

Commission services position paper on the Trade Sustainability Impact Assessment of the Association Agreement between the EU and Central America

1. INTRODUCTION

The European Union and the Countries of Central America¹ have engaged since 2007 in negotiations in view of concluding an Association Agreement (AA) to reinforce and further develop their trade, political and cooperation ties. An essential part of the Agreement will be the provisions resulting in the gradual liberalisation of trade and investment in a WTO-compatible manner underpinned by a strong set of rules.

In line with the policy of the European Commission, a Trade Sustainability Impact Assessment study was commissioned in 2008 and carried out in 2009 by a consortium of consulting firms (Ecorys, Netherland, leader; Corporate Solutions, Spain; CEDR, Costa Rica; IIDE, UK).

The final report of the study was released in October 2009 and is available on-line at:

- <http://ec.europa.eu/trade/analysis/sustainability-impact-assessments/assessments/>

- <http://tsia.ecorys.com/ca/>

In line with the methodology guidelines, the study has involved a series of public meetings with stakeholders in Europe and in Central America, bilateral contacts with experts and on-line consultations. This has allowed to take into account views and documentation from a broad base of actors from different sectors and to raise awareness about the on-going negotiations.

The present document constitutes the response from the Commission Services to the study's findings and recommendations on policy measures.

2. THE FRAMEWORK FOR EU – CENTRAL AMERICA TRADE SIA

2.1. Objectives of the Trade SIA

The European Commission follows an approach aimed at assisting its decision-making as regards FTAs with the prior identification of both positive and negative potential impacts on sustainable development of the FTA, screened in terms of economic, social and environmental criteria. The Trade SIA is part of this approach. It presents recommendations and policy measures that - in view of the analysts - should be taken into account, when assessing the performance of the EU-Central American AA against the sustainability criteria mentioned above.

It should be noted that the objective of achieving a positive impact of trade and investment liberalisation on Sustainable Development is a shared concern between the EU and its partners of Central America. The results of the analysis will thus be relevant for all Parties concerned.

Moreover, as the criteria of Sustainable Development run through the negotiations of the entire AA, the Commission Services believe that results of the study may offer elements to consider beyond the trade part.

2.2. Scope and methodology of the Trade SIA

An inherent principle in all Trade SIAs is the focus on the three dimensions of Sustainable Development in a way to identify and explicit the trade-offs of different alternatives so as to make the decision-making

¹ Initially Costa Rica, El Salvador, Guatemala, Honduras and Nicaragua. Panama following a period of being observer joined the negotiation process in March 2010.

as transparent as possible. To achieve this objective, the study needs to quantify, where possible, the impacts and spell out the basis of the qualitative judgments made.

To improve the specificity of the impact analysis, the focus of the SIA is put on the sectors that are deemed to have the largest relevance. In order to consider the effects of the alternatives over time, the impacts are analysed against both short- and long-run scenarios.

In the specific context of the EU-Central America AA, the quantitative analysis has been carried out using a CGE model based on a modelisation of 32 sectors of the economy. The impacts have been measured over both macro-economic² and sector-specific³ indicators. The trends of the orientations in trade policy have been captured by two alternative liberalisation scenarios. The impact of Panama being part of the Agreement has also been taken into account.

The quantitative data from the CGE model are complemented with the measure of the variations of the output at sector level expected from the foreign direct investments triggered by the FTA.

It should be noted that the estimations of the changes in the poverty levels are not calculated, but inferred from quantitative data on income and prices.

The qualitative appreciation of the impacts derived from the alternative scenarios is extracted essentially through the consultations that have been carried out in Europe and Central America. The different opportunities for gathering information have consisted of workshops, public and bilateral meetings and digital consultations via the website created specifically for this purpose.

The Commission services are of the view that the methodological approach followed by the study is appropriate and constitutes an acceptable basis for the analyses of the Trade SIA of the EU-Central America AA, and more specifically its trade part.

