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# Pacific Alliance

## NEXT STEPS IN INTEGRATION



By Jason Marczak and Samuel George

With María Fernanda Pérez Argüello and Andrea Saldarriaga Jiménez



## Atlantic Council

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# The Pacific Alliance, 2.0

Just a few years ago, the Pacific Alliance, then a new pact between Chile, Colombia, Mexico, and Peru, was considered “the most important alliance you’ve never heard of.”<sup>1</sup> That anonymity was short-lived. Dubbed the Pacific Pumas in a 2014 Bertelsmann Foundation study,<sup>2</sup> the four countries continuously show an ability to work together to solve tough issues, with a pragmatic approach to integration that has quickly caught the world’s attention.<sup>3</sup>

Since the official launch of the pact with the Lima Declaration in 2011, Alliance members have achieved remarkable success: tariff elimination on a wide range of products, the integration of four national stock markets, the removal of inter-Alliance visa restrictions, and the opening of joint international trade missions. Its outward-looking economic approach prioritizes private

sector cooperation, announcing to the world that the bloc is open for business.

These developments have not gone unnoticed. Forty-two countries across six continents have signed on to the pact as observers. Costa Rica and Panama are currently seeking to join what would be tantamount to one of the ten largest economies in the world. The Alliance is also part of a turning tide in Latin America. For example, in Argentina, President Mauricio Macri’s

administration speaks openly of finding ways to marry the *Mercado Común del Sur* (Mercosur) with the Pacific Alliance.

The advancements are stunning, but the Pacific Pumas are not satisfied with a good start.

**Mexico City’s skyline symbolizes the country’s dramatic growth and its endless possibilities ▼**



LIDIA LOPEZ/FLICKR

Significant opportunities exist for deeper integration. To achieve these more challenging elements, the pact will need more time to deliver. For example, despite the foundation built by the *Mercado Integrado Latinoamericano* (MILA), financial integration has been underwhelming, and regulatory harmonization remains incomplete. Issues pertaining to pension funds, bank accounts, the joint financing of development projects, and obstacles in capital flows must be addressed. All four member countries pursue liberalized trade in an effort to move away from commodity reliance, yet, as slumping commodities yield decelerating growth, more attention must be paid to export diversification. Both observer countries and member states still wrestle with how to harness the potential of such an impressive coalition, and deeper energy integration remains one of the greatest opportunities for the Alliance.

These challenges point to the Alliance's still untapped potential. Chile, Colombia, Mexico, and Peru have picked some of the "low-hanging fruit" of regional integration. Now, the next stage begins. This means reaching for the higher, more difficult—yet ultimately more fulfilling—levels of collaboration. It is crucial to establish milestones—three, five, and ten years out—to maintain momentum.

With this in mind, the Bertelsmann Foundation and the Atlantic Council began a collaboration in 2015 to celebrate the Pacific Alliance's success and explore the barriers to deeper integration. The goal was to work with a variety of stakeholders to propose policy options that will enhance the Alliance. As two transatlantic think tanks with dedicated Latin America centers, we drew on first-hand lessons of European integration, and applied this knowledge and network to a twenty-first century interpretation of transatlantic affairs.

Over the course of the last year, we held two private roundtables featuring global leaders from the public, private, multilateral, and academic sectors. In particular, this network called attention to opportunities in financial, energy, and commercial integration. The group also discussed the Pacific Alliance's potential as a regional leader and global player, with a specific emphasis on making use of the pact's diverse observer countries.

This document reflects the outcome of our dialogues—both as a group and bilaterally. We devote specific attention to identifiable barriers, as well as actionable recommendations. These strategies can help keep Pacific Alliance momentum thriving, and help turn the pact you never have heard of, into one capable of reshaping Latin America.



**Chile, Colombia, Mexico, and Peru have picked some of the “low-hanging fruit” of regional integration. Now, the next stage begins.**

# DEEPENING FINANCIAL INTEGRATION: MILA and Beyond



Internationally, the Pacific Alliance is primarily considered a free trade agreement, with the oft-cited figure of a 92 percent elimination of intra-alliance tariffs. This is an impressive achievement, but it must be put into context. Members already had bilateral free trade agreements in place, and none are major trading partners with each other.<sup>4</sup>

Perhaps the focus on real integration is misplaced. While opportunities to deepen trade ties certainly exist, the largest gains may be accessed through financial sector integration. The financial markets of Colombia, Peru, and Chile may individually seem shallow, but their integration together, and with a

▲ **Stock market integration sets the Pacific Alliance apart. The Mexican Bolsa de Valores (pictured) is the second largest in the region.**

larger market such as Mexico, could create dynamic and complementary opportunities.<sup>5</sup>

Financial integration could facilitate the diversification of investment and liquidity channels, while also limiting the exposure and risk inherent in markets that are currently one-dimensional.<sup>6</sup> One featured area of opportunity is MILA, the Alliance's shared stock market.

