undocumented immigration and drug production and distribution, as well. The standard argument is that increased economic opportunities for citizens of CBI countries provide alternatives to immigration and illegal activities, which have security benefits for the U.S.

While the humanitarian reasons and security issues are important, we believe that the arguments in these areas are clear, compelling, and well understood. Thus we will focus more narrowly on the issue of how extending NAFTA parity to CBI countries will help the economies of both those countries and the United States.

The rest of the paper is organized as follows. In section II, the impact of NAFTA on the CBI countries is documented, looking in detail at the textile and apparel industries, and it is compared with the impact projected by the North American Integration and Development Center (NAID Center) research with estimates of the actual impact to date. Section III contains an analysis of labor supplies in NAFTA, NAFTA+CBI, and Asia, comparing each with the labor requirements for integrated textile and garment production. It is shown that NAFTA+CBI can produce at a lower cost than NAFTA alone, improving the competitiveness of North American garment and textile production relative to Asian production. In section IV, there is a look at how extending NAFTA parity to the CBI region would benefit the U.S., both in terms of short-run efficiency gains and long-run productivity enhancement. Section V focuses on economy-wide benefits to the CBI countries, and refutes claims that NAFTA parity would somehow hurt the CBI countries.

There is a focus on garments and textiles in much of the following analysis for three main reasons. First, garments and textiles account for many of the largest and fastest growing elements of production, exports, and imports in CBI countries. Second, this recent growth is related to special market access granted as part of the original CBI initiative. The "leg-up" once enjoyed by CBI countries in apparel was based on a so-called 807 exemption in which garments made of U.S. fabric and cut in the U.S. can be assembled in CBI countries and exported to the U.S. duty-free. Third, NAFTA confers special status on Mexico particularly in the areas of garments and textile trade. The 807 exemption pales in comparison to the NAFTA privileges enjoyed by Mexico, whose goods can enter the U.S. duty-free as long as they originate entirely from the NAFTA region. Thus, much of the trade and investment diversion resulting from NAFTA has been and will continue to be in these key sectors.

II. HOW NAFTA HAMSTRINGS INDUSTRIAL DEVELOPMENT IN THE CBI COUNTRIES

Around the time of the passage of NAFTA, a number of researchers predicted that the results of a U.S.-Mexico preferential trade liberalization could have a negative effect on Central America. Most of these a-priori predictions were based on the possibilities

of trade diversion and investment diversion, which are common after the setting up of preferential trading agreements. A number of Computable General Equilibrium (CGE) models have been constructed to actually measure the potential nature of these trade diversion effects.³ These models are based on the data detailing the relative cost competitiveness of each country in North and Central America, as well as the pattern of trade and trade barriers. The models are used to estimate the impacts of alternative scenarios of trade liberalization in the region, concentrating on trade flows, output, wages and profits. How tariff elimination will impact the economies and key sectors throughout the region will thus depend on the nature of pre- and post-NAFTA tariff barriers.

TRADE BARRIERS

Despite the high volume of trade in throughout the North and Central American region, there are a number of import barriers such as tariffs, quotas and non-tariff barriers. Despite NAFTA, Mexico has an average tariff rate on U.S. imports more than three times higher (4.2 percent) than that of U.S. protection on imports from Mexico (1.4 percent). Both Mexico and the United States still place high tariffs on certain agricultural products. Average barriers in Central America and the Caribbean are significantly higher, at 19.3 percent and 21.7 percent, respectively. Both regions have high import barriers on light manufacturing, with a 46 percent tariff making this Central America's most protected sector. The Caribbean region also makes it difficult to access the agricultural program crops and consumer durables markets with trade weighted average tariffs of 36 percent and 34 percent, respectively.

In the capital goods, intermediate goods, and other light manufacturing sectors, Caribbean reliance on the U.S. is considerable despite relatively high tariffs (20.5, 13.3, and 27.7 percent). In the case of Central America, asymmetry is lower but import barriers are higher in the light manufacturing and intermediates sectors. Given this fact, there is clearly room for U.S. expansion into these markets. Free trade would lower the costs of these items and help stimulate production in other export sectors in Central America and the Caribbean, which could in turn further increase demand for U.S. intermediate and capital goods.

About half of the U.S. exports of food corn are destined for the Mexico, Central America and the Caribbean, with all three areas purchasing all or most of their imports of this product from the U.S. This was despite the fact that Mexico's pre-NAFTA trade barriers on corn were among the highest of any sectors in North America. Pre-NAFTA research on these trade flows and Mexican high tariffs, along with the huge productivity differences, indicated a large disruptive potential due to the liberalization of Mexican agriculture, and particularly the food corn sector. Although NAFTA will not dismantle all non-tariff barriers, and in fact Mexican subsidies to the maize sector will be increased, the large number of workers who could be affected signals the migratory pressures that would be generated by severe disruptions in the sector (Robinson, Burfisher, Hinojosa, and Thierfelder, [1992] pp. 455-514) This set of Mexican circumstances, however, is not the case for Central America. Central American protection rates on corn are one-tenth that of Mexico pre-NAFTA rates and the economies in the region are much less dependent on the food corn sector.

MODEL RESULTS

The results of the NAFTA-Central America CGE modeling exercises (Hinojosa-Ojeda, et al [1996] and [1999]; Hinojosa-Ojeda and Yunez-Naude [1999]) have consistently shown a negative impact on Central America from NAFTA due to an increased concentration of trade between the NAFTA partners and a diversion of imports and exports by the NAFTA partners away from Central America and the Caribbean. Intra-North American exports for the U.S. and Mexico were predicted to grow by over 20 percent strictly due to the «static»

effect of NAFTA tariff elimination, while it was estimated that trade with Central America would decline by 4-8 percent, depending on the country.⁴ In the dynamic results, U.S. intra-regional exports increase while Mexican intra-regional imports rise, signifying a relative enhanced competitive position of the U.S. due to NAFTA. Intra-regional imports by Central America fall further in the dynamic NAFTA scenario, as do extra-regional exports. In both the comparative static and dynamic results, it is also seen a decline in total exports and imports by Central America. This decline is due both to the NAFTA trade diversion effect as well as to a decline in extra-regional exports by Central America, signaling the difficulty in shifting their exports from North America to the rest of the world:

The impact on factor returns and real wages also demonstrates the negative effect that NAFTA produces in Central America relative to the NAFTA partners. The rate of return to capital increases slightly in the U.S. and more so in Mexico, but it falls throughout the rest of the region. All U.S. and Mexican labor categories gain with NAFTA (except for a large fall in Mexican rural wages in comparative statics), while all Central American labor lose with NAFTA (except for a slight rise in rural wages). The movement in urban wages is largely a function of the rise in two-way trade in most manufacturing goods between the U.S. and Mexico due to NAFTA. NAFTA, meanwhile, generates a decline in exports, output, and wages in these same sectors throughout the rest of the Central American region, particularly in low wage manufacturing.

