

BETTER NEIGHBORS

TOWARD A RENEWAL OF ECONOMIC
INTEGRATION IN LATIN AMERICA



CHAD P. BOWN, DANIEL LEDERMAN,
SAMUEL PIENKNAGURA, AND RAYMOND ROBERTSON

OVERVIEW

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Better Neighbors

*Toward a Renewal of Economic
Integration in Latin America*

Chad P. Bown, Daniel Lederman,
Samuel Pienknagura, and Raymond Robertson

This booklet contains the Overview and a brief list of contents of the forthcoming book, *Better Neighbors: Toward a Renewal of Economic Integration in Latin America* (doi: 978-1-4648-0977-4). A PDF of the final, full-length book, once published, will be available at openknowledge.worldbank.org and print copies can be ordered at www.amazon.com.

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Abbreviations

Introduction

- 1** Economic Performance and Geography: Rising and Falling with Our Neighbors
- 2** Regional Trade in the Americas: A Stepping Stone towards Stable Growth?
- 3** LAC's Trade Policy and Regional Integration
- 4** In Search of Growth and Stability through Factor Market Integration

Abbreviations

APEC	Asia-Pacific Economic Cooperation
BIT	bilateral investment treaty
CAFTA-DR	Dominican Republic–Central America Free Trade Agreement
CEPII	Centre d’Etudes Prospectives et d’Informations Internationales
CMI	capital market integration
EAP	East Asia and Pacific
ECA	Eastern Europe and Central Asia
EU15+	European Union 15 extended
FDI	foreign direct investment
FTA	free trade agreement
GDP	gross domestic product
GVC	global value chain
HO	Heckscher-Ohlin (model)
ICT	information and communication technology
LAC	Latin America and the Caribbean
MENA	Middle East and North Africa
MFN	most-favored nation
MILA	Mercado Integrado Latinoamericano
MNC	multinational corporation
NAFTA	North American Free Trade Agreement
OLS	ordinary least squares
OR	Open Regionalism
PPML	Poisson-Pseudo Maximum Likelihood (estimator)
PTA	preferential trade agreement
PWT	Penn World Table
R&D	research and development
RCA	revealed comparative advantage
RoOs	rules of origin
SAR	South Asia
SSA	Sub-Saharan Africa
WDI	World Development Indicators
WTO	World Trade Organization

Overview

Introduction

In a clear break from its past, Latin America and the Caribbean (LAC), particularly South America, experienced a growth spurt with equity during the first decade of the 21st century.¹ In fact, LAC's gross domestic product (GDP) growth rate during that decade stood at around 4 percent, well above the region's historic average of 2 percent. Moreover, the incomes of the poorest households in many countries in the region grew at a faster pace than those of high-income households. Unfortunately, the latest period of prosperity seems to have waned and, with a few exceptions in Central America and the Caribbean, countries in the region confront once more a reality of low growth.

As the good times have faded, there is now a clear understanding that such impressive performance was the result of a demand boom fueled by an increase in the price of LAC's exports relative to the price of the region's imports (a terms-of-trade improvement) (de la Torre, Filippini, and Ize 2016). Moreover, the slowdown has brought back fears of economic instability. To be sure, there is no evidence to date suggesting that LAC is returning to the volatile days of the

1980s, partly because of improvements in its macrofinancial framework. Yet it is undeniable that such fears exist, especially in the context of expected increases in global interest rates. Against this backdrop, policy makers in LAC are now in search of sources of long-term growth and stability.

One policy area that has moved to center stage is regional integration. Indeed, since at least the 1960s, LAC has experimented with various forms of regional integration with the hope that fostering regional economic ties can yield the type of economic success that the region has long sought. The current push toward regional integration has been influenced by the success of the East Asia and Pacific region (EAP) where intraregional trade, exports to the rest of the world, and incomes have risen together as the region continues to catch up to the income levels of the United States (de la Torre, Lederman, and Pienknagura 2015). Whether this coincidence of trade and growth outcomes is the result of regional commercial or other policies, or whether regional growth itself caused the rise of intraregional trade and global exports, remains an open question. Still, EAP continues to be a source of inspiration for Latin Americans.

Hence, underlying the push in favor of deeper integration at the regional level is the belief that part of LAC's low growth problem is its low level of intraregional economic integration. In fact, LAC has levels of regional integration that pale in comparison to those of the European Union, EAP, and Eastern Europe and Central Asia (ECA). Taken at face value, this suggests that pursuing formal policy arrangements with the potential of strengthening economic links within the region might boost growth in LAC.

The goal of leveraging formal trade arrangements to accelerate growth is evident in many of the trade agreements that are in place in the region. For example, an objective of the Pacific Alliance—the 2012 integration agreement between Chile, Colombia, Mexico, and Peru—is “driving further growth, development, and competitiveness of the economies of its members.”² Similarly, the Dominican Republic–Central America Free Trade Agreement (CAFTA-DR) lists the creation of “new opportunities for economic and social development” and “new employment opportunities and improved working conditions and living standards in their respective territories” as some of its resolutions.³ And, while not explicitly stated in the agreement, many view Mercosur—the customs union comprising Argentina, Brazil, Paraguay, Uruguay, and República Bolivariana de Venezuela—as a useful vehicle to achieve higher growth for the countries in the Southern Cone (Fanelli 2007).

The objective of taking advantage of regional integration to boost growth is not new to LAC. In fact, the region has explored several models of integration to achieve this goal—from the “old” regionalism that prevailed until the late 1980s, which emphasized the role of regional integration and import substitution as integral parts of industrialization strategies, to the “new” regionalism that emerged amid the wave of reforms that the region implemented in the 1990s (see IDB 2002). Importantly, the latter form of regional integration views regionalism as a stepping-stone toward the goal of global integration, hence earning the label of “Open Regionalism” (hereafter OR).⁴

This study revisits the concept of OR and presents evidence supporting the idea that a revitalized OR strategy can contribute to growth with stability by exploiting the complementarities between regional and global economic integration. It proposes a five-pronged strategy, including (i) reducing external most-favored-nation (MFN) tariffs, (ii) deepening economic integration between South America and Central and North America, (iii) harmonizing rules and procedures governing the exchange of goods, services, and factors of production, (iv) stepping up efforts to reduce LAC's high trade costs, and (v) integrating labor and capital markets in the Americas. This agenda is nothing short of a wholesale renewal of the notion of OR.

Since the 1990s, OR in LAC focused primarily on preferential trade agreements and their relationship with trade policies affecting trade with extraregional partners (Bergsten 1997). The ultimate goal of the renewal of the OR strategy is to enhance the region's competitiveness with respect to the rest of the world, which depends on smart (yet complex) policies that enhance intraregional economic integration while also lowering barriers to international trade with the rest of the world. Because the magnitude of bilateral trade and migration flows is dependent on the geographic distance between economic partners, a key analytical challenge is to assess the potential for region-wide efficiency gains that can be attained through regional integration efforts (beyond the pull of geography) combined with domestic structural reforms and further liberalization of trade with the rest of the world. The preponderance of the evidence compiled for this study suggests that how the Americas become integrated can affect the region's long-term growth prospects and stability, precisely because the forces of geography imply that pro-growth global integration cannot be achieved without strengthening our own neighborhood. A key implication is that the renewal of OR embraces domestic structural reforms that can raise the economic efficiency of the Americas as a whole.

To be clear, the analysis presented in this overview does not quantify the impact that

OR has had on LAC economies in the past. Nor does it quantify the potential gains of the proposed renewal of the OR strategy. Rather, it relies on the economics literature to identify accepted channels through which different forms of international economic integration can stimulate growth and stability, which in turn can be quantified as an indirect way of assessing the priorities for the renewal of OR in the Americas. The report draws upon two prominent strands of economic theory. The first argues that the gains from trade depend on differences between countries. In these “neoclassical” models, these differences are usually modeled as arising from either factor supplies (for example, being “labor abundant” or “capital abundant”) or from technology. The second argues that trade facilitates learning, either through the experience of exporting or from the exposure to new products and ideas that are embodied in imports. Although these are not the only theories that explain trade and the gains from trade, these are two that have perhaps the longest and most established history in international economics.⁵ The intuition from these models can, in certain ways, also apply to factor market integration.

To keep the discussion focused, this overview leaves aside two important aspects of regional integration. First, it does not discuss the effects of economic integration on inequality and poverty, a subject that has been widely discussed in the existing literature.⁶ The potential effects of international integration on inequality and poverty are important to consider but go beyond the scope of this report. For now, it suffices to say that there is evidence that global integration in LAC has probably helped reduce inequality. Following the extensive trade liberalization of the 1990s, wage inequality eventually fell throughout Latin America (Lopez-Calva and Lustig 2010; Messina and Silva, forthcoming). Falling inequality could be linked to trade, as predicted by neoclassical trade theory (Robertson 2004). Perhaps more importantly, concerns about poverty and inequality are generally considered to be less effectively addressed through trade

policies than through alternatives, such as expanding the coverage of public education, improving the quality of education in poor neighborhoods, or conditional cash transfers, among other policies that would not hamper growth or economic efficiency. The second limitation of this study is that it does not discuss noneconomic objectives or consequences of regional integration.⁷

The rest of this overview is organized around the topics that lie at the heart of the arguments it presents. It first discusses the importance of geography in shaping both economic performance and integration patterns around the world. Having discussed the role of geography, the overview analyzes observed regional integration patterns. Then it assesses the benefits of integration through two separate theories—one that argues that potential efficiency gains depend on how much countries can complement each other and another one that argues that benefits depend on how much countries can learn from each other. With this evidence in hand, the overview then lays out the five-pronged strategy for renewing OR in the Americas. In discussing each area of the strategy, the overview presents the current state of policies in the region as well as the challenges that lie ahead.

Even in the age of globalization, geography matters for trade, factor flows, and economic performance

In recent decades the world has experienced significant technological and economic changes that have transformed international economic relations. These changes have led many to claim that “distance is dead” or that “the world is flat.” In short, one expects that in a “flat world” a country’s economic performance should not be affected by its geographic location.⁸ The Internet and improvements in transportation have certainly affected trade patterns and facilitated new trade relationships (see box 1).

As significant as these changes are, however, the effect of distance does not seem to

BOX 1 Is distance dead? Technology and its impact on international integration

The advent of information and communication technologies (ICTs) and the Internet is regarded as perhaps the most disruptive change affecting international economic interactions in the past thirty years. It has led many economic and business commentators to suggest that economic and business interactions are no longer bound by geography (the “death of distance” hypothesis). A literal interpretation of this hypothesis is that, in the extreme, geographic distance should not affect bilateral trade and factor flows. Despite some anecdotal evidence in support of the death of distance hypothesis (Friedman 2007), a large number of academic papers suggest that distance is still an important force shaping economic interactions.

How can one reconcile the expectation that technology would facilitate international economic interactions, especially between faraway countries, and the reality that distance still plays an important role in shaping trade flows? The answer is that most of the evidence of the economics literature supports the view that technology has affected trade—especially by reducing the fixed costs associated with exporting (Freund and Weinhold 2004). These are the costs that are **not** associated with the movement of goods and services from one country in the world to another but are, instead, the costs of establishing a business relationship. They range from transactions that exporters have to undergo before exporting a good or service to the costs of acquiring the information needed by buyers and sellers. There is no robust evidence, however, of systematic changes in the costs that are associated with the movement of goods and services over the past thirty years.

To illustrate the impact that technology has on fixed costs, it is useful to focus on online markets, such as Amazon or eBay, and contrast these with traditional “offline” markets. A seller that wants to serve foreign consumers and firms through offline markets would have to establish client and distribution networks in every destination it wants to serve. In contrast, a seller that operates through online markets can avoid these costs by accessing the online platform’s networks. In this sense, online markets reduce unnecessary duplications of transaction costs.

The role of technology in facilitating business transactions by reducing information costs can be illustrated by assessing the differences between online and offline markets from the point of view of buyers. Buyers make decisions regarding the goods they acquire based in part on the information they have about the goods and their producers. A business transaction is more likely if the buyer trusts and has better quality information about a good and its producers. In offline markets information is dispersed and costly to acquire, thus reducing the scope for a transaction to materialize. In contrast, in online markets information is easily accessible. An implication of the cost-reducing effects of online markets is that they make it easier for firms that are smaller or from less-known countries to export (Lendle et al. 2012).

What does the evidence say about the relationship between technology and the costs directly linked to the movement of goods and services across borders? The literature has provided two pieces of evidence suggesting that, at least for a broad set of goods, these costs are still affected by distance. Berthelon and Freund (2008), for example, showed that there is a large degree of heterogeneity across goods in terms of the responsiveness of bilateral trade flows to distance. In fact, most goods have large and negative distance elasticities, which capture in part freight and insurance costs. To be sure, it is undeniable that technology (ICTs and the Internet, specifically) has reduced the transportation costs for certain services (Freund and Weinhold 2002). For example, an architect selling his services to a foreign client can deliver those services at the same cost (close to zero), regardless of the location of the client. For a large share of the goods and services making up world trade, however, freight costs are still large and have not significantly declined over time (Hummels 2007).

In sum, ICTs and the Internet have changed world trade. They have reduced transaction and information costs, allowing more buyers and sellers to participate in global markets. Nevertheless, moving goods across borders is still costly, and these costs increase with distance. In this specific sense, trade and factor flows are still bound by geography.

have disappeared. As discussed in box 1, geographic forces are also important drivers of economic integration. That is, even in the absence of policies favoring regional integration, proximity facilitates economic integration. This bias is the by-product of costs associated with the movement of goods, people, and, to a lesser extent, capital across borders. The literature has found that such costs increase with distance.

The incidence of geography on trade and factor flows (capital and labor) has important implications for the patterns of regional integration observed across regions. Countries that are geographically closer to their regional partners are expected to have higher levels of regional integration compared to those that are more distant.