Originally conceived in 2010 as a multistep mechanism to integrate the Chilean, Colombian, and Peruvian bourses, MILA took a major step forward with the integration of the Mexican Stock Exchange in late 2014. With Mexico, MILA now represents the largest bourse in Latin America in terms of capitalization (\$1.1 trillion), and the second largest, following Brazil's BOVESPA, in terms of the number of companies listed.<sup>7</sup> MILA has the potential to convert mostly overlooked and often illiquid markets into a bourse of global relevance.<sup>8</sup>

Yet, while MILA may be the most well-known opportunity for financial integration, it is certainly not the *only* opportunity. Cross-border infrastructure investment, pension fund

integration, and the removal of intra-alliance capital controls are additional examples of financial integration that could spark mid- and long-term growth.

Insurance integration could also be a win-win. Peru's insurance sector is valued at nearly 2 percent of gross domestic product (GDP), suggesting ample room for growth (in Chile, the sector is valued at 5 percent of GDP).<sup>9</sup> Highlighting this opportunity, the Chilean firm Consorcio Financiero announced a \$40 million investment in the Peruvian insurance sector in August 2015.<sup>10</sup>

Given that all four presidents and finance ministries of the core Alliance countries are committed to deepening financial integration, it is important to consider what is preventing it.<sup>11</sup>



**Despite the many achievements, there are barriers to deeper financial integration.**

**Liquidity.** Although MILA initially generated significant buzz, a lack of liquidity in the different markets has prevented a “take-off.” The initiative lost some momentum in 2015 as oil prices faltered and as a slowdown in the Chinese economy led to an unwinding of the commodity boom, which, in turn, hurt a number of MILA’s publicly listed firms.

**Complex Bureaucracy.** Red tape prevents the potential of financial integration from becoming reality. Regulatory concerns have specifically stifled pension fund integration.<sup>12</sup> For example, Mexican pension funds—the largest in the Alliance—“are prohibited from investing more than 20 percent of their portfolios internationally, and restricted to assets deemed less risky than their Mexican equivalents.”<sup>13</sup>

Insiders note the process is further complicated by differing rating norms in the member countries. As a result, only 1 percent of local Pacific Alliance pension funds have been invested in other alliance countries.<sup>14</sup> The bureaucratic obstacles are not entirely self-imposed; some of the red tape stems from international regulations. For example, the Organisation for Economic Co-operation and Development maintains caps on investment in international pension funds, creating an additional layer of bureaucracy for Chile and Mexico.

**Capital Volatility.** Financial integration offers growth opportunities, but limited controls can pose daunting threats. Often, the easier financing can flow in, the easier it can flow out. Capital flows also tend to be pro-cyclical—a potential risk as the region finds itself at the tail-end of a commodity boom. Capital volatility is thus an important factor for policymakers’ approach to financial integration, but also to explain why flows have underwhelmed in the first years of the project.

**Policy Differences.** Although Pacific Alliance leaders may support financial integration, this has not translated into coordination on national fiscal or monetary policy. For example, all four core alliance members completed far-reaching revisions to their tax regimes over the last year. Yet, the reforms of individual countries did not necessarily align with those of the others, creating incongruities that dampen or complicate cross-border investment. As a result, the quartet continues to tax different rates on capital gains, dividends, and stock market trades.<sup>15</sup> A similar lack of harmonization exists on the monetary side, specifically in terms of setting base interest rates.

## Recommendations



### **LIST FIXED INCOME SECURITIES ON MILA.**

A major hindrance to MILA is a lack of liquidity. Currently, the exchange only features stocks that account for a minority of trades conducted by Alliance-based brokerages. Fixed income securities, particularly government bonds, still account for the majority of transactions. Featuring such bonds on the MILA would rapidly inject liquidity into the market.



### **ESTABLISH A ROBUST CLEARANCE SETTLEMENT INTEGRATION.**

While MILA may be operational, the “beta version” features notable inefficiencies. For example, the clearance settlements from listings exchanged internationally are still conducted through New York institutions. If a Peruvian purchases a Chilean stock on MILA, brokers execute the exchange by selling Peruvian *soles* to New York financial institutions for Chilean *pesos* that are then moved to Santiago, with New York charging a commission on both sides. An integrated clearance settlement system would eliminate these fees. However, insiders suggest that until fixed-income securities are available on MILA, trade volume will not be great enough to warrant this new infrastructure.