3. OVERVIEW OF THE FINDINGS OF THE TRADE SIA

3.1. *Economic*

The Trade SIA reports an overall positive impact of the AA on the economic output for both regions, the EU and the Central America, with the most liberal scenarios yielding the highest positive impact in economic growth rate. Per head growth creation is measurable across Central America, though with some countries benefitting more than others. The regional impacts (improvements in terms of trade, job creation and wage levels) are projected to be positive overall. But due to the specialisation induced by the AA, some of these would occur as a result of compensations across sectors and countries. Net gains are expected both in primary sectors (fruit, nuts and vegetables) as well as in industrial production (electronics and, to lesser extent, in agro-industrial products). Due to competitive pressures from European competitors in the services sectors, it is expected that some sector adjustments will occur in Central America. However, there will be very positive spin-off effects across sectors, which will benefit from improved access to financial services. As regards manufacturing industries it is estimated that Central America may face some restructuring from increased competition.

Overall, the trade flows are expected to be significantly larger than the scenario without the AA, and this will induce some shift in patterns as a result of the dynamic effects of specialisation and adjustment to each country's competitive advantage.

The estimated impact of the influx of foreign direct investments (from the EU to the Central American region) is projected to be positive. An increase in foreign direct investments will result in an additional production capacity in Central America, adding to the benefits of the trade liberalisation with Europe. Importantly, the full benefits of foreign direct investments are also linked to the degree of regional

2 Changes in income and gross domestic product, effects on labour, effects on import/exports, capital formation, use of natural resources and emission of greenhouse gasses.

3 Changes in output, employment, price and trade.

integration that Central America will achieve both through the Agreement and through endogenous factors. Effective removal of barriers to trade and harmonisation of the regulations in areas such as customs procedures, technical requirements, competition and transports infrastructures will be key to achieving the maximum returns to the process of liberalisation and bi-regional increases in trade.

3.2. Social

The study estimates the impact on three main aspects of the social dimension: wages, employment levels and their relation with the alleviation of poverty.

The effect on wages is found to be generally positive for the Central American region, though some differences in the intensity are likely due to specific circumstances in each country. Wage increases in one sector or country are expected to induce some reallocation of labour across countries and sectors. Due to the large informal labour sector, the effect on employment is in fact likely to translate into the entry of workers into the formal labour market.

The patterns of reallocation are expected to follow the distribution of growth and the comparative advantages across Central America. Even if some sectors are likely to shed labour, this should be largely compensated by the employment gains in sectors benefitting the most from the specialisation and liberalisation of trade, such as fruit/nuts/vegetables or textile.

The study considers also the potential risks on work standards, such as the occurrence of child and forced labour and inequalities affecting vulnerable groups, both for the EU as well as for Central America.

Although this analysis of the potential adverse effects on the working standards is not conclusive per se, it is clear that national mitigation measures and careful implementation will contribute to avoiding possible negative consequences such as job losses due to the dynamic specialisation of the economies in a more limited number of sectors with high levels of capitalisation and with high productivity. The analysis identifies some patterns of convergence (e.g.: trade level, wealth creation) as well as elements of divergence across the region that the consultants consider would benefit from being addressed.

The specialisation of labour induced by certain trade related effects may pose a problem for vulnerable groups such as indigenous people, as they are particularly represented among the group of unskilled labourers. This underscores the importance of taking appropriate national mitigation measures and for the EU to support such measures, where possible, to alleviate negative impacts.

More in general, the possible impact of the specialisation in certain sectors on migratory flows should be followed closely. Commission services consider that this dimension could have been reflected further in the study.

Another sensitive front on which the trade effects may have a social dimension is that of land and the use of natural resources. The intensification of the production in agriculture and forestry may lead to conflicts of use, in particular with those groups that depend on subsistence farming and on access to natural resources.

3.3. Environmental

Among the different variables linked to the environmental impacts, the study focuses on the emissions of green-house gasses (GHG), the land use changes, biodiversity losses, in particular linked to deforestation and the loss of coastal areas. The study also considers environmental quality indicators, mainly related to production of waste and pollutants. For each of these dimensions, the study aims at detecting likely changes attributable to the AA.

In terms of GHG, the impact of the Agreement appears negligible, and even in the breakdown of the contribution accruing to each of the Parties of the Agreement, the increase for the EU, which is the one with the largest increase in emissions, is only a fraction up from current levels.

Reallocation of land from extensive low-input production to export crops might take place in Central America, notably in connection with the increase in the area destined to fruit, vegetables and nuts crops following the reallocation of production factors in accordance with the comparative advantage of Central America. The move from subsistence and extensive traditional grain and animal crops to higher value ones is projected to increase pressure both on land and on maritime and coastal resources. Conversely, it is possible that the Agreement will contribute to a shift towards more extensive crops in EU, where issues of maintenance of cultural farm landscape may arise.

