Chapter 2

Macroeconomic prospects for Latin America and the Caribbean

Latin America and the Caribbean (LAC) is undergoing a subdued recovery after a two-year recession. In the short term, growth paths vary from one country to another, reflecting differences in exposure to external shocks and soundness of domestic policy. In the medium term, potential growth is lower than expected and most of the region seems to be tangled in the middle-income trap, with low productivity growth at the heart of the problem. This chapter assesses LAC's growth prospects and explores the role that trade could play to increase productivity and ensure higher potential growth. In addition, it analyses the need for the region to continue to pursue openness and globalisation, with a special focus on regional integration.

Macroeconomic prospects for Latin America and the Caribbean

Better but not good enough

Slow growth

Potential annual growth rate is **lower than expected**, unlike the average rate that characterised **the mid-2000s**

Low labour productivity

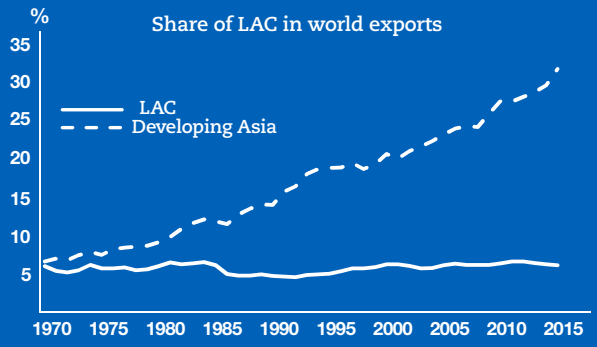
Low labour productivity in Latin America explains the **70% gap of GDP per capita** between LAC and the upper half of OECD economies

Middle-income trap

As Latin American countries reached middle-income levels, **growth exhibited a long-lasting slowdown,** known as **the middle-income trap (MIT)**

Trade can help boost productivity and increase potential output

The share of LAC in world exports **has stagnated since 1970,** unlike the performance of developing Asia



Tapping on the **unexploited potential of regional integration** is an effective policy response to the challenging global environment

The deterioration of the macroeconomic outlook in Latin America and the Caribbean (LAC) in recent years has already had an impact on living standards, as well on the prospects for socio-economic progress. It is thus emerging as one of the main drivers of citizens' discontent.

The slowdown that began in 2011 led to a two-year recession in 2015 and 2016, from which the region is currently emerging. Activity is expected to expand modestly in 2017 and continue to gain momentum in 2018. However, despite the decline of potential output, the output gap will remain in negative territory, highlighting the weakness of the recovery. The region will benefit from the mild improvement of global activity and the stabilisation of commodity prices, but policy uncertainty may dent investment. Furthermore, political uncertainty and the delay of large infrastructure projects will also contribute to tilt the balance of risks upwards.

It is still about "Americas Latinas" rather than "America Latina" in terms of cyclical positions and policy options. In general, activity in net commodity exporters in South America bottomed in 2016; in most countries, output gaps are closing. In particular, growth momentum will benefit from Argentina and Brazil coming out of recession. Agents are downgrading expectations for growth in Mexico and Central America, but growth will still outpace South American economies. The scope for demand policies to stimulate growth remains limited. The space for monetary policy is opening up for South America, but higher prices in Mexico and Central America may call for some tightening. Fiscal space remains constrained since most countries need further adjustments to stabilise debt.

In the medium term, the region's low productivity will hamper momentum for growth. Although cyclical factors are causing part of the slowdown, the main reason remains structural shortfalls: low productivity is at the heart of the problem. Furthermore, LAC has been unable to reap productivity gains from trade as it has not achieved diversification (both by partner and product), to increase participation in global value chains (GVC) or add more value to its exports and or integrate, both intraregionally and globally, owing in part to the complexities of the region's trade architecture (trade agreements, non-tariff measures, etc.).

All in all, this macroeconomic outlook suggests the need to undergo a series of institutional responses. The region needs to build the pillars of a growth model that can guarantee sustained socio-economic progress and thus improve well-being. This will in turn have an impact on citizens' prospects for advancement and strengthen the social contract in LAC. The institutional response must include actions to face short-term risks. However, it needs mainly to adopt institutional reforms to overcome the middle-income trap, underpin productivity growth and further exploit the potential benefits of deeper regional and global economic integration. This will necessitate a greater focus on policies to enhance the productivity-inclusiveness nexus.

To further analyse these issues, this chapter first examines the global context. It focuses on the economic outlook for key partners of the region, as well as the perspectives for global financial and commodity markets. An analysis of the short-term economic perspective for LAC will then highlight the heterogeneity among countries ("Americas Latinas") and the lack of policy space for demand policies (fiscal and monetary). Consequently, the chapter dwells on the medium and long-term perspective for the economies of the region, analysing the causes of low potential growth and the main policy areas to increase productivity and overcome the middle-income trap. Finally, and as in previous editions of the *Latin American Economic Outlook*,[1] the chapter focuses on a key policy area for the region. This year's edition analyses the potential gains from deeper and more effective regional and global trade integration as a channel to increase productivity as an engine for growth.

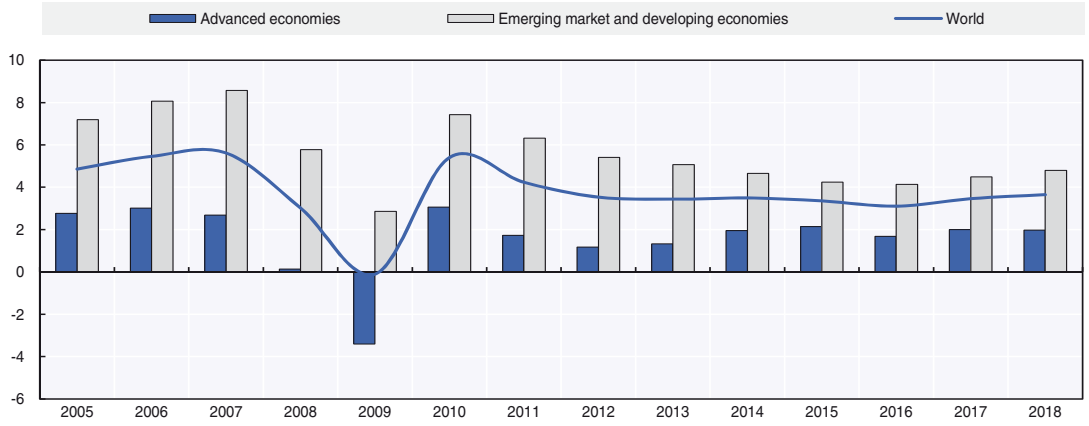
A subdued recovery in Latin America and the Caribbean with a brighter global context

A more positive global context

Global growth is expected to improve in 2017 and 2018 as the global economy recovers, supported by policy stimulus, solid progress in employment, a moderate upturn in investment and a pick-up in trade growth (IMF, 2017a; OECD, 2017a) (Figure 2.1). Activity in advanced economies will gain more traction, particularly in the United States (US), but also in the European Union and Japan. However, low productivity growth restrains a more robust recovery in the medium term. Emerging economies will pick up the pace as activity in the People's Republic of China (hereafter "China") stabilises and large commodity-dependent economies leave recessions behind (Russian Federation and Brazil) or accelerate (India).

