Chapter IV

Regional Integration: Issues at Stake

A. INTRODUCTION

As crises affecting the global economy become increasingly more complex and intertwined, policymakers at all levels of the multilateral system are seeking solutions that would safeguard against future shocks and ameliorate existing inequities and asymmetries across the global economy. Global issues require a coordinated response, yet inclusive multilateral dialogue requires a high degree of trust among contracting parties that is difficult to attain in the context of global instability and growing geo-political tensions. Moreover, the existing multilateral institutions established at the end of the second World War have struggled to adapt to the challenges of the new millennium, including those posed by new types of economic and financial crises.

New institutions of collective action that rely on selective participation, such as the G20, have proved to be only a partial success. The talk of strengthening the global safety net increasingly appears to be at odds with the growing number of developing countries caught in a vicious circle of recuring external shocks, mounting economic distress, climate crises and deepening uncertainty. Meanwhile, financial and corporate control over markets has become more sophisticated, while multilateral regulatory approaches are weakened by political tensions, economic disparities and institutional rigidities.

As Part 1 of this Report has shown, this global landscape reduces the policy space available to all national governments, but the problem is especially acute for developing countries faced with a myriad of external shocks, internal challenges and scarce resources.

Regional integration – whether through market-driven processes or as government-led trade and economic agreements, or a mixture of both – has long been advanced as a building block towards more effective and inclusive solutions to problems of economic development, including trade, financial integration and governance. In the past 20 years, this idea received new impetus from the growing interest of many countries of the Global South in both intra- and cross-regional trade agreements.

The new phase of formal regionalism is paralleled by the greater role of South-South trade linkages in the structure of global trade, as well as a more prominent role of South-led developmental banks in financing regional development projects. But despite these shifts, key issues affecting development paths and exacerbating existing asymmetries – including the impact of financialised markets, corporate control and market concentration – often remain outside of the purview of formal regional integration initiatives. This disparity brings up three key issues that are likely to play a central role in determining future success of ongoing regionalisation efforts.

First is the issue of the gap between *formal regionalism* based on treaty signing, and developmental regionalism that prioritises long-term, strategic national and regional developmental aims centred around the structural transformation of economies and tied to an underlying framework of the developmental state (UNCTAD, 2016). Although the distinction between formal and developmental regional integration should not be taken as a rigid classification, it is particularly important in the context of the growing scale and scope of regional trade agreements spanning many sectors (so-called, "megaregionals"[1]), along with the retreat of the state from strategic economic management and coordination. This raises the question of whether the current phase of formal regionalism driven by a plethora of regional agreements and treaties has the capacity to deliver sustainable growth and economic resilience in the absence of an established framework of development states reflected in regional development models. Chapter 5 of this Report delves into this issue in depth, analysing recent trends in trade regionalism across industry and services, and comparing them with the record of successful developmental regionalism in Asia.

[1] Mega-regionals are deep integration partnerships between countries or regions with a major share of world trade and FDI. Beyond simply increasing trade links, the agreements aim to improve regulatory compatibility and provide a rules-based framework for ironing out differences in investment and business climates.

Second is the issue of *institutional resilience, adaptability and depth*. These qualities are pertinent to any type of institution-building for development, but are particularly relevant in the context of the financial challenges of a climate-constrained world. Using the case of development finance institutions, Chapter 6 analyses the main challenge for regional development banks (RDBs) in today's global context. Having evolved in parallel to the multilateral lending institutions and spurred further by the economic rise of large developing economies in the opening decade of the millennium, RDBs if better financed, as well as better coordinated in their policy priorities, can provide a larger and more strategic role in development cooperation. This will also allow these institutions to be able to foster resilience in the face of new type of external crises confronting the development work. Chapter 6 offers recommendations on how these institutions can best adapt to meet the needs of participating countries.

Third, despite recent shifts, the expansion of regional trading areas and new challenges of multilateral lending are vastly inefficient in the face of *structural asymmetries* in the global financial system and corporate architecture which threaten to undermine regional developmental initiatives and diminish the space for development policies. Chapter 7 of this Report investigates the effects on developing countries of the North-South divide in the financialised economy of MNEs. Financialization, understood as the growth and consolidation of financial and legal innovations driving corporate arbitrage globally, is closely linked to the decreasing ability of national and regional host authorities to manage the behaviour of global corporate groups investing in their regions, while the reorganization of global value chains has been paralleled by finance-driven patterns of rent extraction, where developing countries remain at a structural disadvantage.