### **PURSUE HARMONIZED REGULATIONS.**

Three areas may see rapid financial integration: pension fund integration, the issuance of exchange-traded funds (ETFs) indices, and the development of regional clearing mechanisms. However, these steps all require similar regulatory frameworks from Mexico City to Santiago. Institutional frameworks in member countries should be aligned and include both recourse and back-up mechanisms (such as insolvency procedures and counter-party risk) in the event of a dispute. MILA is also hampered by a lack of regulatory harmonization. For example, for a Peruvian stock to be listed on MILA it must separately meet compliance tests in the other three markets. A single Pacific Alliance compliance test could streamline this time-consuming process.



### **ENSURE PENSION PORTABILITY.**

Few procedures exist for pension holders to move their account between member countries. If a Peruvian pension holder wanted to move his account to a Chilean fund, he would face significant tax penalties. The ability to move accounts within the Alliance without penalty would increase competition in the largest portfolio sector in Latin America.

# ENERGY: Untapped Potential

**A**lthough not formally on the agenda of the Pacific Alliance, energy plays a crucial role in the economies of all member countries. Now is the moment to build a more sustainable energy strategy and to begin transitioning to an energy matrix that will result in economic, environmental, and energy security benefits.

At a time of record low oil prices, the Pacific Alliance has an opportunity to rethink how it fulfills energy needs, as well as define its role in the new energy economy. As US Vice President Joseph Biden noted on May 4, 2016, “We’re in the midst of a seismic shift in the global economy: the ascendancy of the Americas as the epicenter of energy production in the world.”

The world is in the midst of an energy revolution, which directly affects the four Alliance members and the Alliance’s many observers. The United States, Canada, and Mexico have achieved continental self-sufficiency. The United States alone has replaced Saudi Arabia as the world’s largest oil producer and Russia as the world’s largest gas producer. Europe is seeking to diversify oil and gas supplies away from Russia. Africa and Asia—with India acting as the biggest player in the field—are seeking higher quantities of natural gas for power generation.<sup>16</sup>

Changes are afoot within the Alliance as well. Hydrocarbon-rich Mexico continues its ambitious energy reform, now in the implementation phase. Chile, a country facing energy scarcity, is working to unify its two electric systems, an effort made all the more immediate by the 193 percent rise in electricity costs over the past ten years. Colombia and Peru are energy-rich countries, maintaining large hydrocarbon reserves. These conditions set the perfect scenario to discuss a more integrated approach that interconnects the countries, despite Mexico’s geographic distance from its Alliance partners.

A comprehensive, integrated energy matrix within the Pacific Alliance has precedent. The Inter-American Development Bank, for example, has explored the future of energy in the Americas, and it continually identifies integration as a top priority. It worked relentlessly to build the Central American Electrical

Interconnection System (SIEPAC) and their Regional Electricity Market (MER). Both of these “offer distinct advantages in that they optimize national electricity markets and facilitate generation projects at a regional and more efficient scale.”<sup>17</sup> The Pacific Alliance can learn from this; Mexico and Colombia already have a presence in SIEPAC as extra-regional partners.

Total energy use in Latin America and the Caribbean is projected to expand by more than 80 percent through 2040, accompanying the region’s economic growth and its rising middle class.<sup>18</sup> This is an opportunity for member countries, especially energy-rich Pacific Pumas such as Colombia, Mexico, and Peru. With the increasing threat of energy insecurity that Venezuela’s Petrocaribe represents to Central America and the Caribbean,<sup>19</sup> and with the opportunity of penetrating the Asia-Pacific markets as well, Pacific Alliance countries have a unique opening for furthering integration. Now is the time to identify direct lines of cooperation.

**Pacific Alliance countries have a unique opening for furthering energy integration. Now is the time to identify direct lines of cooperation.**



**Momentum is possible for energy integration, but barriers exist.**

**Geographic Divisions.** Physical electrical integration is a challenge for the obvious geographical divide between Alliance members. Electricity grids and production chains must connect from the United States through Central America and into South America, making the connection between Colombia and Panama vital. From a business perspective, interconnectivity through Central America will eventually happen, but member countries could contribute to accelerating this integration. In addition, electrical integration is costly, as the SIEPAC experience proves. Energy is also lost in the transmission process as a result of the grids’ insufficient capacities.