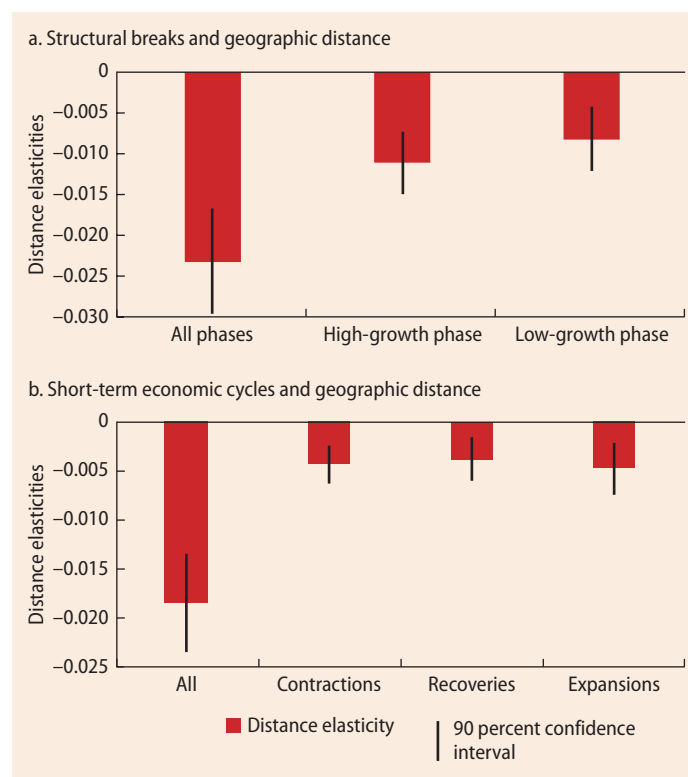
Economic performance around the globe is also geographically clustered. In particular, a country's economic performance in both the long run and the short run is highly correlated with that of its neighbors. The likelihood that two countries will simultaneously experience prolonged episodes of either high growth or low growth falls with geographic distance (figure 1, panel a). Similarly, the probability of two countries going through the same phase of a business cycle decreases with geographic distance (figure 1, panel b). Moreover, the geographic forces that shape economic performance haven't diminished over time. On the contrary, they have increased. New research presented in this study shows that regional forces affecting a country's GDP growth have gained prominence in the recent past, to the point that, for the average country in the world, they have surpassed country-specific and global factors as key determinants of macroeconomic fluctuations (figure 2).

Regional forces have become increasingly important over time for Latin American countries as well. By the 1995–2011 period they were as important as country-specific factors. To be sure, the lion's share of this increase is due to the rising prominence of forces that similarly affect many countries in the region but are linked to developments in other corners of the world. This finding is

likely explained by China's rise in the global economy and the impact it has had across LAC (see de la Torre et al. 2015).

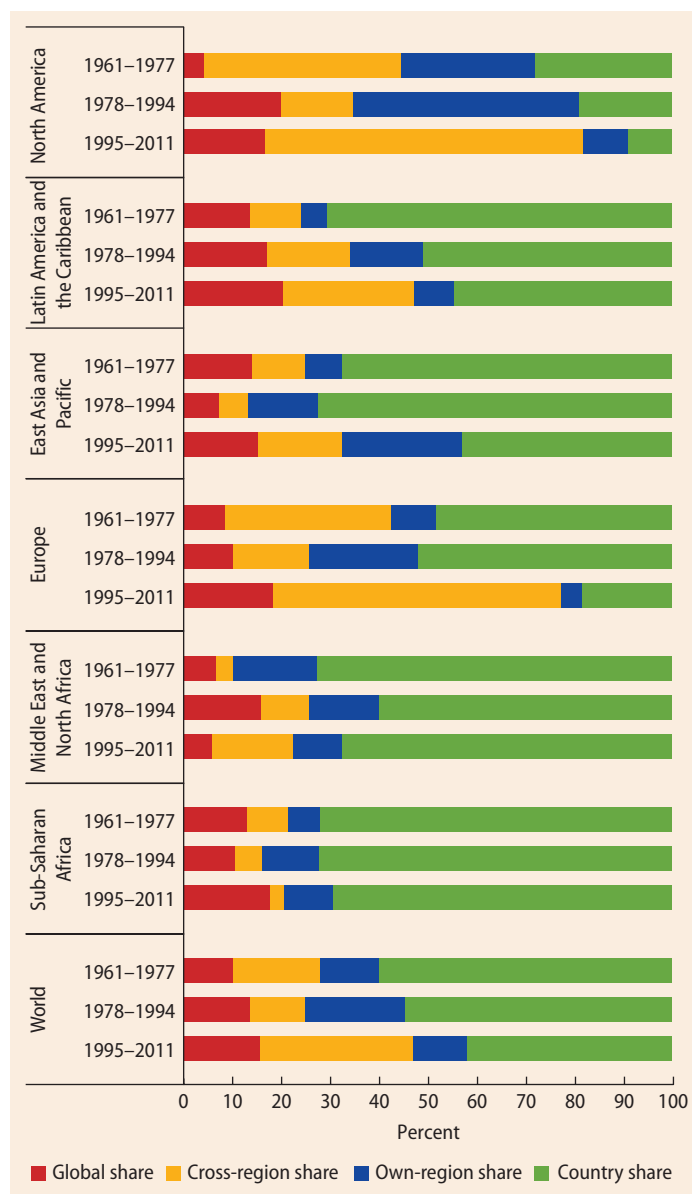
There are at least two hypotheses for the geographic clustering of economic performance. One is that it is a consequence of trade and the integration of capital and labor markets, which themselves are geographically clustered (see Calderón, Chong, and Stein 2007). Another is that endowments, institutions, and other determinants of economic performance are geographically clustered.

FIGURE 1 Economic performance and geographic distance



Sources: World Bank calculations based on PWT (Penn World Table) 8.1 (see Feenstra, Inklaar, and Timmer 2015) and national sources.

Note: Phases are prolonged episodes of high or low average growth. Episodes start after a structural break, which is identified using the algorithm proposed by Bai and Perron (2003). The distance elasticities in panel a correspond to the coefficient of the logarithm of distance from an ordinary least squares (OLS) regression of a dummy variable taking value one if a pair of countries experience simultaneously the same economic phase (high-growth or low-growth) on log distance, country fixed effects, additional gravity controls, and economic distance, measured as the absolute value of the difference of the natural logarithm of gross domestic product (GDP) per capita of each pair of countries. The distance elasticities in panel b correspond to the coefficient of the logarithm of distance from an OLS regression of a dummy variable taking value one if a pair of countries experience simultaneously the same short-term economic cycle (contraction, recovery, and expansion) on log distance, country fixed effects, additional gravity controls, and economic distance, measured as the absolute value of the difference of the natural logarithm of GDP per capita of each pair of countries.

FIGURE 2 Variance decomposition by region and subperiod

Source: Hevia and Servén 2016.

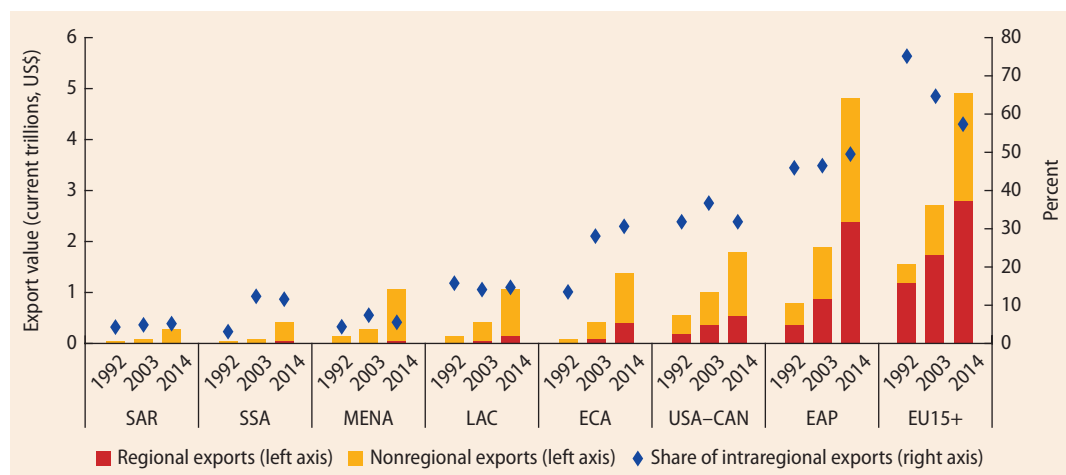
Note: Numbers for each region correspond to the contribution of each of the three factors to the growth variance in the average country in the region. Global share is the share of a country's real gross domestic product (GDP) growth variance that is explained by a global factor—that is, a factor that is common to all countries in the world. Regional share is the share of a country's real GDP growth variance that is explained by a regional factor—that is, a factor that is common to all countries in the region. The regional factor for each region is split into two components, one that is orthogonal to other regions (own region) and one that is correlated with those of other regions. Finally, country share is the share of a country's real GDP growth variance that is explained by an idiosyncratic factor. See appendix A for a list of countries in each region.

Regardless of the explanation, the geographic clustering of economic performance and the way it has evolved over time affect the gains from integration predicted by neoclassical models of trade based on endowment or technological differences and by models of learning through trade. Similarly, the forces of geography are expected to affect the observed levels of regional integration. The rest of this overview analyzes in more detail these two points. The analysis will then guide the policy discussion that lays the ground for the proposed renewal of OR.

Regional trade in LAC and in the Americas: International comparison and determinants

Regional trade flows are an integral part of international trade flows. Approximately half of total trade flows occur between regional partners. There are, however, significant differences in the incidence of intraregional trade flows in total flows across regions. On one extreme stand EU15+ (European Union 15 extended) and EAP, regions where intraregional exports accounted for 60 and 50 percent of total trade in 2014, respectively (figure 3). At the other extreme stand regions such as South Asia (SAR), Sub-Saharan Africa (SSA), and the Middle East and North Africa (MENA), where intraregional exports accounted for a meager 10 to 15 percent of total trade in 2014.

As mentioned above, the remarkable performance of EAP in terms of regional trade integration has caught the attention of other regions, including LAC. However, replicating EAP's experience has proven a difficult challenge for LAC. The region has pursued regional integration efforts through formal trade integration agreements since the 1960s, efforts that have only intensified since the mid-1990s. Indeed, prior to the year 2000 the average country in LAC held a preferential trade agreement with about 4 regional partners; by 2013 this number rose to close to 10. Despite these efforts, the incidence of intraregional exports in LAC's total exports has remained stable at about 20 percent.

FIGURE 3 Intraregional trade across regions

Source: World Bank calculations based on data from UN COMTRADE.

Note: The share of intraregional exports is calculated as the ratio between intraregional exports and total exports. EAP = East Asia and Pacific; ECA = Eastern Europe and Central Asia; EU15+ = EU15 plus Iceland, Norway, and Switzerland; LAC = Latin America and the Caribbean; MENA = Middle East and North Africa; SAR = South Asia; SSA = Sub-Saharan Africa; USA-CAN = United States and Canada. See appendix A for a list of countries in each region.

The discussion above raises a question: Why is the region not more integrated? Or, more precisely, what are the constraints to boosting regional trade that policy makers in LAC face? To answer these questions, the rest of this section explores a potential explanation that follows from the insights of the international trade literature, which points to economic size and trade frictions associated with geographic distance as gravitational forces shaping trade flows.

Size and geographic distance matter for trade flows

Understanding the determinants of international trade patterns is a research goal that dates back to the early 1800s. Neoclassical models of international trade focused on the role of technology (Ricardian models) and differences in factor endowments (Heckscher-Ohlin model) in explaining observed trade patterns. As appealing as the insights of these models are, however, studies from the 1970s, 1980s, and 1990s found little empirical support for these theories as explanations for observed trade patterns because most global trade was between wealthy and nearby countries.⁹

One empirical model that appears to fit the trade data particularly well is the so-called “gravity” model of trade.¹⁰ Its central tenet is that trade flows should be proportional to the GDP of trading partners and inversely proportional to their geographic distance. The positive relationship between bilateral trade flows and the GDP of trading partners captures the idea that large, wealthy countries demand and supply more goods from and to the rest of the world relative to smaller countries, yielding high levels of trade between them.¹¹ The inverse relationship between trade and distance captures the idea that trade implies moving goods, and that the cost of moving goods is expected to increase with distance.¹² Hence, the prices charged by more distant producers are expected to be higher than those of producers nearby, resulting in lower demand for exports (varieties) from more distant countries. The effects of distance, therefore, may prevent countries from realizing the benefits of trade predicted by neoclassical models.

The relationship predicted by the gravity model has important implications for understanding the regional integration patterns discussed above. First of all, the negative relationship between trade flows and distance

predicted by the gravity model and observed in the data implies that, all other things being equal, trade flows between nearby partners are expected to be higher than between far-away partners. In other words, even if trade policy around the world were nondiscriminatory, the gravity model predicts that trade should be largely regional because of trade costs that vary systematically with geographic distance.

Another important implication of the gravity model is that differences in the size and distance between countries within regions can play an important role in explaining differences in the incidence of regional trade across regions. In particular, regions comprising countries with large GDP values and with short distances between them are expected to exhibit higher regional trade flows as a share of total trade than others, all else being equal.

Table 1 provides a preliminary look at some of the characteristics that may be behind the cross-regional differences in regional integration patterns depicted in figure 3. For example, Europe, a region that stands as one of the most integrated in terms of trade flows, is also one of the regions with the highest average GDP and the shortest

average distance between regional pairs of countries. EAP, another highly integrated region, ranks poorly in terms of distance but has the third-largest GDP among all regions (it includes Japan and other high-income countries). In contrast, SSA, the region with the second-lowest level of regional integration, has the lowest average GDP and the second-highest average pairwise distance. Thus the logic of the gravity model seems consistent with the data.

