REGIONAL INTEGRATION

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OBJECTIVE

The Inter-American Development Bank has been committed to regional integration initiatives since its inception, though it has had no formal umbrella strategy in place for its integration support.[1] This commitment was put into words by the first President of the Bank, Felipe Herrera, who in 1961 declared "We shall be the Integration Bank." The Bank's support for integration gained new impetus as one of the core mandates of the Eighth Replenishment. Further reinforcement for its commitment was provided in the Institutional Strategy, which made regional integration one of four priority focuses for Bank support, with the ultimate aims of environmentally sustainable economic growth and poverty reduction with enhanced equity.

The central objective of the Bank's regional integration strategy is to guide the institution's support for the creation of regional public goods (RPG), specifically (i) *regional integration* and (ii) *regional cooperation*, so as to maximize the impact of the resources available. Regional integration is a process involving formal agreements whereby the partner countries acquire rights and obligations to end discrimination in the movement of goods, services, labor and capital. Policy and institutional harmonization are sometimes an added feature of these accords. "Regional cooperation" refers to cooperation not related to undertakings in an integration treaty. In pursuing the activities proposed in the present strategy the Bank would need to take due account of the countries' goals, the state of their development processes, appropriate policy sequencing, multilateral rules, and potential contribution to development.

Regional integration is not an end in itself: it is one more policy instrument for achieving a set of development goals and objectives. The first Post-War integration initiatives in Latin America and the Caribbean (LAC) were designed to advance and deepen an import-substitution industrialization strategy, bolstered by substantial external protection and State intervention. This economic development approach lost currency with the economic crisis of the 1980s, and the underlying integration arrangements collapsed. The 1990s saw the emergence of fresh regional integration initiatives with a different thrust, as befit the altered global economic policy backdrop. Today regional integration is an integral part of the structural reforms under way in the countries since the 1980s. As such, it complements other policies the countries have crafted in order to integrate their economies with the rest of the world, foster private markets and modernize institutions, with a view to positioning themselves firmly in a globalizing economy, transforming production patterns, and making themselves more competitive. The ultimate goals of the process are to spur environmentally sustainable economic growth, improve social equity, foster peace and democracy, and reduce poverty in line with the Millennium Development Goals (MDG).

The tangible expression of this process, which some experts have dubbed the "new

[1] The Bank has been preparing strategies for LAC subregions in its regional programming papers for many years.

regionalism,"[2] has been a wave of formal integration agreements and major regional cooperation initiatives. These initiatives had their origin in traditional subregional forums but, as the process has advanced, a web of bilateral and interregional initiatives has taken shape. There also has been a growing trend toward agreements with industrialized countries.

Regional integration agreements in Latin America and the Caribbean foster, first and foremost, trade between the partners, affording reciprocal, preferential, unfettered market access. References to "trade" in this paper refer to trade in both goods and services. Some accords confine their ambitions to a "strictly business" free trade area, while others strive for 'deeper' integration. This term refers to integration that goes beyond increasing trade relations to take in possible labor and capital market integration and coordination of institutional activity. In some cases, it can be seeked by creating a common external tariff (CET) as a step toward a customs union or common market. Generally, regional cooperation in both the economic and noneconomic spheres has been driven *ad hoc* by growing interdependence—the result of strengthened trade ties or the desire to forge solid common geopolitical strategies to operate in the globalizing marketplace.

The broader aim of regional integration and cooperation is to produce desirable outcomes that are difficult, if not impossible, for individual nations to achieve on their own. For instance, countries are combining regional integration with unilateral and multilateral trade liberalization in order to lower average protection levels and spur competition, create trade, and help realign their production apparatus. This is accomplished by creating a rules-based preferential regional market conducive to export diversification, economies of scale, greater specialization, productivity, and attraction of foreign direct investment. Integration agreements, with the legal commitments they demand of participating countries, also make it harder to backtrack on reforms.

This paper is one of a package of Bank strategies: two that pursue the twin core objectives of the Bank's Institutional Strategy —*poverty reduction and social equity promotion and sustainable economic growth*—and strategies addressing the Bank's four priority action focuses: *modernization of the State, competitiveness, social development, and regional integration*. All these strategies have been developed following a common format. Bank actions posited in the different strategies are intertwined and mutually reinforcing. An environmental strategy with these same features has been developed. Within this umbrella framework, the regional integration strategy will help guide the use of the Bank's toolkit of financial and nonfinancial products as well as its internal organization, to assist LAC countries by furthering regional integration and cooperation. The actions being proposed are based on an analysis of the achievements and shortcomings of regional integration and cooperation and on an evaluation of Bank activities in support of those processes. From the analysis findings this paper outlines a series of work focuses, prioritized in light of the requirements of regional integration and cooperation processes and the comparative advantages the Bank offers to help further these processes.

[2] The 2002 Report on Economic and Social Progress (IPES) has a larger analysis on the new regionalism and on the contribution of regional integration on global integration.

DIAGNOSIS

The forces of globalization and liberalization at work the world over have been driving *de facto* integration of the global economy in goods, capital, labor and technology markets. Since 1990 there has been appreciable progress in regional integration, creating an adjunct policy space in which to manage the forces of globalization and use them to propel the region's development.

Reciprocal preferential trade liberalization in regional agreements has been relatively swift, universal, and in line with World Trade Organization (WTO) agreements. Accordingly, the close to 30 accords sealed to date have for the most part succeeded in creating trade, diversifying exports, increasing specialization and attracting investment. Time will tell what effects they will have on boosting global competitiveness.

A number of free trade agreements have advanced to the "second generation" stage, addressing new issues regarding services, investment, intellectual property and others. The subregional pacts enter the realm of collaboration in international trade negotiations, incipient macroeconomic cooperation, greater labor mobility, and collective initiatives to preserve democracy in partner countries. Large-scale cooperation within subregions and beyond the region also has emerged in plurilateral initiatives that take in a whole spectrum of economic, social and political issues.

The benefits that participating countries stand to gain from 'deep' integration are undeniable but, because of the varying strength of the underlying political commitments, the subregional integration accords have made limited progress in strengthening ties, fulfilling objectives and improving compliance with the rules adopted. Other hurdles on this front have been weak points in the design of the original agreements and difficulties in securing a consensus to remedy these constraints, economic and partisan-politics crises, and asymmetries in the benefits and costs accruing to the partner countries.

As LAC countries put through structural reforms to move their economies into the global marketplace they turned their attention increasingly to integration arrangements with industrialized nations. Driving this trend was the desire to augment the benefits stemming from integration in the subregions. One distinct benefit of such agreements is assured access to major markets, creating entrées into heavily protected sectors in which LAC has competitive advantages. In addition, such agreements expose the subregions to a set of comparative advantages simulating the ones they would confront multilaterally. This kind of exposure helps minimize trade diversion and fosters productivity.

Negotiations for a comprehensive, balanced Free Trade of the Americas Agreement (FTAA) that would take in 34 nations in the hemisphere are moving forward. The FTAA initiative became more complex when many countries decided to pursue parallel bilateral free trade agreements—a move that can serve both as a building block and a stumbling block for pan-American integration, depending on the precedents it creates.

Trade integration arrangements with the European Union (EU), another core objective of the new regionalism, could yield benefits similar to the FTAA's. Though the EU now has formal trade agreements with Mexico and Chile it has shown a certain ambivalence about accelerating negotiations with MERCOSUR because of its sensitivity over agricultural liberalization. Progress on these talks and prospects for launching EU-Central America and EU-Andean Community negotiations would appear to hinge on eventual Doha Round agreements. CARICOM might finalize a free trade agreement with the EU before 2008. Negotiations to work out a free trade agreement in APEC (involving Chile, Mexico and Peru) have lost momentum.

Though they do not involve regional integration, the Doha multilateral talks are extremely important since they have to do with global market liberalization. Also on the table at that forum are some systemic issues that are critical for North-South relations but are difficult to tackle in regional talks (e.g. abolishing agricultural subsidies). The scant progress made thus far in these talks raises doubts about the 2005 target date for the wind-up of negotiations.

Throughout the 1990s, LAC countries continued to lower economic barriers and boost trade flows, regional integration being one facet of this larger liberalization strategy. Countries did gain from these moves to unfetter their economies, but the results of the process on sustained economic growth and poverty and inequality reduction were mixed or indeterminate. This would appear to belie the widely held view that more open economies and increased trade yield net benefits across the board. Even when the net benefits were undeniable they were not necessarily widely or evenly distributed. Not all countries in the region were able to tap all the opportunities afforded by their integration with the rest of the world, owing to serious institutional shortcomings, weak negotiating capacity and bargaining power and, in some cases, insufficient macroeconomic stability. In many countries no compensatory mechanisms were put in place to make sure that the net benefits of trade were distributed more equitably.

