

MESOAMERICA INVESTMENTS



The Case for CAFTA and 2004 Priorities

Harry Strachan, CCAA Conference

El Salvador, February January 2004

Important Questions

- Is CAFTA right for Central America?
 - Does “apertura” create “growth”?
 - Does free trade aggravate poverty?
 - Given results of 2003 negotiations should we go ahead?
- What are the priorities for 2004?
 - Is there political support for CAFTA and the accompanying economic strategy?
 - Is that strategy enough? Are expectations for CAFTA realistic?
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Important Questions

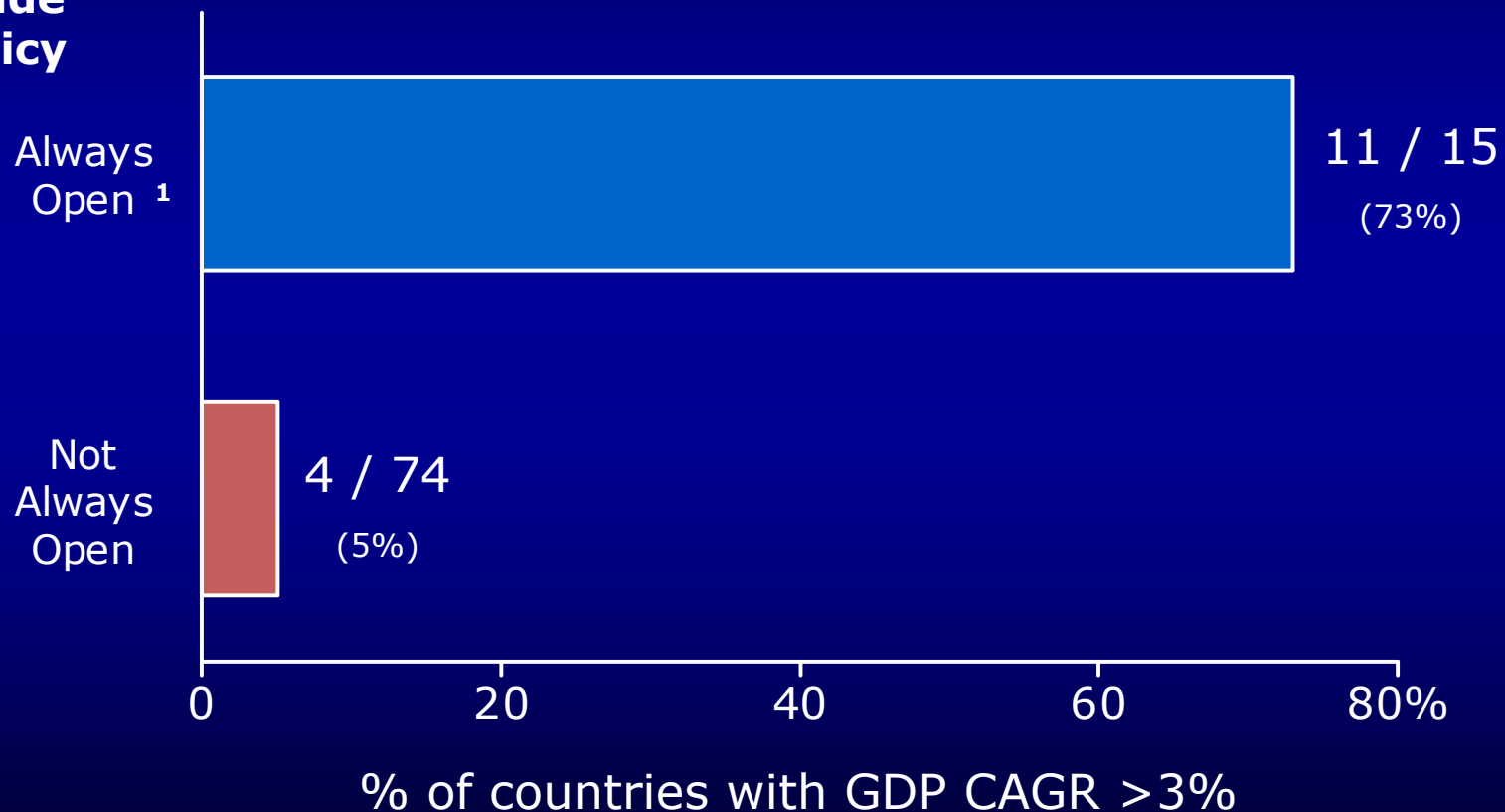
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The likelihood of sustainable growth is much higher in countries with open trade policy

Percentage of countries with Economic Growth > 3%

(89 Countries in Development, 1970-1989)

Trade policy



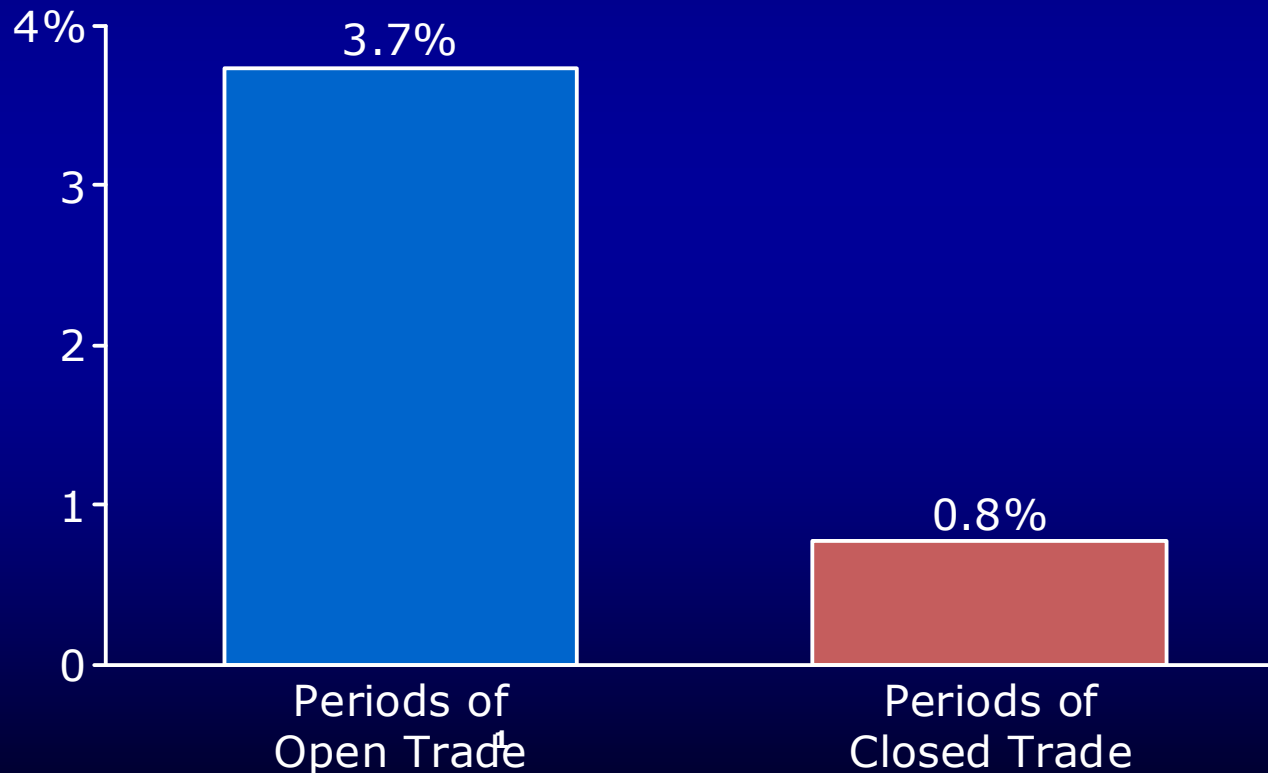
¹ A country is "always open" if it has: a) Non-tariff barriers on less than 40% of trade, b) Average trade tariffs less than 40%, c) Difference between official and black market figures is less than 20% d) non-socialist economic system, and e) Open market in its main exports
Source: *Economic Reform and the Process of Global Integration*, J.D. Sachs and A. Warner, Harvard University

Growth is higher in periods of openness

Growth by Period

(15 Countries in Development, 1950-1989)

GDP Growth
(CAGR by period)



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Other relatively small economies have adopted open market strategies with positive results

European Union

- Spain
- Portugal
- Ireland
- Greece



Average Growth
(CAGR GDP 1985-2000)

8.4%

vs.

European Union
(CAGR GDP 1985-2000)

6.7%

Asian Countries

- South Korea
- Singapore
- Hong Kong
- Malaysia



Average Growth
(CAGR GDP 1985-2000)

10.2%

vs.

Southeast Asia
(CAGR GDP 1985-2000)

4.8%

Ex-Communist Countries

- Hungary
- Poland
- Slovenia
- Albania



Average Growth
(CAGR GDP 1994-2001)

6.7%

vs.