This is an issue that is likely not only to define developing countries' success in attracting international firms but whether or not they can bend the activities of those firms to support local development needs. It raises the question of what measures can developing countries undertake, at national as well as regional levels, to improve the regulation of global corporatins, and regulate the phenomenon of corporate arbitrage that deprives national economies of financial revenues necessary for long-term stability and growth. This, as Chapter 7 of the Report shows, remains one of the steepest challenges confronting authorities across the global economy, and where regional forums are only beginning to tackle the problem.

B. REGIONALISM: CONCEPT, EVOLUTION, CHALLENGES

International trade theory has tended to view regionalisation efforts with alarm. In the economics literature, they are often associated with trade-diverting agreements that threaten the advantages of full utilisation of factors of production in an open global trading system. In reality, more fundamental forces, dating back centuries, have linked industrialization to regional development through the rise of intra-industry trade.

These dynamics tend to generate economies of agglomeration and open channels for mutual learning across political boundaries. Together, these forces can bring cumulative benefits that can help boost productivity growth, but also encourage a higher degree of market concentration over time that allows firms to further boost their profits. These accumulated advantages, in turn, spur domestic firms into doing business abroad but also introduce their own economic asymmetries and distortions. Once such forces are engaged, there is pressure from producers within the region to lower or remove the various barriers to intra-regional trade, including bureaucratic red tape, conflicting legal restrictions and administrative procedures, etc., as well as demands for better transport and communications

infrastructure. These various demands are likely to be accompanied by the creation of institutions for closer regional cooperation, a process typified by post-Second World War European development.

For many developing countries constrained by the limited size of their own domestic markets, closer economic ties with their neighbours have been seen as a possible route to establishing cumulative advantages for their own fledgling corporations. However, the record is an uneven one, with only East Asian economies exhibiting a more lasting process of growing successful regional ties and cooperation, including, most recently, with China's development model.

Politics inevitably plays a crucial role where governments are required to coordinate more closely with each other in some policy areas and to give up certain policy options and resources in others. This has often proved a major obstacle to a building regional integration particularly among countries in the early stages of economic development. There are signs, after a series of false starts and disappointments, that such integration is again gaining converts in parts of the developing world. Proposals to forge greater consistency with respect to trade and investment policies are back on the agenda in both Africa and Latin America.

In terms of the scope of regional arrangements, there is a familiar distinction between shallow and deep regionalism – defined by the normative reach of the agreement between members and the type of regulatory impact of the agreement. *Shallow* regionalism describes those Regional Trade Agreements (RTAs) that merely concern the removal of tariff barriers, including partial scope agreements. *Deep regionalism*, in contrast, means establishing far-reaching RTAs that go beyond trade liberalization, to include trade of services, investments, competition, and public procurement, whilst also taking on some features of a common market and focusing on regulatory issues (Kang 2016, p. 250).[2] Shallow regional integration is seen as enabling participating countries to retain policy space over key areas of the economy, while modern examples of deep regionalism are often seen as constraints on national governments' ability to form strategic approaches to economic growth, financial stability, debt sustainability, public health and environmental protection (Thrasher, 2021) .

Deep integration projects can arise as a response to processes already underway in the corporate sector, often triggered by earlier regionalisation schemes. Such projects are closely associated with the institutional foundations of a common market and are based on common regulatory measures in trade of services, investments, competition, and public procurement. The EU is the most obvious example of deep regional integration, while NAFTA, prescribing coordinated regulatory provision of investment and dispute mechanisms, is an example of deep North-South regional integration (Kang 2016). At the same time, as both Euromed and NAFTA are free trade areas (FTAs), the distinction between shallow and deep integration reveals that RTAs can be considerably different not only in terms of effectiveness and scope (Capaldo, 2014)[3], but also in terms of their impact on welfare.

For example, in the case of East Asia, deep regional integration has been driven on the one hand, by the development of micro-level regionalized linkages (regionalization), including through the continued expansion of international production networks and corresponding increases in intra-regional trade and investment, and the growing number of international economic agreements that have been signed among East Asian countries on a region-wide scale, especially after the region's 1997/98 financial crisis, on the other (Dent 2008).

