Policy Discussion Brief

New Frontiers for Regional Integration

6th Meeting of Finance Ministers of the Americas and the Caribbean

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SIXTH MEETING OF FINANCE MINISTERS OF THE AMERICAS AND THE CARIBBEAN

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This policy discussion brief has been prepared jointly by the Inter-American Development Bank (IDB), World Bank, and United Nations Economic Commission for Latin America and the Caribbean (ECLAC) as the basis for discussion among the Ministers during the Sixth Meeting of Finance Ministers of the Americas and the Caribbean, held in Washington DC, on October 8, 2014.

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The World Bank Group

How the Rise of the South Is Shaping the Growth Prospects of Latin America and the Caribbean

The world economy is not what it used to be thirty or even fifteen years ago. Although for most of the 20th century the global economy was dominated by the developed *North* (think of the G-7 and the Western European countries), the *South* (the rest) has arrived with surprising speed since the dawn of the 21st century. Between the 1970s and 1990s, the GDP of the South remained at around 20 percent of the world GDP. Since then, it has doubled to 40 percent. Moreover, the globalization process of the South, which had picked up in the late 1980s and continued strongly during the 1990s, accelerated and intensified substantially in the 2000s. The rise of the South has actually been a widespread phenomenon, going beyond the emergence of China as a giant in the global economy, with new South-South as well as South-North and North-South connections developing. However, the second half of the 2010s is posed to have different dynamics. Since 2010 or so, the world seems to be entering a phase that many have called "the new normal," characterized by not only slower global growth, but also a rebalancing of global growth away from the South and towards the North. Nonetheless, despite the swiftness of all these changes, current projections suggest the rise of the South is not a temporary phenomenon and the South will continue to gain space in the global landscape.

Structural Differences in the Rise of the Economic Weight of the South

The weight of the South has been felt not only because of their higher growth rates vis-à-vis those of the North, but also because of their structural features. The patterns of globalization of the emerging South and the North are different in important ways. In particular, the rise of the South has not been symmetric across sectors or across types of commercial and financial flows. Regarding trade, the traditional overlap between the North and the center (and the South and the periphery) has been reconfigured and a new global commercial network has emerged. In fact, several economies from the South have become part of what can be empirically characterized as the "center" of international trade relations. Moreover, these countries from the South at the center of the global trade network play a different role than the countries from the North at the center. In contrast, in the sphere of finance, countries from the North still stand alone at the center of the global financial network, even though the South has clearly increased its connectivity within the network. Whether this asymmetry proves to be transitory is subject to debate. Be it as it may, it is clear that the trade-finance asymmetry thus far stands in sharp contrast with broad historical developments (since the Industrial Revolution and throughout most of the 20th century), when countries that rose in importance in real economic activity also rose as international financial centers.

Despite the increase in and diversification of trade connections around the world, there is a significant degree of regional clustering in global trade and global finance. The strongest trade ties for countries in both the North and the South are with neighboring countries, suggesting that geographical proximity still plays an important role in the evolution of these connections. Although Southern economies

typically send and receive most of their financial investments to and from the North, neighboring Southern economies come in second place as a share of these investments. That is, countries in Latin America and the Caribbean (LAC) typically invest in other LAC countries; Asian financial flows largely go to other Asian countries; Eastern Europe invests mostly in Eastern Europe; and so on. Underpinning these clusters has been the development of global value chains (GVCs)—that is, the fragmentation of production stages and processes across countries. GVCs are in effect more regional than global. Yet, the extent and manner in which countries participate in GVCs shapes the dynamics of trade, finance, and growth. Economic development in today's world is inherently linked to upgrading within GVCs, but participation in GVCs does not automatically translate into additional gains from trade and finance beyond those associated with increased cross-border flows.

