Policy Discussion Briefs

# Regional Integration in the Current Economic Slowdown

8th Meeting of Finance Ministers of the Americas and the Caribbean

Chaired by the Republic of Paraguay • Washington DC, October 5, 2016

ECLAC

# Eighth Meeting of Finance Ministers of the Americas and the Caribbean

## Policy Discussion Briefs

## Regional Integration in the Current Economic Slowdown

Washington DC, October 5, 2016

The following policy discussion briefs were prepared as the basis for discussion during the Eighth Meeting of Finance Ministers of the Americas and the Caribbean held in Washington DC, on October 5, 2016, and chaired by Mr. Santiago Peña Palacios, Minister of Finance of Paraguay.

Overall direction for the preparation of the briefs was provided by Santiago Levy, Vice President for Sectors and Knowledge (IDB), Augusto de la Torre, Chief Economist for Latin America and the Caribbean (World Bank Group), Robert Rennhack, Deputy Director of the Western Hemisphere Department (IMF), Pablo Sanguinetti, Chief Economist (CAF), and Alicia Bárcena, Executive Secretary (ECLAC), respectively.

The briefs were prepared by Mauricio Mesquita Moreira (IDB), Augusto de la Torre, Daniel Lederman, and Samuel Pienknagura (WBG), Robert Rennhack, Medotij Hadzi-Vaskov, Yan Carrie Swallow, Carlos Caceres and Pelin Berkmen (IMF), Pablo Sanguinetti and Adriana Arreaza (CAF), Daniel Titelman, Ricardo Martner, Michael Hanni, Cecilia Vera, Ricardo Sánchez and Gabriel Pérez (ECLAC).

The Technical Secretariat of the Meeting of Finance Ministers of the Americas and the Caribbean was led by Antoni Estevadeordal and Paolo Giordano, of the Integration and Trade Sector of the IDB, who also coordinated the production of this report and provided technical support to the process.

The opinions expressed in these policy discussion briefs are those of the authors and do not necessarily represent the views of the Inter-American Development Bank, the International Monetary Fund, the World Bank Group, the United Nations Economic Commission for Latin America and the Caribbean, the CAF - Development Bank of Latin America, or their member countries.

# Regional Integration in the Current Economic Slowdown

## Economic Growth Prospects

Regional Economic Outlook ........ 1

Boosting the Investment Cycle to Reinvigorate Growth ........ 7

## Challenges to Regional Integration

Making Sense of Regional Integration: Time to Be Bold ........ 13

Toward a Renewal of Open Regionalism ........ 19

Trade Integration ........ 25

Financial Integration ........ 31

Physical Integration and Infrastructure Investment ........ 35

Regional Value Chains and Logistics Integration ........ 39

# Regional Integration in the Current Economic Slowdown

**Washington DC, October 5, 2016**

The Meeting of Finance Ministers of the Americas and the Caribbean—also known by its acronym RFM — is an annual policy dialogue whose objective is to discuss issues of strategic importance and with the potential to promote economic integration and regional cooperation.

RFM meetings are attended by Finance Ministers from 34 countries of the Americas and the Caribbean, as well as the Heads of the International Monetary Fund (IMF), the World Bank Group (WBG), and the Inter-American Development Bank (IDB). Regional institutions such as the United Nations Economic Commission for Latin America and the Caribbean (ECLAC), the Development Bank of Latin America (CAF), the Central American Bank for Economic Integration (CABEI) and the Caribbean Development Bank (CDB) contribute to the discussion of Ministers.

The Inter-American Development Bank, through the Integration and Trade Sector, acts as the Technical Secretariat of the Meeting of Finance Ministers of the Americas and the Caribbean, and provides technical and logistical support in coordination with the country that chairs and organizes the annual meeting.

During the Eighth Meeting the Ministers will discuss policy options that contribute to growth, and technical issues related to regional integration in the context of the economic slowdown.

Mr. Santiago Peña Palacios, Minister of Finance of Paraguay, will moderate the discussion among the Finance Ministers of the Americas and the Caribbean.

**International Monetary Fund**

# Regional Economic Outlook

## Global Context: Disappointing Growth, Ongoing Realignments

The global outlook continues to be shaped by a subdued recovery and weak trade. Specifically, 2016 is turning out to be another year of lackluster growth, extending a series of growth disappointments since the global financial crisis. In the near term, the outlook is being affected by shifting global trends. First, the secular decline in commodity prices seems to have tapered. Going forward, these prices are expected to remain at relatively low levels, following their mild recovery in the recent past. Second, global financial conditions have eased. Capital flows to emerging economies have recovered after a sharp decline in the second half of 2015 — reflecting the partial recovery of commodity prices, expectations of lower interest rates in advanced economies, and a strengthening of financial market sentiment. As a result, currencies of emerging markets, particularly those of commodity exporters, have generally appreciated relative to their lows seen in recent years. Third, the ongoing U.S. recovery is softer than expected six months ago, mainly reflecting weakness in investment and inventories. At the same time, a key downside risk to the growth outlook was in fact realized in June with the Brexit vote, but market reaction has generally been contained, though its longer-term impact remains uncertain at this stage. Looking beyond these shifts, medium-term growth prospects remain mediocre, shaped by ongoing realignments. The most prominent among these include rebalancing in China, continued adjustment of commodity exporters to a persistent decline in their terms of trade, deteriorating demographic trends, and a protracted slowdown in productivity in advanced economies.

Overall, global growth is projected to remain modest at 3.1 percent in 2016—in line with 2015 outcomes and expectations in April—and at 3.4 percent in 2017.[1] While growth outlook for advanced economies has weakened (to 1.8 percent in 2016 and 1.8 percent in 2017), prospects in emerging markets and developing economies are expected to strengthen, albeit very modestly (4.1 percent in 2016 and 4.6 percent in 2017), as a handful economies currently in recession are expected to recover gradually.

Softer-than-expected growth in the United States is an important contributor to the slowdown in advanced economies, with wider implications for LAC. The last quarter of 2015 and the first half of 2016 point to some loss of momentum, despite a mildly supportive fiscal stance and a slower than projected pace of monetary policy normalization. While consumption remained strong on the back of a solid labor market and expanding payrolls, continued weakness in non-residential investment together with a drawdown of inventories weighed on the headline growth number. Even though high frequency data and surveys point to a rebound of activity in the second half of the year, growth projections have been revised to 2.2 percent and 2.5 percent in 2016 and 2017, respectively. Risks are broadly balanced as the

[1] Projections are based on July 2016 World Economic Outlook Update.

upside risk of a stronger rebound of inventories and business fixed investment is offset by the downside risk of heightened uncertainty related to the electoral cycle, weaker than expected trading partner growth, and further dollar appreciation.

With no major signs of price pressures and slow growth, future U.S. rate hikes are expected to be gradual. Short-term fiscal policy is appropriately accommodative. There is, however, a need to boost the economy's productive capacity through investments in infrastructure and education. Policies should focus on alleviating rising income polarization and inequality; immigration reform; further expanding the Earned Income Tax Credit and raising the federal minimum wage; and reforming comprehensively the corporate income tax code. A medium-term consolidation plan is needed to ensure sustainability of public finances, while structural policies should be financed within the envelope of an overall consolidation plan, to ensure fiscal sustainability.

The moderation of growth in the U.S. has been spilling over to its trading partners, including in North America. Canada's economic performance in 2016, for example, has been affected by disappointing export performance due to weaker investment in the United States. While economic activity in the second half of the year is set to rebound, supported by fiscal spending, output growth in 2016 is expected at 1.4 percent, only slightly up from 1.1 percent in 2015. In 2017 real GDP growth is projected to strengthen to 2.1 percent, as monetary and fiscal policy are expected to remain accommodative. The medium-term outlook for the Canadian economy is clouded by uncertainty about oil prices, global demand and the ongoing structural adjustment to lower energy prices.

### Latin America and the Caribbean: Subdued Outlook, Shifting Short-Term Trends

Against this backdrop, the overall outlook for regional economic activity is broadly unchanged relative to six months ago, with subdued medium-term prospects. The region's growth performance, on average, has fallen behind the rate of increase in global activity since 2013—with cumulative GDP growth of zero percent in LAC in contrast to 11 percent in the rest of the world since then—although there is significant variation within the region. As global short-term trends shift, the region's near-term outlook is being shaped by the following factors:

- A weaker-than-expected U.S. recovery has been spilling over to its trading partners (e.g. Mexico and Central America).
- The stabilization and mild recovery of previously declining commodity prices have provided some breathing space for countries facing negative terms-of-trade shocks.
- In light of easing terms-of-trade pressures, expectations of even lower interest rates in advanced economies, and favorable domestic developments in some large LA countries, capital flows to the region have picked up. As a result, financial conditions have improved, with sovereign and corporate spreads declining and equity prices increasing.

- Domestic developments continue to dominate the outlook of some key countries, such as Brazil, Argentina, and Venezuela.

Reflecting shifting near-term trends, most currencies have strengthened somewhat since the second quarter of this year, following large and persistent depreciations in the past few years, particularly for those countries with flexible exchange rate regimes. As expected, this flexibility has helped cushion the impact on external accounts which have worsened less than those of countries with more rigid currency regimes. More recently, current accounts have started to improve, as a result of declines in imports given weak domestic activity and lagged response of exports to the previous sizable depreciations. However, global demand and trade remain weak, thus limiting the boost to non-commodity exports.

In this environment, regional output in LAC is expected to contract by 0.4 percent this year, after contracting slightly in 2015. Growth is expected to rebound to 1.6 percent in 2017, as global demand gradually picks up and domestic policy uncertainties decline. Medium-term projections continue to be subdued, with the region expected to grow somewhat below 3 percent a year.

Downside risks continue to dominate. On the external side, weaker-than-expected U.S. recovery, and global growth and trade—due to various factors including political discord, inward looking policies, stagnation in advanced economies, and ongoing rebalancing in China—could delay export recovery in South America and influence the outlook for Mexico and Central America. Renewed volatility in global financial markets could spill over to domestic financial conditions through higher sovereign and corporate risks, particularly given high leverage (*2016 April WHD Regional Economic Outlook, Chapter 3*). On the domestic side, failure to implement ongoing micro and macro structural and fiscal reforms could weigh on the outlook for some large economies. Renewed concerns about further spread of the Zika virus could affect tourism revenues in the Caribbean. Venezuela is already in a full-fledged economic crisis and if current policies continue, it faces severe risks, including of an even larger collapse of economic activity accompanied by hyperinflation. The already acute shortages of basic goods, especially of food and medicine, could become even tighter, evolving into a humanitarian crisis that could, in turn, trigger a wave of migration to neighboring countries. On the upside, continued implementation of policies addressing various macro and micro imbalances could bolster domestic confidence and demand further.