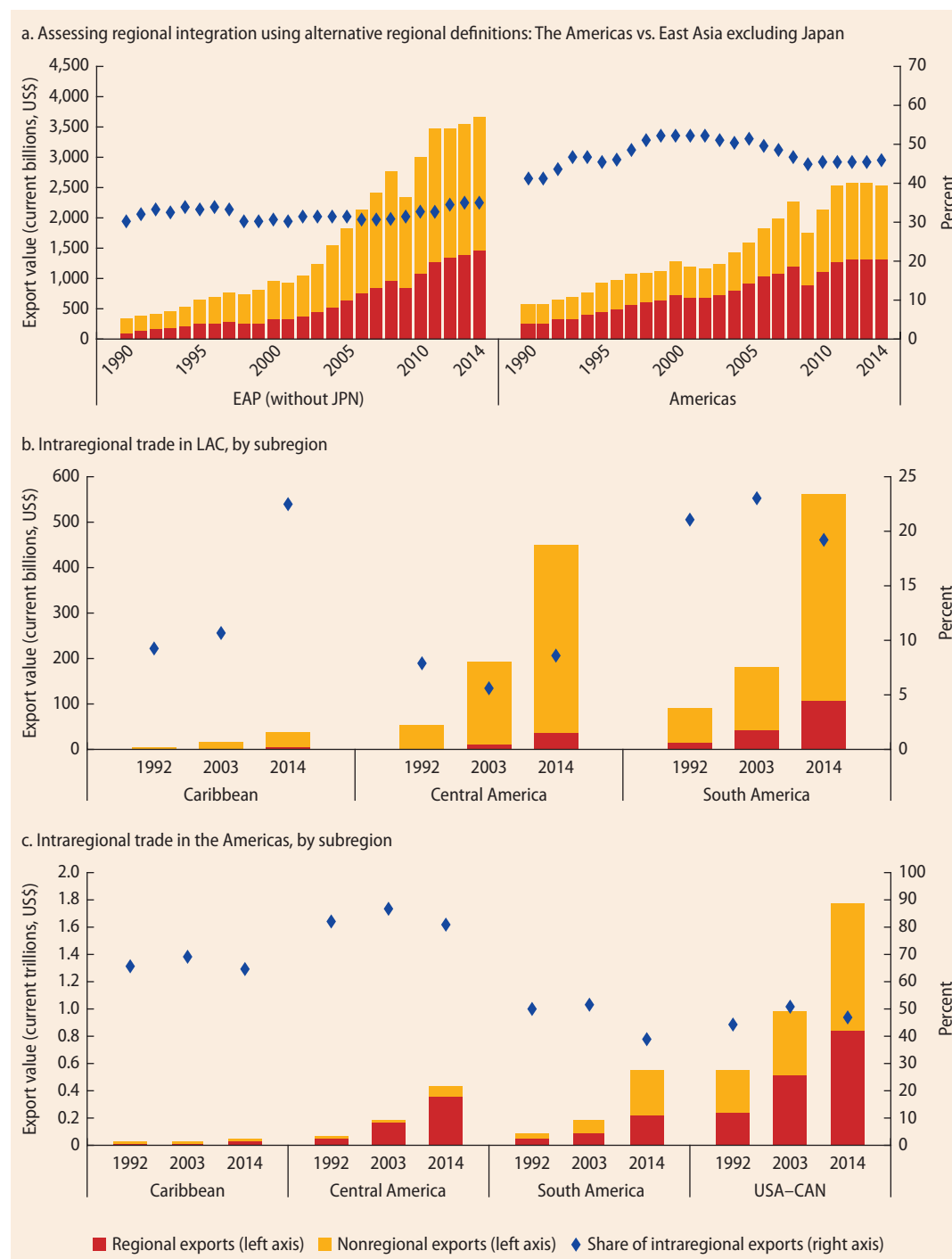
The points made in table 1 can be further illustrated by an alternate definition of regions. Figure 4, panel a, shows the levels of regional integration in the Americas, comprising LAC plus the United States and Canada, and EAP without Japan. Hence, the exercise adds two large countries to LAC (pushing in favor of regional integration compared to LAC alone) and subtracts one big economy from EAP (pushing against regional integration compared to the original EAP definition). The results confirm the importance of the size of countries in a region for its level of integration. The incidence of regional exports in the Americas (LAC plus the United States and Canada) stands at about 50 to 60 percent of total trade, higher than the 20 percent for LAC and the

TABLE 1 Gravity variables, by region

	Within-region country pairwise distance, in kilometers		2014 GDP (as % of U.S. GDP)		2014 GDP per capita (as % of U.S. GDP per capita)	
	Mean	Median	Mean	Median	Mean	Median
SSA	3,360	3,120	0.24	0.07	4.91	1.91
EAP	4,840	4,464	5.23	1.07	29.45	7.92
ECA	2,190	1,864	1.00	0.30	19.22	16.78
EU15+	1,260	1,242	6.55	3.08	90.98°	87.87
LAC	2,816	2,531	1.08	0.17	16.06°	13.63
MENA	2,193	1,952	1.04	0.63	35.69	12.27
SAR	1,735	1,710	2.14	0.43	4.59	2.44
Central America	795	571	1.23	0.25	11.62	7.29
Caribbean	1,366	1,236	0.07	0.02	18.41	15.20
South America	2,504	2,376	2.40	1.18	16.63	13.52

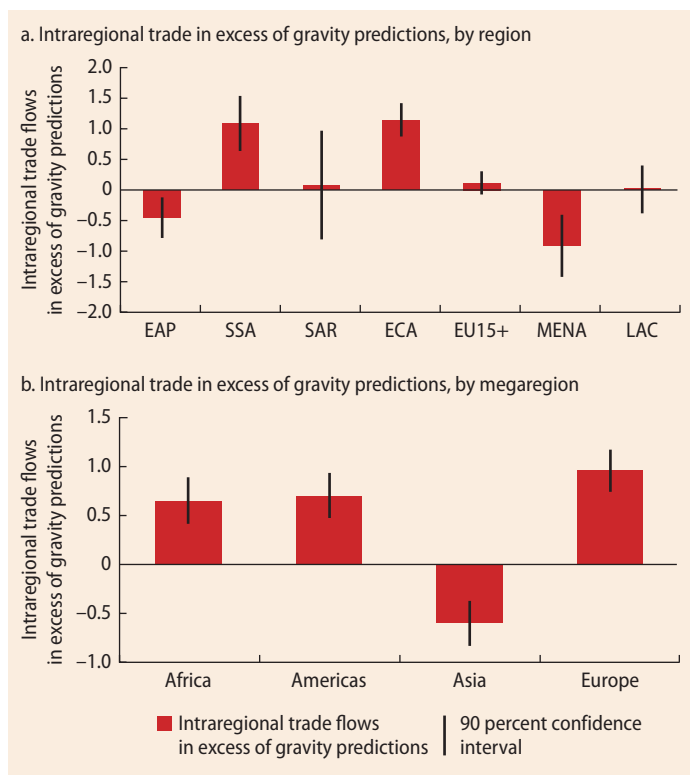
Source: World Bank calculations from World Development Indicators and Centre d'Etudes Prospectives et d'Informations Internationales (CEPII).

Note: EAP = East Asia and Pacific; ECA = Eastern Europe and Central Asia; EU15+ = EU15 plus Iceland, Norway, and Switzerland; GDP = gross domestic product; LAC = Latin America and the Caribbean; MENA = Middle East and North Africa; SAR = South Asia; SSA = Sub-Saharan Africa. See appendix A for a list of countries in each region.

FIGURE 4 An illustration of the gravity forces of international trade

Source: World Bank calculations based on data from UN COMTRADE.

Note: The share of intra-regional exports is calculated as the ratio between intra-regional exports and total exports. Americas = LAC plus the United States and Canada (USA-CAN); EAP = East Asia and Pacific; JPN = Japan; LAC = Latin America and the Caribbean. See appendix A for a list of countries in each region.

FIGURE 5 Benchmarking regional integration through a gravity model of trade

Source: World Bank calculations based on Artuc, Hillberry, and Pienknagura 2016.

Note: In both panels the coefficients capture the excess intraregional trade of a region (megaregion) relative to its trade with nonregional partners conditional on gravity characteristics. Vertical lines capture 90 percent confidence intervals. Standard errors are clustered at the importer level. In panel a, ECA = Eastern Europe and Central Asia; EAP = East Asia and Pacific; EU15+ = EU15 plus Iceland, Norway, and Switzerland; LAC = Latin America and the Caribbean; MENA = Middle East and North Africa; SAR = South Asia; SSA = Sub-Saharan Africa. In panel b, Africa = SSA plus MENA; Americas = LAC plus the United States and Canada; Asia = EAP plus SAR; Europe = EU15+ plus ECA. See appendix A for a list of countries in each region.

35 percent for the United States and Canada in the original classification. Likewise, EAP's regional integration falls from 50 percent in the case where Japan is included to 40 percent when it is excluded.

In addition, the exercise with alternative regional definitions demonstrates the importance of distance in shaping regional integration. Under standard regional definitions, figure 4, panel b, shows that South America displays the highest levels of regional integration with LAC as a whole (20–25 percent of total trade flows) and Central America the lowest levels (below 10 percent). When the United States and Canada are included in the

Americas, the rankings are reversed (figure 4, panel c). Thus, while the inclusion of two big countries increases regional integration levels across the board, it favors disproportionately countries that are close to them.

The insights of the gravity equation suggest that, in order to carefully assess LAC's standing in terms of regional integration and to understand the factors underpinning it, one should take into account the impact of geography and size on trade flows. Background research prepared for this study follows this approach and compares LAC's standing relative to other regions in terms of intraregional trade, after stripping away the impact of these variables.¹³

The results of this exercise show that the average pair of countries in LAC, which originally ranked poorly in terms of the incidence of regional trade, have intraregional trade flows that are in line with or exceed what is predicted by gravity variables (figure 5, panel a).¹⁴ In contrast, EAP, a region that ranked second in the original comparison of intraregional trade flows, presents levels of intraregional trade that are statistically lower than those predicted by gravity variables.

Naturally, as illustrated by figure 4, differences in regional integration within LAC are sensitive to the definition of region, as the inclusion or exclusion of countries can change the size and distance of the average pair of countries in the region. This will, in turn, affect intraregional trade patterns because of the role of geography and size in shaping trade flows. For instance, an assessment of integration in the Americas provides substantially different conclusions relative to the assessment in figure 5, panel a. The analysis of megaregions shows that intra-Americas trade is statistically larger compared to what gravity variables would predict, suggesting that the inclusion of the United States and Canada boosts trade in the Americas beyond what would be predicted by their economic size and distance to LAC countries (figure 5, panel b).

The results highlighted in this section show that, if one of their objectives is to increase intra-LAC or intra-Americas trade

flows, Latin American policy makers have two options. Countries in the region could grow at a rate higher than that of the average country in the world, or they could reduce trade frictions associated with policies and distance. But clearly growth is a policy goal in its own right, and arguably a more important one than regional integration per se. Thus, instead of focusing on policy actions that have the sole objective of boosting regional integration, the rest of this overview explores integration strategies that can help LAC achieve high and stable growth.

The conceptual arguments for a renewal of Open Regionalism

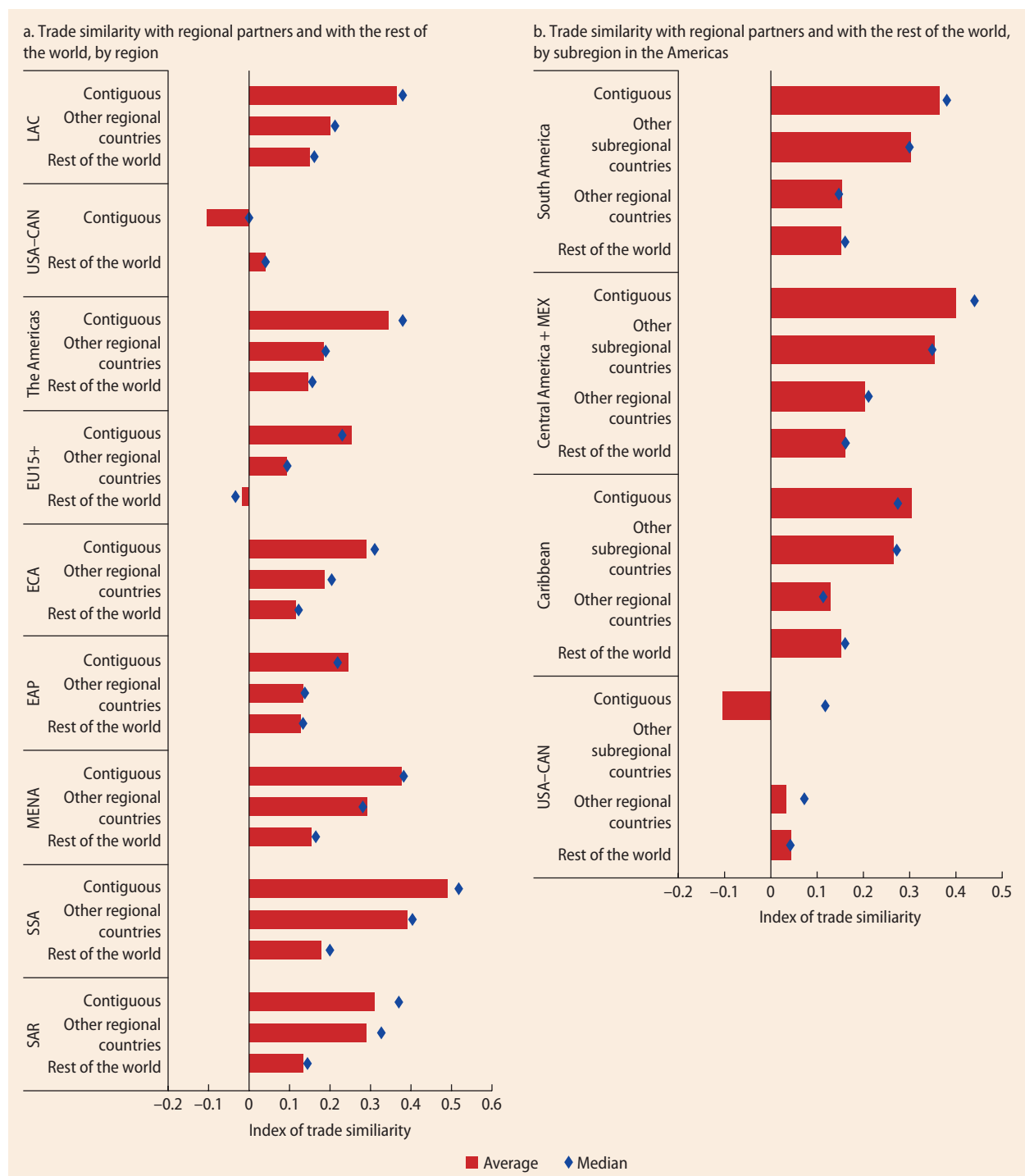
This study assesses the benefits of different integration strategies through the lens of two prominent strands of economic theory. The first is inspired by neoclassical models, which suggest that the gains from trade and economic integration more broadly crucially depend on how different economies are in terms of their technologies and their endowments. The gains are expected to be larger when partners are more different. Likewise, the gains in terms of stability are also expected to be larger when trade occurs between dissimilar countries because they are exposed to different types of shocks.

The second strand of theory highlights the role of economic integration as a conduit for technological diffusion and learning. According to these theories, countries could, for example, learn from the technological content embodied in the goods they import. This knowledge content depends on the innovation efforts of a country's partners and those of their partners' partners (Coe and Helpman 1995; Lumenga-Neso, Olarreaga, and Schiff 2005). Similarly, economic integration may allow firms in one country to learn about the goods, production processes, and business relationships in third markets of the firms with which they interact in another country. This, in turn, may facilitate productivity improvements and entry and survival in third markets (Morales, Sheu, and

Zahler 2014; Chaney 2011). Importantly, according to these theories the characteristics of a country's partners matter for the benefits stemming from learning. The gains are expected to be larger when a country's partners are knowledge hubs (invest in research and development [R&D]) or when they are open (have more business connections and trade with knowledge hubs).

What do these two strands of the theory imply for the attractiveness of different economic integration strategies for LAC countries? From the point of view of neoclassical models, countries in the region would benefit the most by seeking trading partners that are not near them. This point is illustrated in figure 6, panel a. It presents an index that captures the similarity of the structure of net exports across pairs of countries. For the average country in a region, it assesses how similar its pattern of net exports is with respect to those of regional and nonregional partners. A high positive number indicates a more similar pattern of comparative advantage, which would imply that there is less scope for efficiency gains from trade integration if the neoclassical theories are valid. The results show that, in all regions, integration with the rest of the world appears to provide larger potential efficiency gains compared to regional integration. In LAC, however, the average pair of countries appears to be much more similar compared to the average pair of countries in developing regions such as EAP or ECA.

