Robert Z Lawrence.

Capitalizing on CAFTA:

Ehancing El Salvador's Integration into the Global Economy.[1]

Over the past decade, increased integration into the global economy has been an important component of El Salvador's economic strategy. In order to accomplish this, the government of El Salvador has reduced its trade barriers, created special zones for exporters, adopted policies to attract foreign investors and made the US dollar its currency. The government has also sought to improve the access of Salvadoran products to foreign markets by negotiating preferential trade agreements with regional and hemispheric trading partners and through participation in the World Trade Organization. [2]

Over the next decade, El Salvador's global immersion is scheduled to advance even further. If the current negotiations for a CAFTA are successful and it is implemented, the agreement will eliminate trade barriers and deepen integration with El Salvador's most important trading partner, the United States. Although prospects remain uncertain, there could also be additional liberalization through the FTAA, the Doha Round and more bilateral arrangements.

[1] I thank Laura K Wilson and Camilla Rodriguez for excellent research assistance. I am also indebted to my colleagues who worked on the project for their companionship and insights and to FUSADES for their wonderful hospitality and superb feedback on earlier drafts of this paper.

[2] Between March 2001 and June 2002, El Salvador signed regional agreements with Mexico, Chile, Panama and the Dominican Republic. It has also entered into negotiations with Canada and the United States and begun discussions with the European Union.

How well has the economy of El Salvador responded to this increased international integration? What is likely to be the impact in the future? Are additional policies required to ensure that the benefits of integration are fully captured? To answer these questions, the first part of this chapter identifies the major features of El Salvador's trade and investment performance and policies over the past decade. The second part then uses these features to consider how best to capitalize on CAFTA.

Section I. Trade and FDI: Performance and Policies.

The reductions in El Salvador's trade barriers have been extensive. In 1989, tariffs averaged over 30 percent (check) and were as high as 295 percent; by 1995 they averaged 10 percent [3] and by 2001 the average had declined to 7.4 percent (6.7 percent for non-agricultural products and 12 percent for agriculture.) In response to this liberalization and the recovery of the economy from the civil war, the volume of imports grew rapidly. Between 1990 and 1995 the annual increase averaged 17.3 percent. Thereafter import growth moderated and between 1996 and 2001 slowed to an average annual rate of 6.5 percent. Exports, by contrast took longer to accelerate Volume increases averaged 11 percent between 1990 and 1995 but their growth speeded to 13 percent between 1996 and 2001. Measured as a share of GDP, therefore, El Salvador has managed to maintain its trade balance in goods and services within a fairly narrow range.

Table 1: Trade Balance (% of GDP)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
On Goods and Services	-14.33	-13.59	-17.48	-14.49	-14.99	-16.70	-12.94	-11.64	-12.12	-13.05	-15.04	-13.94	-15.45
On Goods	-14.65	-13.37	-17.71	-13.82	-14.47	-15.40	-12.05	-10.27	-10.88	-11.50	-13.25	-13.93	
On Services	0.32	-0.23	0.23	-0.73	-0.52	-1.28	-0.88	-1.37	-1.24	-1.55	-1.79	-0.02	

SOURCES: IFS, CEPAL, FUSADES

[3] These numbers come from the WTO Trade Policy Review.

This performance is particularly noteworthy given the extensive trade liberalization, particularly in the early 1990s; the marked decline in the value of the major agricultural export, coffee at the end of the decade; and, as discussed in chapter 1, a strong real exchange rate. [4] This export performance was also impressive when compared with other countries in the region. According to CEPAL, for example, over the decade as a whole, the average annual growth in ES exports measured in US dollars was the fastest in the hemisphere.

Exports.

El Salvador's exports are best considered in three parts. Table 2 reports data on

exports sent to three markets (CACM, USA and Other). The Table also divides exports into three product categories traditional (coffee, sugar and shrimp), maquila (mainly clothing) and non-traditional (basically manufactured goods). This division indicates some interesting trends. This division indicates some interesting trends.

[4]According to the WTO Trade Policy Review, between 1996 and 2001, while the contribution of the agricultural sector to GDP declined from 13.5 to 11.8, the share of manufacturing increased from 21.1 to 23.6.

Values in percents												
Share in Product / Share in Market	1990				2000				2002			
	CACM	USA	Other	Total	CACM	USA	Other	Total	CACM	USA	Other	Total
Traditional	0.01 0.01	0.38 0.47	0.61 0.74	0.45	0.00 0.00	0.48 0.09	0.52 0.42	0.11	0.01 0.00	0.40 0.03	0.59 0.23	0.05
Non-Traditional	0.60 0.99	0.18 0.21	0.22 0.26	0.43	0.65 1.00	0.13 0.07	0.22 0.58	0.37	0.69 1.00	0.17 0.09	0.14 0.77	0.36
Maquila	0.00 0.00	1.00 0.33	0.00 0.00	0.12	0.00 0.00	1.00 0.84	0.00 0.00	0.52	0.00 0.00	1.00 0.88	0.00 0.00	0.59
Total	0.26	0.37	0.44		0.24	0.62	0.14		0.25	0.67	0.07	

SOURCE: own and FUSADES calculations from Comercio Exterior, BCR; SIECA; CEPAL;USITC

The bottom row of the table shows the increasing importance of exports to the United States – up from 37 percent of the total in 1990 to 67 percent in 2002; it also reveals the fairly constant share of exports to the CACM 26 percent in 1990 and 25 percent in 20002 and the dramatic decline in the share of exports to the rest of world (44 percent in 1990 to 7 percent in 2002). Comparing the last column of the table for each year shows large changes in the composition of exports. The share of Maquila exports rose from 12 percent in 1990 to 59 percent in 2002 while the share of traditional products declined from 45 percent in 1990 to just 5 percent in 2002.

The relationship between these trends can best be understood by appreciating that El Salvador exports a different mix of products to each major market. In 2002, for example an astounding 88 percent of exports to the US originated in Maquila's; by contrast, almost 100 percent of exports to the CACM were non-traditional products and the share of traditional exports was largest in sales to other markets.

El Salvador does not export significant quantities of traditional exports to the CACM and it exported very few non-traditional exports to developed countries in Europe and Japan. Indeed, El Salvador's exports of non-traditional exports have become increasingly concentrated in the CACM market, with the CACM share of these non-traditional exports rising from 60 percent in 1990 to 69 percent in 2002. These exports are quite diversified. They include significant quantities of paper, mineral fuels, plastics, iron and steel, soap, apparel, pharmaceuticals, manufactured foods, nuclear reactors and electrical machinery. Moreover, while somewhat more concentrated in agricultural products, El Salvador's

CACM imports have a similar character. It is noteworthy that four sectors appear in the lists of both the top ten exports and imports (fuels, edible preparations, plastics and pharmaceuticals). This indicates that Salvadoran firms and their counterparts in other Central American economies have been able to take advantage of the reduced regional barriers to manufactured goods trade.

Table 3 illustrates in greater detail the degree to which El Salvador's exports to the US are concentrated in apparel. [5] In 2002, for example, according to US customs data (a measure that differs slightly from the data used in Table 2) apparel and textiles accounted for 85.9 percent of US imports from El Salvador. Traditional exports (mainly coffee and sugar) accounted for an additional 3.3 percent. Non traditional exports, by contrast amount to about ten percent of total exports to the US and are widely dispersed.

2002 US Imports (customs value)	Value	Share	Duty Rate
APPAREL	1,554,706	78.7	4.9
KNIT APPAREL	119,618	6.1	1.1
TEXTILE FURNISHINGS	23,761	1.2	6
TOTAL APPAREL AND TEXTILES	**1,698,085**	**85.9**	
COFEE	31,728	1.6	0
SUGAR AND CONFECTIONERY	24,378	1.2	0.1
FISH AND OTHER MARINE PRODUCTS	8,128	0.4	0
TOTAL TRADITIONAL	**64,234**	**3.3**	**0**
SEMICONDUCTORS & ELECTRONIC COMPONENTS	26,022	1.3	0
PAPER PRODUCTS	23,514	1.2	0
IRON AND STEEL AND FERROALLOY	10,400	0.5	0.3
MISCELLANEOUS MANUFACTURED GOODS	7,372	0.4	0
BASIC CHEMICALS	6,012	0.3	0
FOOTWEAR	5,988	0.3	1.2
OTHER LEATHER PRODUCTS	5,566	0.3	9.7
PRINTING, PUBLISHING AND SIMILAR PRODUCTS	4,992	0.3	0
OTHER	123,597	6.3	1.2
TOTAL NON-TRADITIONAL	**213,463**	**10.8**	**0.9**
TOTAL IMPORTS	**1,975,782**	**100**	**4.1**

Source: United States International Trade Commission.

[5] US customs data are used in the table because they report duty collected by US customs

With the exception of semiconductors, paper, and steel there were no other major product categories above 10 million dollars. Table 3 also indicates that the average duty rate paid on non-clothing exports to the United States in 2002 was low -- just 0.9 percent. To be sure, this aggregate figure may disguise the role of tariff peaks in limiting certain imports such as footwear (average rate of 9.7 percent). Nonetheless, it suggests that by and large, US tariff barriers are not the reason for the small value of El Salvador's exports. Instead these exports are relatively small because of El Salvador's inability to supply them. Indeed. As shown in Table 4, El Salvador's exports to the United States are more concentrated in clothing than and of its regional neighbors.

