Investing in The Pacific Alliance Countries

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Like minds aim to tread united line

The pact's members were philosophically predisposed to forming the grouping, writes *John Paul Rathbone*

All smiles: Presidents Batchelet, Humala, Peña Nieto and Santos share liberal democratic principles — Alfredo Estrella/Getty

Does the environment create the mindset, or the mindset the environment? This philosophical "nature versus nurture" debate is one of the oldest in the world.

In Latin America, though, it might be applied to the Pacific Alliance, the pro-business trade pact that groups Mexico, Chile, Colombia and Peru — four countries that were pro-business long before the pact was launched in 2011.

Geographically, the Alliance stretches almost 7,000 miles. It is one of the longest trade pacts in the world — and one of the thinnest, just 40 miles across at one point in Chile.

Indeed, this improbable profile reinforces the notion that the Pacific Alliance is more of an attitude than a physically coherent group.

But what is that attitude, and how has it been strengthened by the pact? The answer boils down to four aspects: the macroeconomy; the business climate; financial markets; and pension funds. Each has a bearing on investments.

Take the macroeconomy first.

Pacific Alliance economies are more stable than their Latin American peers, a factor that should help them attract more investment, relatively, amid the emerging markets sell-off.

Over the past five years, Pacific Alliance countries have, on average, expanded their GDP 1.5 percentage points more than the Latin American average; invested 2.5 percentage points of GDP more; and had inflation that is 3.6 percentage points lower.

In 2013, the pact also agreed to cut tariffs on merchandise trade and scrap tourist visas, freeing the movement of goods and people, which should improve relative performance further.

Ricardo Marino is chief executive of Brazilian bank Itaú's non-Brazilian operations; the bank has just spent $1bn expanding into Chile and Colombia. He says: "We [in Latin American] are facing a challenging environment. But Chile, Peru, Colombia and Mexico are among those countries better placed to cope."

Then there is the business climate, as reflected in levels of cross-border foreign investment. Pacific Alliance companies were expanding into each others' home markets long before the pact, even if it reinforced that trend by creating a platform to help networks grow.

Examples abound: Chilean retailers such as Cencosud and Ripley have moved north into Colombia and Peru. Colombian utilities have expanded south: this April, EPM spent close to $1bn buyingAguas de Antofagasta, a Chilean water company .

In August, Mexican retail group Femsa spent a reported $600m on a majority stake in Chilean holding company, Sofocar. Sofocar controls two pharmacy chains: Cruz Verde in Chile and Farmasanitas in Colombia.

Alberto Luzarraga, a partner at US law firm Linklaters, says: "It is hard to say whether these countries already had 'multilatinas' [multinational corporations] because they had to expand out of their smaller home markets; or if they were encouraged to step outside of them by the creation of the Pacific Alliance.

"It is a chicken and egg situation, but either way it seems to be mutually reinforcing."

Third, there are financial markets, none of which have done well this year, although they performed particularly badly among Pacific Alliance countries.

In dollar terms, Chile's stock market fell 14 per cent this year; Colombia's 37 per cent; Peru's 14 per cent; and Mexico's 12 per cent.

This poor performance, much of it because of steep currency depreciations against the dollar, has left local investors in a funk. Yet the drop has also started to attract attention from value investors.

"Value is beginning to emerge for investors with long horizons, say five to 10 years," said Romas Viesulas of Nau Securities, a brokerage. "They're starting to do their homework now."

The underperformance of local markets relative to non-Pacific Alliance countries is partly because they are more financially integrated with the rest of the world. The Argentine peso and the Venezuelan bolivar barely budged in

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Inside

Mexico learns lessons after July auction flop

Oil

Flexibility is the watchword in historic move from state control, reports *Jude Webber*

Mexico's economy has long been open, with the notable exception of its energy sector.

Now, as trade integration under the Pacific Alliance highlights its manufacturing power, Mexico is prising apart an eight-decades-old energy monopoly in a bold overhaul designed to boost the supply of cheap energy to feed its factories.

No one said it would be easy: Mexico's historic first oil and gas tender had the misfortune to take place against a backdrop of falling international prices that squeezed corporate budgets. With domestic production also sinking fast, Mexico needed to reel in as much investment as possible to boost output.

But the auction, in July, proved a flop: the number of bidders and several of their offers fell way short of expectations, and only two of the 14 exploration blocks in shallow waters of the Gulf of Mexico ended up being awarded.

The country is now preparing for its second oil tender on September 30, hoping that spruced-up terms will trigger a bigger turnout and better bids for the nine fields on offer. They are grouped into five blocks, have certified reserves as exploration has been done, and are ready to start producing.

So far, so good: four of the five consortiums pre-qualified to bid submitted offers last time, including Mexico's Sierra Oil & Gas and Talos Energy of the US from the consortium that acquired the only two blocks previously awarded.

The pre-qualified line-up includes US major Chevron, the Anglo-Dutch company Shell, Cnooc of China and Lukoil of Russia, raising hopes that the fields on offer might attract a big name.