Even so, there are still important differences among LAC countries that could lead to neoclassical-style gains from trade. Data show that there is a positive relationship between the similarity of the revealed comparative advantages (RCAs) of a given pair of countries and that pair's similarity in terms of economic size. Likewise, there are marked differences in terms of patterns of RCA between countries in South America and those in Central and North America (figure 6, panel b). In fact, the average efficiency gains that LAC countries could obtain from trade with regional partners outside their subregion are comparable to those that could be

FIGURE 6 Trade similarity

Source: World Bank calculations using data from UN COMTRADE.

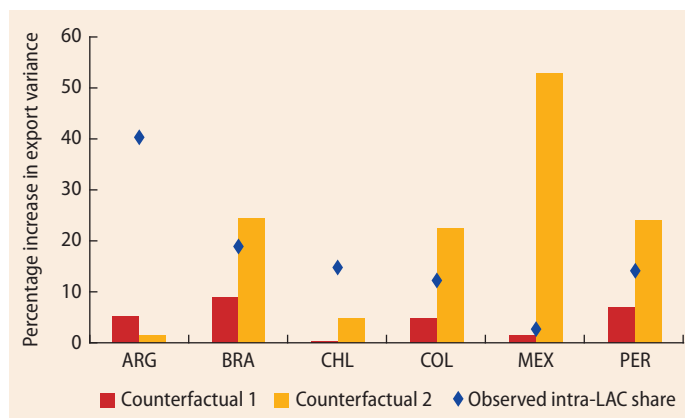
Note: Calculations are made using data for 2014. Export similarity between any pair of countries is calculated as the Spearman rank correlation of the vector of revealed comparative advantages of the two countries. The ranking ranges from -1 (most dissimilar) to 1 (most similar). For the bilateral correlations all products with zero trade in both countries are excluded. Regional numbers correspond to the average correlation between countries in the region and partners in the relevant partner group. EAP = East Asia and Pacific; ECA = Eastern Europe and Central Asia; EU15+ = EU15 plus Iceland, Norway, and Switzerland; LAC = Latin America and the Caribbean; MENA = Middle East and North Africa; MEX = Mexico; SAR = South Asia; SSA = Sub-Saharan Africa; USA-CAN = United States and Canada. See appendix A for a list of countries in each region.

attained from trade with partners elsewhere in the world. These findings suggest that deeper integration between small and large countries in LAC and between South America and Central and North America could yield efficiency gains if the neoclassical theories are valid.

In addition to limiting the efficiency gains predicted by neoclassical trade models, the similar trade structures observed between LAC countries, especially those that are nearby, also limit the prospects for regional integration to deliver stability. LAC economies are typically exposed to similar shocks (for example, terms-of-trade shocks), thus limiting the scope for regional integration to diversify country-specific risks. This point is illustrated in figure 7, which presents the results of two counterfactual exercises assessing the effect that an increase in the incidence regional trade integration has on export growth volatility. The first exercise assumes that the incidence of regional trade integration on total trade doubles and the second assumes that the weight of trade with the rest of the world is reduced in half. In both cases the volatility of LAC's exports increases as a result of the increase in the weight of regional partners, which typically have highly volatile and correlated import demands.

Learning models do not provide much more support to regional integration. Countries in LAC do not have as many trade connections as do other countries in the world and invest too little in R&D, thus limiting the benefits predicted by these models. To be sure, the desirability to integrate with specific partners depends on how transferable knowledge is between countries. If knowledge is fully transferable, the characteristics of a country's partners become irrelevant because countries can build upon the stock of knowledge of the world. In this case, the stock of knowledge of a country can be appropriated by that country's trading partners, the partners of its partners, and so on. This is illustrated in figure 8, panel a, which shows the average total stock of knowledge of a country (proxied by R&D intensity), assuming that it can produce

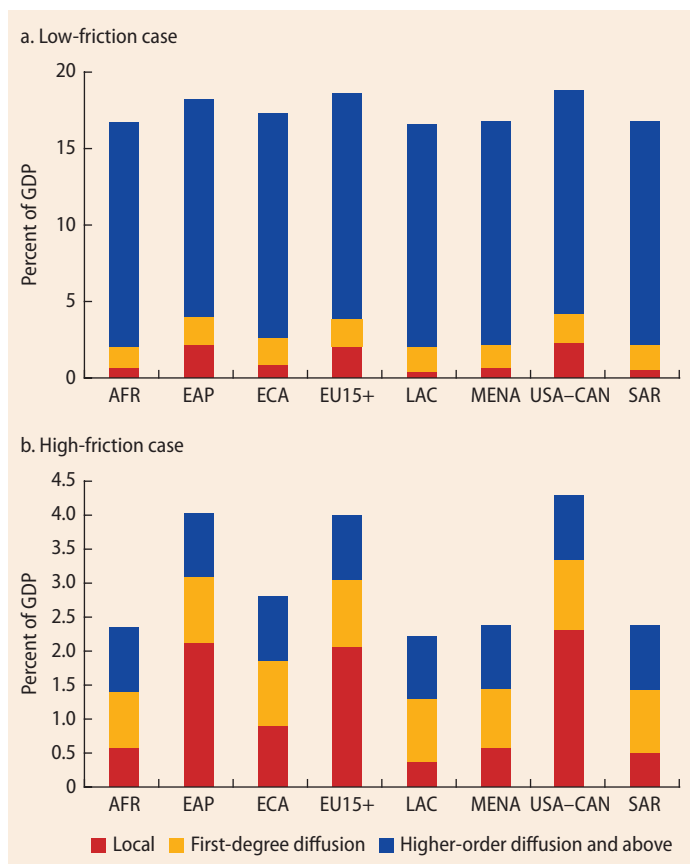
FIGURE 7 Regional integration and its effect on export volatility in selected countries



Source: World Bank calculation based on Bennett et al. 2016.

Note: Changes in export variance are calculated under two counterfactual exercises. The first assumes that for each country intra-LAC export shares double compared to the observed share. The second assumes that the ROW share (the non-LAC share) halves compared to the observed shares. ARG = Argentina; BRA = Brazil; CHL = Chile; COL = Colombia; LAC = Latin America and the Caribbean; MEX = Mexico; PER = Peru; ROW = rest of world.

knowledge domestically or import it from its trading partners and that knowledge transfers face very low frictions. In this case, most countries have a very similar stock of knowledge. In contrast, if knowledge transfers and learning are not easily diffused across space, the characteristics of a country's trading partner become more important and countries will differ in their stock of knowledge (figure 8, panel b). Countries that have high domestic investment in R&D, and that are surrounded by partners with high investment in R&D, are expected to have higher stocks of knowledge. The assumption that there are frictions to knowledge diffusion and learning is supported by evidence, suggesting that the identity of partners matters (Keller 2002). Moreover, frictions appear to increase with distance, both geographic distance and distance in levels of development, which means that the potential gains from trade from the point of view of learning models will depend on the characteristics of a country's nearby partners. A country is expected to have more scope for learning when its nearby partners are knowledge hubs or have strong commercial ties with knowledge hubs.

FIGURE 8 Knowledge stocks across regions: The role of frictions in the diffusion of knowledge

Source: World Bank calculations based on Lumenga-Neso, Olarreaga, and Schiff 2005.

Note: The stocks of knowledge are calculated as in Lumenga-Neso, Olarreaga, and Schiff 2005.

More specifically, the total research and development (R&D) stock of a country i is calculated as $R \& D_i^t = R \& D_i^0 + (1-\rho) \sum_{j=1}^t m_{ij} R \& D_j^{t-1}$, where j is an index capturing a country's trading partners, m captures the trade shares, and ρ captures frictions to knowledge diffusion. Panel a assumes a $\rho = 0.1$; panel b assumes $\rho = 0.9$; AFR = Africa; EAP = East Asia and Pacific; ECA = Eastern Europe and Central Asia; EU15+ = EU15 plus Iceland, Norway, and Switzerland; GDP = gross domestic product; LAC = Latin America and the Caribbean; MENA = Middle East and North Africa; SAR = South Asia; SSA = Sub-Saharan Africa; USA-CAN = United States and Canada. See appendix A for a list of countries in each region.

There seems to be tension, therefore, between geographic forces and the policies that facilitate regional integration and the predictions of economic models that drive countries in LAC to look for efficiency gains beyond their immediate neighbors. Indeed, there is a tension between preferential trade arrangements that provide incentives for intraregional trade perhaps at the expense of trade with the rest of the world and the realization that geography naturally favors intraregional trade. Why would LAC pursue

an integration strategy that combines global and regional integration? The short answer is that there are important complementarities between regional integration and global integration that make LAC's international competitiveness and its ability to reach extraregional markets dependent on regional integration. Thus, a comprehensive renewal of OR can make LAC more competitive in global markets.

There are several reasons why a balance between regional and global integration efforts can boost LAC's competitiveness. First, the impact of geography is unlikely to disappear any time soon. This implies that trade links with nearby countries will affect the global competitiveness of countries in the region. The link between regional trade and global competitiveness is most clearly illustrated in the case of "regionally traded goods." These are goods and services for which the costs associated with distance are so high that they are typically exchanged only by neighboring countries and for which the policy-related barriers to trade are not import tariffs per se, but rather differences in regulatory schemes. For these goods and services, regional integration efforts are equivalent to global integration. Notable examples of these goods and services are electricity and land transportation. Hence, regional efforts to assure the quality and the efficient provision of these types of goods and services will be crucial for the growth and stability prospects of LAC and for the ability of the region to gain international competitiveness in sectors that use these "regionally traded goods" intensively.

Similar arguments can be made in the case of labor markets. Migration decisions are shaped by the costs faced by migrants to move and successfully adapt to the host country. These costs, which can be monetary and non-monetary, are expected to increase with distance. Moreover, there is evidence of persistent wage differentials between countries in LAC, which suggests that there is scope for achieving region-wide efficiency improvements by enhancing intraregional mobility of labor. Expanding the talent pool for employers, and

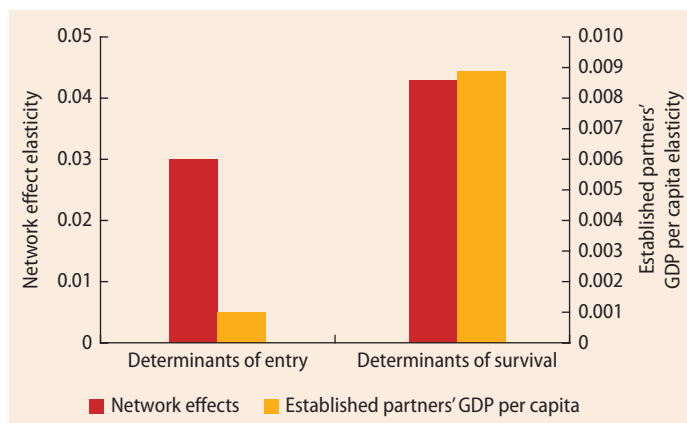
the employment options for workers, may facilitate matching and a more efficient allocation of workers across countries.

Geography also appears to affect the ability of international economic interactions to facilitate the diffusion of knowledge and a country's ability to learn from the experience of its peers. Knowledge diffusion and learning can be larger between nearby countries. The strength with which these channels affect a country's growth and competitiveness, however, will be affected by the stock of knowledge, the level of development, and the degree of global integration of its peers. For example, a country's likelihood to enter into and survive in third markets is larger when its current trading partners are actively exporting to those markets (figure 9). This implies that a country's ability to learn from the experiences of its nearby partners depends on how open they are to global trade, which illustrates the complementarities between regional integration and global integration. Thus, the potential growth and competitiveness benefits that LAC countries can get from interacting with their neighbors will depend on regional efforts to invest in innovation and to integrate globally.

Coordinated regional efforts can also facilitate LAC's competitiveness in relation to the rest of the world, even if these efforts are not directly aimed at strengthening regional trade and factor market links. This point can be easily illustrated in the case of infrastructure and logistics, two areas where the region has a noticeable deficit. Domestic and regional policies that seek to improve the quality of LAC's infrastructure and connectivity can lower the costs associated with distance for all countries in the region, costs that rank among the highest in the world. Moreover, the potential for region-wide competitiveness gains is expected to be greater to the extent that these policies are implemented by a large number of countries in the region.

In a nutshell, the preponderance of the evidence discussed above suggests that, for LAC to reap the benefits of international integration, it has to exploit the complementarities between efforts to integrate at the regional

FIGURE 9 Determinants of entry and survival in new exporting markets



Sources: World Bank calculations based on data from UN COMTRADE; World Development Indicators (WDI); and Centre d'Études Prospectives et d'Informations Internationales (CEPII).

Note: Elasticities are the estimated coefficients of ordinary least squares (OLS) regression of the likelihood of entry into a new export market and an OLS regression of survival of one year or more in a new export market on a set of controls that include previous exporting experience and product-year and exporter-importer-year fixed effects. The network effect indicates that a current established partner has export ties to the new market. Established partners' gross domestic product (GDP) per capita is a trade-weighted average of the exporting country's established partners' GDP per capita. An established partner is defined as a partner to which a country has exported successfully in each of the five years prior to a new entry episode.

level and those aimed at integrating globally. In the past, the OR strategy of some countries in the region was short on the "O" and long on the "R." Going forward, a rebalancing might be desirable in the renewal of OR as a means to achieve higher growth with stability.

Toward the renewal of Open Regionalism in the Americas: Past efforts and current challenges

Since the 1990s, with varying timing and intensities, most countries in the region advanced policies with the central objective of pursuing a global integration agenda (the "O") through strengthened relationships with their immediate neighbors (the "R"). The early momentum toward OR, however, has slowed in some countries and completely stalled in others. This report seeks to illustrate with evidence what could be done going forward in the five areas that constitute the renewal of OR in light of the economic models discussed earlier.

1. Tariff liberalization with the rest of the world: An unfinished agenda

Past efforts in the OR agenda are perhaps most clearly seen in the commercial policy front. Since the 1990s, MFN tariffs (external tariffs applied to nonpreferential partners) have significantly fallen in most LAC countries. For some countries, these reductions were the result of the negotiations to join the World Trade Organization (WTO). For others, reductions in MFN tariffs go beyond their WTO commitments and appear related to advances in regional preferential agreements. For instance, Estevadeordal, Freund, and Ornelas (2008) studied regional preferences and MFN tariffs in ten LAC countries for the period 1990–2001 and found that preferential tariff reductions in a given sector led to a reduction in the MFN tariff in that sector. Their evidence supports the idea that regionalism in LAC in the 1990s was in fact a building block toward global trade integration, thus satisfying Bergsten's (1997) definition of OR.

