The Evolving Economic Relationship Between Asia-Pacific and Latin America

- **A pick-up in global demand will boost trade between Asia-Pacific and Latin America in 2018–19. The largest economies in both regions will continue to dominate the commodities-for-manufacturing trade relationship.**
- **Official efforts to strengthen and expand inter-regional integration will continue, resulting in an increasing number of formal trade and investment agreements between Asia-Pacific and Latin America.**
- **Bilateral investment flows are driven by China, Japan, and offshore financial centres in the Caribbean. China will increasingly be expanding its footprint in Latin America via FDI and policy bank lending.**

Protectionist trade policy biases in the US have prompted developing economies around the globe to look elsewhere in their pursuit of deeper worldwide economic integration. Indeed, economies in Latin America (LATAM) and Asia-Pacific (APAC) are prime examples of this as they are making progress in deepening their bilateral trade and investment ties.

Trade in goods can be considered the foundation of commercial relationships between two regions. Once such links have been established, other business flows—such as services trade and investment—are able to thrive. This report studies the evolution of these connections between LATAM and APAC* in recent years with the intent to give the reader a factual overview of the current state of the two regions' bilateral relationship and an assessment of how it will likely evolve over the coming years.

RAPID GROWTH IN BILATERAL TRADE IS SET TO RESUME IN 2018–19

Trade in goods between Asia-Pacific and Latin America has risen notably since the beginning of the millennium, outperforming global trade gains. After 2000, when bilateral trade amounted to only USD 78 bn (chart 1), the exchange of goods between APAC and LATAM soared to USD 593 bn by 2014 (partially reflecting commodity price movements). In 2015–16 flows experienced a soft patch, but signs of a solid rebound emerged in 2017. On average, goods shipments from APAC to LATAM increased by 13.6% annually between 2000 and 2016 while trade in the other direction increased by 15.0% annually. As a comparison, global trade growth averaged 6.9% annually during the same period.

The momentum is largely explained by the dynamism of Asia-Pacific and Latin America, as the regions have driven global economic momentum in recent decades. This reflects the fact that both APAC and LATAM are characterized by developing economies that are growing from relatively low bases, resulting in rapid GDP and trade gains. **In addition, we have identified three key reasons for the pick-up in trade between the two regions since 2000. They are:**

* For the purposes of this report, we define Asia-Pacific as developing Asia plus Australia, New Zealand, Hong Kong, Macau, Japan, South Korea, Singapore and Taiwan. Latin America is defined as Mexico, Central America, the Caribbean (unless stated otherwise), and South America.

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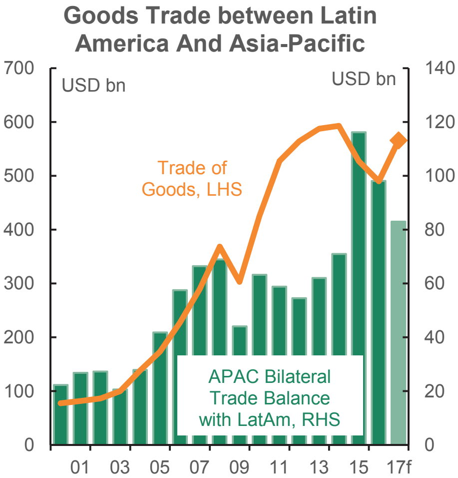
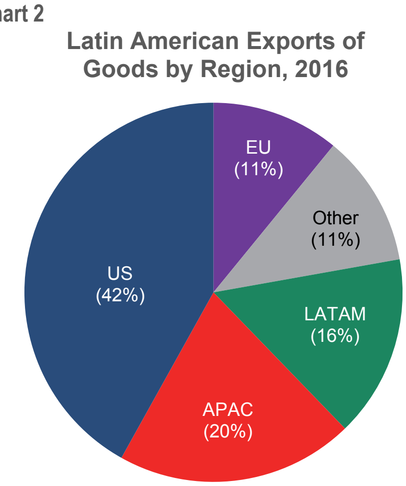
Chart 1



Sources: Scotiabank Economics, IMF DOTS.

Chart 2



Sources: Scotiabank Economics, IMF DOTS.

