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Latam Flash

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Economic Analysis

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Trade protocol for the Pacific Alliance signed

The trade protocol signed this Monday is the most important agreement since the initial Framework Accord. It makes effective the removal of 92% of tariffs on trade between the four members of the Pacific Alliance (PA) and defines the regulations on origin which will boost international production chains within the PA.

- **The Trade Protocol will remove tariffs on 92% of the products traded between the four members.**

  The heads of States of Chile, Colombia, Mexico and Peru, as part of the VIII Summit of the Pacific Alliance,[1] signed last Monday 10 February the Trade Protocol which increases to 92% the products and raw materials traded within the block that will not be subject to trade tariffs. Following the Framework Accord executed in 2012, the trade protocol signed this Monday is the next specific step in the block's integration process. The remaining 8% is mainly concentrated in the agricultural sector[2] and tariffs are expected to be reduced gradually over the coming years (from one to a maximum of 17 years), with sugar being the only product excluded from trade agreement which is set to enter into force once it has been ratified by Congress in the four member countries. The protocol covering this reduction will be a key factor for increasing the volume of trade among the Alliance members which currently represents only 4% of the total foreign trade of the PA member countries.

  Until now, free trade between the four member States was limited to bilateral agreements on specific issues, while this Protocol increases the number of goods and the scope of interregional free trade.

- **The Rules of Origin agreement will boost the global production chains**

  An important part of the agreements signed on 10 February includes the accumulation mechanisms and common rules of origins whereby inputs and raw materials from one country could be used by another one and the end product will be considered a national product. The member countries can also opt to exploit the "production chain" that will enable each country to take advantage of trade agreements negotiated by other members, thereby allowing their products to reach markets where the other PA members had previously already negotiated agreements. This possibility is essential for key players such as Colombia for which the Protocol will make it easier to take steps towards the trade agenda with the Asian-Pacific region.

  On their part and in order to facilitate trade, the countries negotiated the creation of a cooperation and mutual assistance mechanism for exchanging customs information and expressed their commitment to continue eliminating non-custom barriers and to facilitate customs procedures.

1:For a more detailed analysis on the Pacific Alliance, see the observatory Financial Integration in the Pacific Alliance, BBVA Research, October 2013.
2: Some of the goods considered "sensitive" products include corn, wheat, banana, coffee, beans, and potatoes. These and another 400 goods were excluded from the agreements between Colombia and Mexico and between Chile and Peru.

- ## New members on the horizon: Costa Rica and Panama

Costa Rica, already having Free Trade Agreements with four member countries, will formalise its membership in the Alliance in the coming months while Panama is awaiting the conclusion of its negotiations with Mexico.

In addition to the execution of the Protocol, 17 chapters were also signed which include the lifting of internal visas for job mobility and to promote tourism. Note that the PA was conceived as an ambitious project not only the trade of goods, but also of services, cooperation, the free movement of capital and people, and other issues.

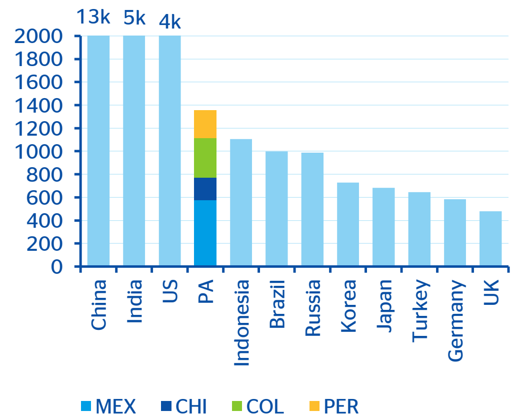
- ## Big room for improvement in interregional trade within the PA

The PA is, as a whole, the sixth major economy in the world (in terms of USD millions, adjusted for PPP) and the fourth that is set to contribute the most to global growth over the next 10 years (Chart 1). PA countries account for 50% of Latin America's trade with other countries in the world. This alliance is committed to opening up trade, with 66 free trade agreements signed among its member countries with others such as the US, the EU, Japan, and China. [3]

As mentioned above, there is enormous growth potential for trade within the PA which currently represents only 4% of its foreign trade in contrast with a potential market whose population represents 35% of the population in Latin America. This interregional growth potential will benefit Mexico, in particular, and Colombia, albeit to a lesser extent (Chart 2).

