

Economic Engagement with the Pacific Alliance: Why it should be a priority for Australia

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1. Introduction

Two years ago in our book *Trading Nation*² we asked the question: what can the Australian Government do to increase the likelihood that the Australia–Latin America relationship takes off?

Our answer was to focus on developing more ‘bite sized’ strategies for engaging what amounts to an amazingly diverse continent with different regional groupings and major opportunities for trade, investment and cooperation.

One of those strategies related to Chile, Colombia, Peru, and Mexico – the founding members of the Pacific Alliance.

Two years on, we continue to hold the view that engagement with the Pacific Alliance should be a key element in Australia upgrading its economic and trade relationship with Latin America more generally.

In this presentation, we would like to elaborate and update our views on the Pacific Alliance by attempting to answer three broad questions:

- Why the Alliance’s approach to regional integration is significant in regional and global terms.
- What this significance implies for the region and Australia in terms of trade and investment and, more generally, for the development of trade policy.
- And what more Australia should consider doing to engage further with the Alliance.

2. Why is the Pacific Alliance significant?

There is a great deal that is significant about the Alliance and its approach to regional economic integration.

Let’s start with a few basic facts:

- Its market is similar in size to Brazil’s or India’s.
- It has grown robustly over the last few years.
- It accounts for over one half of Latin America’s exports and imports.

¹ Partners, *Trading Nation Consulting*. This address benefitted greatly from comments and suggestions from Ron Wickes (Partner, *Trading Nation Consulting*), consultations with Latin American Ambassadors and others engaged with Latin America in Australia, including in government, academia and business. We thank them for so generously giving us their time. The views and judgements expressed, however, are very much our own.

² Adams M, Brown N and Wickes R 2013, *Trading Nation: Advancing Australia’s interests in world markets*, UNSW Press, Sydney.

- It consistently ranks highly on measures like ease of doing business and competitiveness compared with the rest of Latin America.
- And it has a good record in attracting foreign direct investment.

The Alliance also seems to have good economic growth prospects out to 2020, assuming the basic reform agenda continues to be implemented.

According to IMF forecasts, Alliance members should grow significantly faster than Latin America as a whole, and import demand for goods and services also should grow faster, particularly in the cases of Chile, Mexico and Peru.

Going beyond these basic facts and figures, We'd like to highlight three things about the Alliance's approach to regional integration that we believe are significant in regional and global terms.

First, it is ambitious. We are looking at an approach to regional integration that encompasses:

- Deep economic and social integration – goods, services, capital, labour;
- A liberalising approach to economic growth and management to push growth, development and job creation; and
- And building a platform to engage the world, with particular focus on the Asia- Pacific.

The substance behind this ambition remains to be fully tested by members' resolve to carry through with economic reform.

That said it may well turn out to be that the real value of the Alliance will be to strengthen members' commitment to trade and economic liberalisation or, at least, makes it that bit harder for them to backtrack.

Second, the approach to integration focuses on strengthening commercial relations and has delivered results over a short period. Alliance members have made progress where they can, for example:

- Eliminating most non-agricultural tariffs.
- Agreeing cumulative rules of origin that count inputs from other partners as national inputs, encouraging intra-regional trade.
- And liberalising aspects of people movement.

Alliance members have stepped back from linking economic, political and strategic issues.

They are adopting a pragmatic approach to economic integration.

They haven't gone in for grand gestures like common external tariffs.

And they have been prudent in leaving aspects of sensitive issues like liberalising agricultural access, services and government procurement to another time when political and economic circumstances might be more propitious.

And third, the Alliance is building a trade platform to engage the world, especially the Asia-Pacific region.

The platform is based on all four Alliance members having FTAs with each other and all having FTAs with the United States that are based on NAFTA – the North American Free Trade Agreement:

- This provides a common platform for their trade policies.
- In turn, Chile and Peru have trade agreements with a broad range of regional economies.
- And Colombia and Mexico have FTAs with some Asian countries.