## Regional Policy Focus

Repeated growth disappointments and downward forecast revisions, including those for the medium term, point to lower potential growth for Latin America. In this context, structural policies, such as closing infrastructure gaps, improving educational outcomes, incentivizing female labor participation, and improving the business environment and the rule of law are needed to support medium-term growth and diversify economies away from commodities. But they will likely take time to bear fruit. In this context, macro policies, in addition to their traditional role of helping close output gaps and responding to shocks (in countries where there is macro policy space), could also address some of the structural shortcomings (e.g., by preserving efficient infrastructure spending) and mitigate the short-

term costs of structural reforms. That said, in the presence of downside risks and uncertainty regarding the new level of potential output, macro buffers and policy credibility should be preserved and rebuilt. Given these guiding principles, macro policy priorities for the region as a whole are as following:

In light of shifting global trends, the exchange rate should remain the main shock absorber, with foreign exchange intervention limited to containing excess volatility in the event of disorderly market conditions.

Appropriate monetary policy stance is determined by price stability considerations, and in many cases the need for a contractionary stance of monetary policy has dissipated with the decline in inflation and inflation expectations and moderating growth prospects:

- For many countries in the region, estimates suggest that neutral rates are now lower than in the past, partly reflecting lower potential growth assessments and the decline in global real and neutral interest rates.

- At the same time, inflation and inflation expectations are coming down from their peaks in most countries. As a result of large and persistent depreciations, average inflation in South America had increased, albeit at a much lower rate than in past episodes owing to a weaker exchange rate pass-through (*April 2016, WHD Regional Outlook*, *Chapter 4*). With the pressures from exchange rates easing and output gaps persisting, inflation and inflation expectations have moderated in most counties. This has led most central banks in the region to keep policy rates unchanged.

- With lower neutral rates, anchored inflation expectations, and inflation rates converging to target ranges, a pause in monetary policy tightening is appropriate for many countries in the region.

- In a few countries with inflation and medium-term inflation expectations above targets (e.g., Argentina and Brazil), a tight monetary policy stance is appropriate to anchor expectations and maintain and build credibility.

Fiscal policy should focus on preserving and rebuilding buffers, given the already high debt levels relative to other emerging markets, structurally lower commodity revenues, and dampened potential growth. The average debt level in the region has increased since 2011 and is expected to increase further. At the same time, overall deficits are still large, relative to the past, and primary balances remain below debt stabilizing levels. With the easing of pressures stemming from declining commodity prices and more favorable global financial conditions, now is the time for strengthening fiscal buffers, while preserving critical capital expenditures and social outlays. The speed of adjustment would differ across countries depending on the current level of debt, the degree and cost of market access, the cyclical position, and the size of fiscal multipliers. A faster pace of adjustment is warranted for countries with large debt burdens and sizable market pressures.

Real credit growth is slowing in most countries (e.g., Brazil, Paraguay, Uruguay), except in a few countries (e.g. Mexico), and non-performing loans are picking up in some (albeit from a low base), highlighting the importance of closely monitoring bank and corporate sector health. To ensure resilience to shocks, adequate macro-financial monitoring is critical, including by identifying linkages across sectors, closing data gaps (e.g., hedging activities by corporations), regularly stress-testing the financial sector, and closely monitoring financial cycles.

**Economic Commission for Latin America and the Caribbean**

## Boosting the Investment Cycle to Reinvigorate Growth

In a context of mounting uncertainty in the world economy and a slump in domestic demand, the region's GDP is projected to contract for the second successive year. According to ECLAC, output is expected to fall by 0.8% in 2016, a larger decline than the 0.5% observed in 2015, resulting in a 2.0% drop in per capita GDP.

As in previous years, growth patterns differed greatly between countries and sub-regions. These growth trends are a reflection of both external and internal factors. ECLAC estimates that Mexico and Central America will grow by 2.6% in 2016 while the economies of the non-Spanish-speaking Caribbean are expected to contract by 0.3% and those of South America to contract by 2.1%. This last sub-region faces an important deterioration in terms of trade and simultaneously weaker external aggregate demand (from China and intraregional partners).

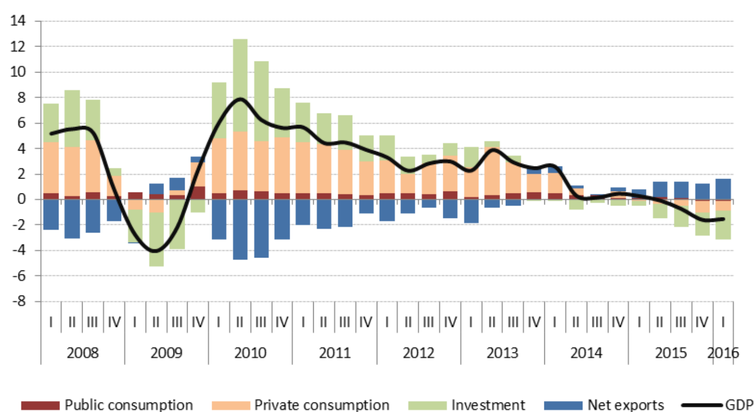
On the internal front, a significant development has been the slowdown in domestic demand, and within the latter, a key component explaining this is the fall in investment.

Although for the region on average the contribution of investment to GDP growth had been negative for the last seven quarters, again there have been different dynamics at the sub-regional level (see Figure 1 (a), (b), (c)).

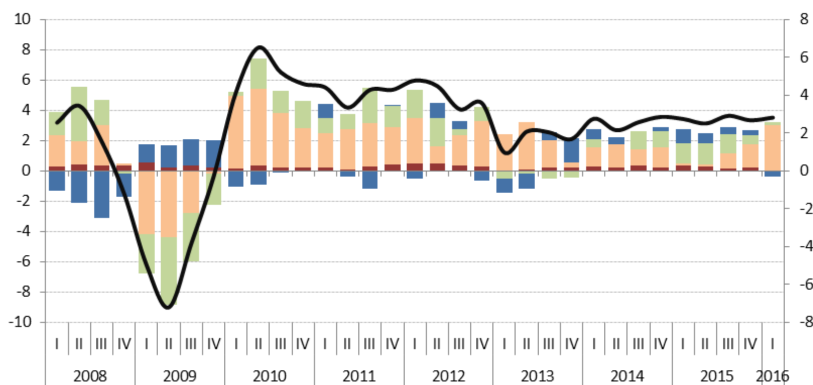
**Figure 1: Latin America: Year-on-Year GDP growth rates and growth contribution of aggregate demand components, 2008-2015**

*(Percentages)*

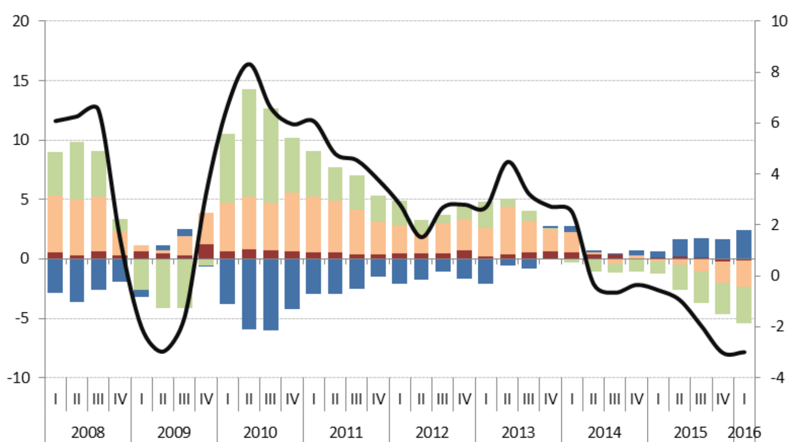
**a) Latin America**



**b) Central America and Mexico**



**c) South America**



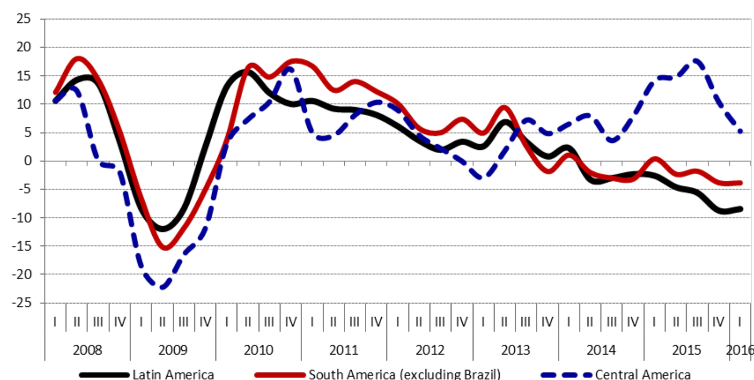
Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures
Note: The non-Spanish-speaking economies of the Caribbean are not included because quarterly information is not available for that subregion.

As Figure 2 shows, on average for the region, gross fixed capital formation has been on a negative growth trend since the second quarter of 2014, thereby accumulating seven quarters of negative growth rates. This poor performance has been due to a contraction in both construction, and in machinery and equipment, but particularly in the latter.

Differences exist at the sub-regional level. In Central America the growth of gross fixed capital formation actually accelerated until the first half of 2015 but experienced a slowdown since the second half of that year, falling into line with the weakening trend in South America.

**Figure 2: Latin America: Year-on-year rates of change in gross fixed capital formation, 2008-2015**

*(Percentages)*




Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.

The falling investment rate and the reduced contribution of gross capital formation to growth are worrying, since they are harmful not only to the business cycle, but also to the capacity and quality of medium- and long-term growth.

For that reason, one of the main challenges for the resumption of growth in the region is to revitalize the process of gross capital formation.

In general, investment is the most volatile component of aggregate demand, and Latin America is no exception to this. However, in the region this component is more volatile than elsewhere in the world, essentially because of the dynamics of the machinery and equipment component, which tends to be associated with productivity. When this component is highly volatile, so too are productivity gains, which consequently cannot be sustained over time. This is one reason for the productivity gap between Latin America and the Caribbean and other regions.

Investment volatility reflects specific characteristics of the region’s business cycle. The data suggest that the dynamic of the region’s investment cycle has been unfavorable to sustained, inclusive medium- and long-term growth.

Analysis of business cycles between 1990 and 2014 shows that the investment cycle is highly synchronized with the GDP cycle. Nonetheless, its contractions are larger and its expansions weaker, investment contracting for almost six (5.8) quarters and GDP for four. In other words, investment downturns are 30% longer on average than GDP downturns. Furthermore, investment contracts by an

average of four times as much as GDP in downturns. Conversely, investment upturns are shorter than GDP upturns, with investment growth outstripping GDP growth by an average of only 60%.[2]

Public investment has contracted particularly sharply, and by more on average, than in other regions of the world. Lastly, during cyclical upswings investment growth has not been enough to make up for the large and protracted declines during the downturns.

Investment behaviour not only affects the speed and rate of capital accumulation, but also has a direct bearing on productivity. The causal relationship between capital accumulation and productivity makes the cyclical characteristics of investment an important determinant of long-run growth capacity.

