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Economic Watch

Pacific Alliance

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Economic Analysis

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Financial integration in the Pacific Alliance

High potential and major challenges to successful integration

- **The Pacific Alliance (PA) was founded to promote cooperation among Chile, Colombia, Mexico and Peru. Over the last decade, the PA member countries have enjoyed strong economic growth**

  The PA is the sixth biggest economy in the world, with more than 200 million consumers and a per capita GDP of more than USD 10,000. The PA countries stand out within the emerging economies. Not only have they consolidated their institutions, growth and economic development indicators, but they also have broad trade agreements in place with the rest of the world.

- **The group's countries have played a major role in the growth of foreign direct investment flows in Latin America**

  All the member countries are among the top positions of the world ranking in terms of potential to attract foreign direct investment and in observed FDI flows. Because of its combined size and exporting potential, the PA is very attractive for investments from the U.S., Europe and Asia-Pacific. However, FDI among the PA countries is still very concentrated on flows from Chile to its Andean neighbors.

- **The MILA has made slow progress since its creation and the challenge is to build a similar regulatory and tax framework in all the countries, continue incorporating financial products and conduct joint stock market openings**

  Despite the moderate flows, the market capitalization of the PA countries is similar to that of Brazil, although the depth of their markets is lower. For now, the tax treatment is quite different and could be limiting greater gains in the financial integration sought by the MILA. In general, it seems promising to standardize, clarify and coordinate the tax treatment among the authorities of the countries.

The Pacific Alliance is moving towards integration on several fronts

The Pacific Alliance (PA) is an ambitious economic and trade integration process. One of its pillars is the building of an area of close integration in a participatory and consensual manner, to move gradually towards the free movement of goods, services, capital and persons.

It is a regional integration initiative made up of Chile, Colombia, Mexico and Peru, and founded on April 28, 2011, although it is open to new members (Costa Rica and Panama are in the process of joining). Its goals are to (1) Build an area of close integration in a participatory and consensual manner, to move gradually toward the free movement of goods, services, capital and persons; (2) Promote greater growth, development and competitiveness in the economies of the member countries in order to achieve greater well-being, overcome socioeconomic inequality and ensure the social inclusion of its inhabitants; (3) Become a platform for political expression, for economic and trade integration, and for worldwide projection, particularly in the Asia-Pacific region.

The Pacific Alliance pursues cooperation initiatives in the following areas: free movement of persons, conservation of, and respect for the environment, setting up of a scientific research network on climate change, academic and student exchange, cultural promotion, stock market integration, opening of joint trade offices and participation in fairs and exhibitions in the same space, improvement in competitiveness and innovation in micro, small and medium enterprises, and tourism.

This means that the Pacific Alliance is not a Free Trade Agreement (FTA), but rather a space that promotes integration by combining agreements with highly ambitious trade aspects, as well as agreements in the other work areas to ensure the well-being of people and the growth of the member countries.

The trade integration Agreement already reached, details of which were recently presented by the Presidents of the four countries at the Pacific Alliance Business Forum held in New York, consists of 21 chapters which include ambitious and latest-generation disciplines on subjects such as Access to Markets, Rules of Origin, Trade Facilitation, Technical Barriers to Trade, Sanitary and Phytosanitary Measures, Services, and Investments and Public Procurement. 92% of the goods will be tax-deductible in their entirety from the day on which the Agreement becomes effective; around 6.5% of the other goods will be tax-deductible in the short or medium term. This Agreement will enable the Pacific Alliance countries to consolidate and improve their potential while promoting their links with the rest of the world. Boosting trade with countries outside the Alliance is a goal of great interest, especially with the Asia-Pacific region, which today concentrates nearly 50% of the world population, 30% of global GDP and 30% of what is purchased in our planet.

In this context, the work carried out by the Business Council of the Pacific Alliance (CEAP) is particularly relevant, as it is a consultative body made up of businesspeople and high-level organizations from the four countries. Its objectives are to promote the Alliance in both the member countries and the global business community and make recommendations and suggestions to the respective governments to foster the integration and economic-commercial cooperation process among the member countries.

The group also seeks to promote and present joint views and actions to third markets, particularly in the Asia-Pacific region, and submit recommendations to the business associations of the four countries related to the areas of cooperation.

The complementarities and potential of the Alliance for boosting trade flows have been analyzed in a previous issue of *Economic Watch* ("*The new Pacific Alliance bloc: Mexico and the Andean countries look to Asia*"), where we highlighted the PA's overall potential for increasing foreign trade. However, there is a certain imbalance in the potential to increase trade in goods within the Alliance, which in principle would benefit Mexico more than the other three Andean countries, while the space for cooperation, know-how transfer and investment is best seen in the development of infrastructures and capital markets.