THE POST-NAFTA RECORD

Apparel exports from the CBI countries grew rapidly, after the signing of the CBI. But the preferential access of Mexico under NAFTA has already threatened that continued growth. Table 1 and figures 2,3, and 4 below show how NAFTA has enabled Mexico to increase its share of regional exports to the U.S. in several key apparel products.⁵ Mexico arguably already has an advantage in terms of proximity to the key Southern California market, the relative attractiveness of the border infrastructure, and the ability of U.S. managers to live on the U.S. side and work on the Mexican side of the border. The additional advantages under NAFTA have clearly tipped the balance of incentives toward Mexico and away from the poorer CBI countries.

In the five-year period following NAFTA, from 1994 to 1998, total U.S. imports in these three important categories of textiles and apparel from these countries increased from just over \$ 5 billion to nearly \$ 12 billion, an annual average growth rate of more than 18 percent. Over that period, Mexico's share has increased from 31 percent to more than 47 percent, reflecting a growth rate of more than 28 percent, more than double the 12 percent growth rate for the CBI countries.

Table 1 below focuses more narrowly on Mexican exports in the pre- and immediately post-NAFTA periods. Here we have disaggregated to nine specific products, each with 1996 export values in excess of \$ 30 million, and a total value of \$1.8 billion. We see that exports of these apparel products accelerated after NAFTA, from 20 percent to 30 percent annual average growth.

In addition to a phenomenal growth in exports from Mexico shown in Table 1, Figures 2-4 below show a clear pattern of increased apparel exports to the U.S. from Mexico after NAFTA, at the expense of the market shares of nearly all CBI countries. Although this impact is just as predicted by economists, it is an impact that was not anticipated and certainly not intended by proponents of NAFTA. Current legislation offers an opportunity to correct these unintended, negative impacts on the economies of the CBI countries.

Table 1

MEXICAN EXPORTS TO THE US: APPAREL PRODUCTS (minimum 1996 value: US\$ 30 million)			
Product Description	Growth Rate	Growth Rate	Export Value
	1990-1993	1994-1996	1996 (in current US\$)
Men's and boys' clothing, n.e.c.	19.2%	54.1%	\$ 38,699,651
Women's and children's underwear	9.2%	12.3%	\$ 71,910,390
Men's and boys' underwear and nightwear	42.4%	49.4%	\$ 87,742,218
Bras, girdles, and allied garments	6.5%	9.5%	\$ 182,687,632
Women's and misses' blouses and shirts	25.2%	51.1%	\$ 190,692,280
Men's and boys' shirts	63.4%	56.3%	\$ 198,022,418
Sporting and athletic goods, n.e.c.	2.4%	18.6%	\$ 210,040,541
Girls' and children's outerwear, n.e.c.	9.7%	27.5%	\$ 343,551,776
Men's and boys' trousers and slacks	18.7%	21.1%	\$ 522,740,032
Sum			\$ 1,846,086,938
Non-weighted average growth rates	21.9%	33.3%	
Weighted average growth rates	20.2%	29.4%	

Source: Data base from the NAID Center. USA-Mexico and author's calculations

Figure 2

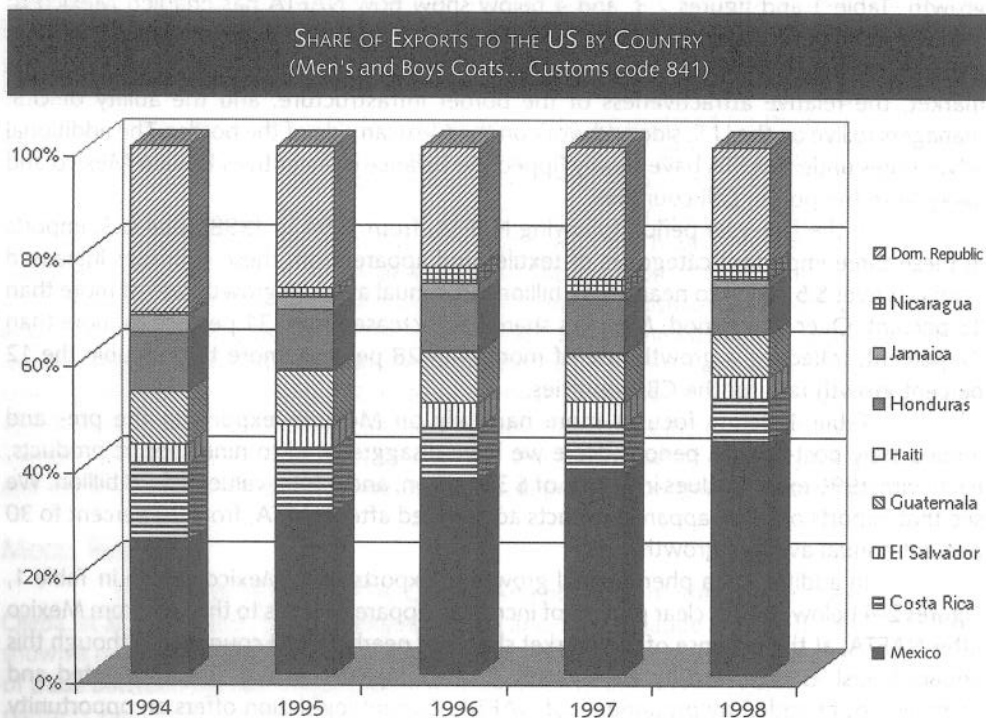


Figure 3

SHARE OF EXPORTS TO THE US BY COUNTRY
(Women's and Girl's Coats... 842)