**Human Capital.** Inadequate opportunities for human capital development stifles innovation in the

▲ Clean energy, including the wind power generated by Acciona’s Eurus facility in Oaxaca, Mexico, opens new possibilities for integration.

energy sector, which is crucially important to advance countries’ renewable energy needs. Untapped potential can be addressed through greater training and skills development, as well as the free movement of labor across member countries.

**Private Investment.** Energy integration, which includes but is not limited to the interconnection of electrical energy grids and the establishment of common markets, requires significant investment. New sources of funding—that move away from public funds—are imperative for member governments’ energy integration agendas. The private sector represents a critical source of capital, but so far business has remained relatively disengaged from public-private partnerships in cross-border energy projects within the Pacific

Alliance. The energy sector's future development depends on the ability of member countries to engage different stakeholders.

**Regulatory Frameworks.** Inconsistencies in the regulatory framework and domestic pricing systems could potentially slow down the integration process and drive investors away. Energy subsidies complicate the issue. Fuel subsidies represent 1 percent of GDP, and those for electricity amount to 0.8 percent of GDP.<sup>20</sup> These inconsistencies and the associated negative externalities, coupled with the lack of political will to address them, will continue to limit energy development and integration.

**The Alliance [s]hould create an energy council and/or a working group to focus on energy policy harmonization.**

## Recommendations



**HARMONIZE ENERGY PROJECTS.** Policy harmonization is essential to establish clear rules and mechanisms, especially with regard to pricing. Subsidies must continue to be eliminated or replaced with price stabilization mechanisms that are not costly for public coffers. Physical electrical interconnection is also vital as is coordination on the intergovernmental level with SIEPAC, Ecuador, and Panama. The Alliance could create an energy council and/or a working group for this purpose. The success of any reforms will rest on implementation and on the coordination of future energy projects.



**COORDINATE PRIVATE SECTOR PARTICIPATION.** Rapid regulatory convergence—and a policy environment that welcomes change—must be in place to synchronize private sector participation. Public-private partnerships and joint ventures in electricity, gas, liquefied natural gas (LNG), and oil should be explored and harmonized. Latin America needs roughly \$305 billion for electricity generation alone from 2015 to 2025.<sup>21</sup> But historical reliance on hydroelectric plants for energy generation is changing. In fact, the share of non-conventional renewables will increase significantly in the next decades. Private sector participation will be essential, but investors will seek long-term contracts. Stronger investment conditions would bring more competition and more efficient prices.



**SEIZE ON INTEGRATION IN THE US AND MEXICAN GAS MARKETS.** The Alliance should take advantage of a trickledown effect from Mexico's integration with the US gas market. Mexico can export gas not just to Central America but also to the greater Pacific region. This will change the energy landscape in the Pacific, where Colombia also has the potential to be a net exporter. Both Colombia and Mexico can shift from conventional thermal gas-powered generation, to combined cycle generation and other technologies.<sup>22</sup> Furthermore, the Caribbean has "grown dependent on high-cost, high-carbon fuels for power generation,"<sup>23</sup> where a transition to more sustainable energy mixes could mean a shift toward natural gas. This presents another opportunity for the Alliance, given its geographical proximity.



**CLEAN UP THE ENERGY MATRIX.** Clean energy is the low-hanging fruit of Alliance energy integration. Solar, wind, and wave power<sup>24</sup> in Latin America and the Caribbean saw an average growth rate of 34 percent in the past decade. However, these sources still represent only 0.9 percent of total regional power generation.<sup>25</sup> The large volume of hydroelectric power available allows for limited carbon output. The Alliance must explore and exploit the potential of non-conventional renewable sources of energy, which could diminish the long-term consumption of fossil fuels in the member countries and could help them move toward export diversification.

# TRADING: Sparking a Chain Reaction

The commercial agenda begins with the elimination of tariff barriers on 92 percent of all products. But, given minimal intra-bloc trade, this is just a starting point.

The real advantage for the Alliance is its unique position to integrate commercial relationships across value chains and with the broader global economy. Here, the Asia-Pacific region is uniquely positioned to broaden trade ties. More than just seeking to increase exports, huge potential exists for member countries to more deeply embed in regional and global supply chains, through actions such as the harmonization of rules of origin and the creation of a single digital window.

In an era of megadeals, the international trade environment is rapidly shifting. Any strategy for trade integration must take into account the potential ratification of pending megadeals: the Trans-Pacific Partnership (TPP); the Free Trade Area of Asia-Pacific (FTAAP); and the Transatlantic Trade and Investment Partnership (TTIP).