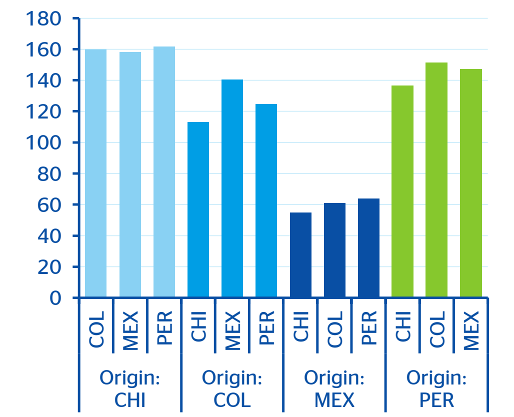
Greater trade integration should also have a positive effect in attracting direct foreign investment in the region. PA countries are already among those with the greatest potential for attracting FDI in the region, considering variables such as the appealing internal market, the workforce, natural resources, and the state of the infrastructure. Nevertheless, greater integration of internal markets and of the workforce of PA countries should increase this strong potential even more (Chart 3).

Chart 1
Greater contribution to worldwide growth over the next 10 years (USD mn adjusted for PPP)



Source: BBVA Research and Cometrade

Chart 2
Export potential within the PA (Index 0 = very high; 200 = very low)



Source: BBVA Research and IMF

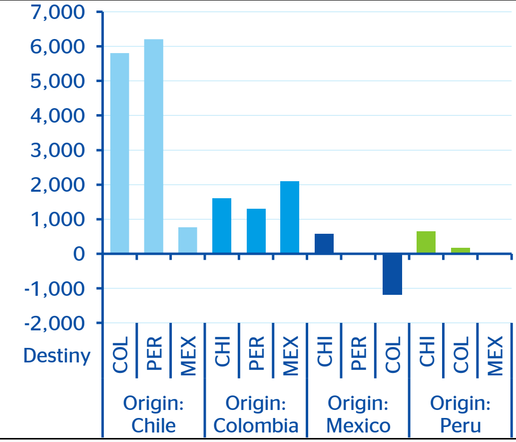
3: The four AP member countries have free trade agreements with the US and the EU. With the exception of Colombia, the other countries have free trade agreements with Japan and, except Colombia and Mexico, also with China.

Bear in mind that in order to maximise the efficiency of the integration efforts in the region, major challenges will have to be faced in relation to: the high degree of informality of the region, the limited quality of physical (infrastructures) and human capital (quality of education), as well as the rather weak tax systems and the heavy dependence on only a few natural resources.

- ## Pending challenges with the PA

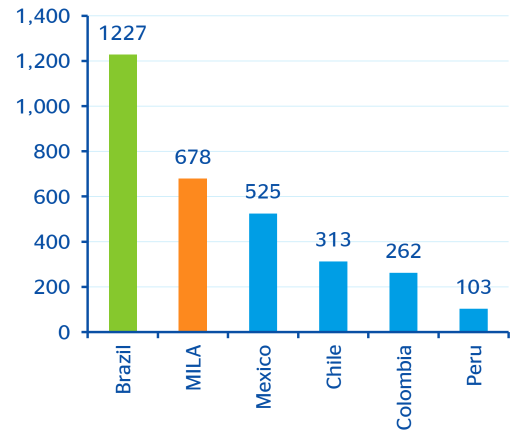
The key challenges the Alliance faces, once the elimination of tariffs is underway, is the integration of the securities markets. The Integrated Latin American Market (MILA, Spanish acronym) electronically integrates the Chilean, Colombian, and Peruvian stock markets enabling transactions among these countries. With the incorporation of Mexico, expected this year, the combined market cap of the four countries will be equivalent to the capitalisation of Brazil, although trading volumes will probably remain at low levels. The obstacles to be tackled are mainly the lack of standardisation between the tax regimes, investment in the pensions market and the lack of currency hedging tools.

Chart 3
Direct accumulated investment among PA countries 2009-2012 (origin-destination, USD mn)



Source: BBVA Research and Banco Central de Chile

Chart 4
Market capitalisation (USD mn, Dec. 2012)



Source: BBVA Research and Bloomberg

From now on, and given the strong fundamentals of the PA member countries based on credible inflation targets, supported by prudent fiscal policies and flexible foreign exchange rates, the upturn in the US economy and the expansion and growth in Asia should have an impact on the exports of the member countries.

The Pacific Alliance is set to become one of the main trade blocks in the continent. PA is backing the integration of its members and with the rest of the world. The total elimination of tariffs and the market access agreements are essential steps in the right direction for this consolidation process.

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