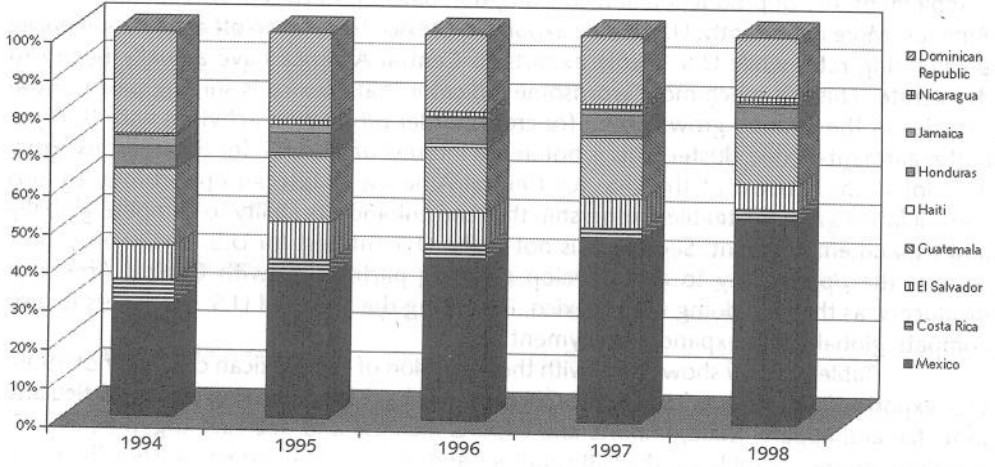
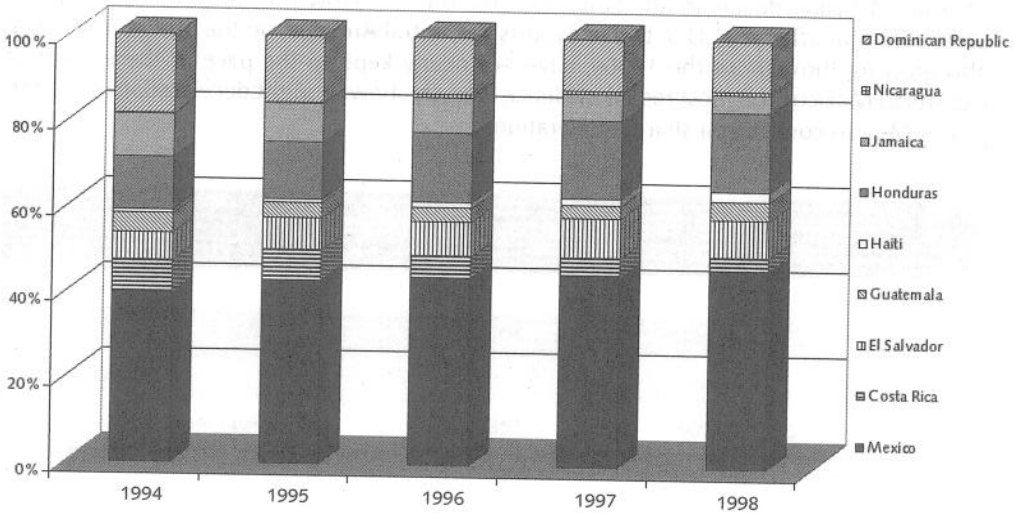


Figure 4

SHARE OF EXPORTS TO THE US
(Articles of apparel... Category 845)



The loss of Central American apparel market share relative to Mexico has also had a series of implications for U.S. exports to the region, as well as the ability of consolidating stronger bonds between U.S. and Central American producers that could help both regions face future global competition. In particular, the post-NAFTA record has shown a slow down and even decline of U.S. apparel exports to Central America, while exports to Mexico have been growing at a faster level. This is indicative of a declining complementarity of production and consumption patterns between the U.S. and Central America. More importantly, U.S. textile exports to Mexico have taken off at a phenomenally accelerating rate, while U.S. textile exports to Central America have actually begun to decelerate. This is a much more worrisome indicator that Mexico is surging past Central America as the primary growth zone for cross-border production activities with the U.S. in the garment-textile cluster. This is not in the interest of the U.S. for two reasons. First, it is not in the interest of the U.S. for Central America to lose an opportunity to also consolidate a garment-textile partnership that can enhance its ability to compete globally and expand employment. Second, it is not in the U.S. interest for U.S. textile producers to miss the opportunity to also develop a strong partnership with Central American producers, as they are doing with Mexico, increasing the ability of U.S. producers to also compete globally and expand employment.

Table 2 below shows that, with the exception of the Mexican crisis year of 1995, U.S. exports of apparel products to the CBI countries have been slowing down. Particularly in textile and apparel trade, imports and exports increase and decrease together, as U.S. components are assembled in the CBI countries and re-exported to the U.S. Thus the slow-down indicated here is a mirror image of the slow-down in the share of regional exports to the U.S. from CBI countries seen earlier. The most disturbing figure, of course, is the actual reduction in the value of apparel imports overall and in four of the five products charted here. While the current problems in the CBI countries are much more than just trade and investment diversion from NAFTA, NAFTA parity for CBI countries is clearly an appropriate starting point in crafting U.S. contributions towards solutions.

Table 3 and figure 5 present the information on U.S. textile exports to Mexico and Central America. The most striking trend that is revealed from this data is the explosive growth in U.S. textile exports to Mexico since 1995. Not only has this period seen a growth of nearly 1 billion dollars in additional exports, but the growth rates have continued to accelerate year after year. U.S. textile exports to Central America, on the other hand, while also growing throughout the 1990s, have not nearly kept up the pace of the growth of exports to Mexico. The most recent evidence actually shows a slight deceleration in growth just as Mexico continues a sharp acceleration.