Table 1
Macroeconomic indicators of the Pacific Alliance

	2000	2011	2012
GDP (USD trillions)	0.8	1.9	2.0
Population (millions)	185	213	216
Exports (USD billions)	206	535	556
Imports (USD billions)	217	529	561

Source: Haver, BBVA Research

The Appendix shows the relative positions of the PA countries in various indicators. All the PA countries have shown significant improvements in their poverty, institutional, macroeconomic management and competitiveness indicators. In this context, they are becoming more alike in economic terms and in the profile of their macroeconomic policies and, therefore, cooperation and joint efforts become increasingly important for promoting the flows of goods, services and capital.

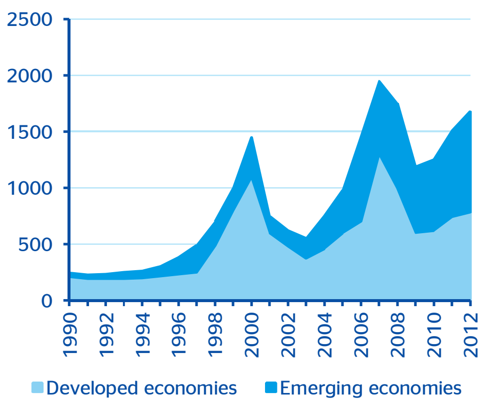
The high potential for FDI in the Pacific Alliance results in strong inflows. But FDI between PA countries is still very concentrated

Global flows of Foreign Direct Investment (FDI) to emerging economies have increased their share since the beginning of the last decade. As a whole, emerging markets have begun to increase their share in global productive capital flows. From receiving 24% of global FDI flows towards the end of the last decade, developing economies received nearly 53% of the total in 2012 (Chart 1). During the same period, the PA countries have become even more attractive as a destination for global productive investment, with a 25% expansion in FDI received, above the total growth in FDI toward emerging economies (15%).

The PA countries have been major recipients of productive investment, mainly from the U.S. and Europe (Chart 2). Cheaper labor and the exploitation of natural resources have been the main reasons behind such a high and permanent flow of foreign investment from the developed economies to the PA countries. In the case of Mexico, the high share of FDI from the U.S. can be explained by higher value-added goods and its geographical proximity and size.

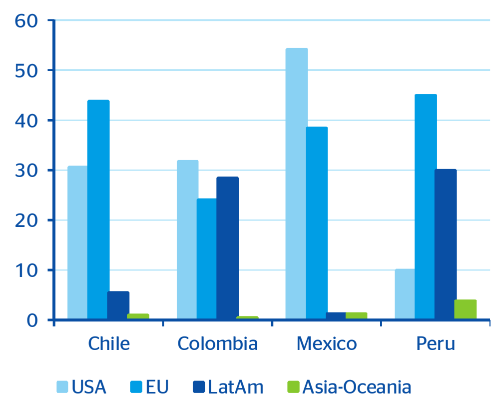
One of the PA's initiatives has been to promote the inflow of investment from Asia-Pacific. Flows from Asia come mostly from Japan and compare very unfavorably with other sources. There is considerable room for attracting productive capital to infrastructures, industry and services. Chile and Mexico have managed to capture the growth in FDI from Asia; in Mexico, investment from Asia accounted for 7% of total FDI in 2009 and this figure increased to nearly 30% in 2012 (Chart 3).

Chart 1
Global flows of FDI, developed and emerging countries, by destination (USD billions)



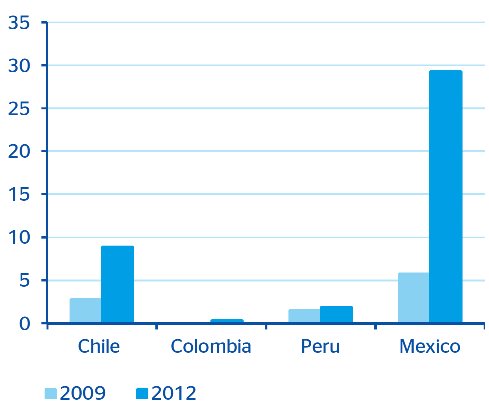
Source: ECLAC, United Nations Conference on Trade and Development (UNCTAD), Global Investment Trends Monitor, BBVA Research

