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How might CAFTA change macroeconomic fluctuations in Central America? Lessons from NAFTA

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Abstract

This paper examines the potential impact of the Central America Free Trade Agreement (CAFTA) on macroeconomic fluctuations in Central America in light of Mexico's NAFTA experience. CAFTA and NAFTA share a number of common characteristics as both agreements envisage comprehensive tariff reductions, cover a broad spectrum of sectors, and include provisions about settlement of disputes. NAFTA helped spur a dramatic increase in trade and financial flows between the member countries and was associated with significant changes in the Mexican business cycles. The findings in this paper suggest that CAFTA could also result in similar effects. In particular, CAFTA could boost trade and financial flows between the United States and the Central American countries. The agreement also could play a major role in reducing the volatility of business cycle fluctuations in the region and could lead to an increase in the degree of co-movement of business cycles in the Central American economies and the United States.

Keywords: Macroeconomic fluctuations; Regional integration; Volatility; NAFTA; CAFTA

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1. Introduction

Signed by five Central American countries (Costa Rica, El Salvador, Guatemala, Honduras, and Nicaragua), the Dominican Republic, and the United States in 2004, the Central American Free Trade Agreement (CAFTA) could constitute a turning point in the region's integration with the global economy.[1] CAFTA is a comprehensive trade agreement changing the framework of trade relations between the United States and the Central American countries (initial five and the Dominican Republic). The agreement provides enhanced access to the Central American countries' largest export market and could be instrumental in increasing foreign direct investment (FDI) inflows to the region.[2]

This paper examines the potential implications of CAFTA for macroeconomic fluctuations in Central America in light of the Mexico's experience under the North American Free Trade Area (NAFTA). While similar preferential trade agreements are relatively recent—therefore, providing little empirical evidence—Mexico's experience under NAFTA is quite insightful offering some guidance as to how CAFTA could affect Central America. Signed by the United States, Canada, and Mexico a decade ago, NAFTA was the first major trade agreement including a developing country and highly developed economies.[3]

CAFTA and NAFTA share a number of common characteristics as both agreements envisage comprehensive tariff reductions, cover a broad spectrum of sectors, and include provisions about settlement of disputes. CAFTA aims at eliminating tariffs and substantially reducing non-tariff barriers between the United States and the Central American countries. CAFTA also includes provisions covering investment flows, financial services, government purchases, protection of intellectual property rights, as well as labor and environmental issues. While the Central American countries already have strong trade and investment relations with the United States and enjoy preferential access in the context of the Caribbean Basin Initiative (CBI), CAFTA is more comprehensive and changes the form of trade relations from the unilateral preferential arrangement defined under the CBI to a negotiated bilateral agreement.[4]

CAFTA's main objective is to eliminate all tariffs and substantially reduce non-tariff barriers between the United States and the Central American countries.[5] During the past 10

[1] Negotiations for CAFTA began in January 2003. These negotiations were unique in that Central America negotiated as a single region and the demands of six separate countries were addressed within a single framework. Schedules for market access, however, were negotiated bilaterally between the United States and the individual Central American countries. Five Central American countries signed the Central American Free Trade Agreement (CAFTA) on May 28, 2004. The Dominican Republic joined the negotiations at the beginning of 2004 and signed the agreement on August 5, 2004. The agreement will go into effect after it is enacted by the legislative bodies of the member countries, which is expected to take place by early 2005.

[2] Within Latin America, Central America is the United States' second largest trading partner behind Mexico, as measured by dollar value of US trade in 2003.

[3] Kose, Meredith, and Towe (in press) and Lederman, Maloney, and Serven (in press) provide reviews of NAFTA's impact on Mexican economy.

[4] In many respects, the agreement is modeled on other bilateral free trade agreements the United States has recently signed, such as those with Chile and Singapore.

[5] Hornbeck (2004) and Griswold and Ikenson (2004) provide detailed discussions about the provisions of CAFTA. Salazar-Xirinachs and Granados (2004) discuss economic and political objectives of the Central American countries in CAFTA.