

The Pacific Alliance: A Way Forward for Latin American Integration?

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June 2014

www.cgdev.org/publication/pacific-alliance-way-forward-latin-american-integration



ABSTRACT

The Pacific Alliance, an agreement by Chile, Colombia, Mexico, and Peru to achieve deeper integration and jointly promote economic relations across the Pacific, constitutes one of the few bright spots in current Latin American integration efforts. Given its features, the Alliance has significant potential to benefit the member countries, enlarge its constituency, and promote trade with other areas. This essay presents a brief overview of the Pacific Alliance, how it was created, what progress has been made so far, and the potential benefits it offers to Pacific-Rim Latin American countries.

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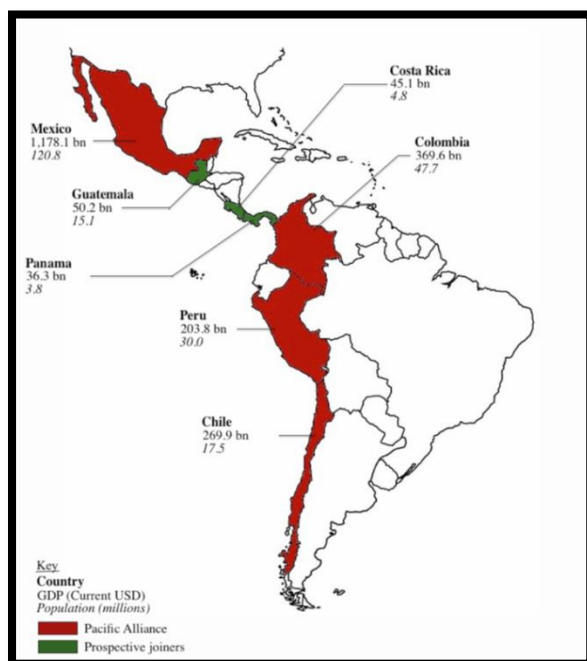
Introduction

The Pacific Alliance has many of the traits I identified as a way forward for Latin American economic integration in my recent CGD policy paper.¹ First, it is a pragmatic and dynamic deep integration process, more akin to Asian integration initiatives than to other Latin American processes, such as Mercosur or the Andean Community. Indeed, it is proceeding by deepening previously existing free bilateral trade agreements among member countries, especially through harmonization and *cumulation* of rules of origin (see below), but also by going well beyond trade objectives, promoting freer circulation of labor and capital and cooperation in other areas. Second, the process subscribes to the modern view of *open regionalism*. It is actively attracting new members and promotes the global integration of its present members, in particular with respect to Asia-Pacific countries. With the Additional Trade Protocol signed on February 10 in Cartagena, Colombia, by the four presidents, and other recent group decisions, the high expectations created by the original 2011 presidential agreement are beginning to be realized, though still with important limitations.

The current members of the Pacific Alliance (Chile, Colombia, Mexico, and Peru) have a total population of 216 million and an aggregate gross domestic product (GDP) of US\$2.02 billion, representing 35 percent of total Latin American GDP (and 45 percent of total Latin American imports). It will become the seventh-largest market on earth, in terms of GDP—equivalent to that of the state of California or the Great Lakes states combined (see Figure 1 and Table 1).

¹ G. Perry, *Regional Public Goods in Finance, Trade and Infrastructure: An Agenda for Latin America*, CGD Policy Paper 037 (Washington, DC: Center for Global Development, 2014), http://www.cgdev.org/sites/default/files/regional-public-goods_final.pdf. See in particular pages 41–50.

Figure 1. The Pacific Alliance and prospective members



Source: World Bank, data for 2012.