Table 4: Share of Clothing in US Imports

	Total	Clothing	Share
El Salvador	1976	1675	0.85
Honduras	3260	2503	0.77
Nicaragua	677	432	0.64
Guatemala	2780	1672	0.6
Dominican Republic	4166	2176	0.52
Costa Rica	3146	729	0.23

Clothing, thus clearly represents the core of El Salvador's export performance. Indeed, El Salvador's maquila export performance over the decade has been impressive. Between 1993 and 1998, the growth of these exports tripled, raising their share of total US clothing imports from 0.8 to 2.4 percent. [6] This pace was almost as rapid as that of Mexico, despite Mexico's advantages from its NAFTA preferences and the large devaluation of the Mexican peso. [7] It is also important to note that up until 2000, (although they received rebates for value-added in the US under US program 9802 which allows for production sharing) Salvadoran clothing exports to the US were still subject to average tariffs of 9 percent. El Salvador has more recently been able to take advantage of the additional preferences its clothing exports were given under the Caribbean Basin Trade Preferences Act (CBTPA) in 2000. [8] As reported in Table 5, the duties paid on these exports fell from $144 million in 2000 to $89 million in 2002. El Salvador's share in US imports of apparel increased from 2.5 percent in 2000 to 2.7 percent in 2002. Table 5 also indicates that over this period, El Salvador's clothing export growth outpaced that of Mexico, Costa Rica and Dominican Republic and although lagging behind Nicaragua was similar to that of Guatemala and Honduras. While the passage of CBTPA has made an important contribution towards reducing them, El Salvador still faces tariff and non-tariff barriers on its clothing exports to the United States. As reported in Table 5, in 2000, before the passage of the CBTPA program, for example, almost all

---

[6] According to Buitelaar (2000) Mexican garment exports increased their share from 4.3 to 13.5 percent.

[7] Buitelaar op. cit. analyses performance of countries in Central America and the Dominican Republic against that of Mexico between 1993 and 1998. He finds that in several of these countries growth exceeded that in Mexico despite the devaluation of the peso and NAFTA agreement. He places much of the explanation in improved efficiency. ES is one the most dynamic countries with a striking adjustment through wage reductions. In addition labor productivity increased by 5 percent and the unit value by 37 percent –supported by a 21 percent increase capital intensity. He concludes "With wages at the intermediate level, the country has inserted itself in a highly dynamic manner after NAFTas entry into force."

[8] In May 2000, the United States passed the Trade and Development Act 2000, which extended the benefits of the CBI. El Salvador and the other countries in the region were given preferential access to the United States market for some products which had in the past been excluded from the Initiative. The measure grants tariff benefits up to September 2008 or until the FTAA enters into force. The measure eliminated duties on added value paid on textile products made in the region with cloth from the United States. In addition, free trade is permitted in a number of clothing items made from regional cloth using United States coarse thread with annual ceilings. These ceilings will be increased by up to a maximum of 16% a year until 2004. After that, the position will be reviewed to determine the percentage growth. Source: WTO Report.

(98.3) clothing exports to the United States entered at MFN rates and paid an average duty of 9 percent. By contrast, in 2002, 63 percent entered duty free. However the remaining products paid an average duty of 12.5 percent. For these products, significant the burdens are imposed by rules of origin in the program (through requiring higher cost US inputs and administrative costs) and the impact of quantitative limits.

Table 5: US Clothing Imports

Country	Program	1997	2000	2001	2002	% change 2002/1997
Costa Rica	Duty Free	0	15,633	409,660	475,754	
	Subject to Duty	839,172	808,544	361,335	252,007	
	Duties Paid	50,415	43,164	17,765	14,890	
	Duty Rate	0.06	0.05	0.05	0.06	
Subtotal - Costa Rica		852,485	830,461	774,441	729,480	-14.4
Dominican Republic	Duty Free	0	47,044	1,536,535	1,763,887	
	Subject to Duty	2,214,195	2,376,301	735,782	401,661	
	Duties Paid	165,647	196,286	74,703	42,733	
	Duty Rate	0.07	0.08	0.10	0.11	
Subtotal - Dominican Republic		2,234,148	2,442,208	2,285,045	2,176,203	-2.6
El Salvador	Duty Free	0	25,929	935,374	1,052,784	
	Subject to Duty	1,049,760	1,573,432	698,439	622,263	
	Duties Paid	93,402	143,706	89,302	77,578	
	Duty Rate	0.09	0.09	0.13	0.12	
Subtotal - El Salvador		1,052,251	1,600,452	1,634,137	1,675,464	59.2
Guatemala	Duty Free	0	14,731	423,022	552,484	
	Subject to Duty	961,978	1,468,214	1,191,242	1,107,023	
	Duties Paid	124,189	235,812	209,557	196,239	
	Duty Rate	0.13	0.16	0.18	0.18	
Subtotal - Guatemala		973,021	1,495,613	1,629,698	1,672,920	71.9
Honduras	Duty Free	0	45,616	1,460,412	1,772,034	
	Subject to Duty	1,663,770	2,315,561	911,864	667,703	
	Duties Paid	125,243	189,508	102,403	81,667	
	Duty Rate	0.08	0.08	0.11	0.12	
Subtotal - Honduras		1,688,562	2,416,251	2,437,505	2,503,098	48.2
Mexico	Duty Free	1,827,148	5,352,417	5,587,170	5,750,764	
	Subject to Duty	3,489,743	3,351,285	2,524,378	1,967,786	
	Duties Paid	14,223	28,641	33,490	64,879	
	Duty Rate	0.004	0.01	0.01	0.03	
Subtotal - Mexico		5,316,891	8,703,718	8,111,553	7,718,552	45.2
Nicaragua	Duty Free	0	274	81,063	127,742	
	Subject to Duty	181,992	336,794	299,136	305,118	
	Duties Paid	28,270	49,762	48,384	50,889	
	Duty Rate	0.16	0.15	0.16	0.17	
Subtotal Nicaragua		181,999	337,254	380,209	432,870	137.8
Total		**12,299,355**	**17,825,958**	**17,252,590**	**16,908,586**	37.5

SOURCE: United States International Trade Commission

Sales of El Salvador's traditional exports are more dispersed geographically than its manufactured goods exports. In 2002, for example 40 percent went to the United States and 59 percent to other countries outside Central America. In recent years, however, these exports have been decimated. As shown in Table 6, Coffee exports have been damaged by a global slump and in 2002 the value of these exports was just over a fifth of their peak levels and the volume of exports in 2002 was fifty percent lower than in 1990. While there has been a modest recovery of prices in 2003, the market has become increasingly competitive with large new entrants such as Vietnam and India. Shrimp production has been reduced to replenish stocks and although sugar export volumes have been more robust, but prices have been volatile.

Table 6: Traditional Exports

	1990	1995	1996	1997	1998	1999	2000*	2001*	2002*
Coffee									
Value	260.2	361.9	339.0	517.8	322.0	245.1	297.9	115.1	106.9
Volume	149.45	0	138.2	165.6	100.7	113.9	150.4	92.1	94.7
Sugar									
Value	20.3	37.8	36.7	56.1	66.5	37.3	40.0	70.0	44.4
Volume	44.9	0	97.6	174.0	243.9	176.7	256.4	310.4	221.3
Shrimp/Small Lobster									
Value	14.4	26.1	38.8	29.7	32.6	24.9	15.7	19.6	9.5
Volume	3.1	4.3	5.6	3.5	4.5	2.6	1.8	2.4	1.3

* Preliminary
SOURCE: Informe de Comercio Exterior, BCR.

Policies have played a role in this export performance. Some have been implemented by trading partners. Salvadoran raw sugar cane receives benefits under US tariff-rate quotas and El Salvador also enjoyed preferences under the original CBI program, the Generalized System of Preferences (GSP) programs of the US and the EU and, since 2000, CBTPA. Other programs have been domestic. El Salvador operates two programs to boost exports.[9] The first grants a refund of 6 percent of the fob value of exports outside the Central American Area. (Exports from maquilas containing more than 30 percent ES value added were also eligible.) Between 1998 and 2001, according to WTO (2003) between 7.6 and 8.2 percent of exports received refunds under this program averaging $12.6 million.[10] The second more important program involves export processing zones in which allow full exemptions from import duties on machinery and equipment used to produce exports, exemption from duties on fuels, income taxes and municipal taxes and tax on the transfer of real property. In these respects El Salvador's incentives appear to be fairly similar to those of its CACM counterparts despite the fact that these programs have not actually been coordinated. [11]

The government does not operate separate export financing programs but Salvadoran producers make use of financing from the CACM's Central Bank for Economic Integration which finances credit facilities for economic activity in general and exports in particular. BMI has a loan portfolio used for private initiative projects that granted $5million to exporters in 2001.

---

[9] Export subsidies are prohibited under WTO rules and developing countries were given 8 years to phase these out in Article 27.4 of the SCM. Countries then have to apply to the WTO Committee on Subsidies and Countervailing measures for WTO permission for extension.