ECLAC has argued that there exists a need to move towards an inclusive fiscal framework to promote public and private investment.[3] In that way, it is essential to fully assess the importance of fiscal policy for medium-term growth in the economies of the region. This is, in fact, a global discussion: recent estimates of fiscal multipliers have yielded widely varying results, depending on the methodologies used and the structural features of economies, including their degree of openness and terms of trade, and the stage of the economic cycle they are traversing (Auerbach and Gorodnichenko, 2012). The region is no stranger to this discussion. There is ample evidence that the formulation of fiscal rules needs to protect public investment, because of its proven significance in boosting medium-term growth. Or, put the other way around, that cutting investment spending during slowdowns damages economies in the longer run. Using ECLAC data, Riera-Crighton (2015) estimates the cumulative effects on output of changes in public spending for 16 countries of the region. The multipliers are estimated for both current and capital spending, using a panel model with annual data from 1990 to 2014. It is found that the investment spending multiplier is substantially higher than the consumption multiplier. A one-unit rise in investment spending has a short-term impact close to 1, whereas the current spending multiplier is around 0.7. After two years, the current spending and investment multipliers are 1.3 and 2, respectively.

These results show that although public spending in Latin America has a small impact in the short term, its effects are lasting and rise significantly after two years. They also show that spending multipliers have stronger impacts during recessions or slowdowns. In these conditions, countercyclical fiscal policy has a positive impact, whereas procyclical policies have harmful effects on the economy. Unfortunately, the rules now in place in the region are largely along the lines of debt ceilings and limits on balances and spending and afford little importance to investment for inclusive growth.[4]

Also, it has been argued that fiscal rules should protect capital spending.[5] To address macroeconomic volatility in the region, it is extremely important to design efficient countercyclical schemes. For minimizing adjustment costs and boosting expectations of potential growth and future stability, schemes to complement countercyclical policies by protecting (and stimulating) investments during

[2] See ECLAC (2015)
[3] See ECLAC (2015, 2016)
[4] See ECLAC (2016).
[5] See ECLAC (2015).

troughs in the business cycle could be much more effective than fiscal rules based solely on spending or deficit targets.

Fiscal space is typically defined as the resources that are available for a specific purpose without affecting the sustainability of the government's financial position (public debt) or of the economy as a whole.[6] But that static definition does not take into account the dynamic effects that occur in the investment process: it is perfectly possible to safeguard the fiscal space (or maintain solvency) if public capital spending favors growth and thus generates future tax benefits. In other words, well managed public spending can help generate a virtuous circle of sustainable growth. Public investment can thus broaden the fiscal space, since it stimulates growth and thus secures future tax revenues.

Together with protecting public investment, a great challenge is to foster private investment since the latter constitutes the largest part of investment in the region. Private investment plays a key role in the growth and development process and in this sense, the region's experiences in public-private partnerships have shown that one of the main benefits of such partnerships is that they use private resources to finance infrastructure investment without putting pressure on fiscal space.

## References

Auerbach, A.J. and Y. Gorodnichenko (2012), Measuring the output responses to fiscal policy, American Economic Journal: Economic Policy, vol. 4, Nº 2.

ECLAC (Economic Commission for Latin America and the Caribbean) (2014), Fiscal Panorama of Latin America and the Caribbean 2014. (LC/l.3766), Santiago, 2014.

ECLAC (Economic Commission for Latin America and the Caribbean) (2016), Economic Survey of Latin America and the Caribbean 2016: The 2030 Agenda for Sustainable Development and the challenges of financing for development, Santiago.

ECLAC (Economic Commission for Latin America and the Caribbean) (2015), Economic Survey of Latin America and the Caribbean 2015: Challenges in boosting the investment cycle to reinvigorate growth, Santiago.

Riera-Crichton, D. (2015), Fiscal multipliers in Latin America, unpublished.

[6] See ECLAC (2014)

**Inter-American Development Bank**

## Making Sense of Regional Integration: Time to Be Bold

Despite a long history of trial and error and successes and failures, governments across Latin America and the Caribbean (LAC) and across the entire political spectrum continue to profess their commitment to deeper regional integration. To make good on this unwavering commitment and avoid repeating past mistakes, it seems important and opportune for the region to take a step back and try to answer some tough questions. Why exactly should integration still be a priority? What were the lessons of the past half century? What should the agenda ahead be in this much-changed world economy?

As is well known, the region's first formal attempts at integration were pioneered by Central America in the early 1960s, with the Central American Common Market, followed later by the Andean Group, the Caribbean Free Trade Association (which later became CARICOM), and by more ambitious initiatives such as LAFTA (South America plus Mexico), which evolved into ALADI. Undermined by protectionism and political instability, those initiatives never bore any significant economic or institutional fruits, perhaps with the exception of Central America, and slowly fell into oblivion.

The quest for integration started up again in the early 1990s, when the debt crisis and the ensuing market-oriented reforms gave rise to the "new regionalism" — a group of deeper, more comprehensive and more open integration initiatives that led to the consolidation of five subregional trade blocs: the Andean Community, the Central American Common Market (CACM), CARICOM, MERCOSUR, and NAFTA.

Nearly a quarter of a century later, this initial scenario of five trade blocs evolved into a wide and complex network of intra- and extraregional trade agreements that stretch as far as Europe and Asia, covering a wide and varying range of disciplines from trade and investment to labor regulation. The initial agreements themselves went through important changes that arose as a result of internal conflicts, shifting memberships, the emergence of competing initiatives such as the Pacific Alliance (PA), and, in some cases, new commitments towards deeper integration. They have also been joined by new sectoral initiatives focusing on issues such as infrastructure (IIRSA and the Mesoamerica Plan) and finance (MILA), and by new regional institutions with noneconomic objectives such as UNASUR and CELAC.

What lessons can be drawn from these experiences? Has the "new regionalism" met expectations of it? Which institutional architecture delivered the best results? How can the region build on the legacy of these initiatives? These questions need to be addressed if we are to develop an effective policy agenda for the coming decades and generations.

### Why integrate?

This and other related questions can only be effectively answered if there is a clear understanding of the motivation behind this almost secular quest for integration. Even though there are certainly sound and

legitimate political reasons involved, it can be argued that, at its core, integration has always been about improving lives. It has always been about the belief that bigger, integrated markets can deliver more growth opportunities, as firms and individuals can reap the benefits of greater economies of scale and specialization. That much was already clear in one the first integration initiatives put out in the late 1950s, which talked about a Latin American common market.[7]

Thirty years later, these very same expectations of scale and diversification would inspire a new wave of integration initiatives and they still seem to be guiding most of today's prospects. All around the region, integration agreements are still sold on the idea that larger and more competitive markets will make firms more productive on the back of scale and specialization gains, while providing more opportunities for every member to diversify towards goods, services, or tasks with higher value added.

Economic theory all the way back to Adam Smith has broadly supported the importance of these gains, but the devil is in the design and implementation. The motivation behind them might be the same, but not all integration schemes are equal. The range of combinations of types of partnerships (North–South or South–South) and designs (customs unions, free trade zones, or common markets) can produce vastly different results. Likewise, these initiatives do not take place in an economic and political vacuum. If the macro and growth fundamentals are weak, benefits are likely to be minimal. If there is no political consensus on what economic policies to follow, the results are bound to be disastrous. The external environment also matters. An agreement signed in a world economy with few regional blocs is likely to offer a different payoff than an agreement signed in a world heavily populated by regional trade agreements (RTAs), such as the one we see today.

## Results?

LAC's own history with regional integration could not be more illustrative of the difficulties in translating sound motivations into effective designs and implementation. There has been a constant mismatch between aspirations, design, and implementation, which was much reduced with the new regionalism of the 1990s but that continued to play an important role. This was particularly the case with South–South RTAs, whose ambitious economic and institutional expectations were at odds with the size of the markets in question, the similarity of the members' comparative advantages, and their institutional weaknesses, let alone their poor record of implementation.

This is not to deny the important contribution of these agreements to regional integration, with measurable scale and diversification gains as suggested by the substantial increase in LAC intraregional trade, which rose from 14% in the late 1980s to a peak of 20% before the recent financial crisis. The relevant question is whether these gains were enough to substantially raise productivity and alter the

[7] "The progressive establishment of a common market would permit its gradual transformation, with important advantages derived from a more rational productive system that effectively realizes the potential of land, and in which industry, overcoming the narrow limits of the national market, acquires more economical dimensions, and thanks to higher productivity can further enhance its already significant contribution to the standard of living of Latin Americans". *The Latin American Common Market. United Nations. 1959.* Mexico: p.4.

quality of the region's insertion in the world economy. Will they be enough in a world with mega-economies like India and China and with the prospect of mega-agreements such as the Transpacific Partnership (TPP) and the Transatlantic Trade and Investment Partnership (TTIP)? Is it merely a matter of poor design and implementation?

### Time to be bold

This does not seem to be the case. If the region is seeking to significantly boost productivity, improving the design and implementation of the existing spaghetti bowl of agreements would be welcomed, but it would not be nearly enough.

Achieving such productivity gains would require moving beyond the current balkanization into 20 RTAs and 36 preferential agreements. Instead, ironically, we need to go back to the lofty ideals of the 1950s around a LAC free trade zone (LAC-FTZ), but this time designed and implemented to match its ambitions. We are talking about a region with an economy of US$5 trillion, approximately 7% of the global total, with enough critical mass to give firms a significant boost in productivity.

This new initiative would have to go beyond eliminating tariffs and nontariff barriers and address the historical deficit in infrastructure and the more obscure hurdles in trade facilitation. It would have to consider developing a common regulatory framework to facilitate the movement of capital and people, if the full potential of integration is to be exploited.

Finally, it would have to be developed hand-in-hand with extraregional agreements for at least two basic reasons: first, although these entail more risks, their scale and diversification gains cannot be matched, and second, it can be rather costly to be left outside of the current wave of mega, transcontinental agreements.

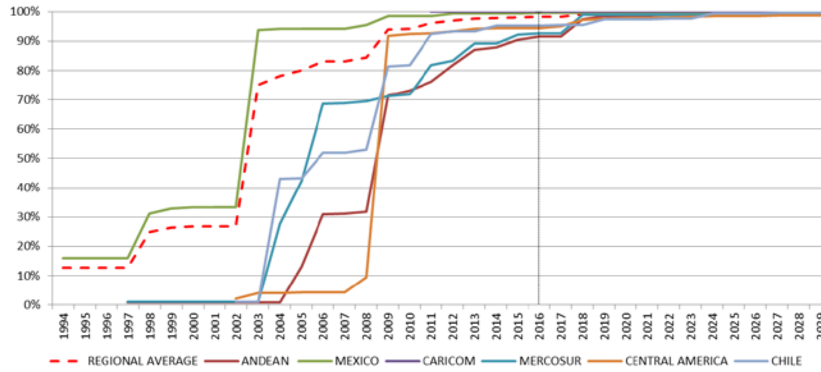
Given the region's history with regional bureaucracies and institutionally intensive agreements, not to mention its current strict fiscal constraints, this initiative should be based on lean, low-cost institutional architecture, similar to recent experiences such as the Pacific Alliance (PA). There is no reason why this challenge cannot be met by a LAC commission made up of ministers or senior-level officials who would oversee the implementation and operation of the agreement and guide its future evolution.