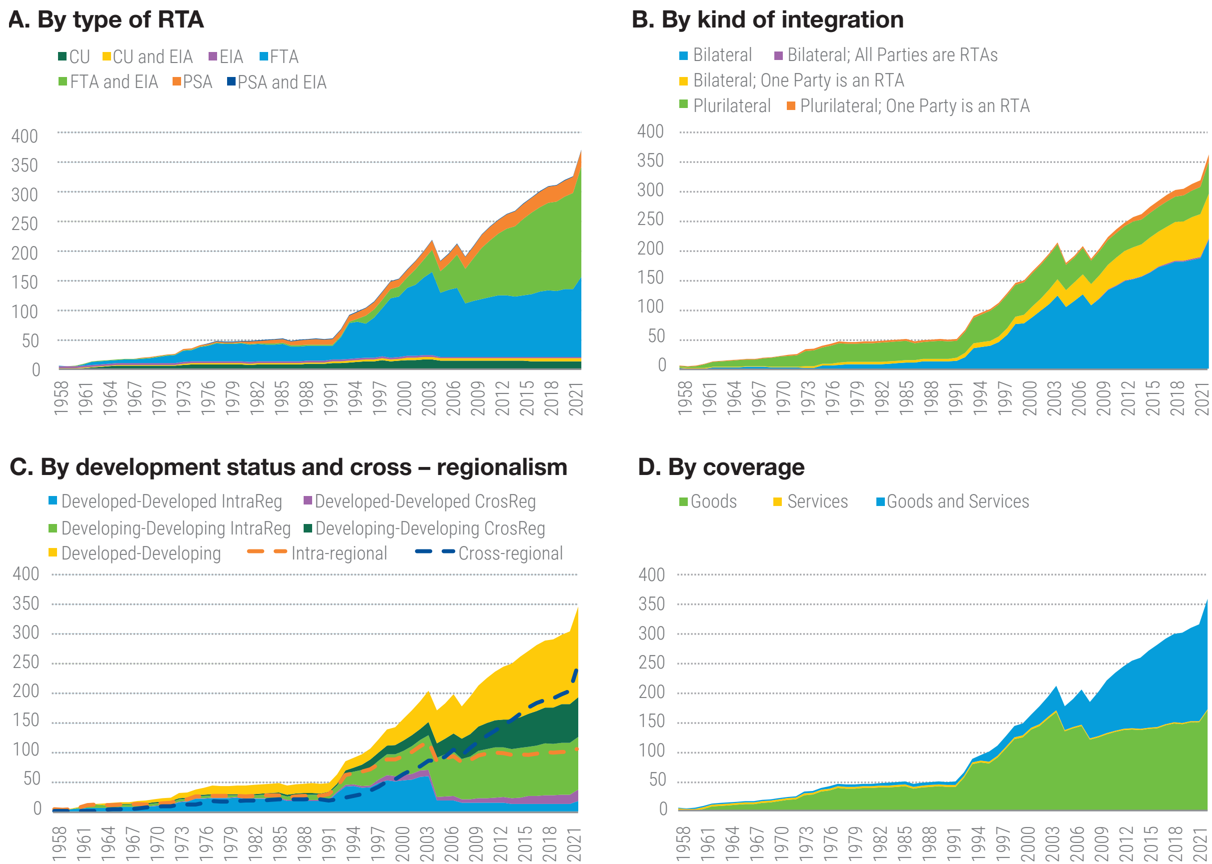
As survey of regional integration initiatives in the developing world shows (figure 4.1), that regional economic integration activity has been growing at both intra-regional and in particular, cross-regional levels (figure 4.1.C), with agreements covering good and services growing since 2007–08 (figure 4.1.D). For most areas of the global South, regional participation in RTA agreements increased manifold, with Free Trade Areas and Economic Integration Areas exhibiting particularly strong growth since

[2] Before the 1990s, most RTAs concluded between developing countries tended to be of a shallow integration nature (Kang, 2016).

[3] https://unctad.org/system/files/non-official-document/cimem5_2014_Capaldo.pdf

2007 (figure 4.1.A). Notably, these integration initiatives have increased at the level South-South and North-South cooperation, while North-North types of integration initiatives have been largely static (figure 4.1.C).