Transition Countries
(CAGR GDP 1994-2001)

1.7%

Mexico and NAFTA

- NAFTA negotiations began in June, 1991. There was a heated national debate on how NAFTA would affect Mexico. Simplified the arguments were as follows:

Proponents

- NAFTA will stimulate economic growth through investments, higher exports, and structural changes
- The old model (import substitution) reduces Mexico's competitiveness and relegates Mexico to petroleum export dependence
- NAFTA will have a positive impact in the democratization of the country, forcing necessary reforms

Opponents

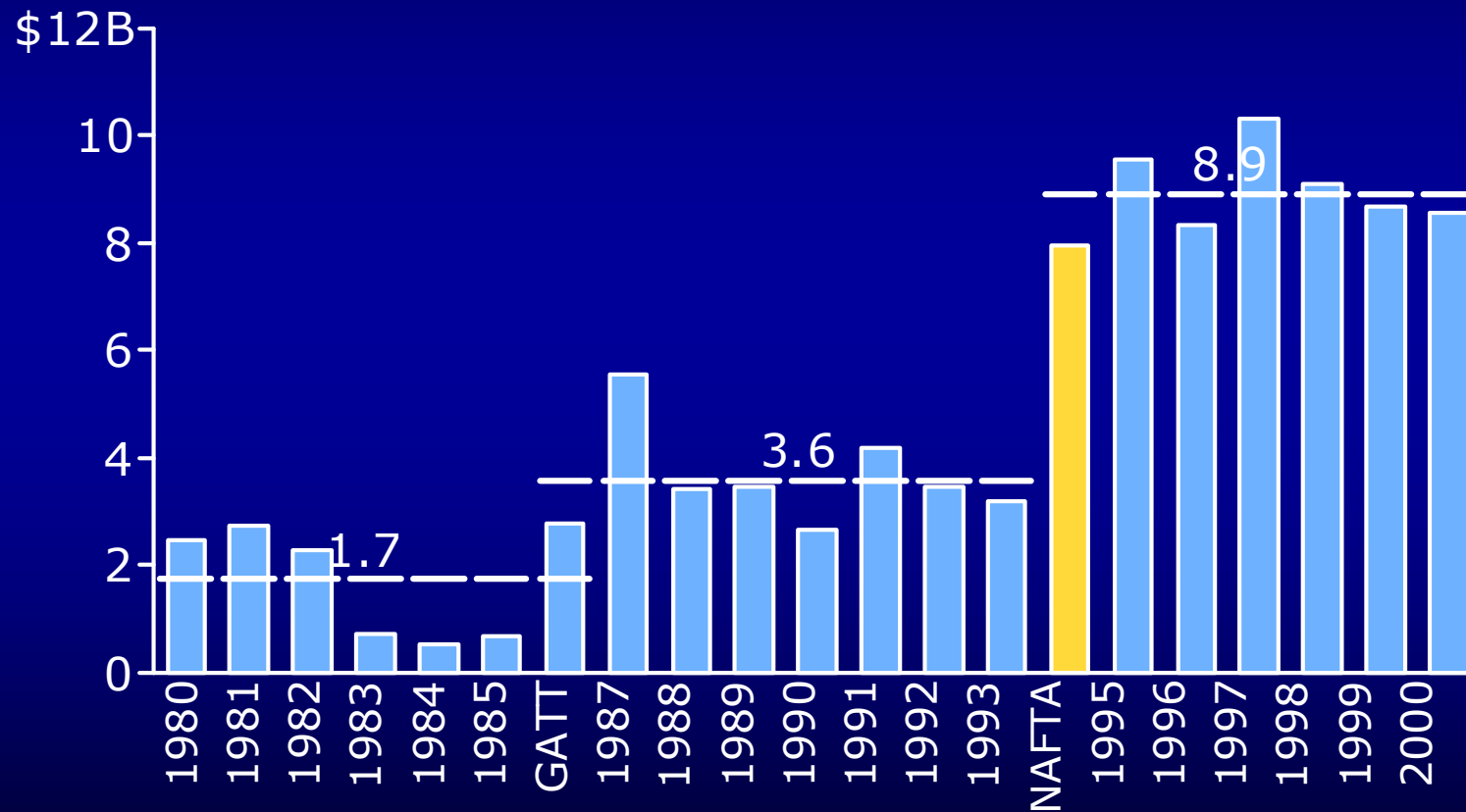
- Mexico's production platform is not competitive versus the US and Canada and will impede Mexican economic growth
- Democratic reforms are necessary before any free trade negotiations can take place
- Mexico will lose its sovereignty and cultural identity and will have to modify its constitution

NAFTA's results have supported the proponents far more than the opponents

- Mexico entered NAFTA in the midst of a major economic crisis yet
 - Foreign investment increased -- 150%
 - Exports doubled from 1993 to 2000
 - The recuperation was much faster than anticipated.
 - Annual economic growth averaged 3.6% vs. 2.2%
- While opponents predicted negative economic, political and cultural effects, the opposite has occurred:
 - An end of one party rule in 2000, greater freedom of press
 - Increased Mexico influence on U.S. policies
 - Mexican culture has enjoyed a boom around the world: literature, music, TV, theater, food and art
 - NAFTA adjusted to the Mexican Constitution not vice-versa.
- Since NAFTA Mexico has become the #1 economy of L.A.

NAFTA has significantly stimulated foreign direct investment...

Foreign Direct Investment
(1995 US\$B)



