THE PROMISE OF INTEGRATION
OPPORTUNITIES IN A CHANGING GLOBAL ECONOMY
THE PROMISE OF INTEGRATION

The promise of integration

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Substantive contributions were made from across the regional teams:

Poverty and Equity: Carlos Rodriguez Castelan (Practice Manager, ELCPV), Sergio Olivieri (Senior Economist, ELCPV), Diana Marcela Sanchez Castro (Research Analyst, ELCPV), Karen Yiseth Barreto Herrera (Consultant, ELCPV), Iván Gachet (Consultant, HLCSP), Kelly Yelitza Montoya Munoz (Consultant, ELCPV), Cicero Augusto Silveira Braga (Consultant, ELCPV), Hugo Ñopo (Senior Economist, ELCPV) and Jaime Estuardo Fernandez (consultant, ELCPV).

Finance, Competitiveness and Innovation: Peter Kusek (Senior Economist, ETIIC) and Eduardo Antonio Jimenez Sandoval (Consultant, ETIIC).

Human Development: Luis Benveniste (Regional Director, HLCDR), Michele Gragnolati (Practice Manager, HLCHN) and Nicole Fuene de Colombi (Health Specialist, HLCHN).

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OVERVIEW

THE ELUSIVE PROMISE OF INTEGRATION—OPPORTUNITIES IN A CHANGING GLOBAL ECONOMY
The Latin America and the Caribbean (LAC) region has proved to be relatively resilient in the face of increased debt stress, stubborn inflation, and uncertainty arising from the Russian invasion of Ukraine. Income and employment have largely recovered from the pandemic, poverty has receded, and markets remain guardedly optimistic about the near future.

However, headwinds have picked up, and the 2023 outlook is substantially bleaker than 2022. Global uncertainty is rising, and while the world may want to move on from COVID-19, new variants and diseases will remain a threat. Strengthening resilience, both on the health and macroeconomic fronts, will be paramount. Progress remains pending in both vaccination coverage and health system preparedness, while the institutional integrity of macroeconomic policy in some countries is being questioned.

Although numerous global factors can explain the very modest 2023 growth rates, the forecasts going forward predict the same lackluster pace of the past two decades, which remains insufficient to reduce poverty, promote inclusion, and defuse social tensions. Hence, identifying the opportunities for, and bottlenecks to, dynamic, inclusive, and sustainable growth remains paramount.

In particular, the evolution of the global economy is providing two new areas of opportunity: the trend toward nearshoring—moving production closer to the US and European markets—and the imperative to combat climate change, which is giving the region a new comparative advantage in sun, wind, hydro, and natural capital. Taking advantage of these will require greater integration into the global economy. Yet, paradoxically, in the face of these opportunities, LAC is becoming less integrated. Trade intensity has largely stagnated, and foreign direct investment (FDI) to most countries has declined.

Chapter 1 of this report lays out the recent social and macroeconomic evolution of the region and the near-term challenges it faces. Chapter 2 discusses the trends in trade and investment, and suggests some factors that diminish the region’s attractiveness, and long- and medium-term reforms that may open new opportunities.

Chapter 1: Strengthening Resilience, Boosting Growth

As in the rest of the world, COVID-19 has largely receded, and LAC is back to business. On the economic front, challenges remain and are perhaps becoming more acute, but as yet markets remain guardedly optimistic. On average, the region has fully recovered its lost growth of gross domestic product (GDP), although since COVID-19, growth is below that of all regions except war-torn Eastern Europe, which LAC only slightly exceeds. Further, the averages obscure significant variations across countries, with the Caribbean in particular continuing to lag, partly because of the sluggish recovery of tourism. Looking forward, growth is expected to fall as former tailwinds fade and headwinds strengthen: commodity prices are softening; global interest rates continue to climb to combat inflation, with depressive effects on Group of Seven (G7) markets; and China’s recovery remains unsteady. Forecasts for growth in the United States, the euro area, and Japan have fallen by 0.8, 1.4, 0.8 percentage points, respectively, from mid-2022 projections, while China’s stagnated at 5.3 percent. Largely following these trends, LAC forecasts of 2023 growth have been steadily downgraded over the last six months to 1.4 with an increase to 2.4 in 2024; while the variance around market forecasts has increased, proxying for increased uncertainty globally. The recent wave of bank failures in the US and Europe introduces additional uncertainty around whether the advanced countries will moderate future interest rate rises, the likelihood of a recession in the G7, and the trajectory of future inflation. Further, whether the underlying dynamics have resonance in the LAC banking systems and capital flows remains to be seen.
Markets remain cautiously optimistic that regional authorities will be able to manage a difficult situation. Service on the debt accumulated during the pandemic has been rising with interest rates, although country risk premia have not risen appreciably and are of the magnitude of those seen in Southern Europe, testifying to general market confidence in the macro-authorities. However, higher payments have largely offset the gains in primary surpluses generated by governments seeking fiscal space. The average public debt to Gross Domestic Product (GDP) ratio rose sharply during the pandemic by 15 points to 75.4 percent which while eroded to 69.3 by the recovery in GDP, will remain a brake on any major investments in equity and productivity enhancements. Disappointing news on inflation in the G7 and strong US jobs reports point to continued rises in global interest rates that will put further stress on fiscal accounts.

Regional inflation, excluding Argentina and the República Bolivariana de Venezuela, stands at 7.9 percent, which is below that of the Organisation for Economic Co-operation and Development (9.4) and Eastern Europe (18.8), although above inflation in East Asia (4.7). This relative success reflects the early and aggressive response of regional authorities, which has led to decreases in inflation in several countries. The authorities in Chile and Brazil have announced a pause in further hikes. In most countries in LAC, inflationary expectations remain anchored and central bank targets are expected to be achieved in 2024.

**Strengthening Resilience**

To increase resilience against future global diseases, for instance, new variants of COVID-19 or the Avian flu, additional progress in vaccination and preventative measures will continue to be needed. While some countries in the region have globally stellar rates of vaccination, including the latest boosters, much of the Caribbean shows continuing low coverage. Further, remedying the deficiencies in the health system revealed during the pandemic—underinvestment in human resources and infrastructure, financing and service delivery fragmentation, poor governance, and slow adoption of technical innovations in provision—remains paramount.

On the economic side, to date, the COVID-19 recovery marks the second major crisis in which LAC performed generally not worse than its global comparators. The region’s relative success in fighting inflation and the move toward more countercyclical monetary policies since the mid-2000s reflect hard-won gains in the quality and credibility of macroeconomic management that has given the region a certain normalcy in macro policy that is distinct from a generation ago. This has largely been a result of stronger armorings—reduction in foreign-denominated debt, fortified reserve positions that have reduced the likelihood of currency mismatches, as well as stronger supervision of banks; greater professionalism and institutional strength of ministries and central banks; and the independence of central banks as well as the shift to inflation targeting. Although the persistently high domestic interest rates and their dampening effect on short-term growth are generating intergovernmental tensions, these too are normal and the reason for central bank independence in the first place. As stresses may further increase, the gains in credibility, which have allowed for relatively nontraumatic management of a difficult global context so far, need to be preserved.
Chapter 2: Reengaging a Changing World Economy

Importantly, the depressed rates of growth are only partly due to monetary tightness. The 2.4 percent growth rate forecasted for 2024 is more or less the level experienced across the 2010s, before the crisis and inflation, and it is insufficient to alleviate poverty and diffuse social tensions. Taking a longer perspective, since 1980, LAC has diverged from the level of income of the G7, falling from 43.7 to 31.6 percent, as Asia has risen from 5.2 to 25.4 percent. The October 2021 edition of the *Latin America and the Caribbean Economic Review* (LACER) highlighted a list of long-recognized, growth-impeding internal shortfalls in infrastructure, education, energy policy, firm capabilities, and innovation.

However, changes in the global economy are offering new growth opportunities that will require tighter integration. First, the havoc wreaked on supply chains by the pandemic and heightened geo-political tensions have created a demand to diversify suppliers and bring them closer to home, creating possibilities for LAC to capture links in value chains centered on the United States and Europe. China’s success has lifted wages above those in much of the region; therefore, in theory, countries in a similar time zone with extensive cultural, historical, and in some cases linguistic ties should be competitive in this race. Mexico has shown this to be possible. Second, as detailed in the April 2022 LACER, the global imperative to move away from fossil fuels has heightened the region’s emerging comparative advantage in green production and renewable energy sources. Developing these linkages and maximally leveraging them to generate diversified and dynamic development will require all the innovative ideas emerging globally, and access to global markets to gain scale and discipline local actors—which will require more active insertion into the global economy.

Yet, the region seems to be growing less integrated. Trade exposure, measured by merchandise and service exports plus imports over GDP, remains among the lowest in the world—below that predicted by standard gravity models—and has been broadly stagnant over the past 20 years. Excluding Mexico, China has become the region’s principal trade partner, but mostly in primary commodities.

More dramatically, FDI to the region has been falling both in absolute terms and as a share of rising flows to the developing world, falling 16.4 percent in absolute terms and 9.5 percentage points as a fraction of total FDI to emerging markets since 2010. Further, the trends vary across subregions. Inward FDI has risen in Mexico by almost 40 percent over the past decade, while it has fallen in South America by 9 percent. Flows to Central America and the Caribbean remain less clear since available statistics include large financial flows to Panama and four principal islands.

**What Are the Obstacles to Integrating Better and More Dynamically?**

Given the region’s closing wage gap with Asia, wages are not the whole story of what pulls investment. Business consulting groups that have quantified investment attractiveness stress that within basic cost components, the local costs of capital, real estate, and taxes weigh heavily. Here alone, the region loses attractiveness. Secondary considerations include the stability of the rules of the game, costs of transport and general infrastructure, education of the workforce, and business climate. These long-standing issues, some covered in previous LACERs, mean that Canada, the United Kingdom, and even the United States are more attractive than Mexico and Brazil, making reshoring as attractive as nearshoring to LAC. Such indexes are gross characterizations and easily criticized, but they highlight critical areas of concern to investors.
Maintaining the Rules of the Game

Although short-term macro stability has become more credible, the region is sliding on the longer term indicators of political stability and the rules of the game in virtually all the big countries. There is no obvious policy recommendation for establishing such stability, except, perhaps, to address long-simmering social tensions, but it weighs heavily on both foreign and domestic investors whose projects may have gestations measured in decades.

Thick Borders

The ease of entering and exiting products and investment affects the ease of exporting and the region’s attractiveness as an export platform. LAC has made great progress over the past 20 years in terms of tariff levels, which remain higher than those of the advanced countries, Eastern Europe, and Asia, but below the world average. There is substantial heterogeneity—Peru, Mexico, Guatemala, Costa Rica, and Chile are exceptionally open, while the Mercosur country tariffs remain higher. Non-tariff barrier coverage and frequency are low by global standards. However, border compliance costs, measured in time and money, are among the highest in the world. Deep trade agreements are one way of addressing these costs and lending stability to the rules of the game. Overall, protection seems low and certainly in some industries, the impact of Asian competition has been devastating. However, other measures of weak competition and openness, such as industry markups, put the region among the highest in the world, and some sectors remain highly concentrated.

Roads and Digital Connectivity

Physical infrastructure remains a major obstacle. Costs per mile of moving products are substantially higher in LAC than in the European Union or South Asia, for example. There is little hope of remedying that soon. Public Investment spending, at roughly 4 percent of GDP, is small compared to the 7 percent of GDP found in East Asia. Further, calculations of the optimal allocation of infrastructure suggest that what is built is often not the most needed, and key corridors remain underdeveloped. Digital infrastructure is critical for expanding service exports; yet, in LAC, it is roughly at half the density of Asia and Eastern Europe and 20 percent more expensive.

The Enabling Environment

Long identified business climate challenges remain, but an understudied area with particular ramifications for developing both manufactures and services is the functionality of cities as a production platform. LAC has one of the largest shares of population in urban areas. Generally speaking, productivity rises with population density; however, there has been effectively no gain in most LAC cities. Labor productivity, accounting for education levels, is not especially higher in urban than rural areas. LAC cities are not as much productive as crowded, and it is hard to move around in them. Combined with relatively fluid migration, this has led to internal geographical income convergence over the past decades. Urban areas are not pulling ahead, and this does not suggest a dynamic milieu for new industries. In a virtuous circle, urban productivity gains are associated with more urban tradables and more foreign ownership; however, both of these have been falling in LAC.
**Education and Capabilities**

Human capital across the spectrum is central for attracting FDI and exporting. The quality of the workforce is cited as a major secondary factor, and 30 percent of businesses of all types across countries point to a lack of qualified workers and a perennial shortage of mid- and high-level technical skills as barriers to growth. A long literature points to education as a determinant of the spillovers of FDI. Further, managerial skills are closely associated with the propensity to export, engagement as suppliers of multinationals, as well as positive response to increased competition, but these skills are of average strength in the region. As LAC sees the development of green investments, ensuring the necessary stock of technical capital will be key to leveraging these sectors for broader development. More generally, ensuring an abundant supply of entrepreneurial and technical capital is central to leveraging comparative advantage—the ancillary industries that might emerge from natural resource sectors and the service or other spinoffs that might emerge from manufacturing.

Entrepreneurs do not work in isolation. Numerous studies, including on Latin America, have demonstrated that government-sponsored managerial consulting services can help firms benchmark themselves, improve managerial practices, improve productivity, and prepare to export. Historically, such programs have been hugely important. Export promotion agencies also often support firms in preparing to export, and improving their functioning has been shown to increase trade. Such institutions can be located in the broader concept of national innovation or entrepreneurial systems, along with universities and think tanks that serve as antennae for ideas and help in adapting them to the private sector. However, recent measures of collaboration place LAC among the lowest in the world.

**Finance**

Deepened financial sectors are needed both to provide liquidity and to diversify risk. Shallow markets are a disincentive to FDI as foreign investors want to borrow a substantial share in domestic currency to hedge. For domestic investors, any upgrading or entry into a new sector or market implies placing a risky bet and the need to diversify risk. LAC markets have become deeper partly due to the greater macro stability of the past decades. However, reforms in collateral and insolvency resolution, among other factors, remain necessary for further deepening.

**Economic Zones and Corridors**

In an attempt to resolve market failures on a manageable scale and create incentives for FDI, governments often set up special economic zones that provide infrastructure, special legal regimes, and often training or other services. There are many successful cases but many that are not. The disappointing performance results from a combination of poor design and execution, locations for spatial equity reasons that undermine feasibility as a zone, and an ex-ante framework for evaluating the likely benefits. Effective implementation of policy also matters. This requires action that is coordinated across functions (tax, land, and infrastructure)—and thus requires that the organization running the special economic zone is empowered to deliver these functions. There must also be credible commitment to policy for many years ahead. Taken together, these considerations mean that commitment is needed from the highest level of government.
Attracting FDI through Investment Promotion Agencies

Improving investment promotion agencies can help increase and attract higher quality FDI inflows and maximize their impact on the host economies. These agencies range in functions but generally work to improve the image of the host country, identify possible investors, and support project management, and some play an advocacy role in promoting reforms of the overall business climate. They play an important role in matching investors with local suppliers, providing information, facilitating transactions (securing permits and negotiating bureaucracies), and managing investment incentives. Recent studies have shown that in developing countries, investment promotion agencies frequently lack strategic focus, failing to provide the services most valued by investors, such as advocating for improvements in the business climate. Sharpening their focus, building a coherent institutional framework, and strengthening their delivery of investor services can improve efficacy.

The Way Ahead

LAC has tremendous potential both in its traditional areas of comparative advantage and in the new sources arising from opportunities in the green economy. The challenge remains to mobilize investment and know-how to leverage these opportunities to generate diversified and dynamic economies.

Over the past two decades, LAC has not exploited the gains from greater integration into the global economy in terms of scale economies, transfer of know-how and technology, and capital. Trade exposure has largely stagnated and FDI has fallen in most countries, even as reshoring and nearshoring have become more common. Expanding trade exposure and leveraging comparative advantage are critical as the region seeks to raise its growth rates, expand into new areas of services, reduce its environmental footprint, and take advantage of its new areas of green comparative advantage.

Many of the necessary reforms involve those traditionally on the agenda, which have a long gestation period: reducing systemic risk, raising the level and quality of education, investing in infrastructure both traditional and digital, making cities better platforms for manufactures and services, raising capabilities across the whole spectrum of human capital, and ensuring well-functioning financial markets to provide liquidity and diversify risk. These all require long and sustained effort, but they are essential for productive integration.