In Latin America, the TPP will have the most tangible effects on three Alliance members: Chile, Mexico, and Peru. Yet the results may not be as immediate as some would expect. For example, as Mexico and Chile already enjoy free market access in the major economies participating in the TPP, the effects would focus less on tariffs and quotas and more on the new twenty-first century standards of the agreement. Peru, on the other hand, benefits from new market openings for its exports in developed countries participating in the TPP. For Colombia, a non-TPP signatory with interest in eventually docking on, the pact will likely force the adoption of TPP standards, even though Colombia is not currently a partner country.



▲ Private sector involvement is essential to fostering commerce among the four countries. Here, Presidents Humala, Bachelet, Peña Nieto, and Santos (left to right) discuss priorities at a 2014 business summit.

The FTAAP is by far the broadest of today's mega-regional agreements under consideration, as it includes the world's largest economies (United States, China, and Japan) and accounts for about half of global GDP. Members also include Chile, Mexico, and Peru. Peru, in particular, is projected to benefit significantly from both FTAAP and TPP, in part due to a boost in metal exports to developed countries. With higher tariffs on processed goods when compared to those on raw materials, commodity producers often export raw products, even when domestic processing is economically efficient. Removing tariffs from processed

goods changes this calculus: raw metals can be refined in Peru and exported as intermediate goods.

Finally, even though Pacific Alliance countries are not party to TTIP negotiations between the United States and the EU, any agreement between two of the world's largest trading partners is bound to have repercussions throughout Latin America. For Mexico, exports to the United States and Canada could decline under TTIP, as European competition displaces Mexican products in the United States. However, Mexico may seek to offset any decline by increasing its exports to Latin American countries.

One challenge faced by members across the Pacific Alliance is that primary exports still account for a majority of its trade portfolio. Mid-level technology products—chemicals and vehicles—are also part of this portfolio, though to a lesser extent.<sup>26</sup> More deeply connected supply chains, along with a harmonized set of rules of origin could greatly boost trade integration in the Pacific Alliance by creating more backward linkages.



**The four Pacific Alliance countries—which collectively represent the world's eighth largest economy—all rank in the World Bank's top sixty for “ease of doing business.”**

Still, the four Pacific Alliance countries—which collectively represent the world's eighth largest economy—all rank in the World Bank's top sixty for “ease of doing business,” and as Latin America's top four countries for investment.<sup>27</sup> This unique positioning reflects the member countries' commitment to liberalized trade as well as high business standards. The “additional protocol” to liberalize trade—signed by all Pacific Alliance countries in early 2016, with Chile being the last country to ratify it—guarantees an eventual 100 percent elimination of barriers for all goods and services.<sup>28</sup> If Chile, Colombia, Mexico, and Peru can maintain this trajectory and create a virtuous cycle, then diversified investment will continue to flow.

**Despite the many achievements, barriers to greater trade integration exist.**

**Regulatory Harmonization.** Without regulatory harmonization or unified standards, greater and more sophisticated trade integration will not occur. Regulatory harmonization is a long-term process and will take time for some sectors and some countries to complete, but it should be the guiding thread for the trade agenda.

**Physical Infrastructure.** The poor overall state of national roads, small airports, and ports with limited capacity—a long-time Achilles' heel of Latin America—hinder the speed with which trade can develop. Beyond traditional infrastructure, more must be done to enhance the flow of goods and better align customs practices so that goods can move more quickly across borders.

**Labor Mobility.** The lack of labor mobility greatly affects the Pacific Alliance's capacity for real integration. More flexibility for highly skilled and trained individuals to move between member countries could ensure the production of more complex and sophisticated products. Mobility would also be enhanced by setting universal standards for accepting professional credentials.

## Recommendations



### **FOSTER INNOVATION-FRIENDLY ECOSYSTEMS THROUGH PUBLIC POLICIES.**

Innovation allows for the unique partnership of the public, private, and academic sectors. A greater focus on and recognition of the importance of innovation will allow countries that are highly dependent on commodity exports to shift toward a knowledge-based economy. The absence of bureaucracy in the Alliance should be seized on as a leverage point to introduce cutting-edge, innovative policies.



### **LOOKING BACK TO MOVE FORWARD: THE IMPORTANCE OF BACKWARD LINKAGES.**

Backward linkages, defined as “foreign value added to domestic exports of a country”<sup>29</sup> are crucial to boost the region’s competitiveness. This goes hand in hand with the harmonization of rules of origin and would allow for the seamless manufacturing of goods. NAFTA is a good example of this. To further increase exports, accumulation of rules of origin—where producers can use other components to satisfy local content rules—should be a priority as well.



