OPTIMIZING THE ECONOMIC GROWTH AND POVERTY REDUCTION BENEFITS OF CAFTA-DR

ACCELERATING TRADE-LED AGRICULTURAL DIVERSIFICATION (T-LAD): EXECUTIVE SUMMARY

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INTRODUCTION

The United States – Central America – Dominican Republic Free Trade Agreement (CAFTA–DR) represents a new phase in the evolution of the United States commitment to advance trade-led economic growth in Latin America and the Caribbean. The treaty also places the agricultural sector and the broader rural economy of the CAFTA-DR countries at a crossroads. On the one hand, failure to exploit the opportunities afforded by the treaty would make it difficult for CAFTA-DR countries to accelerate their economic growth, which has not been fast enough in most cases to achieve significant reductions in the incidence of poverty. On the other hand, the agreement has the potential to catalyze trade-led agricultural diversification and greater integration of rural enterprises into agribusiness value chains that can raise the incomes of rural producers and enterprises.

We use "trade-led agricultural diversification" (T-LAD) as encompassing three inter-related processes involved in restructuring the agricultural and broader rural sector to respond to the market opportunities and transition period provided under CAFTA-DR:

- The shift of land and labor resources out of low-value basic grains production and into "new era" higher-value crops or other farm-based enterprises (such as agro-forestry and mixed farming systems, to include livestock and aquaculture) that generate higher-value products for sale in local, regional, and export markets.

- The emergence and growth of on-farm and off-farm services and enterprises that produce diverse, higher-valued products sold into market-oriented supply chains that respond to the demands of local, regional, and export markets.

- The broader institutional restructuring required not only in agriculture-related public sector institutions (i.e., market information systems, sanitary and phytosanitary systems, technology systems, etc.), but also to facilitate linking agriculture's primary product base to currently underutilized industry and services sectors.

The need to advance trade-led agricultural diversification (T-LAD) is made even more pressing, complicated, and challenging by the recent global rise in food and energy prices. During 2007, the food price index of the Food and Agriculture Organization rose nearly 40 percent. As of this writing, food prices are projected to stay high for several years, providing an unanticipated windfall for those basic grains producers positioned to take advantage of the increased demand for their crops. However, most small-scale producers in the CAFTA–DR countries are actually "net food consumers," who face significant constraints on increasing productivity and production. The price hike only exacerbates the challenge that small-scale producers routinely face: how to raise their incomes so they can afford to buy the food that they need.

All CAFTA–DR countries share a concern as they implement the treaty: how to achieve the structural reforms that will enable them to maximize trade-led economic growth. Above all, they need to enhance the capacity of their agricultural sectors to generate economic growth and reduce poverty. To achieve these reforms, the CAFTA–DR countries must formulate and effectively implement a market-oriented strategy to diversify and develop their agricultural and rural economies. To help countries address this challenge, USAID recently completed a study on the economic and institutional factors affecting their capacity: *Optimizing the Economic Growth and Poverty-Reduction Benefits of CAFTA–DR: Accelerating Trade-Led Agricultural Diversification*.[1]

The study's goal is to assist CAFTA–DR stakeholders in articulating, mobilizing support for, and implementing a trade-led agricultural diversification (T-LAD) strategy. While the CAFTA–DR countries have made some significant reforms, some policies still retain elements of the protectionism dominant in these nations until the early 1980s. The study examines ongoing government, private sector, and donor responses to changing market realities. In addition, the study highlights lessons learned from Chile and Mexico and suggests key interventions that stakeholders can embrace to promote trade-led, equitable growth under CAFTA–DR.

Need for Agricultural Sector Growth to Address Rural Poverty

In the mid-1990s, agricultural sector growth rates peaked at about 3.5 percent, and since have declined to about 2.4 percent per year. Improved and sustained agricultural growth rates are critical to poverty reduction; and growth rates exceeding three percent per year are needed for poverty to decline (World Bank).

STUDY FINDINGS

As countries implement CAFTA–DR, and as their productive sectors gear up to produce goods and services demanded by the U.S. market, they face a number of significant impediments to generating broad-based economic growth and reducing poverty.