[10] The program is not actually a duty-drawback scheme under WTO rules. Accordingly, in March 2003 the government announced that the 6 percent duty drawback scheme on exports will be eliminated within five years. EIU May 2003 page 24.

[11] According to the WTO Report "In December 2001, there were 243 enterprises operating under the free zone programme. The investment in these enterprises came from the United States (16.5% of enterprises), Korea (6.6%) and Guatemala (1.6%), as well as from Germany, Japan, United Kingdom and Taipei China (0.4% each). The great majority of these enterprises were clothing assemblers (143 enterprises), while the

A number of other institutions are involved in export promotion. According to the WTO "The services provided by these organizations generally include: market information; technical assistance and commercial advice; facilitation of contacts; promotion on international markets; and training."[12] The authorities have pointed out that there is coordination between most of these institutions and the trade missions abroad.

In short, while El Salvador does have some export promotion policies in place, export financial incentives have been, by and large, generic rather than targeted towards specific activities. In practice this has been sufficient to produce success in maquila clothing exports to the US. However, they have not succeeded in fostering other manufactured goods exports to the United States and other developed economy markets. Nor, have they succeeded in generating significant quantities of non-traditional exports of agricultural products.

Imports.

The United States is by far El Salvador's largest source of imports – accounting for 47.5 percent of the non-fuels total in 2000. Thereafter, major sources of non-fuels imports were Guatemala, (10.8.) percent, the EU (6.5), Mexico (5.3 percent), Honduras (3.6 percent) Costa Rica (3.5 percent) and Panama (3.0). Japan (3.0). Overall, the CACM accounts for 18.3 percent of ES Trade. Table 7 provides a decomposition of El

---

rest were mainly divided up between marketing (31), laundry services (13), textiles and embroidery (10), agro-industrial (10), boxes and containers (3) and waste recycling and packaging enterprises (3).

[12] These activities are carried out by Corporation of Salvadoran Exporters (*Corporación de Exportadores de El Salvador*, COEXPORT); the Agricultural and Agro-Industrial Chamber of El Salvador (*Cámara Agropecuaria y Agroindustrial de El Salvador*, CAMAGRO; the Chamber of Commerce and Industry of El Salvador (*Cámara de Comercio e Industria de El Salvador*); the Salvadoran Association of Industrialists

Salvador's imports. Generally, the commodity shares have remained fairly constant over time -- although between 1995 and 2001 there was a decline in the share of capital goods, pointing to the relatively weak performance of investment spending. Another striking feature is the fairly low share of agricultural and food products – each accounting for less than five percent of overall imports in 2002.

Table 7. El Salvador Imports.

	El Salvador: Imports Value in thousands of dollars					
	1995	Share	2000*	Share	2002*	
Agricultural Products	165,777	0.05	229,108	0.05	237,312	0.05
Oil/Chemical Products	395,207	0.12	688,479	0.14	610,992	0.12
Finished Goods	1,548,767	0.46	1,827,451	0.37	1,883,930	0.36
Food Products	138,715	0.04	229,835	0.05	211,855	0.04
Other	93,980	0.03	96,473	0.02	127,094	0.02
Unclassified	1,006,754	0.30	1,875,654	0.38	2,119,017	0.41
Total	3,349,200		4,947,000		5,190,200	

*=priliminary
SOURCE: SIECA; FUSADES

	El Salvador: Imports Value in millions of dollars					
	1995	Share	2000	Share	2001	Share
Intermediate goods	802.3	0.24	1617.00	0.33	1695.00	0.34
Consumption goods	1,210.7	0.36	1218.00	0.25	1271.00	0.25
Capital goods	843.1	0.25	961.00	0.19	900.00	0.18
Maquila	473.0	0.14	1153.00	0.23	1161.00	0.23
Total	3,329.1		4,949.0		5,027.0	

SOURCE: EUI Country Profile 2002

(*Asociación Salvadoreña de Industriales*, ASI); and the National Private Enterprise Association (*Asociación Nacional de la Empresa Privada*, ANEP).

The tariff structure as reported in Table 8 reveals the basic features of policies towards imports. The structure reflects a tariff escalation system with zero and low rates on capital goods and primary inputs and higher rates on finished products. This implies that on finished goods that are made using imported inputs and capital effective rates of protection are considerably higher than the 15 percent nominal rate.

Table 8: Summary analysis of the Salvadoran tariff in 2002

		Tariff rates applied			
Categories	**Number of lines[a]**	**Average tariff applied (%)**	**Range (%)**	**Standard deviation (%)**	**Coefficient of variation**
Total	5,989	7.4	0-40	9.0	1.2
By WTO category					
Agricultural products	879	12.0	0-40	10.9	0.9
Live animals; animal products	108	21.9	0-40	14.3	0.7
Dairy produce	31	26.9	0-40	13.1	0.5
Coffee and tea, cocoa, sugar, etc.	163	12.7	0-40	9.5	0.7
Fruit and vegetables	194	13.4	0-20	4.3	0.3
Cereals	22	12.0	0-40	15.3	1.3
Beverages and spirits	46	19.1	0-40	10.9	0.6
Tobacco	19	7.9	0-30	8.2	1.0
Non-agricultural products (excl. petroleum)	5,094	6.7	0-30	8.4	1.3
Fish and fish products	139	9.8	0-15	5.2	0.5
Textiles and clothing	910	17.8	0-25	7.8	0.4
Leather, rubber, footwear and travel goods	175	8.6	0-20	6.9	0.8
Transport equipment	156	6.5	0-30	9.7	1.5
Petroleum	16	4.3	1-10	3.8	0.9
By ISIC sectors[b]					
Agriculture and fishing	388	8.6	0-40	7.1	0.8
Mining	108	2.2	0-20	3.8	1.8
Manufacturing industry	5,492	7.5	0-40	9.1	1.2
By HS sections					
01 Live animals; animal products	263	14.1	0-40	11.3	0.8
02 Vegetable products	363	9.9	0-40	7.1	0.7
03 Fats and oils	52	7.6	0-40	7.9	1.0
04 Prepared foodstuffs, etc.	257	15.7	0-40	11.8	0.8
05 Mineral products	165	2.8	0-15	3.8	1.3

Categories	Tariff rates applied				
	Number of lines[a]	Average tariff applied (%)	Range (%)	Standard deviation (%)	Coefficient of variation
06 Products of the chemical industries	887	1.9	0-15	4.2	2.2
07 Plastics and rubber	307	4.6	0-15	4.8	1.1
08 Hides and skins, leather	81	9.1	0-15	6.2	0.7
09 Wood and articles of wood	87	7.4	0-15	5.7	0.8
10 Pulp, paper, etc.	191	4.4	0-15	5.8	1.3
11 Textiles and textile articles	891	17.8	0-25	8.0	0.5
12 Footwear and headgear	63	14.9	0-20	5.6	0.4
13 Articles of stone	160	6.5	0-15	6.6	1.0
14 Precious stones, etc.	53	8.2	0-20	6.9	0.8
15 Base metals and articles thereof	675	3.3	0-15	5.0	1.5
16 Machinery	903	2.3	0-15	4.9	2.1
17 Transport equipment	168	6.2	0-30	9.4	1.5
18 Precision instruments	244	4.2	0-25	6.5	1.5
19 Arms and ammunition	17	30.0	30	0.0	0.0
20 Miscellaneous manufactured articles	153	10.9	0-30	5.7	0.5
21 Works of art, etc.	9	20.0	5-30	12.0	0.6

a Excluding the applied in-quota rate.

b ISIC Classification (Rev.2), excluding electricity (1 line).

Source: WTO Secretariat estimates based on data supplied by the Salvadoran authorities.

El Salvador continues to provide considerable protection to agriculture and processed foods. Applied rates in Agriculture and Food can be as high as 40 percent and they average 27 percent for dairy, 22 percent for animal products, 19.1 percent for beverages and spirits, and 16 percent for prepared food stuffs.[13] In addition Tariff Rate Quotas are used to protect sensitive agricultural products. There is also a system of “under-supply quotas” for certain agricultural products in which firms are allowed to import products when domestic producers are unable to meet internal demand. The system permits local firms to import a certain quantity of products duty free provided they purchase agreed quantities of the same product from local producers at set prices. In addition, labor intensive manufactures such as textiles and footwear are protected with tariffs averaging 18 and 15 percent respectively. Apparently, firms producing labor-intensive products in the domestic market are unable to compete without protection. By contrast, it appears that Maquila producers which benefit from tax and duty exemptions and preferential access to the US market are able to compete. [14]

In sum, while El Salvador can be proud of its efforts at liberalization over the past decade, protection remains high on finished goods and agriculture. The experience over the past decade suggests El Salvador can adjust to liberalization and it implies that additional liberalization of these sectors should seriously be considered. To be sure, as the discussion below will elaborate, it is important that the pace of liberalization not be hugely disruptive. Nonetheless, it does not make sense for El Salvador to permanently provide a high degree of protection to domestic producers with costs that are far above those in the rest of the world.