There are also interventions with a shorter time horizon. The first, following Hippocrates, is to do no harm: to preserve the reputational gains of the past 20 years in terms of macro stability. Second, regulatory gains in customs and transport are, in principle, low in cost and could be done over a short time scale. These can be done in the context of deep trade agreements that both provide a framework for the component reforms and add to confidence in the basic rules of the game. Third, export promotion agencies and investment promotion agencies have proven track records. The former has a component of managerial consulting services to get potential exporters over the learning hump. However, in LAC both types of agencies can be unfocussed and hence less effective than their potential. A comprehensive approach to both shorter and longer term reforms could move LAC toward a renewed and more dynamic engagement with the global economy.
## Growth Outlook for the Region

### Real GDP Growth Rates

<table>
<thead>
<tr>
<th>Country</th>
<th>2020</th>
<th>2021</th>
<th>2022e</th>
<th>2023f</th>
<th>2024f</th>
<th>2025f</th>
</tr>
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<tbody>
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<td>10.4</td>
<td>5.2</td>
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<td>2.0</td>
<td>2.0</td>
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**Source:** World Bank staff calculations.

**Note:** The cut-off date for the data is March 23, 2023. “e” stands for estimate; “f” for forecast.
CHAPTER I
STRENGTHENING RESILIENCE, BOOSTING GROWTH
Latin America and the Caribbean (LAC) has largely transitioned from the pandemic period. However, the region continues to confront the challenges posed by potential new variants of COVID-19, ongoing global inflation, persistent and rising interest rates in the advanced countries, and the collateral effects of the Russian invasion of Ukraine. LAC has handled the management of the accumulated debt and fought against inflation in a manner unimaginable a generation ago. LAC has achieved a certain level of “normalcy” in its macro management, and it needs to maintain its accumulated credibility and resilience. Over the longer term, the overarching problem remains one of low growth rates and what is necessary to reenergize incumbent industries, but also to take advantage of the new opportunities offered in the global economy given the shifting map of supply chains and the Green Revolution.

Boosting Resilience for Dealing with the Next Disease

As the October 2022 issue of the *Latin America and the Caribbean Economic Review* (LACER) documented, LAC was one of the regions most affected by the COVID-19 pandemic. Vaccinations played a key role in the economic recovery, with effective health information campaigns raising the coverage of the first scheduled dose in adults and children to 80 and 92.2 percent, respectively.\(^1\)\(^2\) However, decreases in antibody production and the appearance of new variants dictate the need for additional booster doses.\(^3\)\(^4\)\(^5\) Yet, vaccination coverage remains uneven across the region. At the beginning of February 2023, total vaccination coverage varied from 3.2 doses per person in Chile to 2.5 doses in Argentina, to only 1.2 doses in Bolivia and 0.54 dose in Jamaica (see figure 1.1). For the latest round of boosters, only Chile shows more than one dose per person on average; some previous good performing countries, like Mexico and Colombia, fell behind, with 0.45 and 0.28 dose per person, respectively. Many Caribbean countries continue to lag in basic protection and have barely started administering the boosters, leaving their populations vulnerable to new variants. Authorities are also warning about a potential bird flu epidemic.\(^6\) The World Bank Pandemic Preparedness Fund stands ready to build resilience to future diseases.\(^7\)

**Figure 1.1. COVID-19 Boosters Are Prominent in the Region, Except for the Caribbean**

*COVID-19 vaccine initial doses and boosters per 100 people, Feb 4, 2023*

![COVID-19 Boosters Are Prominent in the Region, Except for the Caribbean](source: Our World in Data, as of February 4, 2023.)
In addition to preventative measures, the region needs to redress the weaknesses in the health care and public health systems revealed by the pandemic. As shown in the report *Building Resilient Health Systems in Latin America and the Caribbean: Lessons Learned from the COVID-19 Pandemic*, most health systems in LAC under-perform compared to the average for the Organization for Economic Cooperation and Development (OECD) and this led to severe disruptions in both reacting to the pandemic and in providing ongoing services (figure 1.2). On average, health spending, although it grew in recent years, stands at only 25 percent of OECD countries’ expenditure per capita adjusted for purchasing power. Despite improvements in universal health coverage over the last 30 years, long-standing structural handicaps such as underinvestment in human resources and infrastructure, and poor governance all undermined ability to respond. Fragmentation in service delivery is an important source of waste in the region, leading to duplication of tasks, substantially reducing system efficiency, and exacerbating inequalities. While green shoots have appeared in the form of technical innovations in provision, reforms are urgent to improve access and delivery, and ensure resilience against future health emergencies.

**Economic Performance: Slow Growth, Continued Resilience, and Guarded Optimism**

Although LAC’s gross domestic product (GDP) is now firmly above the pre-COVID-19 levels, going forward, its growth is expected to lag all other regions including war-battered Eastern Europe (figure 1.3). Growth is not expected to pick up soon. The waning energy of the recovery and persistent inflation, the Russian Federation’s invasion of Ukraine, and uncertainty around China’s recovery from the COVID-19 lockdown continue to depress the outlook for growth globally and in the region.

Looking at the subregions in LAC, the growth rate of South America could possibly allow it to regain its previous modest growth trajectory, but Central America shows that, at best, it is achieving a parallel but lower trajectory compared to pre-COVID-19 (figure 1.4). The Caribbean is still recovering from its especially severe downturn, reflecting the incomplete recovery of the battered tourism industry, which fell by 71 percent in 2020 relative to 2019 (figure 1.5). The drop in tourism revenues left Caribbean economies about 10

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**Figure 1.2. Share of Households Reporting Needing Healthcare Whose Healthcare Services were Disrupted between 2020 and 2021**


*Notes:* Three rounds of a high frequency pulse survey (HFPS) were conducted between May and August 2020 at the beginning of the pandemic, and a fourth round was completed between May and July 2021. The HFPS collected nationally representative information about people’s access to services when they perceived the need for them in 14 countries: Argentina, Bolivia, Chile, Colombia, Costa Rica, Dominican Republic, Ecuador, El Salvador, Guatemala, Honduras, Mexico, Paraguay, Peru, and Saint Lucia.
percentage points (p.p.) below their pre-pandemic potential output in 2022 given the slow recovery of travel to the region. The gap is estimated to remain about 5 p.p. by 2024.

Consensus forecasts for GDP growth in 2023 worsened for all regions in the world in 2022 (figure 1.6). Starting from already pessimistic growth expectations, as of January 2023, LAC has been relatively resilient to the lower forecast, losing around 1.2 p.p., compared to North American and Western European economies, which lost 2 p.p. The outlook has worsened the most for Chile, Argentina, and Colombia, while the forecasts for Brazil and Mexico have stabilized, and Peru tops the list with the highest predicted growth, at 2.1 percent.

With the changing forecasts, rising global uncertainty has rendered the outlook increasingly speculative. Figure 1.7 shows the dramatic increase in the spread of industry forecasts. It is also notable that the increase in LAC’s spread is not larger than, for instance, that for the United States.
Four key factors drive LAC’s weakening performance (figure 1.8). First, global interest rates are expected to remain high and rising (panel d). Although the US Federal Reserve has slowed the pace of interest rate hikes, disappointing progress on inflation combined with strong job reports in February have led to expectations of further rate hikes. Second, demand from LAC’s principal export destinations is expected to remain lackluster as growth in the Group of Seven (G7) is constrained by contractionary monetary policy and energy shocks from the war (panel a). Third, there is uncertainty as China recovers tentatively from the COVID-19 lockdown (panel b). Fourth, weak demand has also led to a softening of commodity prices (panel c). An additional consideration, discussed in chapter 2, is that greater geopolitical uncertainty, a desire for closer supply chains, and higher G7 returns are driving capital flows away from many developing countries, including LAC, with the notable exception of Mexico.
Figure 1.7. Consensus Forecasts Have Become More Volatile after the COVID-19 Pandemic
Standard Deviation of GDP (percent change) Forecasts for Current Year

Sources: Consensus Economics; World Bank staff calculations.
Note: LAC(5) represents the simple average of the values for Brazil, Chile, Colombia, Mexico, and Peru. GDP = gross domestic product; LAC = Latin America and the Caribbean.

Figure 1.8. Continued Headwinds on External Factors

a. G7 growth
Percent

b. China’s growth
Percent

c. Commodity Price Index
Index, 2016:Q2 = 100

d. Fed funds rate and 10-year US Treasury yield
Percent

Sources: World Bank Commodity Prices (Pink Sheets); International Monetary Fund World Economic Outlook database; US Department of the Treasury.
Note: f = forecast; G7 = Group of Seven.
However, business confidence levels remain at or above their historical means (represented by 100 in figure 1.9, panel a), although they displayed a downward trend in 2022. The case of Chile is the most salient, with a steep decline in business expectations since the second quarter of 2021. Meanwhile, consumer confidence remains subdued, with most countries reporting low levels relative to historical means (figure 1.9, panel b).

Figure 1.9. Resilience in Business Confidence, Subdued Consumer Confidence

![Graph showing business and consumer confidence indices from January 2018 to November 2022.](image)

Source: OECD (2023).

Note: For both indexes, the historical mean = 100. OECD = Organization for Economic Co-operation and Development.

### Missing on Long-Run Growth

As with the stock market, the more important focus is on the long run, and here the news remains disconcerting. The low forecasted growth rates for 2024 do not reflect post-pandemic scarring or even the fight against inflation as they are roughly the same as those of the 2010s, when world output grew at 3.1 percent and LAC’s output grew at only 2.2 percent. The stabilization of the region’s economies should generate more room to turn again to the longer term reform agenda, including, as chapter 2 argues, how the region can better take advantage of the greening and potentially fragmenting global economy.
Labor Markets and Social Conditions

Incoming data provide a clearer picture of the social costs of the pandemic and how the region has recovered. Employment recovered remarkably fast in LAC. As figure 1.10 shows, by the third quarter of 2021, a little over a year after the collapse driven by the pandemic, employment had recovered its pre-pandemic levels in most of the countries in the region. To put this in perspective, LAC countries’ recovery, which started from a significantly lower level, preceded the US recovery by at least one quarter.

Unfortunately, the good news on the growing numbers of employed workers has been eclipsed by an apparent deterioration in the quality of employment. Using the Job Quality Index, which combines income, benefits, security, and satisfaction as the main set of dimensions that characterize a good job (Brummund, Mann, and Rodriguez-Castelan 2018), figure 1.11 shows lower benefit and job security levels than in pre-pandemic times. These measures have reverted on average to levels seen more than a decade ago (in 2009). Peru, Bolivia, Colombia, and Panama have had the most significant declines in the Job Quality Index due to worsening benefits and job security. This implies that workers in these countries face higher levels of vulnerability and are more exposed to shocks. There have also been cuts in benefits in Ecuador, the Dominican Republic, and Paraguay. Income makes a smaller contribution to the drop in the index than the other three dimensions across countries, with the largest declines in Ecuador, Panama, and Peru.

Although the significant drop in benefits seems to point toward an overall increase in labor informality in the region, figure 1.12 shows that the changes in the percentage of informal workers over the past three years have been heterogeneous across the region. While informal employment increased in Ecuador (11 p.p.) and Argentina (3.4 p.p.), it remained at similar levels in Brazil and Colombia and decreased in Chile (4.4 p.p.) and Paraguay (2.9 p.p.).

While already large gender gaps in employment grew after the pandemic across the region (World Bank, 2022a), splitting informality data by gender shows similar levels of informality among female workers and relative to pre-pandemic times.
As illustrated in figure 1.13, the pandemic did not lead to a significant change in poverty rates compared with 2019–20. However, excluding Brazil and its generous family support programs, the picture is decidedly less positive. The region’s poverty rate, measured at $6.85 a day (2017 purchasing power parity (PPP)), increased from 29.7 percent in 2019 to 34.4 percent in 2020, with approximately 19 million people falling into poverty and setting back previous gains by seven years or more.

The transfers in Brazil served to diminish the impact on the middle class (per capita income between $14 and $81 per day in 2017 PPP). The vulnerable population, those with a high probability of falling into poverty, increased in Brazil but arguably not by as much as in other countries. This was because in Brazil, government support prevented many from crossing the threshold. This did not happen in the rest of the region, resulting in 13 million

**Figure 1.11. ... But Not the Same Quality of Employment**

Change in Job Quality Index and components, 2021-19

**Figure 1.12. Small Changes in the Already High Level of Informality (percent)**

- **a. Andean region**
- **b. Southern Cone**
- **c. Brazil**

Sources: World Bank estimates based on data from the Socio-Economic Database for Latin America and the Caribbean; CEDLAS and World Bank, forthcoming.

Note: The values are the share of informal employment in total employment. Informality refers to workers ages 15–64 who do not receive a pension. In Argentina, Chile, Ecuador, and Paraguay, self-employed workers are not asked about pensions; therefore, in this figure, self-employed workers in these countries who have completed tertiary education are considered formal workers. The data are from February 13, 2023.
people dropping from the middle class. In Brazil, the transfers increased the size of the middle class by 2.1 p.p. The country not only protected families from falling into poverty, but also lifted many people out of poverty in 2020.

As shown in figure 1.14, Brazil’s transfers during 2020 had a significant effect on inequality. The Gini coefficient for the region including Brazil dropped a full point during the pandemic. This was achieved by protecting the most vulnerable during the worst of the pandemic, while the highest income deciles were heavily affected. For the LAC region excluding Brazil, inequality increased during the pandemic despite generalized government efforts to cushion the impact of the health crisis in most countries. The Gini coefficient (excluding Brazil) increased by 0.9 point during the pandemic, from 48.8 in 2019 to 49.7 in 2020.

Figure 1.13. COVID-19 Reversed a Decade of Progress in Decreasing Poverty in Most Countries but Not in Brazil

a. Poverty in LAC at $6.85 per day, 2017 PPP (percent)

b. Vulnerability in LAC at $6.85–$14 per day, 2017 PPP (percent)

c. Middle class in LAC at $14–$81 per day, 2017 PPP (percent)

Sources: SEDLAC; CEDLAS and World Bank, forthcoming.

Note: The LAC aggregate is based on 18 countries in the region for which microdata were available. In cases where data were unavailable, values were interpolated or extrapolated using data from the World Development Indicators and then pooled to create regional estimates (from 2014 backward) and microsimulations (from 2015 onward). Due to important methodological changes in Mexico’s official household survey in 2016, which created a break in the poverty series, a break was created in the LAC-18 aggregate. The values for 2021 are based on SEDLAC’s preliminary data for 11 countries and micro-simulations for the remaining countries. The data are from October 3, 2022. SEDLAC = Socio-Economic Database for Latin America and the Caribbean. LAC = Latin America and the Caribbean; PPP = purchasing power parity.

As shown in figure 1.14, Brazil’s transfers during 2020 had a significant effect on inequality. The Gini coefficient for the region including Brazil dropped a full point during the pandemic. This was achieved by protecting the most vulnerable during the worst of the pandemic, while the highest income deciles were heavily affected. For the LAC region excluding Brazil, inequality increased during the pandemic despite generalized government efforts to cushion the impact of the health crisis in most countries. The Gini coefficient (excluding Brazil) increased by 0.9 point during the pandemic, from 48.8 in 2019 to 49.7 in 2020.

Figure 1.14. Overall Inequality Remains at Pre–Pandemic Levels

a. LAC Gini coefficient trends

b. LAC growth incidence curves

Sources: SEDLAC; CEDLAS and World Bank, forthcoming.

Note: In panel a, the LAC aggregate is based on 18 countries in the region for which microdata were available. In cases where data were unavailable, the values were interpolated or extrapolated using data from the World Development Indicators and then pooled to create regional estimates (from 2014 backward) and microsimulations (from 2015 onward). Due to important methodological changes in Mexico’s official household survey in 2016, which created a break in the poverty series, a break was created in the LAC-18 aggregate. The values for 2021 are based on SEDLAC’s preliminary data for 11 countries and microsimulations for the remaining countries. The data are from October 3, 2022. For panel b, The LAC aggregate is based on nine countries in the region for which microdata were available for 2019, 2020, and 2021. LAC = Latin America and the Caribbean; SEDLAC = Socio-Economic Database for Latin America and the Caribbean.
Effects of the Russian Invasion of Ukraine

The Russian invasion of Ukraine slowed LAC’s poverty recovery by increasing food and energy prices, which led to a reduction in household purchasing power. Domestic fertilizer prices for farmers in LAC are still around 2.5 times higher than pre-pandemic levels. The higher costs of such inputs (coupled with droughts in some areas) are adversely affecting farmers’ livelihoods and reducing planting areas and/or yields. The food crisis may turn from issues of affordability (food access) to issues of availability (food production) in 2023 in some countries and subregions where harvests may be below average.

As shown in figure 1.15, panel a, the impacts on poverty vary significantly within the region. Countries and subregions are experiencing exacerbated poverty (Colombia, Peru, and Costa Rica), social tensions (Panama), and food insecurity (Central America, Haiti, and Andean countries).