FDI/GDP

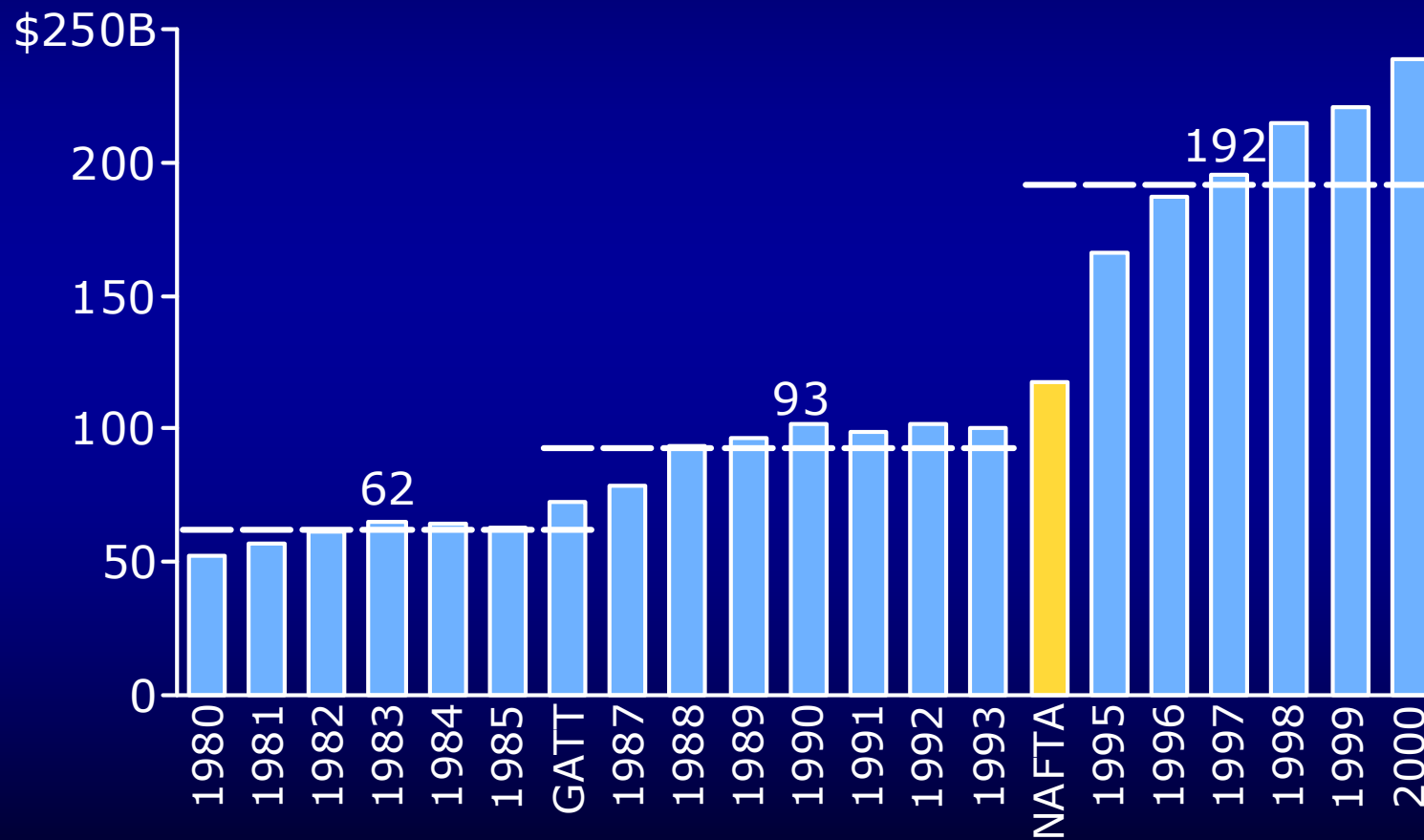
0.7%

1.4%

2.8%

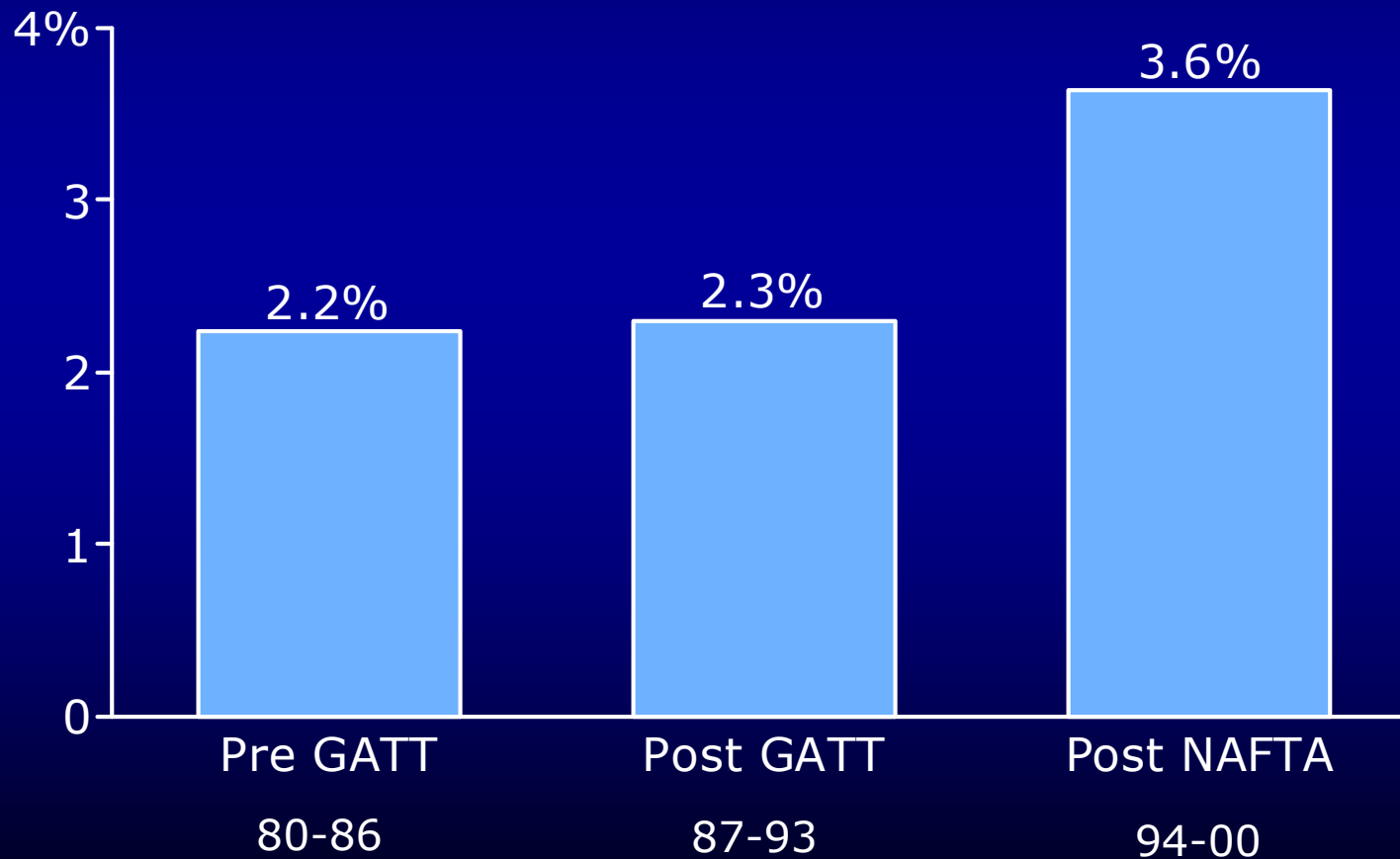
...as well as external trade

Exports + Imports (US\$B)



With NAFTA, the Mexican economy has grown at a faster pace than in the past...

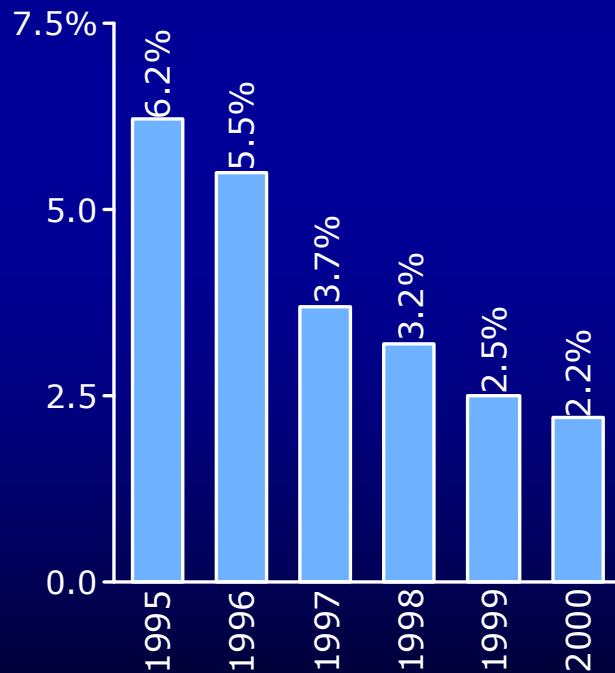
Average GDP growth (%)



NAFTA played a strong role in unemployment reduction while positively influencing salaries

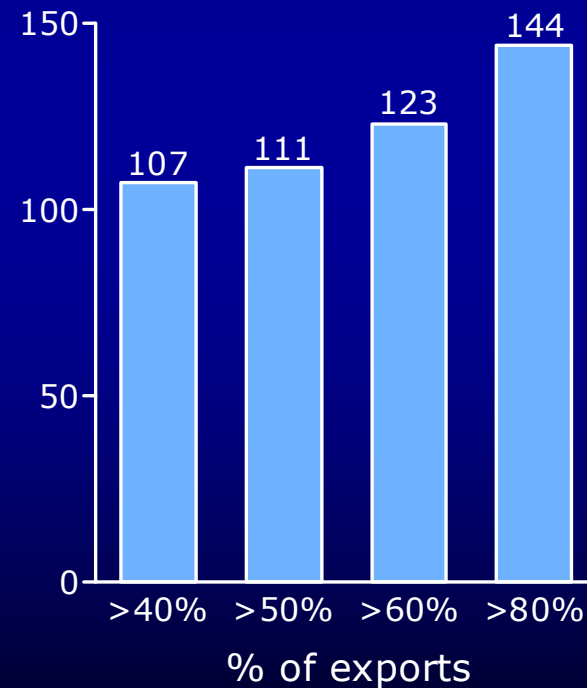
Reduction in unemployment rates

Unemployment



Better compensation in exporting companies

Mfg industry compensation
(100 = industry average)

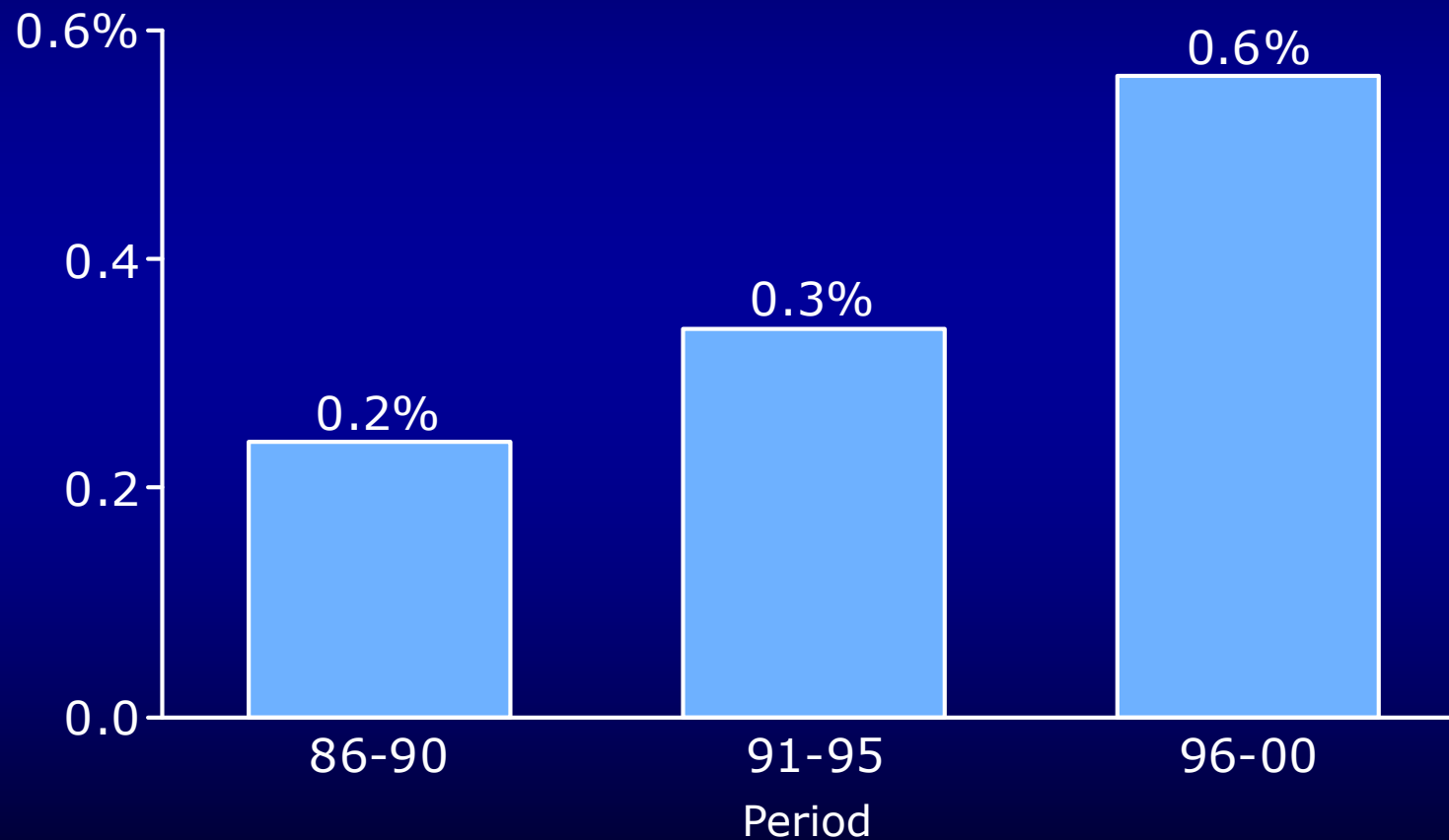


Source: INEGI, Secretaría del trabajo y previsión social

Note: Unemployment = persons more than 12 years old not working (not even one hour) are engaged in looking for employment. Includes the 47 most important urban zones of the country