### Bold but not unrealistic

Is the agenda of a LAC-FTZ unrealistic? It is much less daunting than it appears. A close look at the existing spaghetti bowl shows that the region is not actually that far from achieving free trade. Approximately 80% of intraregional trade is already covered by RTAs, and trade within these RTAs will be 95% to 100% duty free by 2020 (Figure 1). For all practical purposes, there are just two significant missing links in the web of free intraregional trade in LAC: MERCOSUR and Mexico, and the Caribbean with most of the region (Figure 2).

**Figure 1: Tariff reduction schedule of LAC RTAs**

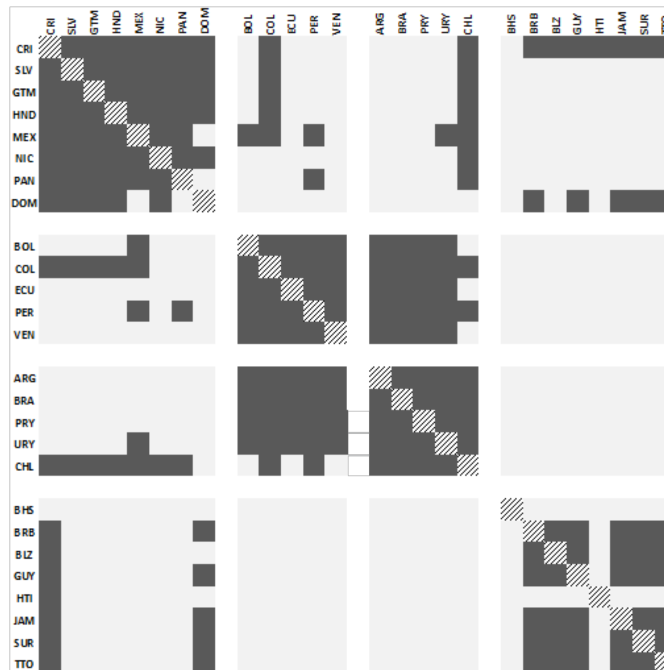
(% of negotiated regional trade, 2014)




Source: IDB/INT calculations

**Figure 2: Coverage of LAC RTAs**

(darker cells represent agreements in force, 2015)




Source: IDB/INT

Yes, there might still be some political resistance in a few countries, but recent developments in the region, particularly in the Southern Cone, suggest that the political pendulum is swinging towards a more pro–free trade stance, which might offer an historic opportunity to make economic sense of decades of balkanization. Moreover, once a common framework of eliminating remaining tariffs and harmonizing rules of origin is put in place, the costs of remaining outside will be perceived as extremely high. In any event, the framework could be flexible enough for countries to accede at the time of their choosing.

Harmonization and enlargement can also be seen as setting the stage for a more ambitious, hemispheric project, which could bring the US and Canada into the arrangement. A LAC-FTZ, with a common set of rules of origin that allows for accumulation and whose institutional architecture is simple and streamlined would certainly increase the appeal and greatly facilitate hemispheric negotiations, if and when political conditions are ripe.[8]

Overall, the message should be clear. If the main motivation of regional integration is to boost the quality and depth of LAC's position in the world economy, and if the economic history of last 50 years is any indication, the current balkanization is unlikely to deliver significant results. Instead, it is time to be bold.

## References

Estevadeordal, A., P. Giordano, and B. Ramos (2014) "Trade and Economic Integration" in Domínguez, J. and A. Covarrubias. Routledge Handbook of Latin America in the World, New York and London: Routledge.

Estevadeordal, A. and K. Suominen (2009) "Bridging Regional Trade Agreements in the Americas," Washington, DC: Inter-American Development Bank.

Estevadeordal, A., and E. Talvi (2016) "Towards a New Trans-American Partnership," Brookings Global Policy Brief, Washington, DC: Brookings Institution, 2016.

[8] See Estevadeordal, A., and E. Talvi, 2016. *Towards a New Trans-American Partnership, Brookings Global Policy Brief.* Washington, DC: Brookings Institution.

**World Bank Group**

# Toward a Renewal of Open Regionalism*

Few doubt that a deeper and more robust integration into international markets is crucial for Latin America and the Caribbean (LAC) to succeed in lifting its long-term growth rate. Paradoxically, just as the region's citizens and policy makers appear ready to embrace outwardly-oriented growth strategies, the world is not helping. The current sluggishness of global trade may be prolonged, and anti-globalization attitudes have been stiffening in advanced economies. Given these global circumstances, regional integration has moved to the forefront of the policy debate in LAC, as it seems to offer a viable intermediate solution—if politics in the G7 are unsupportive of open international markets, LAC could respond by emphasizing greater integration within regional markets.

Whether such a response will deliver the expected growth dividends is not obvious, however. It will depend on the underlying vision of regional integration and the extent and quality of complementary domestic ("behind-the-borders") policies and reforms. The chances of success will certainly improve if LAC avoids the key mistake of "old regionalism," namely, pursuing inward-looking regional integration at the expense of, or as a substitute to, global integration. While remnants of that approach are still present in some of LAC's sub-regional trade arrangements, there is a growing consensus that it is a misguided approach, one that leads to uncompetitive, inefficient firms. Sustained efforts will be needed to push toward an intelligent renewal of "open regionalism" (OR), whereby an improved and more integrated LAC decidedly promotes deeper integration with the world, and vice versa. This is the core message of the forthcoming annual report of the World Bank's Chief Economist Office for LAC. The rest of this note summarizes a few of its main arguments and results.

## The Case for Open Regionalism

Economic theory has long highlighted that the gains from trade depend on the characteristics of trading partners. For example, the gains predicted by neo-classical models are greatest when trade occurs between structurally different economies that specialize in products related to their respective comparative advantages. Learning models suggest that dynamic gains from trade (i.e., gains that raise the country's production possibilities over time) are largest when a less developed country trades with knowledge hubs or countries with numerous and deep global connections. This line of reasoning clearly militates in favor of global, rather than regional integration, as LAC economies appear to have similar trade structures, do not have as many trade connections with the world as other regions, and invest little in R&D.

Why, then, pursue an OR agenda? The short answer is that there are important complementarities between regional and global integration. First, trade structures across the region are not as similar as

* This policy note is based on the forthcoming study *Better Neighbors*: *Toward a Renewal of Economic Integration in Latin America.*

the simple averages suggest. In particular, South America's net exports are quite different from those of Central and North American countries, which indicates that greater integration between these sub-regions could yield additional efficiency gains that could not be had by focusing only on sub-regional integration. Second, even where trading patterns are similar, there is significant scope to harness the benefits of spatial proximity. In particular, since the flows of goods, services, labor and capital are geographically clustered, as is economic performance more generally, neighboring economies have to strive to make the best of their neighborhood.

The starkest case in favor of regionalism as a vehicle for enhancing global competitiveness concerns "regionally traded goods and services." These face such high trade costs that they are typically only exchanged between neighboring economies. By enhancing the scope for trading in these goods and services, regional integration can reap benefits equivalent to the gains from global integration. Notable examples are electricity and land transportation, which are key inputs in other economic activities. Thus, efforts to assure the efficient provision of these types of goods and services across adjacent borders can be crucial for the region's ability to improve international competitiveness.

Similar arguments can be made about labor markets. Migration decisions are shaped by the costs faced by workers to move and successfully adapt to the host country. These costs arguably increase with distance, spatial and cultural. Geographic proximity, coupled with cultural affinities among neighboring countries, facilitates growth-promoting flows of labor, particularly where skill complementarities abound. Additionally, new evidence that documents significant persistence in wage differentials between countries in LAC further suggests that there is scope for achieving region-wide efficiency improvements by enhancing intra-regional labor mobility.

The geographic clustering of trade also implies that economies can seize learning opportunities from nearby countries. The strength with which these channels affect a country's growth, however, is greater the higher the degree of global economic integration of its neighbors. In addition, a country's likelihood to enter into and survive in third markets is enhanced when its trading partners already export to those markets.

## Toward a Renewal of Open Regionalism

Since the 1990s, with varying timing and intensities, LAC has been pursuing a global integration agenda. Consistent with the notion of OR, this was typically done through a combination of unilateral trade liberalization and free trade agreements, especially with neighboring countries. The early momentum from the 1990s, however, has slowed in some countries and stalled in others. Moreover, insufficient attention has been given to reform efforts that seek to lower non-tariff barriers to trade and to integrate Latin American factor markets. The potential complementarities between regional and global integration have also been commonly overlooked. The rest of this note illustrates the current state of OR in LAC and what could be done going forward in the five areas that constitute the proposed renewal.

*1. Tariff Liberalization: An Unfinished Agenda*

Most favored nation (MFN) tariffs fell significantly in most LAC countries in the 1990s, and continued to fall well into the 2000s in many Central American countries, Mexico, and in some South American countries such as Colombia, Chile, and Peru. In other South American countries, reductions in MFN tariffs stalled. Further reductions in MFN tariffs would result in a more collectively open LAC, which, as mentioned, can facilitate entry into global export markets for countries in the region, especially to the extent that they can learn from the experiences of their regional partners.

Even countries with relatively low MFN tariffs display noticeable tariff binding “overhang,” whereby the tariff levels to which a country is committed under the WTO are higher than applied MFN rates. Tariff binding “overhang” introduces uncertainty in trade relationships as governments have the option to raise import tariffs without risking WTO-sanctioned retaliation. Reducing this overhang can stimulate local economic activity and attract foreign investment.

*2. Enhancing Global Integration of the Americas through Regional Preferences*

There are clear divisions within the region in terms of tariff preferences. For example, the group of countries comprised by Bolivia, Ecuador, and the members of Mercosur, provide each other with fairly universal coverage of bilateral tariff preferences, but similar preferences are typically not granted to other countries outside the group. These are also countries with relatively high MFN tariff. By contrast, the group comprising Chile, Colombia, Peru, Mexico, and Central American and Caribbean countries, typically grants tariff preferences to high income countries and has either low MFN tariffs, tariff preferences to a large number of countries in LAC, or both. Hence there is scope for additional preferential trade agreements (PTAs), especially between countries in South America and those in Central and North America, because their notably different patterns of net exports imply that PTAs between these countries could bring additional gains from trade.

There also seems to be unexploited efficiency gains available via PTAs with high income countries (especially the U.S. or the EU). Pursuing these agreements can give countries in LAC access to economies with different economic structures, which can result in efficiency gains from trade specialization as well as dynamic gains from increased transfers of knowledge by deepening ties with knowledge hubs. PTAs with high-income countries can also facilitate further reductions in extra-regional tariffs. Indeed, the trends since the 2000s suggest that continued reductions in external tariffs in LAC seem to be associated with having reached preferential trading agreements with high-income countries.