### **CREATE ONE-STOP CUSTOMS SHOPS.**

*Ventanillas únicas*, or single windows, reduce customs clearance times and decrease the number of steps and costs for imports and exports. A national and multinational shared database—using cloud computing—could greatly improve services and support the business environment in these countries. This is common practice in the Association of Southeast Asian Nations (ASEAN), where its effectiveness has been proven.



### **WORK TOWARD FREE MOVEMENT OF PEOPLE, GOODS, CAPITAL, AND SERVICES.**

The elimination of frontiers among members will allow for the free mobility of people, goods, and services, and will help forge a Pacific Alliance identity. Countries must go beyond the removal of visa requirements, and focus on more technical and complex issues such as accreditation of degrees and other technical certifications.

Robust supply chains should build on each country’s comparative advantages. However, supply chains require efficient infrastructure to move parts from one market to another. At first glance, this is easier among the three countries that share borders, but even Mexico can be a critical part of these supply chains given its access to the US market. More integrated supply chains also mean faster recovery after economic shocks.



### **SEIZE MOMENTUM WITH MERCOSUR.**

Both Argentina and Brazil are in the midst of a reorientation of commercial policy to be more outward-looking. In Argentina, the Macri administration, in a complete reversal from the previous government, has fully embraced the global market and is seeking to diversify its trade and investment base. Brazil, partly out of necessity sparked by the current economic downturn, is rethinking its economic posture with the potential to move from its traditional inward-looking economic development approach. Both these trends imply closer ties between Mercosur and the Pacific Alliance. This momentum should be seized upon and fully embraced. With these changes, gone may be the days of a Mercosur-Pacific Alliance divide, and this development starts with deepening commercial relationships.

**Both Argentina and Brazil are in the midst of a reorientation of commercial policy to be more outward-looking. This momentum should be seized upon and fully embraced.**

# FOREIGN POLICY: The Pacific Alliance and the World



**T**he Pacific Alliance has caught the world's eye, but can the pact capitalize on international attention? Major opportunities—and barriers—exist for the Pacific Alliance to become a driving force.

## The Pacific Alliance and Latin America: A New Regional Model

**W**hile the Pacific Alliance may have been created with an eye toward Asia, it is having a major impact in Latin America. The Pacific Pumas stand out as role models for regional countries drawn to the market-oriented, politically centrist strategy. The new Macri government in Argentina, for example, has spoken openly in favor of deeper collaboration. The Alliance could increase its membership in the Americas—but it must do so with care lest the pact become unwieldy and inefficient. Moving forward, Pacific Alliance members must weigh the benefits of expansion against the risks, especially in terms of some Central American countries. Could the Alliance

### ◀ Time for greater convergence with Mercosur?

safely incorporate Panama—a country often associated with tax evasion? Would Colombia and Mexico, two countries eager to exorcise the demons of drug wars, be able to waive visa requirements with Guatemala and Honduras?

Representatives from Chile, Colombia, Mexico, and Peru have all stressed that the Pacific Alliance is an agreement between like-minded nations seeking deeper integration, and that the pact's formation should not be understood as a rebuke of the historically inward-facing policies of Mercosur. In fact, at the behest of Chilean President Michelle Bachelet, the Alliance has made tentative overtures to Mercosur members over the last two years, exploring opportunities for collaboration. The Alliance's relationship with Mercosur represents a critical regional fault line, but that may be on the verge of change. The Pacific Pumas would greatly benefit from a united Latin America, and the signs out of Argentina and Brazil suggest a shifting Mercosur.<sup>30</sup>

In theory, the more market-tested firms of the Pacific Alliance would be competitive across the Andes if granted privileged access to Mercosur economies. The Mexican automobile sector, for example, has already demonstrated an ability to be very competitive in Brazil.<sup>31</sup> Colombia, Peru, and Chile also see an opportunity to act as a bridge between Asia and Atlantic South America: Argentina, Brazil, and Venezuela conduct significant trade with China, and, with improved infrastructure, Pacific Alliance countries could serve as intermediaries.<sup>32</sup>

This would be expedited with key Mercosur members looking to boost international trade. Argentina's Macri has dramatically shifted his country's commercial orientation since taking office in December 2015. After twelve years of increasing isolation under former Presidents Nestor Kirchner and Cristina Fernández de Kirchner, Argentina is now open for business.<sup>33</sup> Brazil and Uruguay have aggressively pursued an agreement with the EU, for some years now,<sup>34</sup> and momentum for an agreement has picked up steam from the Mercosur



side since Macri took office. Though impeachment proceedings in Brazil have yet again put negotiations on ice. Uruguay and Paraguay, already observers in the Pacific Alliance, have expressed high-level interest in joining as members.<sup>35</sup>

### The Pacific Pumas and East Asia: Running with the Tigers

The Alliance's long-term success will hinge on its ability to move beyond commodity reliance and toward integration into the intricate supply chains that generate rapid growth and development in Asia's Pacific Rim. This is why member countries have entered into a series of trade agreements with East Asian countries. That said, an agreement on paper does not necessarily create trade linkages in practice.<sup>36</sup> A key challenge is how the Pacific Alliance can maximize existing agreements to become embedded into supply chains throughout the Pacific region.