Figure 2.1. **Economic growth outlook by groups of economies**

Annual growth percentage



Source: OECD/ECLAC/CAF based on IMF (2017a), *World Economic Outlook Database*, April 2017.
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Economic growth in the US is expected to accelerate in 2017 and 2018, despite policy uncertainty. Industrial production continues to strengthen, while the labour market tightens and wage growth accelerates. Expectations remain optimistic and investment should increase, especially in the mining sector. Inflation is nearing its target and the Federal Reserve will likely continue its progressive tightening cycle; the reduction of its balance sheet will soon be appropriate (OECD, 2017b). As the economy is close to its potential, further fiscal stimulus may prompt a faster monetary tightening cycle. This could induce volatility in financial markets.

Activity in European countries improved in 2016. It is expected to slightly pick up pace over the next two years, supported by a stronger global backdrop. Consumer confidence is on the rise and business indicators suggest further acceleration in economic growth in 2017. Unemployment rates are falling, but remain high in several countries and growth remains below potential. Investment prospects may be hit by political noise due to elections and the Brexit negotiations. Inflation will remain below target so the European Central Bank is expected to hold monetary stimulus in place at least until 2019.

Growth in Japan is expected to pick up in 2017, before slightly slowing in 2018. Growth in 2017 will be supported by stronger export growth, an expansionary fiscal stance and a recovery in consumption after the stagnation that followed the tax increase in 2014. The labour market is tight, which could improve wages. Industrial production is also improving as domestic demand recovers and external demand gathers momentum. Deflationary pressures have eased, but the Bank of Japan is likely to sustain monetary stimulus, particularly if efforts for fiscal consolidation advance. Growth is projected to slow down in 2018 as the fiscal stimulus fades and the downward trend in public investment resumes (OECD, 2017b).

China is expected to continue towards a soft landing. Activity picked up pace in 2016 thanks to monetary and fiscal stimuli. However, the reversal in credit growth to avoid financial instability will eventually soften the impulse of demand. Production indicators suggest that activity is no longer accelerating. The risks to growth are more medium term owing to lack of progress on the rebalancing process with loose credit, creating more industrial overcapacity and debt overhang. A continued inefficient allocation of resources would hamper potential growth. This, in turn, would elevate the risk of a disorderly financial unravelling in the medium term.

World trade will recover slightly in 2017, but remains less robust than in the pre-crisis decade. In 2016, world trade growth was particularly low at 2.4%, but is expected to pick up for 2017 and 2018 above 4% per year. This is below the historical average of 7% growth (IMF, 2017a; OECD, 2017a). Weak trade growth can be explained by changes in aggregate demand, structural developments such as a low growth in GVCs, a possible rise in non-tariff protectionism and the declining impact of financial deepening (IMF, 2017b; IRC, 2016). The pervasive low trade-growth rates and international trade elasticities to output growth indicate a "new normal" where the high growth rates of the pre-crisis were an exception (Martinez-Martin, 2016).

Financial markets are under strong uncertainty

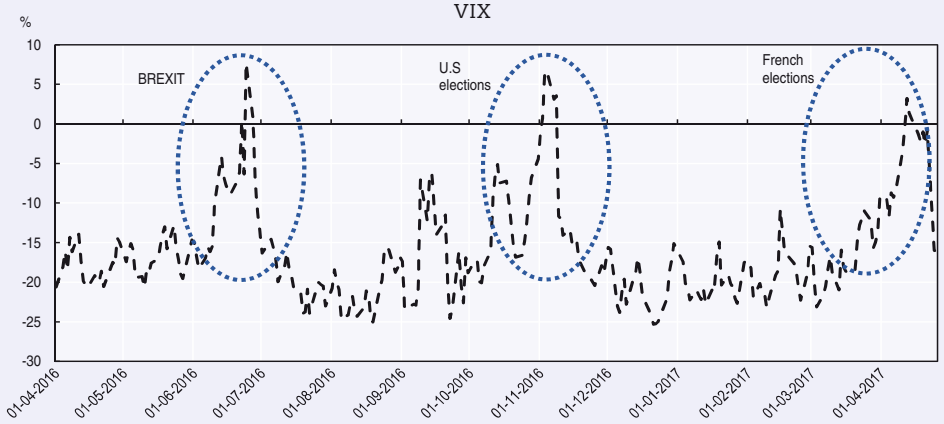
US policies regarding fiscal stimulus and trade are perhaps the largest sources of global uncertainty in the short term.

Financial volatility may surge around elections in Europe and Brexit negotiations (Box 2.1). Geopolitical risks – such as rising tensions in the Middle East – may also dampen investor sentiment towards emerging markets. China poses medium-term risks; potential growth may falter if Chinese authorities favour short-term output over the correction of imbalances (over capacity and increasing leverage).

Box 2.1. **The effect of financial volatility in Latin America**

Following the result of the US elections, stock markets in developed economies climbed on the prospects of a large fiscal stimulus in the US. However, investors have curbed their enthusiasm as the chances of significant changes in the tax code or infrastructure investment have decreased. Spikes in volatility around the political events also took place around the Brexit referendum and French elections (Figure 2.2).

Figure 2.2. **Volatility bouts: The new normal?**



Note: VIX refers to the Chicago Board Options Exchange Market Volatility Index.
Source: OECD/ECLAC/CAF based on the Institute of International Finance (IIF).
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Box 2.1. **The effect of financial volatility in Latin America** *(cont.)*

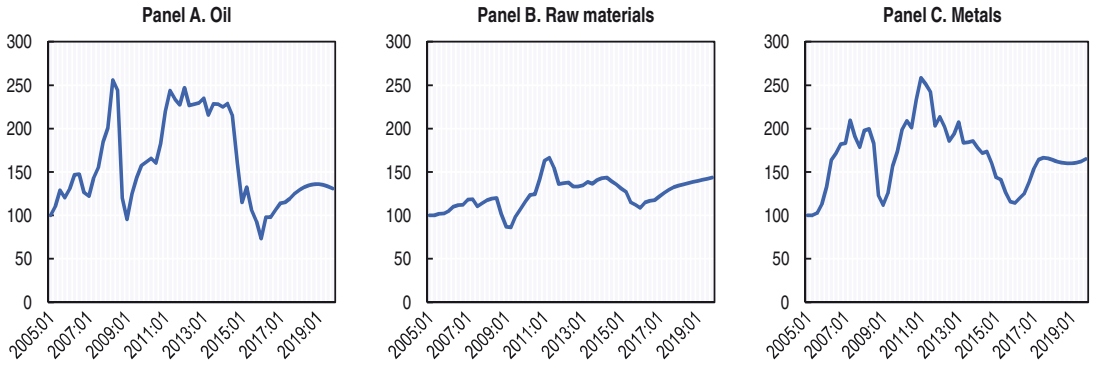
The effects of the events, however, have been short-lived. Markets recovered the losses after Brexit – perhaps the British pound being the only longer-lasting casualty. Even the Mexican peso, which plummeted more than 20% in a matter of hours following the US elections, returned almost fully back to pre-election levels. Likewise, these events have not derailed the ongoing recovery in developed and emerging markets. In fact, in spite of these spikes, volatility is at record lows. According to Gibbs et al. (2017), four factors may explain the apparent disconnect between political uncertainty and financial volatility. First, investors may be unable to adequately price unprecedented outcomes of political events. Therefore, a future correction may take place. Second, the mild recovery of the global economy entails that fundamentals are more supportive of financial assets. Given that the extent of the expected fiscal stimulus has diminished, any initial enthusiasm after the US elections has somewhat waned. Third, there is abundant liquidity in global markets. Central banks in advanced economies expanded their balance sheets and lowered interest rates to negative levels to stabilise global markets. So lower volatility should actually be expected. Fourth, a savings glut persists. Some countries with large current account surpluses are still investing in financial assets, while firms in developed markets have reduced capital expenditure in favour of savings.

