RESEARCH

Economic Watch

Colombia

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Economic Analysis

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Colombia and the United States open their doors Free Trade Agreement will boost Colombia's product and competitiveness

- **Free trade makes the markets more competitive and reduces the cost of living**

Free trade is an opportunity not only to increase exports, but to improve the wellbeing of the population. The broadening of trade will increase the variety of products available to consumers, will boost the productivity of producers, and will make the markets more competitive translating into a reduction of the consumers´ cost of living.

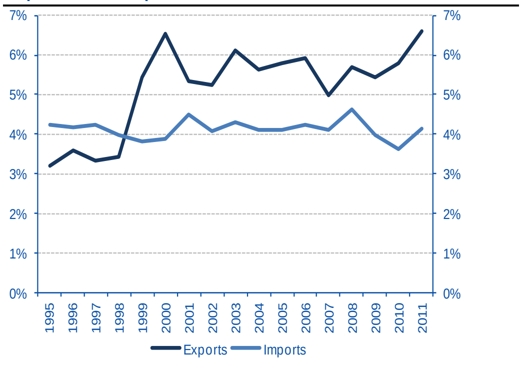
- **International trade with the main commercial partner is broadened**

The agreement will consolidate the trade relations between the two countries and will allow some sectors that did not previously benefit from the ATPDEA tariff preferences to enter the U.S. market without tariffs. Some products with a relative advantage for Colombia will strengthen their exports, while other sectors will have to carry out productive improvements to address the challenges of the agreement.

- **Prudent tariff elimination, together with improvements in infrastructure and regulations**

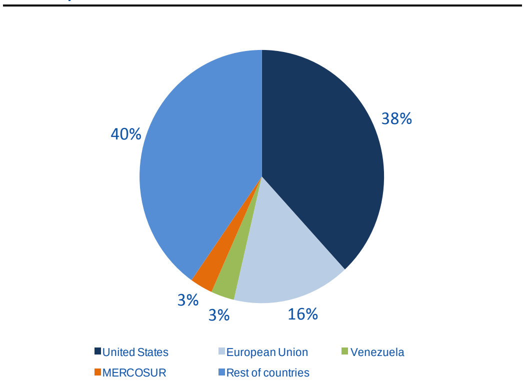
When the agreement takes effect, 76% of the products from the United States will become duty free to enter the Colombian market. Meanwhile, 94% of Colombian products will do so in the U.S. market. The remaining products will undergo a tariff phase out and quota process, which, in all cases, will be gradually removed while the producers adjust their production to address the challenges of the agreement.

Chart 1
Exports and Imports from Colombia to the USA (%GDP)



Source: DANE and BBVA Research

Chart 2
Distribution of Colombian exports by destination country in 2011



Source: DANE and BBVA Research

Openness and trade diversification strategy

The importance of the agreement with the United States lies in its stake in Colombian foreign trade. The United States is the main recipient of Colombian exports (Chart 2) and the leading country of origin for imports, with a trade surplus on Colombia's behalf since 1999 (Chart 1).

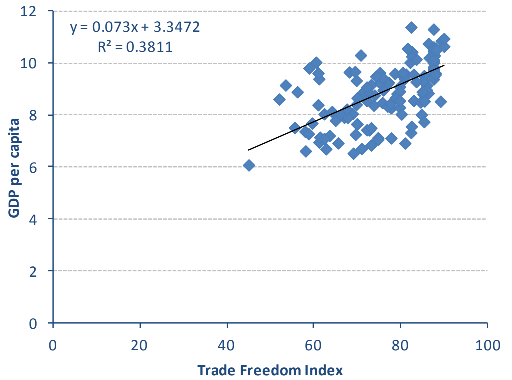
However, the agreement with the U.S. only forms part of an ambitious trade openness and diversification strategy. The government is also negotiating trade agreements with South Korea, Turkey, Israel and Panama; it is awaiting the confirmation of the treaty with the European Union by the European Parliament, and has recently signed trade agreements with Canada, EFTA nations (Switzerland, Iceland, Norway, Liechtenstein), and the northern triangle (Guatemala, Honduras and El Salvador). This is in addition to the treaties already signed with Mexico, MERCOSUR (Argentina, Brazil, Paraguay and Uruguay) and the Andean Community (Bolivia, Peru and Ecuador).