Table 2

US EXPORTS OF APPAREL TO ALL CBI COUNTRIES (Millions of US current dollars)									
Description	Code	1992	1993	1994	1995	1996	1997	1998	
Apparel of textile fabric	845	330	425	477	684	829	1,005	985	
Clothing accessories, textile or knit	846	174	252	298	511	712	847	1,108	
Men's and boys' coats and jackets, textile, not knit	841	412	541	643	611	646	821	776	
Women's and girls' coats and capes, textile, not knit	842	266	304	342	348	354	400	370	
Women's and girls' coats and capes, textile, knit	844	155	176	178	204	222	271	225	
Growth rate from previous year									
Apparel of textile fabric	845		28.8%	12.2%	43.4%	21.2%	21.3%	-2.0%	
Clothing accessories, textile or knit	846		44.8%	18.3%	71.5%	39.3%	18.9%	30.9%	
Men's and boys' coats and jackets, textile, not knit	841		31.3%	18.9%	-5.0%	5.7%	27.2%	-5.5%	
Women's and girls' coats and capes, textile, not knit	842		14.3%	12.5%	1.8%	1.7%	13.0%	-7.4%	
Women's and girls' coats and capes, textile, knit	844		13.5%	1.1%	14.6%	8.8%	22.0%	-17.0%	
Unweighted annual growth rate, all products			26.6%	12.6%	25.3%	15.4%	20.5%	-0.2%	

Note: For 1997 and 1998, totals are reflat by dividing the available data for the eight largest regional importers by their share of 1996 imports, which was 95%.

Source: www.ita.doc.gov/industry/otea/usfth/cbic.e-i

Table 2 a

US EXPORTS TO MEXICO OF CODE 845					
	1994	1995	1996	1997	1998
millions US\$					
Apparel of textile Fabrics	351	465	509	772	914

Table 3

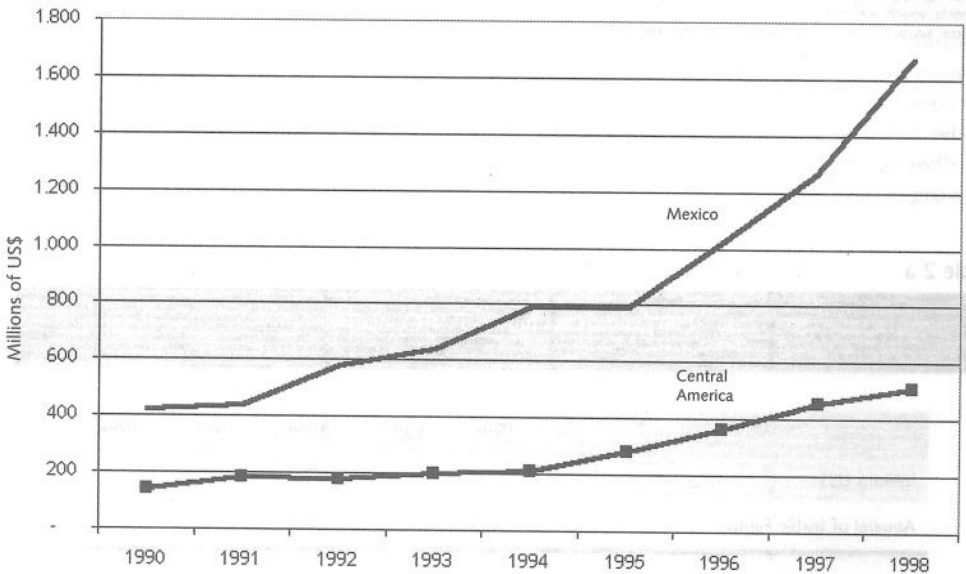
US STANDARD INDUSTRIAL CLASSIFICATION GROUP 22 (SIC 22) * EXPORTS
TO CENTRAL AMERICA AND MEXICO -1990 TO 1998

US\$ millions	1990	1991	1992	1993	1994	1995	1996	1997	1998
Mexico	422.6	439.7	581.1	637.1	792.2	789.4	1,025.8	1,276.5	1,668.8
Central America	138.6	182.2	180.1	198.6	212.3	283.5	365.8	453.7	511.4
Costa Rica	60.4	74.7	77.7	81.4	88.0	70.5	73.1	74.6	78.4
El Salvador	5.9	8.6	13.8	20.9	23.3	62.1	98.9	143.9	153.2
Guatemala	19.0	28.4	34.6	40.3	32.5	41.7	54.7	53.5	60.1
Honduras	24.9	37.0	27.1	30.9	43.9	86.1	117.8	157.4	197.8
Nicaragua	0.5	1.5	2.4	1.8	2.2	4.5	3.7	4.0	3.4
Panama	28.0	31.9	24.5	23.2	22.4	18.5	17.6	20.4	18.5

* SIC 22: Textile Mill Products

Figure 5

US STANDARD INDUSTRIAL CLASSIFICATION GROUP 22 (SIC 22) * EXPORTS
TO CENTRAL AMERICA AND MEXICO -1990 TO 1998



* SIC 22: Textile Mill Products

III. POTENTIAL U.S.-CBI INDUSTRIAL COMPLEMENTARITIES: TEXTILES AND GARMENTS

Economic research has traditionally approached the issue of comparative advantage and trade from the perspective of the national economy. As economic integration forges bonds among regional products and, in some cases, labor markets, it is increasingly necessary to look at the comparative advantage of a region, in international competition with other integrated regions. For instance, an obvious question would be how does NAFTA help North American regional producers better compete with integrated production from Asia and the European Union? ⁶ To summarize this body of technical work briefly, the underlying assumption is that increasingly open world capital markets have left a country's labor force as the primary determinant of comparative advantage. Thus the focus here is on labor of different skill levels, related to educational attainment.

Goods today, particularly complex manufactured products, require numerous fabrication and assembly steps. Each of these steps may require different labor skills. Economic integration allows these different processes to be accomplished in different locations, in order to lower the cost of each stage of production. Economies with different labor skill profiles would be the lowest cost locations for these different production processes, once trade barriers have been removed. On the one hand, this means some parts of the production process that had been done at a higher cost in the U.S. would be moved abroad, if the cost savings exceed the transportation costs. On the other hand, lower costs of production overall allow goods produced in the integrated North American market to be more competitive against similar goods produced in Europe and Asia, increasing U.S. sales and thus increasing the demand for labor of all types used in the various countries.