*3. Harmonizing Regulatory Frameworks in LAC to Achieve Global Competitiveness*

Non-tariff impediments to trade are increasingly recognized as barriers to integration around the world. One example of these impediments are rules of origin requirements (RoOs) established by existing PTAs. RoOs can impose hefty administrative and compliance costs to exporting firms, costs that are aggravated by the fact that there is a growing number of PTAs and each of them establishes its own RoOs. Hence, efforts to harmonize and allow for RoOs with full accumulation can help LAC attain higher

dividends from its existing PTAs. RoOs with full accumulation are such that they allow products of one country of a PTA to be further processed or added to products of other countries in the PTA as if they had been produced in the latter. Thus, they allow firms to use materials from other countries without losing preferential access.

Another example of non-tariff impediments to trade are differences in regulatory frameworks, some of which are particularly problematic for the exchange of regionally traded goods and services. In the specific case of electricity, while important steps towards an integrated energy grid have been taken, especially in Central America and Mexico, countries in the region have been unable to fully capitalize on these efforts partly because of conflicting regulatory standards.

*4. Reducing Distance Costs*

In addition to policy obstacles, LAC faces barriers to integration related to the region's relatively high costs associated with geographic distance. In effect, measures based on gravity models suggest that trade in LAC is more sensitive to distance than in other regions.

One reason behind this may be the poor quality of the region's infrastructure, a key factor known to drive up trade costs. This argument is supported by data on the quality of land transport. For example, while the share of unpaved roads in LAC is around 70%, it is less than 50% in the South Asia region and less than 30% in East Asia and the Pacific. Arguably, LAC needs even better road transport infrastructure than other regions, given its challenging geography.

A second reason for LAC's higher trade costs is the region's comparatively weaker position in the global network of maritime and air transport. Unfortunately, LAC is largely connected to these networks via branch lines (as opposed to main lines between hubs), putting it at a disadvantage when it comes to international integration. This is partly the result of LAC ranking poorly in port efficiency. There is thus much scope for LAC to improve its position in the global system through investments that seek to improve the efficiency and infrastructure of the region's ports.

*5. Factor Market Integration*

Aside from trade integration, evidence shows that there could be substantial efficiency gains through better integration of labor and capital markets. Some regional agreements in LAC have taken notice of the potential benefits of pursuing policies to integrate factor markets, namely labor and capital markets. Nonetheless, even in these cases the emphasis on trade preferences overshadowed the emphasis on factor market integration. The rest of the discussion highlights the potential benefits from bringing factor market integration to the forefront of a renewed OR strategy.

Labor market integration allows workers to flow from low productivity sectors to high productivity sectors, thus allowing for the realization of aggregate efficiency gains. In the case of LAC, there are large and persistent wage differentials between workers of similar characteristics across countries. This could be interpreted as persistent differences in productivity across LAC and therefore implies that there is scope for improving region-wide efficiency through migration.

There is also scope for greater mobility of capital (especially risk capital) across the region. This is particularly important considering the evidence that knowledge diffusion appears to decay with distance, which thus puts limits on the positive spillovers from FDI from faraway economies. As with trade, the direct growth dividends from intra-LAC capital flows can be boosted to the extent that LAC firms invest more in innovation and improve managerial practices.

Investment agreements can also yield collective efficiency gains through other channels, and, if enacted jointly, can magnify the benefits from global capital integration. For example, the Pacific Alliance's Latin American Integrated Market (MILA, according to its Spanish acronym) provides a unified set of norms and reduces transaction costs for regional and global investment. Similarly, regional agreements can facilitate coordination in the provision of incentives to foreign capital among countries in the region and avoid a race to the bottom whereby countries sacrifice revenue as they compete for FDI. As a result, such coordination has the potential to maximize the positive impact of foreign capital across the region. The bottom line is that initiatives such as MILA should be seen as efforts to improve the collective investment climate.

The time is ripe to bring LAC's open regionalism back onto center stage. The challenge lies in designing an agenda that is conducive to region-wide efficiency gains by exploiting the complementarities between regional and global integration. Importantly, the ambitious agenda presented in this note should not be seen as a substitute to domestic reforms. On the contrary, the extent to which the region as a whole can reap the benefits of OR is likely intertwined with the strength of each country's individual reform agenda. After all, evidence suggests that successful global integration is hard to achieve without building a strong neighborhood.

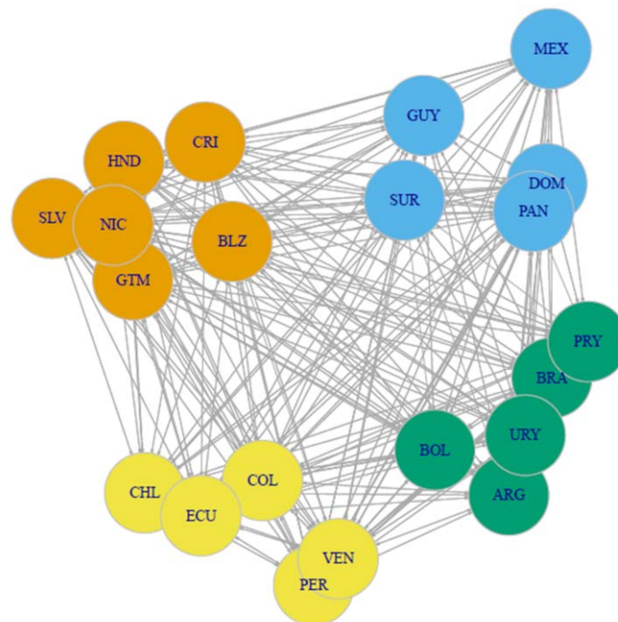
**International Monetary Fund**

## Trade Integration

Trade integration within LAC could become an engine of growth for the region, helping offset the weaker economic outlook. The downturn in commodity prices and weaker external demand, particularly from emerging markets, have dampened growth prospects in the region. Nonetheless, LAC can improve its outlook by integrating within the region as well as outside the region, by further reducing tariffs, including on capital goods, and non-tariff barriers. Past trade agreements have been highly successful in raising trade, and the new generation of agreements, such as the TPP, focus on an array of complementary trade issues. Domestic policies, such as improving infrastructure and skills, are also critical for effective integration into regional and global value chains and for upgrading the complexity of exports.

Latin America lacks a dominant trading hub, as regional trade is clustered around partnerships and neighboring countries. With only about a quarter of total exports destined to markets within the region, LAC lags behind Emerging Asia and Europe, where intra-regional destinations account for over two thirds of exports. Outside the region, the United States is the top export destination for most countries in the region, while China became the most important export partner for some countries in recent years. In addition, there is no clear trading hub in LAC comparable to China in Asia or Germany in Europe. In fact, trade activity remains segmented and clustered broadly in line with the main sub-regional trade agreements (Mercosur, Andean Community, Central America, etc.).

**Figure 1: Regional trade clusters within LAC**




Source: Direction of Trade Statistics and Fund staff calculations

Although LAC's trade openness remains lower than in other regions, there are stark differences among groups of countries within the region. The large economies of South America tend to be much less open to trade than the countries in Central America and the Caribbean. In addition, while LAC's intensity of trade flows is limited compared to Emerging Asia and Europe, the region is above average in its diversity of trade partners.

Promotion of participation in global production and value chains can boost investment and trade, which have been highly intertwined in the LAC region. In fact, the association between FDI flows and trade has been particularly close for the LAC region in the "boom" years over the past decade and a half. In addition, recent findings indicate that economies with higher presence of FDI tend to have higher levels of participation in global production chains. As global trade trends become increasingly shaped by cross-country fragmentation of the production processes, vertical FDI undertaken by multinational firms is expected to gain further prominence.

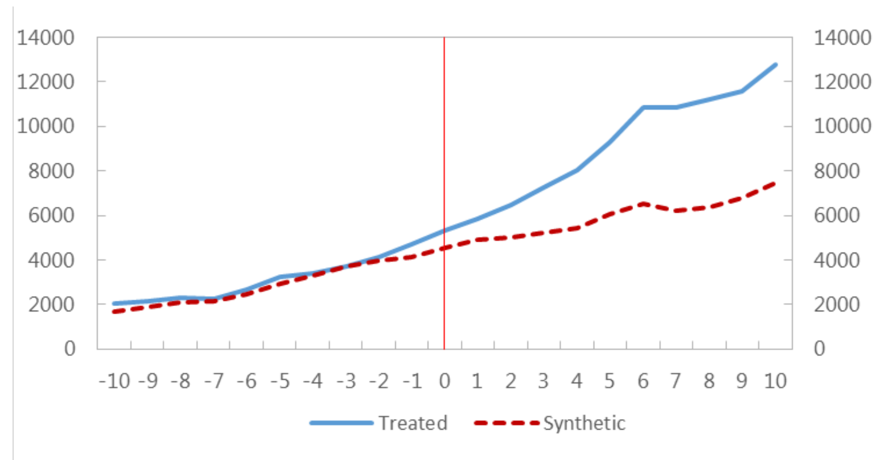
Responses to an IMF survey indicate that the largest number of country authorities in LAC see intra-LAC trade initiatives as most important, followed by agreements with advanced economies, fast-growing emerging markets and TPP. Authorities in TPP members from LAC underlined numerous benefits, including better access to new markets, elimination of non-tariff barriers, and opportunities for higher FDI. On the other hand, non-members are concerned about the likely trade diversion and erosion of preferences in the US markets (textiles and footwear). However, non-members also emphasize that the TPP has set new benchmarks for future trade agreements and has raised the incentives to do more trade deals, with some of them showing interest to join the agreement once it is ratified.

The TPP will likely have a positive impact for members from LAC, while the adverse impact on LAC non-members will likely be negligible. Findings based on computational general equilibrium models imply that gains for TPP-members arise mainly from reduction in non-tariff barriers, while the adverse effects due to trade diversion away from non-members in LAC appear to be insignificant. In addition, the estimates suggest that non-members from LAC would benefit from eventually joining the TPP, mainly as a result of the expected reduction in non-tariff barriers.

History shows that trade agreements are likely to generate a substantial increase in exports. Recent studies that focus on the ex-post impact of LAC's trade agreements indicate that they can generate substantial gains, with an average increase in exports of 80 percent over ten years (these estimates are also similar to the estimated effect of NAFTA on export growth). These benefits are found to be especially important for emerging markets, and for trade agreements between emerging markets and advanced economies.