Table 1. The relative size of the Pacific Alliance

Country/state	GDP (current US\$ billion)	Population (total, million)	Imports of goods and services (current US\$ billion)
Chile	269.87	17.46	91.35
Colombia	369.61	47.70	72.93
Mexico	1,178.13	120.85	406.08
Peru	203.79	29.99	48.57
PACIFIC ALLIANCE	2,021.39	216.00	618.93
Latin America (LA)	5,738.36	601.08	1,365.45
Pacific Alliance / LA (%)	35.00	36.00	45.00
<u>US comparators:</u>			
California	2,003.48	38.04	
Great Lake states (Illinois, Indiana, Michigan, Ohio, Wisconsin)	2,165.31	46.57	

Sources: World Bank and US Bureau of Economic Analysis GDP by State Table, data for 2012.

Just as importantly, the four countries share stable democratic government, good macroeconomic policies and a similar pro-market orientation, and a common interest in deepening economic ties with their counterparts in the Asia-Pacific region. The original idea was to encompass all the Latin American Pacific Rim countries (the so-called ARCO del Pacifico initiative), but as negotiations moved slowly the presidents of the four largest countries, which already had bilateral free trade agreements among them, decided to speed up the process on their own on April 28, 2011, leaving the door open for others to join later. Currently, all the other Pacific Rim countries in the hemisphere, in addition to several other countries, participate in Alliance meetings as observers, and the three largest Central American economies (Costa Rica, Panama, and Guatemala) are either beginning the process of joining or have expressed interest in doing so.

On June 6, 2012, the four presidents signed the Framework Agreement, which, once approved by their respective countries, granted juridical status to the agreement. Since then, several decisions have been made that push forward the main objectives of the Alliance's framework (the free circulation of goods, services, capital, and persons within the area), the most important being the Additional Trade Protocol signed on February 10, 2014.

Deepening trade: the new trade protocol

The recently signed protocol includes provisions that will deepen and *regionalize* the existing bilateral trade agreements by adopting common regional rules in seven areas: market access (trade liberalization) and rules of origin, trade facilitation and customs cooperation, sanitary and phytosanitary controls, technical obstacles to trade, investment, public procurement, and trade in services.

The four countries had already liberalized most of their trade through bilateral agreements. With the additional provisions, 92 percent of the goods traded among them will benefit from zero tariffs in 2015, provided they comply with significantly less-restrictive rules of origin, as discussed below, and that congressional approval does not face unanticipated problems.² The remaining 8 percent are primarily agricultural and animal products that had been excluded or had long liberalization periods in existing bilateral agreements. The protocol kept only one product (sugar) excluded. The rest will be gradually liberalized, though still

² In the case of Colombia Congress approved the Protocol, but the Constitutional Court found a failure to comply with procedimental, so the approval process is starting anew and is expected to be finalized promptly

over long periods, most of them from 12 to 17 years (see Table 2). It is disappointing that net exporters of agricultural products, such as the four members of the Alliance, continue to be so protective of their own domestic agriculture, consequently missing important opportunities to increase and diversify their agricultural exports.

Table 2. Products excepted or with gradual tariff reduction

Product	Countries affected	Period for tariff reduction	Base tariff
Beef (except fine cut)	All	8–10 years	80%
Pork	Mexico	5 years	30%
Poultry	All	16 years	45%
Eggs	All	3–8 years	5–20%
Sugar	All	Excluded	Excluded
Chocolate and other cocoa products	All	3 years	20%
Beans	All	8–17 years	5–60%
Potatoes	Mexico	17 years	15%
Milk	Mexico	10 years	33%
Cheese	All	13 years	20–33%
Liqueur	All	3–8 years	20%
Rice	All	17 years	80%
Corn	All	10–17 years	5–25%
Tobacco	Mexico	15 years	15%

Source: Pacific Alliance, Additional Trade Protocol, 2014.

Given the extent of previous trade liberalization initiatives and the modest advances in agriculture and animal products, the most significant achievements of the new agreement are those related to rules of origin, harmonization of trade practices, public procurement, and trade in services. We turn to them below.

But before we do so, we should recall that most Latin American countries have already significantly liberalized their trade through both unilateral liberalization measures and a complex overlapping web of bilateral or multilateral free trade agreements (FTAs), which has been referred to as the “Latin American FTA spaghetti bowl.”³ For all its virtues, such a complex web of agreements has a major disadvantage: rules of origin and other trade practices vary significantly from FTA to FTA, creating significant distortions and high transaction costs for firms trading in the region. Previous studies⁴ suggested that in order to

³ A. Estevadeordal and K. Suominen, *Bridging Regional Trade Agreements in the Americas* (Washington, DC: Inter-American Development Bank, 2009).