Chart 2
Source of FDI, average for 2000-2012 (percentage of total FDI received)



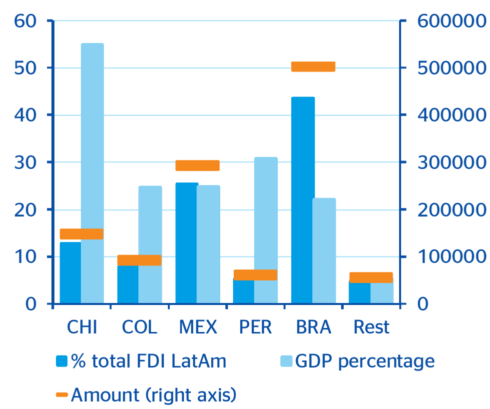
Source: ECLAC, Agency for the Promotion of Private Investment in Peru, Bank of the Republic of Colombia, Central Bank of Chile, BBVA Research

Chart 3
FDI flows from Asia to PA countries (% of total FDI received in each country)



Source: ECLAC, Agency for the Promotion of Private Investment in Peru, Bank of the Republic of Colombia, Central Bank of Chile, BBVA Research

Chart 4
FDI inflows by recipient country, 2000-2012 (USD millions and %)



* Argentina, Bolivia, Ecuador, Paraguay, Uruguay and Venezuela.
Source: ECLAC, Agency for the Promotion of Private Investment in Peru, Bank of the Republic of Colombia, Central Bank of Chile, BBVA Research

Chile, Peru and Colombia have a low share of investment originating in Asia. Only Chile seems to have improved lately, with an increase in FDI from Japan of 8% of total FDI received in 2012 (4% in 2009).

Worth mentioning are the large Latin American economies as FDI recipients, which is the case of Mexico and Brazil (the latter is not a member of the PA). The size of these economies and the benefits derived from the generation of economies of scale in markets of this size allow them to concentrate a significant percentage of productive flows. Brazil alone accounted for 43% of total FDI received by Latin America over the last 12 years (Chart 4). However, if the PA is considered as a whole, it received an even higher percentage, with 51.5% of total FDI in Latin America.

How does this percentage of FDI received by the Pacific Alliance compare with the figure that could be expected according to the characteristics of its member countries? To answer this question we first need to have a reference of the FDI aimed at the countries not only in absolute terms (billions of USD), but also in relation to their size, in order to take into account the absorptive capacity of FDI in each country. In this dimension, the Pacific Alliance countries are among the top positions in the world ranking in attracting FDI (Table 2), with the Andean countries within the top 25% of the ranking and Mexico in the second quartile of the distribution (although in the case of Mexico, non-equity mode of production transactions, such as contract manufacturing or service outsourcing, are very important).

As for the potential to attract FDI, the determining factors behind these investment flows need to be taken into account. Firstly, the market's attractiveness for FDI seeking to serve the internal market in the country of destination. This factor can be related to the market's size, the population's purchasing power and the future growth potential. A second determining factor of FDI is the availability of sufficiently qualified and low-cost labor for FDI seeking greater production efficiency. This can be approached through unit labor costs and the size of the workforce in the manufacturing sector, which is usually the best qualified one. A third determining factor of FDI is the existence of natural resources in the country for investments seeking their export to other markets. A last determining factor of FDI is the existence of appropriate transport, energy and telecommunications infrastructures.

An index can be prepared based on these four determining factors to classify the countries according to their potential to attract FDI. In this dimension we find the four Alliance countries among the top 25% in the world ranking in terms of their potential to attract FDI. In this way, by comparing both dimensions, we observe that the Pacific Alliance countries not only have high potential for attracting FDI flows, but they actually achieve this as would be expected for this high potential, unlike many countries in the region (Table 2).

Table 2
FDI attraction index vs potential FDI index, 2011 (quartiles)

Above expectations | In line with expectations | Below expectations

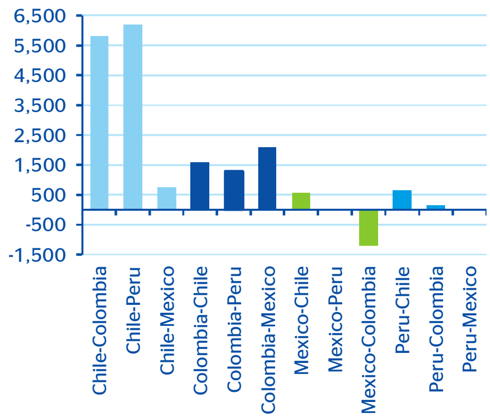
FDI attraction index (2009-2012) \ FDI attraction potential index	4th quartile Low	3rd quartile	2nd quartile	1st quartile High
1st quartile High		Bahamas	Uruguay, Panama	Brazil, **Chile, Colombia, Peru,** China, United Kingdom
2nd quartile	Nicaragua	Costa Rica, Honduras	Portugal	**Mexico**, France, Germany, Spain, USA
3rd quartile			Bolivia, Guatemala	Argentina, Japan, Korea
4th quartile Low		Paraguay, El Salvador	Ecuador, Greece	