**Figure 2: Impact of trade agreements in Latin America**

Average exports (USD million)



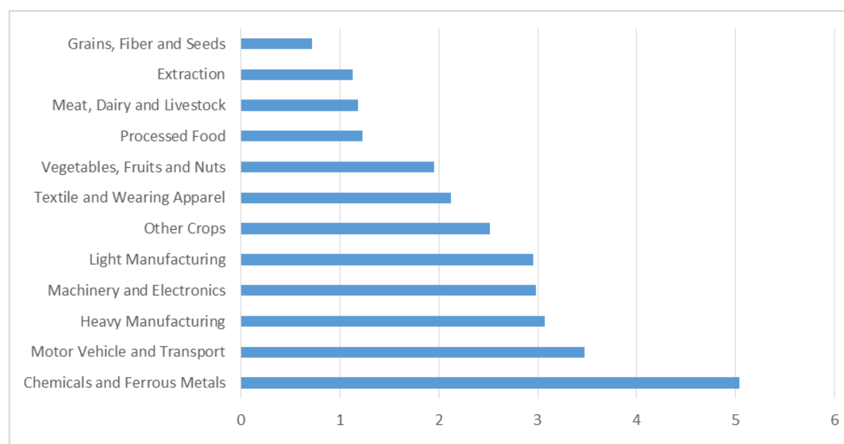

Source: UN Comtrade data and Fund staff calculations

Trade agreements can lead to lower tariffs, especially on capital goods, which can stimulate domestic investment—an essential component of the trade-growth nexus. Imports of capital goods, such as machinery and transport equipment, represent key inputs for investment, and this relationship has been empirically documented for various cases in Latin America. A comparison with other regions in the world suggests that many countries in LAC still have room to lower tariffs on capital goods imports and facilitate imports of investment inputs. Such measures, in turn, can help reduce the cost of investment and help boost economic growth.

Besides broader reliance on trade agreements, an upgrade of LAC's transportation infrastructure could especially stimulate exports from industries with potentially high value added such as chemicals, motor vehicles, and heavy manufacturing. In their responses to the IMF survey, country authorities placed the weakness of infrastructure as a key constraint to increasing exports, ahead of non-tariff barriers, lack of human capital, and high production costs. Indeed, the logistics performance index (LPI) indicates that LAC lags behind most other regions in the world, with the exception of Sub-Saharan Africa and South Asia. An upgrade in LAC's transportation infrastructure to the level of the next highest region (MENA) is estimated to result in significant export growth. Moreover, the positive effect is concentrated exactly in industries that can become future leaders in generating high value-added for countries in LAC, such as chemicals, motor vehicles, and heavy manufacturing. In sum, policy focus on high-quality infrastructure is particularly important for countries that aspire to diversify and move up the value ladder, as timely delivery is more important for processed goods and manufactures than for primary commodities.

**Figure 3: Effect of Infrastructure Improvement on exports**

Percentage change in export volume

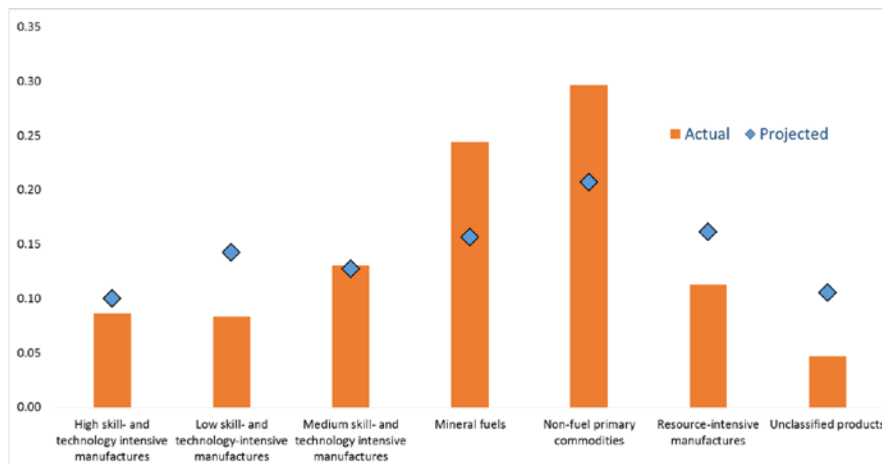



Source: World Bank Logistics Performance Index and Fund staff calculations
Note: The results show the effect of a 7.9% increase in the LPI of Latin America, which increases its level of infrastructure to that of MENA.

The commodity boom in the 2000s interrupted LAC's significant progress in increasing its share of complex and technologically-advanced exports. The LAC region has traditionally enjoyed revealed comparative advantage in mineral fuels and primary commodities, but lagged significantly behind other regions on skill- and technology-intensive manufactures. Over the last half a century, the region has slowly diversified into new industries, steadily improved its revealed comparative advantage in skill- and technology-intensive manufactures, and increased the share of more complex products in the export portfolios. However, the commodity boom in the 2000s interrupted and even reversed somewhat this trend, implying a larger share for less complex, primary products. In fact, this development stands in sharp contrast with Emerging Asia, where the progress continued without major interruption.

LAC can take advantage of its current areas of comparative advantage to diversify and gain competitiveness in related industries. The growing literature on economic complexity and product proximity suggests that the ability of a country to produce a certain product depends on how similar or close it is to the country's current production set. Based on its current export basket and the proximity between corresponding product groups, LAC is likely to export less mineral fuels and primary commodities, and export more resource-intensive, low- and high-skill manufactures in the future.

**Figure 4: Actual and "projected" areas of comparative advantage**




Source: UN Comtrade data and Fund staff calculations

Successful diversification into more complex and skill-intensive exports is likely to be a gradual, incremental process that critically depends on adequate policies to upgrade skills and infrastructure. Episodes of effective diversification into new products (including in Emerging Asia) were not sudden and abrupt events, but rather proceeded gradually through intermediate stages that involved products fairly close to the existing production set. In fact, the composition of LAC's export portfolio in the late 1980 has correctly predicted the change in all categories of exports except for high-skill ones, where comparative advantage decreased instead of increasing. While this finding reflects the lack of necessary skills, technology and adequate infrastructure that prevented LAC to capture its opportunity to move up the next ladder, it also emphasizes the urgent need for policy actions to make progress in several areas. These would include education, especially to focus on improving student achievement scores (beyond higher enrollment rates that were targets in the past), strengthen secondary school curriculum with technical subjects/skills, increase opportunities for trainings and internships. Another key area is to focus on high quality public investment in infrastructure, particularly in roads and energy (as mentioned in the survey results this was also emphasized as a key constraint by the authorities).

**International Monetary Fund**

## Financial Integration

Supported by strong economic growth and stable macroeconomic policies, Latin America's financial markets have developed a great deal in the past twenty years, in part through greater integration with financial centers in the United States and Europe. However, they remain characterized by less integration across countries within the region than is found in other emerging market regions, such as ASEAN. With the region facing a structural deceleration in investment following the end of the commodity super-cycle, there is a need to identify new engines of growth.

In a recent report,[9] we argue that Latin America stands to reap a modest but still important growth dividend by promoting greater regional financial integration. Overall, by expanding possible financing options and vehicles for savings in a country, financial integration can enhance financial development, which in turn has been linked to higher economic growth. Better financial integration within the LAC region can confer several benefits:

Cross-border financial activity (bank and nonbank) both follows and can be followed by cross-border trade and thus could help foster wider regional economic integration. A larger common market creates new growth opportunities, which may be influential in Latin America in a context of lower commodity prices and tighter global financial conditions.

Regional banks (robustly supervised with sufficient high-quality capital to support their cross-border operations) may be able to provide expertise particularly suited to the host country, such as in the area of improving financial inclusion. The homogeneous importance of commodity exports across the region is also fertile ground for transplanting expertise in trade and industrial credit.

Regional banks can fill the hole left by retrenching global banks. Since the global financial crisis, financial pressures and increased regulatory oversight have led some global institutions to reduce their cross-border activities and pull back into their core markets. Responding to the withdrawal of these banks, regional activity has been growing rapidly in a number of emerging markets, particularly in Asia and emerging Europe. This trend has so far been less pronounced in much of Latin America, although global banks continue to downsize and withdraw. Regional integration could help avoid increased consolidation of domestic financial sector activity and mitigate a possible credit squeeze if North American and Spanish banks were to continue reducing their presence in the region. Although this strategy could lead to the emergence of large regional banks and bring the risk of concentration at a regional level, it would nonetheless foster greater competition and diversification of risks within domestic markets.

[9] International Monetary Fund, 2016, "Financial Integration in Latin America," IMF Policy Paper, Washington, D.C.

Regional integration can also alleviate the pressure on domestic markets arising from the significant growth of the nonbank financial sector (particularly pension funds) in Latin American countries in recent years. Current regulations governing pension fund investments in Latin American countries compel the funds to invest the vast majority of their portfolios in domestic assets. Given the relatively small size of many Latin American financial markets, the investment options available to these pension funds are severely limited, and most end up overweighted in domestic government securities. Although the motivation behind these investment restrictions is the preservation of savings and financial stability, the development of domestic financial markets in most Latin American countries has not kept up with the growth of their pension funds, and the restrictions may paradoxically lead to the creation of bubbles and instability. If regional integration—through the harmonization of regulations and more coordinated supervision—were to widen pension funds' permissible investment options to include other countries in the region, this could be a solution.

Almost all Latin American countries currently face the urgent need to improve their physical infrastructure. However, upgrades to logistics and transport infrastructure typically require sizable investments, necessitating deep and well-developed financial markets. While pension funds in some Latin American countries have invested in domestic infrastructure projects, the caps on their permissible investments in such projects are dwarfed by the size of the projects. Thus, given the absence of deep domestic markets, the need for economies of scale is yet another reason to carefully assess the possibility of advancing regional financial integration in Latin America. Investment vehicles could then be established at a regional level to pool resources for infrastructure projects around the region.

In our report, we document a series of actionable areas that have constrained regional financial integration in Latin America. Overall, leveling the playing field for domestic and cross-border financial institutions will be key. Specifically, regional integration would be facilitated by the following measures:

- The harmonization of accounting and regulatory practices across countries, with a view towards convergence with international best practices;
- Developing stable and transparent tax rules for domestic and cross-border financial activities, and establishing arrangements to avoid double taxation;
- The coordination and consolidation of supervision would also pave the way for "passporting" of financial services across the region;
- Developing an explicit, open, objective and non-discriminatory statutory and regulatory framework for entry of cross-border financial institutions;
- Enhancing consolidated supervision of all banking groups, and expanding the supervisory and resolution colleges to cover all regional banks with significant cross-border activity;
- Exploring prospects for revitalizing regional currency settlement;

- Harmonizing legal frameworks for bank resolution and restructuring, as well as non-bank insolvency regimes to bring them in line with international best practice;

- Considering the relaxation of exchange controls by those countries that maintain these controls in a timely and sequenced manner, taking into account other macroeconomic and financial sector prudential policies. This could include permitting individuals to hold foreign exchange accounts abroad.

Existing political agreements such as the Pacific Alliance and Mercosur offer natural springboards for promoting closer regional integration of financial markets, and some have started doing so. The diversity of the productive structures of their memberships makes them well-suited to risk diversification. The political desire to push forward exists in many countries; and importantly, the technical case for doing so is strong.

- *The Pacific Alliance* (Chile, Colombia, Mexico, and Peru) could foster integration by permitting a higher tranche for investment into other member countries, and by allowing cross-border investments within the Alliance to be counted as domestic, once appropriate supervisory arrangements have been put in place. Strength could be drawn through the creation of technical secretariats tasked with preparing and disseminating a framework for promoting financial integration. The Market Integration in Latin America (MILA) is a welcome initiative, but has seen limited take-up so far. It could be kick-started by expanding its reach to sovereign and corporate bonds, and by "passporting" broker-dealers in MILA countries, while ensuring that they are subject to regulatory oversight in both home and host countries. Coordinated supervision among member countries could also be facilitated by encouraging the bilateral exchange of technical staff and through secondments to the proposed secretariat. Members could also examine the potential for expanding the geographic scope of the agreement.