- *Industrial growth failed to reduce rural poverty*. Industry has not generated enough jobs or increased wages sufficiently to reduce rural poverty. While agriculture's share of total employment has declined in relative terms, and net migration to urban areas (and abroad) has continued, many of these rural emigrants have ended up in low-productivity service occupations, often in the informal sector. In recent years, the number of workers employed in agriculture — primarily producing lower-value basic grains — has grown significantly in most of the countries reviewed, the only region in the world where this occurs.

- *The influence of protectionism continues*. Despite varying degrees of trade and price liberalization, the economies of all CAFTA–DR countries continue to be constrained by weak domestic institutional structures and vestiges of protectionist policies. These constraints have limited appreciation by local producers and policy makers, not only of the need to make domestic products more competitive in global markets but also of the potential for trade-led agricultural diversification to stimulate economic growth.

[1] Optimizing the Economic Growth and Poverty Reduction Benefits of CAFTA DR - Volumes I & II, 2008. David D. Bathrick. This study was initiated by Carana Corporation under USAID-funded LAC Trade 3, and completed by Chemonics International under the USAID-funded LAC Equitable Growth Best Practices Task Order.

- *High levels of rural poverty persist*. Despite increased remittances from abroad and expanded public assistance to the rural poor, the region continues to register high levels of rural poverty. Excepting El Salvador, rural poverty figures in the CAFTA-DR countries have stagnated or increased in recent years, in part the result of the continuing predominance of low-value basic grains in the region's economy. While current high prices for these crops are beneficial for producers, the longer term market outlook for basic grains is not favorable, as tariffs on these crops will decline over the treaty's transition period. This will leave small-scale basic grains producers less competitive in the face of cheaper imports, unless producers can add value (e.g., through processing, packaging innovations, or growing improved varieties having high demand in domestic and regional markets) or shift into higher-value crops.

- *Support to the agricultural sector has been weakened.* As countries sought to adopt fiscal restraint as part of IMF structural adjustment programs and as agricultural commodity prices continued to decline, the governments favored spending reductions over increased taxes. As a result, the public sector and major donors reduced funding for the agricultural sector without nurturing development of new structures to support local producers and enterprises as they attempted to respond to the unprecedented opportunities and challenges associated with globalization.

- *Under CBI, the region made limited market gains*. Though the Caribbean Basin Initiative (CBI) provided lucrative access to the U.S. market, CAFTA–DR countries were unable to sufficiently diversify their agricultural and nonagricultural sectors toward the growth of enterprises that are competitive and profitable. While there were increases in exports during the 1990s, growth rates since then have declined for agricultural and industrial exports. In part, this is due to these countries' diminished hold on the U.S. market for apparel, fruits, and vegetables in the face of increased competition from producers in other markets.

- *Countries' agro-industries are insufficiently productive and competitive.* In all countries the broad agro-industrial sector — including traditional agricultural primary production and agro-industrial processing — is becoming an important economic base. However, despite the market opportunities available under the CBI, the CAFTA–DR countries still have low levels of productivity and competitiveness. Access to production credit and capital for other investments is a constraining factor. This condition will likely continue under CAFTA–DR unless the enabling environment is improved through regulatory reform and new investments in infrastructure, technology development and related support institutions and services, and strengthening of human capital through education and workforce development.

The barriers described above suggest that the agricultural sectors are ill-prepared to compete under CAFTA–DR or in the global economy. Currently, small- and medium-sized producers and enterprises have suboptimal access to market information, technology, technical/managerial skills, financing, or other support (such as irrigation) — all of which they need to be competitive in producing higher-value products that comply with market requirements, including sanitary and phytosanitary standards.

Over the past 30 years, developing countries — including CAFTA–DR countries — have promoted agricultural and rural development using strategies drawn from two models: (1) a trade model, which has tended to stimulate economic progress, and (2) a protectionist model, which has generally perpetuated poverty and dependence. Within the Latin American and Caribbean region, the trade model was used most successfully in Chile. In this model, a broad network of agribusinesses — including agricultural producers and providers of related value-added processing/services — became a major driver of economic growth.