**Figure 1.15. Estimated Social Costs of Food Inflation in the Region: Changes in Headcount Poverty and Inequality, 2022 (percentage point change)**

*a. Poverty at $6.85 per day, 2017 PPP (p.p. change)*

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*b. Inequality (p.p. change)*

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<td>Panama</td>
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Note: The figures compare 2022 (considering the scenario with additional inflation based on Annual Meetings assumptions) vs. 2022 (considering the scenario with baseline inflation according to Spring Meetings assumptions). LAC = Latin America and the Caribbean; p.p. = percentage points; PPP = purchasing power parity.

In absolute terms, an estimated 5.5 million people have been pushed into poverty, with the countries with the largest populations, like Mexico, Brazil, and Colombia, seeing the largest increases. Simulation results indicate that the inflation crisis has also exacerbated inequality (as measured by Gini coefficient points), with varied impacts across countries. In Colombia and Nicaragua, the estimated rise in inequality is triple the regional average; in Brazil, Uruguay, and Panama, it is less than half the rise in the region (figure 1.15, panel b).
Policy responses in the region continue to be dominated by subsidies and price controls, tax measures, and social assistance (in that order). Within subsidies and price controls, fuel subsidies are still the leading response (44 percent of the subsidy response), more than in any other region. Inertia in policy measures remains a concern and many measures are not timebound, with the concomitant risk of long-term policy distortions and fiscal pressures.

**The Macro Panorama: Difficult but Resilient**

The region’s fiscal and monetary authorities continue to manage a difficult combination of higher interest rates, complicating the service on a higher stock of public debt, and resistant inflation. Both restricted fiscal space and tight monetary policy are likely to remain the norm going forward. However, the region’s resilience and success relative to historical experience have provided a level of almost normalcy in LAC policy that would have been unimaginable a generation ago. Preserving the hard-won gains in macroeconomic management and credibility over the past decades is as critical as increasing vaccinations is for resilience in the health sphere.

**Fiscal Space Continues to Be Limited, with Heavy Financing Costs, but the Markets Remain Calm**

LAC’s regional fiscal deficit widened significantly to 8.7 percent of GDP in 2020 as governments struggled to protect their citizens from the effects of the COVID-19 pandemic. Helped by the growth rebound, significant fiscal retrenching occurred in 2021. The regional deficit decreased to 4.4 percent of GDP, although further progress in consolidating public balances was minimal in 2022 as the region’s fiscal deficit for 2022 is estimated at 4.4 percent of GDP.

At the country level, the efforts of large economies, such as Brazil, Colombia, Mexico, and Peru, to post a primary surplus or near surplus in 2023 will be insufficient to offset growing interest payments on elevated

**Figure 1.16. Increased Primary Surpluses Are Insufficient to Cover Growing Interest Payments**

*Fiscal Balance in LAC - 2023 Forecast*

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Note: Values are based on projections (as of March 24, 2023). GDP = gross domestic product; LAC = Latin America and the Caribbean.
public debt stocks, resulting in relatively large overall deficits (figure 1.16). The large deficits continued to erode the already tight fiscal space across the region, driven by the increased expenditures during the pandemic, which raised average indebtedness in 2022 by 17.9 p.p. of GDP compared to 2010. Most of the increase accumulated since the start of the pandemic, with an average increase of 7.5 p.p. of GDP since 2019. Among the large economies, the public debt-to-GDP ratios of Argentina, Bolivia, Brazil, Colombia, and Ecuador have increased by more than 20 p.p. since 2010 (figure 1.17), with most of the increase again concentrated during the past three years.

While economies like Brazil, Colombia, and Mexico are starting to see relatively large increases in financing costs (figure 1.18), these increases seem to be associated with the mechanical adjustment to higher interest rates in advanced economies and the aggressive rate hikes conducted by domestic central banks in response to accelerating inflation. The increases are less related to large market-imposed risk premiums.

International investors have remained calm in the wake of the region’s current debt challenges, reflecting broad confidence in the overall management strategy. Sovereign spreads remain higher than they were during the period preceding the pandemic, but not dramatically so. To put this in perspective, both levels and increases in spreads for the large economies in the region are of the same order of magnitude as those currently faced by Southern European economies (figure 1.19) and are rated “above investment” grade.

The situation will become more difficult should interest rates continue to rise in advanced countries, and the search for fiscal space will continue as will the search for new sources of revenues and savings. These issues were discussed in the October 2022 LACER (World Bank 2022b). However, at present, the markets seem to deem that the situation is manageable.
Progress on Reducing Inflation

For the region excluding Argentina and the República Bolivariana de Venezuela, inflation closed out 2022 at an average of 7.9 percent, which was below that of the Organization for Economic Co-operation and Development and Eastern Europe but above that of East Asia (figure 1.20). Monthly inflation peaked in April 2022 at 1 percent and fell to 0.4 percent in January 2023 (figure 1.21); yearly inflation is expected to fall to 5.0 percent in 2023.

Although inflation pressures remain formidable, expectations remain well anchored at historically low levels, ranging from 2 to 4.5 percent (figure 1.22).

LAC’s relative success in fighting inflation is largely due to early action on the part of regional central banks, which reacted up to a year earlier than the US Fed in the case of Brazil and increased rates much more aggressively than in past episodes (figure 1.23). However, as shown in figure 1.24, in no case is a large economy in LAC expected to...
**Figure 1.20.** LAC Kept Inflation below the Rates in OECD Countries in 2022

*Annual Inflation in 2022*

Sources: Macro Poverty Outlook, World Bank (2023); OECD (2023); World Economic Outlook database (October 2022).

Note: The annual inflation rate represents the percent change in end-of-period consumer prices. Aggregates are calculated by taking simple averages of the countries in the group. LAC = Latin America and the Caribbean; OECD = Organization for Economic Co-operation and Development.

**Figure 1.21.** Inflation Rates Declined Sharply in the Second Half of 2022

*LAC monthly inflation (Median, sa m-o-m)*

Sources: National authorities; Haver Analytics.

Note: LAC = Latin America and the Caribbean; sa m-o-m = seasonally adjusted month-over-month.

**Figure 1.22:** Long-Term Inflation Expectations Remain Anchored at Historical Lows

*Long-term Inflation Expectations (6 to 10 years)*

Source: Consensus Economics.

Note: Inflation expectations represent the average long-term forecasts (6 to 10 years) of consumer price inflation (percent change from previous December); y-o-y = year over year.
meet its official inflation target before 2024; therefore, even if they do not increase, policy rates will remain high. The situation puts economies in the standard trade-off of risking slower growth or risking inflation remaining unchecked. There are heated discussions on this trade-off in some parts of the region.

Latin American central banks have particular experience in managing inflation. The so-called Developing Country Monetary Policy Dilemma (Vegh et al. 2017) has long required monetary policy to move pro-cyclically, in contrast to the advanced countries—that is, as the economy weakens, interest rates are frequently raised. For instance, a fall in the terms of trade would not only depress growth, but also require a further depressing (procyclical) rise in interest rates to defend the exchange rate. This is necessary to prevent inflation pass-through, minimize increased pressure on servicing largely foreign-denominated debt, and bolster confidence that the situation was being stabilized and exchange rates would not depreciate further. As a result, whereas in the advanced countries, monetary policy moves countercyclically, dampening excessive exuberance and mitigating downturns, the reverse has been the case in LAC. To illustrate, figure 1.25, panel b, shows that in advanced countries, as growth falls, inflation also falls, consistent with a story where authorities raise interest rates to reduce excess demand. However, panel a shows that in LAC, as inflation rises, interest rates rise and growth falls. This pattern is clear across countries in the region (annex 1A).

As previous issues of LACER have documented (for example, World Bank 2017), since roughly 2004, LAC’s monetary authorities have moved toward a countercyclical policy. This change has allowed the region’s central banks to lean more against downturns and the resulting unemployment, instead of aggravating them.
The experience managing the monetary dilemma has also led to a policy pattern termed “the cycle within the cycle,” which is appropriate for the present context (Rojas, Vegh, Vuletin (2023)). As inflation increases, so does the policy rate, but once inflation stabilizes and/or decreases, the monetary authority can pause and eventually decrease rates to stimulate production. After the recovery in 2021, growth decelerated over 2022, while at the same time inflation has risen across the region in the standard pattern. As in the past, policy rates have been increasing to stabilize inflation (figure 1.26). As inflation levels off and decreases, as in the cases in Brazil, Chile, Mexico, and Peru, history suggests that there will be a reversal in monetary policy across the region as countries start to address subdued demand issues by loosening their monetary grip. Chile and Brazil have already announced pauses in further rate increases. Although the region is not out of the inflationary difficulties and further adverse shocks can be expected, LAC is miles away from the inflations of decades past.

The Need to Defend Hard-Won Economic Resilience

While in no sense is LAC out of the macroeconomic difficulties, it is clear that the region has made great strides toward a more macroeconomic “normalcy” as seen in the three areas discussed above, i.e. overall decrease macroeconomic volatility, price stability, countercyclical monetary policy. The rise in interest rates and slow growth compound increased debt difficulties. However, international markets are calm and this is the second major crisis when Latin America has not fared especially worse than average. These are signs of increased resilience and reflect the region’s respectable performance in fighting inflation and its move toward countercyclical monetary policy.10,11

The improvement in macro performance and resilience is largely due to reforms implemented over the past 25 years, in response to the raging inflation of the 1970s and 1980s, which led to a deep slump in real incomes and social discontent. The improved performance reflects three main changes.

*Increased professionalization of authorities and stronger institutionalization.* Finance ministries and monetary and supervisory authorities have become more professional, and regulation has become more effective, gaining in institutional strength over time. Often, central banks and ministries of finance are staffed
Figure 1.26. Current Policy Dilemma for LAC: Actual Inflation, Target, and Policy Rate


Note: Inflation refers to the percentage change in the Consumer Price Index with respect to the same month in the previous year. Similarly, growth refers to the percentage change in quarterly real gross domestic product with respect to the same quarter in the previous year. LAC = Latin America and the Caribbean.
by economists who have graduated from the best regarded universities in the world, and LAC economists are full partners in global macroeconomic debates. This has led to both better management and enhanced credibility.

Central bank independence and inflation targeting. In the 1990s, most of the region’s central banks were granted political and operational independence to enhance their inflation-fighting powers. Studies have shown this has led to decreased inflation over time and reduced the incidence of inflationary outbreaks. Institutionality, which is the rule among advanced countries, has been central. The adoption of clear inflation targets also enhances predictability. The tensions seen with some political authorities today is also “normal” in the sense that the most important purpose of independence everywhere is precisely to insulate the long-term goal of price stability from pressures arising from short-term output concerns or the need to finance fiscal deficits, and to create expectations that this is, in fact, the case.

Increased armor. Regional authorities have taken steps to build a better defense against shocks. Foreign-denominated debt has nearly halved since 2004, falling from 60 to 35 percent of total debt in 2021. As shown in figure 1.27, the currency denomination of public debt varies substantially among LAC economies, but in the two powerhouses in the region, Brazil and Mexico, public debt is mostly denominated in domestic currency (94 and 81 percent, respectively).

In addition, central bank reserves have almost doubled, from 12 percent of GDP in 2004 to 20 percent in 2021, and they have remained high after the pandemic (figure 1.28).

**Figure 1.27. Less Balance Sheet Exposure to Exchange Rate Risk...**

*Public debt by currency of denomination*

Lower foreign exposure and more tools to defend currencies have significantly reduced the risk of unsustainable currency mismatches, which caused a lot of trouble in the past.

Taken together, the historically modest rates of inflation, increased resilience to shocks (and the relative calmness of international markets), and ability to use monetary policy countercyclically all reflect a hard-won increased confidence in the region’s institutions and policies. These gains and the consolidation of institutionality face challenges in the context of political tensions in the region. However, they need to be defended as macroeconomic stability is a critical foundation for the investment and innovation that are necessary to take advantage of changes in the global environment and the region’s emerging areas of green comparative advantage.
Is Resilience Enough? The Paradox of LAC’s Declining Integration into the World Economy

The combination of LAC’s resilience and declining integration into the world economy poses a paradox that the exit from pandemic crisis mode should bring to the fore. The region has limited fiscal space and extraordinary needs in infrastructure, but investment and growth remain low. LAC will need foreign capital and knowledge to take advantage of the reorganization of global value chains and unlock the vast potential of its green industry. At the same time, the region’s increased stability should provide domestic and foreign investors a more secure platform to take advantage of this potential. However, LAC’s trade has largely stagnated and, with some notable exceptions, the region seems to be losing the interest of foreign investors. As figure 1.29 shows, foreign direct investment inflows have dropped by 35 percent over the past decade. This is not simply a trend shared globally as flows to developing countries have continued to increase—the region is dramatically losing share. At its peak in the late 1990s, LAC commanded 43 percent of global flows destined to emerging economies; today, these flows are roughly 15 percent, a fall of 28 p.p. in two decades. Chapter 2 explores what recent research suggests about LAC’s welcoming environment for foreign investors.

Figure 1.28. ...And More Self-Insurance through International Reserves
Total Reserve Assets as Percent of Trend Component of GDP

Sources: World Economic Outlook database (October 2022); World Bank staff calculations.
Note: GDP = gross domestic product; LAC = Latin America and the Caribbean. f = forecast.

Figure 1.29. Foreign Investors Are Losing Interest in LAC for Long-Term Investments
Inward Foreign Direct Investment Flows

Source: UNCTAD 2022.
Note: EM = Emerging Markets; LAC = Latin America and the Caribbean; RHS = right-hand scale.

Figure 1A.1 shows a strikingly different pattern of inflation behavior during recessions between LAC countries (panel a) and advanced economies (panel b).

**Figure 1A.1. Patterns of Inflation and Growth over the Average Business Cycle**

*a. LAC economies*
Figure 1A.1. Patterns of Inflation and Growth over the Average Business Cycle (continuation)

b. Advanced economies

Note: After identifying the different episodes of recessions, each “Trough” is defined as the quarter with the minimum growth rate during an episode. These quarters are labeled as the moment zero in the x-axis. Then for each quarter around the “Trough”, the difference between the growth rate in the particular quarter and the growth rate at the Trough is calculated. To normalize the growth rates, this deviation from the Trough is then divided by the standard deviation of the growth rate (calculated over all quarters). The graphs show the average over the entire period for each quarter around the Trough. A similar expression is calculated for (annual) inflation.
What explains this difference in behavior? External conditions are among the most important drivers of the business cycle in LAC. Variables such as the terms of trade and the growth rate of industrial countries are closely associated with business cycles in the region, and with the policy dilemma (figure 1A.2).

**Figure 1A.2. Factors Affecting LAC’s Average Business Cycle**

![Graphs showing the relationship between terms of trade and growth rate of industrial countries in LAC.](image)

**Source:** Rojas, Vegh, Vuletin (2023).

**Note:** After identifying the different episodes of recessions, each “Trough” is defined as the quarter with the minimum growth rate during an episode. These quarters are labeled as the moment zero in the x-axis. Then for each quarter around the “Trough”, the difference between the growth rate in the particular quarter and the growth rate at the Trough is calculated. To normalize the growth rates, this deviation from the Trough is then divided by the standard deviation of the growth rate (calculated over all quarters). The graphs show the average over the entire period for each quarter around the Trough. Average weighted by population. LAC = Latin America and the Caribbean; S.D. = standard deviation; ToT = terms of trade.

Negative external conditions can drive the economy and inflation in opposite directions. As the terms of trade deteriorate or the cost of financing increases, exchange rates tend to depreciate, creating a pass-through inflation effect into the economy, making foreign imports and foreign financing more expensive.
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Notes

1 Urrunaga-Pastor, Bendezu-Quispe, et al. (2021).
3 CEPAL (2021).
4 Fiolet et al. (2022).
8 CEDLAS and World Bank (forthcoming, chapter 1).
9 Vegh et al. (2017).
10 Vegh et al. (2017).
11 Rojas, Vegh, and Vuletin (forthcoming).
12 Jácome and Pienknagura (2022).
CHAPTER II

REENGAGING A CHANGING WORLD ECONOMY
Latin America is again reappraising how it engages with the global economy. Despite decades of trade reforms and free trade agreements, the region remains under-diversified and vulnerable to commodity price shocks, and, as chapter 1 showed, growth remains too low to reduce poverty and alleviate social tensions. The context of rising questions about the adequacy of the outward-oriented model, domestic shortages arising from broken supply chains during the pandemic, talk of the end of globalization, and fragmentation of the global economic order has prompted thoughts of turning inward again. The region remains one of the least integrated regions by global standards, and, with a few exceptions, trade openness and foreign direct investment (FDI) flows have been stagnant or decreasing over the past 20 years.