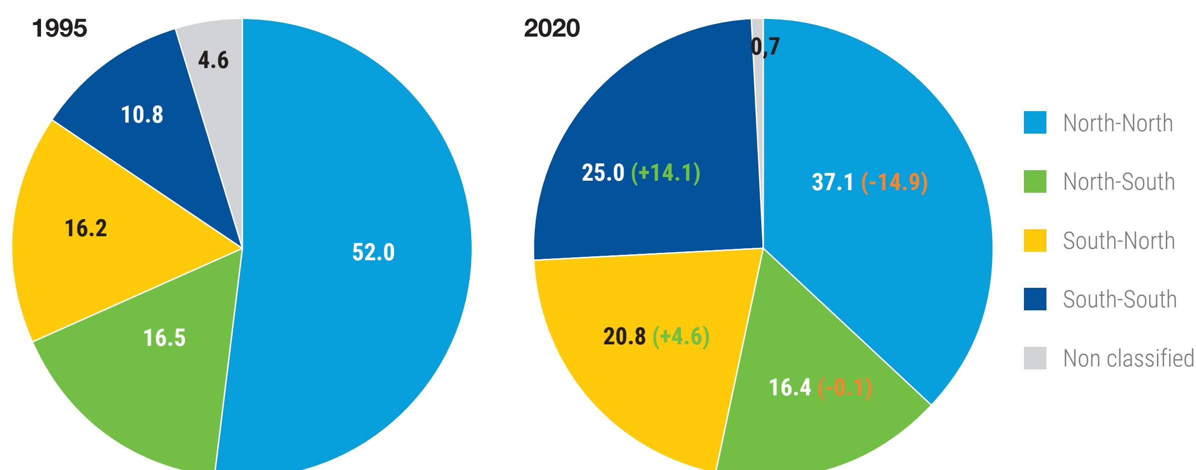
Figure 4.1 Regional trade agreements, by groups, 1958-2021



Source: UNCTAD secretariat calculations, based on Regional Trade Agreements Database, World Trade Organization
Note: Customs Union (CU); Free Trade Agreement (FTA); Partial Scope Agreement (PSA); Economic Integration Agreement (EIA).

Within this broad trend many new, sub-regional economic areas were formed, often centred on the underlying processes of regionalization and governance of a common resource. Their format varies from trade partnerships to customs unions and common currency areas, but as a whole, these projects parallel the expansion of South-South initiatives and trade flows, and are characterized by active South-South economic links. This shift is also reflected in the changed structure of international trade over the past 25 years, where the share of trade between the developed economies has declined by nearly 15%, having been superseded by the growth in North-South (+14.1%) and South-South (+4.6%) trade linkages (see figure 4.2).

Figure 4.2 Shares in global trade, 1995 and 2020



Source: UNCTAD secretariat calculations, based on UNCTADstat Database, Merchandise Trade Matrix.
Note: Imports are mirror figures as received exports.

C. DEVELOPMENTAL REGIONALISM: KEY CHALLENGES

1. Trade and Developmental Regionalism: Issues at stake

Chapter 5 focuses on regionalism in trade and discusses its role in pathways towards open developmental regionalism. This model is closely associated with shallow trade agreements that do not unduly reduce the policy space available to developing countries to manage the trade-offs that accompany any move towards closer integration with multiple countries. The strategies of open development regionalism allow participating countries to implement the collective actions that arise from closer cooperation and at the same time, to continue to support the broad range of goals of an inclusive and sustainable development strategy. The model aims, first and foremost, at boosting productivity growth and creating jobs through economic diversification and technological upgrading. But an open and pro-active regional trade governance could also shield developing economies from adverse global effects.

By itself, however, shallow regionalism cannot evolve into an institutional framework of open developmentalism. Not only can the many rules and regulations in existing bilateral, regional and multilateral agreements constrain the use of industrial and environmental policy, but trade regionalism centred on formal treaty signing can, itself, jeopardize a more inclusive multilateral trading system.