Note: The ranking and distribution by quartiles are based on a total of 177 countries. The table only shows the Latin American countries and some selected countries outside the region.
Source: UNCTAD

An additional point to take into consideration is the multiplier effect of the integration process of the AP on each member. The sizes of the market and labor forces are determinants of the attractiveness and potential of FDI. In the first case, the PA allows to see each member as a bigger market, where labor mobility –whenever is reached– will attract more FDI. On the other hand, we also need to recall that as the PA does not end up as a trading union may diminish the multiplier effect.

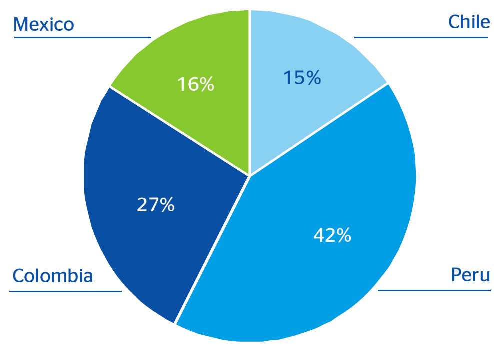
A different perspective is to consider intra-PA FDI flows, which in the 2009-2012 period only amounted to USD 18bn, less than 0.9% of the annual aggregate GDP of the member countries (3% of total FDI received from all sources). In addition, these flows are mostly concentrated in Chile, where the smaller size of its economy has led to the search for diversification and expansion of operations of some of its companies within the region (Chart 5).

Chart 5
Accumulated FDI flows in 2009-2012, intra-PA, source-destination perspective (USD millions)



Note: A negative sign denotes repatriation of investment
Source: Central Bank of Chile, BBVA Research

Chart 6
Destination of intra-PA FDI, accumulated for 2009-2012 (%)



Source: Central Bank of Chile, BBVA Research

Chile seems to be the country that most productive investment contributes within the PA. The reason would lie in the fact that trade and financial liberalization reforms began earlier than in the rest of the PA. Moreover, its local market has limited room for implementing economies of scale, leading it to search for larger markets in the region. In this context, there is no doubt that the maturity of the pension system enabled capital to be injected into companies with regional expansion policies in place, particularly in the retail sales and financial sectors.

Thus, Peru and Colombia stand out as destinations, two countries whose geographical proximity to Chile would offer comparative advantages in relation to Mexico. One possible explanation for this could be associated with lower monitoring and control costs for those investments. In addition, we cannot rule out that it may be due to more favorable tax conditions for investing in those destinations. The foregoing is also reflected in the aggregate figures from 2009 to 2012, when Peru absorbed 42% of intra-PA foreign investment, followed by Colombia with 27% (Chart 6).

In addition, Table 3 shows that a significant portion of FDI in the Alliance countries is based on M&A processes on companies established in the countries of origin. The foregoing suggests that such investments do not necessarily increase the productive capacity of countries of destination, but would rather be changes in the ownership of companies already established. Notwithstanding the above, this same process has efficiency and productivity gains in itself.

Lastly, a significant number of companies within the Alliance invested their resources abroad in 2011, increasing their employment-generating capacity beyond their borders. On the other hand, it can be seen that those investments were well diversified in sectoral terms (Table 4).

Table 3
Largest cross-border mergers and acquisitions of companies in Pacific Alliance countries, 2011-2012 (USD millions)

