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PROMOTING PROSPERITY WITH TARGETED U.S. TRADE POLICY

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Cover: Santo Tomas de Castilla, Guatemala - February 11, 2018: A merchant container ship arriving in port. (PARTYRAISER / Shutterstock)

CENTRAL AMERICA: PROMOTING PROSPERITY WITH TARGETED U.S. TRADE POLICY

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A vicious cycle of poverty, rampant crime, and institutional weakness in the Central American region is driving much of the recent irregular immigration to the United States. Meanwhile, as China has become a disruptive player in global markets and a revisionist geopolitical force, it is seeking to exploit Central America's weakness to challenge American predominance in our immediate region. These two core interests of immigration and the China threat, each central to our national security and future prosperity, intersect in Central America.

Our recommendation:

LINK THE U.S.-DOMINICAN REPUBLIC-CENTRAL AMERICA (CAFTA-DR) TRADE AGREEMENT WITH THE U.S.-MEXICO-CANADA AGREEMENT (USMCA)

The U.S. has used an array of traditional foreign assistance tools to address the crisis in Central America. The Central America Regional Security Initiative, an Obama Administration program to strengthen Central America's institutions of governance. Funding from the Millennium Challenge Corporation, a Bush Administration innovation to promote building of hard infrastructure, has had a significant impact across the region. To these tools, the Trump Administration added the Development Finance Corporation, a newly created agency that uses focused foreign assistance to catalyze private investment in key sectors, including technology infrastructure.

These are important and positive attempts to address a complex challenge. However, the U.S. funding comes with strings attached and can be difficult to access. The Chinese, on the other hand, are more focused on wielding influence and accumulating political clients, so their funding is more flexible and they are less focused on return on investment. The United States needs to do more.

The Biden Administration and Congress should work together to craft a trade policy that strengthens U.S. interests.

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Technically known as cumulation, this initiative would allow a company manufacturing in Mexico to source components in Central America that would count toward the threshold for duty-free access to the United States under USMCA.

Since Central American goods have duty-free access to the United States under CAFTA-DR and to Mexico under the Mexico-Central America free trade agreements, this move will encourage the North American supply chains, which currently source many components in China and elsewhere in Asia, to re-shore to Central America. It would not change U.S. tax receipts or open new access to the U.S. market for Mexican or Central American products. The result would be to reduce the cost of manufacturing in North America – making us more competitive – and to stimulate job creation in Central America, creating new opportunities for Central Americans to remain at home instead of emigrating to the United States. According to one study, if just 5% of the investment currently in China producing for U.S. supply chains were to move to Central America, as many as a million jobs would be created in Central America.

A trade policy built on CAFTA and USMCA would lend powerful coherence to the nascent U.S. strategy. It would fully engage the private sector in the region and encourage some of the investment currently feeding U.S. supply chains from China to move to Central America to the benefit of U.S. manufacturers and consumers. And it would put the United States back in its traditional position as Central America's principal economic, security, and political partner. Not incidentally, it would create hundreds of thousands of jobs in Central America, which would encourage Central Americans to seek their futures at home instead of in the U.S. and drain personnel and power away from the gangs and drug cartels.

CAFTA-DR, an agreement bringing the United States together with the Dominican Republic and the five nations of Central America in a free trade group, represents a commitment by the United States to use regional trade integration as a development strategy. Since CAFTA-DR began to enter into force in 2005, it has spurred a 20% increase in merchandise trade between the United States and the other six countries in the agreement: Costa Rica, the Dominican Republic, El Salvador, Guatemala, Honduras, and Nicaragua.

However, because U.S. tariffs were already low prior to the agreement, trade among the other six countries (known as CA-5+DR) has actually grown at a much faster clip. Goods trade among the CA-5+DR countries, which stood at $6.5 billion annually when the agreement went into effect in 2006, increased 62% in real terms to $10.6 billion annually by 2019. What is more, the value of inward foreign direct investment (FDI) stock in the CA-5+DR has increased to $139 billion from $42 billion over the same timespan.

As a corollary benefit, the political collaboration among the other six governments of the CA-5+DR that was required to negotiate and implement CAFTA-DR also led to a strengthening of regional banking standards and regulatory oversight, an initiative that attracted international banks to further develop the region's capital markets.

However, despite the resulting progress in reducing poverty and promoting growth, the Central American countries remain relatively impoverished. As a result, the stakes are high for U.S. interests in the region, and there is an opportunity to push back against China's efforts to undermine our prosperity and drive wedges between us and our friendly neighbors. We urge the administration and Congress to act.

Most of the investment that is leaving China under pressure of the U.S. tariffs is going to other Asian countries, especially Vietnam, and to Mexico. An initiative like the one proposed here might at the margin divert investment and jobs to Central America and away from Mexico, but the diversification of the region's supply chains would likely result in net job creation in Mexico at higher levels of productivity and wages over time. In the short to medium term, it would promote industrialization in Central America, boosting productivity and prosperity there and opening job opportunities that would encourage Central Americans to stay home instead of seeking to emigrate to the United States. And, in the longer term, it would certainly strengthen the prosperity and security of the region as a whole, to the benefit of the United States and Mexico in addition to the Central American countries themselves.

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