Though great strides have been made in trade liberalization there still is much work to be done to reap all the potential fruits of regional integration and ensure that all the parties receive their fair share of those benefits. This is a very complex agenda, requiring simultaneous action on multiple fronts, a resolute collective vision and political leadership, particularly in integrating countries with dominant markets.

The trade and integration agreements operating in the four subregions—CARICOM, Andean Community, Central American Common Market and MERCOSUR—have common-market objectives. Among the benefits of 'deep' subregional agreements are bolstered international negotiating capacity, international competitiveness (thanks to unrestricted movement of factors of production, harmonized policies and rules, etc.), and cooperation in managing common problems. However, constraints in a number of areas have kept countries from realizing all of integration's potential benefits: (i) the persistence of major nontariff barriers; (ii) failure to finish implementing genuine customs unions and serious perforations of common external tariffs; (iii) slow progress on instituting "second generation" protocols; (iv) inadequate regional infrastructure; (v) weaknesses in the regional institutional apparatus (and in the national counterparts); (vi) unfinished country structural reforms; (vii) scant coordination of macroeconomic and sector policies, and tax systems that do not work for integrated markets and do little to stimulate external trade and investment; (viii) no mechanisms to promote socioeconomic development such as would compensate for asymmetries in the different integrating zones and regions, within individual countries and between partner countries; and (ix) international barriers to exports. A further constraint for the delivery of RPG is the suboptimum level of regional cooperation.

If countries have yet to feel the full benefit of liberalization as they dismantle tariffs on trade with their integration partners it is because of the persistence of *nontariff barriers*, typically in the form of customs procedures, technical standards, surcharges, etc.

One key avenue for deepening regional integration is the *formation of a genuine customs union*. This does away with the need to administer rules of origin and assures the operation of common customs procedures along with regional mechanisms for tariff revenue collection and distribution. A customs union also facilitates en *bloc* negotiations with third parties. Such a union is an aspiration of all the subregional agreements, but this goal is still a long way off. Some progress has been made on common external tariff implementation but such tariffs are not fully operational or there have been serious perforations. Furthermore, members of a customs union frequently negotiate on their own with third parties, thereby aggravating the perforation and eroding the subregional bloc's bargaining power.

Subregional agreements have made slow progress on *implementing second generation protocols*, missing out on the opportunity to deepen integration and spur structural reforms by explicitly including services (notably financial services), investment, government procurement, intellectual property rights, etc. Specifically, little has been accomplished in efforts to expedite financial deepening, taking advantage of scale economies and diversifying risk.

LAC countries' infrastructure investments have not done much to further integration: as a percentage of GDP their infrastructure outlays have declined over the past two decades, dampening fast-growth prospects. Country fiscal constraints and the need to address environmental sensitivities were two factors at work here. The infrastructure projects that did come to fruition failed to address all the positive externalities that could have been captured had there been inter-country coordination. Consequently, these investments have lacked a regional vision and collective mechanisms that could have multiplied their development impact and their effect on regional integration. Further regulatory harmonization to soften regulatory barriers is another observed need. Two recently launched initiatives—the Puebla Panama Plan (PPP) and Regional Infrastructure Integration in South America (IIRSA)—offer promising prospects to overcome those impediments in the energy, transportation, and telecommunications sectors. In both initiatives there are provisions for civil society participation and proactive environmental protection.

The PPP, an integration initiative for the Central American countries and Mexico, is fostering cooperation to accelerate economic and social development and advance integration in the participating countries, with careful attention to environmental considerations and the interests of local communities. The eight key cooperation areas are: sustainable development, human development, natural disaster prevention, tourism promotion, trade facilitation, highway system integration, electrical interconnection, and telecommunications development. The specific goal for Mexico is to compensate for development asymmetries—a NAFTA effect—between that country's north and south. Substantial progress was made on infrastructure ventures in 2002, with the ratification of the Bank-supported SIEPAC power grid project and an agreement on the International Network of Meso-American Highways.

The purpose of IIRSA is to improve coordination of infrastructure development plans, modernize regulatory systems and harmonize transportation, energy and telecommunications policies across South America. This initiative, based on nine integration hubs and eight sector integration processes, proposes to bring to a regional level the binational and subregional physical and economic integration processes the countries have been pursuing for a decade, as a means to improve productivity and competitiveness. It will help improve energy and communications regulatory frameworks and markets for logistical services such as shipping, insurance, warehousing and licensing, and spur the formation of integrated regional energy markets. The ultimate goal is to improve the quality of life and opportunities for local populations in the regional integration hubs, taking careful account of the social and environmental dimensions of infrastructure projects and building consultation and participation mechanisms.

Weaknesses in the regional institutional apparatus and in the national counterparts have held back the development and effective implementation of integration initiatives, the development, monitoring and enforcement of rules and the use of dispute resolution mechanisms, and have made it difficult to dispel economic agents' uncertainty and to address problems quickly. According to "functionalist" approaches, economic interdependence creates natural incentives to augment cooperation, lower transaction costs and develop common regulatory regimes. However, there is no clear evidence that the increasing interdependence of LAC economies has significantly stiffened the regional institutional fabric in the process. "Realist" approaches hold that regional institution-building incentives come out of the hegemony, collective vision and leadership of their major members, so there need to be incentives for those members to spearhead the process with an eye to the common good. Leadership in LAC subregions has been inconstant and marked by the 'leader' countries' economic and political vulnerabilities. Ultimately, both these approaches have their place in any successful process, and they interact as the process unfolds.

Structural economic reforms have helped augment regional integration's benefits, improving macroeconomic stability, opening economies even further to the global marketplace, lessening direct State intervention in markets, and creating an enabling environment for private enterprise. However, the impact of sharp reductions in external capital flows to the region, particularly in the Southern Cone, has underscored the persistent vulnerabilities that are dampening growth and worsening the income distribution, slowing the integration impetus.

Insufficient *macroeconomic coordination* as countries became more commercially interdependent by virtue of integration agreements increased the transmission of macroeconomic instability not just directly—with a falling-off of economic activity and trade—but also indirectly through the heightened risk of contagion in global financial markets. These problems were compounded when some integration partners adopted incompatible exchange regimes.

Moves by member countries in LAC subregions to dismantle trade and financial barriers and pursue regional integration were not accompanied by even a minimal *harmonization of tax policies*—not even taxation coordination mechanisms. The result was distortions in traded products' competitiveness conditions and in project returns, affecting investment localization decisions. The governments' reaction to this situation led to unfair competition, harmful tax practices and fiscal degradation.

The lack of *sector policy coordination* held back the development of regional production chains, making it more difficult for many products to achieve the productivity levels that are essential to compete with third markets.

Since there were no *national and regional policies to compensate for asymmetries* in the distribution of integration's benefits, there was no way to protect or compensate segments of the population that had come out losers in the trade liberalization process. This, coupled with the lack of real opportunities for consultation and dialogue with civil society, sparked a mobilization against integration moves, particularly North-South initiatives.

The region's export trade is being hampered by protection being afforded to sectors that the industrial economies consider to be politically sensitive. Typically these are areas in which LAC has distinct international comparative advantages (agriculture, textiles, footwear, steel, etc.)—this being one of the factors that prompted countries in the region to explore free trade agreements with the North and to participate actively in the Doha Round. But there are considerable differences in the participants' capacity, with the smaller economies at a definite disadvantage.

Not many LAC countries fully tapped into the resources available for strengthening negotiating capacity and the capacity to implement trade and competitiveness agreements. Unfortunately the magnitude of the problem is such that many countries find it difficult even to systematically identify the support they need in this sphere. Many countries' development strategies have not put this issue front and center, so external assistance has not been made a priority. Meanwhile, donors and international lending agencies have not effectively coordinated the delivery of this kind of support.

The 1990s integration initiatives that triggered new trade and investment flows also engendered close to 30 agreements in the region, creating costs because of the so-called 'spaghetti bowl' of rules and regulations they created, with the concomitant lack of transparency and higher transaction costs for trade. One expectation for the proposed FTAA is that it might be a way of absorbing some of the simpler agreements, thereby lowering these 'spaghetti bowl' costs.