The study also focuses on the potential changes related to the increased agricultural activity in Central America and the impact on biodiversity. In view of the prominent role of the Central American region as a hotspot for biodiversity, the expected impacts give rise to recommendations for flanking measures.

Additional concerns are linked to the risk of the interaction between pro-environmental policies such as the EU bio-fuel policy and the possible expansion of the agricultural frontier in Central America to satisfy increasing demand for agro-based combustibles (oil and ethanol from palms and sugarcane). The study identifies measures that could facilitate market-based mechanisms to satisfy the increased demand for environmental services and compensate or mitigate the risks of such negative effects on the natural resources base.

Finally, impacts – both positive and negative - are predicted in terms of environmental quality, notably related to the increase of production and trade. More than in other areas, the study points out how the overall balance – especially in the Central American countries - largely depends on the internal regulatory and policy framework and on the existence both of environmental standards in Central America as well as the capacity to monitor and enforce compliance of such standards.

4. DISCUSSION OF THE FINDINGS AND VIEWS OF THE COMMISSION SERVICES

4.1. General considerations

As already pointed out, the findings of the study are based on the trends in the trade policy making, both at regional and country level, but also and most importantly at multilateral level. The baseline is thus referring to a scenario of liberalisation (without FTA) in the context of the multilateral trade negotiations in the WTO. While this in many ways is a sensible point of departure, a caveat needs to be attached to this scenario as the outcome of the current multilateral round is undecided. This weakens the predictive power of the model.

The study frequently bases itself on recommendations that imply a somewhat narrow field of policy options and of constrained policy space and margin for national decision-making, notably in terms of social, labour and environmental issues. In this context, the Commission services would like to draw attention to the importance of domestic action based on international instruments and to the opportunity that the AA represents to upgrade such policies, and in particular those most directly related to the objectives of Sustainable Development. This process would be based on an agreement on common commitments, in a context of norms and regulations whose depth and breadth remain subject to the decisions of each Party. As a result, the improvement of social and environmental provisions remains a shared objective, through a methodology of sustained interaction, dialogue and cooperation based on multilateral instruments.

4.2. Sector studies

a) Fruit, Nuts and Vegetable (FNV)

The study projects a significant increase for output, employment and trade in all scenarios, but depending on the depth the process of liberalisation. Panama's participation in the AA impacts positively, in terms of output and all Central America countries would benefit from Panama being part of the AA. For Europe, the results indicate that some production would be lost as a result of the de-specialisation based on comparative disadvantages in the sector.

According to the study, key challenges for a more positive outcome of the AA in relation to the FNV sector are the long-standing infrastructural deficiencies of the Central American region and the absence of a proper transport network. In the same line, the study stresses appropriately that improvements of port facilities, logistics and the liberalisation of transport services would ensure a more efficient handling of perishable products along the value chain, and allow greater benefits for Central American countries. In the same line, the study points out the necessity for regulatory convergence on labelling and other technical barriers, as well as on sanitary and phyto-sanitary measures, if opportunities for exports from Central America are to be reaped.

The Commission services agree with the remark that the capacity to comply with rigorous SPS and other quality standards is a necessary prerequisite to improve the competitiveness of Central American products on the European market. In view of this, the Commission services point out that the improvement of production methods, the reinforcement of the technical and financial capacities for increased compliance, regional integration and the dissemination of expertise for increased penetration of the European market, are already among the objectives of the cooperation actions funded by the EU in the Central America.. The Commission agrees that it could be pertinent to consider strengthening this cooperation further in the future.

The study highlights two similar risks for Europe and Central America, especially when considered at sub-regional level.

For Europe, on some ultra-peripheral and Mediterranean regions, impacts are estimated to have the potential to be significant on the FNV sector, in terms of loss of output and employment. The Commission services share the concern for these potential negative impacts and agree that it would be important to minimise the imbalances on product and labour markets, in particular through the adoption of measures having no effects on trade.