In a context of low volatility and improving fundamentals, capital flows to emerging markets have been benign, quickly resuming after these political events. In Latin American economies with open capital markets, currency flexibility has also been a crucial shock-absorbing mechanism. Therefore, the shocks did not undermine momentum. Support for financial asset prices, however, should weaken as central banks increase interest rates and unwind quantitative easing (QE), and as external imbalances diminish. More volatility might be expected, particularly considering that valuations in developed markets may be high and thus prone to corrections.

Commodity markets will slightly recover

The baseline scenario for commodity markets is of a slight recovery in prices as global demand gathers pace (OECD, 2017a). Commodity prices recovered mildly in 2016 after the sharp decline of previous years (Figure 2.3). A moderate increase of oil prices is expected over the next two years, but with large uncertainty and below previous levels. On the one hand, the rapid response of non-conventional crude production in the US to price changes caps a price surge. On the other, the recovery of global demand should support prices. The important compliance of the Organization of the Petroleum Exporting Countries (OPEC) with the production agreement – over 90% in the first three months – should also support a price recovery. However, there is uncertainty regarding the compliance of the agreement, owing to political tensions between some member countries in the Middle East. The structural slowdown and rebalancing in China may weigh on prices for industrial metals. However, if a boost in infrastructure investment in the US materialises, prices may climb. In the case of agricultural commodities, prices are likely to remain stable. However, rebalancing efforts in China may push prices up, as consumption increases.

Figure 2.3. **Commodity prices outlook (2005=100)**



Source: OECD/ECLAC/CAF projections based on a GVAR.
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Latin America is undergoing a subdued recovery, with risks ahead

LAC is undergoing a subdued recovery after a protracted decline in economic activity. Following a two-year contraction, activity bottomed in 2016. It is expected to expand in 2017 and continue to recover towards 2018.

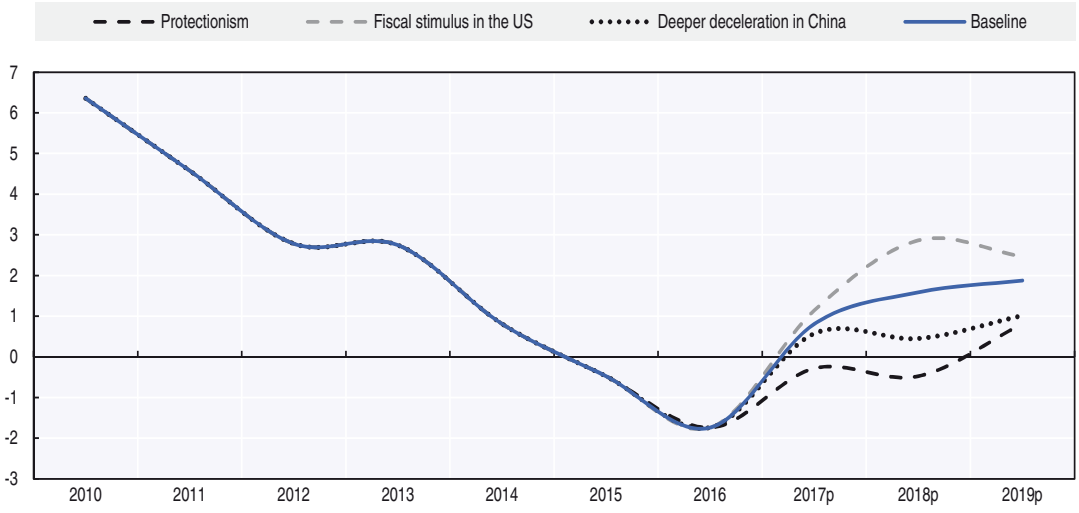
The region faces uncertainty stemming from external factors that could derail growth. Policy uncertainty in the US is perhaps the most relevant external source of risk that LAC faces in the short term. The US plays a key role in the global and regional economy because of its size and multiple linkages. First, it is the single largest importer in the world, accounting for one-fifth of global purchases. Exposure to developments in the US is also uneven across countries in the region. Mexico, Colombia, Ecuador and Central American countries have the largest trade exposures to the US among LAC countries. Second, the US is also the largest source and recipient of foreign direct investment (FDI) flows. This leaves Mexico, Costa Rica, Chile and Brazil as the most vulnerable to changes in the volume of these flows. The US also accounts for the largest share of emerging markets' portfolio assets. Changes in monetary policy could become important sources of changes in the direction of capital inflows. This is particularly true in countries that partially rely on these flows to fund current account deficits, such as Colombia, Panama and some Central American countries. It could also have implications for fiscal sustainability in some highly indebted countries in the Caribbean with a large fraction of foreign currency debt. Third, the US is still a key producer and consumer of commodities, in spite of the gains China and India have made in these markets. In consequence, business cycles in advanced economies and emerging markets tend to be synchronised with the US. At the same time, growth, financial and policy shocks in the country have sizable spillovers on the global economy and thus in Latin America (Kose et al., 2017). More recently, cycles in Mexico and Central American countries exhibit a larger co-movement with the US cycle than South American countries, which have become more exposed to China (Izquierdo and Talvi, 2011). Similarly, a larger than expected deceleration in China would represent an important setback for recovery in LAC. Resource misallocation and debt overhang entail medium-term risks for productivity and growth in China, which should not be neglected. However, the risks of a hard landing in China in the short term have somewhat dissipated as policy stimulus helped stabilise activity.

To illustrate the possible impact of policy changes in the US and a deeper than expected deceleration in China, three alternative scenarios are modelled under a Global VAR model. In the first scenario, a surge in US growth due to a large fiscal stimulus

continues for two years. It entails personal and corporate tax cuts, as well as spending in public infrastructure investment. Growth gradually comes down as monetary policy in the US tightens faster than expected to curb inflationary pressures. This is an upside for global growth and the region benefits from trade and commodity links. While all countries gain from stronger activity in the US, Mexico is the largest beneficiary. In the second scenario, the fiscal stimulus in the US is muted by a more protectionist stance, targeting Mexico and China. The global implications of this scenario are negative, particularly since activity takes a toll on China, but also on Europe. The region would be strongly impacted over the next two years through the impact of protectionism in Mexico. Further, the pervasive slump caused by protectionism in China would particularly hit industrial metal exporters in South America (Brazil, Peru and Chile). The third and final scenario is a stronger than expected deceleration in China. This exercise highlights the region's sensitivity to activity in China through trade and commodity prices. This is particularly the case for net commodity exporters in South America, since the exposure of Central American and Caribbean economies to China is more limited (Figure 2.4).[2]

Figure 2.4. **GDP growth in Latin American economies under alternative scenarios: Fiscal stimulus in the United States, an increase in protectionism and a deeper than expected deceleration in China**

Annual percentage



Notes: Weighted average for Argentina, Brazil, Chile, Colombia, Mexico, Peru, Uruguay and Venezuela. The fiscal stimulus scenario is operationalised by a surge in GDP growth in the US compared to our baseline scenario. Oxford Economics US GDP growth projections for a similar scenario, entailing a USD 1 trillion cut in personal and corporate taxes and USD 250 billion in public infrastructure investment. Growth picks up to 2.2% in 2017 (from a baseline of 1.8%) and to 3.3% in 2018 (from a baseline of 2%). It diminishes progressively to 2% by 2021. We adjust the resulting growth acceleration to our baseline scenario. For the protectionist scenario, we assume targeted measures by the US against Mexico and China. These measures are operationalised by a one-off 20% currency depreciation in Mexico and in China against the US dollar by Q3 2017. Exchange rate levels change with respect to the baseline for the simulation period, but the rate of variation stabilises. For the scenario of deeper deceleration in China we assume that growth diminishes from 6% to 4.5% between 2017 and 2021.