Hence, the emergence of the South has had a significant impact on the structure of global trade and finance. The economic shocks emanating from the rise of the South as central players in global economic relations brought significant changes to LAC economies. LAC is an increasingly globalized region and its economic future depends a great deal on the extent and quality of its external connections. That is, it is likely that not only the incidence of international trade and financial connections, but also the structure and quality of trade and financial linkages matter for its future economic growth and for the generation of quality jobs for its workers. Overall, increased linkages with the South have largely been a mixed bag for countries in LAC, with notable differences across the Americas depending on each country's individual economic structures inherited from the 20th century. Thus far, there is no single answer as to whether the changes in LAC connections are evolving in a direction of greater quality that could provide further boost to the long-run growth.

Potential Impacts on LAC Long-Term Growth Prospects

The aforementioned trends are the subject of analysis of the World Bank Group's forthcoming annual Flagship Report on LAC development, which is tentatively titled *The Rise of the South: Challenges for Latin America and the Caribbean*. Although the findings are not definitive, they highlight potential challenges for the long-term growth prospects of the Region. First, econometric evidence appears to indicate that labor productivity in manufacturing industries of developing economies, including LAC, is not affected by foreign direct investment flows (more precisely, by FDI in the form of Mergers and Acquisitions, M&As) emanating from either Northern or Southern economies; Northern, high-income economies do seem to benefit from such FDI. More specifically, labor productivity within manufacturing industries tends to rise by approximately 2.8 percent only when such investment flows come from other high-income economies. Hence we have much to learn from future research about why is it that advanced economies from the North experience gains in labor productivity from FDI from similar economies. The usual suspects that could explain these findings include the so-called "absorptive capacity" of firms operating in high-income environments, which is characterized by high-skilled labor forces, superior management practices, and higher rates of investment in innovation. But these remain hypotheses to be tested in future research rather than definitive policy prescriptions.

On the trade front, the Report argues that the structure of trade conditions the impact of the volume of trade on economic growth, across both high-income and developing economies. A key finding is that the

trade linkages with high-income economies (the North) seems to yield higher growth payoffs than trade with the South: a one percent increase in the ratio of trade flows over GDP appears to be associated with an average increase in GDP per capita of roughly 1.6 percent. However, the estimated effect of trade with developing countries is much lower: a one percent increase in the incidence of trade on GDP seems to yield an increase of GDP per capita of about 0.3 percent. Further, this difference of estimated effects seems to be associated with differences in the structure of trade between high-income countries and developing economies. For example, for a given level of openness, a one percent increase in the share of total trade that is due to intra-industry trade yields an additional gain in terms of GDP per capita; similarly, an increase in an economy's share of trade in middle stages of a GVC also bumps up the effect of trade openness on GDP per capita. Since intra-industry trade and countries' participation in the middle stages of GVCs seems to be higher in LAC trade with the North than with the South, we can speculate that the patterns of trade with emerging markets is possibly less pro-growth than those with high-income economies.

How Size Conditions Development in a Changing Global Economy

In addition to differences across countries due to geographic location and endowments (such as the size of arable land, the value of physical capital relative to the number of workers, and the share of skilled workers over unskilled workers), economic size might also shape a country's ability to adjust in this era of global structural change. One way in which size conditions at least the volatility of economic growth (if not its trend) is that size is a determinant of the level of export diversification. Simply put, large economies are more diversified than small economies. Consequently, small economies tend to face a permanently higher level of volatility of their terms of trade, which in turn feeds volatility of economic growth. These empirical regularities have been documented in a 2012 publication of the World Bank Group.[1]

This said, small open economies might be able to compensate for excessive economic concentration with flexibility and regional integration. In this context, flexibility is about an economy's ability to change its economic structure over time. Ongoing research at The World Bank Group suggests that small economies, including those from LAC (with less than 10-15 million inhabitants), do tend to switch their export product-services mix with more agility than larger economies. But such adjustments can be painful when economies are inflexible in terms of the ability of labor and capital to get re-oriented towards new emerging industries.

Regional integration can also play a role to enhance the competitiveness of small open economies. The reasoning is simple: a share of production costs of enterprises is due to costs of energy, transport and other inputs whose costs can be reduced when sourced from large suppliers. Consequently it is likely that small open economies in LAC and elsewhere will soon take a fresh look at the nature of regional integration, which will probably go well beyond the traditional approaches that have an exclusive focus on trade flows.

