CHEMONICS INTERNATIONAL INC.

NICARAGUA BRIEFING PAPER # 2: CAFTA NEGOTIATION PRELIMINARY RESULTS

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CAFTA Negotiation – Preliminary Results[i]

During the December 2003 CAFTA negotiations with the United States in Washington, D.C., in December 2003, Nicaragua walked away the winner among the four Central American countries including Guatemala, Honduras, and El Salvador (the CA-4); Costa Rica abandoned the talks citing further consultations with its government were needed before proceeding. (Costa Rica has yet to reach an agreement on telecommunications, dairy, and other sensitive bilateral trade issues.) Chief negotiator for Nicaragua, Carlos Sequeira, said the trade talks achieved and, in many cases, surpassed objectives allowing Nicaraguans to focus on sectors with the greatest potential for job creation and increased income. Although Nicaraguan sugar, peanuts, meat, and to a lesser degree, cheese quotas, will bring tangible benefits to some Nicaraguans and a few private groups, the future of Nicaragua can not be built upon these sectors. Nicaragua should thus shift its focus to the accrued benefits of consolidating unilateral and temporal Caribbean Basin Initiative (CBI) benefits into permanent trade benefits under CAFTA. CBI consolidation, plus special treatment obtained for Nicaraguan textiles, holds greater promise for Nicaragua than export of the current mix of products. To this end, the proposed institutional and administrative simplification reforms presented in the National Development Plan becomes of the utmost priority if Nicaragua wants to advance at a faster pace than the rest of Central American countries.

A. Key Preliminary Results from CAFTA Negotiations:[ii]

A1. Market Access

1. *Overall trade*: Nicaragua was granted immediate tariff-free access to the U.S. market for more than 120 percent of Nicaragua's agricultural exports to the United States. This implies an immediate increased access of some US$37 million for these products. In exchange for this increased market access, Nicaragua liberalized access on 83 percent of current U.S. agricultural imports.

Table 1. CAFTA Preliminary Results
Expected Increase in Nicaraguan Agricultural Exports to the United States under CAFTA (in US$000 and percentages)

Product	Average Export to the U.S. 2001-03	Percentage of Total Ag Exports to the U.S.	Increased Export Expected over 2001-03	Increased Export as % of total Ag exports to U.S.	Average Total Ag Exports to U.S. 2001-03
Cheese	1,178.95	1.40%	1,227.06	1.46%	**84,105.12**
Meat	19,513.95	23.20%	24,217.39	28.79%	
Peanut	26.42	0.03%	6,413.49	7.63%	
Sugar	7,981.51	9.49%	5,318.21	6.32%	
	28,700.83	**34.12%**	**37,176.15**	**44.20%**	**100.0%**

2. *New quotas granted*: Nicaragua obtained new quotas for products such as cheese, other dairy products, peanuts and peanut butter.

3. *Old quotas increased*: Current sugar and meat quotas doubled.

A2. Big Ticket Items in Market Access

(1) *Industrial goods.* Nicaragua obtained immediate free market access for 100 percent of its industrial goods, including fishery products. As a result, Nicaragua and other CA-4 countries made CBI benefits permanent and Nicaragua granted the United States free market access for 79 percent of Nicaragua's industrial imports.

(2) *Textiles.* The United States granted Nicaragua special Tariff Preference Levels (TPL) for 100 million square meters of textiles per year for five years, after which this allotment will start to decline. This special condition allows Nicaragua to export to the United States textile products manufactured with third countries' fabrics, including Asian fabrics. This will create an initial boom and afford Nicaragua a temporary comparative advantage over other Central American countries. Currently close to 87 percent of the textile products export to the U.S. are subject to tariff due to the origin of their fabric components.

(3) *Investment incentive*. Nicaragua was granted the sole right to maintain the existing Export Incentive Law that provides exporters with 1.5 percent of the export value in lieu of indirect taxes paid throughout the production process. Likewise, Nicaragua was allowed to maintain the existing incentive to the Free Trade Zone regime, allowing these firms to (a) continue to operate under the "Temporary Import Regime"; and (b) internalize up to 40 percent of their production into the local market. These provisions offer additional incentive and flexibility for textile investors who want to set up shop in Nicaragua.