1. China joined the World Trade Organization in 2001 and opened its economy to the rest of the world, facilitating the rapid expansion of its economy.
2. The first free trade agreement (FTA) between Latin America and Asia came into force in 2004 (Korea-Chile FTA), and was followed by several other accords as inter-regional integration became the prevalent development in global affairs. The trend of generally higher openness to trade evident in both LATAM and APAC in recent years will likely continue in the foreseeable future.
3. Intra-regional integration in both continents created a stronger local foundation for reaching out to new markets. Indeed, Latin American countries have increased regional economic cooperation through several decades via Mercado Común del Sur (MERCOSUR), the North American Free Trade Agreement (NAFTA), and the Caribbean Community (Caricom)—and more recently via the Pacific Alliance. APAC has harmonized its institutional framework via Asia-Pacific Economic Cooperation (APEC) and the Association of Southeast Asian Nations (ASEAN).

The current trade relationship between LATAM and APAC is robust and the outlook looks to be favourable based on the recent pick-up in global demand and solid economic performance in both regions. Additionally, continued regional integration efforts are reducing regulatory impediments and helping create a more favourable business environment. For instance, Singapore, Australia, New Zealand (as well as Canada) recently joined the Pacific Alliance (consisting of Colombia, Chile, Mexico and Peru) as associate members, broadening the APAC and LATAM countries' bilateral links and helping integrate their supply chains in the future. In 2016, trade between the two regions amounted to USD 491 bn; 2017 is on track to record a substantially higher number. In the first three quarters of 2017, Asia-Pacific exports to Latin America grew by 6.8% y/y. Meanwhile, LATAM shipments to APAC skyrocketed by 18.7% y/y, significantly outperforming worldwide trade growth which averaged 8.6% y/y in the January–September period. We estimate that bilateral trade between APAC and LATAM reached USD 566 bn in 2017 and that it will comfortably exceed the 2014 peak (of USD 593 bn) in 2018.

ASIA-PACIFIC WILL CONTINUE TO DOMINATE THE BILATERAL RELATIONSHIP, WITH LATIN AMERICA COUNTING ON SUSTAINED ASIAN DEMAND

The trade relationship between Asia-Pacific and Latin America is uneven; the former holds a dominant position given the fact that its economy is almost five times as large as that of LATAM. Due to its huge economic might, APAC will continue to be a very important export market for LATAM economies, which currently ship 20% of their total foreign sales—almost USD 200 bn in 2016—to Asia-Pacific (chart 2). That is nearly triple APAC's share of LATAM exports in 2000. Meanwhile, APAC sells only 5% of its exports to LATAM (chart 3), double what it was in 2000. Despite a smaller share of total exports, the value of Asian shipments to Latin America was much higher—nearly USD 300 bn in 2016—reflecting Asia's role as a global exporting power. Accordingly, APAC recorded a USD 98 bn bilateral trade surplus with LATAM (chart 1), which has caused some discomfort among Latin American policymakers.

Another factor causing some uneasiness among Latin American authorities is the region's dependence on Chinese demand. Indeed, **China plays a key role in the relationship between the two regions and we do not foresee this dynamic changing anytime in the near future**. Currently 52% of LATAM exports to APAC go to China, while 55% of LATAM imports from APAC come from China (charts 4 and 5). The

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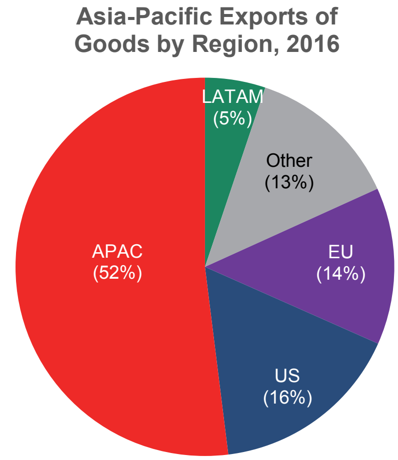
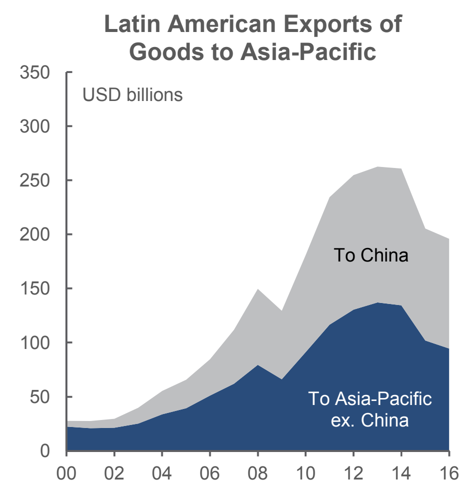