<u>Technical and SPS Barriers.</u> In its annual review of foreign trade barriers, the United States gives El Salvador high ratings on the absence of technical barriers to trade. Indeed these appear to be lower than other Central American Countries. The US Government states " There are no legal barriers to US exports of manufactured goods or bulk, non-agricultural commodities. Moreover, standards have not been a barrier to the implementation of US consumer-ready food products." [15] However the US does complain

---

[13] The data are from WTO (20003).
[14] Most of El Salvador's customs tariff has been bound at 40% – the main exceptions being food products, wood and non-metallic minerals.

[15]Source: http://www.ustr.gov/pdf/1999_elsalvad.pdf

about SPS measures that limit poultry imports, restrictions on rice imports that have been made without any risk assessments and discriminatory standards applied only to imported products.

Services. While they were temporarily raised in 2001 as a result of insurance payments received because of hurricane Mitch, El Salvador's services exports have grown as rapidly as exports of goods in the second half of the 1990s. Between 1990 and 1995, by contrast the share of services exports had declined from 33 to 19 percent. Some progress has been made in generating travel exports but unlike many of the neighboring countries, El Salvador's tourist industry is not highly developed. As reported in Table 9 travel income represents just 1.5 percent of El Salvadoran GDP in 2001, far lower than in all other regional economies besides Mexico.

	Ratio of travel exports to GDP Travel Income as % GDP											
Table 9	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Costa Rica	5.0	4.7	5.2	6.2	6.1	5.8	6.0	5.8	6.5	7.0	8.2	7.3
Dominican Republic	10.3	10.0	9.5	12.7	13.7	13.2	13.4	13.9	13.6	14.3	14.6	13.1
El Salvador	1.7	1.3	1.3	1.2	1.1	0.9	0.8	1.3	1.7	1.9	1.6	1.5
Guatemala	1.5	1.5	1.8	1.8	1.6	1.5	1.4	1.5	1.6	2.0	2.5	2.7
Honduras	0.9	1.0	0.9	1.7	2.1	2.7	2.8	3.1	3.2	3.8	4.0	3.5
Mexico	2.1	1.9	1.7	1.5	1.5	2.1	2.0	1.8	1.8	1.5	1.4	1.4
Nicaragua	1.1	0.9	1.3	1.6	2.3	2.7	2.8	4.1	4.9	5.6	5.3	5.3
Panama	3.3	3.5	3.2	3.1	3.4	3.9	4.5	4.4	.	.	.	.

SOURCE: CEPAL Statistical Yearbook 2002

The bulk of tourists to El Salvador come from neighboring countries – particularly Guatemala --- and most visit the country to conduct business (42 percent) or to visit friends and family (41 percent.). Only 13.3 percent came for leisure and/or recreation. [16] As shown in Table 10, in 2000, the typical tourist spent about $319 dollars

[16] This discussion draws on Inman et al (2002).

per visit – compared with well over a thousand dollars for visitors to Panama and Costa Rica and $647 for visitors to Guatemala.

Table 10	Central America: Total earnings from tourism in 2000 Values in thousands of dollars		
	No. of Tourists	Per Arrival Income	Total Tourism Earnings
Costa Rica	1,088	1.13	1,229,440
El Salvador	795	0.319	253,605
Guatemala	826	0.647	534,422
Honduras	408	0.588	239,904
Nicaragua	486	0.238	115,668
Panama	479	1.202	575,758

SOURCE: World Tourism Organization

While El Salvador has some potential to attract tourists, given its climate, beaches –particularly suited for fishing and surfing – ecology and archeological heritage, it has not been exploited. The government offers participants in the sector no incentives and does little to promote these attributes or to upgrade the country as a tourist location by regulating standards and upgrading quality. El Salvador also has to face regional competitors with much to offer.

Direct Foreign Investment.

Although recently its performance has improved, compared with countries in the region Salvador has a relatively small stock of foreign investment. (See Table 11) Estimates of this FDI stock in 2001 indicate that as a ratio to GDP, it remained the lowest among Central American countries and just half the level of Honduras, the Dominican Republic and Costa Rica.

Table 11 Foreign Direct Investment & GDP (in billions of us dollars)

	FDI Stock	GDP	Ratio
Panama	7.30	9.50	0.77
Jamaica	4.00	7.30	0.55

Costa Rica	5.60	15.70	0.36
Domincan Republic	6.40	19.00	0.34
Honduras	1.80	5.90	0.31
Nicaragua	1.50	5.63	0.27
Gautemala	3.90	19.60	0.20
El Salvador	**2.24**	**13.00**	**0.17**

Source: UNCTAD

On the other hand, as reported in Table 12, the stock has increased rapidly in recent years. Between 1997 and 1999 privatization resulted in major inflows of $800 million in electricity and $398 million in communications. More recently, with the exception of agriculture, El Salvador has been more successful in attracting FDI. Between 1999 and 2002, the stock increased at an annual rate of 10.6 percent. Thus, while they remain at low levels, between 1997 and 2002 measured in US dollars the value of FDI stocks in Industry, Trade and Services each doubled.

Table 12	**FDI by economic sector Annual balances in millions of dollars**						
	1997	**1998**	**1999**	**2000**	**2001***	**2002**	**2003**
Industry	196.4	286.9	304.6	336.5	372.4	419.0	427.9
Business	106.0	124.6	142.0	169.1	190.2	225.9	232.8

Services	54.1	60.3	66.0	70.0	90.0	109.4	109.9
Construction	11.1	11.1	11.8	12.2	12.3	12.3	12.3
Communication	3.5	254.5	288.6	291.0	352.6	401.2	403.9
Electricity	0.0	598.4	723.5	806.9	821.5	848.2	848.2
Agriculture/Fisheries	-	21.0	21.0	10.0	40.0	48.5	48.5
Mines/Quarries	14.0	15.6	-	-	-	-	-
Financial	37.8	77.2	104.6	120.4	161.8	173.9	174.7
Maquila	57.2	134.4	137.6	156.9	182.6	192.7	202.4
Total	**480.1**	**1,583.9**	**1,799.7**	**1,973.1**	**2,223.4**	**2,431.3**	**2,460.6**

*Preliminary figures
SOURCE: Banco Comerical Reserva de El Salvador

The government has indicated an interest in attracting FDI. Legal and institutional measures have increased investor protection and reduce the difficulties faced by foreign investors in meeting regulatory requirements. In particular the Investment Law (Decree 732 of 14 October 1999) guarantees freedom of investment and national treatment, notes the relatively few exceptions and sets up a single window -- National Investment Office (ONI) for formalities required to be met. There are also numerous bilateral agreements on reciprocal promotion and protection of investments. In addition the National Commission for the Promotion of Investment in El Salvador (PROESA) was established in February 2000. PROESA has a board of directors chaired by the Vice President of the Republic. It has an annual budget of about $3 million derived from interest of trust funds resulting from telecommunications privatization. While it is certainly too soon to tell if PROESA will succeeded, its presence has yet to affect the FDI data if a noteworthy fashion.

Regional Integration.

Salvadoran firms and their counterparts in other Central American markets are hindered from reaping requisite scale economies by the small size of their domestic market. Regional integration therefore has an important play in offsetting this disadvantage. In addition, as the discussion above indicates, firms from the region have been able to compete successfully in neighboring countries whereas they have not been able to compete in markets that lie further afield. Accordingly, and appropriately, EL Salvador and other Central American economies have sought to establish in Central American a more integrated market.

The label Central American Common Market dates back to the 1960s when the nations of Central America sought to emulate the European Common Market. The term generally describes a customs union in which there are not barriers to the movement of goods, services, labor and capital. Judged by this definition, however, the label CACM does not accurately described the degree of regional integration in Central America today. Central America does not yet have an integrated internal market for goods or a common external tariff. While there has been progress towards these, much remains to be done.

First trade is not completely free within the region. To be sure the majority of products originating within the CACM are not subject to tariffs. However important exceptions relate to sugar, coffee, ethyl alcohol, wheat flour, distilled alcoholic beverages and petroleum products all of which are subject to quantitative limits.

In addition, particularly in agricultural goods, non-tariff barriers continue to impede trade. The greatest remaining barriers, according to SIECA arise in agricultural products and relate to discrepancies in rules of origin. [17]These difficulties are related not the rules of origin themselves, but rather to their application in context of a weak institutional framework. The slow operation of customs is also a problem.

Second, the countries do not have a common external tariff. Efforts have been made to establish a more complete customs union. In the early 1990s, the Central American economies were able to reduce and standardized their tariffs with a view to adopting a common external tariff that would range from 0 to 15 percent. More recently El Salvador and Guatemala began to negotiate a customs union. In June 2000 Honduras and Nicaragua joined these efforts which led to harmonization of 71 percent of the Common External Tariff.[18]

Third, only limited progress has been made towards harmonizing regulations, standards and rules. No regional bodies establish norms. These lacunae inhibit regional investment. According to SIECA (2001), among important policies required for greater economic integration of firms are speedy and common registration, effective registry of trademarks and patents, harmonization of labor legislation, registry of sanitary norms for medical and food products, business organizations with sub-regional approaches, elimination of trade barriers etc. Investment in subregional agriculture has also been limited because of food safety considerations and the protectionist interests of local groups.

---

[17] This discussion draws heavily on Sieca

[18] The Common tariff –raw materials, intermediate goods and capital goods produced outside the subregion –pay zero tariff. But raw materials in the subregion 5 percent, intermediate goods and capital goods in the sub-region 10 percent and Finished produces 15 percent. It appears as though there is a higher tariff on goods produced within the region than from the outside!!! Need to check this.