Source: OECD/CAF/ECLAC simulations based on a Global Bayesian VAR model.

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There are also important domestic risks to the downside. In particular, delays in the execution of infrastructure projects (mostly in Peru, Panama, Argentina, Colombia and Costa Rica) will undermine investment and dent growth (Box 2.2). Expectations may also be affected by volatility due to upcoming elections, political noise and corruption scandals.

Box 2.2. **The Odebrecht case and its regional impact**

Odebrecht, the largest engineering and construction company in Latin America, has been involved in corruption scandals with public authorities in more than ten Latin American countries.

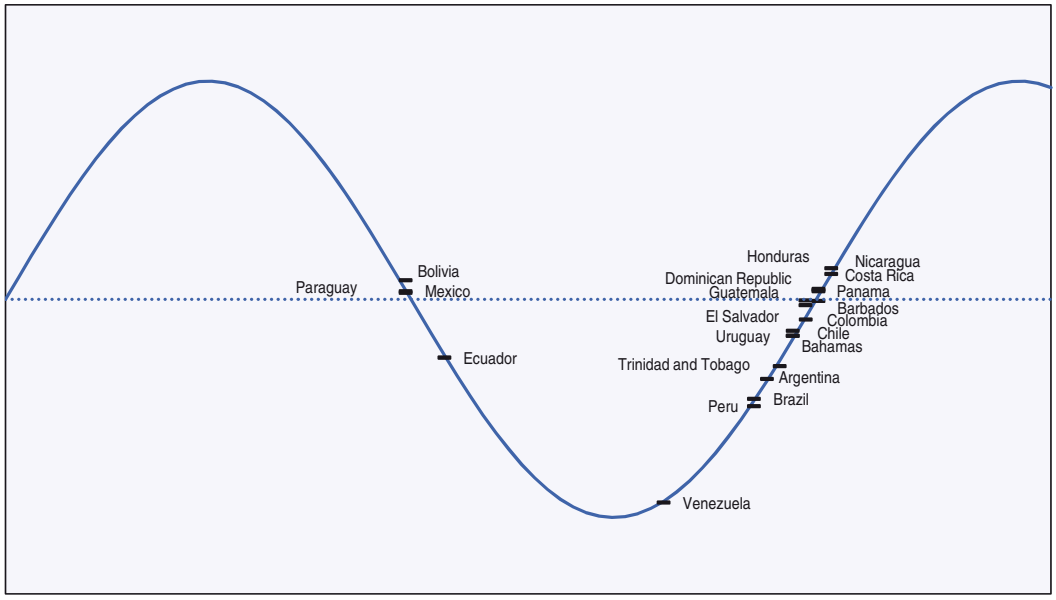
These corruption scandals, apart from the impact on Odebrecht itself, have caused the delay of infrastructure investment in LAC. To some extent, substitutes for the company are not abundant in the market in the short term. The company will only be able to bid for public tenders in Brazil (and probably worldwide) after cancelling the fines for over USD 2 billion, undergoing management restructuring and adherence to strict anti-corruption mechanisms. This could take some time, hampering the prospects of timely completion of projects.

Many infrastructure projects of the Brazilian conglomerate are now paralysed, at the request of justices, to review the conditions in which they were tendered. Companies associated with Odebrecht face costs to their reputations, generating a capital crunch, especially in Brazil, that threatens the short-term dynamics of investment in infrastructure. Outside Brazil, the more serious repercussions so far are in Peru, Colombia and Panama. According to Moody's, the potential cancellation of the Chan II hydroelectric project in Panama may cost 0.5 percentage point of growth this year. In Colombia, delays in the Ruta del Sol road corridor and in the Rio Magdalena navigation projects may keep growth under 3% over the next two years. In Peru, the paralysis of the Gaseducto del Sur energy project, among others, downgraded growth by almost 1 percentage point this year.

This unfortunate episode compromises business integration, highlighting the pervasive corruption and institutional weakness in the region. Latin American institutions face the great challenge of a timely and competent resolution of this scandal through justice. Lessons learned from the anti-corruption operation in Brazil, the so-called Lava Jato Operation, should help configure stronger institutions that allow a more transparent and efficient management of infrastructure projects and foster regional co-operation.

The region shows an important heterogeneity that needs to be factored in and can be illustrated in the cyclical position of countries placed within a stylised economic cycle (Figure 2.5). This reflects the differences across countries in exposure to the external backdrop, as well as the soundness of the domestic policy framework. Commodity exporters in South America are on a recovery phase, benefiting from recent gains in commodity prices and the decline of inflation. Brazil and Argentina will emerge from recession, but no large rebound is expected, particularly in Brazil. Growth in Andean countries will advance over the next two years as the adjustment to the commodity shock progresses. Activity may be dented by weaker than expected investment as large infrastructure plans lag behind, with greater risks in Peru, Panama, Colombia (delays in some project financing agreements for 4G projects) and Argentina. Only the Bolivarian Republic of Venezuela (hereafter "Venezuela") is expected to remain in recession. Mexico and Central America, on the other hand, will struggle more amid policy uncertainty in the US, but still outperform South American economies. Activity in Mexico, particularly investment and consumption, will be mostly affected by uncertainty due to rising inflation and increasing interest rates. Although the protectionist rhetoric against Mexico has softened, uncertainty is still denting a stronger performance. The Caribbean will experience a passive recovery after the 2016 contraction. In spite of the recovery of net commodity exporters in South America, most countries maintain negative output gaps, highlighting the frailty of recovery. This is even taking into account lower potential output growth (OECD/CAF/ECLAC, 2016).

Figure 2.5. **An illustration of the cyclical position of selected Latin American and Caribbean economies**



Note: The output gap is calculated for 2016 and its projected evolution. The output gap is calculated as a deviation from trend using Hodrick-Prescott (HP) filter (lambda=6.25).

Source: OECD/CAF/ECLAC based on IMF (2017a), *World Economic Outlook Database*, April 2017, OECD (2017b), *OECD Economic Outlook*, Vol. 2017/1, OECD Publishing, Paris for Argentina, Brazil, Chile, Colombia, Costa Rica and Mexico and OECD (2017c), OECD *Multidimensional Economic Survey on Argentina*, OECD Publishing, Paris for Argentina.

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External adjustment continues

Current account deficits keep narrowing and remain mainly financed by FDI. In 2016, current account correction was largely via import compression and to some extent substitution by domestic producers rather than to increasing exports. Lacklustre export dynamics reflect a weaker currency depreciation in real effective terms than the one depicted by depreciation against the US dollar (Powell, 2017). For 2017, exports are expected to aid the forecasted current account correction as they are showing signs of recovery (Figure 2.7). The use of flexible exchange rates has become widespread in the region. It has been useful as a first line of defence against adverse external shocks. Real depreciation has led to a small boost in exports (Box 2.3) and a strong reduction in imports, with demand shifting towards local goods (IMF, 2017c). Exchange rates may continue to cede ground as the dollar strengthens, but the recovery in commodity prices should contain further losses in South America, while the Mexican peso will continue under pressure. Current account deficits remain largely financed by FDI, although for the last three years FDI inflows have continuously decreased.