A3. Specific Market Access Quotas Granted

Additional tariff-free quotas were obtained for:

- *Meat:* 10,000 MT per year, plus 5 percent flat annual increments
- *Sugar:* 22,000 MT per year, plus 2 percent flat annual increments
- *Cheese:* 875 MT per year, plus 5 percent composite annual increments
- *Other dairy products:* 650 MT
- *Peanuts:* 10,000 MT per year, plus an additional 1,000 MT after the sixth year
- *Peanut butter:* 280 MT per year, plus 10 percent annual increments

Nicaraguan trade negotiators estimate that for every dollar of tariff-free access granted, the country earns back $3.6 dollars.

A4. Sensitive Products

To protect internal production, Nicaragua obtained a long, back-loaded, tariff reduction schedule, as follows:

1. *White corn* was excluded from the negotiations, implying that this product will not be subject to a re-regulation schedule and will remain protected at its current tariff level of 45 percent. The United States excluded sugar but granted an increased quota to all CA-4.
2. *Red beans:* A 15-year tariff reduction schedule, starting from its current 30 percent tariff.
3. *Rice:* An 18-year tariff reduction schedule, with a grace period of 10 years and two four-year differentiated reduction periods.
4. *Chicken:* An 18-year tariff reduction schedule, with a grace period of 10 years and two four-year differentiated reduction periods.
5. *Dairy products:* A 20-year tariff reduction schedule, with a grace period of 10 years and two five-year differentiated reduction periods.
6. *Yellow corn:* A 15-year non-lineal tariff reduction schedule, back-loaded.
7. *Meat (beef):* A 15-year non-lineal tariff reduction schedule, back-loaded.

The United States recognized the asymmetry between it and the CA-4 and agreed to a long, back-loaded, non-lineal tariff reduction schedule based on the CAFTA talks. This schedule, summarized in Table 2 below, provides an adequate timeframe for the local producers to undertake important structural reforms in their respective sectors as to increase their respective comparative advantage and/or shift to higher value, higher productivity activities.

Table 2. CAFTA Summary Table
Negotiated Tariff Reduction Schedule for Nicaragua's Sensitive Products List

Product	Starting Tariff Rate	Tariff Reduction Schedule
1. White Corn	10%	Excluded from negotiations
2. Red Beans	30%	15-year period
3. Rice	45.0% milled 63.5% unmilled	18-year period with 10-year grace period and two 4-year differentiated reduction periods
4. Chicken	164%	18-year period with 10-year grace period and two 4-year differentiated reduction periods
5. Dairy Products	40% 60%	20-year period with 10-year grace period and two 5-year differentiated reduction periods
6. Yellow Corn	15.0%	15-year period Non-lineal, back-loaded reduction schedule
7. Meat (Beef)	15%	15-year period Non-lineal, back-loaded reduction schedule

Although Nicaragua negotiated favorable conditions under CAFTA, the country and the different producer groups will need to take steps to avoid setbacks. Rice and sorghum producers, for instance, need to significantly increase their productivity levels to compete under a free trade regime. The trade liberalization period is lengthy and offers direction and incentive for Nicaraguan producers to become more competitive and to progress into more attractive production opportunities. Nevertheless, they do need new investment and new technology to improve productivity and competitiveness in rural areas. In any event, the new conditions established under CAFTA present a serious challenge for those farmers in highly protected sectors that are low in productivity. Those most vulnerable are farmers unaccustomed to competing in the open market and who depend on high tariff and government handouts to survive and prosper.

A5. Other Benefits

1. *Safeguards for agricultural products.* For all sensitive products, plus onion and sorghum, Nicaragua obtained a "special agricultural safeguard" to protect these products from negative distortions from subsidies and incentives programs in the United States. This provision does not invalidate the use of more sophisticated trade instruments available through the WTO such as compensatory rights and anti-dumping mechanisms.