⁴ A. Estevadeordal et al, op. cit., and G. Perry, op.cit.

reduce these distortions and transaction costs, the easiest way forward would be to harmonize trade practices among groups of countries that already had bilateral FTAs among them, and that the most important step forward would be to harmonize rules of origin and to introduce cumulation⁵ of origin among them. This is precisely what the recent trade protocol does for the Pacific Alliance partners.

In bilateral agreements, rules of origin imply that only goods exported from country A to B can benefit from the negotiated reduced tariffs, provided that they have a minimum *national value added*, and imported inputs from country B are treated as domestic inputs for this purpose. In a regional agreement, rules of origin are harmonized, which by itself makes life easier for regional exporters. But, even more importantly, when cumulation is allowed, as in the Alliance trade protocol,⁶ the benefit of reduced tariffs is extended to goods produced in any signatory country, whenever there is a minimum regional value added. Thus, exporters from Colombia to Mexico can benefit from freer access when using inputs not just from these two countries (as before), but from Peru and Chile as well, as inputs from any Alliance member will be considered *domestic inputs* for all purposes.⁷

One of the most important benefits of harmonization of rules of origin with cumulation is that it will facilitate the development of regionally integrated productive value chains and regional transnational production of some complex goods, as the Asians have been successfully doing. It will also facilitate the region's integration into existing Asian value chains.

Some limited advances were made with respect to cumulation of origin before 2012 in Latin America (in particular under the Central America Free Trade Agreement with the US, CAFTA),⁸ but the 2014 Pacific Alliance trade protocol represents the first systemic advance in this direction among large countries in the region. The Alliance's efforts to promote the entrance of other members (see below), may thus eventually lead to a significant unwinding of the "Latin American FTA spaghetti bowl."

⁵ According to the World Customs Organization, "cumulation," also known as "cumulative rules of origin," is the process through which countries that are members of a preferential trade agreement are able to share production to jointly comply with rules of origin.

⁶ With a regional value added of at least 50 percent in most cases, though this figure varies from zero to 70 percent.

⁷ For a detailed explanation of how "extended" cumulation, a similar solution, works, see http://www.cgdev.org/sites/default/files/1424480_file_Elliott_ROOS.pdf.

⁸ Perry, *Regional Public Goods*.

The protocol also includes some important advances with respect to public procurement.⁹ The bilateral agreements between Chile, Colombia, and Mexico already accepted that goods and services from bilateral partners would have equal treatment to domestic goods and services in public procurement, provided they were not explicitly excepted and they complied with the bilateral rules of origin. Peru's bilateral agreements did not have such a provision. Under the new agreement, public procurement in each of the four countries will concede national treatment to goods and services produced in any of the other three, provided they are not explicitly excepted and they comply with the new harmonized rules of origin. In other words, the benefits from harmonization and cumulation of origin will be extended to public procurement within the region for all goods and services not included in the lists of exceptions. In addition, countries agreed to adhere to more transparent procurement processes, which may help overcome some practical difficulties being experienced under current bilateral agreements.

The provisions relating to trade in services represent a few advances regarding financial services, with respect to what was in effect through bilateral agreements. Unfortunately, no agreements were reached in other important areas such as air and maritime transport services, despite intense negotiations. In their joint declaration, the four presidents indicated their willingness to move forward in these areas. In particular, "open skies" agreements among the four countries would be of enormous importance.¹⁰

The protocol includes clauses addressing other areas (trade facilitation, sanitary measures, technical obstacles, and investment) that may lead to freer trade and better implementation of the current agreements. For example, countries agreed to expedite customs procedures (freeing goods in at most 48 hours), accept digital certificates of origin, interconnect the existing national one-stop shops, and eliminate sanitary and other obstacles that do not have a strong technical rationale, among other measures. Perhaps more importantly, joint institutional channels were established for the implementation of various aspects of the agreement and for the resolution of controversies. Having specified such channels may result in faster advances in the future.