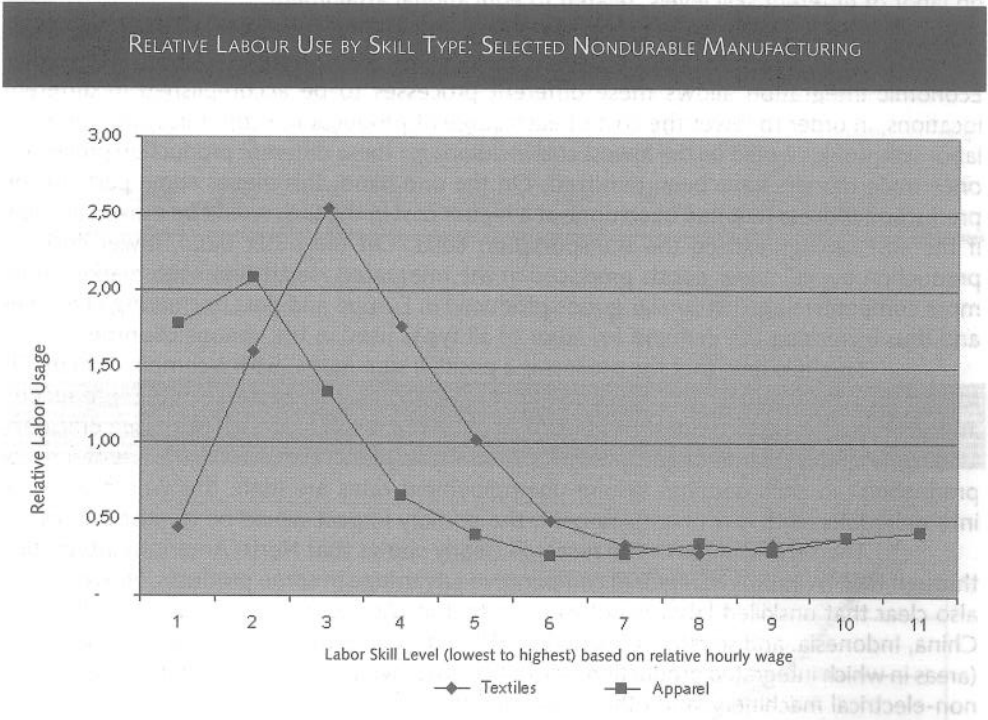
Thus it is seen that the process is a positive sum game, with a combination of: (1) reshuffling production locations, which might result in an initial decrease in U.S. production and a corresponding increase in production in partner countries, and (2) increased efficiency leading to greater demand and production levels, resulting in more of the "right kind of production" in each country. Where unemployment rates are high, this would translate into more jobs; with low unemployment, the primary impact would be to raise wages.

The second stage of the research clearly shows that North American integration through NAFTA improves regional comparative advantage in some products. However, it is also clear that unskilled labor is not as abundant in Mexico as it is in Asian countries like China, Indonesia, and several in South Asia. Thus the comparative advantage of the region (areas in which integrated production will lead to cost savings) is in transportation equipment, non-electrical machinery, and other capital goods, as opposed to consumer goods.

The next question to ask would be if an extension of NAFTA to the CBI countries could further expand North America's comparative advantage. Several CBI countries have larger shares of low skill labor than Mexico, and these include the largest labor forces in the region, in Guatemala, Haiti, Honduras, El Salvador, and the Dominican Republic. The total labor force of the 10 CBI countries for which data were available (about 18 million) is still smaller than that of Mexico, but they would contribute a different mix of skills to the expanded regional labor force. In particular, the types of labor skills available in the CBI countries correspond more closely with those required for production of apparel, textiles, and miscellaneous manufactures (for instance, toys and sporting goods), areas in which Asia exporters dominate the U.S. market. In the absence of further policy action, this dominance will increase, as the provisions of the Multi-Fiber Agreement (MFA) are phased-out by 2005 as part of the Uruguay Round WTO accord. In some ways, the appropriate policy choice is the lesser of two evils. Freer global trade is extremely important to U.S.

exporters, but will hurt U.S. producers who compete with imports. The U.S. garment and textiles industries are prime examples of import substitutes that must cut cost, rationalize production, and carve out appropriate niches to survive the onslaught of global competition in the next 10 years. No economic policy can preserve the industries in their current state, given the forces that have been set in motion by the WTO accord. However, granting NAFTA parity to the CBI countries would allow a rationalization of the industry, in which outsourcing in some area prevents job losses in others. Cost cutting, through the integration of production and markets, will create a leaner, stronger regional industry that can better survive enhanced global competition. At the same time, other benefits are generated for the U.S. and CBI countries, as detailed below.