The trade model requires a strong commitment to strengthening policies and support services that facilitate increased investment. A commitment to strengthen the enabling environment will encourage investment in market-oriented agribusinesses that (1) link producers of differentiated traditional exports (such as high-value coffee and cocoa) to dynamic markets and/or (2) promote diversification from basic food crops (such as grains) into higher-value, resource-based enterprises, such as aquaculture, seafood, nontraditional fruits/vegetables, and certified forestry — many of which are linked to processing industries using advanced technologies.

Chile, a premier example of trade-led success. Chile has dramatically reoriented its agricultural sector toward export-led growth by unilaterally reducing tariffs and establishing an enabling environment for trade-led growth. This environment was created by investing in infrastructure, market promotion, research and development, financing, and human capacity, including special efforts to reach small-scale producers. The model contributed to an increase in rural jobs and incomes and a notable decline in rural poverty, especially after 1990, when government programs began to reach the poor more effectively. At various points in the 1980s and 1990s, CBI countries with considerable USAID assistance sought to follow the basics of the trade model but much less robustly than Chile. Initially, their agricultural and agro-industrial exports expanded significantly. But in the end, because the CBI countries paid insufficient attention during a too short period of competitiveness, results were suboptimal. Eventually, productivity declined and, in numerous cases, countries lost shares of export markets they had earlier gained.

Mexico is the clearest example of the protectionist model. Following passage of the North American Free Trade Agreement (NAFTA), the Mexican government made cash payments, through the *Programa de Apoyos Directos al Campo* (PROCAMPO), to small-scale producers of sensitive commodities to compensate for projected income losses as cheaper imports from the United States entered the Mexican market and as import tariffs declined toward zero by January 1, 2008. However, even as other government-supported programs such as the *Alianza para el Campo* focused on helping to increase agricultural productivity, this assistance was not sufficient to help small-scale producers cope with the risks involved in diversifying from basic food crops to higher-value crops and value-added products. More could have been done to help small-scale producers to diversify, for example, by providing information on market demand for higher-value crops and value-added products, technical assistance on how to grow and produce them, and agricultural credit to finance farm-level investments. Absent such focused assistance, the steady flow of PROCAMPO cash payments provided small-scale producers with neither the incentive nor capacity to diversify production to take advantage of markets opened by NAFTA.

In Mexico's case, failure to shift the rural sector out of low-value and sensitive commodities (e.g., basic grains) eventually led to a backlash against free trade. Indeed, in January 2008, as tariffs on a few remaining sensitive products were lowered to zero, small and medium-sized Mexican producers, as well as some congressional leaders, voiced loud opposition to NAFTA and called for its renegotiation.

Lessons Learned from Mexico

"As Mexico's NAFTA experience shows, the CAFTA countries [and the Dominican Republic] must undertake various structural reforms to sustain the potential benefits associated with the treaty. Although NAFTA has had a favorable impact on exports and FDI flows, Mexico's growth could have been even stronger if structural reforms were more aggressive. The major lesson is that a trade agreement like CAFTA-DR should be used to accelerate rather than postpone needed reforms."

— 2005 IMF report

The governments of smaller and poorer CAFTA–DR countries continued to support protectionist tariffs – because they could not afford the cash payments along the lines Mexico did – but not the mix of requisite support services that would encourage their small-scale producers to diversify their enterprises so as to take advantage of the market opportunities available under the CBI. As a result, the rural sectors of the Central American countries witnessed decreased household income, increased internal/external migration, greater dependence on remittances, accelerated environmental degradation, and inability to sustain the market gains achieved in the early years of the CBI.

POTENTIAL ACTIONS

If CAFTA–DR countries are to capitalize on the agreement's potential to drive economic growth and reduce poverty, they will need to forge a national coalition — of government ministries, the private sector, nongovernmental organizations, universities, civil society, and donors — committed to accelerating trade-led agricultural diversification. As Chile's experience demonstrates, a national commitment that transcends short-term changes in political power is essential to build a favorable enabling environment. A serious systematic commitment to reform and re-engineering will position the countries to attract private investment and the donor support needed to integrate rural sectors into the international economy, boost rural employment, and lift incomes to significantly reduce poverty.

Success Story

Guatemala is a regional leader in nontraditional agricultural export crops and specialty coffee exports. Nongovernmental organization Fundación Agil has facilitated direct producer-buyer linkages generating improved profit margins that stimulate a price "check off" system to replace previous donor support.