This OR trade agenda continued well into the 2000s in many Central American countries, Mexico, and in some South American countries like Chile, Colombia, and Peru. Average MFN tariffs in these countries are noticeably lower today compared to what they were in the mid-1990s. In parallel, preferential agreements with regional and extraregional partners flourished over the past 15 years. In contrast, in other South American countries the building-block effect of regional preferential agreements appears to have stalled.

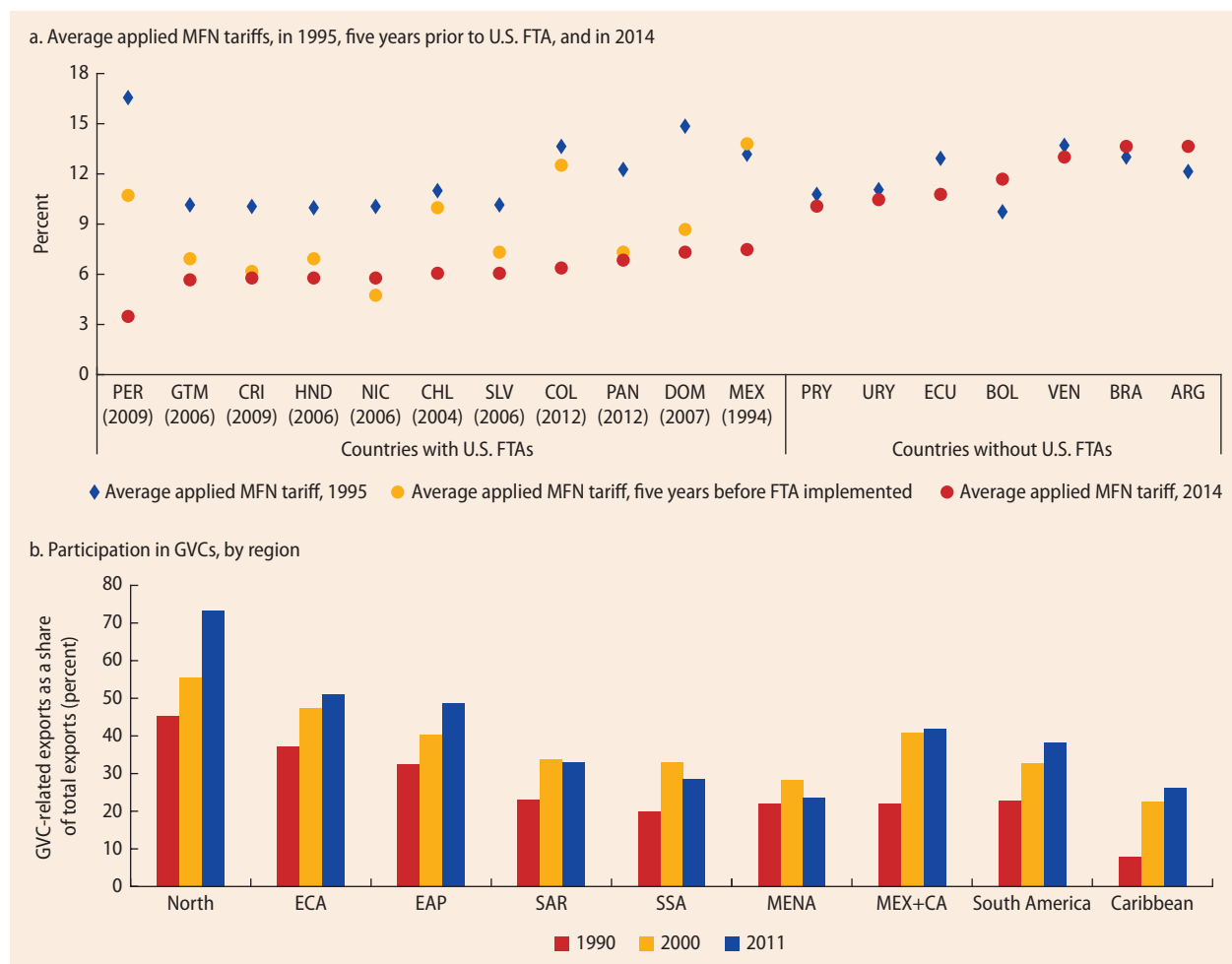
A proximate cause behind the diverging paths in MFN tariffs observed between certain South American countries, especially those in Mercosur, and the rest of the region is the advent of FTAs with high-income economies. MFN tariffs fell sharply during the 2000s in countries that signed preferential agreements with the United States and Europe, and they remained flat in countries that did not (figure 10, panel a). Thus, the positive reinforcement between regional preferences and external liberalization appears to have mutated in the 2000s.

Regional preferences alone do not seem related to further MFN liberalization; rather, external liberalizations appear to follow preferential agreements with key players in the global economy. Clearly, the evidence does not establish a causal link between the two because the relation can be spurious or driven by other factors. The evidence does, however, illustrate the diverging paths of applied MFN tariffs of countries that signed preferential agreements with large economies, such as the United States and Europe, and those that did not.

A deeper, and arguably more interesting, cause behind these differences is the intensity with which countries in LAC participate in global value chains (GVCs). Final goods tariffs are expected to decrease as the domestic content of imports increases (Blanchard, Bown, and Johnson 2016). Thus, participation in GVCs gives countries an incentive to reduce tariffs. This is consistent with the fact that Mexico and countries in Central America, which are deeply immersed in GVCs, have lower tariffs compared to countries in South America with an incipient participation in GVCs (figure 10, panel b).

Importantly, the above differences show that tariff liberalization with the rest of the world is still an unfinished agenda for many countries in the region. Despite significant reductions over the past two decades, many countries in the region, especially those in South America, still have relatively high MFN tariffs (figure 10, panel a). Lowering them could facilitate LAC's ability to connect to countries that offer large potential for efficiency gains and learning opportunities according to the models that constitute the organizing conceptual framework of this study.

Moreover, most countries in the region, even those with relatively low MFN tariffs, display noticeable tariff binding “overhang”—defined as the difference between applied/effective MFN rates and the tariff commitments countries have with the WTO. Tariff binding overhang introduces uncertainty in trade relationships as governments have the option to raise import tariffs

FIGURE 10 MFN tariffs, preferential agreements, and participation in GVCs

Sources: Panel a is constructed from data from the World Trade Organization and World Development Indicators. Panel b is from de la Torre et al. 2015.

Note: In panel a, 1989 data for Mexico (MEX) were replaced by data from 1991, 1995 data for Panama (PAN) and the Dominican Republic (DOM) were replaced by data from 1997. In parentheses is the year the country implemented the free trade agreement (FTA) with the United States. Countries in each group ranked from low to high according to average applied most-favored-nation (MFN) tariff in 2014. In panel b, participation in global value chains (GVCs) is proxied by the share of a country's exports that are part of a multistage trade process. This measure is constructed by adding the foreign value added used in a country's own exports (backward GVC links) with the value added supplied to other countries' exports (forward GVC links), and this total is scaled by the country's total exports of goods and services. North countries comprise the G-7 and Western European economies. ARG = Argentina; BOL = Bolivia; BRA = Brazil; CHL = Chile; COL = Colombia; CRI = Costa Rica; EAP = East Asia and Pacific; ECA = Eastern Europe and Central Asia; ECU = Ecuador; GTM = Guatemala; HND = Honduras; MENA = Middle East and North Africa; MEX+CA = Mexico and Central America; NIC = Nicaragua; PER = Peru; PRY = Paraguay; SAR = South Asia; SLV = El Salvador; SSA = Sub-Saharan Africa; URY = Uruguay; VEN = República Bolivariana de Venezuela. See appendix A for a list of countries in each region. Regions exclude countries that are included in North.

without risk of WTO-sanctioned retaliation, thus distorting investment decisions. From this it follows that reducing the tariff binding overhang can lead to welfare improvements (Handley and Limão 2015). Cutting applied and binding MFN tariffs, however, may require difficult political decisions. In the case of custom unions, for example, all

member countries should in principle agree to reduce MFN tariffs, and often the benefits of such decisions can take time to materialize.

Pursuing further reductions in MFN tariffs and reducing the tariff binding overhang could help build a more open, globally connected LAC, which could in turn yield dynamic gains for countries in the region.

New research prepared for this study shows that entry into, and survival in, new product markets is more likely when a country's trading partners have more trade connections. These findings, together with the forces of geography, imply that a more open LAC can facilitate entry into global export markets for countries in the region. Similarly, reducing tariff binding overhang can reduce policy uncertainty and stimulate local economic activity and attract foreign investment.

2. Enhancing the global integration of the Americas with tariff preferences

Preferential trade agreements (PTAs) are an integral part of today's global trade architecture. Moreover, their presence has been on the rise, especially in recent decades. In the early 1980s, the average country in the world granted tariff preferences to approximately six partners. In the early 2000s that number doubled, and by 2011 it had reached 28 countries.

LAC countries are no exception to this pattern. In fact, the increasing number of PTAs has been one of the defining traits of LAC's OR agenda. In the early 1980s, the average LAC country granted preferences to about 6 countries; by 2010 that number had increased to 23.

Despite the advances made by the region in terms of preferential agreements, there is scope for further improvements as part of the renewal of OR agenda. On the regional front, there is still room for additional regional preferences, especially between South America and Central and North America, which have notably different patterns of net exports. This would be consistent with neoclassical theories of the gains from trade. Table 2 summarizes the state of bilateral tariffs in LAC. Rows in the table characterize importing country tariff preferences offerings, and columns in the table characterize exporting country receipt of potentially available tariff preference offerings. The table suggests that there are roughly two groups of countries in LAC. The first group (group A),

which mainly comprises countries in Mercosur plus Bolivia and Ecuador, is displayed in the top part of the table. It is characterized by relatively high MFN tariffs, a fairly universal coverage of bilateral tariff preference offerings to other countries in the group, more modest bilateral tariff preference offerings to other countries in the region, and no tariff preference offerings to high-income countries. The second group (group B) comprises Chile, Colombia, Mexico, Peru, and Central American and Caribbean countries. Broadly speaking, these countries typically offer tariff preferences to high-income countries and either have relatively low MFN tariffs, offer tariff preferences to a large number of countries in LAC, or both.

Clearly, achieving the objective of broader tariff preferences between Mercosur and Mexico and Central America is not free of difficulties. It would entail addressing complex political economy constraints that limit the ability of countries to grant preferences in specific sectors. These challenges were manifested in the context of the Brazil-Mexico auto pact, where diverging views between the two countries created difficulties for eliminating the import quotas imposed by the auto agreement.¹⁵ These sectors may be particularly important in shaping value-chain based trade that could strengthen the region. As was highlighted above, however, the potential efficiency gains to be had from integrating the two ends of the Americas appear too large to be ignored.

In addition to pursuing broader regional preferences, table 2 also shows that many LAC countries, especially those in Mercosur, could still offer tariff preferences to high-income partners. Doing so can yield at least two potential benefits. First, it could allow countries in LAC to attain unexploited efficiency gains by deepening commercial ties with economies that have trade structures that differ from those in LAC and that offer a large learning potential. Indeed, once factors affecting trade flows, such as geography and economic size, are taken into account, LAC countries overperform in terms of their trade with partners with which they hold PTAs,

TABLE 2 LAC's imported products with available and granted bilateral tariff preferences, 2014

Share of all HS06 products with applied bilateral tariff rate lower than the applied MFN tariff rate																								
Policy-imposer	Available*	Group A exporters										Group B exporters										Selected other exporters		
		ARG	BOL	BRA	ECU	PRY	URY	VEN	CHL	COL	CRI	DOM	GTM	HND	HTI	MEX	NIC	PAN	PER	SLV				
ARG	96.7	100	100	100	99.9	99.5	100	100	100	99.4	0	0	0	0	0	87.8	0.7	84.3	99.8	0	0	0	0	0
BOL	93.7	100	100	66.5	100	100	100	61.5	64.5	61.5	0	0	0	0	0	98.9	0	61.2	1.7	0	0	0	0	0
BRA	96.8	99.9	99.9	99.9	99.3	99.9	99.9	99.9	99.8	99.9	0	0	0	0	0	90.4	1	88	99.9	0	0	0	0	0
ECU	59.6	89.1	46.3	89.6	88.6	83.7	39.6	39.6	97.7	39.6	0	0	0	0	0	39.8	0	38.9	1.2	0	0	0	0	0
PRY	89.2	99.8	99.9	99.8	97.9	99.8	99.7	99.9	99.6	0	0	0	0	0	0	68	0	65.7	99.7	0	0	0	0	0
URY	87.6	99.8	99.9	99.8	95.5	99.4	99.8	99.9	99.7	0	0	0	0	0	0	98.6	0	70.4	84.5	0	0	0	0	0
VEN	98.1	99.8	84.9	99.7	86.6	99.8	99.8	98.4	89.9	6.5	0	6	6	20.3	83.3	6	83.4	0.9	0	0	0	0	0	0
CHL	99.8	100	100	99	100	100	99.4	100	100	97	0	95.6	99.6	99.9	99.6	99.7	99.7	99.9	99.9	0	100	98.8	96.1	0
COL	54.2	99.1	77.3	98.7	77.3	99.6	99.4	83.6	100	2.2	0	0.4	1.8	30.3	99.3	0.6	75.6	3.1	0	99.8	98.6	75.4	0	0
CRI	51.7	0	0	89.6	0	0	0	0	0	99.6	99.8	99.8	99.8	0	0	99.8	98.1	90.7	99.8	99.8	98.6	75.4	0	
DOM	46.6	0	0	0	0	0	0	0	0	31.1	87.3	87.3	86.9	0	0	87.3	3	0	87.3	31.1	38.8	0	0	
GTM	51.7	0	0	0	16.8	0	0	0	0	55.7	0	85.1	100	0	0	100	97.5	0	100	99.2	75.8	0	0	
HND	52.4	0	0	0	0	0	0	0	0	82.6	99.8	100	100	0	0	100	72.1	0	100	99.8	77.3	0	0	
HTI	55.7	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	
MEX	57.4	64.5	69.7	64.5	73	76.1	95.6	65.7	99.1	97.6	97.2	0	96	95.6	0	99.5	66.7	86.8	0	100	92.5	87.8	0	
NIC	51.9	0	0	0	0	0	0	0	0	98.5	98.5	100	100	0	0	0	88.8	0	100	99.8	74	0	0	
PER	48.1	99.6	9.6	99.6	11.2	99.8	74	1.5	99.8	1.5	79.6	0	0	0	0	81.9	0	0.6	0	0	97.9	54.9	77.8	
SLV	52.6	0	0	0	0	0	0	0	0	54.9	0.4	97.9	99.8	99.4	0	0	99.8	69.4	0	99.2	75.3	0	0	

Source: Calculated with Harmonized System HS06 tariff data available from International Trade Centre.