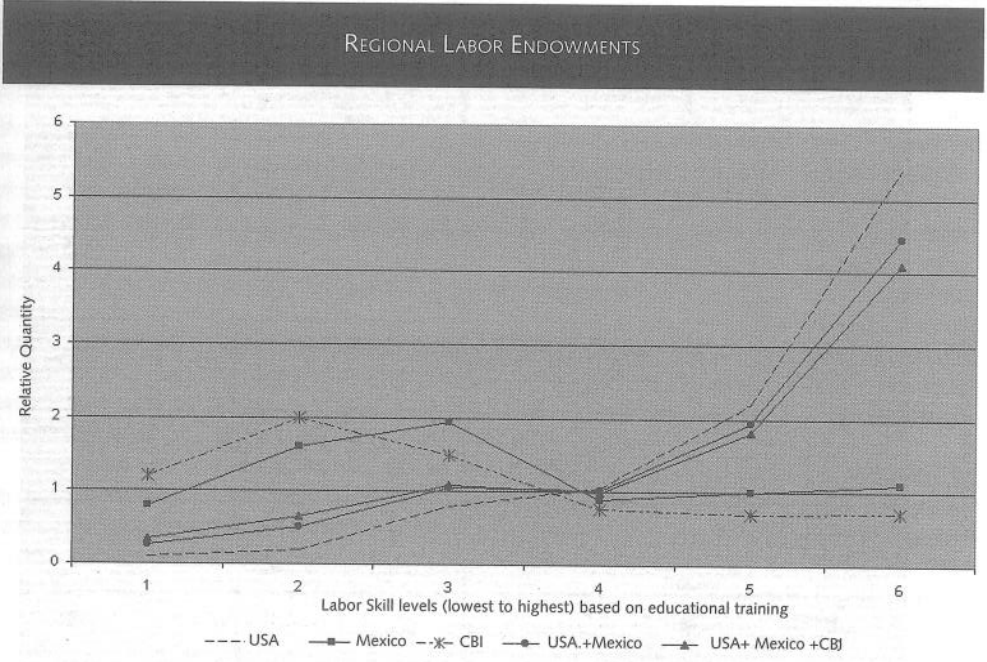
Figure 6



Textile and particularly apparel production intensively use workers with relatively low skills. The U.S., with little low-skilled labor relative to capital, land, and skilled workers, pays relatively high wages to its low skilled workers, reducing the competitiveness of those products on both the domestic and world markets. Protection of the domestic market under the MFA has helped to preserve the U.S. industries at their present size, which is much reduced after a period of trade liberalization in the 1980s. As protection from imports from countries with relatively more numerous and thus lower cost low-skilled labor declines, the U.S. industry will face more tough choices. Rather than competing with lower U.S. wages (either by cutting wages across the board or by becoming increasingly reliant on legal and undocumented migrants from low wage countries), the various sub-products and processes up among the countries of North America should be split according to cost conditions (including but not limited to labor costs). In such an integrated market, falling

costs would lead to more overall production, production that is more appropriate to each member economy, and perhaps more economic activity and even employment in each country, including the United States.

Figure 7

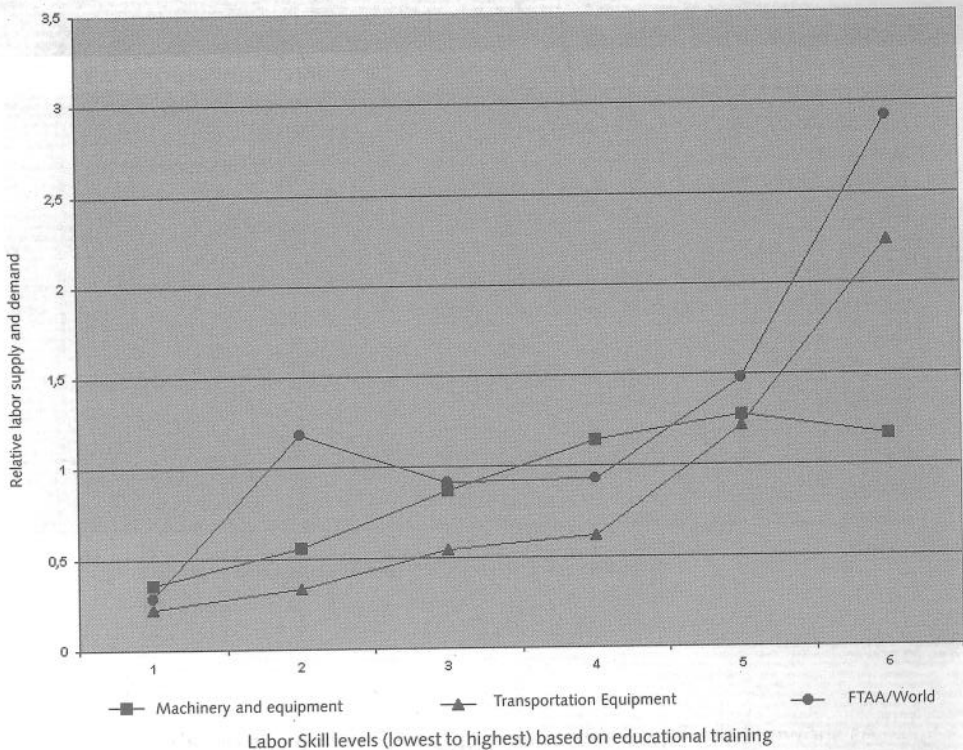


As shown in the figure above, adding the 17 million person labor force of the CBI countries to the more than 170 million workers in the U.S. and Mexico has only a marginal impact on regional relative labor endowment and thus regional comparative advantage. However, those who focus exclusively on relative economic size, as measured by relative GDP in U.S. dollars would conclude that the CBI countries are insignificant (less than one percent), relative to the combined U.S. and Mexican economies. We believe that the focus on the relative size of the labor forces is more revealing as to how further market and production integration with CBI countries under NAFTA parity would impact the U.S. economy. Such integration would lower the costs of producing certain labor-intensive components and final assembly, both in garments and textiles and in other manufacturing sectors as well. The impact will be significant, but not huge. The cost gap for North American production in those areas, relative to Asia, will be diminished, but not eliminated or reversed.

As a final caution, it should be stated again that the comparative advantage in global trade, even of a broader integration area covering all of the Americas (such as the proposed Free Trade Agreement for the Americas, or FTAA) would still be in goods that use relatively more skilled labor, as seen in figure 8. But there is no doubt that closer ties with the CBI countries would make the regional garments and textiles industry more competitive in domestic and world markets, so that a larger fraction of the regional industry would be saved after 2005.

Figure 8

PRO-FTAA SECTORS



The U.S. is the most important source of foreign investment in the Caribbean Basin, with assets in the Caribbean Basin Economic Recovery Act (CBERA)-eligible Caribbean countries totaling almost \$43 billion, although most of this is concentrated in finance (excluding banking), insurance, and real estate. Investment in this sector in the Netherlands Antilles alone equals almost \$ 26 billion. U.S. cumulative investment in Central America (other than Panama) totaled roughly \$ 2.8 billion in 1997.⁷ Investment in manufacturing is quite low and is still concentrated in food products. Export-assembly operations, however, are rapidly gaining importance. The value of export-assembly products imported into the U.S. from the Caribbean Basin doubled between 1991 and 1996, to \$ 3.5 billion, of which Central American products accounted for 30 percent. U.S. investors have played a particularly important role in developing the apparel export industry in the Caribbean Basin, mainly due to special provisions allowing for production-sharing arrangements. In both Jamaica and Honduras, for example, U.S. apparel companies accounted for roughly one quarter of total direct investment in the sector in 1991.