...resulting in more rapid improvements in Human Development

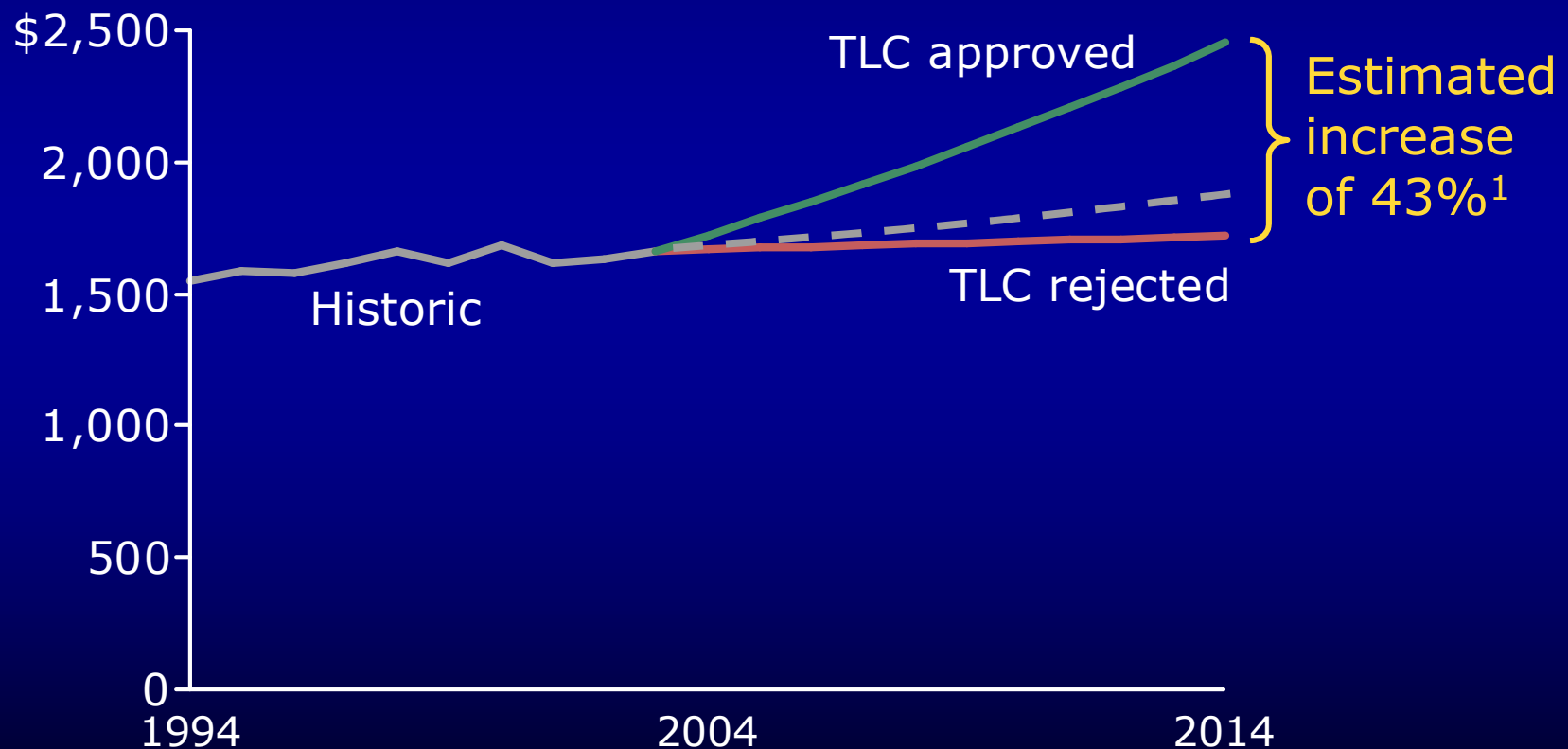
Human Development Index CAGR¹



¹ Index developed for the United Nations program of development. Measures country capacity to create an environment in which individuals can reach their potential and achieve a produce life. Composed of: life expectancy at birth, illiteracy rates, percentage of population receiving an education and GDP per capita

An initial estimate indicates CAFTA will boost per capita income in Central American 43% ..

Central American GDP/Capita



¹ Based on preliminary internal estimates from correlation analysis
Source: *World Development Indicators 2002*, The World Bank Group; *Estimados de crecimiento en Central America con TLC*, MI

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Will CAFTA aggravate poverty? The data says otherwise ...

Do the poorest sectors participate in growth?



YES

At least proportionally to overall growth

Do income disparities increase?



NO

Income distribution is independent of or favored by openness

In general, what happens to poverty in these countries?



DECREASES

Increases in income reduce poverty levels

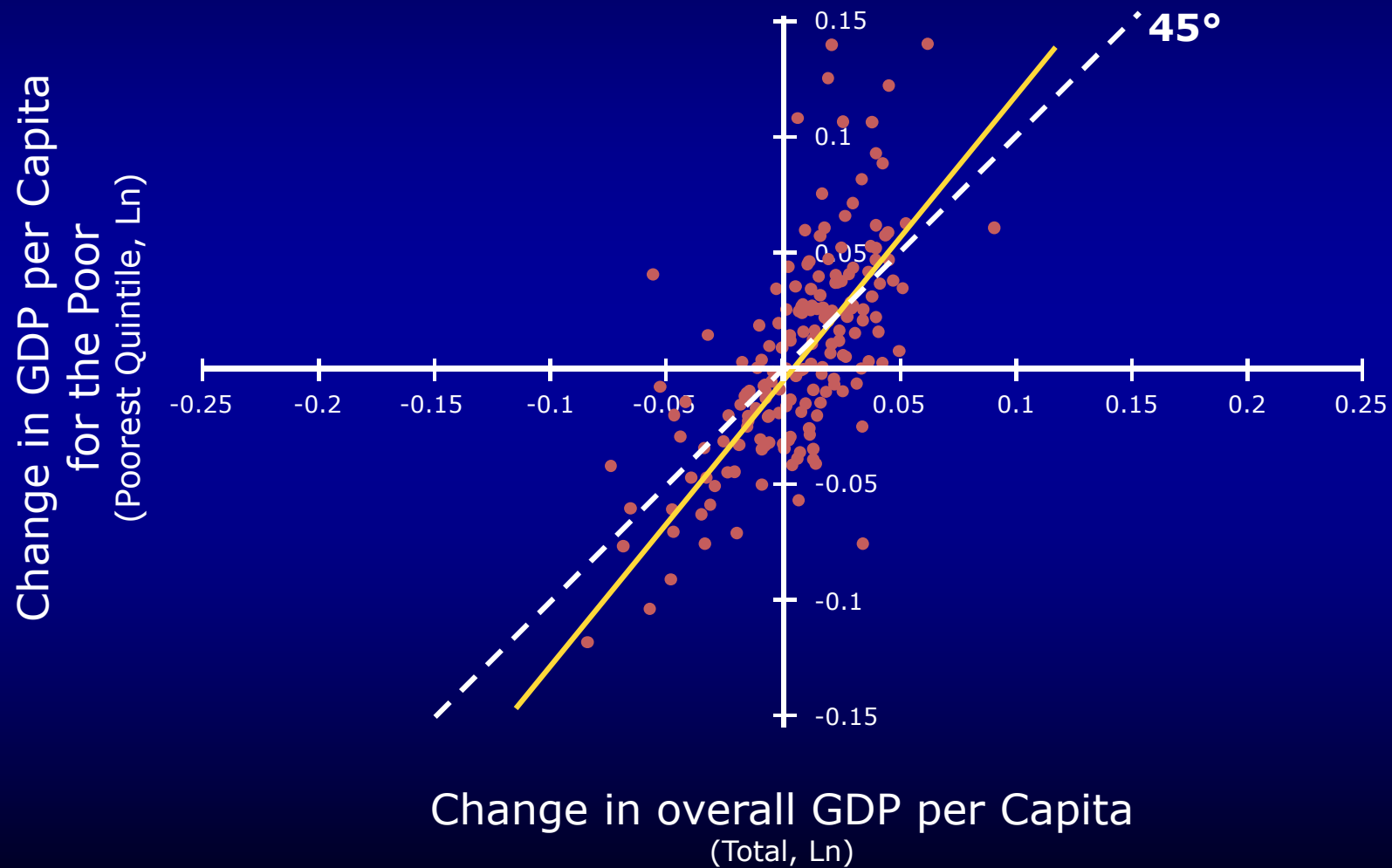
Does free trade encourage corruption?



NO

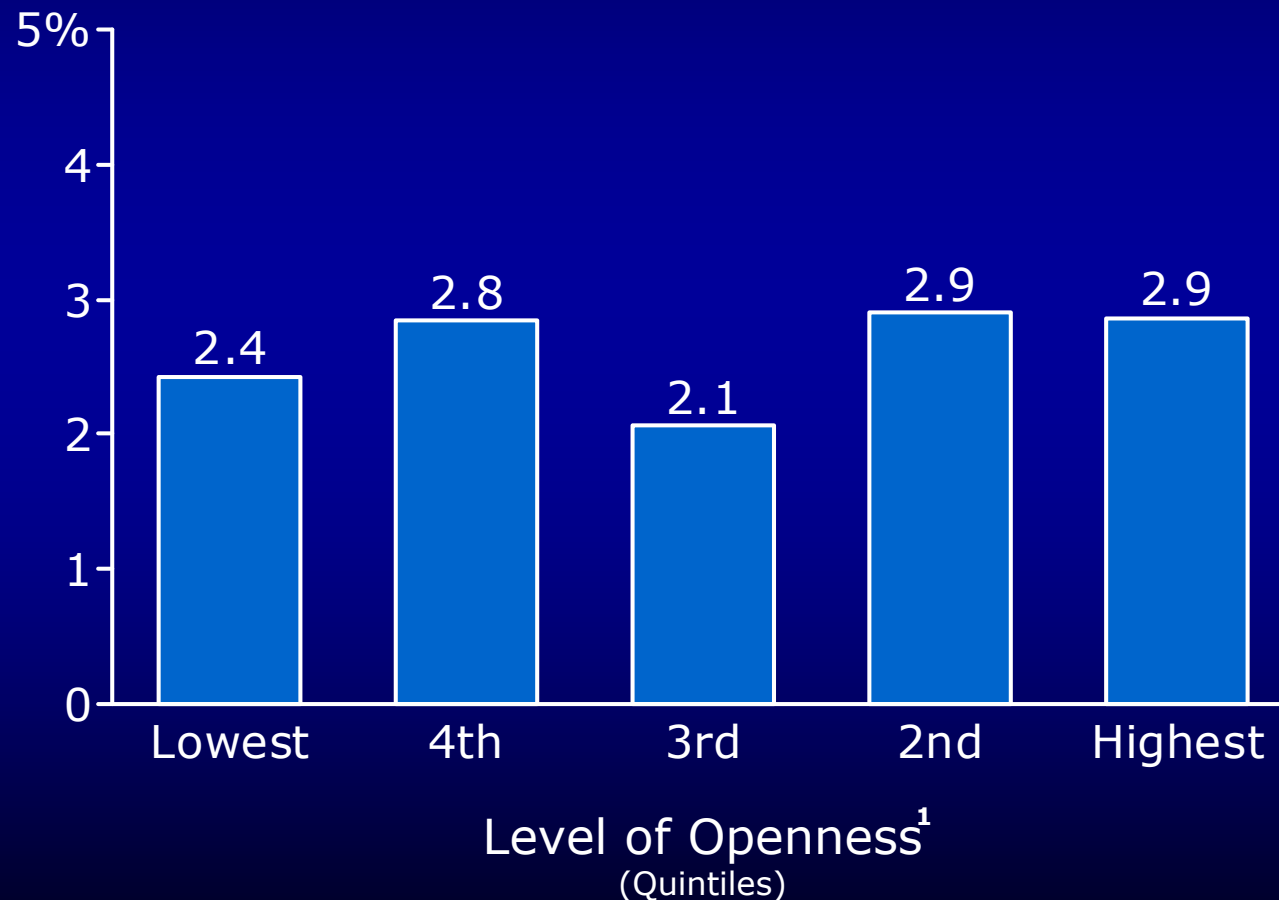
An open system yields fewer opportunities for corruption