In terms of rulemaking, open developmental regionalism would limit binding commitments to border measures, whilst relying on cooperation and an adaptive policy mix that aims at regional harmonization of behind-the-border trade measures as, for example, in the ASEAN model. Supported by institutions of the developmental state and calibrated by cooperation in non-trade areas and regional regulatory frameworks that manage the interface between the global and regional economies, open developmental regionalism may thus also facilitate the management of the diverging interests and sensitivities of

developing and developed countries for a more inclusive and developmental international trade governance.

In this respect, closer trade integration among neighbouring countries, the advance of regional infrastructure projects, cooperation on industrial policies and shared legal frameworks can unleash virtuous growth cycles and mediate the interface between global economic forces and domestic needs. But the nature of competition, regulatory coordination and policy autonomy, are key to the inclusiveness and sustainability of regional developmental projects.

Progress calls for the full use of the principles of special and differential treatment and common but differentiated responsibilities. Without the application of these principles, it will be difficult for developing countries to transit towards diversified and higher value-added activities in a world facing widening inequality and growing ecological instability. This implies that developing countries will need to be engaged in multilateral trade governance whilst capitalizing on the advantages of open developmental regionalism in areas that do not lend themselves to trade rules, and/or where these countries do not yet have the capacity to engage in binding multilateral commitments. In those areas, open developmental regionalism can offer a bulwark against an increasingly challenging world order.

2. Institutional Adaptability: The Case of Regional Development Finance

Open regionalism requires a stable macroeconomic and financial environment that can support productive capital formation and job creation. Such an environment should include policies and institutions that foster the provision of long-term investment finance. The evolution of development finance institutions analysed in Chapter 6 presents a case of institutions that can adapt to and respond to the changing international landscape of risks, and, albeit to varying degrees, respond to policy priorities of national economies.

During the post-WWII period, Regional Development Banks (RDBs) have gone through three phases in terms of their place and function in the changing global landscape of international finance (see Table 4.1). As Chapter 6 points out, the current phase in the activity of regional development finance is marked by a discernible shift in the views on the role of these financial institutions. It includes a renewed attention to the ' role of developing banks in providing "patient capital" for long-term structural transformation, as well as counter-cyclical support in times of crises. Here, the lessons drawn by the developing countries from the 1997-98 Asian financial crisis have proved particularly pertinent: the meltdown of 1997 sparked a renewed interest particularly in Asian, but also more widely Southern-led, multilateral financial institutions (Barrowclough et al., 2021; *TDR*, 2015).

Table 4.1 Evolution of the system of multilateral development banks, 1944–2022

Year	Bank name	Region	Assets
WWII-1960s – Bretton Woods and the global view			
1944	World Bank	Global	263.8
1956	International Finance Corporation	Global	94.3
1950s-1980s – Regional development banks and regional integration for development			
1956	Council of Europe Development bank	Europe	25.7
1958	European Investment Bank	Europe	555.8
1959	Inter-American Development bank	LAC	129.5
1960	International Development Agency WBG	Global	184.6
1960	Banco Centroamericano de Integracion Economica	LAC	10.9
1963	International Bank for Economic Cooperation	Asia Pacific	0.4

Table 4.1 Evolution of the system of multilateral development banks, 1944–2022 *(cont.)*

Year	Bank name	Region	Assets
1964	African Development bank	Africa	13.1
1966	Asia Development bank	Asia Pacific	191.9
1967	East African Development Bank	Africa	0.4
1970	International Investment Bank	Inter-regional	1.3
1970	Banco de Desarrollo de América Latina	LAC	40.5
1970	Caribbean Development Bank	LAC	1.7
1973	Banque de Developpement des Etats de l'Afrique de l'Ouest	Africa	4.6
1973	Arab Bank for the Economic Development of Africa	MENA	4.9
1974	Fondo Financiero para el Desarrollo de la Cuenca del Plata	LAC	0.3
1974	Arab Fund for Social and Economic Development	MENA	12.2
1975	Nordic Investment Bank	Europe	34.9
1975	Banque de Développement des Etats d'Afrique Centrale	Africa	0.7
1975	Ecowas bank for Investment and Development	Africa	0.9
1976	OPEC Fund for International Development	MENA	7.4
1977	Fonds Africaine Guarantie et de Cooperation Economique	Africa	0.1
1977	International fund for Agricultural Development	Inter-regional	9.0
1985	Shelter Afrique		0.2
1985	Trade and Development bank	Africa	5.5
1989	Arab Trade Financing Programme	MENA	1.2
1989	Pacific Islands Development Bank	Asia Pacific	0.3
1989	Nordic Development Fund	Europe	0.9
1990s-2000s – Regionalism and market-led development, global vertical funds, trust funds hosted by MDBs			
1991	European Bank for Reconstruction and Development	Inter-regional	68.0
1993	African Export and Import bank	Africa	13.4
1993	Interstate Bank	Asia Pacific	0.2
1993	North American Development bank	LAC	2.0
1999	Islamic Co-op for the Development of the Private Sector	Inter-regional	3.1
1999	Black Sea Trade and Development bank	Europe	2.0
2005	Economic Coop. Organization Trade and Development	Asia Pacific	0.7
2006	Eurasian Development bank	Asia Pacific	3.7
2010 onwards – Regionalism and the rise of the South, the return of industrial policy			
2014	New Development bank	Inter-regional	10.4
2015	Banque Maghrébine d'investissement de Commerce Extérieur	MENA	0.3
2016	Asian Infrastructure Investment Bank	Asia Pacific	19.6