- *In Mercosur* (Argentina, Brazil, Paraguay, Uruguay, and Venezuela), there is a need to establish a comprehensive financial integration agenda by providing impulse for a revival of the financial Mercosur integration project. In Brazil, the region's largest financial market should ease its restrictions on cross-border activities. Existing limitations have indirectly promoted the use of offshore entities to circumvent regulations, and these practices are coming under increasing public scrutiny. Reforming the bond market by allowing foreign bonds to be sold onshore, and by removing the need for separate legislation for each sovereign issuance, would reduce fragmentation and promote market development. Authorities could publically welcome the recent expansion of Brazilian financial institutions into other regional markets.

**Mitigating risks**

- *Regional spillovers*. As with other shifts towards greater integration, benefits also come with increases in certain risks, as shocks to one country could more readily propagate to others. Mitigating these risks will require a heightened focus on consolidated supervision of financial institutions and conglomerates, as well as coordination among supervisors across national

boundaries. Our estimates show that current financial spillover risks within Latin America are limited, suggesting that there is scope to increase these modestly.

- *Central counterparties* are widely seen as potential carriers of systemic risk, and countries in Latin America should assess the compliance of their regulatory frameworks through peer reviews across the region using the CPSS-IOSCO Principles for Financial Market Infrastructure methodology.

A regional integration agenda should not be viewed as a substitute for strengthening ties to global financial markets. Indeed, creating a vibrant and integrated Latin American financial system is likely to make the region more attractive to large global financial firms by providing a larger market with homogenized regulations. In this spirit, it will be important for Latin American countries to comply with international efforts to intensify anti-money laundering and the combat of terrorism financing (AML/CFT) by adopting the Financial Action Task Force standards.

**CAF – Development Bank of Latin America**

## Physical Integration and Infrastructure Investment

The tailwinds that propelled economic growth in LAC in the past decade are no longer there. The region is undergoing a prolonged economic slowdown, with mounting evidence that points to the deterioration of productivity and potential output growth in most LAC countries. This confronts many Latin American economies with the task of finding new drivers of productivity to boost long-term growth and employment to avoid further undermining of the social gains achieved in the last decade. Regional integration could be one of such drivers. Regional integration could enlarge productivity gains by taking advantage of economies of scale which could spur efforts at innovation and product specialization. Moreover, these initiatives could serve as platforms to facilitate the region's access to global markets; participation in global value chains; and attract more foreign direct investment. This is the idea behind open regionalism: strengthening regional integration without compromising the relationships with the rest of the world (Kuwayama, 1999). Integration could thus be a driver of a much needed reallocation of resources from low productivity firms and sectors to the more dynamic enterprises that seize the opportunities of access to larger markets, both regionally and globally.

Regional integration efforts are not new in the region. Several initiatives were launched over the last decades. For instance, the Andean Community (ANCOM), created in 1969, promotes the development of member countries through integration and economic and social cooperation, fostering sub-regional solidarity, forming a Latin American common market and reducing external vulnerability. Mercosur, established in 1991, pursued the creation of a common market with free movement of goods, services and productive factors. More recently, the Pacific Alliance was incepted in 2011 to foster integration among member countries by reducing trade barriers, create a common stock exchange, and eventually establish joint diplomatic missions and allow visa-free travel.

But these efforts have borne little fruit in terms of changing trade patterns in Latin America or advance toward a single regional market. Intraregional trade as a share of total trade is merely 19.2% in Latin America compared to 50% in Asia, 59.1% in the European Union, and 59.6% in NAFTA (Cepal, 2014). Only Africa stands lower, with at most 12% of intraregional trade (Woolfrey, 2012)). During the last decade, China gained ground as a destination of Latin American exports, particularly commodities, reinforcing the weak pattern of intraregional trade. For example, intraregional trade in Mercosur went down to 16% in 2014, the lowest level observed since 2006. Trade among the Pacific Alliance members is also quite low, representing 4% of overall trade. CARICOM fares no better with a mere 12% of total trade destined to CARICOM countries. However, Latin American countries are recipients of 41% of CARICOM's trade (SELA, 2015).

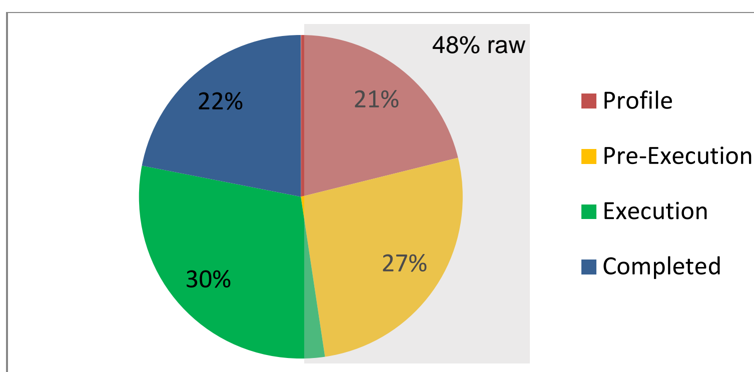
Several factors explain these poor results. First, in some cases liberalization measures were not fully implemented. For example, Mercosur maintained many exceptions to the intra-bloc tariff liberalization. Second, there are various nontariff barriers such as phyto-sanitary and regulatory technical standards,

plus a myriad of inconsistent rules of origin that have undermined commerce within the free trade areas.[10]

Another factor that has been emphasized and documented in recent years is the high transport and logistics costs that merchandise trade is subject to (Moreira, Volpe and Blyde, 2008; BID, 2013). Reducing these costs is essential to promote trade in the region. Logistics deficiencies materialize in freight costs that are almost as high for intra-regional exports as for extra-regional exports. Specifically, exporting to the United States is significantly cheaper than exporting to Latin American countries. Regional trade is hindered by poor transport, communications, and energy infrastructure even between neighboring countries. This is aggravated by logistics deficiencies, particularly in customs procedures. In Latin America, 57% of exports are perishable or logistics-intensive, compared to 17% in OECD countries. Improving logistics services could improve labor productivity in the region by 35% (OECD, CAF, ECLAC, 2014).

A big push in infrastructure investment is crucial to improve physical integration among countries in the region. An important initiative launched for this purpose is the Initiative for the Integration of Regional Infrastructure in South America (IIRSA). Established in 2000, this is one of the most influential initiatives in promoting intra-regional connectivity and trade in Latin America. IIRSA contributions are especially in physical infrastructure projects in transport, energy and communications, developing more than 524 projects (ECLAC, 2009). Nevertheless, progress has been modest at best (Figure 1) as only 123 projects (23%) have been completed.

**Figure 1: Stages of IIRSA projects**




Source: IIRSA

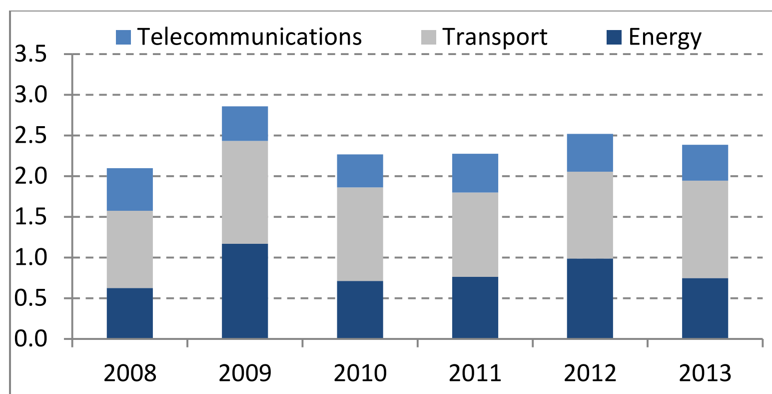
[10] Regional agreements such as NAFTA and MERCOSUR have restrictive rules of origin as compared to other agreements such as the South Asian Free Trade Area (SAFTA). Restrictive agreements include adopting multiple criteria for determining the origin of products, making it more complex and leading to higher costs. Also, these agreements have restrictive variants of individual criteria and product specific rules (for some goods, MERCOSUR demands 60% added value and also a change in tariffs). The SAFTA agreement have smaller changes in tariff classification and less regional value content requirements (Gretton and Gali, 2005).

The lag in infrastructure investment is well reflected by the World Bank Logistics Performance Index (LPI). No country in the region is in the top 25% of the LPI global ranking, although there is a large heterogeneity across countries.

Part of the problem is the relative low level of investment in infrastructure necessary for physical integration (transportation, energy and communications). Average investment in infrastructure in Latin America between 2008 and 2013 was around 3% of GDP (Figure 2), while in other emerging countries it was much higher (9% in China, 6% in India and between 5-6% in OECD countries (Blundell-Wignall and Roulet, 2015)). Reducing the infrastructure gap with respect to OECD countries will demand investment rates of around 5% of GDP, equivalent to USD250 billion over the next decade (Ideal, 2013, 2015).

**Figure 2: Investment in infrastructure by sector**

(% of GDP)




Source: Ideal 2015

Considering the recent growth performance and fiscal consolidation requirements in the region, the chances of a significant push in public funding for investment are slim. Nonetheless, the scope for fiscal action varies across countries. Some economies in the region have accumulated public savings and moderate debt levels that allow some room to maneuver, although in some cases they remain bound by structural fiscal rules. Other countries are already undergoing some form of fiscal consolidation, including spending cuts and tax reforms. Overall, all countries need more efficient and focused allocation of the available resources based on improving state capacity to deliver goods and services (OECD, CAF and ECLAC, 2014).

In view of the limitations of public funding some countries are resorting to public-private partnerships (PPPs) as a way to manage large investment requirements, especially in transport infrastructure. Effectively exploiting the benefits of PPPs requires the development of efficient management of concessions contracts. This can be accomplished by developing stronger institutions and modern frameworks whose primary focus is the development of infrastructure in the region.

Current integration platforms could play a major role in fostering PPP schemes to finance regional infrastructure. For example, the Pacific Alliance has set up an infrastructure fund that could be used to leverage private investment through PPP schemes to improve physical integration among member countries. International financial organizations such as, CAF, the World Bank and IDB could also play a key role by providing financial and technical support through special financial vehicles to attract institutional investors to fund PPPs.

## References

BID, (2013), Muy lejos para exportar. Los costos internos de transporte y las disparidades en las exportaciones regionales en América Latina y el Caribe.

Blundell-Wignall, A., Roulet, C. (2015), Infrastructure versus other investments in the global economy and stagnation hypotheses: What do company data tell us? OECD Journal: Financial Market Trends.

CEPAL, (2015), Panorama de la Inserción Internacional de América Latina y el Caribe. La crisis del comercio regional: diagnóstico y perspectivas.