Growth in income of the most poor is usually proportional (or better) to overall growth



Participation of the poor in total GDP is not reduced in open trade countries

Share of GDP for poorest 10% of population

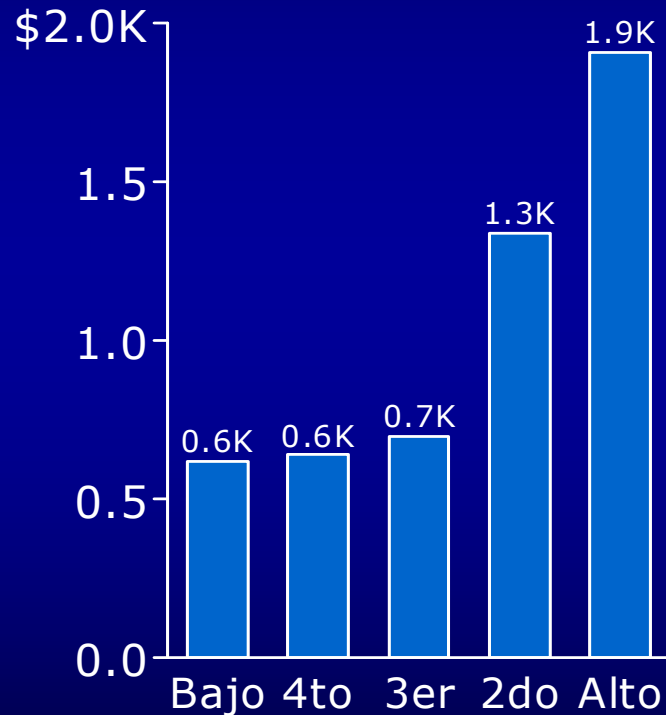


¹ Indicator based on: tariffs, import quotas, non-tariff barriers, exchange rate and control of capital
Source: *Economic Freedom of the World: 2002 Annual Report*, J.Gwartney and R. Lawson, The Fraser Institute; *World Development Indicators 2002*, The World Bank Group

Market openness increases the wealth of the most poor, reducing poverty levels

Income of those in Poverty (70 Países en Desarrollo)

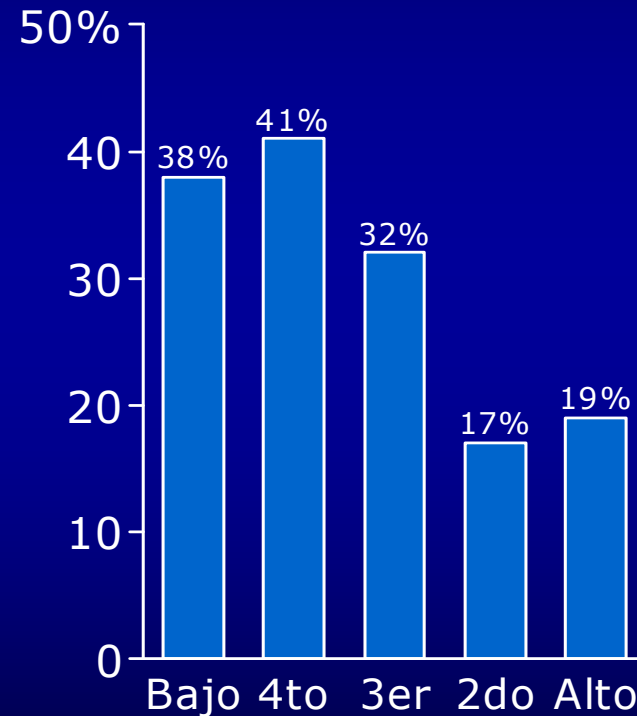
PIB/Capita (2000)
10% Más Pobre



Level of Openness²
(Quintiles)

Percent in Poverty¹

Porcentaje (2000)



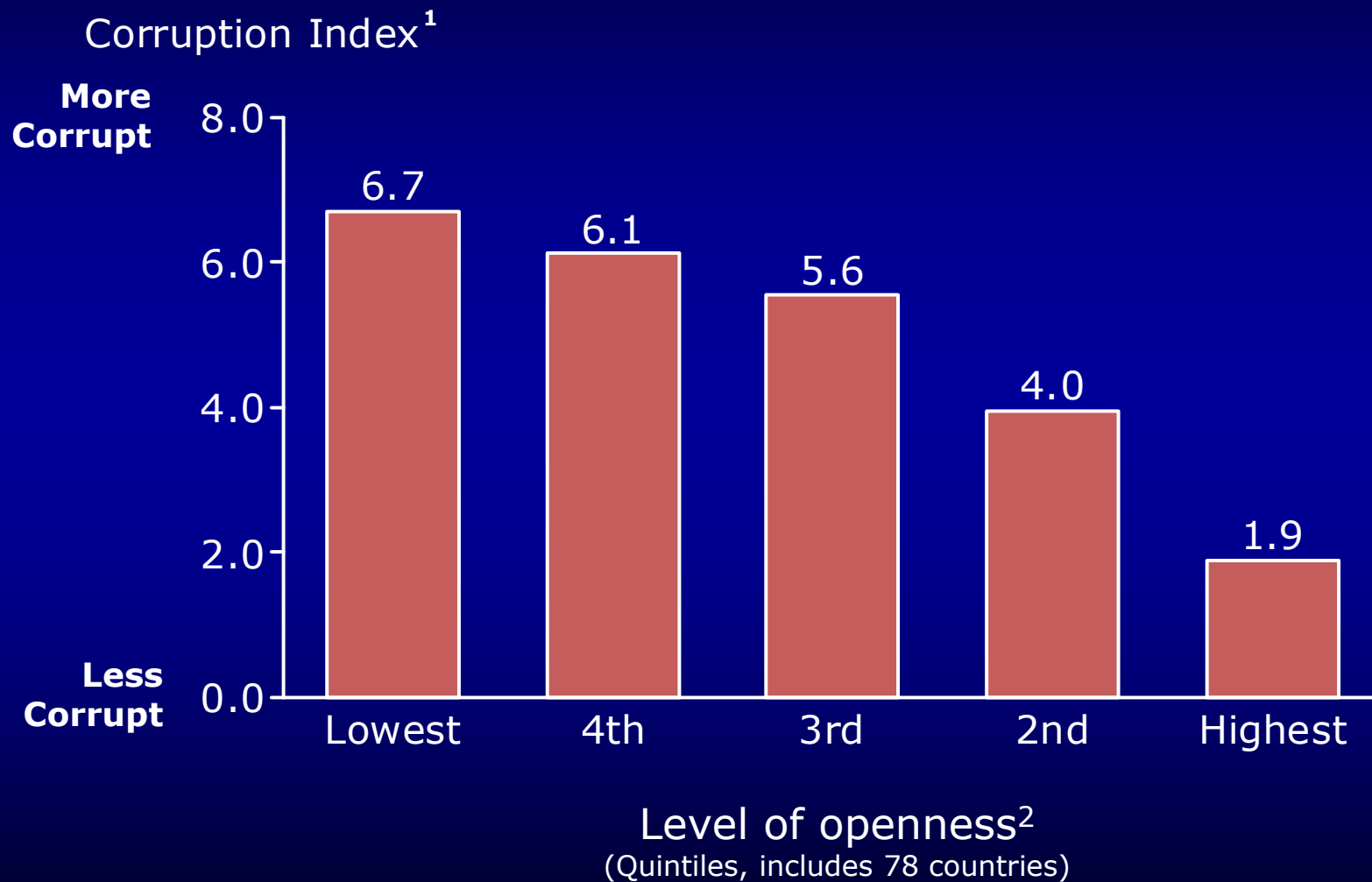
Level of Openness
(Quintiles)

¹ El nivel de pobreza se define con base en el porcentaje de hogares cuyo ingreso es menor al doble del costo de la canasta familiar

² Indicador con base en: aranceles, cuotas de importación, barreras no arancelarias, tipo de cambio y controles al capital

Fuente: *Economic Freedom of the World: 2002 Annual Report*, J.Gwartney and R. Lawson, The Fraser Institute; *World Development Indicators 2002*, The World Bank Group; *Economic Freedom and Human Welfare: Some Empirical Findings*, H.G. Grubel, Cato Journal

Additionally, open markets reduce opportunities for corruption



¹ The corruption index is shown in inverted form (0=Less Corrupt, 10=More Corrupt) to simplify the display of information

² Indicator based on: tariffs, import quotas, non-tariff barriers, exchange rate and control of capital

Sources: *Economic Freedom of the World: 2002 Annual Report*, J.Gwartney and R. Lawson, The Fraser Institute; *Corruption Perception Index*, Transparency International

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The warning on the negotiations of CAFTA?

- “Harry, I guarantee you are going to hate the final agreement. There will be lots of omissions. There will be inconsistencies. It won’t reflect theory very well.
- “We aren’t going to be able to get much that we need. The U.S. will slip in self-serving clauses. The five countries will trip over themselves in the negotiations.
- “Implementation of many of the agreements will seem to take forever”
 - A C.A. Min. of Trade, in October 2002 before the negotiations

The negotiator was right ...

- Disappointing results in some sectors
- Political conflicts among and within the countries
- Much that is excluded, not resolved or delayed

Nevertheless ... my opinion remains that

- We've had negotiators 'de lujo'
- They've done an extraordinary job under difficult conditions
- They exceeded realistic expectations.

Is CAFTA still the right course for Central America (given results of negotiations)?

- **Yes ... it gets us started on the right road**
 - It will accelerate economic growth
 - It will force important structural reforms
 - Central American Integration
 - Rule of Law and Transparency
 - Competitive pressures will push us to raise our standards
 - It can help us mobilize resources to combat poverty
 - It can be improved along the way

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Are we following the right economic strategy?