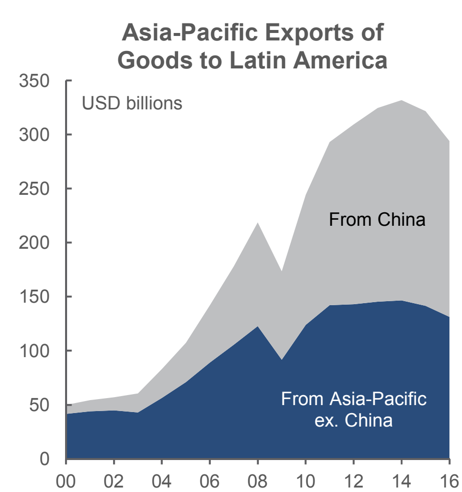
Sources: Scotiabank Economics, IMF DOTS.

Chart 4



Sources: IMF DOTS, Scotiabank Economics.

Chart 5



Sources: IMF DOTS, Scotiabank Economics.

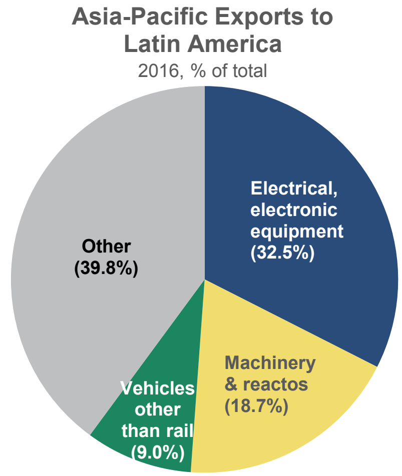
high importance of China as an export market and as a source for imports makes Latin America vulnerable to shifts in its economic cycles. Moreover, in the coming years, LATAM countries will likely feel the adverse impact of China's structural transition—particularly in their commodities exports—as China continues to shift from an industrial sector-driven economy toward a services-oriented one. Large economies dominate in the Western hemisphere too, with Mexico being the key destination for APAC exports while Brazil is the main origin for LATAM shipments to Asia-Pacific.

BILATERAL TRADE IS—AND WILL BE—CHARACTERIZED BY THE EXCHANGE OF COMMODITIES FOR MANUFACTURED GOODS

The composition of bilateral trade is lopsided as well, reflecting the two regions' differing comparative advantages, domestic demand conditions, and supply constraints. **Latin America mainly exports its abundant raw materials to Asia-Pacific**, while natural resources are relatively scarce in APAC countries (with a few exceptions such as Australia). Meanwhile, **APAC economies have a comparative advantage in higher value-added manufactured products that are shipped to LATAM**. This reflects the fact that some countries in Asia-Pacific enjoy relatively low labour costs (e.g., China, India, Vietnam) while others have ample capital and industrial expertise (e.g., Japan, South Korea, Taiwan). The combination of these factors has allowed Asia-Pacific to create a tight regional supply chain and become the world's manufacturing hub. APAC's exports to LATAM consist predominantly of electronics, such as telephones, computers, and broadcasting equipment, as well as machinery and vehicles (chart 6). Meanwhile, the top Latin American exports to Asia-Pacific are ores (predominantly copper and iron ore), crude petroleum, and soybeans (chart 7).