Achieving even a 10- to 15-year period of sustained efforts in reforms and investments within a traditionally politicized sector will require national leadership, focused decision making, and effective implementation. In the increasingly competitive global economy, the CAFTA–DR countries should act quickly to make appropriate strategy, policy, program, and investment choices. This study recommends that all stakeholders consider how the following actions can be undertaken so as to maximize the benefits of trade-led agricultural diversification.

Build consensus on a national, long-term commitment to promoting trade-led agricultural diversification. In each country, members of the public and private sectors need to discuss how they can partner to support and accelerate trade-led agricultural diversification. Potential items for discussion include identifying the reforms (policy, legal, and regulatory), institutional improvements, and incentives needed to accelerate diversification. Stakeholders should consider whether successful diversification will require more market-responsive institutional structures than the traditional Ministry of Agriculture and trade associations and, if so, how they will create and support them. Such structures would offer opportunities for public-private partnerships.

Strengthen policy analysis and strategic planning. As countries implement CAFTA–DR, they will need strong policy analysis and strategic planning capabilities to help advance trade-led agricultural diversification. National governments and the private sector need to improve these capacities. For example, government and business could establish a forum for policy and strategy discussions about key topics to ensure consideration of economic tradeoffs, public investment planning to mobilize budget support, comparative production cost analysis to help the private sector target the most promising markets, periodic monitoring of rural households to assess income and livelihood shifts during the transition period, and guidance to donors to help coordination, program design, and financing.

Mount a public education campaign. While general information about CAFTA–DR has been widely circulated, a credible and effective campaign is needed to counter the erroneous, but strongly held, perceptions concerning the treaty's impact on rural areas. Such a campaign would explain the purpose of the transition period, tariff rate quotas, and other relevant information. It would also profile small- and medium-sized producers who are successfully diversifying, highlighting key requirements to expand opportunities for other producers to similarly benefit. Local media could make use of written materials that highlight prospects for expanding established exports and include information about the profits associated with these products. The campaign might also note that more rapid economic growth will shift food consumption patterns toward higher-value fresh food that often can be produced locally and marketed to the expanding supermarket industry, thereby reducing risks associated with exports.

Strengthen technology development and outreach systems. CAFTA–DR countries need to identify how they will develop and maintain the science and technology capacities needed to access, adapt, and apply the technologies required to meet production, post-harvest, and agro-processing standards. Doing so will enable producers and processors to become and remain competitive in global markets. Currently, these countries have limited applied research capacity, even for the traditional basic grains. At best, they have achieved small productivity gains. Most notably, they are paying little to no attention to the quality requirements of nontraditional products. Areas needing systematic upgrades include fruit and vegetable cultivation, greenhouse management, soil and water conservation/management, integrated pest management, post-harvest and food science technology (the key element for amassing value-added employment generation), cost-monitoring systems, and farm/business management.

Strengthen plant/animal health and food-safety systems. Skeptics of regional free trade agreements often point out that some of the countries' exports to the United States are denied entrance because they do not meet sanitary and phytosanitary (SPS) standards. While this is true, many CAFTA-DR countries have made progress upgrading their SPS systems. Private- and public-sector capacities are improving, but exporters are still concerned that these efforts are inadequate. Some countries are considering offering companies certified product pre-inspection services to reduce risk and cost prior to shipment. However, because it is critical that Central American and Dominican agricultural exports not be detained or delayed at the border, the U.S. and its CAFTA–DR partners should collaborate more intensively to identify how SPS capacities can be upgraded in the CAFTA-DR countries. Given the recently highlighted problems with the safety of imported foods and President Bush's proposal to implement a new product certification system requiring U.S. inspection prior to actual shipment, this issue is particularly important.

Invest in the region's human capital. As with all sectors, today's agribusinesses rely heavily on technology and know-how. Throughout the region, many of those interviewed noted with concern the limited know-how at all levels. Renewed donor support could significantly strengthen the region's human resources by improving access of Dominican and Central American nationals to U.S. universities and by building local capacity to educate participants along the agribusiness value chain. A strong demand exists for post-graduate degrees from U.S. universities in various fields, including biotechnology, plant pathology, integrated pest management, agro-ecology, agricultural economics, food technology/safety, information systems, agribusiness management, forest products, and farm management. CAFTA–DR countries should look for opportunities for agribusinesses and local educational institutions to collaborate on curricula that produce graduates with the knowledge and skills that agribusinesses are looking for in prospective employees.