Company	Country of origin	Sector	Owning company	Recipient country	Value
Intra-PA					
ING Pensiones y Seguros AL	Colombia	Financial	Grupo Sura	Mexico/Peru/ Chile/Uruguay	3.614
LATAM	Chile and Brazil	Airline	Merger of LAN and TAM	Chile and Brazil	6.502
Cencosud	Chile	Commerce	Carrefour Colombia	Colombia (seller in France)	2.614
CFR	Chile	Pharmaceutical	Lafrancol	Colombia	562
Corpbanca	Chile	Financial	Banco Santander	Colombia (seller in Spain)	1.225
FDI source outside PA					
Magotteaux	Belgium	Engineering	Sigdo Koppers	Chile	960
Repsol	Spain	Oil and gas	PEMEX	Mexico	1.600
BRT Escrow Corp.	USA	Financial	Inversiones Alsacia	Chile	464
CEMEX Southeast	USA	Cement	CEMEX	Mexico	360
Canada Pension Plan	Canada	Infrastructure	Grupo Costanera (50%)	Chile (seller in Italy)	1.174
BTG Pactual	Brazil	Financial	Celfin Capital	Chile	600
NET Servicios de Comunicacao	Brazil	Telecom	Telmex	Mexico	2.544
FDI destination outside PA					
Banco Davivienda	Colombia	Financial	HSBC assets in Central America	United Kingdom	801
Cencosud	Chile	Commerce	Prezunic	Brazil	495
Cencosud	Chile	Commerce	Jumbo	Argentina	484
Molymet	Chile	Mining	Molycorp Inc. (15%)	USA	390
Banco Inbursa	Mexico	Financial	Caixa Bank	Spain	566
Grupo Elektra	Mexico	Financial	Advance America	USA	656

Source: BBVA Research.

Table 4
Largest non-financial companies in Latin America with investments and employment abroad: 2011

Company	Country	Overseas sales ranking	Overseas investments (% of total)	Workers abroad (% of total)	Sector
Petrobras	Brazil	1	32	18	Oil/gas
PDVSA	Venezuela	2	5	5	Oil/gas
Vale	Brazil	3	51	27	Mining
América Móvil	Mexico	4	36	34	Telecommunications
JBS	Brazil	5	67	62	Foods
Odebrecht	Brazil	6	57	49	Engineering/construction
Gerdau	Brazil	7	61	48	Iron and steel/metallurgy
Femsa	Mexico	8	18	36	Beverages/liquors
Cencosud	Chile	9	49	57	Retail commerce
Cemex	Mexico	10	69	66	Cement
Brazil Foods	Brazil	11	16	16	Foods
LATAM	Chile	12	88	56	Airlines
Grupo Alta	Mexico	13	73	27	Auto parts-petrochemicals
Marfrig	Brazil	14	32	42	Foods
Bimbo	Mexico	15	61	53	Foods
Tenaris	Argentina	16	82	72	Iron and steel/metallurgy
Camargo Correa	Brazil	17	15	17	Engineering/construction
Falabella	Chile	18	40	40	Retail commerce
Andrade Gutierrez	Brazil	19	8	10	Engineering/construction
Grupo Modelo	Mexico	20	16	3	Beverages/liquors
Votoratim	Brazil	21	50	36	Cement
Sudamericana de Vapores	Chile	22	38	63	Shipping
Embraer	Brazil	23	27	12	Aerospace
Grupo Casa Saba	Mexico	24	54	68	Retail commerce
CMPC	Chile	25	31	30	Forestry
Grupo Televisa	Mexico	26	22	11	Media
Arauco	Chile	27	24	24	Forestry
Gruma	Mexico	28	19	63	Foods
Elektra	Mexico	29	29	17	Retail commerce

Note: PA countries are shown shaded. Ranking according to aggregate sales volume.
Source: América Economía, ECLAC, BBVA Research

Limited portfolio investment flows between PA countries: considerable potential

It is difficult to geographically track the statistics regarding the source of portfolio investment, which is often due to funds located in tax havens. As a result, we can consider the statistics obtained as an approximate amount, to which the funds from tax havens that channel the funds of institutions or individuals residing in PA countries should be added. In any case, portfolio investment between PA countries has been characterized by small and volatile amounts compared with the total portfolio flows, as shown in Table 5 specifically for Chile.

Table 5
Portfolio investment from Chile to PA countries (USD millions)

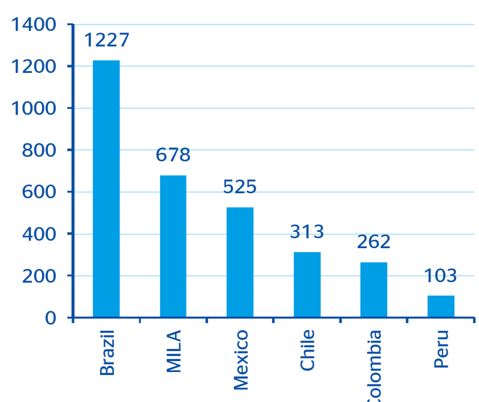
Year	Colombia	Peru	Mexico	Total portfolio flows
2009	7	48	20	14,269
2010	10	22	0	15,710
2011	65	47	37	-806
2012	130	-18	-188	13,891