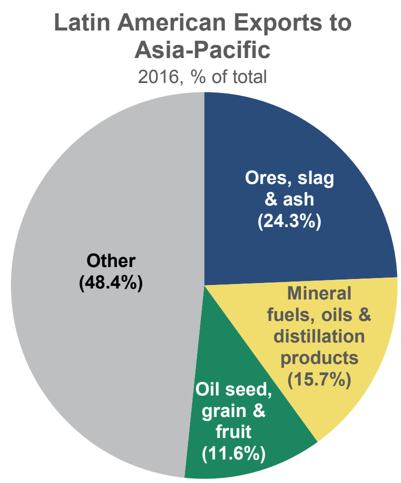
Latin American policymakers regularly highlight the need for regional economies to move up the value chain and to reduce their dependence on natural resources. Despite the authorities' inclination to address the above-discussed imbalances in trade relations, the outlook is not without its challenges. Slowing fixed investment growth in China and the resulting weaker expansion in commodities demand has put urgent pressure on LATAM resource-oriented economies to focus on the diversification of their export products and markets. Nevertheless, given that Asia will likely be a global growth outperformer for years to come, it will remain among the most important export markets for Latin America regardless of any diversification efforts.

Chart 6



Sources: Scotiabank Economics, UN Comtrade.

Chart 7



Sources: Scotiabank Economics, UN Comtrade.

We believe that LATAM countries could find new higher value-added business opportunities within their own areas of expertise to meet the solid Asian demand, such as in sustainable mining and renewable energy (e.g., wind and hydro), as well as in agricultural products development. However, committed collaboration between the private and public sectors is needed to create a supportive policy framework and business environment that would foster such opportunities. Against this backdrop, **we expect that the trade of commodities for manufactured goods will remain the key feature of the bilateral relationship for many years to come.**

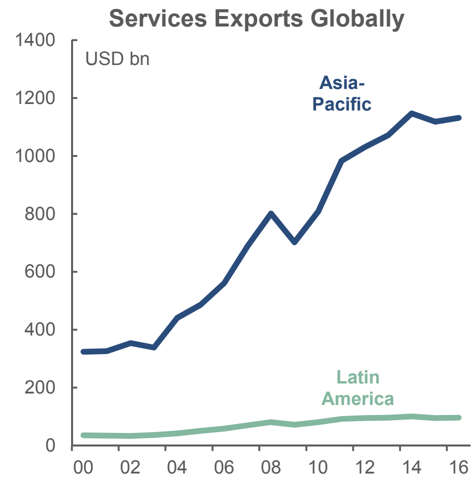
BILATERAL SERVICES TRADE PROVIDES OPPORTUNITIES FOR ECONOMIC DIVERSIFICATION

Given the existing strong trade ties and the fact that elements of services are increasingly embedded in goods trade, prospects for bilateral services trade between Asia-Pacific and Latin America are encouraging. Nevertheless, conducting thorough analysis on the evolution of bilateral services trade between LATAM and APAC is challenging due to data availability limitations. **In our view, bilateral services and business opportunities exist particularly in areas such as finance, transportation, agriculture, travel, and business services due to both regions' existing know-how and complementary comparative advantages.**

Global services trade grew on average by 7.2% annually between 2000 and 2016, outperforming the pace recorded in goods trade by a small margin. Asia-Pacific's services exports grew faster than the global norm, with gains averaging 9.0% annually since 2000. Meanwhile, Latin American services exports increased roughly in line with the global trend, rising by 7.3% y/y (chart 8). In APAC, Cambodia, India, Indonesia, the Philippines, and Singapore have seen the fastest gains in their global services exports (averaging 12–18% annually), while in LATAM Brazil has been the outperformer (recording an average increase of 11% annually since 2000). In APAC, services exports as a share of GDP are notably high in Singapore, Hong Kong, and Thailand (ranging between 17% and 50% of GDP). Apart from the tourism and financial services-oriented Caribbean, services exports play a much smaller role in South America, where Chile is the leader with its services exports equivalent to only 4% of GDP.