[1] Lederman, Daniel, and William F. Maloney. 2012. *Does It Matter What You Export? In Search of Empirical Guidance for Industrial Policies*. Washington, DC: The World Bank.

The Internationalization of Latin America and the Caribbean through Global Value Chains

The world economy has recently seen an increasing trend in the international fragmentation of production, or the geographic separation of activities involved in producing a good or a service across two or more countries. The result has been a substantial increase in interdependencies among economies around the globe which has translated into a fast growing trade in intermediate inputs and services.[2]

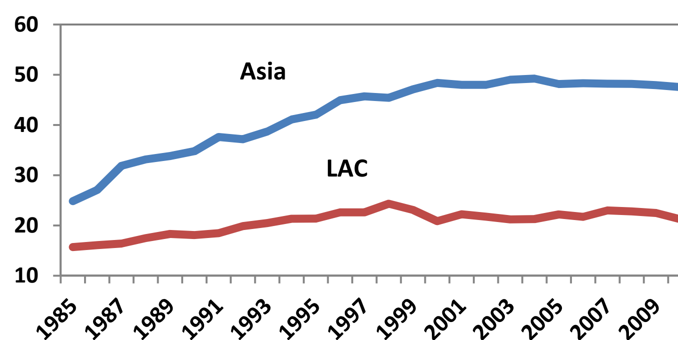
Of particular interest for Latin America is that participation in global value chains (GVCs) tends to be associated with transfers of technical and managerial knowledge that emanates from global buyers to local suppliers which can translate into important productivity gains. An increasing number of studies support this argument. For instance, according to Iacovone et al. (2011)[3], the firms that became suppliers of Walmart in Mexico experienced a 51 percent total factor productivity (TFP) gain relative to the non-Walmart suppliers. Likewise, evidence from the Czech Republic shows that becoming a supplier of a multinational induced a 15 percent increase in TFP over other firms (Javorcik et al., 2009).[4]

Despite these potential benefits, very few countries in Latin America and the Caribbean (LAC) are taking advantage of these new trends in the international organization of production.

Participation in Global Value Chains

Figures 1 and 2 show alternative proxies of GVC participation. Based on the notion that production linkages involve trading related goods at different stages of production, Figure 1 presents intra-industry trade indexes for Latin America and Asia.[5]

Figure 1: Intra-industry trade index (manufactures),1985-2010



Source: IDB, *Synchronized Factories*, 2014

[2] This brief is based on a research project conducted at the Integration and Trade Sector of the Inter-American Development Bank to examine the prospects of Latin America and the Caribbean to participate in global value chains. The results of this project will be published in the IDB report, *Synchronized Factories: Latin America and the Caribbean in the Era of Global Value Chains*, 2014

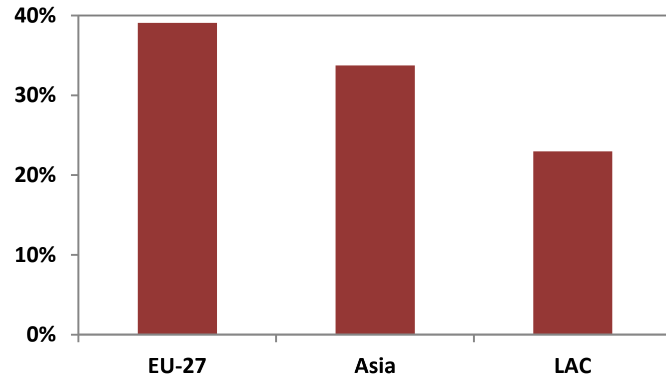
[3] Iacovone, L., B. Smarzynska Javorcik, W. Keller, and J. R. Tybout. 2011. *"Supplier Responses to Wal-Mart's Invasion of Mexico." National Bureau of Economic Research Working Paper* 17204.