Source: Central Bank of Chile, BBVA Research

Portfolio flows include both shares and fixed-income assets. The latter, in particular, shows significant differences among PA countries. On the one hand, Mexico is a sophisticated financial market where foreigners take positions in sovereign and corporate bonds relatively easily. The stake held by foreigners in sovereign bonds exceeds 40% of the current stock. The situation in Peru varies depending on the instrument. For example, in the SOB2020 they account for nearly 90% of the total stock. In total, approximately 54% of outstanding sovereign bonds are held by foreigners. The figures are much lower in Colombia (5.9%) and Chile (2%). In the latter, foreigners have taken positions through Global Depositary Notes, with much lower amounts.

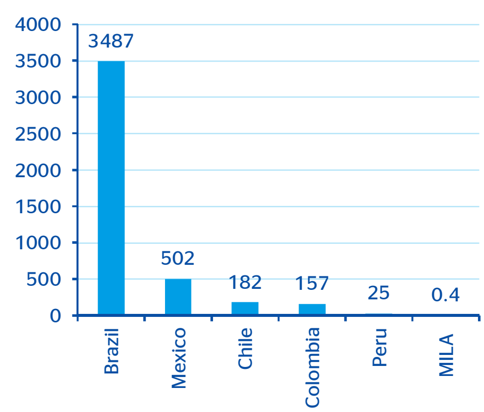
Even though the flows have been moderate, the market capitalization of the PA countries is similar to that of Brazil (Chart 7). However, the depth and liquidity of their markets are even lower as a whole than those of the Brazilian giant (Chart 8). In this context, it is to be expected that the cross-flows will start to increase, building on and generating new synergies toward deeper and more integrated markets. We need to recall that in the literature, the size of the market matters in the portfolio flows to countries. Therefore, more integration should contribute to increase the deepness of the financial market in the PA.

Chart 7
Market capitalization in Latin America (December 2012, USD billions)



Source: Bloomberg, BBVA Research

Chart 8
Daily stock market transactions volume in 2012 (USD billions)



Source: Bloomberg, BBVA Research

MILA: Slow progress, but deeper integration conditional on standardized tax treatment

The Integrated Latin American Market (MILA) is the result of the agreement signed by the Stock Exchanges of Santiago, Colombia and Lima, and the mutual funds Deceval, DCV and Cavali. The MILA was launched on May 30, 2011. Investors and brokers from Chile, Colombia and Peru can buy and sell shares on the three stock markets through a local intermediary. MILA is a cross-border stock market integration initiative with no mergers or corporate integration at global level, based on the use of technology tools and the adaptation and harmonization of regulations governing trading on capital markets and safekeeping of securities in the three nations.

It has enabled the securities of each country to be recognized, and the free trading of shares through the routing of orders from brokerage firms in Chile, Colombia and Peru to the markets of origin.

One of the most relevant characteristics of MILA is the fact that the markets retain their independence and regulatory autonomy, growing together as an integrated market, given their complementarities at individual level.

Moreover, all trading in MILA is conducted in the local currency, without having to leave each country, and with book entries through the local intermediary, which makes international transactions through this tool even easier. The Integrated Latin American Market has 554 listed issuers. Of these companies, 247 are Peruvian, 225 Chilean and 82 Colombian.

As shown in Chart 8, transactions have been very moderate in MILA. Despite being relatively developed financial markets, due to idiosyncratic risk in the PA countries, demand has been low.

In order to publicize the opportunities afforded by MILA, several conferences have been held, the most recent one in June 2013 in New York entitled "Invest in MILA: three countries, one single market", which attracted 200 foreign investors and 100 institutional investors.

As of September 2013, 35 intermediaries (43 with agreements) had registered for reporting transactions through the MILA infrastructure. In addition to the securities available, six Mutual Funds have been set up for investing in MILA to facilitate decision-making at individual level. These funds had attracted US$25 million as of June 2013 (Table 6).