This approach—made all the more pressing by falling commodity prices—is not without risk. For example, Mexico, Peru, and Chile are participants in TPP, and Colombia hopes to join them. The pact would offer Alliance members liberalized access to participating East Asian partners, but it would also grant countries such as Vietnam (which boasts cheaper labor) and Japan (with more advanced manufacturing) improved access to a US market that is critical to Mexico and Colombia. According to a 2016 Bertelsmann Stiftung study, Mexican exports to the US and Canada could fall significantly following TPP implementation.<sup>37</sup>

The challenge for the Pacific Alliance will be to find a niche in the emerging web of trans-Pacific trade, and not to be overrun by it.

### The Pacific Alliance, the United States and the European Union: A Transatlantic Triangle

In the twenty-first century, global growth could hinge on the ability to match developed world expertise, quality, and capital with the dynamism and opportunity of emerging markets. Latin America, and specifically

the Pacific Alliance, is situated to assume a pivotal position in transatlantic affairs. Member countries offer broad growth opportunities and subscribe to political and economic models in line with those of the US and EU. The Alliance's commitment to rule of law and a positive business environment makes it an attractive destination for transatlantic investment seeking stronger returns.

Yet challenges in the transatlantic relationship could be on the horizon. In terms of trade, the US and EU continue to inch closer to a Transatlantic Trade and Investment Partnership (TTIP). If the EU gains preferential access to US markets, it could displace certain Pacific Alliance exports. Although there is generally little overlap between the Andean Pacific Alliance

**With seven Asian observer countries, including Japan and its bustling city of Tokyo, the Pacific Alliance can pursue deeper integration in trans-Pacific trade and investment. ▼**

members' export portfolios and those of EU member states, TTIP would likely affect Mexico's US-bound exports. One study found that TTIP could cost Mexico over 7 percent of global real per capita income.<sup>38</sup> Another report forecasted more modest effects, though even this model showed Mexican imports to the US falling by nearly 6 percent in a post-TTIP



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scenario.<sup>39</sup> Such a drop would also have adverse effects on the US economy, given that Mexico's US-bound exports include roughly 40 percent US inputs. While all economic models should be taken with a grain of salt, how the Pacific Alliance responds in the event of a successful TTIP remains a looming challenge on the horizon. Forecasts underscore the importance of finding Mexico a constructive role to play in TTIP negotiations.

### The Pacific Alliance and Observer Countries: What Now?

Since its inception in 2013, forty-two countries have signed on as observers to the Pacific Alliance. It is an impressive coalition, featuring eighteen European states, fifteen from the Americas, and seven from Asia, three from the Middle East and North Africa, and even New Zealand. The world's five largest economies—the United States, China, Japan, Germany, and the United Kingdom—are all observers, as are massive emerging markets such as India and Indonesia. But just what does observer status entail? How can the Pacific Alliance ensure that observer status has relevance and responsibility, rather than representing the equivalent to just clicking “like” on a social media post?

The Pacific Alliance's guidelines for observer status consists of a two-and-a-half page document with fourteen bullet points, the majority of which are procedural in nature.<sup>40</sup> The document establishes that observers must “[share] the principles and objectives set out in the Framework Agreement of the Pacific Alliance,” and that observers may participate in designated meetings where “they only have the right to speak but not to vote.”<sup>41</sup> The document establishes guidelines for maturing from observer to member, but, to date, no country has concluded this process. A degree of ambiguity may be helpful: the Alliance may seek improved technological cooperation with observers such as Canada and the United States while focusing on trade facilitation with East Asian members, such as South Korea and Singapore.

Both observers and members privately acknowledge that the relationship has lacked guidance. Many of the observer countries signed on in the last two years—a period during which member countries were primarily focused on hammering out their own, internal trade pact. As a result, representatives of Chile, Colombia, Mexico, and Peru quickly faced forty-two very different countries around the table. The situation came to a head at the July 2015 Summit of the Pacific Alliance in Paracas, Peru, at a session for observers that devolved into declarative political statements from many of the attendees, with few tangible results.