Box 2.3. **The trade impact of exchange rate depreciations**

In Latin America, real currency depreciations continue to exert a positive effect on exports. Trade increasingly takes place in the context of value chains, and the share of foreign content in exports rises. With this in mind, research has suggested the positive impact of real exchange rate depreciations on export performance has declined or ceased (Ahmed, Appendino and Ruta, 2015; Leigh et al., 2015). This is not the case in Latin America. Estimates for the period between 2003 and 2015 show the real exchange

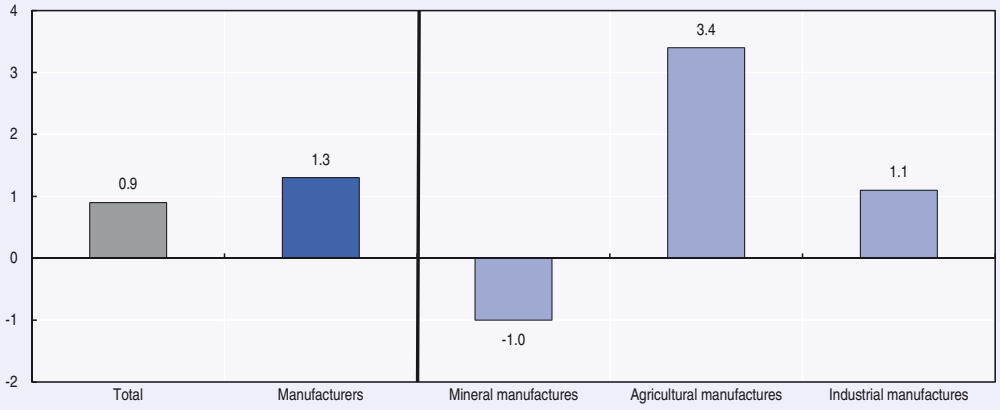
Box 2.3. **The trade impact of exchange rate depreciations** *(cont.)*

rate elasticity of exports remains economically and statistically significant, although it has indeed diminished in recent years (Giordano, 2016). Similarly, Latin America is less responsive to real depreciations than advanced economies or emerging Asia (IMF, 2017c). Furthermore, it is not only the level of the real exchange rate that has an impact on export performance; its volatility was also found to exert a negative effect on some exports.

The responsiveness to real depreciations and its magnitude varies across product category and trade partner. Manufactures are particularly responsive to real depreciations (Figure 2.6). During the period under analysis, a real depreciation of 1% generated an average increase of 1.3% in exports of manufactures compared with 0.9% in total exports. The effect is nonetheless heterogeneous across sub-categories: exports of agricultural and industrial manufactures increased 3.4% and 1.1%, respectively, while exports of mineral manufactures were negatively affected (1.0%)[3] (Giordano, 2016).

Figure 2.6. **Elasticity of Latin American exports to the real exchange rate by product category**

Estimated coefficients, 2003-15



Notes: The reported coefficients are statistically significant at the 1% level.

Source: IDB Integration and Trade Sector, with data from INTrade/DataINTAL, IMF and national sources.

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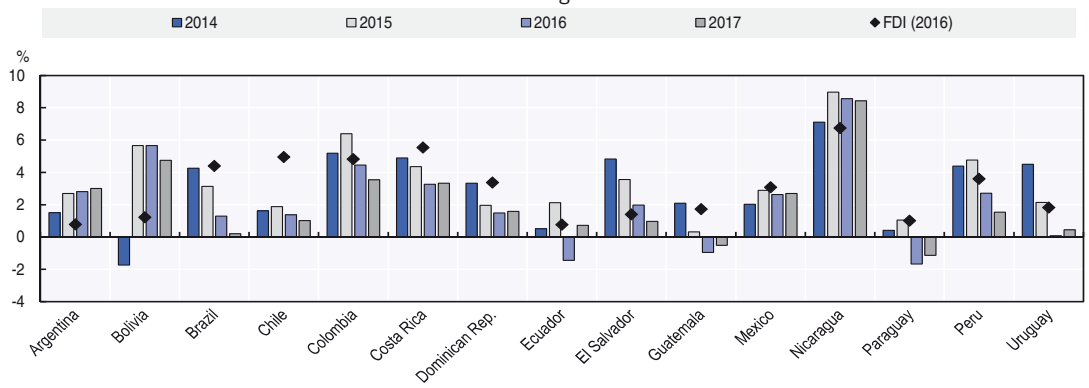
The elasticity of exports to real depreciations could also enhance intra-regional trade. In the observed years, a real depreciation of 1% translated into an average increase of 0.5% for total intra-regional exports compared to a statistically insignificant impact on extra-regional ones. Similarly, a real depreciation of 1% caused an average increase of 0.9% in exports of intra-regional manufactures compared with an impact of 0.6% in those directed to extra-regional partners. All of these effects have nonetheless been diminishing over the years. Between 2003-08 and 2009-15, for example, elasticity of exports fell from 3% to 1% for manufacturing exports. The same trend was observed in intra-regional trade: a real depreciation of 1% led total exports to increase by 3% (2003-08). Conversely, between 2009 and 2015 the effect of depreciation on total exports fell to 0.4%.

Despite the decline over time, the effect of real depreciations on Latin American exports continues to be mostly positive and significant, especially in intra-regional trade. Real exchange rate volatility was found to also negatively impact competitiveness, particularly by tampering with the exports of manufactures (Giordano, 2016).[4] These findings are particularly relevant because over the last two years, as a consequence of a regional terms-of-trade shock, exchange rates have experienced significant realignments. This has major implications for intra- and extra-regional trade flows.

Figure 2.7. **Current account deficits and foreign direct investment in Latin America**

Percentage of GDP



Source: OECD/CAF/ECLAC based on IMF (2017a), *World Economic Outlook database*, OECD (2017a), *OECD Economic Outlook*, Volume 2017/1, OECD Publishing, Paris for Brazil, Chile, Colombia, Costa Rica and Mexico, OECD (2017c), *OECD Multidimensional Economic Survey on Argentina*, OECD Publishing, Paris and ECLAC (2017a), *Foreign Direct Investment in Latin America and the Caribbean 2017*, Economic Commission for Latin America and the Caribbean, Santiago.

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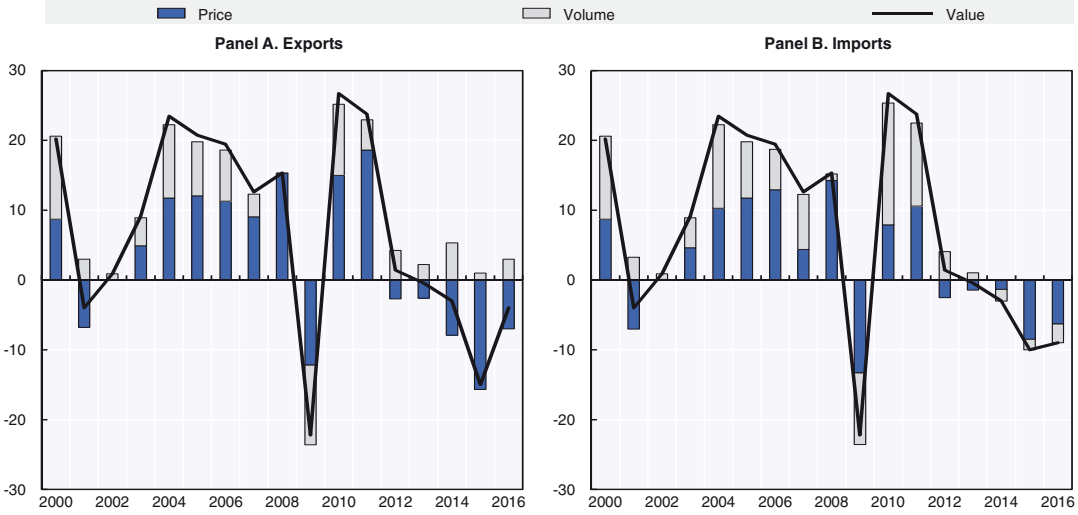
The region has experienced four consecutive years of declining export and import values. The value of the region's merchandise exports fell by 4% in 2016. A breakdown of this contraction reveals a 7% drop in prices and a 3% increase in volume (Figure 2.8). However, the contraction in 2016 was much smaller than the one in 2015 (-15%). Exports dynamics were uneven across the region. While the value of Mexico's exports contracted by 1.8% in 2016, the rest of the countries experienced an average decline of 5.6%. This decline reflected lower commodity demand from Asia, a further decline in prices and the dramatic decline of intra-regional trade in South America. Imports value decreased by 9% in 2016, a similar drop to that registered in 2015 (-10%). Unlike exports, however, imports are not yet showing signs of recovery. Furthermore, while Mexican imports contracted by 1.9% in 2016, the rest of the region's imports fell much more (-14.5%). This drastic decline reflects mostly the second year of recession in South America, with Brazilian imports falling almost by 20% in value in 2016.