[4] Javorcik, B. S., and M. Spatareanu. 2009. *"Tough Love: Do Czech Suppliers Learn from Their Relationships with Multinationals?" Scandinavian Journal of Economics* 111, 4.

[5] The use of an intra-industry trade index to proxy value chain participation is based on the premise that global value chains are associated with sequential production links in which countries may import intermediate goods, add value, and export them to another country. Therefore, these countries exhibit large values of imports and exports in the same industry.

The figure shows how intra-industry trade boomed in Asia in the period 1985-2010 while increasing relatively slowly in Latin America.

Figure 2: Foreign value added of exports, average 2003-2007



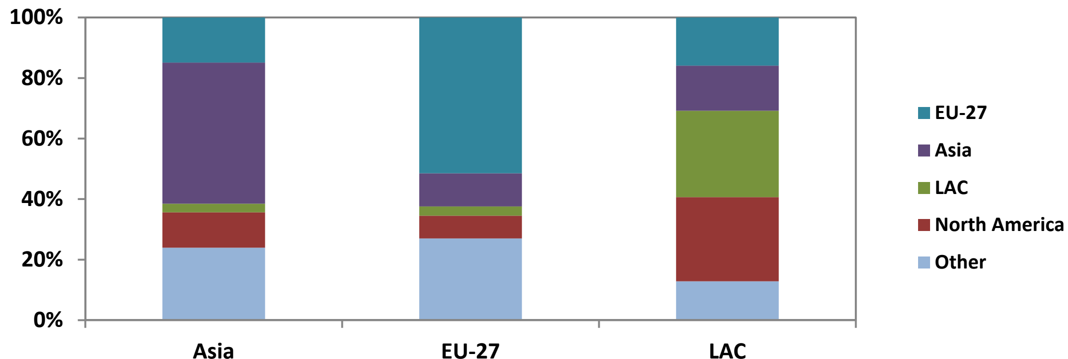
Source: IDB, *Synchronized Factories*, 2014

Figure 2 shows an alternative measure of GVC participation based on trade in value added.[6] It is easy to see that the participation of LAC in GVCs averages less than the participation of the comparator regions. In particular, the exports originating in Asia and in the EU use more intensively imported intermediate inputs than Latin America's exports suggesting that countries in these two regions are more involved in sequentially linked production processes than the countries in the LAC region.

Factors Hampering GVC Participation

Firms seek to fragment production internationally primarily to take advantage of differences in factor prices. However, they will do so as long as the resulting reduction in production costs would more than compensate for the additional costs of offshoring. One important cost of offshoring is the cost of moving the various production blocks around. Accordingly, high transportation costs are likely to discourage the movement of intermediate inputs between countries. In other words, GVCs do not cope well with vast distances. Evidence supporting this claim can be seen in Figure 3 which shows that the participation in GVCs is more intense among countries of the same region than with other regions. For instance, the within-region participation in the EU, Asia and LAC is 51 percent, 47 percent and 29 percent,

Figure 3: Regional contribution to foreign value added, average 2003-2007



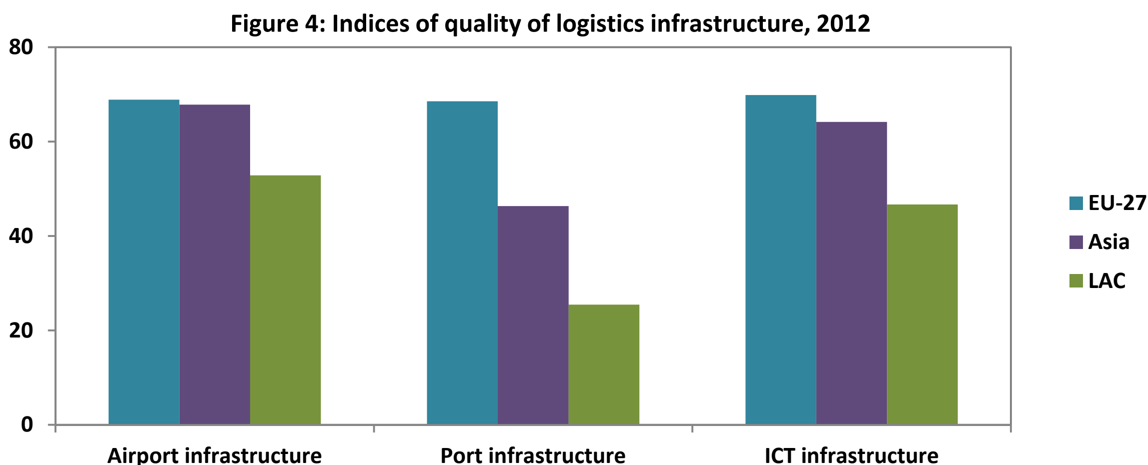
Source: IDB, *Synchronized Factories*, 2014
Note: Based on GTAP 7 and 8 data