As in the first tender, Mexico's state oil firm Pemex, which formerly enjoyed a monopoly on exploration and production, will not take part because of budgetary constraints.

"I'm expecting all those companies that showed interest in the first auction to bid again," says Juan Carlos Zepeda, head of the National Hydrocarbons Commission, who is in charge of the tender.

He says: "I'm not being optimistic. I expect at least a similar number of bidders, and possibly more."

Hammered: its critics said the government was tight-fisted — Susana Gonzalez/Bloomberg

The oil industry heaped criticism on the Mexican government for being too tight-fisted last time. Several companies walked away in July because they found the corporate guarantees too onerous, the blocks too marginal or the financial threshold for participation too high.

Miguel Messmacher, income under-secretary, says Mexico will not sell these assets cheaply, although the government has done a good job of being receptive.

"The authorities continue to demonstrate that they are picking up on most of the issues the industry had concerns about," says an official at one of the companies pre-qualified to bid.

Mr Zepeda says: "The lessons from the first tender were that the consortium rules were too restrictive, the financial guarantees were too high and there was the issue of the timing of disclosure of the minimum price.

"The rules are now more flexible, the guarantees lower and the minimum prices were disclosed two weeks before the auction." He adds: "We did our homework. This was a learning process, and we have learnt."

Two of the nine fields on offer, Tecoalli and Misón, lie above salt structures and companies will be allowed to explore below the reserves. One field, Xulum, is a heavy oil play; the rest hold light oil.

A third auction, of onshore fields, is scheduled for December 15. Some view these early-bid rounds as a rehearsal for the real prize: prospects in deeper waters where risks are high but so are potential rewards.

Mr Zepeda says the package of deepwater blocks and bid terms is still being finalised, and should be announced in October and awarded next summer.

Tim Samples, a legal studies professor at the University of Georgia who is following the bids, notes: "It is vastly more important to get it right than to do it quick."

"Deep water is what[will] make or break the public understanding of the success or failure of the energy reform."

Low prices and volatile market conditions may turn out to be a blessing.

Mr Zepeda says: "Mexico's [liberalised] industry was born in difficult market conditions that are forcing the government to be very competitive.

"It's more challenging, it's a bit more painful, but in the end, it will make the industry stronger."

Colombia needs to impress investors

Infrastructure

Roads, bridges and tunnels are top priorities, report *Amy Bell* and *Andres Schipani*

The Colombian government's transport infrastructure programme promises to boost the country's slowing economy. But the realisation of such expectations rests on how investable projects are and whether the $25bn financing required can be secured.

After five years in the planning, the Fourth Generation, or 4G, road concessions are now under way, starting with the first wave of nine projects.

The first three of these — Girardot-Honda-Puerto Salgar; Conexión Pacífico 3, and Cartagena-Barranquilla highways — were announced as closed in August, with financing secured from both local and international investors.

Over the next eight years 4G is expected to deliver 5,892km of roads in three waves via public-private partnerships, requiring investment of $10.7bn. Initiatives proposed by privately owned infrastructure groups worth $3.32bn are also planned.

Improvements to roads, bridges and tunnels are the top priority, as Colombia depends on its road network for more than 80 per cent of internal transport. Previous attempts to overhaul transport infrastructure, under the second and third generation programmes, were fraught with delays.

Corruption and financing shortfalls were also a problem. The Girardot toll road expansion project in Bogotá suffered severe setbacks and eventually defaulted on its debt in 2004.

Failure to meet deadlines has hindered progress. Institutional complexities concerning land acquisition, the allocation of environmental permits and consultation with communities cause bottlenecks.

The national infrastructure agency, ANI, argues it has addressed this with new laws aimed at streamlining processes and reassuring investors that projects will keep to schedule.

"The challenge now is execution, says its head, Luis Fernando Andrade, who is confident that 4G is on track for completion by 2023. "As most of the projects are awarded and financing packages are closed, efforts should focus on meeting construction schedules," he adds.

Mr Andrade says 23 projects have been agreed for a total value in excess of $8bn at current exchange rates, and projects are being awarded at a rate of one a month. He expects that number to reach 35-40 projects by the end of 2016.

The real test will be whether enough financing can be found and the projects are well-structured and adhere to a solid legal framework.

This is important because under the 4G programme, in order to share the risk of projects and to ensure their completion, concessions are not granted until the project is operational and payment further depends on meeting service and quality requirements.

The news that the likes of Goldman Sachs and Sumitomo banks have signed on as sponsors is likely to ease concerns. To date, bids have come in from Spain, Austria, China and Israel.

Mr Andrade does not foresee difficulties in securing long term financing. "This is only possible because the business proposition is attractive on an international basis. We have never had this level of participation in Colombian infrastructure," he says.