Improve and expand rural infrastructure, financing investments with public and private resources, as well as donor funds. The rural areas of CAFTA–DR countries suffer to varying degrees from deficiencies in rural infrastructure, particularly roads and systems that handle energy, telecommunications, irrigation, potable water, and sanitation — an important element in meeting food safety standards. To address these problems, governments, private sector groups, and donors should cooperate (1) to convene task forces charged with identifying and prioritizing the infrastructure investments that support trade-led agricultural diversification, and (2) to identify potential sources of public, private, and donor financing. Central American governments also need to cooperate regionally on infrastructure projects that affect more than one country.

Improve availability and access to finance and risk reduction programs to facilitate investments in new crops, new technologies, and value added agro-industries. Given the high risks inherent in agricultural diversification, an increased capital base and innovative financial products will be needed to cover the farm- and firm-level investments required for enterprises to reallocate land and labor resources into the production and marketing of higher-value crops and value-added products. Also, due to the risks associated with the production and marketing of highly perishable products, and the almost endemic level of climatic and natural disasters that occur in the region, crop and farm enterprise insurance programs are critical.

Harness donor resources to implement a long-term strategy to achieve trade-led diversification. While many officials interviewed lamented the scarcity of donor grant funds, the countries with access to MCC monies have begun to promote the trade-led diversification of their agricultural sectors, often building on earlier USAID-funded programs. However, interviewees agreed that CAFTA–DR brings uncertainty and opportunity that will require public and private sectors to respond to changing circumstances quickly and with strategic objectives in mind, particularly during the critical start-up period. The agility needed for success will also require much improved cooperation among the public sector, private sector, and donors. At present, too little is being done, and at too slow a pace, to support producers in shifting to "new era" agricultural enterprises. Given the critical need to reduce investor and producer risks, donors should target their interventions to stimulate long-term commitments and demonstrate best practices that can be sustainably replicated.

Focus the donor and business communities in Washington, D.C., and in CAFTA–DR countries on coordinating support for agricultural diversification. Given that governments and donors have given limited attention to the agricultural sector in recent decades, CAFTA–DR countries should place a higher priority on coordination among donors, governments, and agribusiness. Such coordination could be facilitated by the CAFTA-DR Trade Capacity Building Committee. This group could identify priority elements of a country's strategic plan for trade-led diversification that stakeholders should consider funding.

CONCLUSION

This study concludes that the CAFTA–DR countries are not prepared to capitalize on the significant opportunities that the treaty affords for trade-led agricultural diversification. At this stage in their economic evolution, agriculture is the critical component that these countries must develop to stimulate broad economic gains. The recent surge in food prices only highlights the importance of the sector, while also providing a focal point for accelerating the requisite reforms for trade-led agricultural diversification. Public and private sectors — internationally and domestically — have underestimated the potential of agriculture to promote economic growth and reduce poverty. As a result of this neglect, the CAFTA–DR countries have not invested sufficiently to create the conditions that would enable them to benefit from trade-led agricultural diversification.

The recent spike in food prices will likely provide some near-term relief to producers of basic food crops. However, over the longer run, smaller-scale producers, who will not be able to compete in the face of increasing imports from the United States and decreasing tariffs on those imports, will be better served by shifting to higher-value crops and value-added products that provide a market-linked basis for profitable enterprises that can raise incomes and grow economies in ways that create better living conditions for the region's rural poor.

A transition period is provided under the CAFTA–DR treaty in anticipation that considerable reforms and institutional re-engineering will be required to improve the enabling environment. The CAFTA–DR countries need to use this time to make the kinds of policy choices and public sector investments that will strengthen the enabling environment to attract the private investment needed for trade-led agricultural diversification to accelerate and be sustainable. This, in turn, will enable the CAFTA–DR countries to capitalize on the treaty in a way that succeeds in generating economic growth, creating new job opportunities, and reducing poverty.