[6] This measure is also based on the idea that countries linked sequentially in a production process typically use imported inputs to produce goods that are later exported.

respectively. In each case, the within-region participation is always the highest. This result illustrates the notion that GVCs tend to favor production linkages among countries that are not too far apart.

This is relevant for LAC. For example, the average bilateral distance across all the East Asia plus the Association of Southeast Asian Nations (ASEAN) countries is about 2,400 km, while the average distance across the countries in Latin America is 3,000 km. If we include the US and Canada, the distance across all the Americas is 3,200 km, or 30 percent more than in Asia. In the case of the EU-27, the average bilateral distance is a mere 1,400 km. Therefore, geography imposes a challenge when countries in Latin America seek to join distance supply chains in Asia or Europe, or even to develop supply chains within their own region.

But participation in GVCs is not only about transport costs. Logistics costs are also important. Global buyers tend to favor suppliers in countries with adequate logistics infrastructure that minimizes delays and disruptions, and that allows suppliers to commit to practices like 'just-in-time' delivery services. Figure 4 compares Latin America with the EU and Asia in terms of logistics infrastructure indicators that measure three dimensions relevant for the location of fragmented production: the quality of port, airport and telecommunication infrastructures.[7] The results speak for themselves. LAC, on average, has less adequate logistics infrastructure regardless of which measure we use.



Source: IDB based on data from the Global Competitiveness Index, World Economic Forum (WEF)
Note: Original data were normalized to take values between 1 and 100, with higher values representing higher quality.

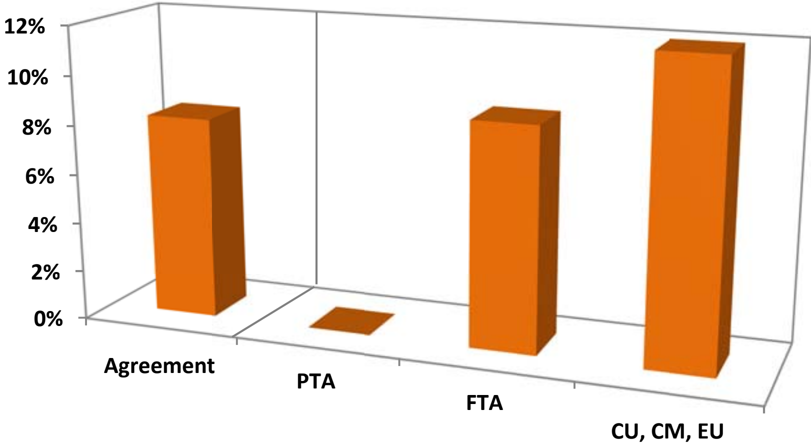
Another determinant of GVC participation is related to the trade costs of crossing borders and in general to the topic of integration. Gains from tariff reductions are magnified when goods cross borders many times, as it can be the case in international production networks. Also, to successfully target GVCs—particularly in developed countries—many potential suppliers in Latin America will need to import high-quality inputs from other countries to complement their own production. In this way, high levels of

[7] Efficient port and airport infrastructures reduce delays and disruptions in the supply chain, inventory-holding costs, depreciation costs as well as handling costs. Adequate telecommunication infrastructure allows countries to move information quickly, cheaply and reliably, which is important to reduce the costs of coordinating production blocks at a distance.

protection at home will damage their ability to complement their own skills with the skills and capacities of suppliers in other countries.