⁹ The agreement covers public procurement by central governments, public enterprises, decentralized agencies, and subnational governments, in the last case with the exception of Mexico, given its federal nature.

¹⁰ See Perry, *op.cit.*

Not just trade: toward freer movement of capital and labor

Deep integration means much more than trade in goods and services. It includes, in particular, free movement of capital and labor, as is the case in the European Union. The Alliance is also advancing in both of these areas and has 24 active technical groups promoting cooperation and negotiations in several areas.

On labor issues, the Alliance has moved fast in eliminating tourism and business visas within the region, as well as in facilitating temporary permits for specific categories of workers (e.g., engineers, pilots).

Regarding financial services, there have been advances in facilitating and protecting cross-border investments originating in the partner countries, which can be particularly important given the rapid expansion of financial *multilaterals*, especially from Colombia and Chile. However, the most ambitious initiative in this area is the ongoing process of integrating the stock exchanges of Chile, Colombia, and Peru, through the MILA (Mercado Integrado Latinoamericano) integration platform, which Mexico will be joining soon, once it harmonizes some key regulations with the rest of the Alliance countries. Required legal changes were recently approved by the Mexican Congress, so it may be able to join MILA by the end of 2014.

Because stock market development and liquidity benefit from economies of scale, individual stock exchanges all over the world have looked for ways to integrate. However, only a few cases have succeeded, as significant limitations stand in the way in terms of jurisdictional issues, convertibility and currency risks, as well as the limited cumulative size and risk diversification potential in comparison to the large and well-established global stock markets (such as New York or London) to which most national governments, large firms, and institutional investors already have access.¹¹ In addition, stock market integration requires national regulators' support through considerable regulatory harmonization. The two previous successful cases were the integration of the Scandinavian stock markets as OMX, a process that began in 1998 and was concluded in 2006,¹² and the integration of the

¹¹ G. Perry, *op. cit.*, pages, 25–28.

¹² Purchased by NASDAQ in 2007.

Amsterdam, Brussels, and Lisbon stock exchanges as EURONEXT in 2004,¹³ though this merger was enormously facilitated by the single (euro) currency trade.

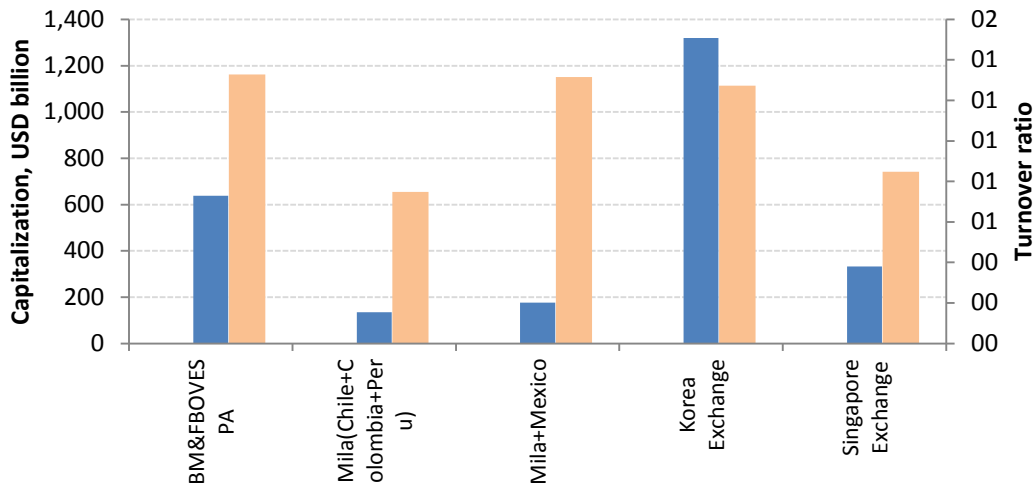
The MILA process started in 2010 when the stock markets of Bogota,¹⁴ Lima, and Santiago, with the support of their respective regulators and depositary agencies, announced their intention to integrate. Intermediated routing of orders for stocks in the secondary market payable in cash has been operative since May 2011, though actual transactions have been quite limited due to remaining regulatory differences among the member countries, most of which are being addressed. This was intended to be a first step in a gradual process of deeper integration, which requires a considerable degree of regulatory harmonization. In 2013 there were advances in this process that will also permit intermediated routing of orders for other variable-rent securities, such as shares of portfolio investment funds, as well as primary stocks and securities issuances. Initial steps were also taken to facilitate bilateral quoting of currencies.