- The “strategy” in C.A. in the 90s and early 2000s focused on:
 - Macroeconomic stability via reduced public expenditures and monetary constraint
 - Reduced tariffs and greater “apertura”
 - Deregulation of prices and privatization of state owned enterprises
 - Increasing dollarization of currency and obligations
 - ... and of course CAFTA

External Perspectives (1 / 2)

- **C.A. has achieved an impressive turnaround.**

"Twenty years ago, Central America was in turmoil. Civil wars wracked El Salvador, Guatemala and Nicaragua. ... (there) is a very different Central America (today). Free elections have replaced military juntas with civilian leaders. Under Panamanian ownership, the Panama Canal is running superbly... Democratic, accountable governments have undertaken substantial reforms, making their economies more efficient and their societies more just... Democratically elected leaders are in charge in these countries, tackling the problems that matter most to their people, such as crime and unemployment... We are close to concluding a free trade agreement with five Central American nations, CAFTA, that will help them expand and retool their economies for a new century. The commerce and investment generated by CAFTA, coupled with the economic and fiscal reforms spurred on by the negotiations, will create jobs and income in Central America for generations to come." –*US Dept. of State, 11/2003*

- **There are positive economic prospects.**

"There are signs everywhere that cash is coming back to five of the Spanish-speaking nations in Central America... There is also a cultural change taking place... From Costa Rica, where the INCAE runs a second campus, comes management talent and information technology. Entrepreneurs from Guatemala, another country rich in capital, are buying up land, particularly farmland, in the labor-rich countries, Honduras and Nicaragua." –*Wall Street Journal, 12/2003*

External Perspectives (2/2)

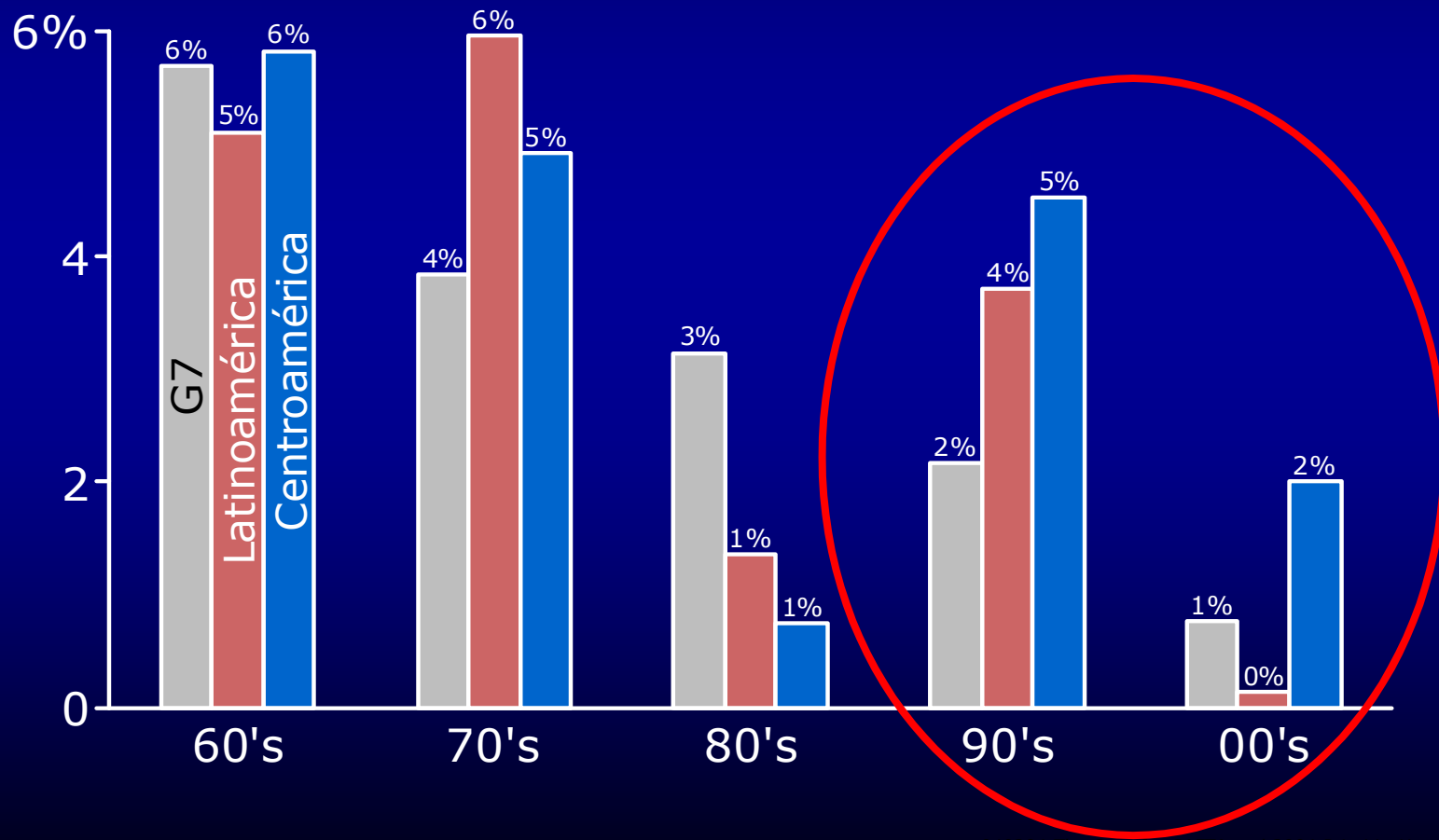
- **The region is on the right course.**

“Most significant, perhaps, has been the strengthening of democracy after many years of conflict. Many countries in the region have embarked on a path of economic reforms. Over the past decade, stronger macroeconomic policies and a growing emphasis on trade liberalization and export-led growth, have brought some important achievements. In particular, growth in the 1990s turned positive, and average per capita incomes rose by 2½ percent per year. Not enough, but a striking contrast to the previous decade's decline... Looking ahead, sustained growth and poverty reduction in Central America will require perseverance on three fronts.

- First, making the economies more "crisis proof", by boosting their resistance to shocks and consolidating macroeconomic stability.
- Second, pursuing structural reforms to raise productivity and strengthen institutions and good governance.
- And third, improving social equity to maintain consensus on the policy framework and achieve lasting poverty reduction” *-IMF, 07/2003*

And Macroeconomic data supports Central America's superior performance in the 90s and 2000s

GDP real growth

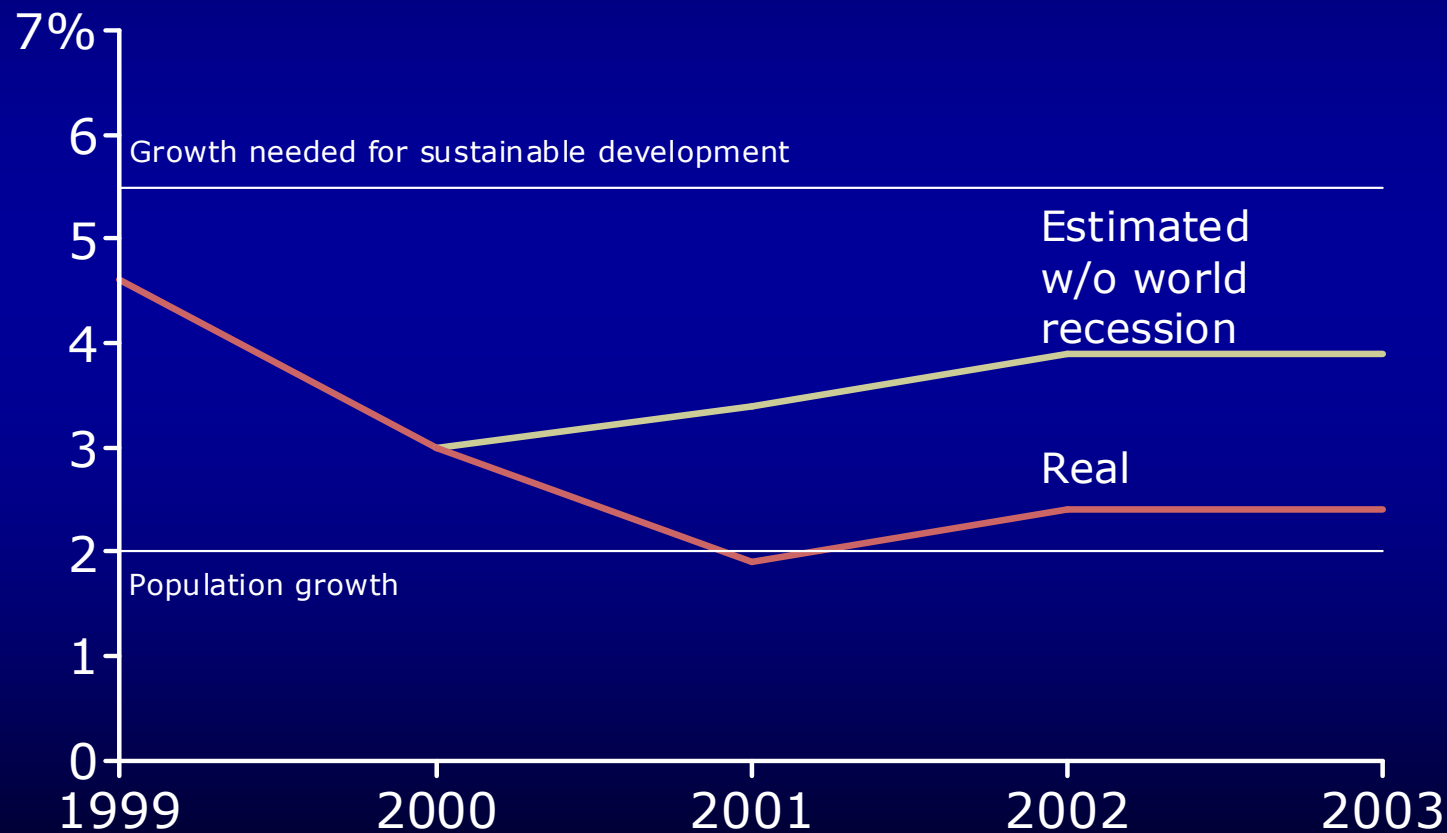


Why is that strategy in question?