One recent development of note is the emergence of large-scale *regional cooperation* between subregions. This has been one way of furthering progress on important fronts without entering into the complexities of integration treaties that demand greater commitments. Two prominent examples are the IIRSA and PPP initiatives discussed earlier, which are moving resolutely ahead with technical and logistical support from regional organizations. Considerable activity also has come out of hemispheric summits, LAC-European Union cooperation, and in APEC. Some of these initiatives already have borne significant fruit, such as democracy clauses and other agreements regarding security and corruption.

One hurdle to trade agreements, particularly North-South compacts, is the introduction of labor and environmental issues and the possibility of enforcement via trade sanctions. The developing countries fear that these standards will be used with protectionist intent and that the use of sanctions will have asymmetrical effects for them. The frequently expressed fear of countries in the North is that erosion of these standards could become an unfair-competition mechanism.

LAC countries have not seized all the opportunities available for the management of regional public environmental goods, such as water resources use and development in shared watersheds, development of a biological corridor, ecotourism promotion, etc.

LESSONS LEARNED

LESSONS LEARNED: FROM THE STANDPOINT OF THE INTEGRATION PROCESS

Not all integration processes are identically sequenced, nor do they follow textbook logic, because they are eminently political processes. This is why the European Union experience, though it can serve as a point of reference, has not turned out to be a straightforwardly replicable model. It is no easy task to follow, in order, its successive stages from free trade area to monetary union.

Regional integration and cooperation demand political commitment at the highest level, and they require sustained leadership. The participating countries—particularly those with the largest markets—have to take a medium-range view. Other requirements are support for ex ante and ex post evaluations of the development impact of integration processes, calculations of the cost of not moving ahead or of reversing course, public forums and avenues for consultation and discussion of these issues, and help in disseminating educational material. The countries have made only modest progress in these areas.

A necessary feature of subregional or extraregional integration agreements is the swift consolidation and preservation of secure preferential access to regional trade and investment markets. Indeed, such access is an essential "glue" for deepening integration.

When regional tariff reductions go hand in hand with economic liberalization moves there is less risk of trade and investment diversion. Excessive preferences or overvalued currencies can generate an intraregional trade in which "regional goods" not readily tradable in world markets are over-represented, creating situations of commercial hyperdependency among the regional partners.

Abolishing tariffs is the "easy" part of integration. The subsequent steps—erasing nontariff barriers, second generation liberalization, formation of customs unions, and macroeconomic coordination—have far greater domestic policy and country sovereignty implications.

Customs unions can do much to facilitate regional trade, bolster bargaining power in world markets, and soften incentives for the stiffening of external protection. They also are a precondition for creating a common market. However, it has proved very difficult to construct full-fledged customs unions in LAC subregions. When customs unions and common external tariffs languish for very extensive periods at a rudimentary stage, the participating countries incur heavy costs but capture no benefits. In such a scenario it is preferable to explore simpler, less ambitious alternatives such as perfecting a free trade area, incorporating "second generation" protocols and making sure that commitments are fulfilled to the letter.

Efforts to boost trade and further regional integration can be frustrated if the regional infrastructure needed to connect national markets and underpin increases in goods and services flows is not in place—hence the importance of support for increases in infrastructure investment, with private-sector participation. Because there are significant externalities in this sphere it is important that the countries coordinate infrastructure development, taking a regional perspective. However, there is no funding available with real incentives for regional infrastructure initiatives that can exploit such externalities and even out financial and technical capacity disparities between the participating countries.

Though large-scale regional cooperation ventures like IIRSA, PPP, and the hemispheric agenda may not bear the same measure of political commitment as formal integration pacts, they do need political support from the partner countries at the highest national and sector levels, a prominent place on their agendas, forward-looking timetables with specific collective work programs, progress benchmark reviews, supervision, and monitoring. Solid collective logistical, technical and financial support for these initiatives is needed as well.

One crucial element for successful integration is institutional development. Transparent, equitable regional rules (with formal contingent mechanisms) need to be developed, as do functional regional institutions and their national counterparts, equipped for regional policy formulation, coordination and implementation. An important factor for regional policy development, to judge from successful 'deep' integration experiences, is that in every such process there needs to be an expectation of significant political integration—understood as the progressive convergence of countries' legal and political systems—and supranational bodies to propel this kind of convergence. Realistic roadmaps and timetables are a necessary adjunct for agenda setting, with fallback positions that help maintain forward momentum. Yet another requirement for regional integration to work for the partners individually and as a bloc is efficient national counterparts for the regional-policy sphere.

There is no cookie-cutter model of the institutional machinery for formal integration agreements, which takes a variety of forms. Some arrangements are "static" contractual undertakings like NAFTA which lay out, up front, explicit rules and member obligations. Other variants are more along the lines of the Treaty of Rome, a "dynamic" constitutional agreement with legal autonomy and prescribed procedures for decision-making and further rule-making. Formal regional institutions to undergird integration processes are more of a necessity in agreements that feature an institutional framework like these "dynamic" accords. However, as countries become more commercially interdependent the demand for formal institutions even for "static" agreements may increase as well.

Recognized, respected regional institutions are a must to gain credibility with governments, private enterprise and civil society and enable integration processes to transcend the vagaries of domestic political cycles. In the absence of technical secretariats, or where secretariats have been weak, some partner countries have found it difficult to move forward initiatives and have ended up creating ad hoc intergovernmental forums instead. (The technical-secretariat problem also causes difficulties for external donor support, since donors require a national counterpart to implement collective projects.) The higher costs this can entail in overlaps or redundancies is just one part of the problem: this situation also is particularly harmful to partners with weaker capacity, which are more reliant on support from technical secretariats to come up with balanced decisions.

Improving regional and country institutions will enhance compliance with regional rules. To solidify regional integration processes there needs to be a much narrower gap between commitments assumed and commitments honored. Some measure of flexibility is needed in the short term but, in the long run, growing economic interdependence in a volatile economic climate will require voluntary adherence to the regional commitments assumed and the ability to resist domestic pressures to reverse them. A more constructive way of channeling private-sector and civil-society demands is to create formal consultation and information forums with country and regional authorities.

One regional institution in particular need of improvement is dispute resolution mechanisms. Their primary role is to support and facilitate cooperation between the member countries and foster equitable application of rules. The absence of formal dispute settlement procedures or, where procedures are in place, serious weaknesses in their administration, hurt the smallest member countries most. There is a range of dispute resolution mechanisms, from those that are empowered to take binding decisions to those that can only hand down nonbinding opinions. If, in the latter scenario, there are significant power differences between the partners, the smaller ones find themselves at a disadvantage. Transparent mechanisms that help narrow the wide power gap between countries that are parties to an agreement are a definite asset to be able to sustain mutually beneficial economic, trade and political cooperation ties. Such arrangements can often keep commercial disputes from escalating, thereby helping to deepen integration. Transparent, uniform, predictable dispute settlement also helps dispel uncertainty, creating a climate in which economic agents will want to invest in the most efficient geographic area of the regional market rather than in the largest national market.

The success of regional integration initiatives hinges heavily on local market factors. Effective domestic policies and democratic institutions are needed to ensure that the fruits of integration are equitably shared across society, to afford social protection and to instill conditions for socially efficient adjustment, in an environment of heightened competition and economic transformations that undoubtedly improve the general welfare but create some losers as well as winners. Small and mid-sized businesses and marginalized sectors should come in for special attention to make sure that they too share in integration's benefits. One special focus should be an assessment of policy options for protecting those who are most likely to lose out in the early stages of integration, for example, policies on employment training and job search programs, unemployment insurance, and social safety networks.

Lasting macroeconomic stability in integration partners is essential to capture the benefits of regional integration. While greater integration with global capital markets is a positive development inasmuch as it enlarges the range of funding sources, it has brought greater risks as well, leaving economies more vulnerable to abrupt shifts in capital flows. Intraregional trade is especially vulnerable to systemic restrictions on international short-term trade finance. Furthermore, the region has no efficient payment systems or mechanisms of its own to be able to minimize the inherent risks of international transactions.

There needs to be greater macroeconomic coordination in the subregions to help preserve stability and propel integration. The demand for coordination will depend on: (i) how interdependent/dependent the economies are; (ii) political objectives regarding the depth of the integration process, and (iii) the need to earn greater credibility for domestic economic policies by "tying" certain instruments to regional commitments, to modify economic agents' perceptions of these policies. The effectiveness of such coordination will depend on the partner countries' credibility, the rules adopted, and how strictly the rules are observed.