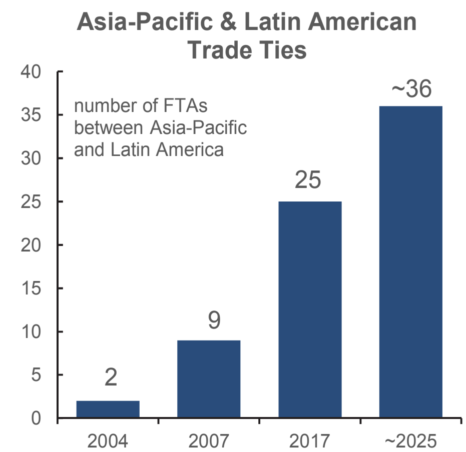
The range of Asia-Pacific's services exports is large, reflecting the more-advanced state of the sector when compared to that of Latin America; travel services are vital for countries such as Cambodia and Thailand, while software services—e.g., contact centres—dominate the Philippines' and India's services exports. In Singapore, most exports come from transportation (i.e., shipping and logistics) and financial & insurance services. Meanwhile, Japan is a key Asian buyer of Latin American services exports. In our view, further development of the services export sector in LATAM (excluding the offshore financial centres) would provide the region an opportunity to diversify its economies away from resource-dependence and help service providers in LATAM reach Asia's rapidly growing economies. In Brazil and Chile, transportation services currently make up a sizable part of their services exports. Latin American knowledge in urban development and food processing could provide further services trade opportunities with the densely populated APAC region.

Chart 8



Sources: Scotiabank Economics, IMF.

Chart 9



Sources: Scotiabank Economics, East Asia Forum, Asia Regional Integration Center.

FREE TRADE AGREEMENTS WILL HELP DEEPENING INTER-REGIONAL INTEGRATION

Continued official efforts by both regions' policymakers will promote further integration between Asia-Pacific and Latin America over the coming years. **We assess that there is a reasonably solid foundation for increased cooperation beyond home continents, created by intra-regional harmonization of policies and liberalization of trade in both LATAM and APAC.** However, further progress in reducing trade and investment barriers at home and improving trade-related infrastructure and technology would underpin bilateral business relationships between the two distant regions.

Since the establishment of the Korea-Chile FTA in 2004, inter-regional integration has deepened significantly through other trade pacts. Around two new FTAs have been signed every year since 2004, taking the total number of FTAs between the two regions to 25 (chart 9). **Chile is the champion of inter-regional integration**, having signed 10 FTAs with APAC countries. Peru—with its five FTAs—has also formalized its vital trading relationship with Asia. The frontrunners in bilateral FTA pursuit in APAC are Taiwan and Singapore (both have four FTAs with LATAM countries), followed by China, Japan, and South Korea (all have three FTAs).

While recognizing that all trade deals may not pay off, our simple analysis compares Chilean and Peruvian exports to China before and after the two countries signed an FTA with China in order to provide some insights into the potential impact on bilateral trade caused by trade deals. The agreement between China and Chile has been in effect since 2006 while the China-Peru FTA became effective in 2010. We found that the two Latin American countries' exports to China were growing hand-in-hand (by around 35% annually) between 2000 and 2006 when neither of them had an FTA with China. In 2007–2009 when the China-Chile FTA was already in effect but Peru and China had not concluded theirs yet, Chile's exports to China rose 43% y/y on average, while Peru's annual export gains slowed to 22%. While other factors likely simultaneously contributed to the diverging export performance, the result highlights the need for deeper assessments regarding the elements of the FTAs that have had the most positive impact on trade and integration.

Generally speaking, FTAs improve and harmonize regulatory frameworks, increasing business confidence and unleashing new business opportunities. Nevertheless, substantial differences exist regarding the scope and depth of the pacts. The Asian Development Bank[8] concludes that, on aggregate, **the existing FTAs between Latin America and Asia-Pacific have led to fast liberalization of goods trade and incorporate comprehensive provisions on services**. **Meanwhile, there is room for improvement in the coverage of "new issues" such as intellectual property rights, investment, transparency in government procurement, trade facilitation, and competition policy**. By addressing these areas decisively the two regions could further bolster their multilateral ties.