- There has been a slowdown in Central America and major setbacks in South America (Argentina).
- Academics have questioned whether the World Bank and IMF are prescribing the right medicine (Joseph Stiglitz)
- The man in the street feels “we are not on the right track”. They perceive the strategy to favor the rich at the expense of the middle class and poor.

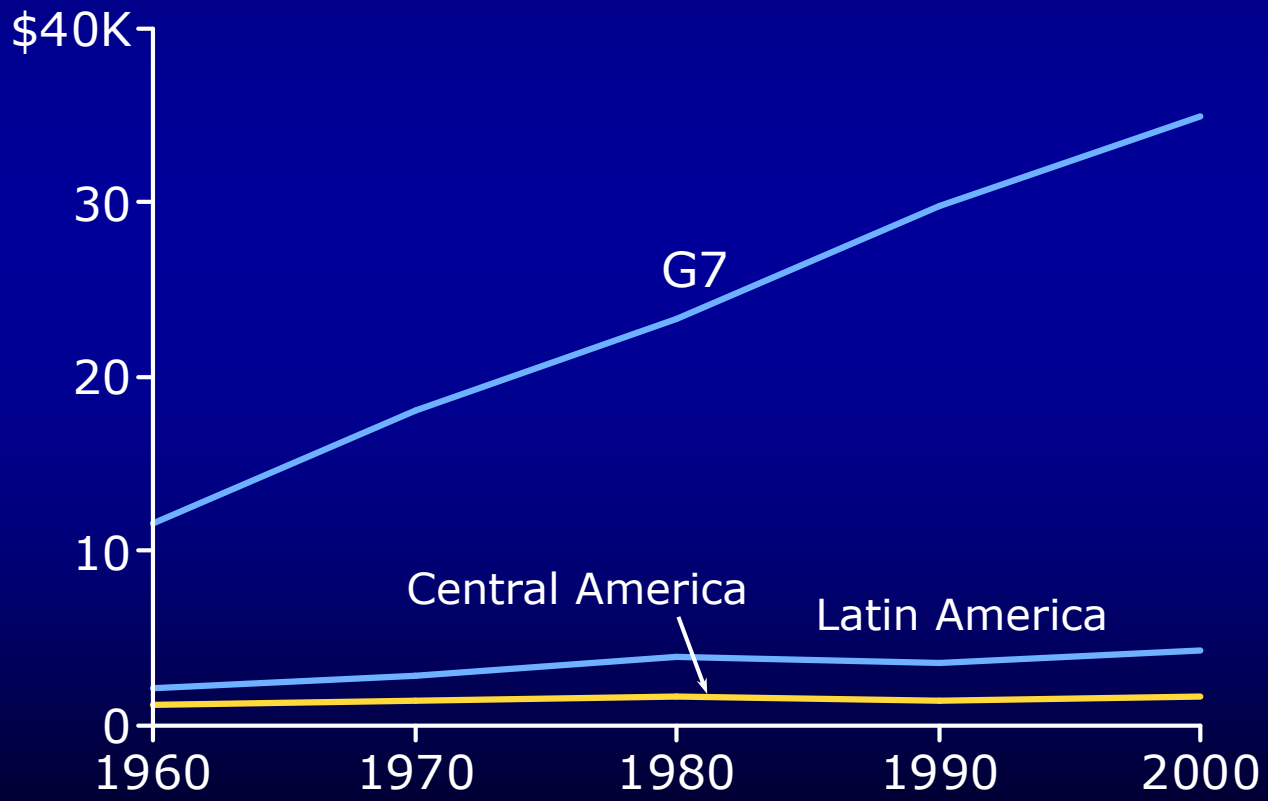
Central American performance, tho' superior to others, and tho' depressed by the World recession, is not enough

Central America GDP real growth



The economic gap vs the rich is not being closed ...

GDP / Capita
Constant Yr 2000 US\$



CAGR '60-'00	GDP/Capita (2000)
2.8%	\$35K
1.7%	\$4.2K
1.0%	\$1.7K

Internal Perspectives (CED-Gallup 2003) differ from External Perspectives ...

- **The economy has deteriorated.** A greater number of Central Americans (Roughly 5:1) believe the economy has deteriorated rather than believe it has improved.
- **Levels of violence are on the rise.** Between a fifth and a third of the households in C.A. have someone who has been victim of robbery or violence in the last 4 months. The major concerns on people's mind in all the countries are: 1) Violence and 2) Unemployment
- **A majority in most countries believe "we are not on the right course."**

My conclusions....

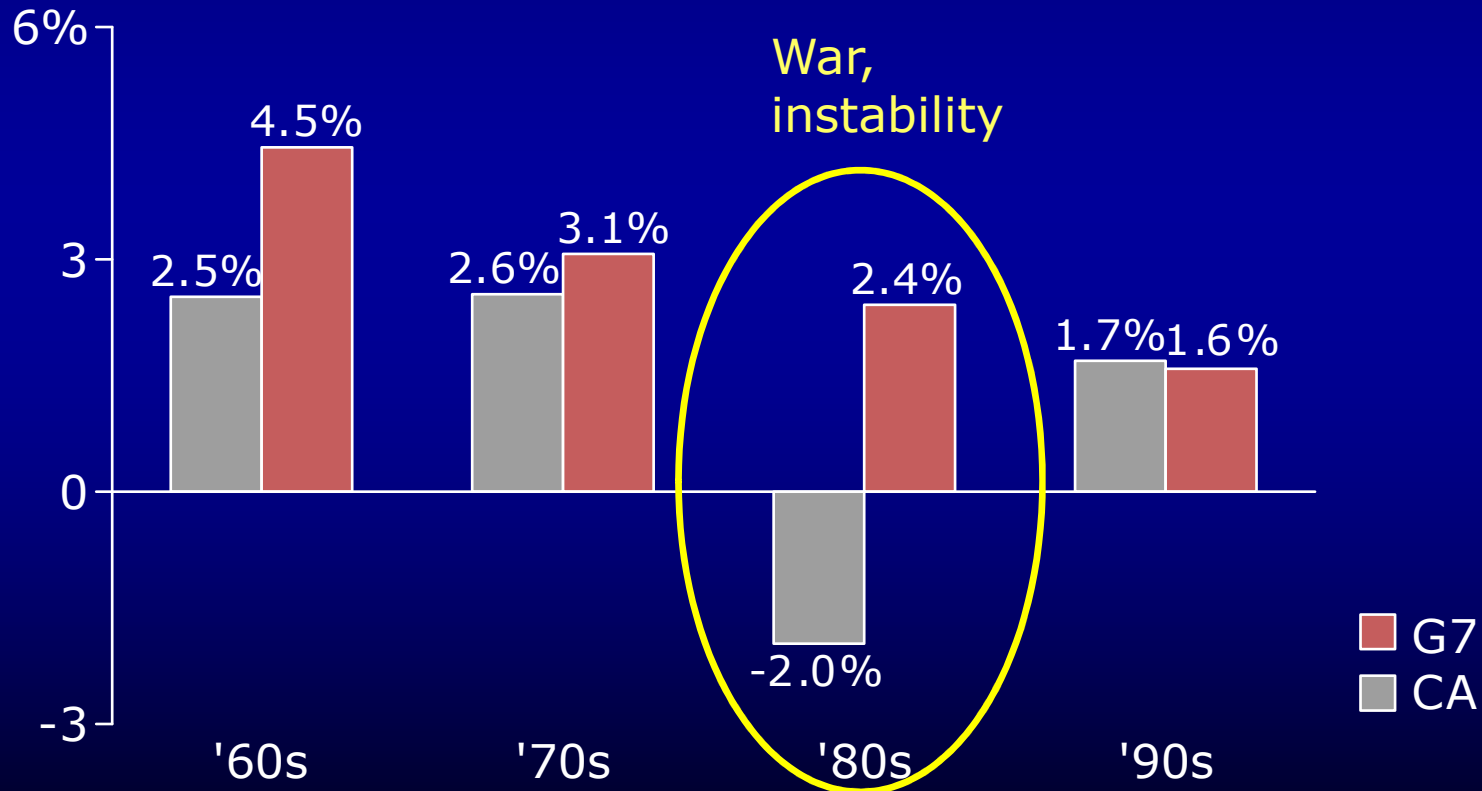
- CAFTA is not enough. It will give us a boost, but must be part of longer consistent strategy that results in
 - Increase national savings and investments
 - Continued "productivity" improvements
- The economic strategy (including CAFTA) will not work unless it is complemented by
 - Strategies to create physical security
 - Legal reforms, transparency and efficient government
 - Increase in social investment in education and health
 - A shared political and cultural vision of cohesion that benefits all sectors
- We haven't closed the gap in the past for lack of sustained effort. This time we must stay the course.

Our gap is not for lack of growth, its from unsustained growth, from periods of internal conflicts and misguided political/economic strategies that destroy progress ...

TACC PIB /

Capita Real por Década

Central America's Record



Nota: El año '79 se incluye en los '80s
Fuente: *World Development Indicators 2002*, The World Bank Group

Chile

In the last 25 years Chile has pursued the most aggressive economic strategy of free trade and open markets on the continent...

...and has had the most success economically of all the countries of Latin America...

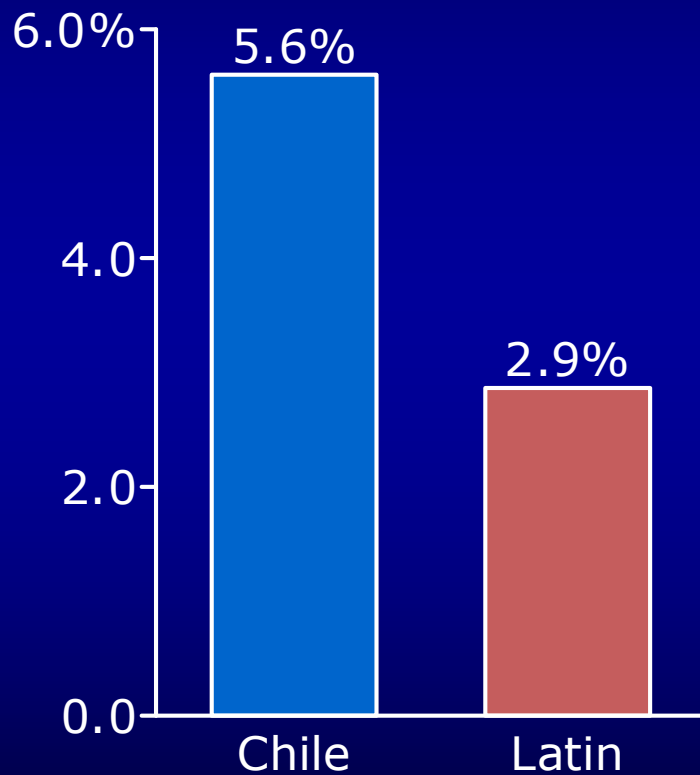
- Growth in exports
- Growth in GDP per capita
- Human Development
- Democratic evolution

The recent socialistic governments have not only maintained the economic strategy but aggressively pursued a FTA with the U.S.