The demand for this kind of coordination is on the rise as integration processes boost regional trade flows and heighten the risk of financial contagion in the subregional group. Externalities become very important here, as economies find themselves more exposed to price and quantity impulses in the rest of the world, notably in the principal trading partners. How intense such spillovers will be and how they spread will depend on the level of interdependence,[3] so as integration processes move forward, collective policy formulation by way of some form of commitment will make good sense. However, there is a risk that any such commitment could be perceived as curbing some country's autonomy or that its implementation cost will be judged to be too high. In sum, there is a scale of macroeconomic coordination possibilities, ranging from simple data exchanges to country institution-strengthening pledges to the charting of macroeconomic convergence goals. Whatever the degree of commitment decided on, it is important that there be an institutional apparatus that works, that concrete goals have been adopted and that there be incentives to achieve them, taking care not to lose credibility or damage reputations in the event of any deviation.

Differences in exchange-rate regimes between integration-agreement partners can trigger serious tension or protectionism or erode consensuses. Moves to align exchange systems, together with predictable exchange-rate management, can spur trade and regional investment. Though a monetary union poses enormous technical and political challenges, the endogenous convergence forces that go with such processes are an incentive for partners with 'deep integration' aspirations to at least explore that avenue.

Trade liberalization has had a pronounced effect on fiscal policy. The reduction, standardization and removal of tariffs has slashed tariff revenues and significantly lowered effective protection of domestic production. This, coupled with pressures for tax benefits and incentives to aid sectors or regions, has required a broadening of the tax base. Trade promotion efforts clearly will demand special attention on the tax policy side, since taxation systems contain hidden subsidies and barriers to trade in goods, services, and capital.

Despite the trade liberalization gains posted by LAC countries there is a perception of a lack of reciprocity on the part of the more advanced nations, even when their average tariffs are low. But those countries afford heavy protection to certain items like agricultural products and textiles in which LAC countries have distinct comparative advantages. In particular, the use of subsidies and their magnitude, negatively affect exports from several countries of the region. This debate is extremely important given the subsidies approved in 2002 through the Common Agricultural Policy of the European Union and the Farm Bill of the USA, and the possibility that agricultural discussions within the FTAA are affected by the delay of agricultural negotiations in the Doha Round. Negotiation is the only way to lower these hurdles to the region's exports, hence the importance of the FTAA, initiatives with the European Union and APEC, and the Doha Round.

There clearly are very positive synergies among agendas to deepen subregional agreements, North-South pacts like NAFTA or agreements with the EU, and between these arrangements and the gradual unilateral opening of economies and advance of the multilateral trade system. Initiatives on these fronts thus ought to move forward in concert, but this creates a heavy institutional and financial burden for Latin American countries. The scale and complexity of these North-South agreements pose major challenges. For one thing, coordinating plurilateral North-South regional initiatives and managing the logistics is a very complex undertaking. The collective technical and logistical support that regional organizations have continually made available to the FTAA since the idea for such a free trade area was first broached has been crucial to level the playing field, expedite the negotiations and

[3] Country size asymmetries can create problems. In such scenarios the demand for coordination would come from the smaller countries, the most affected by macroeconomic spillovers.

help the participants come up with balanced agreements. One requirement for such even-handed agreements, and one that is essential for their sustainability, is country capacity building to be able to negotiate and follow through on commitments. The problem is extreme in the case of small economies, which are especially vulnerable. Agreements like the FTAA also need an institutional architecture that will help balance outcomes among the partners. Otherwise, there is a risk that the agreements worked out will be unsustainable, protectionist, and rife with political conflicts.

As the FTAA takes shape, bilateral agreements between countries or subregions can serve as building blocks provided the precedents set in the process are consistent with a comprehensive, balanced, development-oriented hemispheric agreement that takes due account of the smaller economies' vulnerabilities. Conversely, bilateral agreements that simply promote mercantilist policies could impede consensuses on construction of an FTAA, leaving the region with too extensive a web of hub-and-spoke type agreements, with the concomitant costs for transparency and efficiency.

As economies become more interdependent the demand for more harmonized national rules and procedures is mounting, particularly in the labor, financial, and environmental spheres. Other areas such as natural disaster prevention and mitigation and disease control also need to be addressed at a regional level, regardless of economic interdependency considerations. The opportunities afforded by ecotourism, forest conservation, and biogenetic resource use need to be tapped.

Though bilateral donors do have funding available for regional cooperation, particularly for trade and competitiveness improvements, it is difficult to identify the countries and areas most in need. Donor resource offerings need to be coordinated in order to further integration processes, avoiding unnecessary overlaps.

LESSONS LEARNED: FROM THE BANK'S STANDPOINT

The Bank has supported integration since it first opened its doors. True to its mission, it promoted the "new regionalism" born in the late 1980s. The forms of its assistance have evolved to keep pace with changing needs in the region. The initial target of support was reforms to unfetter the region's economies, one of the goals set out in the Eighth Replenishment document. The Institutional Strategy adopted in 1999 made integration an explicit priority, to foster development in the region. However, the Bank has never produced an institutional strategy paper dealing with support for regional integration.

LAC countries have been unable to fully tap the Bank's integration support instruments, particularly its financial resources. In regional programming exercises in the past there was no attempt to bring the full range of these resources to bear to advance integration initiatives, for several interrelated and mutually reinforcing reasons: (i) the reliance on regional technical cooperation (RTC) funding in subregional strategy implementation; (ii) scant interface between country and regional programming and no thematic regional programs as an adjunct to the traditional subregional exercise; and (iii) insufficient connection between programming processes and project generation in the Bank.

Until a few years ago regional programming did not, in practice, make use of the Bank's complete support toolkit, having concentrated on RTC resources. However, as regional integration moves up on country policy agendas there is increasing demand within the Bank for a closer meshing of regional programming with the use of a greater range of Bank products. Regional programming should be a comprehensive exercise, promoting the use of the entire menu of the Bank's financial and nonfinancial offerings.

Though there was very little interface between country and regional programming in the past, the two exercises have recently become more closely linked and the importance of accelerating and deepening this process is evident. As the two processes become better coordinated, regional programs can benefit from the knowledge of those who work mostly on country issues, while those working on country programs will gain a regional perspective of the repercussions of initiatives in their respective areas. This change is evident in the 2001 Central America programming exercise, as documented by the Office of Evaluation and Oversight (OVE), and should become the general practice. Some integration and trade issues need to be tackled independently of the existing regional blocs; to that end, it would be useful to do thematic programming on border region development, migration, infrastructure, environment, and other topics.

Tighter regional/country programming coordination has been shown to be only the first step toward more structured support for integration. The second step is to make sure that projects selected for support are consonant with the programming exercises. The Bank has been instituting measures to make sure that its projects fit more closely with these programming processes, which will shorten approval procedures for operations that are included in approved strategies.

Since countries' support needs can change abruptly when they are confronted with unanticipated external shocks or natural disasters, it is likely that some proposed projects will not fit the approved strategies. In that scenario there need to be assurances that the new projects, too, will be able to make the most of their regional potential. The Bank should strengthen its internal procedures to make sure there is a regional perspective in such country projects from the outset, by intensifying cooperation between INT and the Regional Operations Departments.

Many of the Bank's contributions to regional integration have not shown up in the statistics as integration support because of how this assistance was classified. The Bank should improve its project classification procedures to provide a truer picture of its support for integration processes.

Regional integration and cooperation fit the definition of classic public goods: they entail externalities and commitments, with coordination problems stemming from information asymmetries and the credibility of commitments. This tends to make for suboptimum cooperation levels. In an era of government funding constraints this situation creates a niche for a variety of financial and nonfinancial products and facilities of regional development banks like the IDB. Indeed, given its lifelong regional focus and mission, its credibility with borrowers and lenders, its financing facilities, and its wealth of experience in regional integration, the Bank can act as a catalyst to bring countries together in collective endeavors that serve their mutual interests and advance their economies.

The Bank has superior financial products and human resources with which to help improve regional infrastructure. However, in some situations its activity has been limited by member-government funding constraints. It thus is important to bring the private sector into regional infrastructure modernization and expansion ventures.

With the FTAA, PPP, IIRSA, and hemispheric summits the Bank has developed another specialized niche: collective organizational, logistical, technical and financial support, working in concert with other regional organizations. This collaborative support for large-scale initiatives has been vital for their birth and growth. The Bank contributes with its staff's knowledge and its institutional neutrality to ensure homogeneous, quality services for all participants.

A salient consideration here is that the Bank's integration support has been affected by the reduction in nonreimbursable technical cooperation funding available (FSO net income) presented in Resolution AG-1/99.