Just like for Australia, Alliance engagement with the Asia-Pacific region makes a great deal of sense if, as seems likely, the Asian Century has dawned.

3. How the Pacific Alliance might impact trade and investment.

So, what might an open, reform-minded Pacific Alliance that is reaching out to the Asia-Pacific region mean for regional trade and investment?

We'll look briefly at the Alliance's relationship with Asia, the rest of Latin America and Australia, as well as trade and investment within the Alliance itself.

The relationship with Asia

Asia has become the Alliance's – and Latin America's - fastest growing trading partner.

There is great potential for this trade to grow, particularly if it broadens to respond both to continuing strong long term demand for minerals and energy in Asia, as well as to growing consumerism, demand for services and demand for high quality food.

Direct investment from Asia has been rising over the last few years and seems set to rise further.

- China now has a big presence in the Alliance and the rest of Latin America. It has big plans to expand cooperation across SMEs, transport, business logistics, ITC, agroindustry, and minerals and energy.
- Japan has signalled at the highest levels of government and business that it is serious about investing in the Alliance, particularly in the auto sector, infrastructure and logistics, and technical training.
- Korean companies are strongly interested in developing infrastructure in the Alliance, along with mining, manufacturing, transport, and energy.
- And the Alliance relationship with ASEAN is picking up from a low base.

Inflows of direct Asian investment linked to technology, knowledge and skill transfers will drive the Alliance's relationship with Asia, particularly if it helps over the medium term to:

- Bring down transport costs through better sea and air connectivity.
- Strengthen the Alliance's production capacity by creating value chains that are more integrated into global value chains
- And assists in broadening the trade relationship.

Intra trade and investment

In common with the rest of Latin America, Alliance members grapple with vast distances, and poor communications.

Intra-trade between members is modest, amounting to only about 10 per cent of their total international trade.

It is hard to imagine that intra-trade will increase enormously in the near-term because:

- Alliance members have FTAs with each other as a condition of membership, so much of the low hanging fruit from trade liberalisation has been picked.
 - What's left is the hard challenges like regulatory harmonisation.
 - It is always difficult in any trade agreement between any group of countries to harmonise SPS regimes, standards, customs, IP, tax, financial regulations, competition policies, and so on.
- And beyond these sorts of challenges, there is the need to build the necessary hard infrastructure to support substantially greater intra-trade, which comes back to FDI.

Furthermore, the optimism of a few years ago about a Latin American economic resurgence has given way to increased scepticism.

Income and growth have been affected by falling commodity prices.

Growth prospects for all the Alliance economies (and for much of the rest of Latin America) have been wound back.

This must dampen prospects for growth in trade between the Alliance economies.

Nonetheless, there are good reasons to expect intra-trade to increase substantially over the longer term, particularly through investment and linked services trade:

- Mexico wants to become a strategic partner to South America, just as it has with North America and with Europe to some degree, and has big ambitions to invest in Alliance supply chains.
- Having cumulative rules of origin should help in building cross-border economies of scale and industrial linkages.
- And further progress in harmonising regulations and administrative mechanisms (like border processes) and liberalising trade in services also will help to build those cross-border industrial linkages.
- But all this will take time, and will depend on implementing reform commitments.

The Pacific Alliance and rest of Latin America

All Pacific Alliance members have substantial trading relationships with Brazil. Their trade with other Latin American countries is mixed.

- So, the Alliance is a long way from becoming a hub for inter-American trade and there is a long way to go to build the infrastructure to support it.

But, depending on its success over time, the openness of the Alliance's approach to trade and investment could well see a strengthening of business links with the rest of Latin America.

- And continuing success for the Alliance will provide benchmarks for policy and showcase the links between certain policy approaches and economic growth, jobs and living standards.

Australia-Pacific Alliance trade and investment relationship.

None of us should be surprised by the observation that, despite obvious growth in both directions and real achievements, at this point in time, the Australia-Alliance trade and investment relationship remains very modest:

- Australia is a small market from the perspective of the Pacific Alliance countries.