Further inter-regional integration is in sight; nine trade agreements between the two regions' economies are currently under negotiation while two have been signed but are not yet in effect. This implies that the number of FTAs might reach 36 over the coming years. The future of the Trans-Pacific Partnership (TPP) will also shape inter-regional dynamics significantly in the medium-to-long term. Following the US withdrawal from the pact, the remaining 11 countries have agreed to move ahead with the deal independently. The tweaked version of the deal—the Comprehensive and Progressive Agreement for the TPP (CPTPP)—will enter into force after at least six member countries have ratified it. **Given that 10 of the member countries, Canada being the lone exception, are either in Latin America or Asia-Pacific, the CPTPP has the potential to substantially transform their economic relationship since the pact has a relatively high coverage of the aforementioned "new issues".**

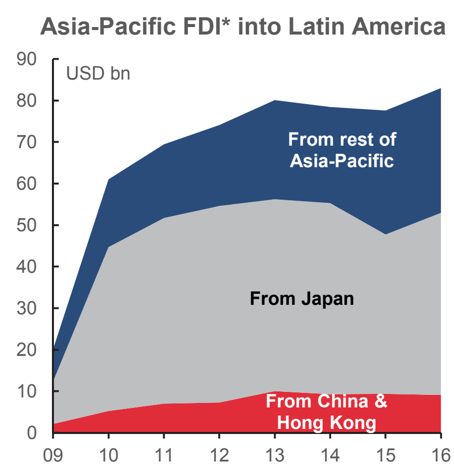
AMPLE ROOM FOR GROWTH IN INTER-REGIONAL INVESTMENT

Foreign direct investment (FDI) helps expand and diversify existing commercial relationships as it allows investing companies to avoid trade barriers and helps transfer knowledge. Indeed, inter-regional investment flows typically strengthen only after a solid trading relationship has been established. Investment flows between Asia-Pacific and Latin America have increased in recent years but they are lagging the volumes recorded in trade. However, **the outlook for stronger investment ties between APAC and LATAM is encouraging given that bilateral trade is on the rise and the two regions have continued to enhance their investment climates and investor protection practices.** According to International Monetary Fund data, the stock of bilateral FDI reached nearly USD 128 bn in 2016 with growth averaging 19% annually since 2009. **APAC dominates the bilateral investment relationship. Almost two-thirds of the regions' combined FDI stock is comprised of APAC investment into LATAM.**

Ample natural resources and large domestic markets make Latin America an attractive investment destination both globally and for Asia-Pacific. Indeed, while the stock of global FDI in LATAM grew rapidly—on average by 21% annually between 2009 and 2016—the region's FDI originating from APAC increased at an even faster rate, by 34% y/y, underpinned by China's outreach. Meanwhile, global FDI stock in APAC expanded at a slower pace than that in LATAM—on average by 10% annually—while investment into APAC from LATAM increased at an even slower rate, by 8% y/y. **Brazil and Mexico are the largest destinations for Asian investment once offshore financial centres are excluded**. Japan is the largest investor (chart 10) accounting for 53% of total APAC investments in LATAM in 2016, followed by China (11% of total). **In terms of Latin American FDI into Asia-Pacific, the majority is invested in China and Hong Kong** (chart 11) **as well as in India.** Most of the investment comes from the Caribbean offshore financial centres and Panama. Once they are excluded, Brazil and Mexico are the biggest investors, with the former being the source of 44% of LATAM FDI into APAC followed closely by Mexico's 41%.

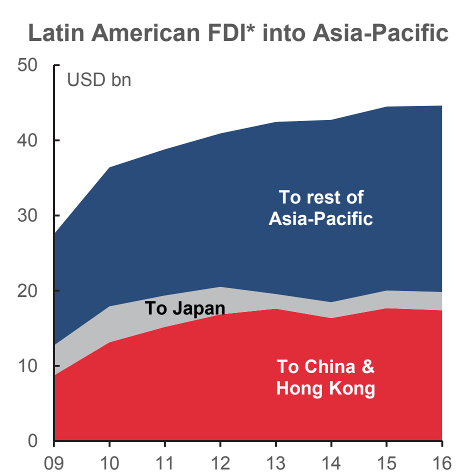
Latin American FDI stock that originates from Japan and South Korea is typically concentrated in the manufacturing sector (e.g., automobiles and electronics). Such investments are **meant to satisfy local demand in LATAM and cut down logistical costs**. Meanwhile, Chinese interests in Latin America have typically concentrated on

Chart 10



* Excludes Caribbean financial centres.
Sources: Scotiabank Economics, IMF.