This has significantly diminished the Bank's capacity to offer the kind of support it had been providing for years to regional integration institutions and their programs. Some recent figures tell the story: regional TC approvals peaked in 1996 at US$42 million and averaged US$30 million annually in 1995-1998 following the Bank's reorganization. The 2000 total was barely US$13 million.

The previous chapter underscored the importance of strengthening the regional institutional apparatus. The weakness (in some instances, the absence) of technical secretariats for subregional agreements has left the Bank without effective regional interlocutors to channel its integration support. An equally serious concern is that without the nonreimbursable support the Bank has been providing to integration groups it is highly unlikely that those institutions will be strengthened. The shrinking of regional TC funding is even more detrimental to regional cooperation since it does not operate within a formal integration framework.

As for country projects to advance integration, a country's priorities as enunciated by its trade authorities do not always find their way into the Bank's pipeline, perhaps because decision-makers are unaccustomed to permitting external funding of trade and integration projects. Other occasional hurdles are budget constraints in countries requesting assistance and the local counterpart requirement. Lastly, countries may be reluctant to allocate resources to integration projects if they think this might leave less money available for purely national priorities.

The Trade Sector Facility, one of the Bank's new flexible lending instruments, has been well received in the region. Though this facility has occasionally run into obstacles because of the lack of priority referred to in the previous paragraph, the demand for this funding mode is such that the current resource allocation for it will be insufficient. It also has become clear that integration processes require more sweeping adjustments than the strengthening of foreign trade institutions.

INTAL has shown that it can respond quickly to frequent urgent requests for modest integration support and has proved to be a valuable vehicle for training and information dissemination, thanks to its recognized "trademark" in integration issues.

As was noted earlier, there is little coordination of donor support for integration and trade. Furthermore, many countries, particularly the smaller ones, sometimes have difficulty identifying their needs. The Bank can bring its experience to bear to coordinate donor/recipient country relations.

The Bank has shown itself to be an active, respected opinion shaper, frequently providing guidance and helping to propel a variety of integration processes. Publications and public event organization (and participation in such events) are its chief avenues of communication in this respect. However, the Bank has not arranged consultation forums with country and regional authorities as it has done on the national scale with the high-level policy discussions known as encerronas.

The Bank's new Regional Policy Dialogue program, in which several Bank departments are involved, has helped to transmit best practices among countries and identify regional cooperation programs. The Special Integration Program has heightened the Bank's profile in integration and trade issues and made it possible to respond quickly to urgent demands for support for liberalization impact studies and information channels for civil society.

AREAS FOR BANK ACTION

Regional integration offers scope for a whole range of actions. The wealth of lessons learned in this field should be put to service to strengthen integration processes, as discussed in the third chapter of this paper. However, the Bank should target its action strategically, giving priority to activities in which it can make the most of its comparative advantages as a regional lending institution. At the same time, priority needs to be given to actions that can substantially aid the consolidation of critical stages in integration processes and/or produce synergies across the countries' integration and cooperation agendas. The ultimate aim of support for regional integration—to spur sustainable economic growth while reducing poverty and enhancing equity along the lines of the MDG—will only be achievable if the integration rules adopted make for balanced opportunities and set the stage for eventual country convergence, and if institutions can compensate in some manner for asymmetries between and within the integration partners. Unless due heed is given in integration processes to poverty reduction and equity enhancement they may well run into political and social opposition.

The Bank's priorities take operational shape in regional and country programming exercises in which countries' needs and requests are addressed and Bank staff bring their professional judgment to bear.

In its activities to further regional integration the Bank's priority focus should be support for subregional and interregional integration processes (including North-South initiatives) which are economically relevant (not all are) and have the political support of the parties concerned. Since in LAC countries these processes pursue different integration goals and are at varying stages, political backing and the countries' development status and their other circumstances all are key considerations. With that in mind, and to provide the necessary focus for the Bank's activity, priority action areas are as follows: (A) Consolidate regional markets; (B) Promote regional infrastructure; (C) Strengthen integration institutions, and (D) Foster other RPG.

CONSOLIDATION OF REGIONAL MARKETS

'Deep integration' agendas can move forward when market access problems have largely been resolved and economic and trade interdependency can increase. The following are the main trade-support areas in which Bank actions can have a significant impact.

The Bank can help countries to research and calculate the costs and benefits of protection and of integration and trade liberalization options. Such evaluations should go beyond an analysis of the static effects of trade creation and diversion: countries also need support to assess the dynamic effects of production transformation and the distribution of benefits between and within the partner countries.

One key focus of attention is regional market consolidation, to preserve the gains achieved thus far and continue to enhance liberalization processes. The priority aim of the Bank's umbrella strategy should be to provide support to countries to devise and enforce rules that will foster efficient trade and investment in the regional marketplace. So that the benefits of the major headway made in liberalizing trade in goods in the subregions can be fully captured the Bank will offer support to countries as they work to remove the plethora of nontariff barriers still in place, including the reduction of dysfunctional regulatory asymmetries.

The Bank also will offer support to countries that wish to liberalize the four basic modes of trade in services: cross-border supply (domestic consumers purchase services from a supplier in another country); commercial presence; consumption abroad, and movement of physical persons (to furnish services outside their home country). Specifically, the Bank will support assessments of alternatives and the eventual implementation of actions to facilitate and boost trade in financial services, primarily in the financial intermediation, insurance, securities, and pension spheres.

Certain intrinsically financial activities are undeniably important for goods and services transactions between individuals and legal persons in different countries. The Bank will offer assistance to countries that wish to pursue trade-relevant actions in the financial arena, principally initiatives involving payments systems and mechanisms.

Given the importance of some extraregional markets and the potential benefits of agreements to secure access to those outlets, the Bank will, on request, support countries' participation in North-South integration initiatives like the FTAA and agreements with the European Union and with Asian countries. It also will offer facilities to strengthen countries' capacity to formulate positions in multilateral forums like the WTO Doha Round, given the importance of such forums for market liberalization and their contribution to regional integration agendas. LAC countries need to bolster their negotiating capacity to be able to obtain trade-barrier reductions in the industrialized nations, see the benefits of growing global trade shared more equally and be able to include agriculture in trade negotiations.

Combining subregional integration with North-South free trade agreements can yield considerable benefits, providing more secure access to larger markets, minimizing trade diversion in the subregions, attracting foreign direct investment, spurring institutional modernization and regional cooperation, and fostering productivity increases. In the area of North-South trade relations the IDB will continue to support studies and initiatives to find ways around roadblocks in trade negotiations, for example, avenues for improving labor and environmental standards with no protectionist motives, and disciplining options for contingent protection measures.

PROMOTING REGIONAL INFRASTRUCTURE

How far integration processes can go depends in large measure on increases in trade and investment among the participating countries. However, unless the present infrastructure is augmented, countries may be unable to follow through on their market liberalization plans. The Bank has a wealth of experience in support for country infrastructure projects but needs to build a regional perspective into such operations, with attention to their social and environmental impacts. Consequently, the Bank should deepen its support in the following areas:

The Bank should continue supporting country infrastructure projects, building in a regional dimension and contemplating existing or potential regional projects. The benefits and costs associated with a regional thrust need to be quantified. Harmonizing and modernizing regulatory frameworks and standards is as important as physical investment. In its catalytic role the Bank should identify projects and leverage funds for infrastructure improvements from the private sector and other sources. The regional perspective is vital in the transportation, telecommunications, and energy sectors particularly.

All the participants stand to benefit from transnational infrastructure projects, but the net benefits for any one country may not be commensurate with the costs. The Bank should take the lead and offer support via the IIRSA and PPP, which are addressing current issues and problems in areas such as short sea shipping, air transport, energy, communications, and border crossings. The following should be the focuses of Bank action in those and other spheres: coordination of sector regulatory standards, this being essential if physical investments are to serve their purpose; selection, evaluation and prioritization of transnational projects; design of financial structures and mechanisms for projects that can even out cost and benefit asymmetries between countries and promote explicit public-sector support (political and financial); mobilization of local and international capital markets; facilitation of private-sector participation in regional infrastructure expansion and modernization; proactive efforts to build in environmental criteria and regarding the positive local-development impact of infrastructure projects; collaboration with other regional institutions to deliver logistical, technical and financial support for collective processes; and support for consultations with civil society and the private sector and for involving those sectors.

INSTITUTION STRENGTHENING

The Bank should assist in the evaluation, strengthening, and rationalization of subregional and/or regional institutional frameworks to help advance integration processes and ease the transition toward free trade. It should continue to collaborate in strengthening national institutions that are the counterparts for integration processes, and in developing the corresponding career civil service areas. It is important that there be an institutional memory and a measure of stability in the national and regional cadres involved in regional or multilateral trade and integration initiatives. Sectors that are key focuses for institutional support, to which Bank activities can contribute significantly, are described below.