This evolution is occurring against a background where there is increasing evidence of faster growth arising from openness, greater access to new technologies and foreign investment, taking advantage of scale economies, and the stimulating benefits of competition. South-North trade is particularly associated with larger impacts on growth and the complexity of exports, consistent with greater possibilities for knowledge transfer from the frontier (box 2.1).

Further, examples from generations of East Asian miracles, the most recent being China and Vietnam, become more compelling with each decade. The East Asia region has seen rapid convergence toward the levels of income of the Group of Seven (G7) over the past 40 years, as Latin America has slipped from close to 44 to 32 percent of G7 incomes (figure 2.1).

**Figure 2.1. Gross Domestic Product per Person as a Share of the G7 Average (percent)**

![GDP per Person as a Share of the G7 Average](chart.png)

Sources: World Economic Outlook database (October 2022) and World Bank staff calculations.

The question cannot be whether Latin America and the Caribbean (LAC) should go back to the more inward-looking stance, which generated poor growth and macro instability. Both LAC’s history and the Asian experience firmly reject that option. Rather, the question should be why the supposedly outward-looking reforms of the past 40 years did not produce better outcomes, and what needs to be done to leverage the region’s areas of comparative advantage.

This question becomes critical for two additional reasons. First, the evolution of the world economy suggests that there are opportunities, but also new challenges, for the region. Forces toward nearshoring away from Asia are already favoring Mexico and could potentially partially reverse the deindustrialization proceeding in the region if conditions allowed. However, global flows of FDI to the region have been falling for a decade even as the advanced countries are reshoring; the region needs to increase its attractiveness to position itself well.
Second, the dramatic potential for green energy points to new opportunities for the region. Latin America’s green energy grid gives it a comparative advantage in all energy intensive products; its extraordinary endowments of wind and sun offer great potential for exporting green energy; its abundance of lithium, copper, and other essential inputs to electrification of the global economy, if extracted sustainably, offer new growth opportunities; and its abundant natural capital could support a variety of new industries. To exploit this new green comparative advantage and ensure that it is leveraged to diversify and energize the economy requires answering the same initial question: what should be done differently?

This chapter offers an overview of the major trends in trade and presents suggestions for the agenda for further reforms, based on recent work at the World Bank.

**The Changing Global Context: Challenges and Opportunities for LAC**

Despite several decades of reforms oriented toward increasing the region’s engagement with the rest of the world, LAC trades little. Exports plus imports as a share of gross domestic product (GDP) in both merchandise trade and services are low compared to any other region (figure 2.2).

**Figure 2.2. Trade in Goods and Services as a Share of Output, 2010–19 Average (percent of GDP)**

<table>
<thead>
<tr>
<th>Region</th>
<th>Service trade</th>
<th>Merchandise trade</th>
</tr>
</thead>
<tbody>
<tr>
<td>Middle East and North Africa</td>
<td></td>
<td>17.7</td>
</tr>
<tr>
<td>Europe and Central Asia (excluding high income)</td>
<td>10.9</td>
<td></td>
</tr>
<tr>
<td>East Asia and Pacific (excluding high income)</td>
<td>7.4</td>
<td></td>
</tr>
<tr>
<td>Sub-Saharan Africa</td>
<td>10.5</td>
<td></td>
</tr>
<tr>
<td>OECD members</td>
<td>13.6</td>
<td></td>
</tr>
<tr>
<td>Latin America and the Caribbean</td>
<td>6.9</td>
<td></td>
</tr>
<tr>
<td>South Asia</td>
<td>10.8</td>
<td>34.3</td>
</tr>
<tr>
<td>Source: World Development Indicators.</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Note: Trade in goods and services is the sum of exports and imports of goods and services. GDP = gross domestic product; OECD = Organisation for Economic Co-operation and Development.

The region also under-trades relative to its predicted potential, accounting for distance from markets, special trade arrangements, common language, partners’ economic size, and other trade fundamentals. Paraguay, Bolivia, Mexico, Chile, and Nicaragua are exceptions (figure 2.3).

Further, over the past 25 years, trade growth has been largely stagnant (figure 2.4), with some reorientation. There has been an uptick in the total volume of trade since 2020 of approximately 10 percent, but the region remains 10 percent below where it was a decade ago. There has also been a shift in the center of gravity of trade. The United States in aggregate remains the largest export destination for the region, but China is now the dominant destination for the region excluding Mexico (figure 2.5). China has free trade agreements with
Chile, Costa Rica, and Peru and, in February 2022, launched talks with Ecuador, which reportedly were almost complete as of December 2022.

The region’s comparative advantage in resources has left it still highly dependent on commodities and food exports (figure 2.6). With the exceptions of Mexico and Costa Rica, LAC is less integrated into global value chains (GVCs) compared to other regions across all sectors. As Rocha and Ruta (2022) show, in 2015, forward participation, which is importing components for use in the assembly of exports, was 19 percent of total exports for LAC; it was close to 30 percent for Europe and Central Asia (ECA) and East Asia and Pacific (EAP).

**Figure 2.3. Actual Exports Relative to Predicted Exports to All Trading Partners (percent deviation)**

![Figure 2.3](image)


Note: The values are percent deviations of actual exports compared to predicted exports. The predictions for nominal exports were obtained from a nonlinear specification of the gravity model, estimated with the Poisson pseudo-maximum likelihood estimator. The Caribbean region excludes the Dominican Republic, which is shown separately.

**Figure 2.4. LAC Trade Has Been Stagnant Since 2000, Except for Mexico**

**Total trade of LAC (6) (percent of GDP)**

![Figure 2.4](image)

Sources: World Bank World Integrated Trade Solution; World Bank staff calculations.

Note: GDP = gross domestic product; LAC (6) = Argentina, Brazil, Chile, Colombia, Mexico, and Peru.
Backward participation, which is the production of intermediate components for export markets, was 16 percent of total exports for LAC; it was 20 percent for EAP and 30 percent for ECA.

Moving up the value chain has also been a struggle. Except Mexico, which is integrated into advanced manufacturing and services GVCs, LAC countries mostly specialize in commodity and limited manufacturing GVCs. Since the 1990s, only Argentina, Costa Rica, and El Salvador have been able to upgrade from commodities to limited manufacturing. It could be argued that this simply reflects comparative advantage. However, it is fair to ask why Colombia, with ports on both coasts and a mass of underemployed labor, or more of the Caribbean and Central America should not also be in Mexico’s position.
In addition, although in LAC services account for 60 percent of economic activity and the region has liberalized services trade, its share remains lower than that of other regions, averaging just 6.9 percent of GDP during the 2010s (figure 2.2). The role of services in GVCs has increased globally, but LAC lags behind other regions in terms of its integration: while in EAP backward and forward participation in services represents 31 percent of gross intraregional exports, the share is only 16 percent in LAC, and it has stagnated since the early 2000s.²

LAC’s current trade profile reflects both local policies and global trends. Employment in urban tradables, especially manufacturing, plummeted during the 1990s and 2000s, especially in the largest cities (figure 2.7) (Jedwab, Ianchovichina, and Haslop 2022). As described in Beylis et al. (2020) and elsewhere, part of this was necessary. Mounting debt and recurring crises signaled that the policies supporting import substitution industrialization had been costly and inefficient, failing to establish globally competitive domestic manufacturing firms that could withstand increased foreign competition. In addition, the adoption of labor-saving manufacturing technologies across the world has reduced manufacturing globally (Beylis et al. 2020). At the same time, the rise of East Asia and other emerging markets as manufacturing powerhouses generated demand for commodities and opened opportunities for the growth of the Latin American mining and agrobusiness sectors in the 1990s and 2000s. During the Golden Decade (2003–13), strong demand for commodities and a resource windfall allowed the economies of LAC to increase their consumption of imported manufactured products and domestic services, further eroding the international competitiveness of the region’s manufacturing sectors.

Figure 2.7. Evolution of the Share of Employment in Urban Tradables, by City Size and Decade in LAC

![Figure 2.7](image)

Source: Jedwab, Ianchovichina, and Haslop 2022, based on IPUMS survey data.

Note: LAC = Latin America and the Caribbean. MFGFIRE stands for manufacturing and tradable services (such as finance, insurance, and real estate services, or FIRE). The size of the agglomeration is proxied with the log of the population size of the agglomeration in terms of number of inhabitants (Inh.).

However, the urgent need to shift toward a greener global economy presents tremendous opportunities for the region (box 2.2), in manufactures, commodities, and services. The fact that currently LAC has the world’s cleanest electricity grid offers potential for a green premium on the region’s exports across all sectors. The abundance of wind and sun positions the region as the dominant producer of green hydrogen and renewable energy generally. LAC is also well endowed with lithium, copper, and other inputs that are used intensively in green technologies. Hence, in principle, the climate crisis offers an entirely new source of comparative advantage to be exploited.
Benefits of South–North Trade Agreements

International trade has been associated with welfare, economic development, and growth since the times of Adam Smith. In an early seminal work, Frankel and Romer (1999) estimate that a one-percentage-point increase in the trade share (ratio of exports or imports to gross domestic product (GDP)) raises income per person by 2 percent. In a recent paper, Irwin (2019) reviews a variety of studies using different measures of policy and finds that economic growth is roughly 1.0 to 1.5 percentage points higher than a benchmark after trade reform. Several studies suggest that this gain cumulates to about 10 to 20 percent higher income after a decade.

As shown in a recent World Bank report, while Latin America and the Caribbean has signed a good number of trade agreements over the past decades, not all trade agreements provide the same benefits (World Bank 2020a). Trade agreements are typically thought to create export opportunities and potential for growth through the productivity transfers embedded in the exchange of goods and services. For emerging markets, trading with developed economies (South–North trade for short) provides access to bigger and richer markets, which enables knowledge exchange with more advanced economies once implemented.

To highlight the importance of South–North agreements, after weighting by the corresponding shares of global GDP, the 110 bilateral trade agreements embedded in the Latin American Integration Association become equivalent to the two agreements signed by Mexico under the North American Free Trade Agreement.

Figure B2.1.1. LAC’s South–North Trade Agreements

a. The agreements involve greater market size...
Another advantage stemming from South-North agreements is the transfer of technology and know-how. Complex economies produce sophisticated and innovative products and services that are sold at a premium in global markets. A country can import knowledge not only from these more complex economies, but also indirectly from their trading partners (Grossman and Helpman 1991; Coe and Helpman 1995).

Using the Economic Complexity Index created by Hausmann et al. (2013) as a measure of the degree of economic sophistication of a country further increases the weight of South-North trade agreements. Counting this way, more than two-thirds of the market access and potential knowledge transfer from trade agreements signed by countries in the region originated from just a few South-North deals (figure B2.1.1). Thus, it takes the equivalent of two Latin American Integration Association deals to reach the same economic potential as the North American Free Trade Agreement.

The estimates also suggest a positive impact of trade openness on economic growth, and especially with countries with the potential to transfer technology and know-how. In the medium term, a South-South agreement raises a developing country’s annual growth rate of GDP by about 0.2 percentage point, whereas a South-North agreement leads to an increase in the growth rate of GDP by about 0.85 percentage point.

Sources: Frankel and Romer (1999), Hausmann et al. (2013), World Bank (2019).
The Promise of Nearshoring and Declining FDI in LAC

FDI can be a source of capital and technology that stimulates growth and creates jobs at scale. The period from 1988 to 1992 saw an explosion of capital flows to China and other parts of Asia, which fueled close to double-digit growth rates. Empirical evidence shows a heterogeneous but typically positive impact of FDI on growth, ranging from 0.1 to 0.8 percentage point increases in per capita GDP growth, with a 1 percentage point increase in the ratio of FDI to GDP for developing economies.

Geopolitical tensions and the logistical complications arising from the COVID-19 pandemic are leading to a desire for greater diversification of production sources closer to home. In theory, this could offer a tremendous opportunity for LAC, which has greater “proximity” to the United States and Europe along many dimensions.

Is LAC Missing the Opportunity of Nearshoring?

However, figure 2.8 shows that FDI inflows to the region have steadily decreased over the past decade. This partly reflects a more general retrenchment and reshoring by the sending countries. Global FDI inflows, led by high-income economies, drastically decreased from their peak of US$2 trillion in 2015 to just below US$1 trillion during the depths of the pandemic (a 77 percent decrease). The reduction in flows to LAC was similar in magnitude, with a total reduction of 75 percent, from US$202 billion in 2012 to just over US$86 billion in 2020, by far the largest drop among developing regions. Although FDI inflows recovered in 2021, the recovery was just enough to put the region back on its downward trend.

Greenfield investment is when a foreign company builds its operations from the ground up. The most dramatic, steady pullback in greenfield investment was in Asia. LAC’s greenfield investment underwent a similarly dramatic decline in 2019, and so far, the region shows no sign of becoming a new destination of choice (figure 2.9).

Figure 2.8. Regional Declines in FDI Inflows Are Widespread in Emerging Markets Except China

Inflow of FDI by region, developing economies (US dollars at current prices, millions)

Source: Calculations using UNCTAD FDI data.
Note: FDI = foreign direct investment.
A simple back-of-the-envelope calculation using the aforementioned range of elasticities shows that LAC could be missing between 0.08 and 0.64 percentage point of GDP growth per capita every year due to the drop in FDI since 2012 (around US$60 billion). The effectiveness of FDI may depend on various co-factors. For example, better absorption capacities are related to higher FDI productivity (Crespo and Fontoura 2007). The same applies to human capital (Borensztein, De Gregorio, and Lee 1998), deeper financial systems (Alfaro et al. 2004), institutional quality (Busse and Groizard 2008), and the stability of the regulatory and political systems (Choe 2003). In LAC, Mexico, El Salvador, and the Dominican Republic, to name a few, have benefitted from similar flows.

Mexico is the striking exception to these trends as it experienced an increase in FDI inflows of almost 40 percent over 10 years, while South America experienced a decline of 8.6 percent (table 2.1). The decreases over the past 10 years have been primarily driven by a 14 percent fall in European investment, especially from the Netherlands (31 percent) and Spain (15 percent), with the United States contributing a measly 1.5 percent increase over a decade. The decreases have been offset by dramatic increases from the same countries with FDI flows going to Mexico. The holdings in Mexico are of a similar magnitude as the entirety of those in South America. Despite China’s role as the premiere export market and import source for LAC excluding Mexico, the official statistics, which may not fully capture inflows, suggest that China role is still relatively small. Central America shows large increases. However, the aggregate numbers conceal large financial flows to Panama, much as they do in the Caribbean.

The comparison of greenfield investment in Mexico and Brazil tells a similar story (figure 2.10, panels a and b). The overall picture appears to be one of nearshoring, but it is from Brazil to Mexico. Announcements from the United States to Brazil fell to their lowest point in a decade, dropping by more than US$5 billion, while the reverse was true in Mexico.

The past five years have also shown significant changes in the composition of FDI (figure 2.11). Most noticeably, since 2017 there has been a large increase in foreign investment in renewable energy across the region. Box 2.2 suggests that this offers major opportunities as a driver of growth. Although the large push for renewables diminished somewhat during the pandemic, the levels of investment remain significantly higher than in the previous decade. However, the Ukrainian conflict reset foreign interest in the coal, oil, and gas sector, which had registered a gradual decline since 2018. There was a big jump in 2022, with coal, oil, and gas becoming the main FDI sector. Metals also saw a sustained recovery, after their big fall in 2020.
### Table 2.1. Foreign Investment Positions in LAC Are Decreasing and Moving North (US$, millions)

<table>
<thead>
<tr>
<th>Region</th>
<th>2012</th>
<th>2021</th>
<th>% change</th>
<th>2012</th>
<th>2021</th>
<th>% change</th>
<th>2012</th>
<th>2021</th>
<th>% change</th>
</tr>
</thead>
<tbody>
<tr>
<td>World</td>
<td>990,172</td>
<td>904,960</td>
<td>-8.61</td>
<td>426,101</td>
<td>592,221</td>
<td>38.99</td>
<td>37,687</td>
<td>72,869</td>
<td>93.35</td>
</tr>
<tr>
<td>Europe</td>
<td>524,132</td>
<td>454,991</td>
<td>-13.19</td>
<td>197,315</td>
<td>310,069</td>
<td>57.14</td>
<td>12,370</td>
<td>30,655</td>
<td>140.8</td>
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<td>156,296</td>
<td>158,668</td>
<td>1.52</td>
<td>185,764</td>
<td>207,360</td>
<td>11.63</td>
<td>10,459</td>
<td>12,002</td>
<td>14.75</td>
</tr>
<tr>
<td>Netherlands</td>
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<td>148,241</td>
<td>-31.40</td>
<td>58,405</td>
<td>115,280</td>
<td>97.38</td>
<td>2,823</td>
<td>12,207</td>
<td>332.42</td>
</tr>
<tr>
<td>Spain</td>
<td>101,243</td>
<td>85,895</td>
<td>-15.36</td>
<td>99,766</td>
<td>44.64</td>
<td>3,283</td>
<td>8,393</td>
<td>133.61</td>
<td></td>
</tr>
<tr>
<td>South America</td>
<td>44,425</td>
<td>52,010</td>
<td>17.07</td>
<td>3,906</td>
<td>93.36</td>
<td>5,335</td>
<td>13,576</td>
<td>154.49</td>
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<tr>
<td>Brazil</td>
<td>9,749</td>
<td>11,397</td>
<td>16.91</td>
<td>2,946</td>
<td>80.99</td>
<td>2,101</td>
<td>9,823</td>
<td>367.45</td>
<td></td>
</tr>
<tr>
<td>Mexico</td>
<td>19,397</td>
<td>11,200</td>
<td>-42.26</td>
<td>4,637</td>
<td>5,019</td>
<td>8.23</td>
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<tr>
<td>China</td>
<td>3,622</td>
<td>2,930</td>
<td>-19.1</td>
<td>1085</td>
<td>139.07</td>
<td>1,498</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Source:** International Monetary Fund Coordinated Direct Investment Survey.