Free trade will bring about improvements in competitiveness and wellbeing

Free trade agreements represent a solid opportunity to improve the country's competitiveness and wellbeing. With free trade, not only do the markets for selling domestically-manufactured products abroad increase, but the variety of products available to consumers also rises. Free trade increases competitiveness by inducing a decrease in prices for consumers and increases productivity by making countries specialize their output on their most competitive products.

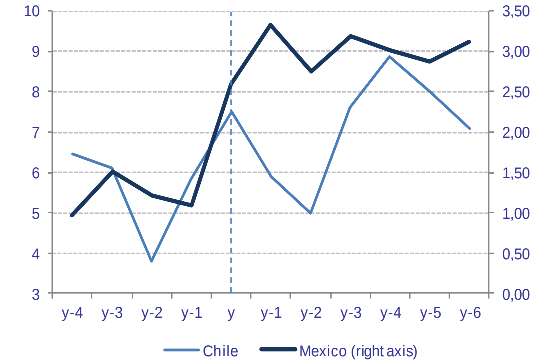
With the FTA with the US, Colombian consumers will find American goods and commodities that were not marketed domestically before due to the high tariffs. They will also see a decrease in the cost of living due to a drop in the prices of imported goods, and economic growth will rise thanks to the increases in productivity[1].

Chart 3
Trade Freedom Index (0-100) and natural logarithm of GDP per capita for different countries



Source: Heritage Foundation, World Bank and BBVA Research

Chart 4
Net Foreign Direct Investment of Mexico and Chile before and after NAFTA and the FTA, respectively (% GDP)



Source: World Bank and BBVA Research

Improvements in competitiveness translate into greater per capita income. Chart 3 illustrates the positive relationship between the Trade Freedom Index[2] of the *Heritage Foundation* and the per

[1] The National Government has estimated a 1% annual increase in economic growth as a result of the FTA.

[2] Index that measures the level of tariff and non-tariff barriers affecting imports and exports of goods and services. The index ranges from 0 to 100, with 100 being an economy with minimum tariff and non-tariff barriers. Read more at the *Heritage Foundation* website.

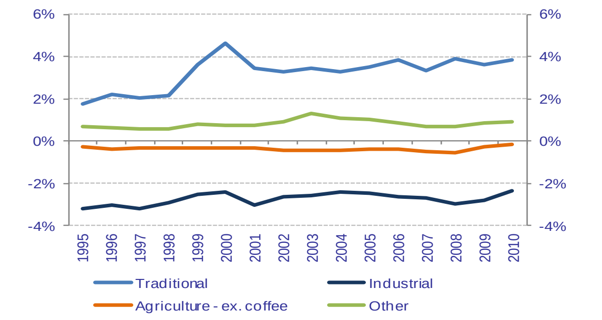
capita income of the countries, reflecting the way in which economies with fewer obstacles to trade have, as a result, greater income levels.

Free trade also increases the levels of net foreign direct investment (FDI). Chart 4 presents FDI as a proportion of GDP for Mexico before and after the NAFTA took effect, and for Chile before and after it signed the FTA with the U.S. In the chart, we can observe how Mexico nearly tripled its FDI, and maintained it at nearly 3% after NAFTA took effect. The case of Chile is less notorious but equally significant, with an increase of its FDI from an average of 5.5% in the four years preceding the FTA to 7% four years after the FTA.