Fourth countries have negotiated extra-regional free trade agreements independently, further fragmenting the common external tariffs both because tariff reduction schedules differ and because of sectoral exceptions. For example Central America economies have concluded Free Trade Agreements with Chile and the Dominican Republic but countries negotiated separately on issues such as rules of origin and market access. Similarly they are acting separately in FTAA with exception of ES and Guatemala and have different agreements with Mexico. Finally, although they are quite similar, CAFTA countries have no binding agreements relating to incentives for attracting foreign investors.

Can El Salvador Compete?

El Salvador has been able to meet the challenges of adjusting to increased liberalization, a strong exchange rate and shocks to its traditional exports. Over the decade, the economy has been transformed from a closed and highly-protected exporter of a few primary products into a far more open and more diversified exporter of manufactured goods capable of maintaining current account balance. This economic opening has been led by unilateral liberalization, accompanied by measures to promote exports and attract foreign investment and complemented with regional and multilateral agreements. Nonetheless El Salvador's structural transformation remains incomplete and its policy framework may not assure continued success.

El Salvador's exports are highly concentrated in clothing produced in Maquila's and sold in the United States. While this performance has been impressive, questions can be raised about the future prospects of these exports if preferences are eroded by US tariff- reductions in the FTAA and other FTAs, the Doha Round, and the expiration of the

Multi-Fiber Arrangement (MFA) in 2005. This suggests diversification into other exports must be a priority. Thus far, however, El Salvador has been unable to produce (non-clothing) manufactured goods that can be exported in significant quantities in the United States and other developed countries. Indeed, its success in exporting these products has been limited to Central America. Foreign Direct Investment offers one mechanism for establishing El Salvador as an export platform but although it has grown fairly rapidly in recent years, the overall stock of FDI in El Salvador remains low. A second approach would be to boost exports of services and non-traditional agricultural products. But thus far tourism remains very small and underdeveloped, and there have not yet been major breakthroughs in alternative agricultural exports. Regional markets are vital for El Salvador but regional integration remains a work in progress.

The government has taken steps to respond to respond to these challenges but they remain in their infancy. Export development programs have been heavily focused on the problems of small firms. Efforts to attract foreign investors and exploit Salvadorans abroad as an asset have been launched but remain on a small scale. Currently, its most important effort is focused on CAFTA. Before considering additional policy measures, let us turn to evaluate its likely benefits and challenges.

Section II. Capitalizing on CAFTA.

Indeed, the CAFTA agreement with the United States is the most important trade policy measure that El Salvador will undertake this decade. Having lived for a decade under the shadow of the NAFTA which gave numerous preferences to their large neighbor, many in Central America are understandably eager to enjoy full and genuine parity with Mexico. By and large, the CAFTA will give Central America such parity.

At the time of writing the CAFTA negotiations have not yet been completed but based on the precedence of other agreements negotiated by the United States, the basic parameters of the agreement can be projected with some confidence.

The United States will eliminate all remaining tariffs and most non-tariff barriers on El Salvador's exports -- many immediately. For its part, El Salvador will implement a host of measures in a wide array of policy areas. These will include:

(a) reduced and eventual elimination of almost all tariff barriers on US exports of goods,

(b) significant liberalization on US services exports,

(c) increased protection for US investors,

(d) opening markets for government procurement

(e) adoption of new rules relating to intellectual property, sanitary and phyto-sanitary standards, technical barriers to trade and environmental and labor standards.

(f) Adoption of rules of origin for eligible products

(g) Participation in dispute-settlement proceedings.

Conspicuous by their absence, however, are likely to be specific agreements to deal with subsidies and anti-dumping. Existing national rules will continue to govern these aspects of trade within CAFTA.

CAFTA is an example of deep international integration, involving legally binding commitments to be enforced by dispute settlement procedures and the possibility of trade retaliation. Reflecting their status as developing countries, the Central American economies countries will be given longer adjustment periods. Nonetheless, once the CAFTA has been fully phased in, both sides will generally assume symmetrical commitments.

El Salvador need not have engaged in CAFTA. It could have simply relied on the preferences it currently receives from the United States and emphasized multilateral and other preferential trade agreements. But this would not have been wise, particularly once other CACM countries agree to free trade with the United States. El Salvador is a close substitute for its CACM partners in location, climate, and factor endowments. It cannot afford to be at a competitive disadvantage with respect to them regarding access to the United States market.

Potential Benefits from CAFTA.

El Salvador's motivations for joining CAFTA are not, however, simply defensive. With CAFTA, El Salvador gains market access preferences that are both more extensive and more secure than it enjoyed under CBTPA. CAFTA not only places the CACM on an equal footing Mexico, but it also enhances their position with respect to those CBTPA recipients from the Caribbean that have not been given the chance for a separate FTA with the US.

By negotiating CAFTA when they did, the CACM countries improved their bargaining positions. On the one hand, CAFTA reduced their dependence on an FTAA agreement that still has uncertain prospects and might not be successfully negotiated by its scheduled date of 2005. On the other hand, the timing of the negotiations strengthened the CACM's position by giving them the ability to offer to help the US build momentum and set a precedent for the broader FTAA agreement.

CAFTA can make an important contribution to El Salvador's economic welfare. CAFTA should enhance and secure El Salvador's access to its most important export market. While the CBTPA preferences granted in 2000 reduced El Salvador's market-access handicaps relative to Mexico, it did not eliminate them. In 2003, for example, Mexico continued to offer superior opportunities for access to the United States market. Clothing, by far El Salvador's largest export to the United States, is an example. Some clothing exports from both countries continue to be subject to US duties because they cannot meet the rules of origin requirements. However, in the first five months of 20003, the average duty paid by El Salvadoran clothing was 4.6 percent -- far higher than the 0.5 percent duties paid on clothing imports from Mexico.

In addition, CBTPA preferences are incomplete and not permanent. There are quantitative limits on market access for certain clothing products and the preferences can be changed or withdrawn by the United States at any time. [19] CAFTA, by contrast will be more inclusive and permanent.

Duty free access to the United States provides immediate benefits to El Salvador's exporters. In addition, the *assurance* of secure duty-free access in the future also improves the environment for investment in export industries by domestic and foreign firms. Between 1993 and 2002, Mexican exports to the United States increased three fold from $40 billion to $135 billion while FDI inflows in the 1990s have been more than

[19] As Salazar-Xirinachs and Granados observe "The reality of this threat was underlined in the recent TPA negotiations when as a result of political pressures, commitments were made to remove the access for textile and apparel products dyed and finished in the region, that had been granted to Central America under the Caribbean Basin Trade Partnership Act of 2000, by hardening the applicable rule of origin."

treble those in the 1980s. If El Salvador can replicate this performance, the employment and growth benefits would be considerable.

El Salvador will also reap benefits by reducing its import barriers on US goods and services. While it has dramatically reduced its average trade barriers, restrictions remain in a variety of goods and services sectors. By reducing these, CAFTA will bring benefits to Salvadoran consumers through increasing variety, reduced prices and more intense domestic competition.

In principle, the welfare impacts of free trade agreements could of course be reduced, or even offset, by trade diversion.[20] In particular, El Salvador could be hurt if the preferential access it grants to US products diverts purchases from more competitive producers in other countries. However, this should not be a source of major concern. El Salvador already imports almost half of its non-fuel imports from the United States -- 49 percent in 2000. In addition, it imported an additional fifth from CACM countries (19.6 percent in 2000) with whom it has free trade, and an additional 8.8 percent combined from countries with which it has Free Trade Agreements. Thus, assuming these FTA agreements remove all barriers, trade diversion could in principle occur with respect to only about a fifth of its trade. But the potential for trade diversion is even smaller since US manufactured goods mainly compete with those made in the EU and Japan (together just 13 percent of imports) and are concentrated in capital goods, for which El Salvador has low or zero tariffs.

Since US agricultural exports are either subsidized or sold at world prices, trade diversion should not be a problem for these products, once the agreement is fully phased in. However, there could be negative impacts during the phase - in period of the agreement if Salvadoran agricultural products are protected with quotas. El Salvador could find its welfare reduced if rents are transferred to US exporters who are given tariff –free access to its protected markets. While transfers from US consumers to Salvadoran producers may be viewed as equitable, the same cannot be said of transfers from Salvadoran consumers to US producers.

CAFTA could promote domestic reforms in areas covered by the agreement such as standards, regulation, intellectual property, judicial practices and competition policies. It would also make such reforms more credible, because they could become subject to international oversight. The rules changes required by CAFTA would help make El Salvador's economy more attractive to foreign investors. But the benefits would not be confined to foreigners. Domestic entrepreneurs would also gain because CAFTA will contribute to El Salvador's institutional development in a way that should improve the overall business climate.

The rules implemented through CAFTA should also enhance Central American integration. As each CACM member brings its policies into conformity with the CAFTA, it will also be bringing its policies into closer conformity with other CACM countries. In principle, to be sure, CAFTA will not require harmonization of standards and CAFTA members will be able to take measures they deem essential to protect human, plant and animal health as long as these measures are based on sound science and are not discriminatory. In practice, however, given the costs and demands of formulating such standards, countries will tend increasingly to adopt those used in the United States, and thus become increasingly similar with each other.