Figure 2.8. **Annual variation in goods trade by volume, price and value in Latin America and the Caribbean**

Percentages



Source: OECD/ECLAC/CAF on the basis of official information from LAC countries.

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For 2017, the region's trade is already showing signs of recovery. In the first quarter, exports and imports expanded by 15% and 10%, respectively. These high rates are partially explained by the low base of comparison. In the case of exports, this improvement is mainly explained by the slight recovery in commodity prices. The recovery mainly benefited South American economies, although Mexico and Central America also improved (Giordano, Ramos and Michalczewsky, 2017).

FDI inflows towards Latin America have been decreasing for the last three years, and 2017 will likely continue the pattern. In 2016, FDI inflows decreased by about 7%, reaching USD 168 billion (ECLAC, 2017a). For 2017, FDI flows towards Latin America are forecast to decrease for the fourth year running. Investment in extractive industries will be restrained as prices remain low. Meanwhile, uncertainties about US economic policies could also hold back investments in LAC. Renegotiation of the North American Free Trade Agreement (NAFTA) or potential tax reforms in the US could have important consequences on investments in the region. Despite this trend, LAC countries have a relatively higher ratio of FDI income relative to their gross domestic product (GDP) compared with the rest of the world. The FDI flows received in the region accounted for 3.6% of GDP in 2016 (ECLAC, 2017a), while the global average was 2.3% (UNCTAD, 2017).

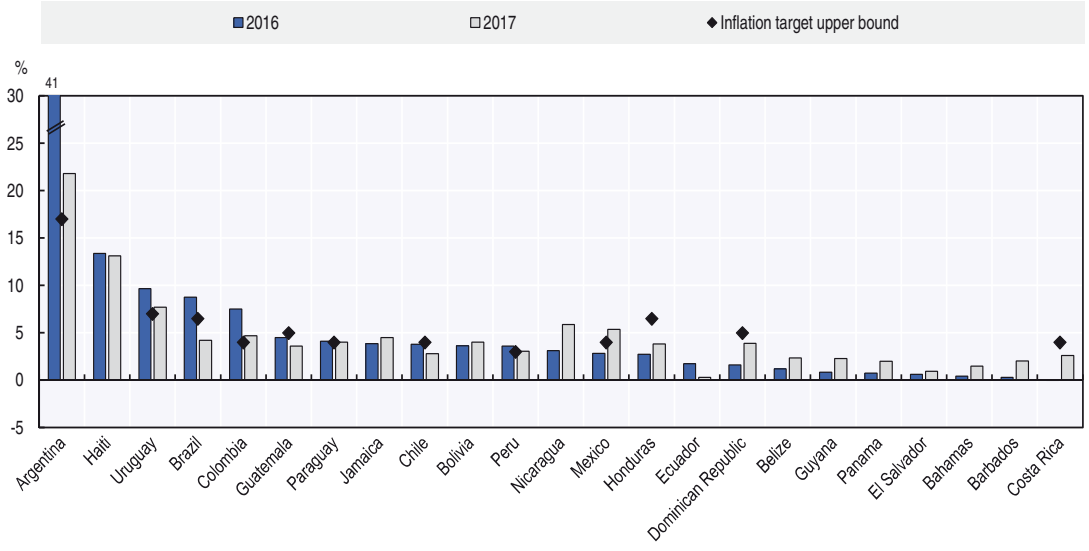
FDI inflows at the country level are highly heterogeneous in Latin America thanks to global- and country-specific factors. South America is facing an important decrease in investment (-8.1%). Only three countries – Brazil, Colombia and Paraguay – registered a growth in FDI inflows. In Brazil, FDI increased by 5.7% to reach USD 78.9 billon. In Colombia, the privatisation of the energy company Isagén for USD 2 billion largely explains the 15.9% increase in FDI. In contrast, countries such as Argentina, the Plurinational State of Bolivia (hereafter "Bolivia"), Chile, Ecuador, Peru and Uruguay faced an important decrease in FDI inflows. In Chile, for example, FDI fell for the second consecutive year; with a drop of 40.3%, to USD 12 225 million, it reached the lowest value of the last ten years. This performance can mainly be explained by a fall in loans between companies, which are one of the most volatile components of FDI. In Mexico, despite a 7.9% decrease compared with the 2015 level, FDI inflows remained at a record high, reaching USD 32 113 million in 2016. After Brazil, Mexico is the second most important market for foreign capital in the region. Mexico also has a unique feature within the region: between 1999 and 2016, 49% of FDI was concentrated in manufacturing. In 2016, this figure reached 61%. The automotive industry is Mexico's most attractive sector, attracting 19% of FDI in 2016. Central America registered a growth in FDI (3.7%). The increase in investments in the two main recipients of the sub-region, Panama and Costa Rica, compensated for the drop in FDI in all other Central American countries. The Caribbean sub-region also saw an increase in total FDI (4.1%), largely explained by the continuous positive trend of the Dominican Republic. The Dominican Republic, which concentrated 55% of all investment in the sub-region, has shown an increasing trend over the last decade. This was confirmed in 2016 with a 9.2% increase in inflows, reaching USD 2 407 million (ECLAC, 2017a).

The predominant sources of foreign investment in Latin America are concentrated in the US and the European Union (France, Germany, Spain, United Kingdom, Luxembourg). However, China played an increasingly important role as a provider of capital to the region in services sectors such as telecommunications, finance and clean energy (Avendano, Melguizo and Miner, 2017). The heterogeneity of capital flows among countries, which includes FDI, portfolio flows and other investment flows, is mainly explained by the global business cycle and by country-specific factors such as better governance, more efficient public institutions, stronger regulatory and legal frameworks, and higher political stability and accountability (IMF, 2017c).

Space for monetary policy might be opening up

Scope for monetary stimulus is opening up thanks to lower inflation rates, although with differences across countries. On the one hand, lower inflation rates in South American economies are widening the space for monetary policy. This is mainly explained by a weaker demand and as the effects of currency depreciation and supply shocks are left behind. This is most notable in Brazil, where inflation breached the mid-range target of the central bank during the first quarter of 2017. Inflation expectations are receding in Argentina, after the adoption of inflation targeting. Annual headline rates remain high and will probably end this year above target, after the surge in 2016 following adjustments in the exchange rate and utilities. Inflation in Colombia also declined; it remained contained in the rest of the Andean countries (Figure 2.9). On the other hand, inflation will uptick in Mexico, driven by currency depreciation and gasoline price adjustments, but also in Central America and Caribbean countries. However, inflation will remain low, considering that many of these countries tend to have less flexible exchange rate regimes. This allows them to avoid the inflationary push of currency depreciation, but at the cost of adapting to external shocks through demand adjustment rather than exchange rate fluctuations.