Source: UNCTAD calculations, derived from data drawn from the Data Visualization Index Agence Française de Développement ADF and Peking University, Institute of New Structural Economics; Ocampo and Ortega (2020); Clifton et al. (2021); Barrowclough et al. (2021) and bank websites.
Note: LAC stands for Latin America and the Caribbean; MENA for Middle East and North Africa

In terms of their scope and function, the RDBs continue to focus on their continent and region, and to pursue market-oriented lending. At the same time, there is more caution about the neoliberal approaches that rose to dominance during the 1980s, as a number of RDBs have rediscovered the merits of a more interventionist, developmental policy.

The renewed interest in the strategic role of development finance includes the use of industrial policy. Development banks have gone beyond simply correcting market failures or financial gap filling (as is so often the rationale for supporting infrastructure) and are more involved in more dynamic and catalytic functions of "market shaping" (Mazzucato and Penna, 2016) and strategic support (UNCTAD, 2016). They also increasingly finance international public goods, both global and regional, especially in the space of environmental sustainability or decarbonization (Marois 2021); including for example through the emergence of dedicated green public banks (*TDR* 2021, p.150; Marois, 2021).

In some areas, RDBs increasingly involve sub-national actors such as localgovernments – suggesting a somewhat different business model that goes beyond the geographical region for lending and towards more interventionist market shaping activities. One example is the EIB – which was originated as a sub-regional bank in Western Europe with a market-promoting function, and subsequently engaged in industrial policy through the European Commission's Investment Plan for Europe and European Fund for Strategic Investment. The EIB was strongly involved in the European pandemic response, both in terms of lending in general and in lending to R&D for a vaccine, in particular. Indeed, most RDBs played a central role during the Covid economic and health shocks; sometimes out-lending the global legacy DFIs such as the World Bank, especially at the start of the pandemic and associated lockdowns, or significantly co-lending, demonstrating speed and flexibility in responding to their members' needs (Griffith-Jones et al., 2022).

This experience of RDBs during the Covid crisis presents important lessons for other crisis scenarios that are likely to confront the developing countries in the climate-constrained world. These concern, for instance, decarbonisation and the shift to low-carbon or zero-carbon development path. The transition will require not only resources beyond the scope of individual national banks, but also, co-ordination and integrated responses across many countries. Hence after decades of being ignored, dismissed or attacked, DFIs are now seen as a vital component of the multilateral development system and the source of the long-term and reliable finance, provided on favourable terms, to support development. For example, a recent OECD report (OECD, 2020: 32) argues that MDBs are the pillar of the multilateral system, thanks to their unique capacity to leverage finances beyond their initial capitalization, as well as their extensive field presence and operational capacities (ibid: 34).

Chapter 6 examines these and other challenges facing the creation and functioning of regional financial institutions in supporting developmental regionalism. Despite their expansion over the years financing remains a key issue that needs to be addressed in regional development programmes. The capacity of these institutions and their role in regional economies remains constrained by precarious funding sources, leaving them vulnerable to the effects of international crises and uncertainty. It is clear that in order to be a viable part of developmental regionalism, RDBs need to be an integrated part of a regional financial system, including liquid capital markets, appropriate regulatory mechanisms, standard-setting bodies, as well as institutions supporting national currency markets and the financial safety net. For most of the regional blocs constructing such a system remains a challenge. To what extent new types of regional integration initiatives have the potential to overcome these and other hurdles to institution-building, is discussed in Chapter 6.