[20] For a discussion see Lawrence (1996) Chapter 3.

CAFTA also makes the CACM countries more attractive negotiating partners for third countries. The need to remain competitive with US products, services and investment in Central America could motivate others to sign similar agreements. Thus CAFTA helps provide some momentum to a more widespread participation in global integration. It is not a coincidence, for example, that, in the aftermath of the NAFTA, Mexico has been able to conclude a large number of FTAs with other nations. The EU, for example, has been eager to eliminate the advantage given to US products by NAFTA and in return has provided Mexican exports with preferential access to their markets.

CAFTA should also improve environmental and labor conditions in El Salvador. To be sure, there are concerns that including labor and environmental rules in the CAFTA could create a pretext for US protectionism, but the other side of the coin is that CAFTA will also make a positive contribution towards improving conditions in El Salvador. [21]

Finally, the debate over CAFTA will present challenges with respect to how the CACM is perceived by Americans, but it also offers opportunities. CAFTA raises Central America's profile in the United States. This could lead Americans to take a fresh look at CACM countries as a market, a location for investment and a source of new products

Obstacles to Reaping the Benefits from CAFTA.

[21] Gene Grossman and Alan Kreuger have elaborated upon how NAFTA could have such an impact on Mexico through mechanisms such as improved sanitary and phyto-sanitary standards, upgrading product quality, speeding up replacement investment etc.

CAFTA provides El Salvador with important opportunities in several dimensions: Negotiating ability, market access, foreign direct investment, consumer choice, regional integration, and institutional reforms. But will El Salvador be able to exploit these advantages fully?[22] Four important obstacles could prevent this from happening.

(i) US Non-tariff barriers. CAFTA will eliminate tariffs on CACM exports but in some cases, their exports face non-tariff barriers in the form of *US* technical and sanitary standards.[23] Since these standards and regulations reflect US domestic priorities, they have not been changed for a trading partner accounting for less than one percent of overall US trade. El Salvador also faces barriers due to US rules-of-origin, and several quantitative restrictions for apparel that currently inhibit Salvadoran access to the US market. As a result of CAFTA, El Salvador should be able to reduce the share of clothing exports to the US that are subject to duties and to remove or expand quantitative limitations. [24]Nonetheless, it is important to recall that even after NAFTA was implemented, the rules of origin induced a substantial numbers of Mexican exporters to the US to elect to take non-NAFTA customs treatment for their products. In 2002, despite the completion of the NAFTA liberalization in clothing, a quarter of US clothing imports from Mexico did not enter as NAFTA products and was subject to an average duty equal to 3.3 percent.

(ii) Fundamental competitive difficulties. Salvadoran exports of manufactured goods to the United States (besides textiles) already enjoy virtually duty-free entry.

---

[22] see El Salvador (2003) for the official strategy for taking advantage of CAFTA. See also USAID(2003).

[23] According to Hathaway, for example, "US TRQs prevent the export of specialty cheeses to the large immigrant population of Salvadorans in the US".

[24] In 2002, for example, despite CBTPA, 37 percent of clothing imports entered under no program, paying an average duty of 12 percent.

Despite this advantage, with the exception of clothing and a small amount of electronic products, manufactured goods exports to the United States are miniscule. While non-tariff barriers undoubtedly play some role, the most important source of El Salvador's relatively weak export performance is an inability to produce the goods and services that Americans will buy. One reason is inadequate knowledge. Prior to the 1990s, producers based in El Salvador viewed traditional agricultural exports such as coffee and sugar as virtually the only products that were competitive in the US. In the 90s they found that maquila-based clothing and a few other manufactured products could also compete. The United States is a highly competitive market and it requires considerable know-how to produce and market products successfully. While there are undoubtedly many goods and services that could be successfully exported to the US, their identification and the practical means for achieving this success, have yet to be undertaken.

<u>(iii) Problems in Attracting FDI.</u> One channel for improving El Salvador's supply-side weaknesses is direct foreign investment driven by the prospects of producing in El Salvador and selling in the United States because of the CAFTA's improved and more secure market access. This is particularly important for El Salvador because it needs to offset the disadvantages its small domestic market presents for foreign investors. However, as the relatively low ratio of the stock of FDI to GNP for El Salvador indicates, several issues remain problematic for foreign investors.

The first is domestic politics. The political debate in El Salvador does not reveal a national consensus on the desirability of market-oriented reforms in general and on the benefits of foreign investment in particular. CAFTA does help lock in El Salvador's commitments to foreign investors. Nonetheless, as long as domestic opponents of FDI remain strong and vocal, foreign investors will be wary. Ironically, as the examples of Chile and, more recently Brazil suggest, the advent of a left-wing government that proves that it is also fully committed to international integration could be the best way to deal with these concerns.

Second, there are regional competitors with similar location advantages and market access to the United States. The CAFTA may well level the playing field for El Salvador with respect to Mexico, but it does not change the relative advantage of El Salvador with respect to other Central American locations for investment. Indeed, given that its neighbors will also have become more attractive locations for investment because of CAFTA, El Salvador would find a policy reversal such as withdrawing from CAFTA especially costly. Assuming it continues with the CAFTA process, El Salvador could simply sit back and reap its proportional share of the increased investment that CAFTA stimulates. But it would be preferable to develop a more compelling strategy the provides foreign investors with additional reasons to prefer EL Salvador over other Central American locations.

Third, unfavorable image In the United States congress there is considerable concern about the treatment of unions in CAFTA countries in general and within export processing-zones in particular. Several Democratic candidates for the US Presidency have announced their intentions to oppose the CAFTA and several Democratic members of congress in particular have announced their reluctance to support a CAFTA without stronger labor and environmental provisions. Regardless of whether they are actually effective in preventing CAFTA's passage, they could well raise CAFTA's profile with respect to these questions, thereby damaging Central America's reputation as a location for investment in brand products.

Fourth, legal and personal insecurity. The experience of American firms in obtaining satisfactory resolution of conflicts through the Salvadoran legal system has been poor. CAFTA provides increased protection and private rights of action for foreign investors, backed up by CAFTA dispute resolution mechanisms, but it remains to be seen how successful these will be in practice. Firms contemplating locating in El Salvador also need an environment in which their executives and their families can be relatively free of fears about crime. As discussed by Piehl, El Salvador's poor record in this area is an important problem

. To be sure, the combination of its dollar currency and the lock-in effects of CAFTA do help make El Salvador a more attractive borrower. But ironically, because of its reform success, El Salvador has already improved its international reputation. Even prior to CAFTA was able to borrow internationally at low rates, and to offer investors security in being able to repatriate their profits. It is unlikely therefore to reap large additional foreign investments benefits due to the CAFTA from this effect.

<u>(iv) Domestic Adjustment.</u> The gains from trade depend critically on the ability of the economy to reallocate resources from import-competing to export industries. If the resources displaced by imports remain idle, however, these gains could prove elusive. El Salvador's economy has already demonstrated its ability to adjust in the 1990s. Despite the dramatic reductions in tariffs, the trade deficit remained within a fairly constant range indicating that exports kept pace with imports. The US is unlikely to be a strong competitor in labor-intensive manufactured goods. Instead, the adjustment pressures will

be in agriculture. The magnitude of the gains from CAFTA will depend, therefore, in part on the ability to channel resources from uncompetitive farming activities into other parts of the economy.

Policies to Capitalize on CAFTA.

In principle, El Salvador has numerous assets that should allow it to expand exports in a variety of areas. These include a large number of farmers that could move into non-traditional agricultural products (fruits, gourmet coffee, ethnic foods, horticulture etc); a productive and hard working labor force that could expand production of labor intensive products such as industrial components and parts -- particularly electronics; well-spoken and educated bi-lingual workers and a modernized telecommunications system that could export services such as call centers and data processing; a large number of Salvadorans abroad who have strong motives for visiting friends and relatives, and other natural and cultural assets, that could stimulate tourism and travel; and dollarization and a financial system that could develop exports of financial services. However, these assets have not been fully exploited and in order to benefit more fully from CAFTA several policy measures should be taken.

<u>(i) Upgrading standards and regulatory and judicial enforcement.</u>

To deal with problems relating to US non-tariff barriers and some of the concerns of foreign investors, El Salvador needs to upgrade its domestic standards and improve its regulatory and judicial systems. It has no choice. *US policies will not change and to* *capitalize on CAFTA El Salvador must view these standards as goals to be met rather than insurmountable obstacles.*

Policies which take advantage of CAFTA can help accomplish this. Indeed, international experience suggests that deep integration agreements can provide opportunities for major improvements in standards and product quality. Mexico, for example, has been extremely successful in using NAFTA to its advantage in raising standards and improving regulation. Sen (2002) emphasizes the extent to which the Free Trade Commission formed as a result of NAFTA and various trilateral committees adopted a problem-solving approach to regulatory issues obviating the need for using dispute settlement mechanisms. NAFTA established an SPS committee along with 9 technical working groups and a Committee on Standards-Related Measures with associated subcommittees that meet regularly to discuss implementation issues. "The mechanism which has a strong problem solving ethos, works to support improving the application of SPS provisions and in reducing regulatory discretion." Similarly, as noted by Salazar-Xirinachs and Granados (2003) "the experience of NAFTA in the environmental area shows that NAFTA's environmental institutions have been partly responsible for the deepening level of technical cooperation on environmental protection between the US and Mexico"

Salvadoran products, particularly those from the agricultural sector, have difficulties meeting the norms and standards required in the US market. As a result, farmers have been hindered from fully realizing their potential. In some cases this may reflect demands for higher quality in other cases, protectionism. At the same time, Americans have objected to the application of discriminatory standards on some of their food exports to El Salvador. The CAFTA provides an opportunity to mobilize both sides to eliminate these trade obstacles by using a problem-solving approach similar to that used in NAFTA.