Rupert Stebbings at Bancolombia says finding the correct instruments for investment is crucial. It has not been difficult for companies to borrow from overseas, he says, citing a recent purchase by pension fund manager Protección's via a third party instrument, a long term private equity fund.

As a long-term fixed rate asset offer-

$25bn	35-40
Financing costs that need to be secured	Number of projects expected to be awarded by the end of 2016

ing stable returns, infrastructure is attractive to institutional investors, but it requires specialist knowledge. It is still unfamiliar territory for local investors, while international investors often lack local market knowledge.

Working with an infrastructure fund manager who can make decisions and monitor the investment can help.

Ensuring that investors are matched with projects is a vital part of the process and international practices have been followed.

As Mr Andrade explains: "at contract stage they are assigned to whoever is best suited to manage them, and they are appropriately capped".

To encourage investment, the government has hedged the local currency. The banks are also playing their part by providing long-term loans and offering competitive interest rates.

It is too early to tell how successful 4G will be but some take encouragement from the early interest of potential investors.

"The fact that international companies are showing interest is a good sign," says Mr Stebbings. "if the projects were not robust enough, they would not be here."

Like minds set sights on treading united line

Continued from page 1

value this year but they are subject to currency controls, so their rates on the black market depreciated instead.

Lastly, the local pension fund industry is large and growing fast. Chile's mandatory pension system, set up in 1980, has $156bn of assets, almost two-thirds of GDP, under management.

Mexico's pension system, established in 1997, has $158bn under management. According to rating agency Fitch, if Mexico's pension system grows to Chile's size in terms of assets per capita, total managed assets would reach $1.1tn.

Where to invest that is increasingly important. To diversify risk, one obvious solution is to invest more abroad; Colombia's $61bn pension system currently invests 30 per cent overseas, versus 56 per cent in Chile.

Possible outflows could go to other Pacific Alliance countries — even if the pact's mooted stock market tie-up, called Mila, remains a work in progress. But some of that money could just as well go into developed markets, which would offer better diversification of risk. Another possibility is to co-invest with public or private investment in domestic infrastructure projects.

For geopolitical types, the Pacific Alliance has a secondary function to its economic role: as a political counterweight to Brazil, and to the region's more leftist groups, such as Alba, which has Bolivia, Cuba, Ecuador, Nicaragua and Venezuela as members.

Michelle Bachelet, the centre-left Chilean president, has taken pains to avoid regional divisions, especially with Argentina and Brazil. Nonetheless, Pacific Alliance countries — with Presidents Juan Manuel Santos, Enrique Peña Nieto and Ollanta Humala in office in Colombia, Mexico and Peru respectively — tend to be more strongly wedded to liberal democratic principles and, perhaps, even to each other.

That could be glimpsed in August at the Organization of American States, when Colombia asked for an official meeting to address Bogota's latest border spat with Venezuela. Alba member countries voted against the motion; Brazil and Argentina abstained; the Pacific Alliance en bloc voted in favour.

That political mindset, married to pro-business principles, is another sign of its members continue to use the Alliance as a way of differentiating themselves from their more truculent peers.

Whether that is enough to make a real difference in today's tough times, with emerging markets particularly out of favour, is another matter.

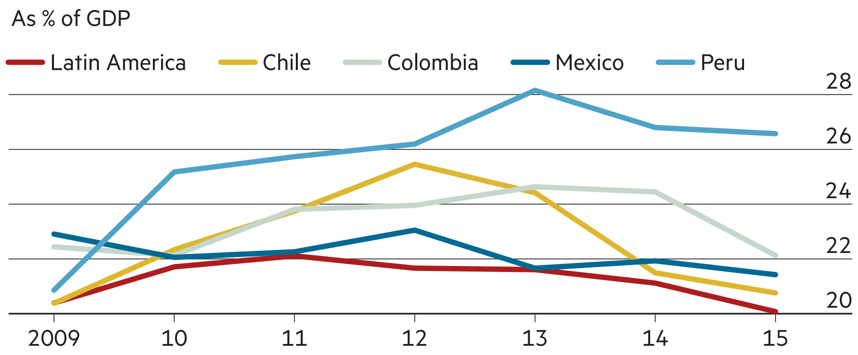
Tellingly, Colombia lost the OAS motion: an indication that sometimes, it is the broader political, economic and financial environment that determines the outcome, whatever the mindset.

Pacific Alliance: investments and savings

Rising commodity prices in the wake of the financial crisis saw investment levels in the resource rich economies of Chile, Peru and Colombia soar above the Latin America average ...

Investment

As % of GDP



... but heavy reliance on extractive industries has meant the commodity slowdown has hit investment levels hard in these economies

Mining industry*

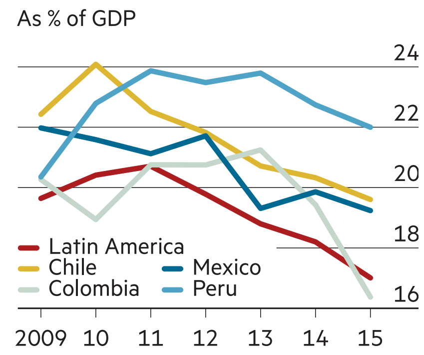
As % of GDP, 2014

* Includes oil and gas extraction

Despite the commodity price collapse, savings are higher than the Latam average ...