2. *CBI benefits.* Through CAFTA talks, Nicaragua and the rest of the CA-4 were able to convert all the unilateral trade benefits accrued through the CBI into permanent benefits.

3. *Free Trade Zone (FTZ)*. Nicaragua and Honduras can continue with the current FTZ status as long as their per capita income remains below the US$1,000 level. Nicaragua was also able to maintain the provision under which FTZ can internalize up to 40 percent of production after paying for local taxes.

4. *Notification for the Free Trade Area of the Americas (FTAA).* Trade negotiators agreed that the tariff schedule resulting from the CAFTA negotiations should replace the schedule presented in June 2003, which allows for additional protection to key sensitive sectors.

B. New Market Opportunities with Respect to 2003 Trade Flows

Door closes on cheese sector. From the outset, CAFTA provides tangible results to Nicaragua, although some benefits appear small or even negligible when measured against the 2003 estimated trade flows. The Nicaraguan cheese sector is a case in point. For decades Nicaraguans have seen the cheese sector as a driver of the rural economy and the United States as potentially the main market. CAFTA has pretty much closed the door on this sector: During the first 10 months of 2003, Nicaragua exported some 944.7 metric tons of cheese to the United States, an already higher amount than the negotiated quota for the country. Even if the whole negotiated quota is reserved for additional exports, this amount only represents 1.7 percent of the total milk production in the country – a percentage too small to create incentive for any significant change at the national level.

Table 3. CAFTA Preliminary Results
Summary Table on Existing and Additional Quotas under CAFTA Negotiations

Product	Jan-October 2003 Exports to the U.S.	Average 2001-03 Exports to the U.S.	Additional Quota Obtained in CAFTA	Total Available Quota after CAFTA	Additional Exports Respect to 2003 Exports with CAFTA
Cheese	944.7	712.6	875	875	None
Meat	7,038.4	8,058.2	10,000	20,000	12,961.6
Peanut	0.0	0.0	10,000	10,000	10,000.0
Sugar	44,514.0	31,642.8	22,000	46,000	1,486.0

The cheese sector appears to be the sector with the smallest gain under CAFTA upon examining Nicaragua's development efforts and initiative to promote competitiveness through the Ministerio de Fomento, Industria y Comercio (MIFIC) clusters. In light of CAFTA results, Nicaraguans need to regroup and rethink the country strategy in this sector.

B1. Managing Quotas

Nicaragua will have to prepare itself to effectively manage the various trade quotas negotiated under CAFTA. The country needs to deal with any equity issue that may arises from managing Sugar, Meat, Cheese and Peanut quotas, balancing the interest of existing firms with the country's needs for additional investment and job creation.

Increased sugar quota. In Table 3 above, the 2003 trade data show sugar exports to the United States are very similar to the total new quota (existing + additional). This sugar trade flow is comprised of 24,000 MT under a higher price quota and 20,000 MT through the lower price world market system. The current sugar trade situation implies that existing producing firms could perfectly accommodate the new quota without expanding production and/or creating significant number of new jobs for the sector. On the other hand, the Nicaraguan government could decide to manage the quota by offering the new quota to existing and/or new investors who want to compete in the internal and external market, thereby lowering the artificially high $23 per quintal internal price. Sugar has been identified as one of the most important staples in the poorest sectors of the Nicaraguan society, thus raising the importance of this issue.

Meat. No one expects Nicaragua to fill the meat export quota in the short term. The country has access through third parties to a 10,000 MT quota, but exports have been consistently lower than the available quota, due in part to other attractive markets in, for example, El Salvador and Puerto Rico, that provide better conditions than markets in the United States. A significant opportunity exists here if Nicaragua is ready to attract investments to expand capacity or create new capacity in this sector.

Peanuts. Nicaraguan peanuts are an easier quota to fill. The country has not been exporting to the United States given the lack of market access and the stiff competition from China; this new quota, nevertheless, does offer additional opportunities for the Chinandega region. As a result of this quota, this region could expand production in 3,000 to 4,000 manzanas.