Conversely, at sub regional level in Central America the possibility of a concentration of the production in certain countries raises social and environmental concerns, due to the fact that high-value crops (sugar and banana) are expected to replace subsistence farming and/or forested area

As the expansion of the FNV sector is likely to occur mainly in the capital-intensive, large-holding subsector, there are concrete risks of displacement of small-holders, which tend to be present in particular among the indigenous groups. Moreover, as the creation of jobs associated with the expansion of the sector could be mostly concentrated in specific production areas of Costa Rica and Panama, this could affect the intra-regional migration flows. The Commission services consider that, in order to prevent the exclusion of vulnerable groups from the benefits of the specialisation induced by the AA, it is key for the Central American countries to adopt an inclusive approach based on transparent decision-making with appropriate consultations of stakeholders, and adequate policies to manage land and rural employment issues.

The study estimates that the impact of the increase of production of high-value export crops will be based on an expansion of the agricultural frontier and on the intensification of land-cultivation similar to other cases where economic activity has been increased.

The Commission services share the concerns for the risks of increased consumption of natural resources, as well as the risks of pollution linked to intensive agriculture. As is the case in any process that increases economic activity, the combination of these factors, if not managed properly, could potentially pose a threat to fragile and valuable natural resources. This underlines the need for each Party to take this into account and to develop appropriate policy measures, such as the monitoring and the mitigation of adverse environmental effects, or the promotion of investments in clean technologies. In the view of the Commission Services, the adoption of social and environmental standards relevant the production of goods is a useful policy option.

On the specific issues of agro-based carburant and the impact that this might have on the process of deforestation in Central America, the Commission services believes that while some concerns exist, they

should be tackled through the formulation of appropriate policy responses in the environmental field in Central America. It should also be taken into account that the EU's Renewable Energy Directive (2009/28 of 23 April 2009) lays down sustainability criteria for biofuels to benefit from domestic support measures and to count against the targets of use of renewable energy. The dialogue mechanisms foreseen in the provisions on Trade and Sustainable development will provide useful channels of communication in the context of formulation of appropriate policy responses.

b) Forestry

The study highlights that gains for the sector as a result of the AA are bound to be negligible both in Europe and in Central America, as the sector has a small dimension relative to the size of the economy. In Central America some increase in the output and trade are likely, that could have a potential negative impact on the sustainable extraction of forest resources. In this view, it is important to improve the monitoring of the use of forest resources by the informal sector.

In order to diminish the risk for degradation of the forestry resources of Central America, the Commission services share the consultant's view that an approach based on sustainable management of forestry resources is an adequate and necessary answer. The trade agreement strengthens the incentives for satisfactory national and regional policy responses to this effect. These, in turn, will create the correct climate for attracting environmentally-responsible investments that are needed both to increase productivity as well as introduce sustainable practices and know-how.

The AA usefully provides incentives both in the trade part as well as the cooperation part for the adoption of sound environmental policy measures that could further promote the diversification of the forest-based economy.

c) Textile and clothing

The projections for the textile sector are coherent with the scenario of specialisation according to the comparative advantages of the Central American region, which sees an overall increase of the levels of production and trade. Europe on the other hand retains its advantages in certain high-end products. This, coupled with the relatively minor volumes of trade with the region in the textile sector, translate into a negligible impact of the specialisation for Europe, with the benefits accruing mostly in favour of Central America

Increases in output, trade, income and prices appear likely to benefit Honduras and El Salvador, followed by Guatemala and Nicaragua, where the existing textile industry is likely to continue on a path of specialisation and the growth of the industry offers opportunities to reduce levels of poverty.

As pointed out by the study, investments are a necessary prerequisite for the modernisation of the sector, both in terms of facilities as well as know-how and processes to integrate into highly competitive globalised production chains. The opening up to European investment by Central America in this area of manufacturing industries as well as other non-services areas is an important factor in this context.

The Commission services consider that the Agreement's provisions in areas such as technical barriers to trade, intellectual property rights and investment overall represent essential incentives to attract the level of FDI required to spark a virtuous cycle of increase in production levels and competitiveness.

The study points out how the larger degree of integration with the European market, made possible by the AA, provides for an opportunity to improve the compliance with high standards, both in terms of product specification as well as for social and environmental criteria. However, the study also underlines the importance of avoiding a short-term competitive gain, based on the lowering of the production costs, e.g. through the compression of wages and any possible discrimination against the most vulnerable workers. Given the high impact of the textile industry on environmental quality, the issue of adequate management is crucial to the process of intensification of the textile production.