**Note:** South America includes Argentina, Brazil, Chile, Colombia, Ecuador, Paraguay, Peru, Uruguay, and the República Bolivariana de Venezuela.

### Figure 2.10. Trends in Greenfield Foreign Direct Investment in Mexico and Brazil, from Selected Main Countries of Origin (US$, millions)

**a. Mexico**

- United States
- Spain
- Germany
- Japan
- China

**Source:** Calculations using data from the fDi Markets database.

**b. Brazil**

- United States
- Spain
- Germany
- China
- France
- United Kingdom

**Source:** Calculations using data from the fDi Markets database.
How can LAC attract more foreign investment...

How can LAC attract the foreign capital it needs to help stimulate both old and new areas of comparative advantage? The somewhat good news is that Asia no longer holds an obvious advantage over the region as wages in China have risen above those even in Mexico and Brazil, and Vietnam is not far behind (figure 2.12). Unfortunately, the region’s wage competitiveness is not enough to make it attractive to investors. A cost of manufacturing operations index calculated by KPMG and the Manufacturing Institute offers a window

Figure 2.11. LAC’s Top Five Foreign Direct Investment Sectors (US$, millions)

Figure 2.12. Costs of Manufacturing Operations and Average Real Wages, 2020

Sources: KPMG 2020; ILOSTAT 2023; OECD 2023.
Note: CoDB = Cost of Doing Business.
into how investors evaluate destinations that sheds light beyond the manufacturing sector. It shows how countries with very high wages, like Canada or the United States, still perform better than emerging markets with relatively cheap labor, like Mexico or Brazil. This is because although the primary costs of operations, such as labor and real estate, are relatively low in emerging markets, corporate taxes and financing are not. Further, secondary or indirect disincentives, such as weak education among the work force, difficulties in the business climate and infrastructure, political risk, and weakness of institutions, are much higher in developing nations. Figure 2.12 shows that relatively high primary costs (the blue portion of the bars in the figure) in Canada are more than compensated by the inflated indirect costs in Mexico or Brazil. Clearly, there is a high degree of subjectivity in these rankings, and the weights used to create the indexes can be disputed. Nonetheless, they suggest some areas where LAC needs to improve to provide both domestic and foreign investors a more welcoming climate.

**... And Leverage The Region’s Comparative Advantages for Faster Growth?**

Faster growth will also require a strategy to leverage the region’s existing and future comparative advantages better than in the past. For instance, in contrast to the resource curse literature, Wright (1999) notes that in the 19th century, the United States leveraged copper to create a knowledge network of engineers and chemists that laid the groundwork for the country’s industrialization and diversification. In the same period, Japan was also an important exporter of copper, generating the copper companies Sumitomo, Fujitsu, and Hitachi. These major, diversified, and high-tech conglomerates are now household names. By contrast, the LAC region’s experience with mining has been focused on pure extraction, with little diversification and no analogues to the Japanese business conglomerates (Maloney and Zambrano 2021). In more contemporary times, Norway has created a diversified economy around its gas and petroleum endowments that has only a distant echo in the LAC region. Again, this is not just a resource curse issue as it occurs across sectors: the Republic of Korea and Guadalajara, Mexico, started exporting assembled electronics in the early 1980s. But there is no Mexican analogue to Samsung. The “how” appears to be as important as the “what,” as argued by Lederman and Maloney (2012), and understanding what is missing in current regional policies is critical. As the region begins to explore its new areas of comparative advantage in commodities, such as lithium, or energy, such as green hydrogen, understanding how to improve on past experience will help determine how diversified and dynamic the economies that build upon them will be.

The next section presents selected insights from recent World Bank work into areas necessary for the region to work on, some with very long horizons, some with shorter.
Box 2.2. Opportunities for Latin America and the Caribbean in the Greening Global Economy

Latin America and the Caribbean (LAC) has tremendous comparative advantage in the green economy. Thus, the region has globally and perhaps historically unprecedented opportunities for new growth and export opportunities.

Many adaptation and mitigation policies aim to improve efficiency and productivity—thereby promoting growth as well as sustainability. Ultimately, building the capabilities and institutions that facilitate low-carbon technology adoption will enable the region to approach the technological frontier and become an innovator itself—laying the foundation for future growth.

First, with an electricity generation matrix based mostly on hydropower, the region already has one of the greenest electricity grids in the world. This means that any energy intensive export can potentially capture a green premium, permitting expansion into new markets and avoiding carbon border adjustment taxes.

Second, the region is endowed with vast potential in nonconventional renewable energy, including geothermal, wind, solar, tidal, wave, biomass, and small hydroelectric plants that can deepen this comparative advantage. Innovative mechanisms in several LAC countries have added large amounts of nonconventional renewable energy and created some of the most dynamic renewable energy markets in the world. Such abundant, reliable, and green electricity can be a major competitive advantage in the production of new energy vectors—such as green hydrogen and synthetic fuels—and other downstream products, like ammonia and other green fertilizers and chemicals. The competitive advantage in the production of green hydrogen can also help decarbonize sectors that are hard to abate in industries such as steel and cement, and may eventually be used to power freight ships, airplanes, and other transport vehicles that cannot be easily electrified.

Third, the region is blessed with huge reserves of lithium—mostly concentrated in Argentina, Bolivia, and Chile—and is dominant in the production of copper. These two critical metals are key in the new decarbonization and electrification technologies. Analysts expect that in the short and medium term, demand growth will outstrip supply, thus putting pressure on prices. The current dynamics in mineral and metal markets suggest that, if mined in a sustainable manner, the region will potentially benefit from increased export revenues.

Finally, LAC has some of the highest levels of natural capital in the world. It has more than one-quarter of the world’s forest area, possesses some of the highest levels of renewable freshwater resources, and holds about half of the world’s biodiversity. To sustain its position as a net exporter of food and agricultural commodities, LAC’s agriculture sector will need to adapt to the effects of climate change and work to prevent its worsening. Fortunately, evidence suggests that many climate-smart agricultural technologies and practices can help the region adapt to climate change and mitigate adverse effects while improving yields and reducing costs, benefiting the bottom line for producers. For example, transitioning toward electrically powered farming machinery and equipment, fed by renewable sources, can save millions in fuel costs while abating emissions (McKinsey & Company 2020). Reforestation, afforestation, and the recovery of degraded land can help ecosystems adapt.
and abate emissions. These actions can also create jobs and develop new markets, particularly in sustainable forestry. Eco-tourism initiatives may also become attractive as tourists become more concerned about their environmental impacts. The nascent voluntary carbon markets and payment for ecosystem services schemes also provide an avenue to monetize these efforts. With appropriate, credible mechanisms to certify, monitor, and verify projects, the region has the natural capital to become an exporter of environmental services through the sale of carbon credits to international firms and governments.

How Can LAC Engage More Successfully in the Global Economy?

The KPMG measures of the costs of working in difficult business climates can only be suggestive, but it highlights key considerations that domestic and foreign investors should keep in mind.

Will Increased Country Risk Deter Further Investment?

Political and policy risks are regularly mentioned as deterrents to investments by both domestic and foreign actors. What is not clear yet is how much these risks may have increased in recent years. As chapter 1 showed, global financial markets, as captured by Emerging Market Bond Index spreads, remain cautious but not alarmed at present.

Much of the overall resilience and success in managing inflation reflects continued confidence in the authorities tasked with maintaining macroeconomic stability and the continued independence of the central banks. They have managed inflation and proven to be important bulwarks against global shocks and their ripple effects. The question is how resilient these institutions will be to persistent and intensifying economic and political shocks. On this, the markets are unsure.

Fitch compiles measures of long-term risk, comprising indicators of political stability (including democratic norms), societal stability, the efficacy of the state, and policy continuity, as well as measures of “short-term” risk, comprising policy-making processes (institutionality), social stability, unemployment, inflation, and again, policy continuity. As shown in figure 2.13, while longer term measures of political risk remain stable, although with some degradation, short-term risk (longer than the conjunctural risk discussed above) measures have deteriorated in most countries, with the exception of Brazil, over the past years and may eventually become long-term risk.

One channel is through the degradation of macro policy and other institutions as social tensions ramp up across the region. Strong signaling about the stability of the broad policy framework can help mitigate concerns on this front.
Thick Borders Restrict Trade and Investment

LAC’s underperformance in trade and FDI partly reflects the region’s “thick borders”—the combination of the economic policy stance and the costs incurred to comply with regulatory requirements at the border. These costs rise with higher tariffs, when a large share of trade is subject to non-tariff barriers requiring inspections at the border or in other locations, and the inefficiency of a country’s trade facilitation process.

In LAC, average tariff barriers have declined substantially since 2000 (figure 2.14), reaching levels observed in other emerging markets. However, they remain relatively high in some countries, including in the largest South American economies, Brazil and Argentina (figure 2.15). Similarly, the prevalence of non-tariff barriers is relatively low, except in the countries in the Southern Common Market (MERCOSUR), where non-tariff barriers cover more than 66 percent of imported products and 77 percent of the imported value (table 2.2).

Figure 2.13. While Long-Run Political Risk Remains Stable, Short-Run Risk Is on the Rise

Long-Term Political Risk Index
(0 = worst, 100 = best)

Short-Term Political Risk Index
(0 = worst, 100 = best)

Source: Fitch.
Note: LAC (6) = Argentina, Brazil, Chile, Colombia, Mexico, and Peru. The grey lines in the right panel represent one standard deviation from Average LAC (6).
However, other costs of trade, such as compliance with norms at the border for both imports and exports, remain among the highest in the world (table 2.3). In theory, such costs can be reduced quickly as they are largely bureaucratically determined.

A new measure of border thickness, which captures the additional cost incurred when trading with neighbors versus domestically, suggests that for LAC, intraregional trade faces significantly higher barriers than domestic trade (map 2.1). These costs go beyond tariff and non-tariff barriers and include border delays, trade finance, and insurance costs. In LAC, the borders are thickest between the countries in Central America and between Brazil and its neighbors to the west and the north.
Thick borders make it difficult for countries to participate in limited manufacturing GVCs and upgrade their GVC participation to advanced manufacturing because trade costs escalate when goods must cross borders multiple times. As shown in table 2.3, it takes much longer and costs a lot more to comply with border regulations for exporting and importing goods in LAC than in ECA and Organisation for Economic Co-operation and Development (OECD) countries, which specialize in advanced manufacturing and services. Although LAC is at par with EAP in terms of the time it takes to comply with border restrictions, it costs more to clear customs in LAC, and it takes considerably less time to clear customs in the fast-growing EAP economies. Despite the fact that Mexico struggles with many of the longer term primary and secondary considerations

<table>
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<tr>
<th>Region</th>
<th>NTM coverage ratio</th>
<th>NTM frequency radio</th>
</tr>
</thead>
<tbody>
<tr>
<td>Europe and Central Asia</td>
<td>69</td>
<td>61</td>
</tr>
<tr>
<td>East Asia and Pacific</td>
<td>60.1</td>
<td>50.4</td>
</tr>
<tr>
<td>Middle East and North Africa</td>
<td>59</td>
<td>47</td>
</tr>
<tr>
<td>Sub-Saharan Africa</td>
<td>52.6</td>
<td>36.7</td>
</tr>
<tr>
<td>Latin America and the Caribbean</td>
<td>41.5</td>
<td>33.8</td>
</tr>
<tr>
<td>Mercosur</td>
<td>77.2</td>
<td>65.7</td>
</tr>
<tr>
<td>Pacific Alliance</td>
<td>59.4</td>
<td>49.6</td>
</tr>
<tr>
<td>CAFTA-DR</td>
<td>12.2</td>
<td>8.5</td>
</tr>
<tr>
<td>South Asia</td>
<td>39.7</td>
<td>28.2</td>
</tr>
</tbody>
</table>


Note: Coverage is proxied by the share of import value subject to NTBs, while frequency is measured by the share of imported products subject to NTBs. No data are available for Chile, the Dominican Republic, Panama, and Uruguay. CAFTA-DR = Dominican Republic–Central America Free Trade Agreement; NTB = non-tariff barrier.

<table>
<thead>
<tr>
<th>Region</th>
<th>Time to export: Border compliance (hours)</th>
<th>Cost to export: Border compliance (US$)</th>
<th>Time to import: Border compliance (hours)</th>
<th>Cost to import: Border compliance (US$)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Europe and Central Asia</td>
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<td>10</td>
<td>20.4</td>
<td>158.8</td>
</tr>
<tr>
<td>OECD (high income)</td>
<td>12.7</td>
<td>136.8</td>
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<td>98.1</td>
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<td>68.4</td>
<td>422.8</td>
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<td>516.3</td>
<td>55.6</td>
<td>628.4</td>
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<td>30</td>
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<tr>
<td>Pacific Alliance</td>
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<td>487.5</td>
<td>70.5</td>
<td>496.3</td>
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<tr>
<td>CAFTA-DR</td>
<td>42.9</td>
<td>355.3</td>
<td>57.7</td>
<td>426.4</td>
</tr>
</tbody>
</table>


Note: The table reports regional simple averages. Border restrictions include customs clearance and inspection procedures conducted by other agencies at the port, border, or another location. When all inspections occur at the border, the estimate factors in this simultaneity. If some inspections occur in other locations, the estimates for the time and cost of these procedures are added to those that occur at the border. If fees are determined by the value of the shipment, the value is assumed to be US$50,000. The region is ranked similarly in the Logistics Performance Index. CAFTA-DR = Dominican Republic–Central America Free Trade Agreement; OECD = Organisation for Economic Co-operation and Development.
of the region, the growing integration with the US economy is importantly due to ongoing efforts to reduce these costs, and the rest of the region could benefit from doing the same.

A recent World Bank publication, *Deep Trade Agreements: Anchoring Global Value Chains in Latin America and the Caribbean*, discusses how deepening and expanding agreements on trade can reduce these costs, facilitate participation in global production networks, increase trade, and attract more FDI (Rocha and Ruta 2022) (see box 2.3). Participation in deep trade agreements (DTAs) can help countries thin their borders and promote GVC-related trade because cooperation on border and behind-the-border policies is needed for GVCs to operate efficiently. However, deeper preferential trade agreements (PTAs) can also promote and secure market access, attract vertical FDI, and address a broader set of objectives related to health and environmental standards.

Improving trade facilitation should be a priority in LAC, where trading across borders is often a costly and time-consuming process. Trade facilitation should aim to reduce border-crossing costs by improving, simplifying, and harmonizing the procedures and controls governing cross-border trade flows. DTAs can advance trade facilitation through solutions that promote coordination, collaboration, information sharing, and the establishment of governance structures that support implementation and work toward continuous improvement of border procedures, compliance, and enforcement. Although they are easier to implement than raising workforce quality or building roads, trade facilitation reforms are nonetheless not easy. They require major investments over a period of several years, and reform progress may be threatened in politically volatile environments. In addition, negotiating and implementing these provisions can be challenging due to differences in the levels of development of member countries and participation in multiple PTAs. Successful implementation requires coordination of efforts to identify the most suitable solution for the different country contexts.