- In 2014, only in the case of Chile was the share of merchandise exports directed to Australia more than one per cent of the total.
- In the same year, Australia accounted for just 0.18 per cent of the Alliance's merchandise imports.
- And the picture isn't much different for direct investment.

Given these very low numbers, it would be easy to conclude that our economies lack complementarity or that difficult transport links will permanently limit the economic relationship.

It is true that our economies aren't complementary in the way that Australia and Asia are complementary, and that there is no prospect of an upsurge in commodity trade between Australia and the Alliance.

But this does not rule out an increasing level of engagement based around direct investment and services and perhaps specialised areas such as industrial capital goods and some rural-based products.

4. Broad issues in the Australia-Latin America economic relationship

There are major policy and economic reasons for expecting that the Australia-Alliance trade and investment relationship will become significantly more important over time – not as important as our relationships with key trading partners in Asia but certainly substantially more important than currently.

First, and fundamentally, Australia and the Alliance (and indeed Australia and Latin America) have a great deal in common

This is a period of difficult structural change caused by China's slowing economy.

Global value chains create pressures to upskill and develop flexible economic policies to succeed in those chains - and to respond to the next wave of global development.

- This will be based less on the quantum of growth – more commodities going to China and so on. And much more on responding to the dividends flowing from that growth
 - such as more trade and investment in the quality of goods and services and in the role of intellectual property in creating new opportunities for collaboration in regional and global markets.

And linked to this last point, Australia and the Alliance have a common interest in responding to drivers of the emerging 21st century economy like:

- Education/ upskilling/ recognition of qualifications/accreditation – which, in their various ways, are linked to the quality and mobility of labour.
- Improving the efficiency of minerals and energy related services
- Improving food supply, water management and food processing (including production and processing in tropical regions).
- Better health care - public health, e-health, hospital management systems, tropical medicine.
- And better urban living and renewal (again including in tropical regions).

And taking this sort of collaboration to a higher level does not have to wait for major improvements in trans-Pacific transport systems. It depends on ideas, opportunities for trade in services and investment.

But one cautionary note: the outcomes of this sort of collaboration will probably not be reflected in a surge of Australian exports to Latin America or in Latin American exports to Australia.

- This is because promising ideas are likely to be taken up by Australian and Latin American company affiliates operating overseas and offering services either within Latin America or across the Asia-Pacific region. Three way tie-ups involving Asian companies also would seem likely.

Second, the time is right for closer links between Australia and the Alliance and more broadly with Latin America.

In a major recent speech, Peter Varghese, Secretary of the Department of Foreign Affairs and Trade, said that the challenge for Australian foreign policy was how to maximise economic opportunity and minimise strategic risk as changes in economic and strategic weight – basically the rise of China - work their way through our region. He suggested that political economy risk in our region is rising and that Australia should be more alert to opportunities to spread our economic risk.

Latin America, it seems to us, offers increasingly worthwhile opportunities from Australian foreign and trade policy perspectives.

- There is no inter-state conflict.
- Long running internal problems, like with the FARC, are being addressed.
- And Alliance countries – and indeed the whole region – have solid long term growth prospects, notwithstanding the current economic slowdown in the region, but always assuming political and economic stability.

If Australia is indeed moving to broaden its trading and investment links in order to spread political and economic risk, one way of doing this is to look east to Latin America, just as from a Latin America perspective another way to achieve the same end is to look west to Asia and Australia.

Third, a new more integrated Asia-Pacific economic architecture is emerging.

This isn't happening in any precise or scientific way.

- There is a scramble for influence in the wider region with different regional groupings and prospective groupings part of a complex strategic play.
 - Trans Pacific Partnership (TPP) negotiations involve three out of the four Alliance countries, along with the US, Japan, Australia and others, and have just been concluded.
 - How the agreement will impact on trade and investment is not yet clear.
 - And how TPP might affect the Alliance's relationship with the rest of Latin America and the pace of reform, including in the Mercosur economies, also is not clear.