ECLAC, (2009), Physical Infrastructure and Regional Integration. Bulletin Facilitation of Trade and Transport in Latin America and the Caribbean. Issue No. 280.

Gretton, P., Gali, J. (2005), The Restrictiveness of Rules of Origin in Preferential Trade Agreements. Productivity Commission. Canberra, Australia.

IDEAL (2015). La infraestructura en el desarrollo de América Latina (documento principal). Bogotá: CAF.

IDEAL (2013). La infraestructura en el desarrollo de América Latina. Bogotá: CAF.

Kuwayama, M. (1999), Operan Regionalism in Asia Pacific and Latin America: a survey of literature. International Trade and Development Finance Division. Santiago, Chile. ECLAC.

Moreira, M., Volpe, C., and Blyde, J. (2008), Unclogging Arteries: A Report on the Impact of Transport Costs on Latin American Trade. IDB and Harvard University Press

OECD, CAF, ECLAC. (2014), Latin American Economic Outlook 2014: Logistics and Competitiveness for Development.

SELA, (2015), Estado actual del proceso de integración en América Latina y el Caribe. Caracas, Venezuela.

Woolfery, S., (2012) Boosting intra-regional trade in Africa: an end in itself? Bridges Africa, Volume 1. International Centre for Trade and Sustainable Development.

**Economic Commission for Latin America and the Caribbean**

# Regional Value Chains and Logistics Integration

## Presentation

Various regional integration processes base their actions on the pursuit of improvements which allow countries to increase their economic complementarities, expand their local markets, and improve their bargaining power in the international arena with the aim of obtaining greater benefits than they would otherwise achieve individually (ECLAC, 2011). While trade, economic and political integration are perhaps the areas with the most widespread integration, physical integration of infrastructure is particularly relevant to regional processes, serving as the foundation upon which the rest of the integration architecture is articulated. It is truly a "silent integration" which is maintained over time and is generally more immune to the political ups and downs in which political and economic integration tend to get trapped (Cipoletta Tomassian, 2009). This allows for a more ample economic view of integration, with increased clarity toward the other aspects such as social, cultural and productive integration. The participation of local governments and the private sector ensure that once the connection is made, the resulting works are used for market expansion, the promotion of tourism and the increase of intra-regional trade between sub-regions which before would have either not been able to trade or would have done so on a much smaller scale due to the lack of a quality connectivity.

In this context, regional value chains (GVC) have received special attention to promote greater competitiveness as well as inclusive social development, particularly due to the advantages they present for: a) Generating a larger market size and thus reducing average costs, a wider supply network and gaining experience before internationalizing operations; b) Increasing employment within logistics-intensive sectors, promoting competitiveness, particularly in the field of SMEs, increasing productivity and the exchange of best practices thus leveraging the full potential of intraregional trade (ECLAC, CAF, OECD, 2013); c) Promoting trade in manufactured goods with value added, balancing demand while preserving the basic sectors of the economy and reducing exposure to exchange rate volatility (IDB, WB, IDB, ECLAC, 2011); d) Favoring investment in strategic sectors, particularly in economic infrastructure, improving negotiation skills and gaining more leverage in the governance of the value chain and the benefits generated by it.

In order for these GVC to materialize, however, physical and technological support which enables efficient and competitive operations is required. In other words, a productive integration of Latin America and the Caribbean is not possible without the previous establishment of integration of logistics (both physical and service related) that provides the connectivity and fluidity necessary for commodities and intermediate goods to move between countries in the quantity, quality, security and time required. Regional physical integration presents advantages and superior outcomes in this area relative to those that could be obtained bilaterally, particularly those linked to closing the gap in economic infrastructure

and reducing logistics costs which are indispensable for generating value chains that favor structural change in pursuit of equitable and lasting sustainable development throughout the region.

### Regional integration as a tool to reduce the infrastructure gap

ECLAC has argued that the absence of adequate infrastructure and the inefficient provision of services through it are major obstacles for the effective implementation of public policies, the full achievement of economic and social development goals as well as the realization of regional integration objectives. In order to close this gap in economic infrastructure, an annual investment of approximately 6.2% of the regional GDP is required to meet the needs arising from businesses and final consumers in the region between 2012 and 2020 (Perrotti and Sanchez, 2011). Given that investment in infrastructure observed in the five-year period between 2009 and 2013 has been 2.7% of GDP (ECLAC, in press), the national effort to close the infrastructure gap is significant, especially in the current macroeconomic context of low dynamism, low savings rates and significant fiscal constraints.

The integration of some economic infrastructure (transport, energy, telecommunications) in order to provide sub-regional services could represent a lower cost alternative to reduce the infrastructure gap, taking advantage of the benefits derived from economies of network and scope. To carry this out requires the specialization and prioritization of some infrastructures to provide sub-regional services in order to:

a) Avoid the multiplicity of infrastructure lacking in regional synergies and focus investments on the missing network links which are among the factors affecting the high logistics costs in the region.

b) Promote greater national connectivity and reduce the asymmetries between territories, also allowing the same level of service in terms of coverage and quality, with less investment and lower operating costs, thereby freeing up public resources for spending on social programs as well as other sectors of the national economy.

c) The interconnection of the energy, transport, telecommunications and eventually water and sanitation infrastructure, would provide and ensure a continuous and safe supply for national participants in line with the United Nations 2030 Agenda, providing alternatives which ensure the continuous operation even in extreme natural hazards or connectivity loss with service levels that would be difficult to achieve individually at a competitive cost.

In order to carry out this effort, countries must coordinate infrastructure efforts and harmonize procedures for planning and investment in infrastructure which is predominantly sub-regional in nature. Advancement in regional institutionality, regulatory convergence and the promotion of regional mechanisms of investment planning are some of the key aspects for tapping the potential of regional integration.

## Value chains linked to natural resources

Latin America and the Caribbean (LAC) significantly bases its development on the exports of natural resources. Although during the first decade of this century saw a rise in prices of natural resources which boosted economies in Latin America and the Caribbean, allowing for significant economic and social progress due to greater economic prosperity, the export matrix continued to be strongly concentrated in low value-added products without productive linkages to promote innovation or development of new products or services. The end of the super cycle of commodity prices represents a huge challenge for the region, particularly for countries that export natural resources, as many of the policies undertaken were associated with the extraordinary income received by rising international prices. Today, with lower prices and an undiversified matrix and thus more vulnerable to international shocks, the fiscal space necessary to maintain investment and social spending can face severe restrictions if new ways to enhance development do not emerge.

Given that logistics costs in Latin America can be up to four times higher than in OECD countries and the exports of natural resources is particularly sensitive to factors such as volume and time (ECLAC, CAF, OECD, 2013), promoting logistics which are specifically geared towards natural resources is an issue of crucial importance for the development of the region. However, despite the strategic importance of natural resources for development, no special attention has been paid to the design of specialized infrastructure, which also makes the possibility of productive chains or value-added exports difficult. Moreover, much of the public infrastructure used for the transport of these natural resources is poor and presents high negative externalities for the population and the environment. Infrastructure for private use, in many cases, is an entry barrier for productive actors and does not favor further improvements in the connectivity of the territory. This lack of an integrated vision of natural resources logistics and its impacts on the territory, limit not only the potential advantages of economies of scale, the network and agglomeration which could be reached through natural resources logistics but also other positive effects on the rest of the economy as well as the process of sustainable development.

It is thus essential to strengthen government capacity on the role of logistics, through actions that strengthen the design and implementation of sustainable logistics infrastructure, promoting changes in policies and regulations that allow for an effective integration of production and generation of sub-regional value chains that are competitive and inclusive. In this context, to take advantage of logistics integration emerges as a tangible way to achieve significant progress in regional cooperation, reducing logistics costs as well as the negative externalities of the activity. To carry this out, sectoral public policies and the institutional framework of integration initiatives must be reformulated to enhance their impact on sustainable development, particularly those related to aligning the concept, design, implementation and monitoring, control and evaluation of policies in order to maximize their impact on development. ECLAC has promoted the need for an integrated logistics and mobility policy that is regionally coordinated and promotes efficient and productive transversal measures and reduces externalities on populations and the environment, thus reaping the benefits of regional integration (Jaimurzina Perez-Salas and Sanchez, 2016).

In accordance with these considerations, the integration of logistics infrastructure is a key aspect of strengthening growth and achieving higher levels of development in the region. Furthermore, the functioning of the region as an integrated space through economic infrastructure and quality services is not only crucial for maintaining competitiveness but also for reducing the costs of imported products. It is thus essential to have a physical infrastructure which connects the countries of the region, linking its communication channels by road, rail and river and sea transport, and to integrate the different forms of energy and telecommunications. It is important to continue moving forward in the strengthening of public policies on logistics and in the reduction of institutional gaps that affect facilitation and transit to neighboring countries, all key elements to realizing the full potential of the regional value chains within a sustainable development context.

## Immediate actions

- Strengthen coordination mechanisms and infrastructure planning by integrating new actors from the public and private sectors in order to address the particular needs of natural resources logistics chains. The regional integration of logistics infrastructure to reduce costs and the negative externalities of the transport of natural resources is an issue that would encourage better regional governance and sustainable development.
- Characterize and prioritize regional infrastructure transport networks, detecting any missing strategic sections and advancing in the facilitation of processes and regulatory convergence within countries in order to reduce time and operating costs as well as negative externalities upon the environment and society.
- Promote the harmonization of regional standards to support the development of a common market and provide transport services for both cargo as well as citizens and tourists, by building a set of indicators for physical integration in order to detect and promptly resolve obstacles in the implementation process and thus strengthen the integration process through greater participation and sense of ownership of the participating countries.

### References

BID, Banco Mundial, CEPAL (2010): "¿Cómo reducir las brechas de integración. Escenarios y recomendaciones de política para promover la infraestructura física y reducir los costes del comercio internacional. Nota de discusión de políticas presentada en la III Reunión de Ministros de hacienda de América Latina y el Caribe, Calgary, 26 de marzo.

CEPAL (2011): "UNASUR – Infraestructura para la integración regional". CEPAL, Santiago de Chile, diciembre.

CEPAL, OECD, CAF (2013) Perspectivas Económicas de América Latina 2014: Logística y competitividad para el desarrollo, Organización Económica para Organización para la Cooperación y el Desarrollo Económicos (OCDE), Francia.

Cipoletta Tomassian, Georgina (2009) Infraestructura física e integración regional. Boletín FAL N° 280. Unidad de Servicios de Infraestructura, CEPAL, Santiago de Chile

Jaimurzina, A, Pérez-Salas, G. y Sánchez, R. (2016): "Políticas de logística y movilidad para el desarrollo sostenible y la integración regional: marco conceptual y experiencia regional" Boletín FAL N° 345. Unidad de Servicios de Infraestructura, CEPAL, Santiago de Chile,

Perrotti, D. y Sánchez, R. (2011) "La brecha de infraestructura en América Latina", Serie Recursos Naturales e Infraestructura N° 153, CEPAL, Santiago, Chile.