A more integrated economic space for the Americas—a long-time aspiration—also becomes more relevant in an era of production networks. Take, for instance, the myriad of trade agreements in Latin America, most of which use different rules of origin. When an exporter produces only one good, and most intermediate inputs are sourced domestically, the costs of complying with multiple rules of origin virtually do not exist. But as firms seek to fragment their production among different countries in different trade agreements, the costs of dealing with multiple rules of origins can be prohibitive. Deepening integration in Latin America and the Caribbean will allow firms to take advantage of the differences in factor prices across countries, enabling them to freely choose the location for each bundle of production according to each nation's comparative advantage.

Figure 5: Estimated impact of trade agreements on vertical FDI



Source: IDB, *Synchronized Factories*, 2014
Note: PTA: preferential trade agreement; FTA: free trade agreement; CU: customs union, CM: common market; EU: economic union.

Using data of trade agreements around the world, Figure 5 shows evidence that GVCs tend to flourish across countries that are more integrated. In particular, the figure shows that there is more vertical foreign direct investment (the type of foreign direct investment in which a subsidiary of a multinational produces an input to its parent) between countries with trade agreements than between countries without trade agreements. Moreover, deep integration agreements provide more incentives for the formation of global supply chains than shallow agreements because they tend to incorporate measures beyond the simple reduction of tariff rates that tend to be important for well-functioning supply chains.

While the Latin American region might not embark on a deep integration agreement of a continental size in the foreseeable future, it can still increase the scope of its integration—for example, by fostering the convergence of many of the trade agreements currently in place. Recent integration efforts in LAC are encouraging, like the "TLC único" for the convergence of bilateral trade agreements among Mexico, Costa Rica, El Salvador, Guatemala, Honduras and Nicaragua. Early evidence suggests that production

linkages among this group are already increasing, as intra-industry trade rose by 27 percent between 2010 and 2013. Further convergence of trade agreements across LAC should foster broader production complementarities.

Participation in GVCs can also be hampered by additional factors, like weak contracting practices, information costs and lack of capabilities. There is policy space in some of these areas. For example, in GVCs the relationship among the parties tends to be specific: buyers demand goods with certain degree of specificity and sellers adapt their production to particular specification. The parameters governing such specifications are established in contractual agreements. Ambiguous practices and uncertainty in contract enforcement can generate distrust between parties of different countries, limiting their willingness to engage in cross-border production sharing. Latin America has a generally subpar record in terms of contracting practices, compared with other regions. For instance, while the average time for enforcing a contract in the Asia-Pacific countries is 398 days, the corresponding figure for Latin America is 733 days. Similarly, while the average cost (as a percentage of the claim) for enforcing a contract in Europe is 21 percent, the cost in Latin America is 31 percent. Clearly this is another area with space for policy action.

Conclusion

As shown here, participation in GVCs can be hampered by various factors. Importantly, the emergence of global value chains has raised the stakes of addressing long-standing policy challenges, such as those related to transportation and logistics discussed in previous Meetings of Finance Ministers of the Americas and the Caribbean, but has also brought to the forefront issues that have been relatively overlooked in the past, like the notion that the quality of the contracting environment can constitute an additional source of comparative advantage. These policies could be part of a broader agenda to re-launch trade and integration in the region, an appropriate initiative at a time when vulnerabilities in the current accounts have become more evident.

Economic Commission for Latin America and the Caribbean

Avenues for Integration and Regional Financial Cooperation

The Latin American and Caribbean region is currently facing major transformations in the global economy, as regards both production and finance. Rapid technological change, the rise of global value chains, the growing economic weight of the emerging economies, and the transition to a situation of tighter global liquidity pose old and new challenges to development and to the region's engagement and positioning in the world economy. In this new international environment, integration and regional cooperation are more relevant than ever (ECLAC, 2014).[8]

This brief note focuses on two key contributions to integration and financial cooperation in the region: a regional reserve fund to boost financial stability, as a regional public good, and support for production integration and intraregional trade.