Non-tariff measures (NTMs), in the form of technical barriers to trade (TBTs) or sanitary and phytosanitary (SPS) standards, impose significant compliance costs. Divergent regulations may also segment markets and raise the fixed cost of entry for foreign companies. However, compliance with NTMs can improve market access by ensuring that traded goods meet the quality, safety, and compatibility standards in destination markets. The percentage of imports subject to TBT and SPS requirements increases with the complexity of the GVC. Thus, the inclusion of NTM rules in PTAs promotes transparency, leads to regulatory cooperation through harmonization or mutual recognition of standards, and ultimately improves the enforcement of these rules.
Box 2.3. The Promise of Deep Trade Agreements

Countries in Latin America and the Caribbean (LAC) started signing bilateral and regional preferential trade agreements (PTAs) that went beyond tariff cuts more than two decades ago (in the late 1990s). These deeper PTAs increasingly included a set of border and behind-the-border policies regulating customs, services trade, technical barriers to trade, sanitary and phytosanitary measures, rules on investment, intellectual property rights protection, competition policy, and labor and environmental standards, among others.

Although participation in PTAs has increased in LAC, the depth of these agreements—measured by the number of enforceable policy areas—varies considerably. Mexico and Peru have signed the deepest PTAs with the largest number of policy areas (18), followed by Colombia and Chile (17 and 15, respectively), and the Caribbean countries (on average, 16). By contrast, MERCOSUR countries have signed mostly shallow PTAs with other members of the trade bloc (only six implemented policy areas) and with the rest of the world (map B2.3.1).

Map B2.3.1. Average Depth of Active Trade Agreements, 2019

LAC countries tend to have shallower agreements within the region than with the rest of the world. Intraregional PTAs typically include policy areas that currently fall under the mandate of the World Trade Organization. They do not include areas that are often included in PTAs with countries outside the region, such as investment, capital mobility, and competition policy. In addition, the detailed content of these policy areas and how they translate into national laws vary greatly, making it challenging to assess the overall depth of the PTAs.
Recent analysis quantifies the depth of existing trade agreements and offers insights about the merit of signing new deep trade agreements (Fontagne et al. 2021). The results indicate that greater PTA depth, measured by the number (or share) of legally enforceable provisions in an agreement, is associated with higher levels of global value chain (GVC)–related trade both globally and regionally (figure B2.3.1), as well as with GVC upgrading or increased participation in advanced manufacturing and services GVCs. GVC-related trade is estimated to increase by 0.3 percent after adding one extra provision to an agreement and by 12 percent after countries without a PTA in place sign the deepest possible PTA (with 30 or more provisions).

In LAC, provisions encouraging GVC participation and upgrading concern four policy areas: (i) trade facilitation, (ii) non-tariff measures, (iii) services trade, and (iv) state intervention and competition. However, successful implementation of this agenda also depends on improvements in the competitiveness of the private sector, especially in terms of institutional quality and the ability of firms to adopt new technologies and innovate.

Figure B2.3.1. Deep PTAs and GVC-Related Trade. Simple Correlations

A lower percentage of imports are subject to TBT and SPS requirements in LAC than in ECA and EAP, but LAC faces significant SPS and TBT barriers in destination markets. Although LAC countries have rapidly increased the number of SPS and TBT provisions included in their PTAs, the region’s record on reducing trade costs through regulatory cooperation is mixed as implementation remains a challenge and differences persist. Still, firm-level evidence from Chile, Colombia, and Peru shows that the inclusion of SPS and TBT provisions in PTAs boosts the exports of smaller firms relatively more than those of larger firms. These provisions not only reduce the NTM-related fixed entry costs of exporting, which are particularly burdensome for small exporters, they also improve the predictability of foreign market conditions by promoting transparency in NTM measures.

Unrestricted trade in services, rules on investment, and policies in support of fair competition also enable countries to scale up and upgrade their GVC participation. A large literature provides evidence on the positive
links between services liberalization and productivity growth and manufacturing exports. The liberalization of trade in transport and telecommunications services, for example, boosts productivity in the manufacturing sectors as these services are crucial for the timely flow of goods and information between manufacturing GVC participants.

One explanation for the low integration through services trade, especially regionally, is the limited depth of LAC’s PTAs, especially with partners in the region. LAC’s PTAs with external partners tend to be more ambitious in content than those with regional ones. The role of services in GVC trade can be boosted by implementing a more liberal set of service sector policies, such as setting a horizontal standstill on discriminatory measures and quantitative restrictions, including provisions related to investment and the movement of people in PTAs, and putting in place enforcement mechanisms to address problems related to implementation.

**Competition**

Policies that support fair competition, such as competition policy, laws limiting the use of subsidies, and regulations on state-owned enterprises (SOEs), can improve the quality of the institutional environment and help expand GVC participation and upgrading, and permit the entry of new domestic firms.

LAC lags behind ECA and EAP in terms of domestic competition, according to the World Economic Forum’s composite measures, although there is considerable country heterogeneity that often confuses the issue. On the one hand, some sectors have been challenged by Asian competition, particularly from China. Chilean manufacturing firms, for example, experienced the same increase in import penetration from 1995 to 2007 as the United States. Although figure 2.3 suggests a less open stance, the same pressure has been documented in the auto parts sector in Colombia (Iacovone, Maloney, and McKenzie 2022).

On the other hand, the recent literature measuring markups—a common measure of the lack of competitive pressure—suggests that the growing markups over the past 40 years in Europe and North America have just reached South America's traditional levels (figure 2.16). It has been documented that efforts to reduce anti-competitive behavior in Peru have had positive effects on productivity, entry, and innovation (Schiffbauer, Sampi, and Coronado 2022). Further, key input sectors—digital or telecommunications provision and energy—remain highly concentrated. As documented in the subsection below on Infrastructure: Digital Connectivity, for example, LAC has the most expensive and least coverage of digital technologies. Having low fossil fuel costs but high costs of communications technology gives the region a comparative advantage in 19th century industries, but it deters entry into 21st century industries. The region also devotes considerable resources to subsidies, which are in the range of 4 percent of GDP in the countries that report these data, compared to an average of just 1.4 percent in the European Union. SOEs also play an important role in many LAC countries, where SOEs often benefit from subsidies and other government concessions, and thus potentially affect market competition.

In addition to more active competition authorities, including provisions that regulate state support to enterprises in DTAs can reduce the harm of state support policies on market competition and the negative effect such policies may have on foreign entry. DTAs could include commitments to adopt competitive neutrality in national legislation; regulate competition, subsidies, and SOEs; operate SOEs on a commercial and nondiscriminatory basis; and broaden the mandate of competition authorities to govern subsidies and SOEs. Institutional quality can also improve if DTAs require policy transparency, especially transparency on subsidies and SOEs; promote evidence-based policy impact assessments; and create frameworks for public-private partnerships.
Deficiencies in Physical and Digital Infrastructure

A recent study prepared for the report Productivity through a Territorial Lens: Leveraging Spatial Development for Economic Growth in Latin America (World Bank, forthcoming) documents how costly and deficient intercity transport costs limit market access and the ability of firms to trade, specialize, and scale up their operations (Conte and Ianchovichina 2022). In Latin America, where most cargo is transported by trucks and railways remain underdeveloped, costly transportation services, especially between large urban areas, reflect both limited competition among transportation carriers (Allen and Atkin 2022) and underinvestment in maintaining and expanding intercity road networks (Gorton and Ianchovichina 2021). Figure 2.17 shows these costs, adjusted for distance. There are many more pairs of urban locations in Brazil where these bilateral trade frictions are higher than those in the United States or China (figure 2.17, panel b). Transportation costs are also high for road shipments across national borders, making it costly to trade with regional partners. The costs of shipments between the largest cities in the region are both higher on average and much higher on the highest cost routes than in Europe or Southeast Asia (figure 2.17, panel a).

Studies from other regions suggest that making additional investments to widen and improve the conditions of highways can generate efficiencies and raise aggregate welfare in an equitable way. In India, China, and Korea, highways connecting major and intermediate economic centers have contributed to higher employment, output, and plant entry in denser and more literate districts along the highway network. Recent analysis suggests that Türkiye’s program to upgrade the national highway system between 2005 and 2010 has generated aggregate real income gains of between 2 and 3 percent through reduced trade costs and travel times and expanded employment at the district level. In LAC, a recent study estimated that the welfare gains from investments that improve intercity highways are on average around 1.6 percent of regional consumption. However, the dynamic gains are expected to be considerably larger as they include gains due

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**Figure 2.16. Evolution of Markups in World Regions**

![Graph showing the evolution of markups in different regions](image-url)

*Note:* The firm’s markup is defined as the ratio of the output price to the marginal cost. The aggregate markup is the sales-weighted average of all firms’ individual markups in the geographical area in a given year.
to specialization and agglomeration of economic activity in areas with better market access and technological diffusion into neighboring areas. Upgrading transnational highways to correct for inefficiencies could boost welfare by an estimated 1.9 percent per year on average for the MERCOSUR bloc of countries and 1.5 percent for the Andean Community group of countries. Landlocked members of each bloc are estimated to benefit the most from these improvements, reflecting their dependence on transnational road transport for access to ports.

Deficiencies in the road networks can be attributed to persistently low levels of public investment (figure 2.18), but also the spatial misallocation of these investments (map 2.2). The October 2022 Latin America and the Caribbean Economic Review and figure 2.18 show that LAC has invested roughly 3 percent of GDP in public investments, compared to almost 20 percent in East Asia or even 7 percent in Africa. Further, the investment that has occurred has been poorly targeted, as shown in World Bank (forthcoming). The typical Latin American country has underinvested along road segments connecting larger urban areas and overinvested in road links in peripheral regions. For instance, in the case of Mexico, there is a need to upgrade the road network connecting the core of the country, centered on Mexico City, with cities along the eastern half of the country, extending to Monterrey and cities along the border with the United States, as well as cities in the South (map 2.2)—but this is not where investments have gone. Within MERCOSUR, additional investments are needed along links connecting Recife in the Northeast of Brazil with São Paulo and Coritiba via Belo Horizonte and in improvements along roads linking Coritiba with Montevideo via Porto Alegre, Asunción via Ciudad del Este, and Buenos Aires via cities in Northern Argentina (map 2.3, panel b). Within the Andean Community, additional optimal investments are needed to improve road connectivity between La Paz in Bolivia, along the coast of Peru to Lima, and through Quito to Medellín (map 2.3, panel a).

It is also the case that poor regulation and competition lead to increased transport costs (Teravaninthorn and Raballand 2009). Such factors can be addressed, in theory, more quickly than the actual physical provision of infrastructure.
Figure 2.18. Public Investment Rates (percent of GDP)

a. Median level of public investment in developing countries

b. Public investment in LAC countries

Note: Regional aggregates are weighted averages. GDP = gross domestic product; LAC = Latin America and the Caribbean.

Map 2.2. Overinvestment and Underinvestment in Roads in Mexico

Source: Gorton and Ianchovichina 2021.
Note: Red links indicate overinvestment; green links indicate underinvestment.
Fast, reliable, and affordable internet infrastructure is an essential ingredient in a strategy to modernize the economy and create more and better jobs in manufacturing and services, especially urban tradables.

Most LAC countries appear ill-equipped to scale up modern economic activity through digital means. Cost remains high compared to other regions, and broadband subscriptions per 100 people remain low (figure 2.19).

**Figure 2.19. Internet Connectivity. Low Coverage, High Cost**

Source: International Telecommunication Union.

Note: The blue bars represent fixed broadband subscriptions per 100 inhabitants, as reported in 2020. The red markers depict the average price per month in 2020 for a fixed broadband connection.
LAC’s Unproductive Cities: Weak Platforms for Launching Service or Manufacturing Ventures

Cities are important engines of economic growth as they are often the center of manufacturing and high-end services generation that would lead to diversification away from non-urban-based commodities. This could be a comparative advantage for LAC as it has some of the highest urbanization rates in the world and a large share of the workforce is concentrated in large and dense cities. The percentage of people living in cities with more than 1 million residents is higher in LAC than anywhere else in the world (United Nations 2016). Regionwide, more than 70 percent of urban areas have population densities above the global median (Roberts 2018).

In advanced countries, increased urban density increases productivity through higher density and better sharing, matching, and learning. This is also the case in many growing Asian cities, where population concentration went hand in hand with structural transformation (Grover, Lal, and Maloney 2021), becoming what Gollin, Jedwab, and Vollrath (2016) call production cities. This concentration of production cities was most pronounced along the coastal areas of China, where easy access to ports, the decline in trade costs, and the rise of information and communications technology enabled the rise of export-oriented industries. The importance of this compositional effect is found in the developing world by Burger, Ianchovichina, and Akbar (2022), who show in figure 2.20 that agglomeration externalities are especially high in manufactures, exporting, and foreign ownership. However, in many parts of the developing world, concentration results from the distribution of commodity rents and deindustrialization (Jedwab, Ianchovichina, and Haslop 2022) or aid flows, access to political power, or the attraction of public services in what have been called “consumption cities.” Here, as box 2.4 shows, production gains from agglomeration may be low or even negative, giving rise to what Grover and Maloney (2022) term “sterile agglomerations.”

Figure 2.20. “Pure” Returns to Density in Developing Countries, after Controlling for Agglomeration Costs, by Type of Establishment

Source: Burger, Ianchovichina, and Akbar 2022.

Note: The estimations are from using geo-coded data from World Bank Enterprise Surveys of more than 51,000 establishments in 649 metropolitan areas and 98 developing countries. The figure shows “pure” agglomeration effects by type of firm. The “net” agglomeration economies can be substantially lower due to agglomeration costs.
Unsurprisingly, most large production cities—defined in Jedwab, Ianchovichina, and Haslop (2022) as cities with a disproportionately large employment share in urban tradables—are located in China, India, and Europe (map 2.4). The returns to density are weaker in LAC where the share of tradables, particularly manufactures and exports, show the highest gains from agglomeration (figure 2.20) has fallen in many countries (figure 2.7). Latin America’s cities are not more productive than rural areas, they are merely crowded. As Productivity through a Territorial Lens shows (World Bank, forthcoming), average urban location premia—wages after controlling for human capital—are not much higher than location premia in rural areas (figure 2.21), mostly due to weak net returns to density, as shown by Ferreyra and Roberts (2018). The returns to agglomeration,
measured by the elasticity of wages with respect to density, are statistically zero in many LAC countries (figure 2.22). Further, as box 2.4 shows, even this measure overstates the true gains—higher wages may simply be capturing rising costs with agglomeration, while actual efficiency measures, such as physical total factor productivity, may be declining.

**Figure 2.22. Estimated Elasticity of Productivity in Urban Areas**

As shown in World Bank (forthcoming), this is a result of weak urban policy, but also the economic structure. Of the 25 largest cities in Latin America, only two are production cities (Guatemala City and San Salvador), seven are consumption cities with disproportionately large employment shares in urban nontradables (Rio de Janeiro, Bogotá, Belo Horizonte, Recife, Fortaleza, Salvador, and Guayaquil), and the rest are neutral cities with a balanced employment mix between tradables and nontradables. Most Latin American production cities are smaller and located in Mexico, Central America, and Southern Brazil (Jedwab, Ianchovichina, and Haslop 2022).

This means that Latin America is missing out on a growth-promoting virtuous circle. Countries with globally significant production cities can catch up faster because productivity in urban tradables varies little across countries and international trade positively affects endogenous innovation and growth in a country. This makes production cities attractive to investment, compounding their status as production cities. A deficit of large production cities of global importance makes it difficult for Latin America to catch up to the high-income status of the developed countries.

Indeed, the reverse effect has been at play. Structural transformation through deindustrialization and commodity exports has shifted the employment composition of urban centers toward nontradable services. Deindustrialization did not lead to deurbanization but to the decline in urban employment in tradables, especially in the largest LAC cities, where the decline in manufacturing employment was large and the increase in employment in tradable services could not offset the loss of these jobs (figure 2.7). Looking at the glass being half full, Box 2.5 shows that the lack of urban dynamism, combined with high degrees of labor mobility, have led to the convergence of urban and rural incomes.
High urban density has also given rise to costs associated with traffic congestion, crime, pollution, and increased competition for customers and real estate in central urban locations. These agglomeration costs may be so high that they surpass the pure benefits from density, resulting in “sterile” net agglomeration economies (Grover and Maloney 2022) (box 2.4). While congestion presents a serious problem in LAC’s mega cities, which are among the most congested cities in the world, new evidence presented in World Bank (forthcoming) suggests that traffic is slow in dense cities not because of congestion but because of low uncongested mobility—that is, it is hard to move around even when it is not rush hour. Urban planning and investments in connectivity infrastructure have not kept pace with urbanization. Thus, in addition to measures to address congestion and improve public transportation services, municipal authorities will need to improve city planning and set aside resources for expansion and upgrades of urban connectivity infrastructure. To ignite a virtuous circle—increased tradables production, leading to greater productivity, leading to more investment in tradables production—LAC cities will need to become more attractive.