Note: Rows are the importing (policy-imposing) countries and the columns are the exporting countries. Dark gray is tariff preference offered in 70 percent or more of preference possible products; light gray is tariff preference offered for between 0 and 70 percent of preference possible products. *Available provides the share of HS06 products within the importing country with a non-zero applied most-favored-nation (MFN) tariff and thus for which a tariff preference is possible. Interpretation: in 2014, Argentina had preferences to offer in 96.7 percent of its HS06 products. It offered bilateral preferences to Bolivia in 100 percent of available products, whereas it offered bilateral preferences to Colombia in 99.4 percent of available products. Tariff preference offerings data for Jamaica and Panama are not available. Three-letter country codes are ISO 3166-1 standard.

which suggests that implementing PTAs with high-income partners could boost trade flows between Mercosur and these countries. A second potential benefit is that, as suggested by figure 10, panel a, signing PTAs with high-income countries has been associated with reductions in extraregional tariffs. If such PTAs were to arise with multiple high-income partners, this could serve as a close substitute for MFN tariff liberalization.

Commercial policy in LAC has surely come a long way in facilitating the region's immersion into global markets and in fostering economic integration in the Americas. This was the main focus of the original OR strategy that emerged in the 1990s. The road ahead requires additional efforts to reduce MFN and extend tariff preferences within the Americas. In addition, the renewed OR strategy could focus on some of the adverse effects of the current "spaghetti bowl" of trade agreements that resulted from the initial OR efforts, an area to which we turn next.

3. Harmonizing rules of origin and regulatory frameworks in the Americas to achieve global competitiveness

Trade flows are thought to be affected by a number of variables. OR focused heavily on one of these variables, namely tariffs. By doing so, however, it left aside other barriers to international trade flows; and, in some cases that will be discussed below, it aggravated them. Factors like standards, regulations, or local content requirements affect the decisions of firms to enter export markets and the intensity with which countries trade. Going forward, initiatives to minimize the trade distortions imposed by these trade barriers can have a large impact on the region's global competitiveness because they would act as a region-wide positive productivity shock. In some instances, these initiatives will entail country-specific efforts such as streamlining import processes, or even wholesale reforms of customs agencies, which tend to be complex (see box 2). In other

instances they will entail coordinated efforts between countries, such as the streamlining of quality and sanitary requirements of products or harmonizing rules.

The potential benefits of coordinated efforts to reduce nontariff trade costs are evident with rules of origin (RoOs). RoOs are the criteria needed to determine the national source of a product and are used to decide whether imported products receive MFN treatment or preferential treatment. The rules aim to avoid granting preferences to goods that are produced outside countries' signatories to a PTA. RoOs, however, 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 establishes its own RoOs. Some take the form of minimum value-added content from the country in the PTA, some rely on identifying the country of manufacturing and processing, and some apply a "tariff shift" rule (Estevadeordal and Talvi 2016). Hence, efforts to harmonize and allow for RoOs with full accumulation within the Americas would help LAC attain higher dividends from its existing PTAs, by allowing firms to use materials from other countries without losing preferential access.

The region-wide benefits of advancing nontariff reform efforts are expected to be particularly large for regionally traded goods. First, as noted above, trade in regionally traded goods is bound to occur between nearby countries because they cannot be transported by air or sea. As a result, the exchange of these goods between nonbordering countries involves goods and services transiting through other regional partners, thus making region-wide coordination crucial. Second, among regionally traded goods are goods and services, such as electric current and land transportation, which are fundamental inputs in the production and distribution of other exports. In fact, in the specific case of electricity, although important steps toward an integrated energy grid have been taken, countries in the region have been unable to fully capitalize on these efforts in part because of conflicting regulatory standards.

BOX 2 The challenge of customs reform

Cross-border trade volumes have increased at the staggering average rate of 9.8 percent per year over the past 50 years. As a result, the incidence of international trade in world GDP increased noticeably. International trade has also become increasingly complex. Today international trade not only gives consumers access to a wide variety of final goods at a relatively low cost but also gives firms the option to use inputs produced abroad. This has given rise to GVCs. Moreover, international trade occurs in a landscape of a vast number of trade agreements that impose complex preferential rules of origin in addition to rules that are already administered by customs.

The rise of international trade and its complexity require institutions that can adapt to the current landscape and facilitate the efficient flow of goods and services across borders. Customs are a country's door to the world. As such, the regulations and procedures that customs agencies impose can facilitate or impede international trade. This observation led WTO members to conclude negotiations on a Trade Facilitation Agreement at the Bali Ministerial Conference in December 2013. The agreement, which presents a set of recommendations to improve the efficiency and transparency of customs procedures and regulations, is currently under the domestic ratification process of WTO member states and will enter into force once two-thirds of the members complete this process.

Achieving the goal of having efficient customs agencies that facilitate global trade may be difficult. In part, the challenges stem from the fact that in some cases they are the only instrument to attain multiple objectives. Customs are the vehicle that countries use to prevent illegal trade, to safeguard the country's security, and to ensure that goods from abroad satisfy domestic environmental, health, and quality standards. Revenue collection is yet another objective of customs agencies. This is particularly important in countries with weak capacity to collect taxes domestically (for example, countries with a large informal sector) or small countries that cannot afford the costs associated with domestic tax collection. Hence, countries may face trade-offs between facilitating the efficient flow of goods and services and the accomplishment of other national objectives. An additional challenge arises from the fact that the interests of private economic actors (port employees and transport firms, among others) collide in customs agencies. Customs reforms can result in short-term losses to them. Not surprisingly, these agents can prevent reforms to the extent that they have sufficient political influence.

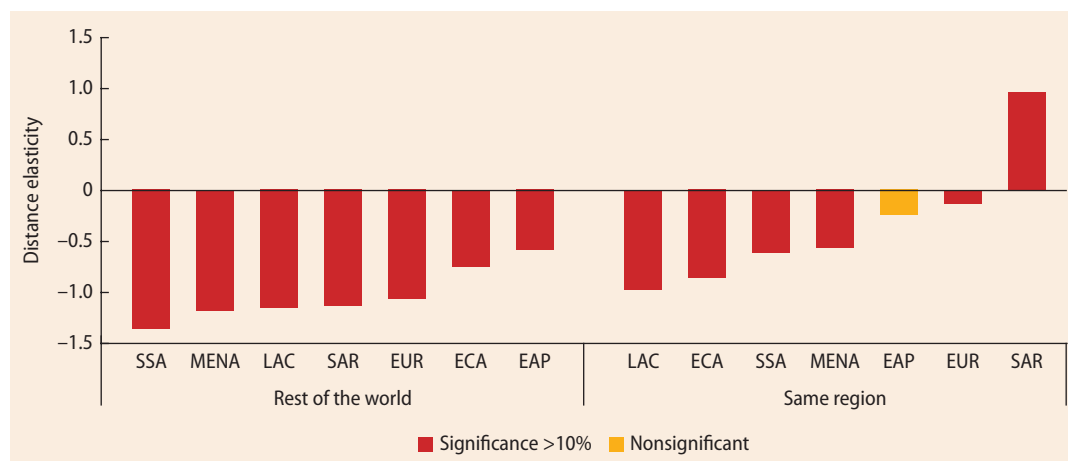
In sum, customs reform appears as an important item in the trade agenda of many countries in LAC. The successful implementation of these reforms, however, could depend on designing an orderly and gradual reform with clear priorities that takes into account the challenges described above.

4. Reducing LAC's cost of distance through investments in infrastructure and logistics

As much as policy-induced reductions in trade costs can facilitate international trade integration, new research prepared for this study shows that LAC faces higher costs associated with distance compared to other regions. Geography together with economic size appear as the preponderant factors underpinning LAC's relatively low levels of trade integration, both within the region and with the rest of the world. In fact, the region's trade flows appear to be more sensitive to geographic distance compared to other

regions, which could mean that LAC faces larger trade costs associated with distance (figure 11).

There are at least two factors explaining LAC's relatively large costs of distance. The first factor is related to infrastructure. The ability of economies to integrate efficiently into the global economy depends on the quality of hard and soft infrastructure services, ranging from transportation, telecommunications, and financial services to border processes and customs practices to the business and regulatory environments.¹⁶ In fact, internal (domestic) trade and transaction costs can have a large impact on a country's international competitiveness.

FIGURE 11 The elasticity of trade flows with respect to geographic distance, by regions and partner

Source: World Bank calculations based on Artuc, Hillberry, and Pienknagura 2016.

Note: Bars capture the elasticity of trade flows with respect to bilateral distance after controlling for exporter and importer fixed effects and other gravity controls. The gravity model estimated allows for regional heterogeneity in the estimated coefficients. Standard errors are clustered at the importer level. EAP = East Asia and Pacific; ECA = Eastern Europe and Central Asia; EUR = Europe; LAC = Latin America and the Caribbean; MENA = Middle East and North Africa; SAR = South Asia; SSA = Sub-Saharan Africa. See appendix A for a list of countries in each region.

The quality of LAC's hard and soft infrastructures appears as an important factor underpinning LAC's relative high costs of distance. Studies such as Mesquita Moreira et al. (2013) or Mesquita Moreira, Volpe, and Blyde (2008) point to inadequate infrastructure compounded by a challenging topography as factors driving transport costs up for LAC. Indeed, data on the quality of land transport infrastructure suggest some scope for improvement in LAC. The quality of the road network, proxied by the share of unpaved roads, is relatively poor when contrasted with other developing regions: almost 70 percent of the roads in LAC are unpaved—a far larger share than in EAP and MENA (less than 30 percent) and SAR (less than 50 percent).

A second factor explaining LAC's relatively high costs of distance is the region's position in the world's network of maritime and air transport. Access to both of these modes of transportation, which account for close to 80 percent of total world trade, is not homogeneous across countries. Both modes of transportation follow a hub-and-spoke operating structure. This structure consists of hub ports, lateral ports, main lines (long-haul

lines that connect hub ports and involve a set of sequential port calls typically across the oceans), and branch lines (short-haul lines connecting several lateral ports in one region to serve the main lines), which together form a complex transportation network system.

In the specific case of maritime transportation, LAC countries have access to this global network through its branch lines, which puts LAC countries at a disadvantage. This is highlighted by the Liner Shipping Connectivity Index, a proxy for the ease of access to high-capacity and high-frequency global maritime freight transport systems. In 2013, the export-oriented economies of East Asia took the top five spots: China and Hong Kong SAR, China, were the highest-ranking economies, followed by the transshipment hub of Singapore. High-income countries, including Belgium, Germany, Japan, the Netherlands, the United Kingdom, and the United States, took most of the other top 15 spots. Within LAC only Panama features in the top 30 (at 25th). Mexico is the second-highest ranking country in the region (32nd), followed by Colombia (38th) and Brazil (39th). The rest of the region ranks poorly.

The spatial design of the maritime transport network reflects an equilibrium outcome in which both demand and supply effects are at play. Demand factors include demand for containerized transport and demand for specific transport services. Central to supply-side considerations are the strategies of container shipping liners, which aim to maximize profits and take advantage of economies of scale through the strategic choice of market coverage (the hub-and-spoke operating structure is particularly important in this regard). Other important factors are port infrastructure, port system development, and internal transport and logistics infrastructure in the hinterland for port access (see, for example, Notteboom 2009). Unfortunately, in many LAC countries port performance is poor. According to the *Global Competitiveness Report 2013–2014*, ports in Brazil and Costa Rica are among the least efficient ports (Schwab and Sala-i-Martin 2013).

Hence, the evidence suggests that efforts to improve LAC's hard and soft infrastructure could facilitate the region's search for efficiency gains that would improve its global competitiveness. Some of these efforts will take the form of country-specific investments in infrastructure, especially in airports, ports, and roads, or improvements in the efficiency of ports and airports. In other instances they will entail coordinated cross-border efforts such as cofinancing joint infrastructure projects. These items entail an ambitious agenda for the renewal of OR in the Americas.

5. Achieving region-wide efficiency gains in the Americas through factor market integration

Factor market integration is another element in the renewal of OR agenda that could bring region-wide efficiency gains. Some regional agreements in LAC took 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 following sections discuss evidence about the potential benefits from bringing factor market integration to the forefront of a renewed OR strategy.

Labor market integration in the Americas

Well-functioning labor markets are essential for countries to reap the benefits from economic integration. Integrated labor markets at the national level guarantee the flow of workers from low-productivity sectors and firms to high-productivity sectors and firms. Similarly, labor market integration across borders through migration can help countries materialize efficiency gains not captured through trade integration.¹⁷ Migration can also help boost growth because it can foster cross-border knowledge transfers. Attracting international talent for sectors in which a country specializes is important in many countries, such as the United States, and will become increasingly important in Latin America as it grows and gains competitiveness in human capital-intensive industries.

Beyond efficiency and growth, labor market integration may also mitigate the consequences of macroeconomic shocks. Cross-border labor market integration allows workers to respond to adverse wage shocks by giving them the chance to seek employment opportunities in other countries. An example of this mechanism at play was seen in the European Union during the debt crisis of countries in the periphery, where workers from Greece, Italy, and Spain migrated toward France, Germany, and the United Kingdom as labor market conditions deteriorated in the former.¹⁸

The potential efficiency gains from liberalizing labor flows across countries have been acknowledged by Latin American policy makers and specifically addressed in trade agreements such as Mercosur and the Andean Pact. The Pacific Alliance also aims to liberalize labor flows. Nonetheless, even in these cases the emphasis on migration is overshadowed by the emphasis on trade preferences.

Evidence produced for this study indicates that there are large wage differences between workers of similar characteristics across LAC

countries, even after controlling for short-term co-movements in wages. More specifically, data suggest that wage differentials of otherwise similar workers (in terms of age, gender, and education) across LAC economies during the 21st century tend to be more than 100 percent larger than the average wage differentials across Mexican states or the wage differentials across the United States. In addition, the speed at which wages move toward those long-run equilibrium differences is much slower in LAC than within Mexico or the United States, although the short-term co-movement of wages across LAC is strikingly similar to the co-movement of wages across Mexican states and across the United States (figure 12). These results can be interpreted as evidence of persistent differences in labor productivity across countries in LAC and unrealized region-wide efficiency gains that could be attained through migration.