At the Country Level

The Bank will continue to support human resources training in individual countries to help develop the requisite pool of experts to manage regional and multilateral negotiation processes and implement and monitor the agreements achieved. Such training should instill a deeper understanding of the benefits and costs associated with commitments coming out of trade negotiations, to manage such undertakings in a socially efficient manner. Training in the development of interministerial coordination mechanisms and avenues for civil society consultations should be addressed as well. The private sector should be able to participate in the training programs provided its representatives help defray the costs of their participation.

Support for public management and national institution strengthening should include activities to equip such institutions to assess and propose policies to manage the adverse impacts of the free-trade transition on certain sectors, regions, or vulnerable populations. To improve integration's prospects of reducing poverty and inequality the Bank should be prepared to assist countries, on request, in developing and implementing policies to manage the free-trade transition which would equalize opportunities within and between participating countries and help them in achieving the MDG.

By way of modernization of the State programs the Bank has been supporting justice system reform and other initiatives intended to entrench the rule of law and strengthen democratic systems across the region. As the

Bank's new State modernization strategy emphasizes, such programs must address the need for convergence between LAC countries on this front, in order to further subregional, regional, and hemispheric integration processes.

Given trade's preeminent role in integration and liberalization processes and the importance of access to funding, the Bank will support country efforts to develop and improve the workings of financial institutions and products with a view to boosting trade. Particularly in the case of SMEs, given their impact on employment and inequality and their greater difficulties to obtain effective and efficient financial intermediation in development countries.

Bank-supported programs to help improve national customs administrations need to be adapted to the multiple demands of the various agreements and a complex web of tariff preferences and rules of origin. The Bank will support customs facilitation initiatives, promoting harmonization of procedures and standards to make for greater transparency and enhance competitiveness.

As economies become more integrated the role of taxation in corporate global strategies becomes more and more important, as do differences in legislation and tax administration (structures, bases, rates, compliance, due process, and treaties); ultimately these can cause economic distortions or encourage tax evasion or avoidance. Most tax systems in the region were structured for more closed economies, with stiff effective protection at their core. Now that economies are opening up, the Bank's modernization of the State activities should include support for countries to rewrite or adjust their tax systems to make them more trade- and foreign investment-friendly and align them with international agreements, rules and practices. Tax systems should avoid distortions that leave domestic producers at a disadvantage to foreign competitors. Likewise, internal revenue systems need to make sure there will be enough resources to make up for anticipated tariff-reduction losses, to produce the balanced budgets that are so vital for macroeconomic management. Other regulatory constraints should be addressed to help attract foreign direct investment.

At the Regional Level

One important benefit of building regional institutions is that they provide a framework for competitiveness improvements. Such institutions require a small team of skilled personnel and a predictable regional budget to defray their costs. Examples of institutions warranting special attention are those in charge of dispute resolution, contingent protection, technical secretariats, and institutions that support cooperation or coordination in key areas for trade and investment, such as technical standards—particularly health and phytosanitary standards—and competition policies.

In some cases, market solidification moves can proceed amidst less uncertainty thanks to the use of common external tariffs (CETs) and customs unions. However, creating and implementing either of these options requires complicated negotiations and careful designing, particularly when there are significant differences in the partners' economic weight. Moreover, some agreements require new collective institutional frameworks for customs matters. The Bank will, on request, put instruments at the countries' service to better equip them to design, negotiate, and implement arrangements of this kind.

The Bank will help further macroeconomic policy coordination through discussion forums and study papers and development of the mechanics for incorporating a regional dimension into country authorities' macroeconomic goals. These actions will expedite the creation and exchange of homogeneous, comparable data and the harmonization of policy measures and goals among national authorities and experts, and will make the countries involved more competitive. In particular, within the framework of integration processes the Bank should discourage the establishment of conflicting monetary, fiscal, or debt policies, or their sequencing, that would run counter to the member countries' shared integration goals.

The Bank will continue to fund seminars and studies to assess alternative approaches to tax policy harmonization that can help countries adjust to the needs created by heavier, freer trade and foreign investment flows in the subregions. A particular focus will be efforts to minimize the risk of "incentives wars" to attract foreign investment. Sector policy coordination to facilitate the development of production chains is another area requiring attention.

As a tool for empirical evaluations of integration processes and also as a way of deepening trade and macroeconomic coordination, it is vital that the Bank continue to help develop and maintain accessible, adequately disaggregated database systems that are cross-country consistent in key areas for integration. Priority focuses here are trade in goods, tariffs and tariff preferences, rules of origin, nontariff barriers, services trade, government procurement, foreign investment (particularly intraregional investment), macroeconomic indicators, and industry surveys.

The Bank should continue providing collective financial and technical support for FTAA negotiations and for the new FTAA Hemispheric Cooperation Program, under which national or regional action strategies are to be developed for training, implementation, and reforms to spur the free-trade transition, and a donors' forum is to be organized. The Bank also should be prepared to respond to requests involving other plurilateral North-South integration initiatives such as the Central America Free Trade Agreement with the USA (CAFTA). As for the multilateral system, the Bank should continue supporting the WTO courses.

The Bank should stand ready to support countries that wish to promote the use of collective compensation mechanisms to share the benefits of trade more evenly, fostering proactive measures to smooth potential imbalances between integrating countries. This is especially important in North-South agreements.

OTHER REGIONAL PUBLIC GOODS

As economies become more intertwined more avenues are opening up for enhanced cooperation, particularly for RPG in spheres that offer high returns to welfare, regardless of the fate of the regional agreements themselves. As a regional bank, the IDB has a natural leadership role to play in these efforts, by way of which it can maximize its impact. As it pursues this mission the Bank should help ensure balanced participation of all countries and their regions, seeking balanced outcomes. To that end it should evaluate and apply best practices in conceptualization, identification, prioritizing, sequencing, monitoring, and evaluation of regional cooperation. The core objectives of reducing poverty and inequality and achieving sustainable growth should be preeminent considerations as the Bank spearheads the generation of RPG. With those twin objectives in mind, the central action focuses are as follows.

The Bank will support the development and implementation of regional codes where such instruments would offer common benefits in areas with significant externalities (e.g., environmental, health, and phytosanitary standards). Capturing those externalities also can improve competitiveness. In some cases—environmental standards, for instance—such assistance can be channeled through technical support commissions[4] whose activities can enhance cooperation.

[4] NAFTA's Commission for Environmental Cooperation, for instance.

The Bank should continue supporting natural resources initiatives involving watersheds, biological corridors, etc. Two priorities here are biodiversity protection and careful stewardship of natural areas and fragile ecosystems that provide environmental services. Other areas warranting attention are coordinated regional action on migration issues, technology cooperation, disease control, and natural disaster prevention and mitigation.

Considering the financial stability of a region's countries as a RPG, the Bank should support collective, consensus-based efforts to improve the quality of regulation and oversight of banks and other financial intermediaries and of other financial activities and services such as the insurance and securities industries. Likewise, it should support the coordinated creation of institutional and regulatory frameworks that will help make more, better-quality information available to private agents, thereby enhancing the region's competitiveness.

Cooperation among LAC countries is important to be able to advocate for a better international financial architecture in the pertinent forums. The Bank should maintain close relations with organizations of regulators and oversight bodies in the region and should continue to support the Regional Finance Sector Forum to expedite discussion and analysis of financial issues, with a regional perspective, among policymakers from across the region.

The Bank should continue to support projects which promote integrated development of border regions, creating legal frameworks that will facilitate cooperation and enhance coordination of socioeconomic development of communities on either side of a border and helping to remedy shared problems in areas such as the environment, migration, sanitary controls, and health, to make these regions more competitive.

The Bank should continue its support for events that bring together senior officials from across the Americas to exchange ideas, share information about best practices and explore cooperation avenues. Of particular importance are forums that further political convergence programs, such as the Quebec summit and Rio Group gatherings. As for large-scale cooperation ventures like the hemispheric process and the agreement with Europe, it is important that the Bank prioritize its support among the numerous activities requested by governments, promoting those that have quantifiable, evaluable objectives.

The Bank should offer its offices to coordinate donor and recipient countries' regional integration and cooperation activity, working closely with the subregional development banks.

Collaboration with other subregional banks and bilateral donors in the creation of RPG.