**Weak Capabilities for Leveraging Comparative Advantage: Skills, Managerial Capabilities, and National Innovation Systems**

Leveraging LAC’s comparative advantage, whether in natural resources, manufacturing, tourism, or services, requires the capability of agents to recognize, adapt, and implement new ideas, techniques, processes, and products. Here, the region faces significant shortfalls across the spectrum of human capital/capabilities—basic human capital, managerial capital, higher-order technical skills, and innovation systems.

At the most basic level, the region’s chronically low-quality public education leaves too many behind and is a major barrier to growth: 29 percent of firms report that growth is stymied by a lack of qualified employees, compared to 12 percent in East Asia, and there is a perennial shortfall of both mid-level technical skills and engineers.

Brazil, Chile, Colombia, Uruguay, and Panama are beginning to address the perennial shortfalls in mid-level technical graduates through short-cycle programs, which are comparable to community colleges in advanced countries. Many public worker training programs in the region remain costly and weakly aligned with the needs of the private sector. Although tremendous progress has been made, particularly in the quality of the region’s universities, LAC universities fail to place among the top 100 in the world, while East Asia has several at this level. Universities in LAC continue to graduate relatively few engineers and scientists—18 percent of graduates in LAC versus 25 percent for the world and 28 percent for East Asia.

Taking a historical view, arguably, this lack of technical capability explains why the United States and Japan could leverage copper to diversify and energize their economies and Chile (and other countries) could not. Latin America entered the Second Industrial Revolution unarmed, with one-fifth the number of engineers per capita of the United States and other countries with incomes similar to Chile’s, like Sweden and Denmark (Maloney and Valencia 2022). The literature also suggests that the impact of FDI depends importantly on complementary human capital factors (De Gregorio and Lee 1998). As the region sees the development of green investments, ensuring the necessary stock of technical capital will be key to leveraging these sectors for broader development.
Box 2.4. Resolving the Urban Productivity Paradox

There is overwhelming evidence of the economic benefits of agglomeration, arising from shared factors of production, improved matching of firms and workers, and externalities related to knowledge spillovers. The canonical measure of such agglomeration effects is the elasticity of wages with respect to density, and the estimates are large: 0.043 in the United States, 0.03 in France, and 0.025 in Spain. Recent findings suggest that these effects are even larger in developing countries: 0.1 to 0.19 in China, 0.12 in India, and 0.17 in Africa—that is, a given increase in density increases wages by four times more in Africa than in the United States. This poses something of a paradox given that other sources of on-the-ground information suggest that developing country cities are not so much extraordinarily productive as just crowded, congested, and even dysfunctional.

However, higher wage elasticities might reflect not increased productivity but just rising costs for which workers need to be compensated. Using firm-level data with product price data from Ethiopia, Indonesia, Colombia, and Chile, Grover and Maloney (2022) estimate physical total factor productivity (TFPQ), or efficiency—which should capture the effects of better matching and externalities—and marginal costs, thereby showing how they contribute to the counterintuitive wage elasticity estimates. They first confirm the literature’s findings of high elasticities of wages and revenue total factor productivity in the poorer countries: wage elasticity estimates using plant-level data for Ethiopia of 0.052 and for Indonesia of 0.057 are not as high as those for China, India, and Africa estimated using the labor surveys mentioned above, but they are three times the estimates for the richest country in the sample, Chile (0.017), which is close to the estimates for more advanced countries.

However, these measured benefits largely disappear after accounting for the concomitant rise in prices—efficiency gains measured as the elasticity of TFPQ with respect to density show negative elasticities for the three lower income countries and significantly so in some specifications for Ethiopia and Colombia. Rather, the findings show that the elasticity of marginal cost is strongly positive for these countries, suggesting that the costs of operating in developing country cities increase sharply with population, and this pushes up prices and hence wages. The estimates suggest that the TFPQ elasticity increases with development, while the marginal cost elasticity decreases (figure B2.4.1). The net benefit to firms of operating in a city rises steeply with development, with the elasticity of gains in productivity exceeding that of increasing costs likely occurring only at middle income.

Figure B2.4.1. Agglomeration Elasticity Estimates with Respect to Wages, Marginal Cost, and TFPQ

Source: Grover and Maloney 2022, using industrial census data and estimating TFPQ following Foster, Haltiwanger, and Syverson (2008) and De Loecker et al. (2016).
Note: Each dot presents the point estimate from regressing the log of wages, firm-level physical total factor productivity (TFPQ), and marginal costs on the log of population density at the district level. All regressions include firm age and 4-digit industry-year fixed effects. Population density is the population in each administrative location.
Box 2.5. Regional Convergence: Low Urban Productivity Growth, Free Migration, and Increases in Commodity Rents Have Led to Lower Geographic Inequality in Latin America and the Caribbean

Greater integration with the global economy typically widens spatial inequality within countries. As Grover, Lall, and Maloney (2021) argue, in China, the emergence of dynamic coastal cities specializing in manufactures for export broke the older patterns where transport costs were higher where manufacturing served local markets. Here, income growth concentrated in the coastal cities, and interior rural areas were left behind, worsening urban-rural inequality. Similarly, urban-rural wage gaps grew in India, following its trade liberalization in the 1990s, and in Ethiopia, where trade-related industrial policies increased concentration in the capital. Following more than three decades of reform, liberal migration policies and good urban planning allowed the Republic of Korea to absorb domestic migrants and close the urban-rural wage gap by 1994. By contrast, in China, the “hukou” system restricted spatial mobility and contributed to the persistence of regional and urban-rural gaps in labor incomes.

By contrast, in Latin America, income inequality decreased over the past decades as lagging regions grew faster than leading urban areas (figure B2.5.1). Weak agglomeration forces did not create dynamic income poles, while rising commodity rents fueled the growth of geographically dispersed rural and mining areas. Meanwhile, deindustrialization led to the decline of manufacturing employment and the rise of the nontradable economy as workers who lost their manufacturing jobs switched to lower quality employment in the nontradable sector. Thus, the leveling up reflected both the catch-up of lagging rural areas and the slowdown of economic growth in the largest and relatively affluent urban municipalities.

Figure B2.5.1. Absolute Convergence in Real per Capita Labor Income, by First Administrative Region

Sources: D’Aoust, Galdo, and Lanovichina 2023.
Note: Reg refers to regions in Chile.
Convergence has reduced the spatial inequities to different extents in different countries in the region. However, large income gaps with leading metropolitan areas remain (figure B2.5.2). In most countries, these income gaps reflect differences in endowments, especially educational attainment, rather than differences in returns to endowments that can be exploited through migration. This result is consistent with other recent evidence pointing to small aggregate output gains from internal migration. a
Box 2.5 (continuation)

Figure B2.5.2. Average Income Gap with the Leading Metropolitan Area, by Country

Source: D’Aoust, Galdo, and Ianchovichina 2023.


a. This result—reported in Conte and Ianchovichina (2022)—is attributed to the small dispersion of entry costs across locations within countries. Yet, the increase in aggregate welfare is larger because reduced frictions allow people to move to areas with better amenities.
The World Management Survey suggests that the region continues to lag in entrepreneurial skills, which are, on average, at the level of Kenya or India. This is due to weaknesses in both the worst and best managed firms (Maloney and Sarrias 2017). Historically, a lack of “entrepreneurial capital” may explain, for example, why a disproportionate share of the region’s industry was started by immigrants and foreigners. In modern times, it is common for multinationals to work with local suppliers to raise managerial quality, to ensure the quality, efficiency, and timeliness of inputs and raise the capacity of local firms to engage in more productive endeavors than, for instance, local content quotas. Recently, managerial skill has been documented as important for promoting exports (Bloom et al. 2021) in the United States and China. Preliminary evidence points to managerial skill as being important in Colombia, explaining not only the amount of exports (figure 2.23), but for entering markets with more sophisticated clients, those further away, and those with non-Spanish-speaking populations, as well as the quality of exports.

Figure 2.23. Managerial Quality Is Associated with Higher Income and Exports in Colombia

![Graph showing the correlation between management quality and employment and exports.]

Note: The figure shows the correlation between management quality and employment and exports.

Capabilities Are Critical for Meeting and Benefitting from Global Competition

Management and technical capability appear to be important for how countries benefit from greater competition. A well-cited conceptual framework by Aghion et al. (2005) notes two types of reactions to increased competition. Firms that are close to the technological and managerial frontier—“leading” firms—are able to invest in innovation to “escape” competition through lowering costs, changing products, or increasing quality. However, “lagging” firms—those that are further from the frontier—behave more in the way that Josef Schumpeter imagined 100 years ago: the reduced rents lead to a halt in innovation and even contraction of the firm. For the United States and France, the share of all manufacturing firms that are leaders is around 50 percent, and they command a large share of the value added in a sector. In China, research suggests that this number is closer to 25 percent. In Chile, which faces increased Chinese competition, World Bank work suggests that the share is around 10 percent, encompassing only about 25 percent of value added, while the remainder of firms are decreasing their innovation on average. This makes sense—from the point of view of global competition, what is relevant is the share of firms close to the global frontier, and developing countries are further from it almost by definition. But the implication is that countries with fewer leaders will get much less of a growth kick from increased competition, compared to those with more leaders. This implies that increased competition will have more salutary effects the higher is the level of firm capabilities to innovate, and improving these needs to be part of the competition reform package.
Numerous studies, including on Latin America, have demonstrated that managerial consulting services can help firms benchmark themselves, improve managerial practices, and raise productivity. However, more fundamental barriers to deepening the pool of capable entrepreneurs are posed by the weak pipeline from the education system.

**Systems**

Clearly, entrepreneurs do not work in isolation. The literature on national innovation systems stresses the importance of the often-non-market linkages between firms, universities, and the state in ensuring their success. Various studies show that managerial consulting services can help firms prepare to export, and historically such programs have been hugely important. Between 1952 and 1958, the United States sponsored training trips for European managers to learn modern management practices at US firms; those managers saw their firms’ productivity rise by 50 percent. Firms that received management training not only adopted the most advanced managerial practices, but also undertook structural changes in their organization and improved access to the credit market (Giordelli 2019). The Japanese government established institutions in the post-war period precisely to improve the productivity of their firms, the quality of their output, and their export capabilities. Firms built on these techniques, distilling them into the Kaizen Approach, which strives for steady improvements in firm productivity punctuated by occasional innovation-driven jumps. This model was exported throughout the Association of Southeast Asian Nations region and parts of Latin America as well. Perhaps most illustratively, in the 1980s, after successfully attracting high levels of FDI, Singapore found that national firms were being left behind and were not upgrading or becoming suppliers to multinationals. The Singaporean government contracted the Japanese Productivity Center for help constructing a local capacity building institution, the Standards, Productivity and Innovation Board (SPRING), as well as implementing a productivity movement much as Japan had. Firms enter a highly subsidized platform to receive a basic diagnostic and plan for improvement, and as they become more sophisticated, they can contract progressively more intensive services, including support from several world-class research institutes.

**Figure 2.24. Exports Increase with the Export Promotion Budget**

![Figure 2.24](chart.png)


Note: The lowess smoother used involves running a weighted regression of the log of exports of goods and services per capita on the log of the export promotion agency budget per capita for small subsamples of data.
Such programs can range from subsidies to private sector providers, generally ex-managers at major multinationals, to more structured agencies, like SPRING. Elements can also be embedded in government export promotion agencies (EPAs), to help with market intelligence; promote the image of the country (think the iconic coffee farmer Juan Valdes who graced the back page of the New York Times magazine for years); provide consultancy services to firms, such as employee training and technical assistance; or provide marketing services, such as exposure in trade fairs and missions. Based on a survey conducted by the World Bank in collaboration with the US Trade Commission in 2010, most EPAs are public-private institutions, with half of their executive board members representing, on average, the private sector. EPAs are charged with market diversification and attend to the needs of typically well-established small and medium-size exporting firms. Most of the EPAs’ budgets are dedicated to the provision of marketing services (for example, trade missions) and export support services (for example, training and technical assistance). These agencies have been documented to have a strong, positive impact of existing EPAs on exports. For each $1 spent on export promotion, the study estimates there is a $40 increase in exports for the median EPA. These results depend heavily on levels of development and types of instruments.

In turn, such agencies can be located within a larger national innovation system or ecosystem that encompasses universities and think tanks, which in the advanced countries work closely with the private sector to identify and transfer technologies and develop new products for export. Here, LAC does relatively poorly (figure 2.24). Surveys of the private sector on opinions about the quality of scientific research done in the country and the degree of collaboration between the research institutes and the private sector place LAC substantially below the advanced countries (World Economic Forum 2022). Further, in the recent Times Education ranking, research institutes in LAC are tied with Africa for a distant last place in terms of working with the private sector and facilitating knowledge and technology flows, while East Asia dominates globally.

In sum, strengthening entrepreneurial and innovation systems requires an urgent agenda of prosaic but often politically difficult reforms of schools; universities; training programs; firms; and managerial, technical, and export support agencies, all located within the broader concept of a national innovation/entrepreneurial system.

**Finance: Liquidity and Diversification of Risk**

In developing countries, these systems must necessarily be more encompassing. Despite the supposed higher returns to innovation of all types from being a follower nation, market failures in markets that are assumed functional in the advanced countries can make these returns hard to realize. Along with access to skilled workers, intermediate inputs, skilled managers, and financial markets emerge as critical sources of liquidity. Cusolito and Didier (forthcoming) draw from a newly constructed data set of 2.5 million private firms across middle- and high-income countries, to analyze financial market inefficiencies. They find that these inefficiencies—namely, financial frictions and market failures—constrain financial flows to firms and, consequently, negatively affect individual firm performance (the “within” margin) and the allocation of resources across firms (the “between” margin). These findings show that the allocation of resources across firms has large implications for productivity growth. This is particularly true for firms with fewer than 100 workers.

But it is not just a problem for small and medium-size enterprises. The reason domestic capital markets rank among the “primary” considerations of foreign investors is precisely that they borrow heavily in destination markets to mitigate exchange rate risk. Hence, as much as FDI is valued as a source of capital, it also requires well-functioning financial markets. However, financial markets also serve critically as a mechanism for diversifying risk. By its nature, the development process is one of placing informed bets—on new processes,
products, industries, or markets. As the region seeks to export more and more sophisticated products, it must make existing industries more efficient and greener, by investing in smart agriculture or big ticket investments in solar, wind, or green hydrogen. Placing these complex and risky bets requires the support of well-functioning financial markets.

This challenge can be seen through the lens of the rise in product quality, which, like rises in productivity, occurs across the development process. Higher quality products are more profitable, mechanically raise productivity, and are necessary to enter more sophisticated markets and become suppliers to FDI.

Quality upgrading, measured by the export prices of countries’ goods commanded in the US market—whether wine or cellular telephones—also requires placing risky bets. Figure 2.25 shows that there is a positive relationship between the growth rate of the quality of a nation’s basket of exports and the variance in the growth rate of prices—a proxy for risk—much as is found for financial assets. As an example, the quality of mobile handsets has risen sharply over time, but the price of a Nokia handset varied so much that the firm had to exit the market, illustrating that high tech is indeed a risky business. Low-end manufactures and commodities show less variance, but also less quality growth potential. Countries that are able to diversify risk in deep financial markets engage in riskier processes within product categories, but also riskier products, and hence they grow faster (Krishna et al. 2023).

Latin America’s position in the lower half of the curve in figure 2.25 is partly the result of insufficient progress in financial development. Part of the increased macro resilience of the region is due to the deepening of domestic capital markets both in volume and coverage over the past decades, including that institutional investors have grown more important relative to banks, diversifying the system. This has resulted from improvements in the enabling environment, reductions in macro-volatility, financial liberalization, better supervision and regulation, and advances in infrastructure (including trade, payment, custody, clearing, and settlement). However, financial markets remain shallow compared to comparable countries; hence, LAC’s financial markets are unable to provide the risk diversification and liquidity that are necessary for firms contemplating increasingly complex investments of long gestation. Credit to the private sector by financial institutions and stock market capitalization as a share of GDP, even in Chile, Brazil, and Peru, are roughly half that found in comparable countries, such as Korea, Malaysia, and Thailand, and tilted toward consumption instead of long-term finance for firms or infrastructure. Further, Cusolito and Didier (forthcoming) show that deepening markets has a disproportionate impact on relieving financial constraints on small firms.