Financial Stability as a Regional Public Good

Economic and financial developments over the past few decades suggest that the global economy could become more prone to instability and volatility. Accordingly, and despite the fact that the region has become more resilient and less vulnerable to external conditions, there is still a need for countercyclical financing to meet balance-of-payments financing requirements and help to ensure financial stability. One of the tools available in the region for this purpose today is the Latin American Reserve Fund (FLAR) which has eight member countries: Bolivarian Republic of Venezuela, Colombia, Costa Rica, Ecuador, Paraguay, Peru, Plurinational State of Bolivia and Uruguay.

A regional reserve fund with broader geographical coverage would make an important contribution to strengthening regional financial stability. This option is feasible because balance-of-payments problems and crises do not usually affect the countries simultaneously. The empirical evidence shows that systemic crises and widespread contagion do not seem to be the norm (ECLAC, 2014). In addition, experience indicates that when there is some degree of simultaneity in the crises affecting countries, it usually occurs among small ones; it is unusual for large and medium-sized economies to experience crises simultaneously. To deal with extreme cases such as a systemic crisis or widespread contagion, and even with intermediate scenarios where the capital of the Fund is not sufficient to cope with the demands of member countries, the Fund should have the capacity to "broaden its shoulders". This can be done by leveraging its capital (that is, by issuing debt to mobilize a larger amount of resources) or by acting in coordination with other parts of the regional financial architecture.

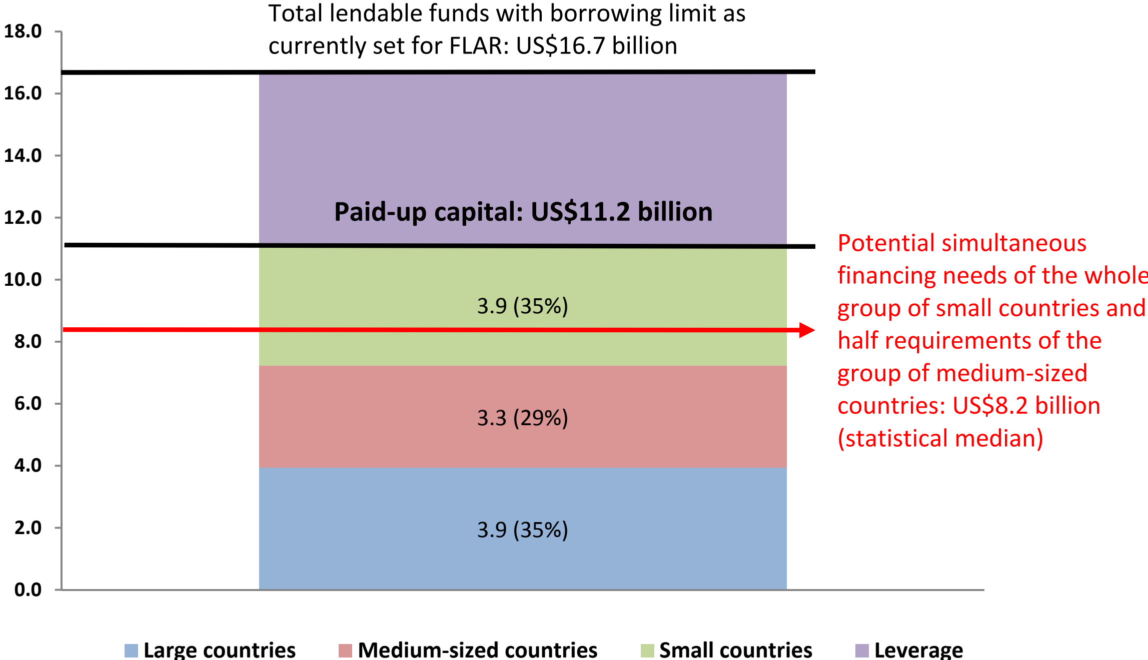
In that regard, ECLAC calculates that in a scenario involving 19 countries of the region, for example, with capital contributions by the countries following the logic currently applied at FLAR, the regional fund would attain a total size of over US$11 billion (equivalent to 1.7 percent of the 19 countries' stock of international reserves). A fund of this size, without any leveraging, would be enough to cover the