Chile has vaulted to the head of economic indices...

Growth GDP/Capita
(US\$ 1995), CAGR 75-00

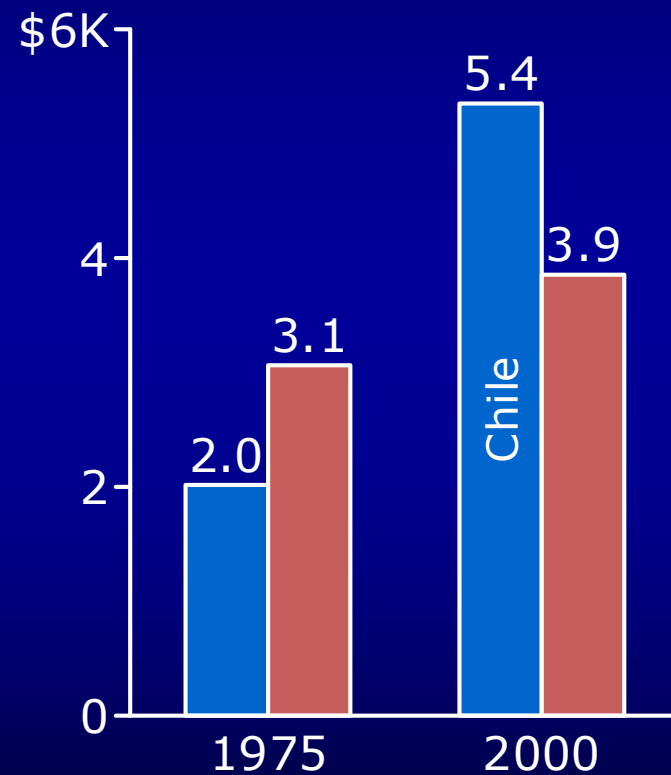
GDP per Capita
(US \$K 1995)



Growth
Ranking

#1

Chile
America



Chile
in A.L.

#14

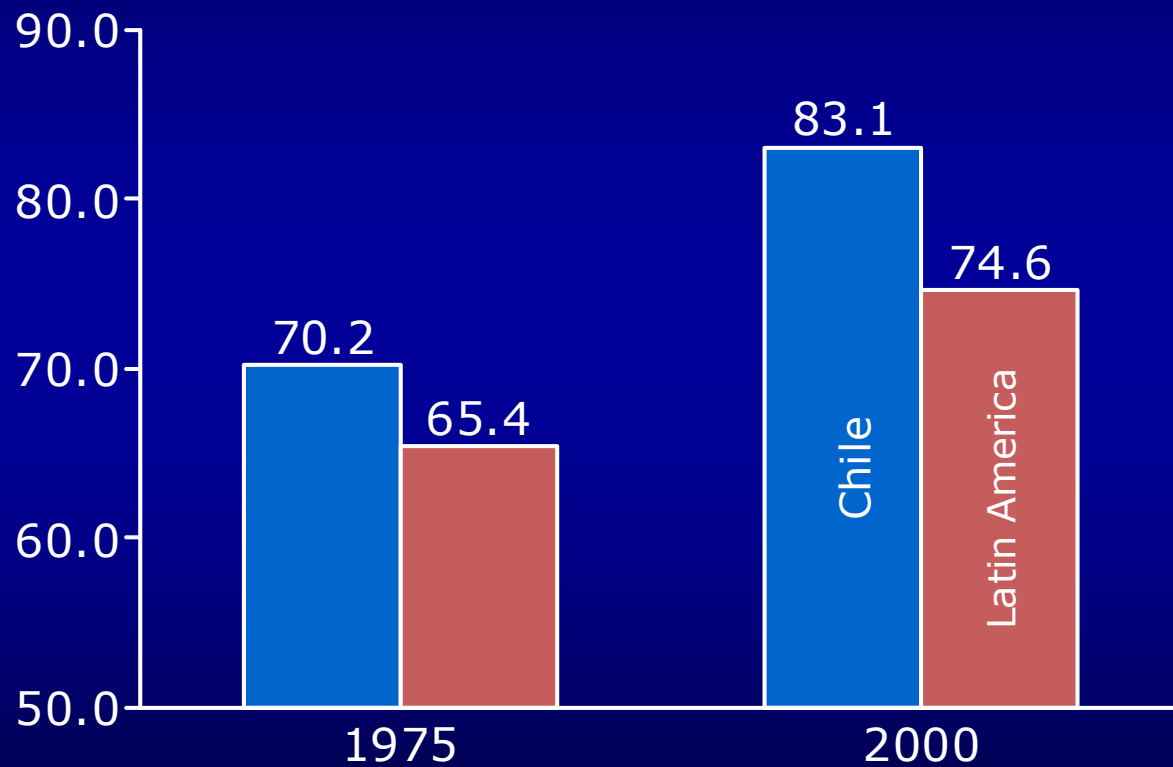
#3

(#1 in 2002)

37

...while its open trade stance has also had a strong impact on Human Development

Human Development Index



Chile/AL

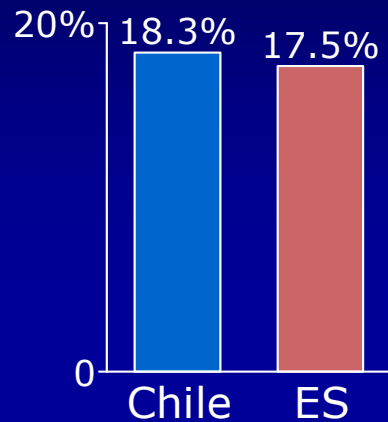
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#2

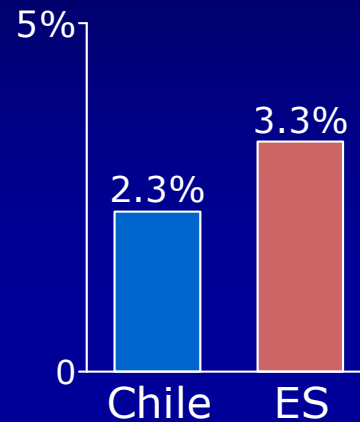
A key component of Chile's success is not just "apertura" but a focus on savings and productivity ...

Early phase:
Chile 86-90
ES 92-95

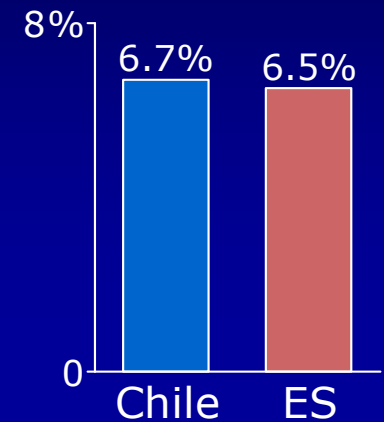
Investment rate (%)



Productivity gain (%)

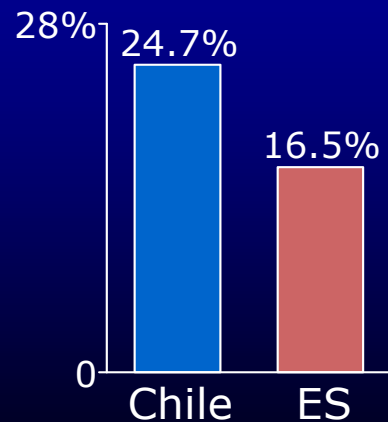


GDP growth

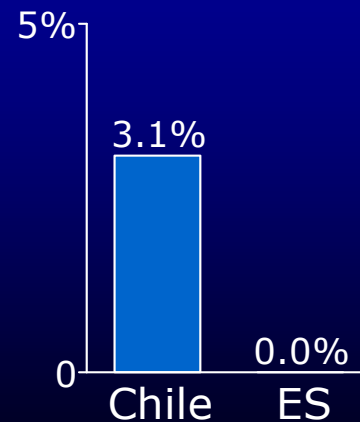


Latter phase:
Chile 90-97
ES 97-01

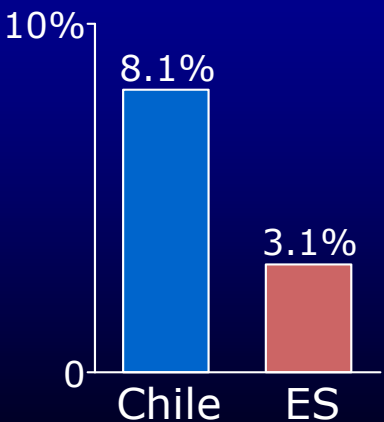
Investment rate (%)



Productivity gain (%)



GDP growth



Another underappreciated aspect of Chile's strategy ... the aggressive attack on poverty

- An integral part of the Chilean economic turnaround was their aggressive attack on poverty:
 - Unemployment compensation
 - Extensive labor retraining and replacement
 - Significant increases in health and educational investment
 - Taxes to finance this and public savings
- This has been critical to their
 - National savings and investment rates
 - Their productivity gains and competitiveness
 - Their social peace and democratic evolution

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Priorities for those of us in the Private Sector

- Help get CAFTA approved – share the data and perspectives
 - In Each Country of Central America
 - In the U.S. Congress
- Help build a national political vision that supports a consistent, sustained, inclusive strategy for the next 20 years.
- In our sphere of action to take full advantage of the opportunities
 - To make our firms more competitive
 - To remove the obstacles in our clusters
 - To help mobilize resources for Social Investments