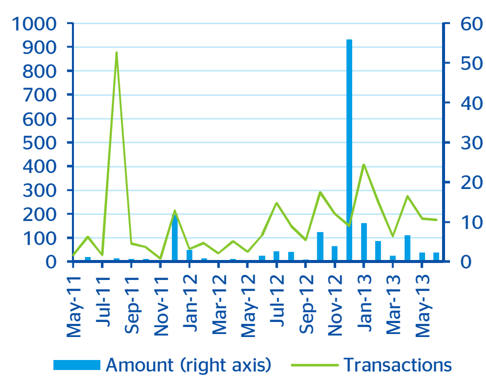
The amount and number of transactions have increased slowly but steadily since its creation (Chart 9). An average of 230 transactions for US$5 million have been registered in 2013.

Table 6
Mutual Funds set up to invest in MILA (USD millions)

Country	Fund	Amount captured
Chile	Banchile Andes	2034
	Sura Acciones MILA	7914
	BBVA Andino	1909
Colombia	Serfinco Mercados Globales	962
Peru	BBVA Fondo Andino	10831
	Sura Mercados Integrados	1780

Source: MILA, BBVA Research

Chart 9
Amount and transactions conducted through the MILA infrastructure (number, USD millions)



Source: MILA, BBVA Research

To promote greater financial integration among the PA countries, Mexico would join the MILA in early 2014, following a series of technological and regulatory approvals. We welcome the joining of the huge Mexican stock market, which would boost the development of MILA. One aspect that seems crucial to ensuring the robust growth of MILA is the standardization of capital gains taxes and transaction costs.

So far, the authorities have shown interest in working on the standardization process. For now, the tax treatment is quite different and could be limiting greater gains in the financial integration sought by the MILA. For example, in Peru taxes are paid on the profits from the sale of shares, while in other MILA countries this tax is not levied or is very low, and this could place Peru at a disadvantage with regard to the other markets. In general, it seems promising to standardize, clarify and coordinate the tax treatment among the authorities of the countries.

Appendix

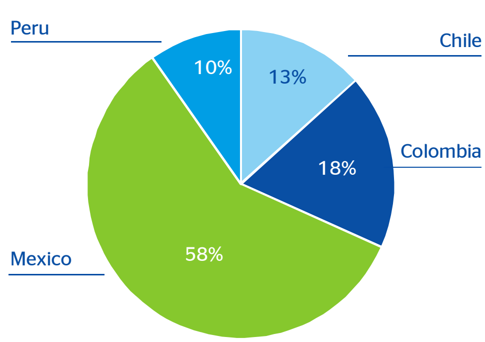
Within a context of stronger growth, the Alliance's output has doubled over the last 12 years, mainly in the Andean countries (Chile, Peru and Colombia). At present, the PA's GDP, which is just above USD2,000bn, is broken down as follows: 59% Mexico, 18% Colombia, 13% Chile and 10% Peru (Charts 10 and 11).

The growth of the member countries is based on the progress made in the institutional and financial integration areas, which has enabled them not only to reduce their levels of poverty, but also to bring down external finance costs and improve the competitiveness of their exports (Charts 12 and 13). The PA countries stand out in Latin America as regards these aspects.

Of particular note is the progress made by Colombia, which has quickly moved up in the institution quality and competitiveness rankings. Chile scores well in the economic and social indicators published by the World Economic Forum (Chart 13).

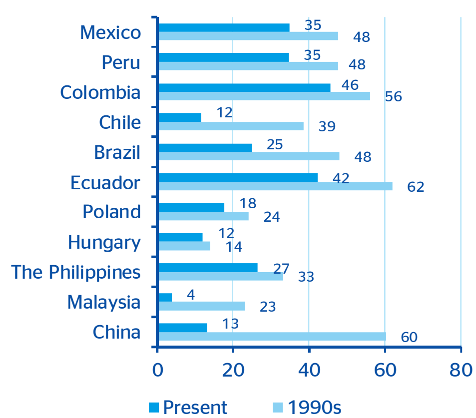
The foregoing is critical to the success of the PA, in particular in terms of macroeconomic management, tax structure and institutions/financial infrastructure. Thus, Chile, Peru and Mexico seem to be slightly ahead of Colombia (Charts 14 and 15).