[8] *Integración Regional: Hacia una estrategia de cadenas de valor inclusivas*, CEPAL mayo 2014

potential demand from the whole group of small countries simultaneously, along with half the needs of the group of medium-sized countries, for a total of US$8.2 billion (statistical median). If the fund leveraged its capital with medium and long-term borrowing amounting to 65 percent of the paid-up capital, which is the maximum authorized at FLAR, lendable resources of up to US$16.7 billion would be generated (see figure 1).

Figure 1. Size of a Regional Reserve Fund for 19 Countries of Latin America[9]

(Billions of US$)



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of Daniel Titelman and others, "*Un fondo de reservas regional para América Latina",* MPRA Paper, No. 42614, University Library of Munich, 2012 [online]] http://mpra.ub.uni-muenchen.de/42614/1/MPRA_paper_42614.pdf

Expanding the Fund's geographical coverage to the countries of the English-speaking Caribbean could be accomplished without great financial effort, and would bring major benefits for the subregion. Being able to fall back on countercyclical financing for the balance of payments would help these countries to build up resilience to financial shocks and natural disasters.

[9] Based on their GDP, the large countries are Brazil and Mexico, the medium-sized countries are Argentina, Bolivarian Republic of Venezuela, Colombia, Peru, Chile and the small countries are Ecuador, Costa Rica, Uruguay, Plurinational State of Bolivia, Paraguay, El Salvador, Guatemala, Honduras, Nicaragua, Panama, Dominican Republic and Belize. It is assumed that the current members of FLAR maintain their contributions at present levels and the rest contribute in accordance with their relative size. It is also assumed that all subscribed capital is paid-up capital.

Development Banks and Financing for Production Integration and Intraregional Trade

Aside from the efforts made through the three payment systems existing in the framework of regional cooperation, national development banks —in coordination with subregional and regional development banks— can also play a stronger role in financing for intraregional trade and support for small and medium enterprises (SMEs). Although at present, according to data from the Latin American Association of Development Financing Institutions (ALIDE), external trade credits represent only a small percentage of the total portfolio of national development banking systems (an average of 5 percent), there is a great deal of variation between banks, with much higher percentages for those specializing in external trade, such as the National Foreign Trade Bank (BANCOMEXT) in Mexico.

National development banks can join forces with the subregional banking system in promoting intraregional trade. In fact, multilateral institutions such as IDB and the World Bank already channel trade financing through the countries' national development banks and foreign trade agencies. National development banks need to carry on taking advantage of these opportunities, given the importance of subregional development banks to intraregional trade financing.

The Central American Bank for Economic Integration (CABEI) has identified support for intraregional production and trade as one of its strategic orientations. The Andean Development Corporation (CAF) has also emphasized trade support and put this into practice by providing firms with direct funding for foreign trade operations, working capital and investment. It also operates as a second-tier bank, supplying credit lines to financial institutions, which then channel resources to the production sector. Foreign trade operations can be financed with these resources. The Caribbean Development Bank (CDB), in conjunction with the United Nations Conference on Trade and Development (UNCTAD), has also launched programs of training in the use of trade financing instruments such as factoring, with a view to extending their use at the subregional level. Lastly, in 2012 the Bank of the South was set up with subscribed capital of US$7billion. Its general purpose is to operate as a development bank for its members in UNASUR, promoting the areas of infrastructure, energy, food sovereignty, social conditions, human talent and science and technology, among others.

Where national development banks are concerned, there is still the challenge of reconciling commercial profitability criteria with a greater role for economic development criteria in the international trade financing process. From this perspective, there seems to be a need to orient financial instruments towards the promotion of an export basket with greater value added and to foster SME participation in the export effort.