Savings

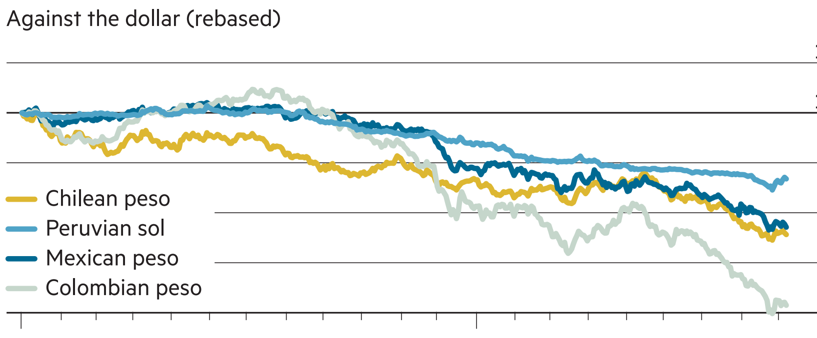
As % of GDP



Weaker global demand for commodities and the general emerging markets selloff h ve sent Pacific Alliance currencies tumbling. The Colombian peso is down almost 40% from mid 2014 ...

Pacific Alliance currencies

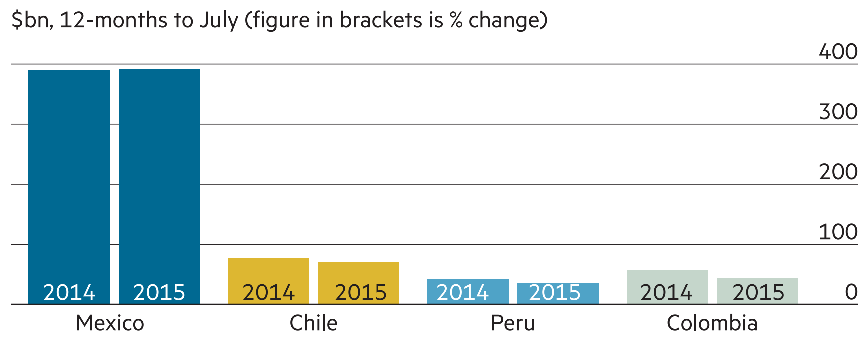
Against the dollar (rebased)



... export values have also been hit hard for the commodity producers; only Mexico with its more diversified economy has seen exports remain firm

Value of exports

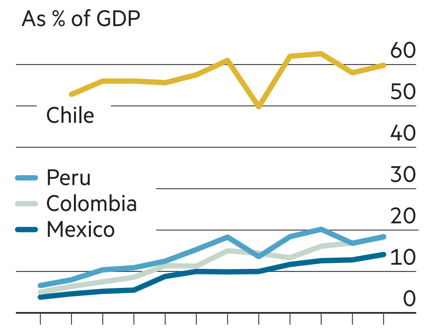
$bn, 12-months to July (figure in brackets is % change)



... and pension assets grew steadily ...

Pension assets

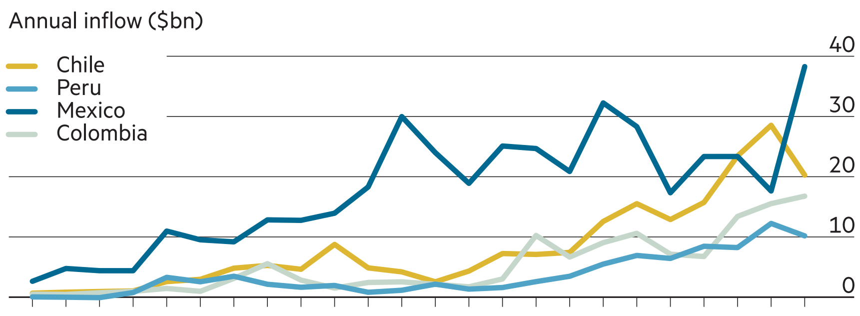
As % of GDP



Foreign direct investment has grown rapidly for all member countres over the past decade but is slowing sharply, for example in Chile and Peru ...