IV. HOW DOES EXTENDING NAFTA PARITY TO THE CBI COUNTRIES BENEFIT THE U.S.?

One view of the globalization process holds that some degree of industrial hollowing in the U.S., as labor-intensive products and processes move overseas, is inevitable and good for the long-term health of the economy. Yet it matters where those firms relocate. For instance, consider a firm deciding whether to locate a new production facility in Honduras or Hong Kong. There are externalities that may make the location in Honduras preferable from the perspective of U.S. society, all else being equal. A firm located in Honduras would be more likely to source capital and intermediate goods (consider also finance, real estate, insurance and other services) from other U.S. firms, while a plant in Thailand may source more locally or regionally in Asia. Additionally, if the output of the plant is itself an intermediate good, then the U.S. affiliate may be supplying high-quality, low cost components for Asian firms competing with American firms in final product markets. In terms of factor payments, the marginal propensity of CBI workers to spend their wages on American goods is much higher than the propensity of Hong Kong workers, but unless these expenditures are specifically on this firm's output, they will not be taken into account in the location decision. Thus locating production facilities in CBI countries instead of Asia will raise exports of U.S. capital goods, intermediate goods, business services, and consumer goods.

To summarize, NAFTA parity for the CBI countries will enhance U.S. competition in global markets by reducing labor costs, by allowing American firms to exploit Honduras' comparative advantage in labor intensive products and processes. "Leakage" is minimized due to the strong existing consumption and trade linkages between the countries. Free trade with Honduras exploits complementarities in resources, labor skills, and climate. Considering CBI countries as a market is less important in the short run compared to their value as a production base, and issues of macroeconomic stability, industrial competitiveness, and political stability are important. In the long-run, as investments and trade boost wages, growth in the market for U.S. capital, intermediate, and consumer goods may prove to be the biggest pay-off for the U.S.

Increased incomes and economic activity in the CBI countries have even more potential benefits for the U.S. In addition to the increased demand for U.S. exports from firms and consumers in the CBI countries, and the increased demand for the U.S. components used in the integrated industries, economic development will have implications for immigration and the drug trade.

MODELING ON ALTERNATIVE FUTURE SCENARIOS

The previously mentioned modeling work produced results of a series of alternative scenarios of potential future paths of trade liberalization between the U.S., NAFTA, and Central America. One set of scenarios which have been discussed in policy circles are the establishment of separate free trade agreements (FTAs) between Mexico and the Central American Common Market and between the United States with the Central American Common Market. The results of modeling these scenarios indicate a likely significant expansion in intra- and extra-regional imports and exports for Central American countries. The impact of the aggregated effects of larger trade flows is evident in a substantial increase in GDP growth rates for all the countries in the region. Results show a growth in real GDP for Central American countries ranging between about 1% and 3% for the US-CACM FTA. The scenario corresponding to Mexico-CACM FTA (which is actually nearing completion) also produces positive impacts, although they are more modest. This is a direct consequence of the differential sizes of the Mexican and US economies.

Another alternative -NAFTA-CBI Parity, combined with a Mexico-CACM FTA- produces the most positive impacts for all countries. This means that for Central American countries the most benefits are produced by the integration with the US, while there are also small additional effects of the simultaneous integration with Mexico. In this scenario there is not any evidence of trade diversion, nor retraction in the rate of growth of real GDP. For the US, the resulting increase in imports of fruit and vegetables are more than compensated by a much larger increase in exports of grains. There is also a very important increase in Central American countries' imports of industrial goods (including light manufacturing, capital goods and consumer durables) which is associated with an important increase in US exports in the same sectors.

The analysis of the results makes evident that the best scenario for all countries is the extension of trade benefits throughout NAFTA and the CBI area. The increase in GDP, for the scenario with potential externality effects is the 0.3% for all countries combined, with individual values ranging between 1% and 3% for Mexico and Central American countries, and 0.08% for the United States.

V. CONCLUSIONS: CLEARING UP MISCONCEPTIONS ABOUT THE IMPACT OF NAFTA PARITY ON THE CBI COUNTRIES

WOULD EXTENDING THE NAFTA HURT CBI COUNTRIES?

1. *The argument that the CBI countries will experience a painful adjustment period is based upon a faulty assumption.* Some argue that the costs of extending the NAFTA will be high because the U.S. will expect several economic concessions in return for CBI countries' privileged access to the U.S. market. That, however, is not the context in which the legislation is currently being considered. Intellectual property rights, lowering of trade barriers, and other possible concessions are not part of the present negotiations. They are, thus, irrelevant in the current context.

2. *It is wrong to think that all the North and Central American apparel and textile industries will necessarily be decimated in 2005.* A more careful examination of the apparel industry suggests a broader range of possible scenarios. In articulating the causes of the rapid growth of apparel investment and production in the Caribbean Basin, many did not include perhaps the most important one—proximity. The U.S. apparel industry relies not only on low cost production, but also on locations that are proximate enough for quick turn production. Quick turn -meaning rapidly moving from the design stage to the assembly stage- is required by most retailers. Asian locations are significantly disadvantaged in that regard. Any cost advantages of producing in China are eliminated if the manufacturer must pay the high price of air shipping in order for US firms to obtain finished goods in time for their shipment to retailers. Because of the still high costs of rapid transportation, many segments of the apparel industry in the U.S. and in locations near it will survive Asian competition.

3. *Transshipments have not been a problem for Mexico and would not pose a problem for CBI countries.* Some argue that any benefit to CBI countries would be limited because most goods entering from that region would be transshipments from Asia. Why, then, there haven't been massive transshipments from Mexico, whose restrictions on apparel imports are much lower than those in the U.S.? Strict rules of origin in the NAFTA define which goods receive NAFTA treatment and which are treated as non-NAFTA imports. The rules of origin require that the fabric and most fiber originate within the NAFTA region. As a result, transshipments are strictly regulated. So long as the rules of origin governing the NAFTA are extended to CBI countries in granting NAFTA parity, concerns about transshipments are unfounded.

4. *Remittances to CBI countries are not likely to lessen, and do not pose a challenge to NAFTA parity.* In arguing that extending NAFTA treatment will hurt CBI countries, some argues that remittances they receive from apparel workers in the U.S. will be reduced because there will be fewer apparel jobs in the U.S. It is true that most apparel assembly workers in the U.S. are immigrant workers, and most are from Mexico or Central America. This does not, however, mean that most immigrants sending remittances are garment workers. Most are not. Most are employed in a variety of blue-collar occupations, most paying far more than garment assembly work.