The CAFTA rules on Technical Barriers to Trade and Sanitary and Phyto-Sanitary Standards should be viewed as an opportunity rather than an obstacle. El Salvador should mobilize support for such an effort from Americans in both the public sector. The United States Departments of Agriculture and Commerce should be asked for technical assistance and the assistance of the US private sector should also be sought. The US interest in developing capacity in this area should be exploited, not only to help improve the regulatory environment in the Salvadoran market but also to ensure improved access for Salvadoran exports to the United States.

CAFTA also offers an opportunity for improving regulatory and judicial processes. In his analysis of the Mexican experience under NAFTA, Sen found a profound impact imparted by US principles of due process on regulatory systems and notes that “A clear and close correlation between transparency and due process, and an improved regulatory environment repeatedly emerged.” Again technical assistance in this area should be sought from the United States.

Similar measures should be taken with regard to financial regulation. El Salvador is said to be the country with the best financial regulatory system in Central America yet it remains inadequate to provide the US authorities with sufficient confidence to allow Salvadoran financial institutions to invest in the United States. As discussed by Velasco services liberalization is an important feature of CAFTA and given its dollar-based economy, El Salvador should seek to become a regional financial hub. In addition, its financial institutions should seek to take more advantage of Salvadorans living in the United States as an export market for financial services exports. Unless the domestic regulatory base is strengthened to the point where Salvadoran institutions are granted access to the US this potential will remain unexploited. Accordingly, there should be increased public investment in regulatory improvement combined with technical assistance from regulatory authorities in the United States.

(ii) Complementing CAFTA within and outside the Region. El Salvador has an interest in deepening regional integration. While they have been relatively unsuccessful in exporting to the United States, Salvadoran firms have done better in the rest of Central America. In addition, El Salvador will become more attractive to foreign investors, if such investment allows them to establishing a regional presence. While CAFTA will automatically contribute to regional integration by inducing greater similarity in the approaches adopted by CACM countries, additional measures are needed to create a single internal market. These should capitalize on CAFTA. CACM countries will all be obliged to reduce their regulatory and other barriers to US exports. They should take steps to eliminate these with respect to one another. *Indeed, an MFN agreement should be negotiated to ensure that Central Americans grant each other no worse treatment than they grant to extra-regional partners.* This would automatically leverage all preferential arrangements into mechanisms for deeper regional integration.

Additional extra-regional agreements should also be pursued ideally together with other CACM members. Emulating Mexico (and Chile), El Salvador (or better still the CACM acting together) should exploit the domino effect of the agreement with the United States to conclude other Free Trade Agreements. Both Canada and the European

Union are attractive partners. Outside of its coffee exports, El Salvador's exports to these markets are extremely small. Since it has a limited interest in agricultural exports, El Salvador is also a potentially attractive partner for Japan. El Salvador could also seek agreements that go deeper than the FTAA with partners from Mercosur, the Andean Group and other nations in the Western Hemisphere. In addition, coordination and harmonization of financial incentives for foreign investors by all CACM countries could ensure that competition to attract foreign investors is based on other factors.

<u>(iii) Improving El Salvador's International Image.</u> El Salvador needs to work on concerns relating to policy continuity and labor rights and practices. One way to allay this concern would be for a pact between all political parties to pledge their willingness to adhere to major aspects of economic reform such as openness to foreign investment, adherence to CAFTA, and maintenance of dollarization, while reserving the right to differ over other policy issues.

A second area relates to labor issues. CAFTA will not impose new labor laws on El Salvador. Instead, it is likely to focus on enforcement of existing laws. In the case of El Salvador the most important concern relates to the treatment of unions. The policy of allowing firms to fire workers -- albeit with compensation -- for seeking to organize is simply not acceptable in terms of internationally recognized worker standards. Our proposal is a deal in which genuine unionization possibilities are provided in return for increased flexibility in labor hours. This would make an important contribution towards allaying concerns in the United States. By acting early and moving first El Salvador would gain an important marketing advantage in the United States. In addition other countries in the region would feel more pressure to match such measures thereby relieving any concerns that might arise about its relative competitive position.

There are concerns in El Salvador and other CACM countries that the US might use the rules relating to labor and environment as a pretext for protection. In this regard the procedures followed in the US-Chile agreement on these issues merit consideration. In that agreement, compliance failures on labor and environment could require monetary payments to a fund designed to remedy such problems rather than trade retaliation.

(iv) Nurturing New Competitors. Export promotion activities need to be enhanced. One dimension relates to attracting foreign investors. Successful globalization entails creating learning opportunities for domestic firms. One clear gap relates to how to market in the United States. In this respect, American firms with such know-how are obvious targets and the efforts of PROESA and others need to be stepped up. The agency remains under-funded and is as yet, relatively inexperienced. Nonetheless, the self-discovery strategy described in the chapter by Rodrik should be implemented.

In its national action capacity building plan prepared for CAFTA, the government has given the following description of its policy strategy:

"In addition to focusing on attracting foreign investment, the Government is also working through the Ministry of the Economy to nurture greater competitiveness in the different productive sectors, in order to create conditions for an expansion of exports. *This will be achieved by diversifying the export basket and strengthening productive capacity among small and micro-enterprises, together with export partnerships and effective promotion*. (Italics added).

What appears striking about this formulation is the strong orientation towards the promotion of small and medium sized enterprises. Enhancing the productivity and skills of these firms could bring important benefits. But it is unrealistic and probably erroneous to assume that the bulk of the export growth to the United States is likely to be directly generated by such firms. There are usually substantial up front fixed costs that need to be invested in exporting and these are subject to economies of scale. Small firms generally service foreign markets indirectly by supplying intermediate inputs to larger firms better equipped to pay these costs. To be sure, the experience in some Asian economies to introduce "small" firms into export markets has been positive, but the experience in Latin American has been less so. One reason lies in the definition of what a small firm is. In general, as noted by Kawayama (2001) an SME is considered to have less than 500 employees, (and in the Eurostat definition used by 19 countries it is less than 250.)[25] In Latin America, however, the term is often used to refer to firms with far fewer employees, often less than 10 or twenty people. Thus, although two thirds of Taiwanese exports are contributed by "SMEs" many would not be considered small in Latin America. [26]

However, in Latin America the record is very different. According to evidence assembled by Kuwayama, in Mercosur, SMEs account for 3 percent of overall exports, in Chile 4.8 percent. In Mexico, where SMEs employ 78 percent of the economically active population and contribute 69 percent of GDP their direct contribution to exports is less than two percent.

Generally these firms engage more successfully in export activities as second and third tier participants. Accordingly, El Salvador's promotion efforts should be more broadly based. In a country where administrative human capital in scarce, programs

---

[25] Kuwayama, Mikio(2001)

should not be biased from seeking out all profitable ventures that could involve larger firms –both foreign and domestic.

Facilitating Adjustment. The fate of traditional agriculture under the CAFTA is a vital social and economic issue.[27] El Salvador has high rates of protection in a number of agricultural products. The presence of Tariff Rate Quotas highlights these sectors of concern which include beef, diary (including cheese), yellow corn, vegetable oils, sugar and tobacco. Some of this protection is applied against other regional producers but US maize and rice present particular problems for El Salvador. Both are heavily supported in the US and ES imports 40 percent of its maize and 60 percent of its rice. [28]

In the case of rice, pork and corn El Salvador operates is quotas through a system in which industrial users of these products negotiate the right to import certain quantities of the product in return for agreeing to purchase additional amounts at a higher local price. Without this protection, El Salvador's farmers would have difficulties competing with their US counterparts even on a level playing field. Given the size US farm subsidies, however, there are fears that competition could be overwhelming. [29]

As noted by Hathaway.

---

[26] Koreans define SMEs as having less than 300 employees and they accounted for 42 percent of total exports in 1996.

[27] The Mexican experience under NAFTA provides hope that the most dire fears about this sector may not be warranted. Yunez-Naude found that Mexican domestic production of agricultural importables did not collapse in the first decade of NAFTA. While prices did decline, there was an increase in yields, particularly in irrigated lands that helped stabilize incomes. Yunez-Naude believes farmers were able to cope, therefore, partly because of their improved productivity, partly because some produced outside the market system mainly for their own consumption and because others benefited from government support policies.

[28] According to Hathaway beans could be another problematic sector but questions arise as to the impact of new subsidies on beans and the substitutability of US and ES varieties.