Broadening of the exchange with Colombia's main trade partner, with "winning" and "losing" sectors

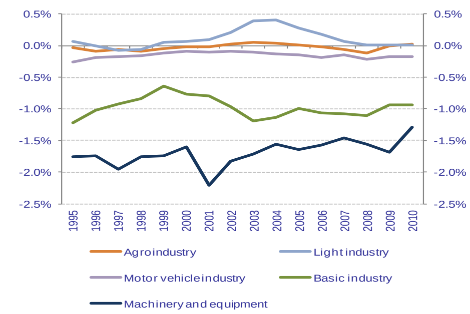
The United States is Colombia's main trading partner, with a 26% share of all imports and 42% of all exports. The most exported products are traditional (coffee, oil, coal, ferronickel and oil products), while the most imported are fuels, wheat and those related to the industrial sector, like machinery and parts.

Chart 5
Trade balance of Colombia with the USA, by product group (% GDP)



Source: DANE and BBVA Research

Chart 6
Trade balance of Colombia with the USA in the industrial sector, by subsector (% GDP)



Source: DANE and BBVA Research

Within the industrial sector, machinery and equipment products pertain to the subsector with the greatest percentage of industrial imports, while the agro-industry and light industry products (food, clothing, footwear and textiles) bear a relatively lower importance in trade within the industry.

It is difficult to estimate the trade pattern with the agreement taking effect (that is, which sectors will "win" and which will "lose" with the FTA). Technology changes year-to-year and the cost structure of a sector can significantly vary in the medium term, making a sector that was not productive in the past into a leader in production in a few years. Likewise, some markets can take advantage of the lower tariffs on its inputs to adopt productive improvements and thus stand out in national production.

However, some measures, (leaving out the aforementioned issues) do allow for the identification of the sectors that ex ante the agreement taking effect present a competitive advantage against the rest of the world (disregarding the fact that tariffs distort the current trade pattern and do not necessarily reflect the ex-post pattern). Balassa's[3] (1965) Revealed Comparative Advantage (RCA)

[3] The index is defined as RCA(ij) = (Xij/Xit) / (Xwj/Xwt) Where X(ij) and X(wj) are the exports of country i of product j, and the world exports (w) of the product j. X(it) and X(wt) are the total exports of country j and the world in year t. A value below 1 indicates that the country has a relative revealed disadvantage in product j. If the index is over 1, the country has a revealed comparative advantage in the production of the product.

indicator takes into account if a country exports a product in a greater proportion than the rest of the world. This would then be a sign that the country is more productive for producing that product with regard to the world, and, therefore, would reveal a comparative advantage in its production. This indicator is calculated for the U.S. and Colombia for an aggregation of the total production in 63 product categories, by presenting if the product is classified with a relative advantage for Colombia or the US (see Table 1 of the Annex). The classification is aggregate; therefore, consideration must be made of the fact that within each category, there could be subsectors with a classification that is different from that of the sector aggregate (for example, Colombia could have a comparative advantage in motorcycle production, despite the fact that the "vehicles" category presents a relative disadvantage in the aggregate).

The classification shows that products like coffee, sugar, oil, leather, silver and aluminum have a relative advantage in Colombia but not in the US, which indicates that the FTA could boost those sectors in Colombia given their advantage with respect to the US. Moreover, there are 25 sectors that do not present a relative advantage in either of the two countries, which represents the potential for its export by both countries. A total of 22 sectors present a relative advantage in the US but not in Colombia, which could cause obstacles with the implementation of the agreement. Finally, seven sectors revealed comparative advantages in both Colombia and the US, which means the implementation of the FTA would intensify their competition.

Prudent tariffs' phase out process to improve domestic competitiveness and to address increasing competition

The free trade agreement will come into force in 2013, coinciding with the finalization of the ATPDEA tariff preferences. The reduction of tariffs will be gradual for both countries (Table 1). With the FTA coming into force, 60% of Colombian products will immediately become duty free in the US market (34% are already duty free), while 74% of American products will do so in the Colombian market in the first year of implementation (2.3% of the products are currently duty free).

A tariff phase out process will be initiated for the remaining products. The tariff relief process varies by product, which, in any case, will end between 2015 and 2030. For some products ("other" on Table 1), the phase out process is accompanied by a quota scheme, which establishes the maximum quantity of goods one country can export to the other; although it will become gradually more flexible over time.