The roots of both the slow deepening and particularly short maturity structure are many and constitute a reform agenda in themselves. Collateral laws need to be strengthened, including the creation of secured transactions and the monitoring of collateral. Contract enforcement costs 30 percent more in both time and share of the claim recovered than in the OECD; insolvency resolution takes almost twice as long, and investors can expect to recover only 30 cents on the dollar, compared to 71 cents for the OECD. The LAC region also lags in the depth of financial reporting standards. Progress on these and other fronts could contribute to deepening financial markets and extending maturities. In the medium term, Cusolito and Didier (forthcoming) suggest that targeting access for small and medium-size enterprises has disproportionate impacts on productivity and growth.

Clearly, structuring increasingly technologically sophisticated projects of long gestation requires increasingly sophisticated managers and firms. In this sense, improving the quality of entrepreneurial capital and increasing entrepreneurs’ access to finance at all stages are important for diversifying based on the region’s comparative advantages and moving up in quality and productivity.
This symbiosis between finance and capabilities of managers is nowhere more evident than in the twenty-fold boom in venture capital (VC) that the region has experienced over the last decade (Rudolph, Miguel, Gonzalez Uribe 2022). First, 90 percent of VC projects involved non-domestic actors and the vast majority of the capital itself has come from four large international firms which have deep experience in managing high risk projects. Generating VC firms is not simply about allowing pension funds to take more risk, it involves generating a cadre of experienced entrepreneurs with the capability to offer venture management support. But second, two-thirds of founders of unicorns in the region studied abroad, learning new technologies, how to manage a high-risk firm, but also how to plug into finance and technology networks that may be of use in growing their enterprise. Both suggest that, at present, cultivating high risk finance and ventures require tight integration in the global economy until both capital and capabilities are consolidated locally.

Figure 2.25. The Quality of Growth. Level and Variation

![Graph showing the quality of growth level and variation](image)


## Economic Zones and Corridors

In an attempt to resolve market failures on a manageable scale and create incentives for FDI, governments often try to set up an economic zone or corridors.

Grover, Lall, and Maloney (2022) offer a detailed discussion of both the rationale and ex ante evaluation of targeted policies. What can be called special economic zones (SEZs) include industrial districts, free trade zones, export processing zones, or any locale with favorable fiscal or institutional treatment. SEZs often employ a range of “hardware” and “software” policies in a well-defined geographical area or areas. Hardware policies include (i) liberal treatment of imports and exemptions from customs duties, particularly (but not only) in the export processing zones and free trade zones that were precursors to the current SEZs; (ii) tax incentives, particularly holidays from corporate income taxes; (iii) provision of infrastructure, including electric power, transport, water, and sanitation; (iv) distinct regulatory regimes, often involving laxer labor regulations, restrictions on union activity, and different land tenure systems; and (v) provision of large parcels of land, often with industrial sheds built in advance of occupation. Software policies include (i) management of SEZs that seeks out and works closely and effectively with private sector investors, (ii) effective implementation and management, and (iii) labor training.
The number of SEZs has sextupled over the past two decades, reaching 5,400 across 147 economies as of 2018 (figure 2.26). There are many successful cases, in China clearly, and also the SEZ in Costa Rica (box 2.6), but that is often the exception. The disappointing performance results from a combination of poor design and execution, but two other factors impinge as well. The first is that export processing zones are frequently used to ameliorate spatial inequalities, but often the targeting is done with an incomplete understanding of the forces that lead to spatial inequalities in the first place that might undermine the success of the SEZ. The second is more generally the absence of a framework to structure sound cost-benefit analysis of often complex projects. Such a framework could help counterbalance the overly optimistic predictions of success (optimism bias, or wishful thinking) by the advocates of place-based policies or lobbying by self-interested individuals, sectors, private interests, and regions expecting to be beneficiaries. These factors determine whether investment will be attracted and have spillovers to local areas, or if they will become expensive but inert real estate.

Many SEZs have been hobbled because key elements of the ecosystem are absent. First, SEZs need to be located in places that are consistent with their objectives and long-term economic viability. If they are export oriented (or import dependent), they need to have good access to port infrastructure. In countries where even well-located regions have difficulty attracting investment, SEZs in backward or remote regions are unlikely to succeed.

However, finding a “good location” is necessary but not sufficient for success. SEZs often offer firms generous tax incentives to locate in their jurisdictions. Yet, there is considerable evidence that tax incentives alone are insufficient for success. Assessing the marginal impact of one policy is difficult given the complementarities between it and the country context (policies in place outside the SEZ). Nevertheless, Farole (2011) looks at data across 77 countries and finds that infrastructure and trade facilitation have a significant positive impact, while tax and other financial incentives are much less important. In some situations, SEZs may be able to remedy a key bottleneck for development. For instance, the main advantage of SEZs in Bangladesh seems to be their ability to offer well-serviced land to manufacturing investors.

Effective implementation of policy also matters. This requires action that is coordinated across functions (tax, land, and infrastructure)—and thus requires that the organization running the SEZ be empowered to deliver these functions. There must also be credible commitment to policy for many years ahead. Taken together, these considerations mean that commitment is needed from the highest level of government. At the same time, the SEZ authority needs to be responsive to the concerns of the firms in the zone.
Beyond the direct effects of attracting investment and creating jobs, a successful SEZ will have an internal dynamic of spillovers between firms, agglomeration, and productivity growth. This will have a horizontal element, with a large number of firms in the same sector building up thick labor markets and other agglomeration economies. It will also have a vertical element, with co-location of input suppliers and the growth of forward and backward linkages. This process encounters the first-mover or “all-at-once” coordination problem—it is hard to start a cluster. Involvement of one or several large firms is one route to kick-start this process, as with the multinational electronics companies (including AMD, Fairchild Semiconductor, and Intel), which were initially attracted to the free economic zone in Penang, Malaysia. Attracting such companies requires governments to deliver intensive packages of soft policy, working closely with the companies and committing to meet international standards. Links from the SEZ to the local economy include developing skills in the local labor market, expanding the technological capabilities of local firms, increasing the use of local firms as suppliers and customers, and leading to entrepreneurial spinoffs from firms in the zone. In successful SEZs, the share of activity in the SEZ being undertaken by local firms increases—sometimes as part of a maturing and upgrading process. In Mauritius, the SEZ upgraded from low-value textiles to higher value and more skill intensive products (off-shoring low-value production to the SEZ in Madagascar). In Malaysia, the Penang SEZ focused from the start on electronics, but upgraded from basic assembly to more advanced and skill intensive goods. Both of these sectoral transitions were accompanied by a transition toward locally owned firms.

The role of government in this process is important and needs to be based on recognition that there are mutual benefits—for firms in the SEZ and the local economy—from developing these spillovers. Thus, rigid domestic content requirements are likely to be viewed as a cost to firms in the SEZ and may transfer little learning to firms outside the SEZ. Working to bring local firms up to the level where they are chosen suppliers is of mutual benefit. The knowledge transfer also benefits the government itself because SEZs can provide a vehicle for learning about what makes an effective business environment.

Attracting FDI through Investment Promotion Agencies

Improving investment promotion agencies (IPAs) can help increase FDI inflows, attract higher quality FDI, and transform the economies of their home countries (figure 2.27). These agencies range in functions but generally work to improve the image of the host country, identify possible investors, support project management, and some play an advocacy role in promoting reforms of the overall business climate. They play an important role in matching investors with local suppliers, providing information, facilitating transactions (securing permits and negotiating bureaucracies), and managing investment incentives. Estimates of these effects show that US$1 spent on investment promotion could yield up to US$189 in FDI inflows and spending a relatively modest US$78 in investment promotion creates one additional job in the promoted sectors. The number of IPAs has increased significantly since 1980, especially in developing countries, where investors suffer from obstacles imposed by institutional and cultural differences from their home countries as well as have less information about local regulation.

Although IPAs can be a useful tool to attract foreign investment, recent studies have shown that in developing countries they frequently lack strategic focus, failing to provide the services most valued by investors, such as advocating for improvements in the business climate. Sharpening their focus, building a coherent institutional framework, and strengthening their delivery of investor services can improve their efficacy. A recent World Bank report recommends that IPAs should (i) focus on a limited number of mandates and target segments, (ii) adopt institutional features common to private companies, and (iii) offer relevant and high-quality investor services across the investment life cycle. The report concludes that to maximize IPAs’
### Box 2.6. Successful Export Processing Zones in Costa Rica: Critical Elements of Success

The Coyol Free Zone (CFZ) in Alajuela, Costa Rica, has won numerous awards, including being named Best Free Trade Zone in Latin America by The European and a Top 10 Free Trade Zone by fDi Intelligence magazine. Established in 2007, the zone focuses on the life sciences cluster and includes such clients as Abbott, Cardinal Health, Medtronic, and Philips. In 2019, the zone exported nearly $2.1 billion in medical devices, amounting to 58 percent of manufacturing exports in Costa Rican free trade zones. It employs 16,000 people.

The CFZ is part of Costa Rica’s free trade regime, which provides incentives for international companies to locate in the country. In the CFZ, these incentives include permanent exemptions from customs on imports and exports, tax on royalties and fees, sales tax on local products, and stamp duty. In addition, there is a 10-year exemption from taxes on property transfers. For service and manufacturing projects, there is a 100 percent exemption from income taxes for eight years, followed by a 50 percent exemption for four more years.

Several infrastructure advantages help make the CFZ successful. First, it is only five miles from Costa Rica’s main airport, the Juan Santamaría International Airport. It has easy access to three highways, allowing for access to the coast and shipment by sea. Second, within the park, much of the essential infrastructure contains several backup systems. The electric grid has three backup substations in addition to the main station, and underground connections, which minimize the risk of weather damage. The water system is similarly redundant, with four wells devoted to the CFZ, and the water both inside and outside the CFZ is potable. Third, the fiber optic network is fully redundant and serviced by five different telecom providers. Together, these redundancies enable companies to feel secure that they will have continual access to power, water, and internet service if they choose to locate in the CFZ. In addition to these redundancies, the CFZ also contains on-site sterilization companies. This represents a cost savings for medical device companies that choose to locate there. It is possible to produce a device in the CFZ, sterilize it, and ship it to its final destination rather than paying for an intermediate stop for sterilization. The CFZ has partnered with the Costa Rica Investment Promotion Agency to create a database of people looking for jobs in the zone, making it easy for companies to find qualified workers.

**Benefits—direct and indirect quantity effects.** Beyond the direct effects of providing the infrastructure that makes the zone attractive for companies to locate there and create jobs, the CFZ has potential positive spillovers to the local area. First, Procomer, the agency in Costa Rica responsible for promoting the country’s free trade zones, believes that indirect employment generated by all the free trade zones in the country amounts to at least 50,000 workers, some of which is due to indirect employment around the CFZ. Indirect employment could stem from several sources, including utility companies that hire additional staff to deal with the increased demand from the zone and restaurants and shops that provide goods and services to the workers. Partnerships between local universities and the CFZ also have human capital spillovers. The CFZ has agreements with multiple universities in the area, which offer training for bachelor’s and master’s degrees as well as technical skills training on-site at the CFZ. The University of Minnesota has collaborated with a local university, Technologico de Costa Rica, to offer a master’s degree in engineering with a focus on medical devices. Programs such as these...
allow the CFZ to offer high-skilled jobs in areas where locals may not have degrees without these partnerships. Locals, even if they are not ultimately employed by companies in the CFZ, still have access to science, technology, engineering, and mathematics degrees, which will make them attractive to other companies as well. If these degrees would not exist in the absence of the CFZ, these human capital spillovers can be considered to be an indirect benefit of the CFZ. The companies in the CFZ also have partnerships with technical high schools to hire students as interns, which may lead to permanent employment.

Costs. While the CFZ yields numerous benefits, it also has costs. First, the incentive programs limit potential government revenue from the program. Tax incentives for companies that locate in the CFZ are lost tax revenue, especially if the companies would have located in Costa Rica regardless of the incentives. In addition to the lost revenue, another potential cost of the CFZ is increased traffic congestion as trucks transport exports from the CFZ to the airport, or as people commute to jobs in the CFZ. Rush hour commutes in the Central Valley (the region in which the CFZ is located) have increased 40 percent since 2015. This increase is not necessarily only related to the CFZ, but the zone could be contributing to the severe traffic congestion in the area. Similarly, the jobs created by the CFZ would be attractive to residents of other parts of Costa Rica. If the CFZ induced migration through direct or the indirect jobs, this would put upward pressure on the cost of living in the region as people move in and demand housing. The final potential cost is environmental. The manufacturing processes in the CFZ generate environmental pollutants, which are thus a consequence of the CFZ that should be taken into account. However, the CFZ has committed some of its acreage to maintaining the ecosystem of the area. Further, Costa Rica is generally committed to environmentalism, and pledged to become one of the first carbon neutral countries in the world by 2021.

Source: Quoted from Grover, Lall, and Maloney (2022).
Figure 2.27. Higher Quality IPAs Can Attract More FDI

Note: The dependent variable is the average FDI inflow received by each country during 2000–10 as reported in the International Monetary Fund’s International Financial Statistics. IPA service quality is measured based on ratings on a scale from 0 to 100 from World Bank (2012). FDI = foreign direct investment; IPA = investment promotion agency.
Conclusion

LAC has tremendous potential both in its traditional areas of comparative advantage and the new sources arising from opportunities in the green economy. The challenge remains to mobilize the investment and know-how to leverage these opportunities to generate diversified and dynamic economies.

However, over the past two decades, LAC has not exploited the gains from greater integration in the global economy in terms of scale economies, transfer of know-how and technology, and capital. Trade exposure has largely stagnated and FDI has fallen for most countries, even as reshoring and nearshoring have become more common. Expanding trade exposure and leveraging comparative advantages are critical as the region seeks to raise its growth rates, expand into new areas of services, reduce its environmental footprint, and take advantage of its new areas of green comparative advantage.

Many of the necessary reforms involve those traditionally on the agenda that have a long gestation period: reducing systemic risk, raising the level and quality of education, investing in infrastructure both traditional and digital, making cities better platforms for manufacturers and services, raising capabilities across the whole spectrum of human capital, and ensuring well-functioning financial markets to provide liquidity and diversify risk. These all require long and sustained effort, but they are essential for productive integration.

There are also interventions with a shorter time horizon. The first, following Hippocrates, is do no harm: to preserve the reputational gains of the past 20 years in terms of macro stability.

Second, regulatory gains in customs and transport are, in principle, low in cost and could be done over a short time scale. These can be done in the context of DTAs that both provide a framework for the component reforms and add to confidence in the basic rules of the game.

Finally, both EPAs and IPAs have a proven track record. The former have a component of managerial consulting services to get potential exporters over the hump. However, in LAC, both types of agencies can be unfocused and hence less effective than the potential.

A comprehensive approach to both shorter- and longer-term reforms could move LAC toward a renewed and more dynamic engagement with the global economy.
Notes

1. The East Asian miracles include Japan; the Republic of Korea; Taiwan, China; Hong Kong SAR, China; and Singapore.
3. See, for example, Li and Liu (2005) and Carkovic and Levine (2005) for summaries of the literature.
4. See Baishvili and Gattini (2020) for a recent estimation across different income levels.
5. The elasticities are typically found to be highly nonlinear for various important development co-factors. Here, a range of average elasticities across low-income and upper-middle-income countries are used.
7. The measure is calculated as the ad valorem equivalent "wedge" between intraregional trade and domestic commerce.
10. See Ruta (2017).
11. Vertical FDI refers to investment made within the supply chain.
12. For details, see Mauro, Rocha, and Ruta (2020).
13. Portugal-Perez, Reyes, and Wilson (2009) show that certification and auditing can generate additional costs.
14. See Kee and Forero (2020) for details.
18. These have been found to be associated with higher value added in services exports.
20. See Ghani, Goswami, and Kerr (2016) for India; Baum-Snow et al. (2017) for China; and Henderson, Lee, and Lee (2001) for Korea.
21. For details, see Coşar et al. (2021).
22. Gorton and Ianchovichina (2021) provide additional details.
23. See Conte and Ianchovichina (2022) for details.
24. See the analysis in Gorton and Ianchovichina (2021) for more details.
25. See, for example, World Bank (2012).
30. See Akbar (2022) for details.
32. See Baum-Snow et al. (2017).
34. See Grover (2019).
36. World Management Survey, worldmanagementsurvey.org, https://www.sciencedirect.com/science/article/pii/S0167268117300021?casa_token=PaS-B0nukFOwAAAA:5qg6CHyYuQ0XCe7Y1GIUukFRolbomwnPMmUH2Gjd2ZpQrDqAIkkHpxdEExekoqDIgVG36qY.
39. See Cirera and Maloney (2017) for a review of evidence on this.
43. See Cirera and Maloney (2017).
45. Krishna et al. (2023).
46. de la Torre, Ize, and Schmukler (2011).
47. Harding and Javorcik (2011).
References