Chart 11



* Excludes Caribbean financial centres.
Sources: Scotiabank Economics, IMF.

commodities and infrastructure with **the principal aim of meeting strong Chinese demand for raw materials and facilitating their shipment to Asia**. Latin American outward FDI into APAC mainly finds its way into the financial and business services sector—particularly FDI from Bermuda and Cayman Islands—as well as into food & tobacco and commodities, such as metals, coal, and oil & gas for the purpose of **benefiting from the region's efficient supply chains and reaching new markets.** It is worth noting though that some of the investments from the Caribbean offshore financial centres actually originate from Asia, especially from China, as the practice of "round-tripping" is used to benefit from China's FDI tax incentives. **Greater interaction between the private and public sectors in both regions could open further bilateral investment opportunities—particularly in LATAM with infrastructure yearning for more funding that is in abundant supply in APAC.**

In recent years, Latin American and Asia-Pacific economies have focused on strengthening institutional quality by guaranteeing investor rights and improving other governance and rule of law aspects; such advances are vital for both FDI and portfolio investment. Indeed, **LATAM and APAC have signed a notable number of new bilateral investment treaties** (BIT), despite the fact that most FTAs between the two regions include an investment chapter. BITs promote the flow of investments as they help alleviate investors' concerns regarding the safety of their assets. According to the World Bank, there are currently 68 signed BITs between the two regions, up from 45 in 2000 (chart 12). **We believe that improvements and convergence of regulatory frameworks in Latin America and Asia-Pacific will facilitate higher FDI flows as well as stronger capital market ties and portfolio investment (both debt and equity) in the coming years.**

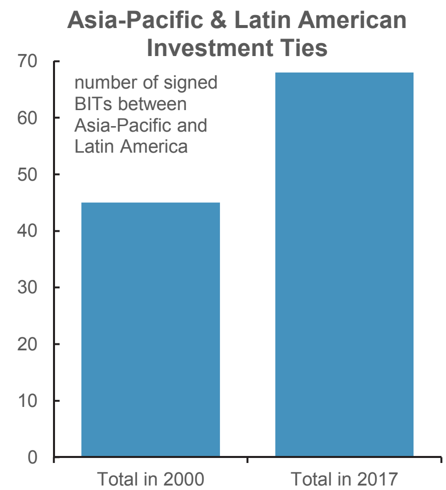
In our view, **one of the key determinants for bilateral FDI in the medium-term is the outcome of the NAFTA renegotiations**. It may impact where APAC companies will establish operations once they have decided to enter the Western Hemisphere. In addition, the outcome will also influence Mexico's biases in global trade and investment, potentially pushing the country to seek deeper ties with APAC. **On the portfolio investment front, the ongoing development of Latin American capital markets will be the key factor shaping the medium-term outlook.** Further deepening of the market suggests that the region will provide Asia-Pacific investors—who possess a large savings pool—with an increasing number of attractive investment opportunities.

CHINA'S INFLUENCE IN LATIN AMERICA IS ON THE RISE

After becoming the largest trading partner for most Latin American countries, **China has demonstrated increased interest in the region via growing investment flows and policy bank lending. This trend will likely persist through the foreseeable future as the Chinese economy continues to stand among global growth leaders, increasing its economic might in the world.** According to the AEI China Global Investment Tracker[2] that covers the years between 2005 and 2016, the largest recipients of Chinese investment and construction contracts were Brazil, Argentina, Venezuela, and Peru (chart 13). The energy sector received 61% of these flows, followed by metals (19%) and transportation (6%).

