NATIONAL CENTER FOR POLICY ANALYSIS

Pacific Alliance Looks East

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After several failed attempts at regional integration, the countries of Chile, Colombia, Mexico and Peru formed the Pacific Alliance in 2011. The new coalition is focused on common economic objectives, including pursuing free market reforms and expanding trade with Asian markets.

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Together, these nations account for 34 percent of Latin American gross domestic product (GDP), receive $71 billion in foreign direct investment and 41 percent of total capital inflows annually and conduct 50 percent of the region's trade activity. The Pacific Alliance is one of the most important economic developments in Latin America's recent history, according to Chile's former Finance Minister Felipe Larrain.

Rivaling Mercosur. Latin American countries have pursued economic integration in two different ways. In contrast to the market liberalization of the Pacific Alliance, in 1991, Argentina, Brazil, Paraguay and Uruguay founded the Common Market of the South (Mercosur) with the twin goals of economic and political integration similar to the European Union. Since then, political shifts in the member countries have turned Mercosur into a protectionist trade bloc. Nations in Mercosur seek to protect their national industries; thus, they adopted high tariffs and imposed trade barriers. In fact, Mercosur has signed only one free trade agreement, with Israel, and its charter prohibits member nations from signing new agreements without the organization's approval.

Chile, Peru, Colombia and Mexico are ranked as the economically freest countries in Latin America, according to the World Bank's "Ease of Doing Business" report. These ratings reflect the political effort by these countries to pursue free market policies. The Pacific Alliance has benefited from economic growth in recent years, outperforming the average of the other Latin-American and Caribbean nations. As shown in Figure I:

- Mercosur, the Pacific Alliance, and the rest of Latin America and the Caribbean followed similar economic trajectories before and immediately following the 2008 economic crisis.
- The Pacific Alliance has seen much more stability in its real GDP growth after a significant recovery in 2010.
- Mercosur has experienced more drastic fluctuations, and now projects lower real GDP growth from 2014 onward.

Due to autonomous central banks that control inflation, maintenance of floating currency exchange rates and sound fiscal policies, the stage is set for the Pacific Alliance countries to flourish and bring economic prosperity to the region.

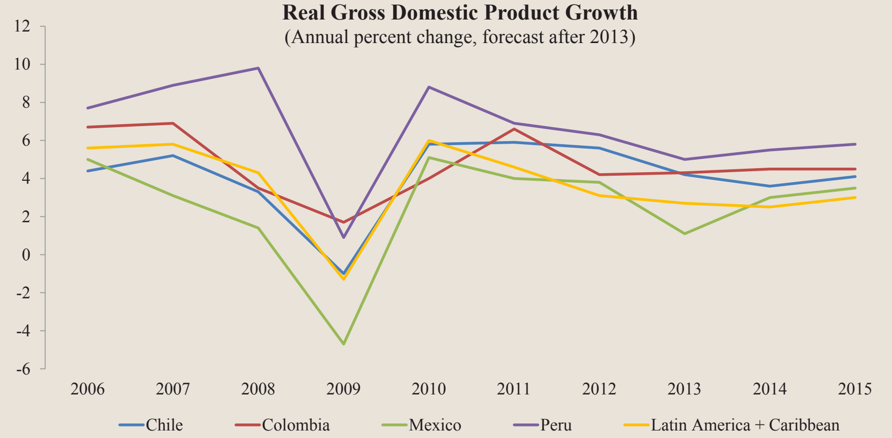
Economic Objectives. The Pacific Alliance recognizes that previous attempts to achieve regional integration failed because of their political goals. The Alliance focuses on economic objectives that will benefit all the member nations, regardless of political orientation.

The four member nations have agreed to the free flow of goods, capital and people. Currently, they trade 92 percent of goods tariff-free, and they have agreed to remove all tariffs on merchandise trade within seven years. They have also eliminated requirements for travel visas, promoting tourism and commerce.

The low rate of inflation in the Pacific Alliance countries gives them a competitive advantage over the Mercosur countries. The fact that the Pacific Alliance countries receive more than $71 billion dollars in foreign direct investment shows investors recognize the advantages of having an open market and controlling inflation. In contrast, Mercosur's protectionist stance has not helped control prices. In fact, as Figure II shows, Mercosur nations have higher average inflation rates than other Latin American and Caribbean nations, and substantially higher rates than the Pacific Alliance.

Trade policies and political ideologies set the Pacific Alliance and Mercosur apart. Protectionism, rampant inflation, lower economic growth and higher deficits make Mercosur less attractive to foreign investors and less friendly to business.

Figure I
Real Gross Domestic Product Growth
(Annual percent change, forecast after 2013)

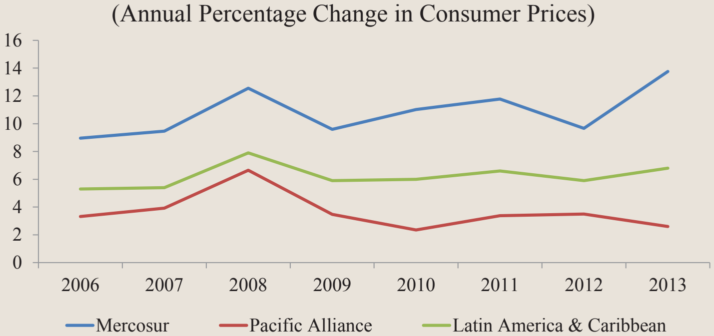


Source: International Monetary Fund, "World Economic Outlook: Recovery Strenghtens, Remains Uneven," April 2014.

Asian Opportunities. Direct access to the Pacific Ocean gives the Pacific Alliance a shorter route to Asia than most countries, which may be beneficial for both the Asian countries and Alliance members. According to the Massachusetts Institute of Technology's Observatory of Economic Complexity, Chile exports 41 percent of its goods (mainly refined copper) to China, Japan, South Korea and other Asian countries, while Peru exports 23 percent to these markets. Colombia and Mexico have the potential to conduct extensive trade with Asian economies, but have not taken advantage of the opportunity.

Forming the Latin American Integrated Market. In May 2011, the Pacific Alliance countries united their stock exchanges into the Latin American Integrated Market (MILA). Without losing each exchange's independence, the exchanges in Chile, Colombia and Peru formed the second largest stock exchange in Latin America. This exchange has the potential to become the largest in Latin America, surpassing Brazil's Bovespa when Mexico joins in mid-2014.

Figure II
Inflation Rates
(Annual Percentage Change in Consumer Prices)



Source: International Monetary Fund, "World Economic Outlook: Recovery Strenghtens, Remains Uneven," April 2014.

MILA reduces transaction costs for cross-border investment and provides a viable alternative for investors in emerging markets.

Conclusion. Each member of the Pacific Alliance intends to open itself to free trade; they know that doing so also opens the door for further development. The Alliance nations' economies have outperformed other Latin American countries. The goal of the Pacific Alliance is to maintain this advantage, potentially raising the rate of global economic growth.

The focus on economic growth, rather than political gains, will prove crucial for the durability of the group. Without this, it will suffer the same fate as other organizations in the past. As the Pacific Alliance looks east, it knows that trade expansion with Asia will help its four economies flourish.

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