OPTIONS FOR BANK SERVICES AND IMPLEMENTATION GUIDELINES

The Bank can bring its toolkit of financial and nonfinancial products to bear at both country and regional levels to implement the integration strategy set out here. Changes in the way these instruments are programmed and employed are being proposed in order to make optimum use of all of them. Implementation of this strategy will be closely interfaced and coordinated with other Bank institutional strategies.

FINANCIAL PRODUCTS

Regional technical cooperation (RTC). This is a key Bank instrument for supporting regional initiatives and providing incentives for innovative policy-making. As was noted in the previous chapter, the effectiveness of RTC has dropped sharply as a result of an abrupt reduction in the funds available. Since it is unlikely that funding availabilities will return to past levels, at least in the immediate future, it is important to come up with alternatives to supplement this vital instrument to further regional integration and cooperation processes. In these circumstances it makes sense to prioritize the use of these funds, to the extent possible, for programs supporting large-scale plurilateral, multipartner integration and cooperation initiatives like IIRSA, the PPP, the FTAA, the hemispheric summit process, and EU-LAC cooperation and trade initiatives. INTAL programs also merit this mode of funding because they specialize in training, including support for WTO courses and public forums for discussion, analysis, and information sharing on integration and trade, enabling the Bank to respond nimbly to modest TC requests.

Country lending. Given the dearth of RTC funding and the importance of integration for structural reform, it is more urgent than ever to add regional integration and trade support programs to country loan pipelines. There are abundant opportunities for institutional strengthening of national counterparts and for their follow-through on regional and multilateral commitments and implementation of national trade policies and institutions.

Special lending in support of trade and integration. The Trade Sector Facility should continue to operate and be given the resources needed to meet the heavy demand associated with the requirements of bilateral, subregional, hemispheric and multilateral agreements that are being negotiated (and will continue to be negotiated), which LAC countries should be implementing in the near future. However, because this Facility does not cover all facets of the sectoral adjustment demands triggered by integration processes, it is proposed that the Bank look at the implementation of integration sector loans, contemplating in such lending an integrated package of support components including preventive and corrective actions in a limited and delineated number of target areas that need to adapt in order to seize all the opportunities that come with integration. The starting point for adoption of these instruments could be a pilot program, taking care not to go into reforms envisaged in other programs already under way. The Bank's operational departments should head up this process, with INT, RES and SDS collaborating as needed.

Regional infrastructure lending. The Bank should explore the possibility of increasing incentives for regional infrastructure investment. Bank actions (including PRI activities) designed to facilitate private sector participation in integration infrastructure, particularly through concession arrangements, should be stepped up.

Multilateral Investment Fund (MIF). The MIF should play a more prominent role in supporting subregional, regional, interregional and multilateral initiatives. Greater use should be made of its trade and investment cluster, channeling this support through subregionally organized programs where there is a measure of similarity between problems, capacities, interests and challenges. Publicity about this cluster also can be improved to better explain all the activities that are eligible. The MIF can assist the private sector and labor unions to understand the obligations emanating from integration and trade agreements and help those sectors make governments aware of their interests and of the opportunities the negotiations afford. The MIF also can broaden its assistance to help prepare companies (especially small and mid-sized businesses) and labor markets for the adjustments, behavior changes and competitiveness improvements demanded by the sweeping liberalization processes born of North-South integration and the WTO agreements.

NONFINANCIAL PRODUCTS

The Bank has a wealth of experience and good credibility in the integration field, which it should place at the service of countries in the region.

The Regional Policy Dialogue has proven to be a valuable forum for senior policymakers to reflect, exchange views and explore cooperation avenues. Its action focuses should reflect country demands, manifested through their participation.

Policy-oriented research, publications, conferences and seminars are important vehicles whereby the Bank can foster and help chart integration and trade processes. One noteworthy development is the creation of research networks like REDINT and Euro-Latin Research Network for Integration and Trade.

The Special Integration Initiative with its three components (occasional policy papers with a wide circulation, written by eminent experts; support for trade liberalization impact assessments, and public education forums on integration and globalization) has had an appreciable impact on integration processes. Given the challenges that await LAC countries in the coming years, this initiative should be extended until at least 2004 to be able to satisfy the heavy demand that can be expected for upcoming negotiations.

The Bank should organize annual meetings of its experts with country and regional authorities from each subregion to discuss advances, issues, and the future direction of their integration schemes.

The Bank should continue to use its good offices to organize countries and donors for structured evaluation processes to assess trade capacity constraints, and donor coordination and information-sharing mechanisms in order to supply technical assistance needs more effectively. Examples of focuses for Bank involvement here are programs supporting the Central America Free Trade Area and collaborative efforts with the WTO secretariat.

Collaboration with the staff and programs of the subregional banks needs to be intensified. In the case of the Organization of Eastern Caribbean States, collaboration with the Caribbean Development Bank could be stepped up, disseminating studies and other Bank materials in these countries.

IMPLEMENTATION ACTIONS

Regional programming papers (RPs). As discussed earlier, the Bank should put its complete menu of financial and nonfinancial products at the service of regional integration and cooperation. The RP—the Bank's tool to help allocate these products—will continue to be coordinated by INT, the Bank department specializing in integration and trade, and will be co-authored by the respective Regional Operations Department. Representatives of SDS, the MIF, and other departments as needed will be members of the teams in charge of RPs.

The current RP practice of producing a strategy for each of the four major subregional agreements every four years will continue. These strategies will be updated by way of annual executive memoranda sent to the Board for information. The Bank would address the dynamic of nonmember countries in a subregion by incorporating them into the RP that is closest to their commercial or geopolitical interests. Thematic RPs (not confining their analysis to the geographic boundaries of a subregion) also will be produced as needed.

To better interface the Bank's programming processes and tap the full range of opportunities that a regional perspective affords, the RP should go beyond its traditional regional-action focus to include country chapters with a regional dimension. These chapters, prepared in concert with the Regional Operations Departments, will complement the RP's traditional regional approach and be inputs for country strategy development. As in the past, INT will help develop trade- and integration-relevant components of country strategies and will provide technical support to the Regional Operations Departments for the preparation and execution of projects with integration and trade content.

INT should provide the regional perspective currently lacking in country project preparation, participating as a Loan Committee member as it deems pertinent. To strengthen this regional focus the Regional Operations Departments should establish focal points for collaboration with INT in regional programming. INT, for its part, will request to its staff responsible for each one of the regional programming exercises to support Regional Operations Departments with country programming and projects that have a trade and integration dimension.

Action Plan

The proposed action plan for implementing the integration strategy can be summarized as follows.

Financial Products

- Prioritize RTC use for programs to support large-scale plurilateral, multipartner integration and cooperation initiatives such as the IIRSA, PPP, FTAA, the hemispheric summits process, and EU-LAC cooperation and trade initiatives, as well as INTAL activities and programs.
- Encourage countries to request more country loans for programs to support regional integration and trade.
- Increase the resources of the Trade Sector Facility to meet the demand, which will undoubtedly grow given the requirements of agreements currently on the table and others to be negotiated in future, and which LAC countries should be implementing in the near term.
- Explore the implementation of integration sector lending, contemplating an integrated set of support components including preventive and corrective actions in areas in need of adjustment in order to fully tap the opportunities the integration process affords.
- Given the externalities that are there to be captured the Bank should look into ways of enhancing its incentives for regional infrastructure investment.
- Improve the MIF's trade and investment cluster, which can be channeled via subregionally organized programs since

there is a measure of similarity between problems, capacities, interests and challenges.

- Use the MIF to help the private sector and labor unions understand the obligations emanating from integration and trade initiatives and to prepare companies (especially small and mid-sized businesses) and labor markets for the adjustments, behavior changes and demands for competitiveness improvements they will have to contend with as economies open up to the global marketplace.

Nonfinancial Products

- Continue supporting the Regional Policy Dialogue, which has proved to be a valuable forum for senior policymakers to share ideas and knowledge and explore cooperation avenues.
- Promote policy-oriented research, publications, conferences and seminars to foster and help chart integration and trade processes.
- Extend the Special Integration Initiative to at least 2004 to address the heavy demands that forthcoming negotiations will entail.
- Organize annual meetings of national and regional experts and officials from each subregion to discuss progress, issues, and the future course of their integration schemes, including the issue of labor mobility.
- Organize structured evaluations of trade capacity constraints and coordinate donor exchanges of information to respond more effectively to technical-assistance needs.
- Collaborate more closely with subregional banks' staff and programs.