3. The Challenge of financialization and corporate control to regional integration

Previous TDRs have delved at some length into the macroeconomic and structural aspects of financialization and, in particular, analysed the gap between the continued expansion of the private credit system and financial asset markets, and investment-led growth pathways available to the developing countries (*TDR* 2016, 2017, 2019). Chapter 7 of this Report argues that an additional set of barriers to the developmental gains from regionalization comes from *the financialization of the corporation* itself.

More specifically, financialization, understood as the growth and consolidation of of financial and legal innovation driving corporate arbitrage globally, is closely linked to the decreasing ability of national and regional host authorities to control the behaviour of global corporate groups investing in their regions. At the same time, the reorganization of global value chains has been paralleled by finance-driven patterns of rent extraction, where developing countries remain at a structural disadvantage.

Chapter 7 analyses the consequences of this problem at several levels of global political economy where, the multiplication of regional agreements and investment treaties has contributed to the creation of a highly complex network of corporate and financial regulations. These, in turn, have been conducive to the rise of the "fragmented firm". Modern MNEs are organised as a network of entities held directly or indirectly by parent through equity ownership.

In the context of developmental gains from regional integration, this means that while regional trade and investment agreements may aim to encourage investment into the region, it is the way the investments are structured through corporate subsidiaries that determines the economic impact of the investment.

This is particularly pertinent to developing economies seeking to attract productive FDIs.

Typically, as Chapter 7 details, MNEs can (and do) structure their investments indirectly, through intermediaries, and ensure that considerable portion of operational activities take place outside of the host market of the developing country. The reason they may do so is because certain countries present them with a more accommodative regulatory environment, lower taxation, as well as other advantages. Due to statistical anomalies associated with financial and legal innovation at the corporate level, none of these outcomes are picked up in FDI statistics.

Chapter 7 of this Report argues that inner organisation of global corporations plays a key role for development outcomes and the gains a host country or region can attain from private international investment. The techniques of corporate arbitrage, enabled by financial and legal innovations, come into conflict with national governments, especially in the context of developing countries, where corporate groups effectively arbitrage national rules through access to investment treaties. The analysis reveals a North-South divide in the registration of value creation in the global economy, with corporate players mostly relying on the financial, accounting, and regulatory infrastructure offered to them by competition states (the Netherlands, Luxemburg, OFC islands). As a result, the majority of developing economies, despite their efforts, remain structurally disadvantaged in the global competition for capital.

In terms of the macroeconomy, earning stripping through the use of corporate subsidiaries affects the fiscal space of any host country. Advanced economies can potentially offset a significant part of the direct corporate tax revenue loss by collecting increased investor-level tax revenues on dividends, interest, and capital gains, which themselves tend to be boosted by higher rates of global corporate tax avoidance. Developing countries, in contrast, are generally unlikely to recover any significant revenues this way. They also face an additional disadvantage in the long-term: their cost of borrowing is higher than those of the advanced economies.

In the absence of a developed set of regulatory standards and a systemic framework of regulation, developing countries need to build the relevant financial, accounting, legal and data expertise, with a view of enhancing the visibility of corporate behaviour at the global level. Regional integration initiatives

have so far lagged behind in the reform of governance standards as a whole, and are yet to tackle this dimension of the financial, corporate and market governance in a systemic way.

Chapter 7 calls for reform measures aimed at tracing corporate tax arbitrage to be connected with closer policy attention to advancing FDI statistics. Similarly, corporate accountability measures in the developed countries need to take a closer look at the role and type of corporate subsidiaries and the nature of their *de facto* economic activity. The availability of reliable data on corporate financial behaviour, professional expertise and dedicated regulatory mandate at national levels, can play a key role here.

While some recent initiatives by international organizations do mark a major step towards global tax justice and corporate transparency, these efforts have so far been evolving in isolation fromeach other. A more integrated approach, aimed at comprehensive multilateral system of measures of corporate and financial regulation, is needed to address the financial-corporate nexus of economic asymmetries dividing developed and developing countries.

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