The phase out process will allow producers from both countries to make investments to improve their productive structure, either by broadening their exports to the other country, improving their productivity to address the growing competition, or modifying their business lines to focus their efforts on the sale of another type of goods. In all cases, this is an opportunity for the private sector to assess and improve its productive structure to face the changes in the trade conditions.

Charts 7 and 8 present the average tariff amount to be applied in Colombia (Chart 7) and in the United States (Chart 8) to the principal imports and exports with the phase out process. The main imports to Colombia will see an average decrease of its tariffs from 14.1% to 5.4%, while products that compete with the exports will have a reduction of tariffs from 9.7% to 4% in the first year of implementation. Afterwards, a tariff phase out process will begin for the products in question that will be finalized in 2023.

The main Colombian exports to the United States (excluding commodities like coffee, coal and oil), will see an average tariff reduction from 4.1% to 0% in the first year the FTA is in effect. Nevertheless, as we mentioned above, other goods will have a relief process, but they represent a lower percentage within the total Colombian exports.

Table 1

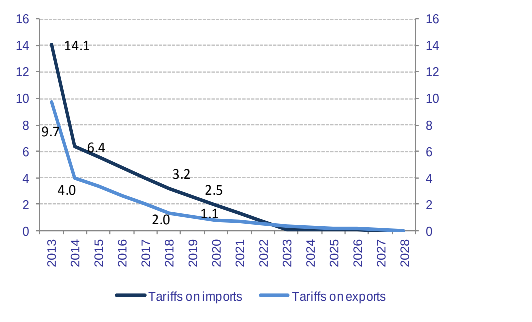
Number of products per relief period by country and sector

	Colombia		United States	
	Agriculture	Industry	Agriculture	Industry
Duty free	0	160	0	3603
2013	714	4401	1233	5176
2015	1	0	0	0
2017	112	317	2	0
2019	0	52	0	0
2020	2	0	0	0
2021	2	0	0	0
2022	23	1056	9	20
2024	1	0	0	0
2027	5	0	35	0
2030	0	0	388	0
Other	76	0	150	18

Source: MinComercio and BBVA Research

Chart 7

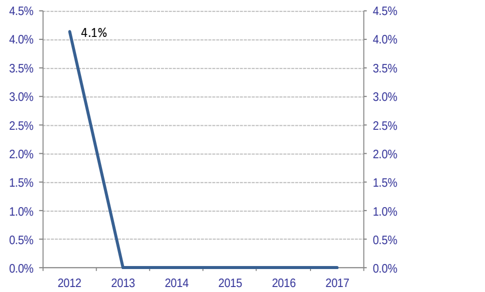
Average tariff in Colombia on the primary imports and products competing with exports (%)



Source: MinComercio and BBVA Research

Chart 8

Average tariff in the US on the primary Colombian exports, excluding commodities (%)



Source: United States International Trade Commission, MinComercio and BBVA Research

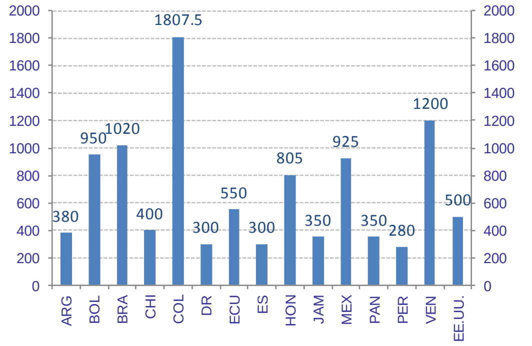
Domestic agenda for infrastructure and regulation to optimize the commercial opening

The government bodies are aware of the shortcomings in terms of roads infrastructure and trade logistics. In terms of regulation, the Government hopes to clear some obstacles to competitiveness by, for example, simplifying customs paperwork, sanitary and phytosanitary public records and other steps that restrict the speed of foreign trade.

As regards infrastructure, the national Government estimates a USD$42.1bn investment between 2011 and 2018. In 2012, it expects a USD$2bn investment in regions the Government has deemed top priorities for addressing the increase of trade due to the FTA. A total of forty projects have been planned to increase the main roads by 1,131km; COP 500m will be invested in two-lane highways and COP1.2bn in road maintenance.