Promoting cross-border migration flows within LAC may require tackling important regional challenges, especially on the side of Latin Americans' preferences for migration. In a nutshell, data from Gallup

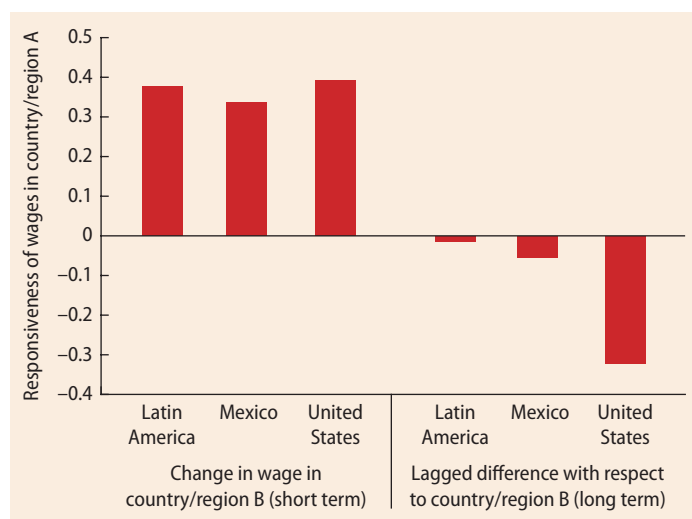
public opinion surveys indicate that Latin Americans prefer to migrate to high-income economies outside of the region. In fact, evidence suggests that intra-LAC migrants are below the number predicted by standard determinants of migration. The numbers reported in Gallup surveys imply that, if migration were costless, the number of Latin American migrants living in other LAC countries would be even smaller (map 1).

Fortunately, LAC appears to be a region that is open to migration. Citizens of Latin American countries with available data have pro-immigration opinions that fare well compared to other countries in the world.¹⁹ These relatively positive sentiments toward migrants are also reflected in the views expressed by policy makers. The share of government officials from LAC who view migration levels as too low or satisfactory is higher than in any other developing region (figure 13).²⁰

This relatively pro-immigration sentiment notwithstanding, policy efforts to attract migrants to LAC may still be subject to difficulties if not managed carefully. The views held by Latin Americans about migrants may be a result of the relatively low levels of migration in the region. In fact, countries that have relatively high immigration rates have less positive attitudes toward migrants compared to those with low immigration rates (figure 14). Hence, policy efforts to foster immigration may end up affecting public opinion such that the pro-immigration attitudes displayed by Latin Americans up to now could be reversed. To be sure, migration attitudes appear to be affected by other policy-related factors. Research prepared for this study shows that positive attitudes toward migrants are more common among the more educated population. This highlights the fact that the effectiveness of LAC's integration agenda is tightly linked to the effectiveness of structural reforms in areas such as education; as the rate of accumulation of human capital in LAC advances, attitudes toward immigration might soften.²¹

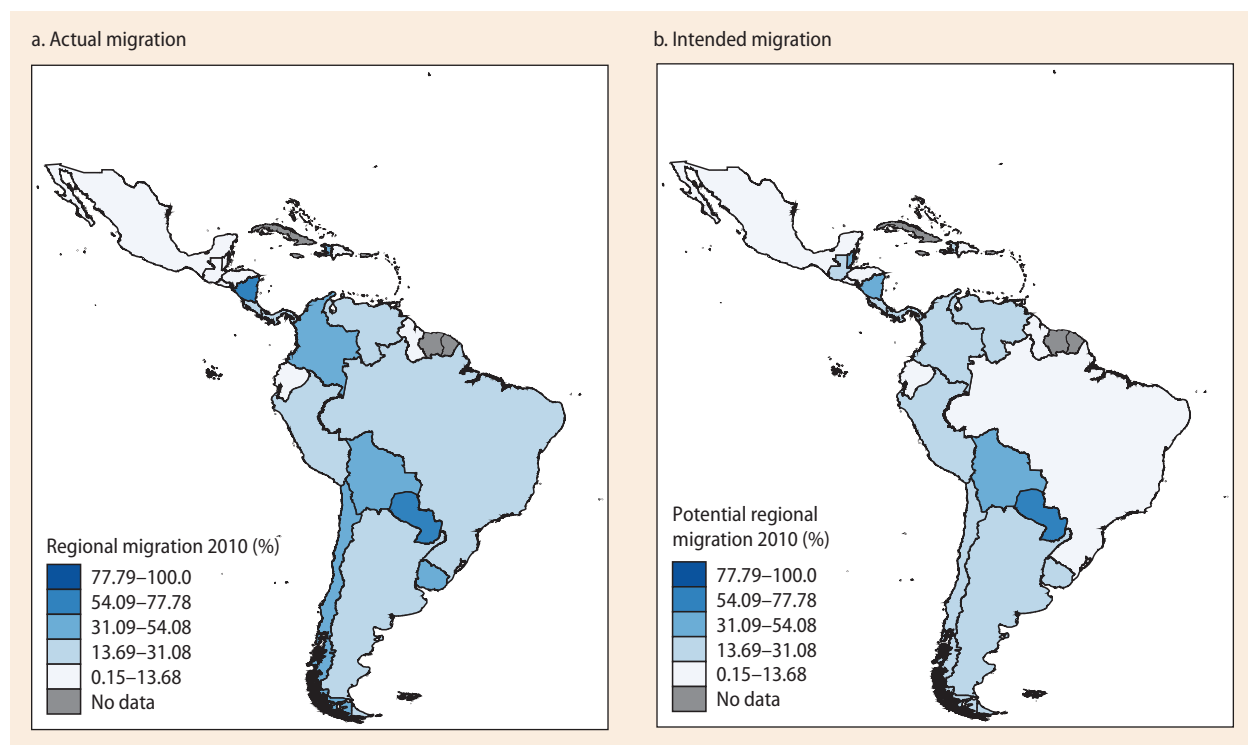
Evidence suggests that there are efficiency gains to be attained through increased regional labor market integration.

FIGURE 12 Short-term and long-term co-movement in wages



Source: World Bank calculations based on Lederman and Robertson 2016.

Note: The figure shows the results of a regression of the change in wage of workers of narrowly defined demographic characteristics in country/region A on the change in wage of the same type of workers in country/region B and the lagged difference in wages between the two countries.

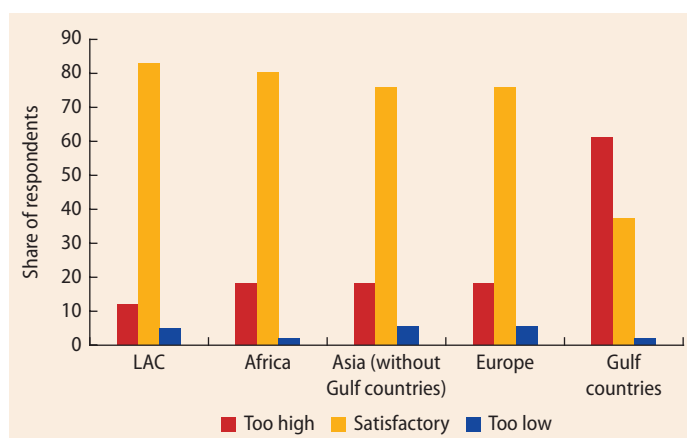
MAP 1 Share of actual and intended intraregional emigration, 2010

Source: Bertoli and Mayda 2016 from Gallup surveys on migration intentions.

LAC's ability to reap these gains hinges on implementing policies, especially on the migration front, that may face short-term opposition in certain countries. Nevertheless, the potential region-wide economic payoffs of further liberalizing international migration in the Americas should not be ignored.

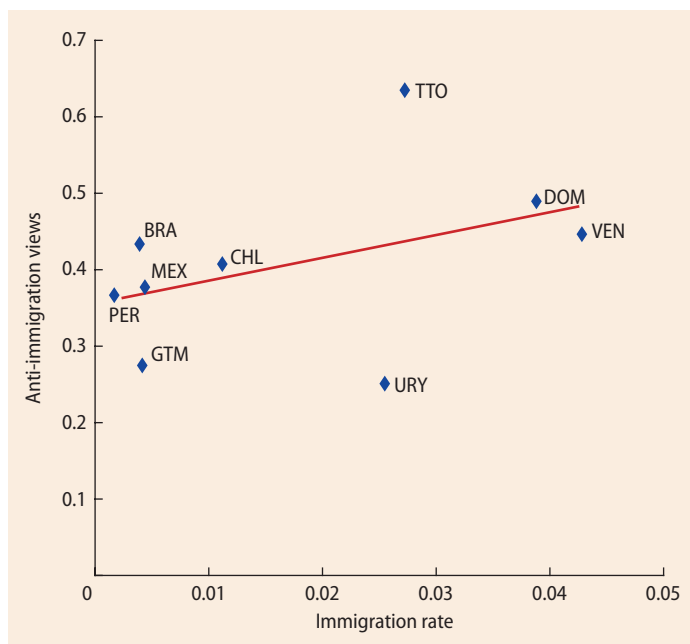
Capital market integration in the Americas

Capital market integration (CMI) is important for growth and stability for several reasons. On the growth side, it can expand credit to households, allowing them to invest in durable assets and in human capital acquisition. Similarly, it expands credit to firms, allowing them to take on productive investments that were not otherwise possible, thus raising productivity. CMI, especially in the form of foreign direct investment (FDI), can also foster innovation and productivity upgrades through additional channels. It can enhance

FIGURE 13 Government view on current documented immigration levels

Source: Bertoli and Mayda 2016 from UN Survey of Government Officials.

Note: Data include government's view on level of documented immigration, including work and family reunification, but not refugees or asylum. LAC = Latin America and the Caribbean. See appendix A for a list of countries in each region.

FIGURE 14 Anti-immigration views and immigration rates in selected LAC countries

Sources: World Bank calculations from Bertoli and Mayda 2016, World Value Survey Data, and World Development Indicators.

Note: The extent of anti-immigration views is captured by the share of the population that responds that its country should "prohibit people coming here from other countries" or that it should "place strict limits on the number of foreigners who can come here." BRA = Brazil; CHL = Chile; DOM = Dominican Republic; GTM = Guatemala; MEX = Mexico; PER = Peru; TTO = Trinidad and Tobago; URY = Uruguay; VEN = República Bolivariana de Venezuela.

competition in the local economy by bringing in new products and new varieties of existing products, and it can bring new processes and managerial expertise that can spill over to domestic firms. On the stability side, credit expansions fostered by CMI can allow households to cope with income shocks and smooth consumption. CMI can also lead to diversification opportunities because firms can invest in new projects that do not face the same risks as existing ones. The downside of CMI, however, is the potential transmission of external shocks to the local economy, which potentially exacerbates macroeconomic volatility when capital flows themselves are volatile and decoupled from economic fundamentals.

Countries in LAC have acknowledged the benefits and risks of CMI and have taken steps to allow capital flows into the region.

LAC embarked on financial liberalization in the 1990s, which resulted in the region's leading other emerging regions as the most financially integrated in the world in terms of de jure policies (Galindo, Izquierdo, and Rojas-Suárez 2010). In the specific area of FDI attraction, countries in the region have used policy tools such as tax and tariff exemptions to attract foreign firms and capital (see UN 2000).

At the regional level, countries in LAC are signatories of investment agreements, either as chapters of FTAs or through bilateral investment treaties (BITs), with a large number of regional partners. More recently, countries in the Pacific Alliance signed an agreement to create an integrated stock exchange (Mercado Integrado Latinoamericano, or MILA). MILA has the objective of unifying the equity trading platforms of the four countries in the Pacific Alliance and in this way concentrating a bigger number of issuers, investors, and intermediaries within these countries.

In spite of recent calls for further CMI among LAC economies (IMF 2016), there is no shortage of financial integration within LAC, once factors such as economic size and geography are taken into account (figure 15). In fact, financial integration within LAC is higher compared to benchmarks after controlling for such fundamentals. Moreover, the arguments in favor of actions to strengthen regional CMI are weak at best. The case in favor of regional CMI could be justified by appealing to the idea that knowledge diffusion appears to decay with distance, thus limiting the positive spillovers from FDI from faraway countries. As with trade, however, the prospects for growth and stability dividends from intra-LAC capital flows appear to be limited. Multinational corporations (MNCs) from the region display lower investments in innovation and worse managerial practices than their peers from other regions, thus limiting the scope for knowledge spillovers to local firms (figure 16). These observations suggest that the benefits from regional CMI in LAC are tightly linked to the vigor of the region's growth and innovation agenda. In addition to the limited

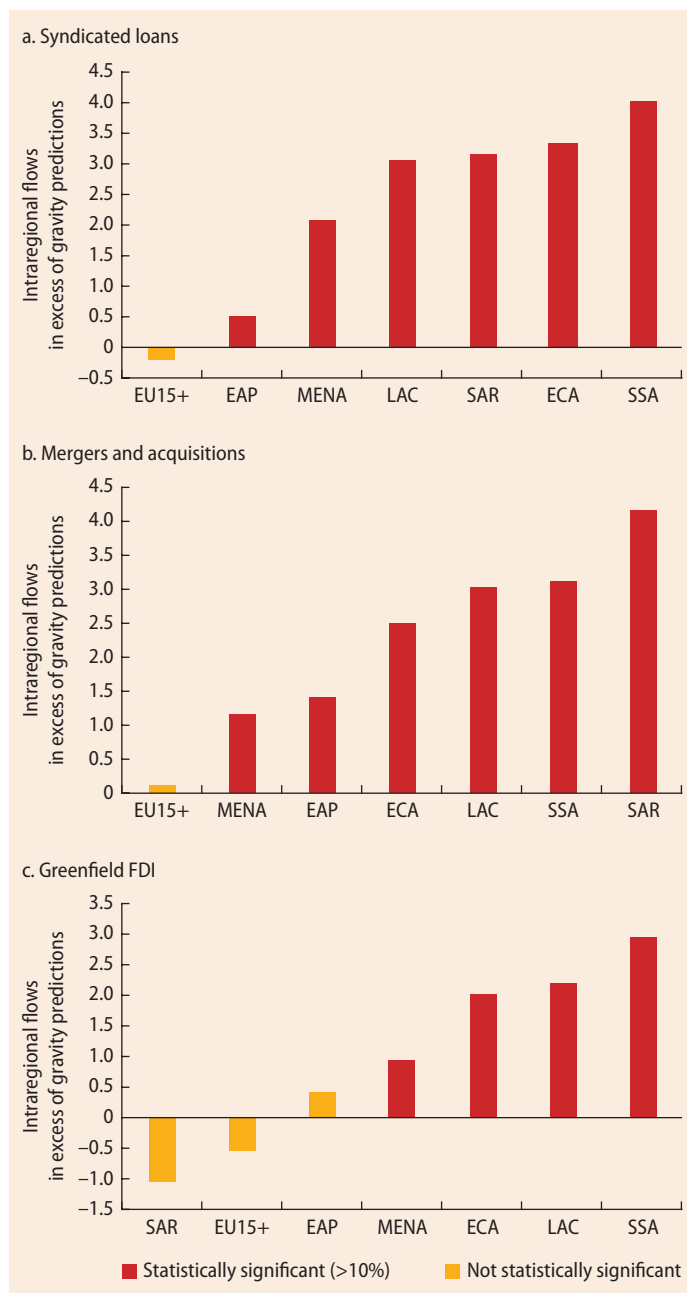
scope for growth and knowledge spillovers from intra-LAC capital flows, the evidence also shows that geography has a weaker pull on financial flows than on trade or labor flows. This implies that, to gain access to foreign capital at a given cost and knowledge content, a country is not as restricted by its geographic location. Hence, it is difficult to see efficiency or dynamic gains from facilitating intraregional capital market integration at the expense of CMI with the rest of the world.