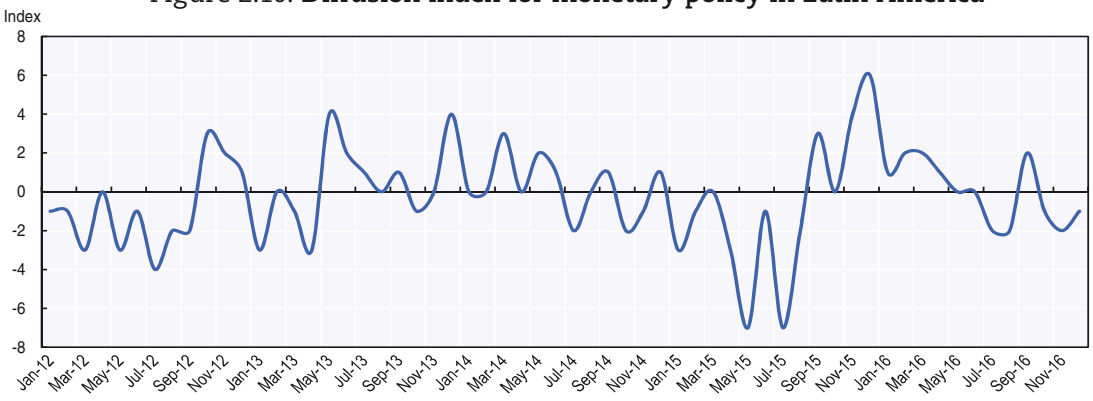
Figure 2.9. **Inflation rates in selected Latin America and Caribbean economies**



Source: OECD/CAF/ECLAC based on IMF (2017a), *World Economic Outlook database*, and OECD (2017a), *OECD Economic Outlook*, Vol. 2017/1, OECD Publishing, Paris for Brazil, Chile, Colombia, Costa Rica and Mexico. OECD (2017c), *OECD Multidimensional Economic Survey on Argentina*, OECD Publishing, Paris for Argentina.
StatLink http://dx.doi.org/10.1787/888933650342

By mid-2016, the number of central banks loosening monetary policy in the region started to outstrip the ones tightening (Figure 2.10). A more neutral stance for monetary policy will likely be more supportive in the coming quarters, considering that most countries are still running negative output gaps. Mexico is an exception as peso depreciation and gasoline price adjustments in 2017 pushed prices up, forcing the central bank to increase rates. Central banks must tread carefully, considering possible bouts of global financial volatility or a faster-than-expected monetary normalisation in the US, which would trigger currency depreciation in the region.

Figure 2.10. **Diffusion index for monetary policy in Latin America**



Notes: The diffusion index measures the number of countries that increase interest rates net of those that lower them for each period. Countries included: Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, El Salvador, Guatemala, Honduras, Mexico, Nicaragua, Paraguay, Peru, the Dominican Republic, Uruguay and Venezuela.
Source: OECD/CAF/ECLAC based on central bank data.
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Space for fiscal policy is still limited

Fiscal space remains limited as debt keeps increasing, while structural primary balances remain below the level necessary to stabilise debt. Average deficit slightly deteriorated in 2016 and debt levels continued to increase. However, fiscal performance was uneven across countries. While primary balances improved in countries like Mexico, Colombia and Barbados, they deteriorated in Brazil, Uruguay, and Trinidad and Tobago. Highly indebted countries with elevated tax pressures must undertake further measures to stabilise debt by reallocating expenditure from current to capital as indicated in previous editions of the *Latin American Economic Outlook* (OECD/CAF/ECLAC, 2016). They must also focus on efficiency of spending to guarantee and improve public goods (see Chapter 4). Spending caps and social security reform were announced in Brazil to curb high deficits and restore credibility. Argentina will gradually adjust spending, benefiting from renewed access to international capital markets and low debt levels in the hands of private markets. However, advances in fiscal consolidation from 2018 onwards will be critical to restore credibility and stabilise debt. Barbados and Trinidad and Tobago will continue fiscal consolidation. The situation in Barbados is more delicate since debt levels surpass 100% of GDP and the primary deficit reduction stalled (Figure 2.11).

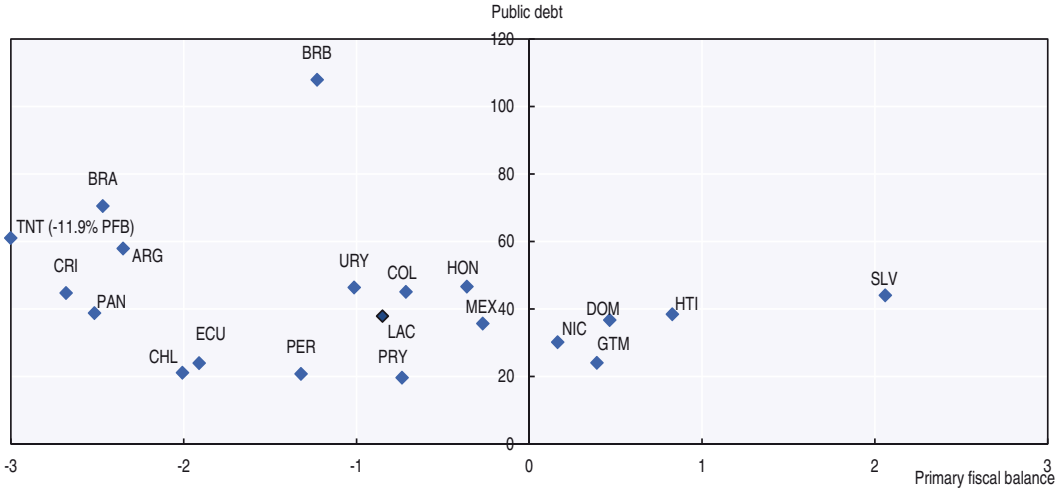
Countries with moderate debt levels and lower taxes to GDP ratios may benefit from tax reform. This could help them avoid cuts to spending, particularly investment with higher multiplier effects. In some cases, depending on the need of fiscal consolidation, economies must both reform taxes and decrease public spending to stabilise public debt. At the same time, they must improve efficiency of public expenditure to guarantee investment and necessary social programmes. So far, adjustments have cut capital expenditure rather than current expenditure (OECD/CAF/ECLAC, 2016).

With respect to fiscal reforms there is some progress in the region (Powell, 2017). There were advances in Mexico, Ecuador, Chile and Colombia. However, fiscal reform is politically challenging as the experience in Colombia shows (Box 2.4). In the case of Ecuador, financing needs have been around 8% of GDP over the past three years. Therefore, further fiscal effort is needed to stabilise debt in the country. Uruguay also has high debt levels, but fiscal balances are moderate. Peru and Chile have more space for countercyclical action than other countries. Chile recently increased social spending to support growth, notably on health and education. Public debt increased rapidly, though higher non-copper revenues from the 2014 tax reform and Chile's structural fiscal rule

allow for gradual fiscal consolidation (OECD, 2017b). In the case of Peru, the government is also using the available fiscal space to stimulate the economy, although it expects to reduce the deficit by 2021 to comply with the fiscal rule.