C. Estimated Preliminary Impacts on Jobs

Nicaragua's main objective in negotiating and signing a free trade agreement with the United States is to open up new economic opportunities that result in additional jobs and economic well-being. Table 4 provides initial estimates on the direct impacts on job creation that CAFTA has for Nicaragua.

Table 4. Job Creation under CAFTA
Estimated Direct Impact on Production Indicators

Product	Category Measured	Unit	Year 2002	CAFTA Quotas
Peanut	Production	Metric Ton	73,190.4	
	Exports to the U.S.	Metric Ton	0.0	10,000.0
	Cultivated Area	MZs	37,972.0	5,188.1
	Yields	MT/MZ	1.93	1.93
		d/h/Mz	15.8	15.8
	Employment	Employees	2,500	342
Sugar	Production	Metric Ton	358,463.5	
	Exports to the U.S.	Metric Ton	44,514.0	22,000.0
	Area[3]	MZs	58,200.0	3,571.9
	Yield	MT/MZ	6.16	6.16
	Employment	Employees	4,325	265
Meat	Production	Metric Ton	60,144.8	
	Exports to the U.S.	Metric Ton	7,038.4	10,000.0
	Slaughtering	Heads	388,848.0	64,652.0
	Yield	MT/Head	0.15	0.15
Cheese[1]	Milk Production	Thous. Gallons	156,393.6	
	Cheese Production	Metric Ton	49,671.3	
	Exports to the U.S.	Metric Ton	946.7	875.0
Textile[2]	Fabric Used by Industry	Square Meter	130,000,000	
	Fabric from Asian Origin	Square Meter	85,000,000	100,000,000
	Employment	Employees	50,000	30,000 to 40,000

Source: BCN Economic Studies Department

In the absence of powerful textile interest groups, it will be easier for the Nicaraguan government over the next couple of years to manage the TPL quota for maximum creation of new jobs. A 20-80 or 30-70 rule can be used to divide the quota between existing businesses and new or expanding textile activities. While it will be hard to create the 30,000 to 40,000 new jobs

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[1] Estimated production of cheese and related products
Notes: Estimated employment based on agricultural costs surveys BCN-MAGFOR
Production based on calendar year 2002
Exports based on period January-October 2003
[2] This assumes that the entire new quota would go to new and/or expanded production.
[3] Production cycle 2001/2002

outlined in Table 4, the country can still secure 20,000 to 25,000 jobs and still allow for higher profit margins for firms. Accordingly, MIFIC is getting ready to open a “Textile Quota Administration Office” as soon as CAFTA is ratified by both the U.S. and the Nicaraguan Congress.

D. Concluding Remarks

Table 4 shows real economic opportunities available after CAFTA ratification. While sugar, peanuts, meat, and to a lesser degree, cheese quotas will bring tangible benefits to some Nicaraguan producers and a handful of private groups, the future of the country can not be built upon these sectors. Accordingly, Nicaragua should focus on accrued benefits resulting from making permanent unilateral and temporal CBI benefits. Consolidated CBI benefits, plus the special treatment obtained for the textile industry, hold greater promise for Nicaragua, but much remains to be done to realize this promise.

Real potential for job creation and increased income levels can be found within industrial activities in sectors such as:

- Food processing
- Wood products
- Tropical fruits products
- High value specialty and niche agricultural products
- High value fishery products
- Shoes products
- Leather products
- Telecommunication
- Textile (full package) products
- Electronics
- Hardware assembly
- Construction products

CAFTA after ratification represents the first step – that of laying the foundation – as Nicaraguan industrial and agricultural products will now have tariff-free market access to the biggest market in the world. Nevertheless, there is a need to move decisively to establish a sound investment and business climate, capable of attracting the level and type of investment needed. To that end, the proposed institutional and administrative simplification reforms presented in the National Development Plan becomes of the utmost priority if Nicaragua wants to advance at a faster pace than the rest of Central America.

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[i] Specific negotiated quantities and/or conditions can change during January-March 2004 period.
[ii] Source: Carlos Sequeira, chief negotiator; Alicia Martin, market access negotiator; Central Bank trade statistics, MIFIC.