The joint stock markets of Colombia, Chile, and Peru comprise the largest number of issuers in the region, though the combined market capitalization is second to Brazil's Bovespa, and joint turnover is third after Mexico and Brazil. Integration with the Mexican stock market is scheduled to be operative in 2015. In 2013 a new Securities Markets Law was approved in Mexico, which harmonizes the legal framework with the initial three members, and a work program has been established to achieve physical integration in 2014. MILA would then roughly double in size, becoming the fifth-largest stock market among emerging countries, comparable to the Brazilian, Korean, and Singaporean stock exchanges (only China's would be significantly larger), though turnover will probably continue to be lower than in the Brazilian and Korean exchanges. See Figure 2.

¹³ Purchased by the New York Stock Exchange in 2007.

¹⁴ There had been a previous integration between the stock markets of Bogota, Medellin, and Cali in Colombia in 2001.

Figure 2. Comparative size and liquidity of stock markets



Source: World Federation of Exchanges, 2012.

Open regionalism: expanding membership, joint trade and investment promotion, and looking toward the Asia-Pacific region

As mentioned above, the Alliance is also envisaged as a means to promote integration with other countries. First, it is open to other potential members and actively promotes their adhesion. Costa Rica and Panama are already at an advanced stage in the process of joining, though they must have operative bilateral FTAs with all the initial members as a precondition; Panama is finalizing an FTA with Mexico, and the Costa Rica–Colombia FTA still requires parliamentary and constitutional approval in Colombia. Furthermore, they must either fully accept existing protocols or negotiate specific exceptions with present Alliance members, a process that will take some time to finalize. Guatemala has also indicated its interest in joining, while Ecuador, El Salvador, Honduras, Paraguay, and Canada, among several other countries, have observer status. It is likely that all the Latin American countries with coasts on the Pacific Ocean will eventually join, as was the plan of the original ARCO del Pacifico initiative. Although the four present Alliance members broke away in order to move forward faster, they have kept the original objectives in sight.

Second, integrating with the Asia-Pacific region has been an explicit objective of the Alliance since it started. Three of the Alliance members are also current members of the Asia-Pacific Economic Cooperation, APEC (Colombia has requested membership, though new admissions have been closed for several years), and are actively participating in the

Transpacific Partnership Agreement negotiations. Further, Alliance members have been actively negotiating bilateral FTAs with Asia-Pacific countries, Chile being by far the most active in this regard.

In addition, Alliance members are jointly promoting Alliance-Asian investment flows and exports (especially in agricultural products) to Asia-Pacific markets, through joint missions and other forms of cooperation. In particular, they have begun to explore how they can use existing bilateral FTAs with Asian countries in order to promote integration of the four Alliance members into Asian productive value chains in specific sectors.

Finally, Alliance members have begun to establish joint commercial offices in other regions (Turkey, Morocco, and Ghana, so far).

Conclusion

The Pacific Alliance is becoming a showcase for the traits that may characterize future advances in economic integration in Latin America. Progress in the Alliance has undoubtedly been facilitated by the fact that the four member countries' governments have been pursuing similar pro-market policies. However, the widely shared interest in most of Latin America in closer trade and economic links with the fast-growing Asia-Pacific region, together with the demonstration effect of the eventual success of the Alliance, may induce several other countries to join and other groupings, such as Mercosur, to increasingly imitate its approach.