Foreign direct investment

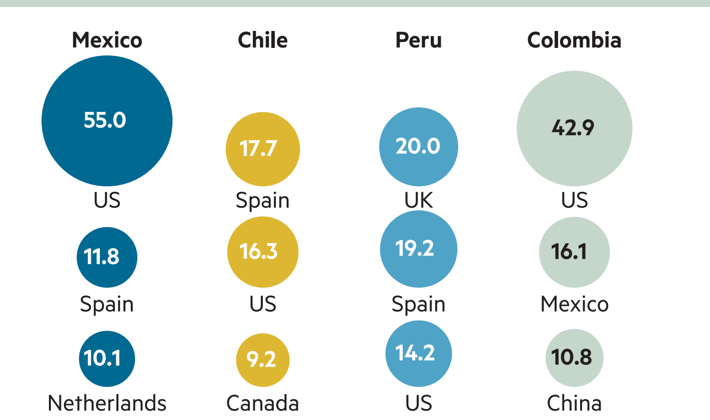
Annual inflow ($bn)



... and the US remains the largest foreign investor in Mexico and Colombia, while Spain also maintains strong links accounting for a large share of foreign investment

FDI stock by origin

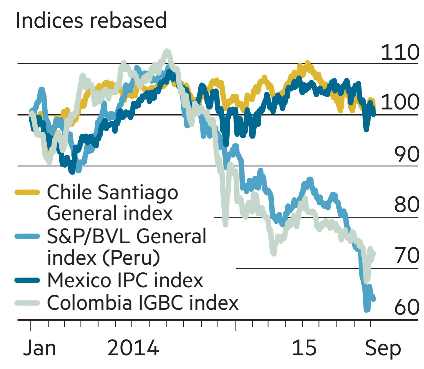
% of total



... but stock markets have still collapsed

Pacific Alliance stockmarkets

Indices rebased



FT graphic Sources: IMF; Thomson Reuters Datastream; UNCTAD; Haver Analytics; OECD

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Peru protests prompt alarm

Mining Not only has the world cycle in commodities turned unfavourably but so has local sentiment, writes *James Wilson*

Focal point: Las Bambas is expected to become one of the world's largest copper mines when it starts up next year

More than 4,000 metres above sea level in Peru's central highlands is one of the biggest construction sites in the western hemisphere.

Some 16,000 workers are building Las Bambas, a huge copper mine. It is already 95 per cent complete and when the project owned by MMG, controlled by China Minmetals, starts producing next year it should quickly ramp up to become one of the largest in the world.

The vast mineral wealth of projects such as Las Bambas have made Peru one of the focal points for mining investment in recent years. But while the resources have not changed, the climate has.

Las Bambas may mark the end of a period of substantial mining spending in Peru that has seen one mine, Hudbay's Constancia, reach commercial levels of production this year, as well as the imminent completion of a big expansion of Freeport-McMoRan's Cerro Verde copper mine.

"In the past four or five years, we have seen important investments in mining projects," says Carlos Gálvez, president of Peru's National Society for Mining, Petroleum and Energy. "But, unfortunately, we are now dropping."

Mr Gálvez details some $30bn of investment in the sector over the past five years, including a peak of $10bn in 2013. But his estimate for this year is for some $7.5bn, with an expected drop to $5bn in 2016. The pipeline for new projects of more than $1bn "has dried up", Mr Gálvez says.

Unfortunately for promoters of mining investment in Peru, not all of this can be blamed on the vagaries of the commodities cycle — though a multi-year fall in the price of copper, accelerating during 2015, will undoubtedly affect investment choices. Peru's more specific problem is that some mining projects have been held up or derailed by vocal and often violent protests.

The opposition to mining in some areas has made a decision to invest in the country much more complicated than any doubts about geology or project economics.

Hugo Santa María, chief economist of Apoyo, a Peruvian consultancy, says:

> 'There is a rational and predictable framework for getting projects permitted, a long history of investor protection'

"Every bit as important as having good engineers or geologists is having good anthropologists and sociologists. It is not only a matter of money."

The complexities were laid bare by the paralysis besetting Conga, a Newmont and Buenaventura gold mine project that has been approved but put on hold after protests erupted in 2011.

This year, they have been most evident in the case of Tía María, a copper mine planned by Southern Copper, already a large investor in the country.

Two decades after initial exploration, and in spite of an environmental study having been approved, Southern's planned $1.4bn investment is on hold after violent clashes between protesters — worried about the mine's effects on water supplies in a nearby agricultural valley — and police. A temporary state of emergency had to be declared.

Raúl Jacob, Southern's chief financial officer, says the company is doing everything it can to ensure the project does not affect the valley and believes the protesters are a minority.

Southern still hopes to go ahead and Ollanta Humala, Peru's president, supports the project.

Peru's politics is strongly regionalised and Mr Humala — in the last year of his presidency — is seen as lacking the ability to impose his will in many provinces. He has earned the wrath of anti-mining campaigners who initially supported him, while not entirely cementing his credibility with the industry.

Peru's political problems for miners are by no means all-encompassing or predictable. While the Conga project has stalled, China's Chinalco has managed to build the large Toromocho mine, relocating and resettling an affected community. And Southern's Mr Jacob says expansion of its Toquepala mine, relatively close to Tía María, is proceeding with fewer problems.

David Garofalo, chief executive of Hudbay, says: "Peru was one of the five countries where we decided to focus our investment dollars. There is a rational and predictable framework for getting projects permitted [and] a long history of investor protection."