- We are inclined to the view that TPP will push the reform process – in the Alliance by opening up more markets and increasing competition, and in countries like Brazil by stirring concerns about being left out of emerging international economic architecture.
- Regional Comprehensive Economic Partnership (RCEP) negotiations are the other big trade negotiation in our region. RCEP involves 16 countries – ASEAN, China, Japan, Korea, India and Australia and New Zealand. It is still early days for the negotiations and too early to say how it might impact on Asia-Pacific trade and investment.

The important point to note, however, is that:

- Serious efforts are being made to integrate the Asia-Pacific economy and lay the foundations for what, one day, might become a genuine Free Trade Area of the Asia-Pacific.
- And the Alliance and Australia want to play full parts in whatever emerges because they have a profound interest in an integrated Asia-Pacific economy.

And fourth, the prospect of ongoing reform in the Alliance, particularly involving regulatory harmonisation over time, should make it easier for Australian companies to operate in member countries.

Ongoing reform could set new norms – for technical standards, for institutional probity, for effective infrastructure and the like.

- This could have a ‘rolling stone’ effect that encourages more Australian and Alliance companies to do business together.
- It also should promote productivity and growth in member economies while having a positive influence on non-members, initially Brazil and perhaps Argentina over time. This would be good for Latin America and for Australian companies operating across the continent.

5. What more could Australia be doing with the Pacific Alliance?

So, we come to the punchline:

- What does all this mean for Australia?
- What more could, or should, Australia be doing with the Pacific Alliance to advance our own interests and hopefully contribute to the advancement of theirs.

We’ll make six brief points from a purely Australian perspective.

First, we need to continue the good work that is being done federally and at state level – especially Queensland and Victoria - by the business community, by Austrade, our universities, and the broader research community.

Second, opportunities arise out of the quality of relationships. We need to invest more in the relationship in order to get to know each other a lot better.

More Australians need to go to Alliance members and to Latin America generally to see the place first hand. That would dispel many of the stereotypes.

There is a knowledge/information deficit.

We know relatively little about each other.

We talk about increasing trade –goods, services, investment – but we certainly are not yet at the stage where there is broadly-based understanding on the part of business on either side of the Pacific about even each other’s business and investment regulations.

Tackling this deficit will take time and involve many players.

- At some stage it must involve prime ministerial visits. John Howard and Julia Gillard visited but in contexts like APEC and the Rio Climate Change Summit. This is very different from PMs leading large ministerial and business delegations, like in the recent cases of David Cameron, Shinzo Abe and Li Keqiang.
- It must involve investing more in the education relationship – not just more students in both directions but in exchanges of senior academics and researchers and access to their networks.
- And it must involve governments addressing how to raise awareness of trade and investment possibilities among small and medium sized companies (SMEs). Government agencies responsible for disseminating information need to answer some fairly obvious questions:
 - Are they providing information that is important and useful from a government/agency perspective or from a business (especially SME) perspective?
 - Is information meaningful? Detailed, technical information might not ‘connect’ with many firms, but general information might be largely useless.
 - And is information going to business through the most appropriate channels? Perhaps firms like freight forwarders and trade advising firms are perhaps the most appropriate points of contact on technical matters like explaining import and export aspects of FTAs.

Third, the Australian Government needs to be more precise in the language it uses on Australia’s role as a gateway for the Pacific Alliance/Latin America to Asia.

The standard picture presented in ministerial speeches is too simplistic. Australia isn’t the only gateway, or even the main gateway, for Alliance goods and services and investment into Asia.

- Alliance members and other Latin American countries already trade heavily with Asia.
- They already have big investment relationships with some Asian countries.
- And countries like Korea and Singapore already present themselves as ‘perfect’ gateways to the wider Asian market.