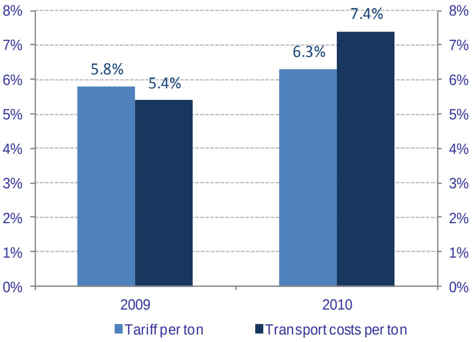
Infrastructural improvements are essential to being able to take advantage of the benefits of free trade. Estimates indicate (Charts 9 and 10) that the transportation costs in Colombia are significantly higher than other countries in the region, which results in the lower competitiveness of domestic output. Likewise, domestic transportation costs in Colombia in 2010 even exceeded the average costs of tariffs per ton imposed on imports, thus generating inefficiencies and obstacles for producers and consumers to take advantage of the benefits of free trade.

Chart 9
Costs of transporting an intermodal container by road in countries in the region and the US (USD)



Source: World Bank and BBVA Research

Chart 10
Average tariff per ton and cost of transporting one ton of freight by road in Colombia (%)



Source: DIAN, MinComercio, World Bank and BBVA Research

Annex 1

Categorization of the Revealed Comparative Advantage (RCA), for all products classified in 63 categories (two-digit SITC3) The table shows the products in which the U.S. and Colombia specialize their production with respect to the general trade pattern of the world. Their definition can be found in the footnotes of page three. The blue arrow presents the products with potential to benefit from the FTA, given the comparative disadvantage of the US.

	USA Comparative Advantage (RCAUSA>1)	USA Comparative Disadvantage (RCAUSA<1)
Colombia Comparative Advantage (RCACOL.<1)	Vegetables and fruit Coal, coke and briquettes Dyeing, tanning and coloring materials Essential oils and resinoids and perfume materials Plastics in primary forms Paper, paperboard and articles of paper pulp, paper or paper board Gold, non-monetary	Sugars, sugar preparations and honey Crude animals and vegetable materials Coffee, tea, cocoa, spices and manufactures thereof Petroleum, petroleum products and related materials Leather, leather manufactures and dressed furskins Silver and aluminum
Colombia Comparative Disadvantage (RCACOL.<1)	Meat and meat preparations Miscellaneous manufactured articles Professional, scientific and controlling instruments and apparatus Road vehicles Feeding stuff for animals Cereals and cereal preparations Miscellaneous edible products and preparations Hides, skins and furskins, raw Oil seeds and oleaginous fruits Crude rubber Cork and wood Pulp and waste paper Textile fibers and their wastes Metalliferous ores and metal scrap Animal oils and fats Organic and inorganic chemicals Medicinal and pharmaceutical products Fertilizers Plastics in nonprimary forms Chemical materials and products Nonmetallic mineral manufactures General industrial machinery and equipment	Live animal other than fish Photographic apparatus, equipment and supplies and optical goods Transport equipment Articles of apparel and clothing accessories Furniture and parts thereof, mattresses and cushions Travel goods, handbags and similar containers Footwear Appliances and parts thereof Office machines and other data processing machines Telecommunications equipment Metalworking machinery Dairy products and birds' eggs Fish, crustaceans, mollusks Beverages Tobacco and tobacco manufactures Crude fertilizers and crude minerals (excluding coal, petroleum and precious stones) Gas, natural and manufactured Electric current Fixed, vegetable fats and oils, crude, refined or fractionated Animal or vegetable fats and oils, processed; waxes and food Rubber manufactures Cork and wood manufactures (excluding furniture) Textile yarn, fabrics, made-up articles and related products Non-ferrous metals Manufactures of metals

Source: World Trade Indicators (World Bank) and BBVA Research.

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