In Hudbay's case, the fact that Constancia already had its permits — and was bought from a junior mining company with a good record of community engagement — was also a plus.

With the commodity cycle turning against mining investment in any case, Peru's mining industry hopes the country's election next year will bring a more supportive government commensurate with the country's geological potential.

There are fears that it is becoming more difficult the world over to gain approval for projects.

One analyst says mining in Peru is not receiving enough government support. "You need a champion for the industry inside the public administration — in Peru no one has provided that."

Chile Red gold loses its lustre

There was a time when investing in Chilean mining was a no-brainer, **writes Gideon Long**.

After 1990, when General Augusto Pinochet stepped down and the country returned to the international fold, foreign companies poured in to exploit vast copper reserves.

Between 1990 and 2004, Chilean copper output grew 9.2 per cent a year. As the industry matured, the growth rate slowed, but by then the commodities supercycle had kicked in.

Copper prices were sky-high. Chile did not need to produce more of the stuff each year; it could simply sell the same amount for more money.

This August, the copper price hit a six-year low and when industry leaders gathered in Santiago for the 14th world copper conference, they were in gloomy mood.

"The decline in the copper price is at the front of everyone's mind," said Robert Pelman, founder and chairman of London-based commodities consultancy CRU, organiser of the conference.

"Many projects that were planned for later in this decade are now looking to start up late in the 2020s and, in some cases, not at all," he says.

A tumbling copper price is not the only concern for Chile's miners. Ore grades are falling, so companies have to blast more rock out of the ground simply to stand still.

Codelco, the world's largest copper miner, expects grades to slip by 33 per cent in the next 25 years. Put bluntly, Chile's easy copper has already gone.

Energy supply is also a worry, given Chile produces virtually no fossil fuels and relies on imported coal and liquid natural gas to power its mines. Energy costs account for 18 per cent of the cost of production.

Water supply is another, and increasingly thorny, issue. Farmers and communities accuse mining companies of sucking the land dry to keep their operations running. A prolonged drought has not helped. Miners are turning to desalination plants or using untreated seawater. But pumping water from the Pacific to the Atacama and the Andes is arduous and costly.

Chile's environmentalist movement forced the government to tighten regulations. In 2001, it took 236 days to get an environmental impact assessment approved. By 2013, it took 506 days.

And then, there is politics.

The second government of Michelle Bachelet has proved less business-friendly than her first. Within months of taking power, she had rammed through a tax reform which Diego Hernandez, chief executive of London-listed Antofagasta Minerals Plc, describes as "a disaster" — because it made the tax system much more complex.

"It's a nightmare to apply," he says. "And when you complicate the system, the country loses competitiveness."

Labour reform is up next, with a bill before parliament. Mr Hernandez says: "If it's approved in its current form, it will make the trade unions more powerful. It won't help create jobs, it won't help Chile's small and medium-sized companies, and it will give employers less flexibility to run their business. It's a bad reform."

It is not all doom and gloom. Analysts point to $67bn-worth of copper projects in the pipeline and new technologies, such as electric cars, offer hope that demand for copper will remain buoyant for decades to come.

Presidential view: Michelle Bachelet has proved less business-friendly in her second term

Bloc seeks leverage by joining bigger groupings

Trade The four nations are pursuing a line of economic openness, writes *Shawn Donnan*

Latin America's rival trade blocs — the two-decades-old Mercosur anchored by Brazil and the much younger Pacific Alliance spearheaded by Mexico — offer contrasting visions.

Armando Monteiro, Brazil's trade minister, looked almost plaintive this year when he insisted that — despite his country's economic woes and teetering government — there was still life in long-stalled trade negotiations between Mercosur and the EU that were relaunched in 2010.

Venezuela, a Mercosur member, has turned to China for help to navigate an economic crisis, has shut its borders with neighbour Colombia, and has jailed opposition leaders. Argentina, too, is stuck in its own economic doldrums.

Meanwhile, the four nations of the Pacific Alliance are pursuing what looks like an accelerating path of regional integration and a model of economic openness.

Tariffs on 92 per cent of products they trade are due to be eliminated next year with the rest phased out over the next seven. Regulations are being harmonised and financial and labour markets liberalised.

Chile, Colombia, Mexico and Peru are betting on each other and that a future together as a market of 250m people representing more than a third of Latin America's economic output is likely to be a prosperous one.

But the biggest advantage for the Pacific Alliance lies in the next project. Three of the alliance's members — Chile, Mexico and Peru — are involved in negotiations for the US-led Trans-Pacific Partnership, a vast Pacific Rim trade zone that is set to cover 40 per cent of the global economy and which after five years of negotiations is close to being finalised.

Moreover, Colombia has a prominent place on lists of the countries most likely to join the TPP when it one day expands.

The world of trade these days is a regional one. If economists such as Jagdish Bhagwati once spoke of a tangled "noodle bowl" of country-to-country trade agreements these days the more apt metaphor for the world may be a plate of regional dumplings.