Australia’s role is better expressed as engaging on an equal basis in developing markets in Asia through mutual sharing of technology, knowledge and skills. Australia specifically can add value to Alliance and Latin American companies trading with Asia by drawing on strengths that include:

- Being a production base for Latin American companies supplying Asian markets – to a limited extent we already are.
- Having valued expertise in doing business with Asia that Latin American companies can use.

- Having an educated and digitally connected population.
- Having developed shipping and air routes to Asia.
- And having preferential access to East Asia through our bilateral and multi-party FTAs and potentially to India.

Modifying language in this way also may fit in with discussions underway in the Alliance on how best to use observer countries in promoting the aims of the Alliance. There are now 42 observers.

Many have much to offer and would be looking for ways to build cooperation – in both directions – with Alliance countries. Australia was one of the first Observers.

It would seem that the Alliance wants to work with Australia on a range of issues, including building relations with China and Asia more broadly.

Fourth, Australia and the Alliance have a lot to offer each other on regulatory matters.

Australia could provide more institutional support in areas like competition policy, financial policy and providing arms' length economic advice to governments.

- The Alliance is keen to move to best practice regulation. Chile and Mexico's membership of the OECD and Colombia's accession negotiations are evidence of this.
- Australia and Chile have worked closely on setting up a version of Australia's Productivity Commission and are currently working on competition policy.
- This sort of collaboration could plausibly extend to similar joint work with other Alliance countries.

Australia also could step up cooperation on issues like recognition of educational qualifications (linked to labour mobility within the Alliance) and on technical issues like harmonising standards (linked to closer integration of Alliance economies and increasing intra-regional trade).

Fifth, Australia might consider acceding to the Additional Protocol to the Framework Agreement of the Pacific Alliance

Now that TPP negotiations have concluded, there is not a pressing case for negotiating bilateral FTAs with Peru and Mexico, and the limited trade between Australia and Colombia would seem to rule this out as a practical option.

There appears to be some interest within our region in the possibility of acceding to the Additional Protocol to the Framework Agreement of the Pacific Alliance.

This would not mean joining the Alliance. But it would mean signing on to the trade part of the Alliance.

This is something for the future. The idea may or may not take off. But it deserves serious consideration by stakeholders in Australia.

- Arguably, the case for giving it serious consideration has been bolstered by the successful completion of TPP negotiations.
- If TPP turns out to be effective in increasing trans-Pacific trade and investment flows, there would be more at stake in forming a closer institutional relationship with the Alliance.

And finally, Australia must decide whether Latin America, including forging closer links with the Pacific Alliance, is to become a greater priority for us.

The current Foreign and Trade Ministers understand the significance of the Alliance and ‘get’ Latin America

- It would seem, however, that the Alliance is shaping up as a priority for Australia but only in the context of the broader relationship with Latin America, which is itself a second or third order priority compared to Asia.
 - Australia struggles to focus on Latin America. The government tends to draw a line around the Indo-Pacific region and focuses intently on political, strategic and economic developments there.

If the Australian Government makes the Pacific Alliance/Latin America a higher priority – because of its growth potential, middle class demand for sophisticated goods and services, and interesting opportunities for partnerships in Latin America and Asia – then it will be important to spell out concrete action that supports our economic and trade relations.

Beyond this, Australia could well take out a leaf out from the play-book of how we engaged with Japan from the 1950s and 60s and built momentum behind Asia-Pacific regional economic cooperation from the 1970s:

- Over time, these transformations involved many countries and contributions from across their societies – government at different levels, business and the academic community were especially influential.
- These transformations required developing a broad understanding that countries stood to benefit more from cooperating with each other than from stepping aside
- And they ultimately required political leadership to convert aspirations into action.

The transformation of Australia–Pacific Alliance/Latin America relations will certainly not be any easier.

- It will require reinforcing trade and institutional architecture.
- It must involve more business-to-business and people-to-people interaction across the breadth of the relationship
 - Because a dynamic relationship requires many more people on both sides of the Pacific with a first-hand knowledge of each other.
- And ultimately, as in most things, this gets back to political leadership.