The Project Cycle

- Produce regional programming papers (RPs) co-authored by the respective Regional Operations Department and with support from SDS and MIF representatives and other departments as needed.
- As is the current practice, produce a strategy for each of the four major subregional agreements every four years. Update the strategies by way of annual executive memoranda sent to the Board for information.
- As necessary, prepare thematic RPs, not limiting their analysis to any one subregion's geographic boundaries.
- In the RP include country chapters with a regional perspective, prepared in concert with the Regional Operations Departments.
- With support from INT, develop trade- and integration-relevant components of country strategies.
- Promote a regional focus in country-project preparation, with INT participating as a Loan Committee member.

MONITORING, EVALUATION, AND PERFORMANCE INDICATORS

This chapter proposes indicators that the Bank can use to gauge the achievement of objectives by virtue of the strategy's implementation. In principle, the strategy's application can be tracked and evaluated using indicators to measure outputs, outcomes, and impact. The former have more to do with direct Bank actions, in which the Bank can have a more rapid, obvious effect; the latter measure general welfare changes, which are affected by many other, more determinant variables. INT will coordinate its work with OVE to develop more specific indicators for the different support actions related to trade and integration proposed in this strategy. Those departments, together with SDS, will jointly develop other specific indicators for actions to support the creation of other RPG.

Output indicators: The following are the proposed indicators to measure progress in instituting the changes suggested by this strategy: number and volume of loan approvals relating to regional integration; number and volume of loan approvals under the Trade Sector Facility; number of country operations containing a regional component or thrust; number of TC operations supporting regional integration; number of nonfinancial products deployed in the integration field; number of evaluations and sector performance reviews. By 2004 there is to be a section on regional integration in the Bank's country strategies. The Bank also should refine its procedure for counting regional content in its funding operations.

Outcome indicators: Evaluating the Bank's integration support instruments will help redirect them to make this support more efficient and effective. These will be the typical indicators used in strategy implementation tracking instruments, i.e., evaluations of projects involving regional integration—by reference to project performance monitoring reports (PPMRs), reports from the Project Alert Identification System (PAIS), and project completion reports (PCRs)—and OVE evaluations of the various programming processes and their implementation, looking at their contribution to regional integration.

Impact indicators: Evaluating the impact of integration is no easy task, whether for the Bank or the academic community, and much hard work remains to be done in this field. Referencing the information available, calculations of the strategy's country-level effects could include indicators developed as part of the initiative to enhance the development effectiveness of Bank activities. Other indicators that could be used to evaluate Bank-supported integration processes in general are: lowering of trade barriers; composition, distribution and levels of trade and intraregional trade and commercial interdependence; participation of smaller economies; attraction of foreign investment, and indicators of macroeconomic convergence.

This strategy will be evaluated three years after its approval.

ANNEX

Areas of Action for the Bank and their Relation to the Sustainable Economic Growth and Poverty Reduction Strategies

Areas of Action	Relationship to the Sustainable Economic Growth Strategy	Relationship to the Poverty Reduction Strategy
A. Consolidation of Regional Markets	**Increased economic growth through increased trade from market expansion**	**Help ensure that the poor share in the benefits of regional trade**
Objective: Help advance the integration agenda by expanding market access, heightening economic and commercial interdependency.	*Objective:* Achieve sustainable increases in trade and economic activity.	*Objective:* Increase opportunities for economic inclusion.
• Evaluation of integration's costs and benefits	• Impact studies of trade agreements in different scenarios.	• Evaluation of agreements' impacts on the most disadvantaged sectors, regions, and populations.
• Consolidation of the regional market, dismantling barriers and promoting efficient customs unions	• Removal of tariff and non tariff barriers, including smoothing of regulatory asymmetries.	• Give the poor greater access to goods and services in the regional market.
• Strengthening of financial services integration processes	• Facilitate efficient trade in financial services, especially in the areas of financial intermediation, insurance, securities, and pensions.	• Enhance marginal populations' access to services.
• Opening up of extraregional markets and softening of protectionist obstacles	• Support for multilateral negotiations and the reduction of barriers to extra regional integration.	• Increase in employment opportunities.

Areas of Action	Relationship to the Sustainable Economic Growth Strategy	Relationship to the Poverty Reduction Strategy
B. Promotion of Regional Infrastructure	**Increase infrastructure as a way of boosting trade**	**Infrastructure investment in less developed areas**
Objective: Lessen regional and national infrastructure constraints that are holding back integration.	*Objective:* Remedy infrastructure limitations that could impede the trade flows needed for economic growth.	*Objective:* Have regional infrastructure expansion also benefit the poorest regions and marginalized groups.
• National infrastructure expansion with a regional development and social sustainability perspective	• Support for country infrastructure projects that promote development within a regional integration framework	• Support for infrastructure projects that benefit marginalized populations
• Intersubregional and hemispheric cooperation for regional infrastructure	• Support for creation of development hubs by virtue of regional infrastructure (e.g. IIRSA and PPP)	• Promotion of development hubs in poor areas

Areas of Action	Relationship to the Sustainable Economic Growth Strategy	Relationship to the Poverty Reduction Strategy
C. Institution Strengthening	**Strengthening the institutional apparatus for growth-driving integration agreements**	**Institutions equipped for negotiating and implementing balanced trade agreements that address economic-inclusion concerns**
Objective: Improve regional and national institutions and rules to help advance integration.	*Objective:* Create the requisite rules and institutions for workable, economically advantageous integration agreements.	*Objective:* Create frameworks that enable balanced integration, providing benefits for the poorest regions and marginalized groups.
• Capacity to negotiate and implement agreements, and to ensure adequate transition to free trade	• Strengthen institutions that implement and monitor agreements and manage the adverse impacts of the free-trade transition; training of negotiators; and creation of effective dispute resolution mechanisms.	• Build negotiating capacity that duly addresses social equity concerns, minimizes adverse impacts and adopts measures to balance trade effects.
• Financial institutions and instruments to promote trade	• Export credit agencies and facilities.	• Priority support for SMEs.
• Adequate customs and tax systems adapted for trade and foreign investment needs	• Modernization of procedures, harmonization of standards, time and transaction-cost reductions and adaptation of tax systems to enhance competitiveness and the investment climate.	• Ensuring that tax reforms do not harm the poor.
• Strengthening and rationalization of integration institutions	• Support for technical secretariats of integration agreements and their national counterpart bodies.	• Development of institutions for societal consensus-building that give a voice to the most disadvantaged sectors and protect their interests.
• Coordination of macro, tax and sector policies	• Exchange of information and harmonization of policy measures among the countries.	• Increased income stability and employment opportunities for the poor through policy coordination at the regional level.
• Collection, evaluation and dissemination of trade and integration data and information	• Expedite decision-making so viable, advantageous agreements can be achieved.	• Fostering of knowledge for decision-making that will benefit the poor and the vulnerable.
• North-South integration processes	• Collective support for initiatives like the FTAA and its Hemispheric Cooperation Program.	• Promoting creation of mechanisms to protect the poorest countries and regions.

Areas of Action	Relationship to the Sustainable Economic Growth Strategy	Relationship to the Poverty Reduction Strategy
D. Other Regional Public Goods	**Cooperation for the creation of regional public goods**	**Promote regional cooperation in public goods that will benefit the poor**
Objective: Maximize cooperation among LAC countries to produce public goods, independently of trade integration agreements.	*Objective:* Create regional public goods in areas that can spur economic activity and capture externalities.	*Objective:* Pursue actions whereby regional public goods can reduce poverty and inequality.
• Codes, common regulations, or consultation mechanisms in spheres involving regional public goods such as the environment and health	• Support for adoption of regional codes and rules that yield common benefits.	• Ensure that regional codes and rules benefit all the countries and improve the lives of the poorest and most vulnerable
• Protect biodiversity through regional actions	• Management of natural areas and fragile eco-systems at the regional level to achieve sustainable growth.	• Management of natural areas and fragile ecosystems the deterioration of the poor's natural capital.
• Integrated development of border zones	• Foster cooperation for the socioeconomic development of border zones communities.	• Support for border area development policies in depressed regions, benefiting the poor and the excluded.
• Fostering of financial stability as a regional public good	• Achieve of consensus-based improvements in financial regulation and supervision.	• Protection of savings and supply of credit, particularly for the poorest and most vulnerable.
• Dialogues for senior level officials	• High-level horizontal cooperation to promote economic development institutions and policies.	• Placement of poverty and inequality reduction issues on agendas.
• Other regional public goods	• Coordination of recipient and donor countries for regional public goods that support sustainable economic growth.	• Support for negotiation forums, mobilization of funding, and other mechanisms for regional public goods that can benefit the most disadvantaged populations.