5. *Extending the NAFTA will help, not hurt CBI countries.* Some argue that rather than NAFTA Parity, the CBI region needs increased aid and debt-forgiveness rather than trade policy measures. We certainly do not disagree that debt-forgiveness and increased aid would help the economies devastated by Hurricane Mitch recover more quickly. We maintain, however, that trade policy measures such as extending the NAFTA will have stronger positive economic development consequences. Limiting the development of the apparel industry in CBI countries to 807 assembly production with its minimal economic spillover effects certainly does not reflect a desire to aid the struggling economies in our hemisphere that are plagued by weak industries. Granting NAFTA parity in apparel would promote the strengthening of CBI countries' apparel industries and would have no visible harmful effects on the region.

WOULD EXTENDING THE NAFTA-PARITY BENEFITS HELP CBI COUNTRIES AND THE U.S.?

1. *Compared to NAFTA benefits, the CBI is not enough to stimulate industrial development in the Caribbean.* Apparel trade in the CBI region is highly constrained, restricted almost exclusively to goods that were merely assembled in CBI countries. CBI garments enter the US as "807" goods-goods made of US fabric, cut in the US and assembled in the CBI countries, and only these assembled goods are privileged under the CBI. Those that were, for example, cut, sewn and finished in Honduras would not receive CBI privileges. Hence, the CBI encourages the development of U.S. and foreign *assembly plants*, not manufacturing plants in the CBI region.

2. *Industrial development, not simply growth, generates economic development.* Assembly plants do generate economic growth (higher GDPs), but do not necessarily lead to industrial development or economic development. Assembly plants do not typically lead to greater industrial integration, stimulating minimal technology transfer, and they do not offer large amounts of quality jobs. Industrial development requires more suppliers and industry services, which the CBI currently discourages.

The economic development implications of the current CBI policy are the creation of a limited number of low-skill jobs with little likelihood of upward mobility for workers. Moreover, assembly plants in the region are often located in export processing zones that are often exempt from paying any taxes. Hence, the state receives no direct income from their operations. The jobs created are low-skill assembly operations. Few skills are learned on the job that could be transferred to other occupations. There are few opportunities for upward mobility within the factory and in the industry generally.

3. *The key reason why Mexico is now a preferred investment location is not only the differences in tariffs, costs or quotas, but especially the freedom from 807-type production.* Mexico's apparel industry has a considerably more favorable outlook now because of NAFTA. Rather than being restricted to apparel assembly by 807 stipulations, any goods produced wholly in the NAFTA region are duty- and quota-free. Apparel can be designed in Mexico, cut in Mexico of US fabrics, and finished in Mexico, allowing apparel manufacturers

more freedom to locate production facilities according to comparative advantages. As Mexico is on its way to becoming a full partner with garment and textile producers in the U.S., this also helps the more competitive and higher wages producers in the U.S.

4. *Because it encourages the working of comparative advantage within North America, the NAFTA strengthens the Mexican apparel industry, whereas the CBI stunts that region's apparel industry.* The US has a comparative advantage in textile production and in apparel design due to high labor productivity. CBI countries and Mexico have comparative advantages in other segments of apparel production, including sewing, cutting, and laundering. US trade policy, specifically the CBI, does not permit CBI countries to capitalize on these comparative advantages, restricting them to apparel assembly. Mexico, in contrast, has seen the growth of sewing shops, apparel services, and suppliers including industrial laundries, dyehouses, cutting firms, legal services and financial services.

5. *Strong, integrated apparel and textile industries in North and Central America will survive 2005 better than a weak, fragmented industry.* The NAFTA has stimulated the development of a more integrated apparel production network through comparative advantage. If the NAFTA is extended to CBI countries, the CBI region will also have the opportunity to develop a more densely integrated apparel industry. The development of an integrated industry in the region is essential to surviving the influx of Asian imports in 2005. Production sharing arrangements with Mexico make US firms highly competitive. They are able to reduce total costs by utilizing more efficient Mexican suppliers and apparel services and more competitive US textiles. Productivity increases as Mexico's industry grows, enhancing both the competitiveness of US textile firms and the Mexican industry. Hence, both the US and Mexico will continue to improve their competitive position through tighter industry integration. By extending NAFTA treatment to CBI countries, their competitiveness with respect to Asia can similarly be encouraged.

6. *Until NAFTA parity is extended to the CBI region, the only apparel work done in the region will continue to be assembly work.* Granting NAFTA parity now allows those participating countries several years to benefit from freer trade as Mexico has. NAFTA parity would create incentives for other types of apparel-related production work to develop. Moving from assembly work towards a more integrated industry within the region offers the opportunity for economic and social development in the CBI countries. Assembly operations currently offer them very little benefit.

Notes

¹ Support for this research was provided from INTAL in order to contribute to the legislation process over this issue at the U.S. Congress.

² A separate proposal to provide debt relief for Nicaragua and Honduras remains under consideration, however.

³ See Hinojosa-Ojeda et al [1996] and [1999] as well as articles in Hinojosa-Ojeda, Raul and Antonio Yunez-Naude [1999].

⁴ This "static" result is meant to measure only the direct effects of a tariff reduction and is not meant to represent the impact of a more realistic "dynamic" scenario based on enhanced productivity growth and macroeconomic expansion.

⁵ Data from www.ita.doc.gov/industry/otea/usfth/top80cty (the U.S. Department of Commerce International Trade Administration). The three products selected were the only apparel categories in the top 20 U.S. imports from all these countries.

⁶ Note that there is no formal economic integration agreement covering all of Asia, in a way comparable to the EU or NAFTA. With the exception of the Association of South Eastern Asian Nations (ASEAN) free trade agreement, which is still in the early phases of implementation, economic integration in Asia is driven by flows of private investment, trade, and technology, responding more to market opportunities than to preferential treatment of regional partners.

⁷ Source: U.S. Department of Commerce, Direct Investment Positions for 1997, <http://www.bea.doc.gov/bea/ai/0798dip/maintext.htm>

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