After years of paralysis in global talks at the World Trade Organisation, the US, EU and other economies have turned to regional agreements as a more feasible option. Beyond the TPP the EU and US are negotiating a Transatlantic Trade and Investment Partnership while the 10-member Association of Southeast Asian Nations is trying to bring together China and India into a single Regional Comprehensive Economic Partnership.

Each represents an agonising long-term project. Even as negotiators wrap up the TPP, the reality is that any deal is unlikely to be ratified by the US Congress and other national legislatures before 2016 — or take force before US President Barack Obama leaves office in January 2017. But when they do become reality, the next step will probably be finding a way to stitch together those regional agreements that succeed.

Chains: Peru wants closer links with Mexico's car industry — Susana Gonzalez/Bloomberg

One of the most likely unions given the overlapping membership is between the Pacific Alliance and the TPP.

The international interest is clear. Thirty-two countries, including the US, Germany and Japan have signed up for observer status to the Pacific Alliance. The members have their eye on expansion. "There is no limit to the countries that can join," Ildefonso Guajardo Villarreal, Mexico's economy minister told a recent World Economic Forum (WEF) meeting. "We are not a closed bloc."

In a world of global supply chains the future lies in becoming part of them. For Peru one result of the Pacific Alliance has been discussions of how Peruvian companies can integrate with the auto industry in Mexico, itself the result of regional supply chains created by the 21-year-old North American Free Trade Agreement with the US and Canada.

Magali Silva, Peru's trade minister told the same WEF meeting: "Integration with Mexico will be the driving force towards the internationalisation of Peru's [small and medium-sized enterprises."

Geography and proximity still matter in trade, even in an age of containerisation. Even so, the TPP will help companies in Peru gain access to even bigger markets in the US and Japan. In future, Ms Silva might say the same of the EU and a transatlantic agreement stitched together with the TPP, and the Pacific Alliance.

Not everyone is a fan of the way things are going. Brazil, which lobbied hard to secure the top spot at the WTO for career diplomat Roberto Azevedo, is still betting that one day the world will once again be ready for a global agreement that might also include poorer countries and big economies such as India that are now largely left out of the regional manoeuvres.

That day looks to be far off. For Latin America and the Pacific Alliance, the very real present is regional.

Funds prove slow in crossing frontiers

Pensions

Bureaucracy and a lack of political will have thwarted intra-regional investment, reports *Amy Stillman*

Several years since Mexico, Chile, Peru and Colombia signed a landmark trade agreement promising to unify their financial markets, intra-regional investment by pension funds is barely a drop in the Pacific Ocean.

Only 1 per cent of local pension funds' combined $450bn in assets under management has been invested in other markets of the Pacific Alliance.

"There was a lot of optimism at the start," says Pablo Berckholtz, the head of Baker & McKenzie's capital markets practice in Lima. "But the reality is that a number of things need to change before we see an integrated market that serves the purpose it was meant for."

Complicated bureaucracy and an apparent lack of political will to change outmoded and insular-looking regulations have stunted development.

"It is quite a complicated set of rules for each country," notes Juan Camilo Osorio, the vice-president of investment at Sura Asset Management, the region's largest pension fund manager.

Andrés Castro, Sura's president, predicts that over the next seven to 10 years the company's Pacific Alliance assets will double to $220bn, and the market could reach more than $1tn.

But, he adds, while the Pacific Alliance presents a significant opportunity to diversify pension funds' allocations, "the investment regime must become much more sophisticated."

The Chilean market is by far the most advanced, buoyed by the expansion of the private pension system in 1980. But it has raised taxes on investment while the failure to homogenise tax processes and tariffs has contributed to the tepid growth of the joint-stock market, MILA.

The S&P MILA Pacific Alliance Composite index is down by more than 30 per cent in the past year, not helped by local currency volatility and wider economic shocks.

Mr Osorio says: "It is not that people do not want to invest, but inefficiencies need to be ironed out, such as unifying tax processes."

The lack of interest in MILA has prevented the Peruvian and Colombian markets from becoming more liquid. This has prevented other Pacific Alliance pension funds from looking at opportunities there. But perhaps the biggest obstacle is Mexico's hugely restrictive investment regime.

Pension funds in Mexico are prohibited from investing more than 20 per cent of their portfolios internationally, and restricted to assets deemed less risky than a Mexican equivalent. The rules prevent them from tapping into assets elsewhere, including private equity, infrastructure and energy funds.

Afore Banamex, the pension fund of the Mexican bank, has allocated all its international holdings to Europe, the US and Asia. "We like infrastructure and energy funds in Peru and Colombia," says Luis Sayeg, the chief executive of Afore Banamex, which manages $28bn. "But local regulations have prevented us from analysing these opportunities."

$450bn Local pension funds' combined assets under management

1% Portion of that $450bn invested in other Alliance members

One proposal is to classify pension fund investment in each other's markets as domestic, removing any reference to international restrictions.