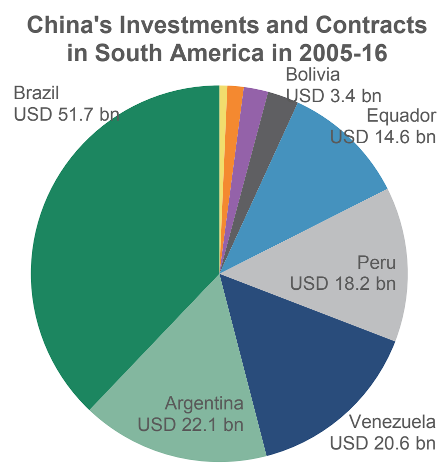
China's interest in Latin America does not stop at commercial relationships. According to the China-Latin America Finance Database[3] by the Inter-American Dialogue, between 2005 and 2016 Chinese policy banks—China Development Bank

Chart 12



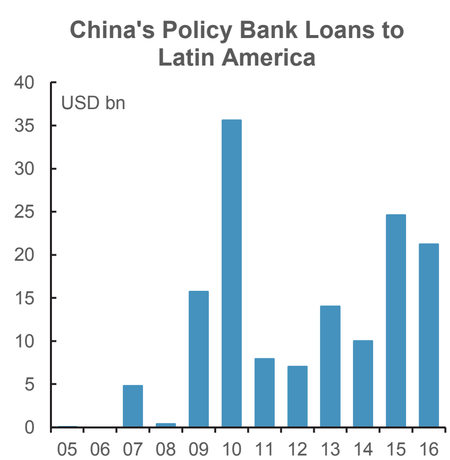
Sources: Scotiabank Economics, World Bank.

Chart 13



Sources: Scotiabank Economics, AEI China Global Investment Tracker.

Chart 14



Sources: Scotiabank Economics, Inter-American Dialogue.

and China Export-Import Bank—have provided over USD 141 bn worth of loan commitments to Latin American and Caribbean countries and state-owned firms (chart 14), larger than the combined financing to the region provided by the World Bank and the Inter-American Development Bank. **In addition to the aim of meeting China's commodity demand, we believe that diplomacy may play a role in these relationships**, implied by the fact that Venezuela is the largest recipient of Chinese policy bank lending. In addition, Brazil, Ecuador, and Argentina have received notable development funding from China. Most of the Chinese policy bank lending—USD 100 bn, around 70% of total—is focused on the energy sector, followed by infrastructure (USD 24.3 bn, 17%).

CONCLUDING REMARKS

The economic relationship between Latin America and Asia-Pacific has seen vast changes over the past two decades, starting with merchandise trade and expanding to include services trade and investment flows. The rapid evolution is largely due to the fact that the two regions boast complementary comparative advantages: ample natural resources in LATAM, and a large savings pool, cheap labour, and technological knowhow in APAC. These complements characterize both bilateral trade and investment flows between the two regions. Additionally, both Asia-Pacific and Latin America are large markets with growing middle classes, making them attractive for companies looking to reach new clients and diversify away from a dependence on demand in advanced economies. We see these dynamics driving further inter-regional integration in the coming years, benefiting both regions. However, whether or not there will be a shift in the existing commodities-for-manufactured-goods theme remains to be seen.

The massive Asia-Pacific economy currently dominates the bilateral relationship with Latin America. In addition to focusing on inter-regional integration, APAC has placed great emphasis on deepening trade and investment linkages within Asia. This has allowed the region to create an efficient regional supply chain where different countries' strengths complement each other. This may be something LATAM countries could learn from. Aside from the need for further intra-regional integration, Latin American economies face another common challenge: China's economic transformation. The Asian giant is slowly transitioning from an industrial economy to one driven by consumers, and this shift will translate into slower growth in China's demand for commodities over the coming years while its demand for services strengthens. LATAM economies could benefit from meeting the strong near-term demand for natural resources while simultaneously developing their services sectors to prepare for the future.

Latin America will remain an attractive trade and investment destination for Asia-Pacific countries over the coming years given the region's abundant agricultural land and other natural resources, large size of its market, and its proximity to North America. In addition, many LATAM countries have successful experiences in poverty reduction and urbanization, which might provide APAC with important learning opportunities. Accordingly, deeper bilateral ties between Asia-Pacific and Latin America have clear benefits to both regions. The relationship can also develop to areas beyond commercial linkages but will require committed policy coordination and dialogue by governments in both regions. We believe that assessing potential policy options that would enhance the two regions' bilateral relationship is worth further research.

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