Chart 10
Breakdown of nominal GDP of Pacific Alliance countries (% of total)



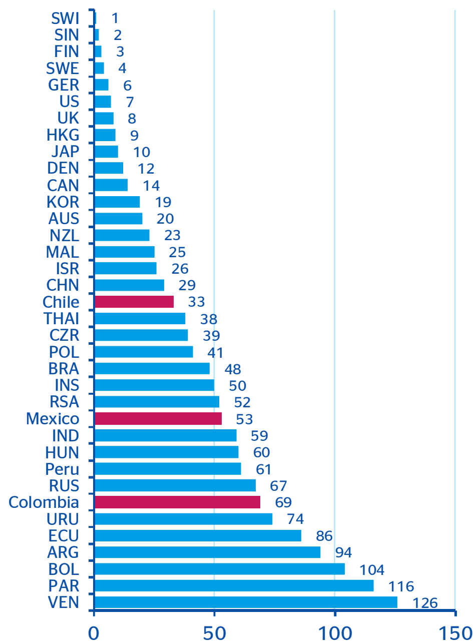
Source: Haver, BBVA Research

Chart 11
Poverty rate (%, population living below the poverty line)



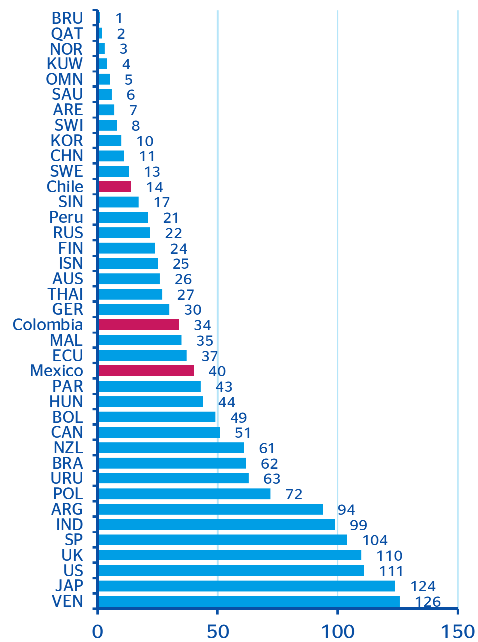
Source: ECLAC, EuroStat, Asian Development Bank, BBVA Research

Chart 12
Competitiveness (2012-2013 ranking)



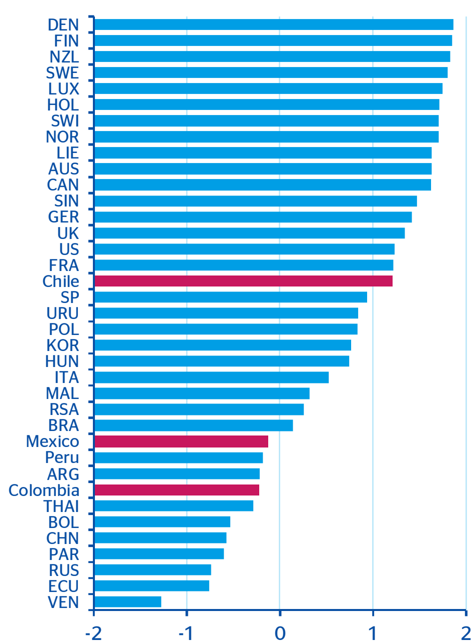
* Note: The competitiveness index measures the country's capacity to achieve high and sustained growth of per capita GDP. The number represents the place in the ranking.
Source: World Economic Forum, BBVA Research

Chart 13
Macroeconomic management (2012-2013 ranking)



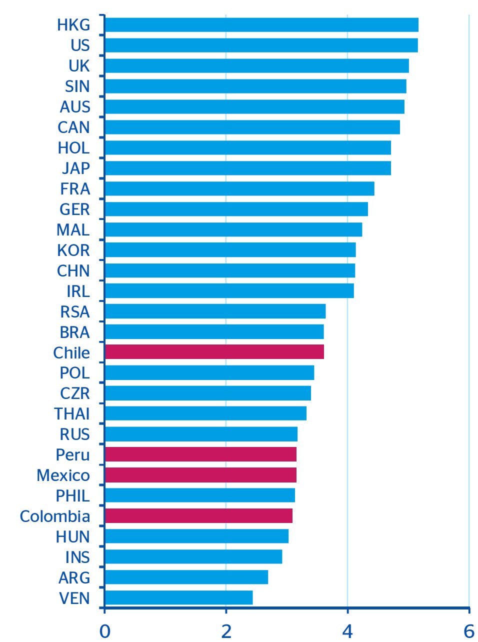
* Note: The number next to each bar represents the place in the ranking.
Source: World Economic Forum, BBVA Research.

Chart 14
Quality of institutions (index, 2011)



* Note: Average of six indexes: Rule of law, Corruption control, Political stability, Regulatory quality, Government effectiveness and Accountability.
Source: World Bank, BBVA Research

Chart 15
Financial Development Index 2011



* Note: Quantified on a scale of 1 (low) to 7 (high).
Source: World Economic Forum, BBVA Research

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