## Recommendations



### PURSUE TRADE FACILITATION WITH MERCOSUR.

A merger or free trade agreement between the Pacific Alliance and Mercosur may not be immediately forthcoming, but collaboration could be on the horizon. Both sides have communicated interest in trade facilitation, which amounts to removing non-trade barriers. Brazil, in particular, has expressed interest in easing border restrictions, limiting or removing import/export processes, improving shared trade technology, and even implementing single-window systems for trade between the Alliance and Mercosur. Though forward movement will be on hold as Brazil sorts out internal political turmoil. The Pacific Alliance should pursue pragmatic and (relatively) apolitical collaboration opportunities, which can perhaps evolve into something deeper. Limiting non-tariff barriers would facilitate the Alliance's ability to act as a bridge between East Asia and Latin America's Atlantic coast.



### NEGOTIATE AS A BLOC.

One way the Pacific Alliance can leverage its impact with East Asia is by negotiating with countries, or even associations like ASEAN, as a unified bloc. A test case for this is already underway with the exploratory trade agreement conversations with New Zealand. If an agreement is reached, it would be the first case of the Alliance negotiating as a bloc with an external partner.



### WORK WITH THE UNITED STATES TO INCORPORATE COLOMBIA INTO APEC.

As members of Asia-Pacific Economic Cooperation (APEC), Chile, Peru, and Mexico are active participants in the Trans-Pacific Partnership. Yet Colombia, a country not part of APEC, is, by definition, precluded from participation in TPP, despite Bogotá's desire to join. Conventional wisdom holds that the leaders of APEC were reluctant to expand while TPP was under negotiation. Now that a deal has been reached (though not ratified), expansion becomes more realistic. US support for Colombia integration would likely expedite the process.



### DIFFERENTIATE BETWEEN TYPES OF OBSERVERS.

Some observers have signed on for geopolitical reasons. Others join for trade and economic reasons, or to collaborate on issues related to technology, education, and entrepreneurship. Rather than meet as a large group and plan ad hoc, one-off events around the globe, the Alliance ought to create subcommittees and working groups related to countries' specific intents for affiliating with the Pacific Alliance. The Alliance's *Grupo de Relacionamento Externo* (GRE) has taken steps toward building a matrix that matches the goals of observers with the needs of members.<sup>42</sup> Its results should come quickly, in order to keep observer interest.

# Conclusion

**T**he Pacific Alliance is no longer the new kid on the block. Our two private roundtables, as well as recent developments, show the high level of interest in pursuing deeper integration. Much of the world is lining up to become a part of the initiative.

2016 marks five years since the initial Declaration of Lima. In record time, member states have deepened integration in a number of sectors. So how far can this successful integration project extend? As far as the member countries—through high levels of cooperation and collaboration—push it.

The MILA is facilitating diversification of investment and liquidity in the financial markets of Chile, Colombia, Peru, and Mexico. It is also limiting the risk inherent in one-dimensional markets. However, the lack of political will, low levels of liquidity, and high capital volatility are major barriers to greater financial integration.

Energy brings an untapped opportunity for cooperation, especially as oil prices remain low and as a global energy revolution is underway. Though geography is a barrier for all countries to physically connect, the Pacific Alliance can learn from the successful example of SIEPAC in Central America. However, to fully tap into its energy resources, the region needs to invest in infrastructure and human capital, as well as work toward the harmonization of energy projects. Private sector participation is also crucial.

In an era of megadeals, effective use of the Pacific Alliance's trade relationships can be an effective, valuable tool to advance prosperity. Complete elimination



## The Pacific Alliance

of intra-alliance tariff barriers is only the first step. Investments in physical infrastructure will help to facilitate trade. More innovation-friendly policies will also help Alliance countries to shift toward economies where knowledge is critical to generating growth.

Back home, the Pacific Alliance can help foster a more outward-looking economic model across Latin America. Chile, in particular, has long advocated for deeper collaboration with Mercosur, an approach that now seems more feasible as Mercosur is increasingly showing signs of openness to international commerce.

This is the moment for deeper, more meaningful integration in sectors such as trade, finance, and energy. Formidable barriers exist, but with a bit of political will and determination, the high-hanging fruit is within reach.

Ultimately, it will be up to the governments, private sector, and citizens of Chile, Colombia, Mexico, and Peru to take the Pacific Alliance to the next level. This document, based on input from public, private, multilateral, and academic sector experts from around the world, offers a blueprint to get that process moving forward.



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