Another suggestion is that pension contributions within the Pacific Alliance countries could be transferable between them. Chile and Peru already have this arrangement in place.

"Addressing these issues would be a huge step for the entire Pacific Alliance project," says Mr Osorio. "The four countries need to talk, announce the changes, and that's all. They just need the will to do it."

Future lies in the comfort each draws from success of the others

COMMENT

Michael Kuczynski

Economic integration is often presented as a matter of intensified cross-border activity. As such, the Pacific Alliance is not particularly integrated. Chile earns less than 4 per cent of its export income from alliance members — Peru, Colombia and Mexico — and twice as much from Mercosur, Latin America's rival and larger trade group.

By contrast, Mercosur — which groups Brazil, Argentina, Bolivia, Paraguay, Uruguay, and Venezuela — is more integrated. About 10 per cent of Brazil's exports go to fellow members. In Argentina's case, that is nearly 30 per cent. But Mercosur productivity is lower and its tighter integration means less openness to international trade.

The Pacific Alliance, which is more open and exposed to the international economy than to its fellow members, is far from being a case of conventional economic integration. Instead, it represents a common attitude to the role of the state to political economy, or how its members have inserted themselves into the world economy.

How this arose is best understood through Latin America's recent past. The starting point is the debt crisis of 1981-87. These were memorable years for other resource-rich countries, too, particularly in Australasia and the Soviet Union. In Latin America, they were convulsive and threw as long a shadow as the 2007-08 financial crisis continues to do over Europe and the US.

Modern Latin America shows the yin-and-yang outcomes of the ramshackle dealmaking that rounded off its crisis in the mid-1990s. In the to-and-fro of debt restructuring, friendlier conditions for foreign investors became the quid pro quo for improved trade access.

The instruments were US Treasury secretary Nicholas Brady's debt restructuring plan and the Uruguay Round of the General Agreement on Tariffs and Trade (with its bells and whistles agreements on trade related investment measures and intellectual property rights — Trims and Trips).

In the annals of economic integration the Uruguay Round is billed as a triumph, replacing the Gatt and its backroom US-led deals with a multilateral-seeming institution, the World Trade Organisation.

En bloc: common views on state's role

In practice, it marked the beginning of the end of economic multilateralism. The US largely relinquished its first-mover role in the international economic order. We are back to a world of intra- and cross-regional arrangements, reminiscent of the late-1930s and aimed more at boosting investment than facilitating trade. Realists might say we never really left it.

Latin America's response to these times has been to split into two camps. On the one side are the converts to the more liberal order. Mexico was an early adherent, perhaps because the 1980s crisis left its old corporatist orthodoxy in tatters. But Chile and Peru have also been active users of bilateral and cross-regional trade and investment agreements.

By contrast, the recusants are mostly east of the Andes. Brazil has stuck more doggedly to its corporatist past. The same goes for the even less successful economies of Venezuela and Argentina.

Smaller states, such as Bolivia and Ecuador, seemingly sit on the fence. In terms of doctrine, they side with the recusants; in practice, they increasingly dance with the converts.

The two sides' philosophical differences are illustrated by recent trade disagreements between Mexico and Brazil over the apple of their manufacturing eye, cars and car parts.

Mexico, with its more competitive economy, wants to enlarge or scrap quotas, Brazil to tighten them further. Both, in their own ways, want to prevent the other from encroaching on their turf.

So much for the origins and character of the alliance. What of its challenges?

Its members need to keep their bilateral and cross-regional agreements suitably diversified as other markets rise and fall. For instance, India appears only in Chile's portfolio of agreements, not among those of other members'.

The US is recovering its relative economic importance as China's stumbles, PAC members need to grapple with the technicalities of meshing their particular portfolio of agreements into that of each other.

The end point is to secure, especially in dealings with the US, the highest common factor rather than the lowest denominator.

Members need to level the cross-border playing field in terms of public procurement of goods and services, in all-important physical and social infrastructure.

Finally — and probably most importantly, given their openness to trade and finance — members need to display their solidarity in each other's endeavour to deliver adequate macroeconomic performance. (In particular, in keeping real exchange rates stable and in simple tax effort.) This is to guard against the ever-present possibility of a slide from market convert to Mercosur-like recusant.

In short, the key to the alliance's success lies less in its integration agreements than in the comfort each participant draws from the reasonable success observed in the like-minded efforts of the others.

Only three years old, the Pacific Alliance has the merit of being institution-light, which may shield it from the dejected prognosis of Simon Bolívar, Spanish America's apostle of independence and integration. On his deathbed in 1830, Bolívar rued that his efforts at integration had been like ploughing the sea — although he may have failed to take a long enough view.

At the time, Chile was still an important regional breadbasket. A century later the ambit of its trade had shrunk to little more than its central valley. Since the 1990s, that same area has become a dairy for China and a vineyard to the world.

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