The Commission services share the view of the consultants that growth models based on any kind of social and environmental dumping are not sustainable and that such practices would hamper the Parties from taking full advantage of the integration between the markets. The Commission Services consider that the Agreement in fact could contribute to avoid this through, for example, the various provisions on Trade and Sustainable Development.

d) Electronics

Electronics represents another sector where the specialisation results from the comparative advantage of the Central American region. From the model used in the study, the impacts on Europe are very small. The impact on Central America, but especially on Costa Rica, is expected to be highly positive, both in terms of output and employment. Trade within the region is also expected to increase even further.

The impact of the AA consists in intensifying the trade flows and the trend towards increased specialisation in Central America.

The analysis correctly set out the context in which the expansion of the trade takes place. The electronic sector in Europe is a strategic component of total manufactured output, and its role on employment is crucial. However, strong competitive pressures exist, and the sector is responding by a process of shifting production facilities outside Europe, while creating jobs and design capacities and specific tasks requiring the high skilled labour force.

In Costa Rica, where electronics is a strategic sector for the domestic economy, the expansion has been possible largely thanks to the large investment of a single multinational but with several local SMEs cropping up subsequently. Trade with non-conventional partners is growing rapidly and the main markets for trade in electronics remain the US and Asia. These aspects appear to be in line with the current worldwide production trends in the electronic sector.

The Commission Services note that the expected increase in the output and other indicators are largely positive for Central America as a region, and in particular for Costa Rica. Overall, the expansion of the electronic sector is a significant asset in the process of diversification of productive base, towards sectors with a higher content of knowledge. However, Commission services consider that the possible environmental impact in Central America of the development of this specific sector is not to be neglected.

The Commission services point out that the AA, with the dialogue mechanisms put in place under the Sustainable Development chapter, increases the options for monitoring and the inclusion of all sectors of society with consultation on specific policies to improve the dissemination of the effect of trade and economic growth. The technical-level dialogue on production standards and compliance with the variety of sector regulation represents an asset in view of a strategy of market diversification. In combination with the Cooperation chapter of the AA, targeted actions for SMEs could be considered.

e) Maritime Transport Services

The impact of changes in the sector are expected to be relatively modest, especially in the EU where the sector's already significant size means that the effects of the increased trade with the Central American region will not change the overall situation.

The Commission Services consider that the liberalisation of maritime transport services in Central America, according to the principle of door-to door delivery of goods, is highly important for increasing trade and attracting investment. Concerns remain over the overall efficiency of the maritime transport system, and notably the possibility of maritime service providers to choose freely among local transport providers for further transport of goods arrived in Central American harbours.

Improvements and efficiencies in the transport sector could also contribute to reducing the negative environmental impact of transport on environment and health. The Commission Services consider that in a sector where interconnectivity and economies of scale are strategic objectives to be achieved, the added

value of the AA is to foster regional approaches to supply chains and door to door delivery. The concomitant removal of existing barriers to transport to and within Central America is a highly important prerequisite for both the attractiveness for the necessary investments in infrastructures as well as their efficiency.

The Commission services do not concur with the consideration advanced by the consultants that issues of public participation in the management of port services per se represents a problem as long as the principles of non-discrimination between nationals and foreign firms or services operators are safeguarded.

5. CONCLUSIONS

The Commission services remain convinced that an ambitious and comprehensive yet well-balanced AA, which results in the gradual liberalisation of trade and investment, can make an important contribution to Sustainable Development both in Central America as well as in the EU.

The Commission services agree that, to ensure a result conducive to Sustainable Development, it will be important not only to agree on liberalisation in trade in goods, services and investment but also to accompany the process of liberalisation with a strong and coherent set of rules. These rules should cover a wide range of areas including but not limited to intellectual property rights, technical barriers to trade, Sanitary and phytosanitary measures, trade facilitation and Sustainable Development.

As is clear from the analysis of the various areas, in order to have an Agreement which contributes positively to Sustainable Development, the liberalisation process will need to be accompanied by appropriate flanking and, when necessary, mitigation measures taken by each Party in accordance with its specific needs and circumstances.

For these reasons, the Commission has from the beginning of the negotiations foreseen the Cooperation part as an integral part of the Agreement with strong links to the Trade part so as to allow that cooperation among Central America and the EU can be channelled in this direction whenever opportune.

It will also be important for Central America and the EU to ensure inclusive processes which allow civil society to participate and provide input in the various areas of the Agreement where this is foreseen and notably in the implementation of the Title on Trade and Sustainable Development.