[29] Considerable attention has recently been devoted to the US farm Bill which provided generous support for US farmers tied to production subsidies. Although these measures represent an increase over the amounts provided in the previous farm bill, they are not a significant increase over supports currently granted and as such are not expected to have a major additional impact on farm prices.

"No one can claim there is a level playing field if US rice producers receive subsidies that provide them with twice the returns that rice producers in other countries receive. A similar point can be made regarding all the US supported commodities especially cotton, corn, and wheat. For a number of Central American countries corn (maize) and rice are sensitive commodities produced by small farmers who are likely to be vulnerable to intense subsidized competition."

Several measures should be taken to deal with these potential problems. The first is to ensure that liberalization proceeds gradually and provides ample time for adjustment. NAFTA phased in its liberalization in agriculture in four phases, with some tariffs only eliminated after 15 years. In addition, however, the most import sensitive products were subject by TRQs and phased out over ten to fifteen years. [30]CAFTA will probably have similar arrangements.

A second is to apply adequate safeguards in the event that the timetable agreed upon proves to be too rapid. In the event of actual or the threat of substantial injury, for example, NAFTA allowed for tariffs to snap back to levels as high as their original rates in 1994.

A third would be to make certain liberalization within CAFTA contingent upon the reduction in US subsidy levels. Alternatively, if CAFTA does not provide for such provisions, the ability to use WTO disciplines should be explicitly retained. In the subsidies code, domestic subsidies that give rise to injury are actionable and countries are within their legal rights to apply countervailing duties. While a peace clause was negotiated not to apply these rules to agriculture for a ten year period, the clause expires

---

[30] For the United States these were in sugar, orange juice and peanuts. (For sugar, if Mexico becomes a net exporter on a global basis, the quota increases by the amount it is a net exporter subject to certain limits. Eventually however, Mexico could export all its surplus production to the US. For Orange juice there were in quota tariffs as well as higher out of quota tariffs. Mexico imposed a TRQ on US corn both the above quota tariffs and the quotas were phased out over fifteen years expanding by three percent a year. It also imposed TRQs on beans, grain and malt barley.

at the end of 2003, and should therefore provide additional market protection. Countries in Central America find it difficult to apply these WTO rules, but since all CACM countries face similar problems, it might be helpful to consider pooling resources and establishing a regional International Trade Commission that could be used to administer national anti-dumping and countervailing duty rules.

Finally, adjustment assistance measures need to be given to farmers to allow them to find alternative economic employment, both within and outside the agricultural sector. The liberalization of agriculture in sensitive products is likely to involve an expansion of the import quantities that are sold in the context of the agreements negotiated between industrial users and local producers. Such an approach provides local producers with relatively high prices, while allowing local producers an increasing share of inputs purchased at world prices. This approach does little to assist farmers who wish to shift to other crops. Consideration should be therefore be given to a mechanism which would establish an Agricultural Adjustment Program. This Program would share in some of the benefits of liberalization. Instead of fully passing through all lower import prices to users, the fund could raise money by buying some of the import quota from US producers at world prices and selling it to users at higher domestic levels. It could then use this money to aid farmers who wish to shift to new crops or it could provide them with adjustment assistance until they find other forms of employment.

Lower grain prices will bring benefits to consumers as well as reduce the costs of producers of meat, poultry and diary products. Nonetheless, given the depressed state of El Salvadoran agriculture in the first place a cautious approach to liberalization is clearly warranted. In addition, some of the benefits enjoyed by consumers should be used to encourage farmers to adopt alternative activities.

Conclusions.

In the 1990s, El Salvador responded to liberalization with a rapid growth in imports. Nonetheless, it has been able to maintain external equilibrium by increasing clothing exports to the United States and other manufactured goods exports to Central America. However, this pattern of adjustment suggests structural weaknesses that could present problems in the future: traditional agricultural exports of coffee and sugar face an uncertain future; maquila-based clothing exports to the United States are likely to face increased competition as the United States reduces its tariffs in multilateral and regional agreements and the Multi-Fiber Arrangement (MFA) expires in 2005. Salvadoran producers have not made much headway in exporting non-clothing manufactured goods to developed countries. Although more progress has been made over the past five years, El Salvador has also not been very successful in attracting Foreign Direct Investment; tourism remains underdeveloped; protection is high in certain agricultural and labor-intensive products and regional integration remains incomplete.

The CAFTA provides an opportunity for reaping additional gains from global integration. CAFTA will improve EL Salvador's market access to the United States and its ability to negotiate preferential agreements with other trading partners. It should help to stimulate foreign direct investment, increase domestic consumer choice and competition, enhance regional integration, and reinforce domestic institutional reform. But there are also problems that could limit the full realization of CAFTA's potential. In particular, there remain non-tariff barriers in the US market due to rules of origin and standards that are difficult to meet. In addition, El Salvador needs to do more than rely on CAFTA to attract foreign investment, improve its competitiveness, and promote adjustment, particularly in agriculture.

To meet these challenges, additional policies are called. Investments need to be made in improving EL Salvador's ability to set, enforce and meet standards and regulations. Cooperative initiatives with the US public and private sector should upgrade sanitary and phyto-sanitary standards to allow Salvadorans to export farm products to the US and financial regulation to allow them to export financial services.

Regional integration needs to be deepened. CACM needs to complete its work in creating a genuine market in which goods, services, labor and capital can all move freely. CACM members should continue to negotiate trade agreements with other partners both together and separately but they should agree to provide each another with Most-Favored Nation treatment with respect to all agreements sign with third parties.

El Salvador's global integration depends on its ability to become a more cooperative society at home. Progress in fighting crime and improving the judiciary and rule of law will not only help local citizens but will also help attract foreign investors and visitors. Similarly, a more explicit national consensus on the desirability of a commitment to basic of economic reform would create a more favorable environment for both domestic and foreign investors. Improving the ability of unions to organize in return for greater employment flexibility would improve worker rights, enhance El Salvador's international image and make it a more attractive source of brand products. Farmers should be assisted in finding alternative income-earning opportunities through an adjustment program for agriculture that mobilizes some of the benefits from liberalization income-earning opportunities. This would eventually permit full liberalization which would mean higher national living standards.

The United States also has a role to play in ensuring CAFTA's success. There is insufficient recognition in the US that the full benefits from such an agreement will only be achieved if measures to enhance capacity accompany improvements in market access. Accordingly it is important that US government agencies and private citizens be mobilized to provide financial, regulatory and technical support. All three types of assistance are required if El Salvador and other CACM countries are to actually implement CAFTA on the ground.

Ultimately, however, El Salvador's success will depend on the ability of Salvadoran entrepreneurs to discover and invest in new ways to mobilize El Salvador's many assets. While freer markets and international agreements can create the setting in which this can occur, as other chapters in this volume explain, there is much the government can do to help ensure that this happens.

References.

Buitelaar, Rudolf M. (2000) "Central America and the Dominican Republic Modernization and Adjustment in the Maquila Garment Sector" in IADB Integration and Trade Journal, may-august No. 11

Cadot, Olivier, Jaime de Melo et. Al. (2002.) “Assessing the Effect of NAFTA’s Rules of Origin” Presented to NAFTA Workshop held in Washington DC May 2002

El Salvador 2003 National Action Capacity Building Plan, Paper prepared for CAFTA Negotiations.

Grossman, Gene and Krueger, Alan B 1992 “Environmental Impacts of NAFTA” CEPR Discussion Paper number 644

Hathaway, Dale. 2003 “The Impacts of Agricultural and Trade Policy on Trade Liberalization and Integration Via US-Central American Free Trade Agreement” Paper prepared for the International Seminar “Agricultural Liberalization and Integration: What to expect from the FTAA and the WTO?” Inter-American Development Bank. April.

Hufbauer, Gary Kotschwar Barbara and John Wilson, (2001) “Trade Policy, Standards and Development in Central America” Washington DC Mimeo

Inman, Chris Gustavo Segura, Javier Moreno and Andrea Prado, (2002) Tourism in El Salvador: The Competitiveness Challenge CEN 621 Working Paper. March

Kuwayama, Mikio E-Commerce and Export Promotion Policies of Small and Medium Sized Enterprises: East Asian and Latin American Experiences, CEPAL, ECLAC Santiago: 2001.

Lawrence, Robert Z. (1996) Regionalism, Multilateralism and Deeper Integration Washington DC: Brookings Institution

Salazar-Xirinachs, Jose M. and Jaime Granados (2003) “The United States-Central America Free Trade Agreement: Opportunities and Challenges” Paper presented at the Institute for International Economics, Washington DC June.

Sen, Julius (2002) “A NAFTA model for the Americas?” Paper presented at a Conference on “Regional integration and global economic governance: regulating integrating markets”, Brugge, Belgium, November.

SIECA (2001) Central American Report : 2000. INTAL –IDB, Buenos Aires 2001.

USAID (2003), Assessment to Identify Legal/Regulatory Obstacles to the Full Implementation of CAFTA within El Salvador Report Submitted to US AID May 2003.

World Trade Organization (2003.) Trade Policy Review: El Salvador Geneva 2003

Yunez-Naude, Antonio. 2002 Lessons from NAFTA: The Case of Mexico’s Agricultural Sector. Final Report to the World Bank, December.