However, regional agreements can yield efficiency gains in other dimensions and, if enacted jointly, can magnify the growth and stability benefits from global capital integration. For example, MILA provides a unified set of norms and reduces transaction costs for investors seeking opportunities in countries of the Pacific Alliance, thus making them a more appealing investment option. Similarly, regional agreements can facilitate coordination in the provision of incentives to foreign capital among countries in the region and prevent a race to the bottom where 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, rather than as efforts to increase intraregional capital flows at the expense of foreign investment from the rest of the world.

It takes a competitive region to make a competitive economy

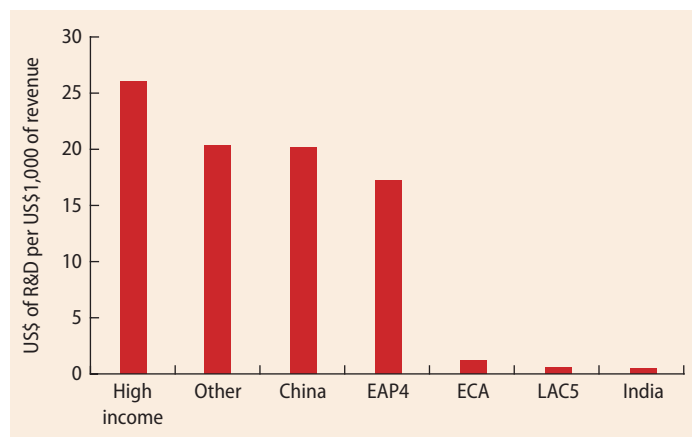
The time is ripe to bring LAC's OR agenda to center stage. The challenge lies in designing an integration agenda that is conducive to region-wide efficiency gains. This does not imply that integration strategies should seek to build regional ties at the expense of those with the rest of the world. Rather, the region could seek integration strategies that exploit the complementarities between regional and global integration to attain higher global competitiveness. The forces of geography imply that pro-growth global integration

FIGURE 15 Benchmarking financial flows in LAC using a gravity model, 2014



Source: World Bank calculations based on Didier, Llovet Montanes, and Schmukler 2016.

Note: In all panels the coefficients capture the excess intraregional flows of a region relative to its flows to and from nonregional partners conditional on country fixed effects and gravity characteristics. EAP = East Asia and Pacific; ECA = Eastern Europe and Central Asia; EU15+ = EU15 plus Iceland, Norway, and Switzerland; FDI = foreign direct investment; LAC = Latin America and the Caribbean; MENA = Middle East and North Africa; SAR = South Asia; SSA = Sub-Saharan Africa. See appendix A for a list of countries in each region.

FIGURE 16 R&D spending by multinational corporations, by home region

Source: Lederman et al. 2014 from Bureau van Dijk's Orbis database.

Note: EAP4 = Indonesia, Malaysia, Philippines, and Thailand; ECA = Eastern Europe and Central Asia; LAC5 = Argentina, Brazil, Chile, Colombia, and Mexico; R&D = research and development.

cannot be achieved without building a strong neighborhood.

This study, therefore, proposes an ambitious agenda aimed at achieving the type of region-wide efficiency gains discussed above. On the trade front, evidence suggests that there is still room for additional preferences at the regional level, especially between Mexico, Central America, and North America on the one hand, and South America on the other. Importantly, there is significant scope for further tariff liberalization with the rest of the world. The latter would help build a more open neighborhood, from which countries in the region can learn about penetrating foreign markets while taking advantage of regional specialization.

The road ahead also presents the challenge of reducing other nontariff trade frictions. Regional efforts to standardize RoOs, to build more efficient customs agencies, to invest in joint infrastructure projects, and to harmonize procedures and standards are some of the key issues in this agenda. The benefits of these efforts appear to be greatest in the case of regionally traded goods (for example, electricity and land transportation), goods for which the cost of distance is so high that trade typically occurs only between regional partners and where their efficient

exchange can lead to improvements in global competitiveness.

Factor market integration, especially in labor markets, stands out as an additional important element of the renewal of OR. Policies aimed at facilitating intraregional migration could allow LAC to capture unexploited region-wide efficiency gains reflected in the region's large wage gaps. Regional coordination in policies to attract foreign capital could also produce efficiency gains by reducing transaction costs and help prevent a race to the bottom whereby countries sacrifice revenue as they compete for foreign investment.

In a nutshell, this study argues that the success of global integration strategies is inextricable from the strength of a country's region. In this sense, the old African proverb "it takes a village to raise a child" applies to the OR strategy delineated here. After all, the evidence suggests that it takes a competitive region to make a competitive economy.

Appendix A. Classification of regions

Many parts of the report emphasize differences in outcomes across regions: this appendix presents the list of countries included in each region. With some exceptions that will be properly highlighted, the list of countries below will be respected throughout the report.

East Asia and Pacific (EAP) includes: Australia; Brunei Darussalam; Cambodia; China; Fiji; Hong Kong SAR, China; Indonesia; Japan; Kiribati; Democratic People's Republic of Korea; Republic of Korea; Lao People's Democratic Republic; Malaysia; Mongolia; Myanmar; New Zealand; Palau; Papua New Guinea; Philippines; Samoa; Singapore; Solomon Islands; Thailand; Tonga; Tuvalu; Vanuatu; and Vietnam.

East and Central Europe (ECA) includes: Albania; Armenia; Azerbaijan; Belarus; Bosnia and Herzegovina; Bulgaria; Croatia; Cyprus; Czech Republic; Estonia; Faeroe Islands; Georgia; Greenland; Hungary;

Kazakhstan; Kyrgyz Republic; Latvia; Lithuania; former Yugoslav Republic of Macedonia; Moldova; Montenegro; Poland; Romania; Russian Federation; Serbia; Slovak Republic; Slovenia; Tajikistan; Turkey; Turkmenistan; Ukraine; and Uzbekistan.

European Union 15 extended (EU15+) includes: Austria; Belgium; Denmark; Finland; France; Germany; Greece; Iceland; Ireland; Italy; Luxembourg; Netherlands; Norway; Portugal; Spain; Sweden; Switzerland; and United Kingdom.

Gulf countries: Kuwait; Bahrain; Oman; Qatar; Saudi Arabia; and the United Arab Emirates.

Latin America and the Caribbean (LAC) includes: Argentina; The Bahamas; Barbados; Belize; Plurinational State of Bolivia; Brazil; Chile; Colombia; Costa Rica; Dominica; Dominican Republic; Ecuador; El Salvador; Grenada; Guatemala; Guyana; Haiti; Honduras; Jamaica; Mexico; Nicaragua; Panama; Paraguay; Peru; St. Kitts and Nevis; St. Lucia; St. Vincent and the Grenadines; Suriname; Trinidad and Tobago; Uruguay; and República Bolivariana de Venezuela.

Middle East and North Africa (MENA) includes: Algeria; Bahrain; Djibouti; Arab Republic of Egypt; Islamic Republic of Iran; Iraq; Israel; Jordan; Kuwait; Lebanon; Libya; Malta; Morocco; Oman; Qatar; Saudi Arabia; Syrian Arab Republic; Tunisia; United Arab Emirates; and Republic of Yemen.

North America includes: Canada and United States.

South Asia (SAR) includes: Afghanistan; Bangladesh; Bhutan; India; Maldives; Nepal; Pakistan; and Sri Lanka.

Sub-Saharan Africa (SSA) includes: Angola; Benin; Burkina Faso; Burundi; Cabo Verde; Cameroon; Central African Republic; Chad; Comoros; Democratic Republic of Congo; Republic of Congo; Côte d'Ivoire; Equatorial Guinea; Ethiopia; Gabon; The Gambia; Ghana; Guinea; Guinea-Bissau; Kenya; Liberia; Madagascar; Malawi; Mali; Mauritania; Mauritius; Mozambique; Niger; Nigeria; Rwanda; São Tomé and Príncipe;

Senegal; Seychelles; Sierra Leone; Somalia; South Africa; South Sudan; Sudan; Tanzania; Togo; Uganda; Zambia; and Zimbabwe.

Notes

1. Appendix A provides a list of the definition of regions used throughout this overview and a list of countries in each region.
2. The objectives of the Pacific Alliance can be found at <https://alianzapacifico.net/en/que-es-la-alianza/#what-is-the-pacific-alliance>.
3. See CAFTA-DR's preamble.
4. The term "Open Regionalism" was first introduced during the Asia-Pacific Economic Cooperation (APEC) discussions in the early 1990s (Frankel and Wei 1995). For an early discussion of OR in the context of Latin America and the Caribbean, see ECLAC (1994). See also Bergsten (1997).
5. Other notable examples are the intraindustry trade models of Helpman and Krugman (1985, 1989) and the heterogeneous-firm models that generally reference Melitz (2003).
6. The academic literature on trade, inequality, and poverty is huge. There are at least six broad literature surveys: Winters, McCulloch, and McKay (2004) and Goldberg and Pavcnik (2004) cover trade liberalization and poverty; Goldberg and Pavcnik (2007) and Harrison, McLaren, and McMillan (2011) cover trade and the distribution of income; Lederman (2013) covers trade and inclusive growth; and Lederman and Porto (2014) cover the distributional consequences of commodity-price fluctuations.
7. See IDB (2002) or Schiff and Winters (2003).
8. The terms the "death of distance" and "the world is flat" were introduced in two books, *The Death of Distance: How the Communications Revolution Is Changing Our Lives* by Frances Cairncross (1997) and the international best-seller *The World Is Flat: A Brief History of the Twenty-First Century* by Thomas L. Friedman (2007), respectively.
9. For example, Trefler (1995) finds that there is substantially less trade observed in the data compared to the levels predicted by the Heckscher-Ohlin (HO) model. The inability of traditional models to correctly predict trade patterns planted the seeds for new trade models that try to match features of the data such as intraindustry trade between similarly

- endowed economies (see Krugman 1981) or the heterogeneity of firms in terms of their productivities (Melitz 2003), which are not usually incorporated in Ricardian or HO models.
10. The gravity model of trade was first used by Nobel Laureate Jan Tinbergen in 1962. The author proposed an empirical relation between bilateral trade flows, economic size, and distance that follows the logic of Newton's law of gravity, which states that the force of attraction between two bodies is proportional to their mass and inversely proportional to the distance between them. In Tinbergen's model, economic size plays the role of mass and the geographic distance between two countries plays the role of the distance between the two objects. Originally, the gravity model was presented as an empirical relationship that provided a good description of bilateral trade patterns. Recent advances in the field of international trade have provided microeconomic foundations for the gravity model and a better understanding of the implications of the relationship. Early papers using the gravity equation were reduced-form estimations of the relationship that in many cases delivered misleading predictions (see Head and Mayer 2014). This problem has been solved by the introduction of structural gravity equations derived from formal economic models (see Anderson 1979 or Eaton and Kortum 2002, among others). Importantly, structural gravity equations allow for the analysis of counterfactual policy experiments.
 11. Although trade flows are larger, trade over GDP may not be.
 12. These costs may be linked to freight and insurance costs, or any other economic friction that increases the costs of international commerce even when not strictly related to geographic distance. The latter are often associated empirically with language differences and cultural differences, as well as with trade taxes and nontariff barriers.
 13. An initial attempt to do such an assessment is presented in the work of Frankel, Stein, and Wei (1995). The authors follow the gravity approach by estimating a regression of bilateral trade flows (in logs) on log GDP of each of the countries, a set of bilateral variables that includes distance and a dummy variable taking the value one if the two countries are members of a preferential trading arrangement. The authors include Mercosur, the Andean Pact, and the North American Free Trade Agreement (NAFTA). Their results show that, once GDP, distance, and other bilateral variables are taken into account, intra-Mercosur and intra-Andean Pact trade in the 1990s was statistically higher than the average pair of countries that are not in the trade blocs studied in the paper. In contrast, NAFTA's trade falls within the predictions of gravity variables. The work prepared for *Better Neighbors: Toward a Renewal of Economic Integration in Latin America* differs from Frankel, Stein, and Wei (1995) in three ways. First, it estimates the gravity equation using the Poisson-Pseudo Maximum Likelihood (PPML) estimator proposed by Santos Silva and Tenreyro (2006), which corrects for biases common in the log-linear ordinary least squares (OLS) model. Second, the estimations presented here use origin and destination fixed effects, which capture not only the role of size but also the so-called multilateral resistance term, a term that arises from the formal theoretical derivation of the gravity equation. Finally, the exercise compares intraregional trade flows as opposed to intra-free trade agreement (FTA) flows.
 14. The gravity specification used in the exercise controls for origin and destination fixed effects, colonial links, same language, and distance. The results presented here, which are based on the specification by Artuc, Hillberry, and Pienknagura (2016), use the average bilateral trade flows between 2004 and 2013 and include an FTA dummy as an additional control.
 15. The agreement was recently extended until March 2019, and Brazil and Mexico are expected to return to a free-trade regime after that. The new agreement increases the quota by 3 percent per year.
 16. The literature provides some evidence that domestic trading costs and the economic business environment are significant determinants of the volume of trade between countries. See, for example, Limão and Venables (2001); Wilson, Mann, and Otsuki (2003); Anderson and Marcouiller (2002); and Hoekman and Nicita (2011).
 17. Migration flows and trade flows can be complements or substitutes. In the extreme where trade is frictionless, the two flows should be substitutes—countries can attain the same efficiency gains by integrating through trade or by integrating factor markets. In contrast, when trade is not frictionless, because of

tariffs or other trade frictions, differences in returns to factors of production may arise and factor movements may become complementary to trade flows. Moreover, migration flows can mitigate frictions in the transmission of technology and know-how across borders or in the transmission of information about foreign markets. In these cases, migration flows can foster trade flows, thus reinforcing the potential complementarity between trade and labor flows.

18. The number of Greek, Italian, and Spanish migrants in Germany increased by 154 percent between 2010 and 2013. In contrast, it grew by 5 to 25 percent between 2007 and 2009.
19. Data on attitudes toward immigrants come from the World Value Surveys.
20. Data on views on immigration from government officials come from surveys conducted by the United Nations Department of Economic and Social Affairs. The data are averages from 1976 to 2009.
21. Between 2000 and 2014, the tertiary school enrollment rate in LAC increased from 20 percent to 40 percent. See Avitale et al. (forthcoming) for an analysis of the challenges facing university education in the region.

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