Figure 2.11. **Gross public debt and primary fiscal balance in selected Latin American and Caribbean countries, 2016**

Central government, percentage of GDP



Note: Estimates for 2016. LAC is a simple average for the 17 economies used. For Mexico, primary balance refers to non-financial public sector, for Peru to general government. For Ecuador, this is net debt (with the private sector), while in Argentina it is gross debt. For Trinidad and Tobago, and Barbados, both figures are general government.

Source: OECD/CAF/ECLAC based on OECD/ECLAC/CIAT/IDB (2017), *Revenue Statistics in Latin America and the Caribbean 2017*, ECLAC (2017b), *Fiscal Panorama of Latin America and the Caribbean 2017: Mobilizing resources to finance sustainable development* and IMF (2017a), *World Economic Outlook Database*, April 2017.

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Box 2.4. **Tax reform in Colombia: What was achieved and what remains to be done**

Passing a comprehensive reform to increase revenue and improve the efficiency and equity of the tax system is not an easy task. Wide-ranging tax reforms inevitably encounter substantial opposition on a number of fronts. It is particularly hard to ensure a comfortable majority in Congress to ensure their approval.

Subject to political support and informal lobbying, the government of Colombia has limited the scope of the tax reform proposals before submitting them to Congress. Between 2010 and 2016, four tax reforms of limited scope were enacted.

The tax reform approved in December 2016 entails an adjustment from distortionary taxes to less distortionary taxes, which are expected to have a positive impact in terms of formalisation and economic growth. The reform should yield enough revenue until the end of the current administration (0.7% and 0.5% of GDP in 2017 and 2018), but falls short of what is needed to fulfill the fiscal needs and to ensure the fiscal adjustment in the long run. The gap between the required revenue and the tax reform revenue increases from 0.9% to 2.2% of GDP over 2018-20 (Table 2.1).

The gains obtained by the hike in value added tax (VAT) rates would be gradually offset by the reduction in direct taxation. The general VAT rate was raised from 16% to 19% (probably the most politically costly element of this reform). Along with other minor

Box 2.4. **Tax reform in Colombia: What was achieved and what remains to be done** *(cont.)*

adjustments in consumption taxes, this would yield 1.0% GDP annually. Conversely, adjustments in direct taxes would have a negative impact, which starts at -0.2% in 2017 and adds up to -1.0% of GDP in 2020.

The original tax proposal aimed to reduce the excessive reliance on tax payments from corporations, while increasing taxes on individuals. However, in its passage through Congress the proposal to increase the income tax base for individuals was rejected, while a watered-down reduction on corporate income tax was approved. The maximum corporate income tax rate went from 40% to 33% over 2017-19. Colombia also made other adjustments to corporate taxes that had a negative impact on tax collection. These included a new deduction of the VAT paid on capital goods and elimination of the equity tax from 2018 onwards. The reduction in revenue due to these changes increases from 0.2% to 1.2% of GDP annually from 2017 to 2020.

Adjustments on personal income taxes did not have a significant impact on revenue. The main changes were the elimination of the previous exemption of dividends from personal income tax and increases on the tax rates applied to non-labour income. The additional revenue raised by these changes would amount to 0.2% of GDP annually.

The 2016 tax reform included some positive aspects to increase the efficiency and effectiveness of the taxation system, but further adjustments are still needed. The most welcome changes include integrating the CREE (a special corporate tax) and the CREE surtax within the corporate income tax; bringing the statutory corporate tax rate closer to the OECD average; ending the business wealth tax as planned; introducing a dividend tax at the shareholder level; reforming the tax treatment of non-profit organisations; and substantially improving tax administration and penalties for tax evasion. However, some key recommendations by the OECD were not retained. These included expanding the personal income tax base, ensuring the progressivity of the taxation system and eliminating the financial transaction tax (OECD, 2017d, 2013a).

There seems to be little space for further cuts in spending. The medium-term fiscal framework already reduces central government investment levels to 1.7% of GDP from 2018 onwards; during the past five years, it was kept to around 2.8% of GDP. Therefore, a new tax proposal could be expected in the near future, with a new administration.

Table 2.1. **2017 tax reform: Additional revenue (percentage of GDP)**

	2017	2018	2019	2020
Tax reform: additional revenue	0.7	0.5	0.2	0.1
VAT and other consumption taxes	0.9	0.9	1.0	1.0
Direct taxes	-0.2	-0.5	-0.8	-1.0
Individuals	-0.1	0.2	0.2	0.2
Corporations	-0.2	-0.7	-1.0	-1.2
Central gov deficit w/tax reform	3.6	3.6	3.8	3.8
Fiscal rule CG target	3.6	2.7	2.2	1.6

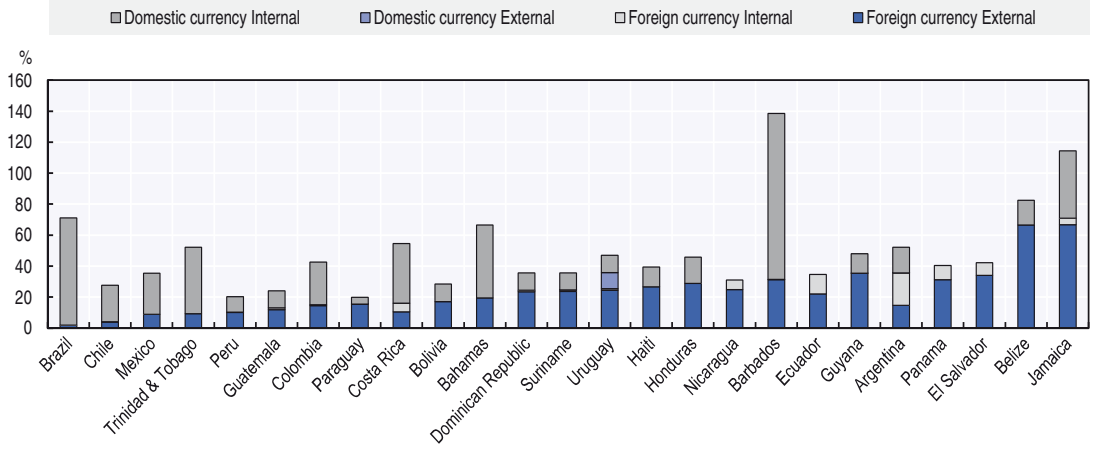
Source: OECD/CAF/ECLAC based on Fedesarrollo.

Fiscal rules may also be helpful to enhance credibility and attain stabilisation. Fiscal rules are associated with a more stabilising role for fiscal policy (Alberola et al., 2016). Structural fiscal rules allow more space for countercyclical action as the observed deficit may temporarily adjust while attaining the structural target. The debt, however, may take longer to stabilise. Rules based on the observed deficit are easier to implement and may help stabilise debt faster. However, they reduce space for countercyclical actions.

High volatility in exchange rate markets could further limit fiscal space. This is especially the case in economies with a large percentage of public debt in foreign currency such as Argentina (68%) or the Dominican Republic (69%). On the contrary, economies such as Brazil (3%), Chile (14%) or Mexico (25%) have small percentages of public debt in foreign currency and are less exposed (Figure 2.12). Small economies are not large enough to fund public debt internally and must recur to foreign markets. For their part, large economies can fund a larger share of debt internally.

Figure 2.12. **Public debt by currency and legislation, circa 2016**

Percentage of GDP, central government



Source: OECD/CAF/ECLAC based on IDB, *Standardized Public Debt Database*.

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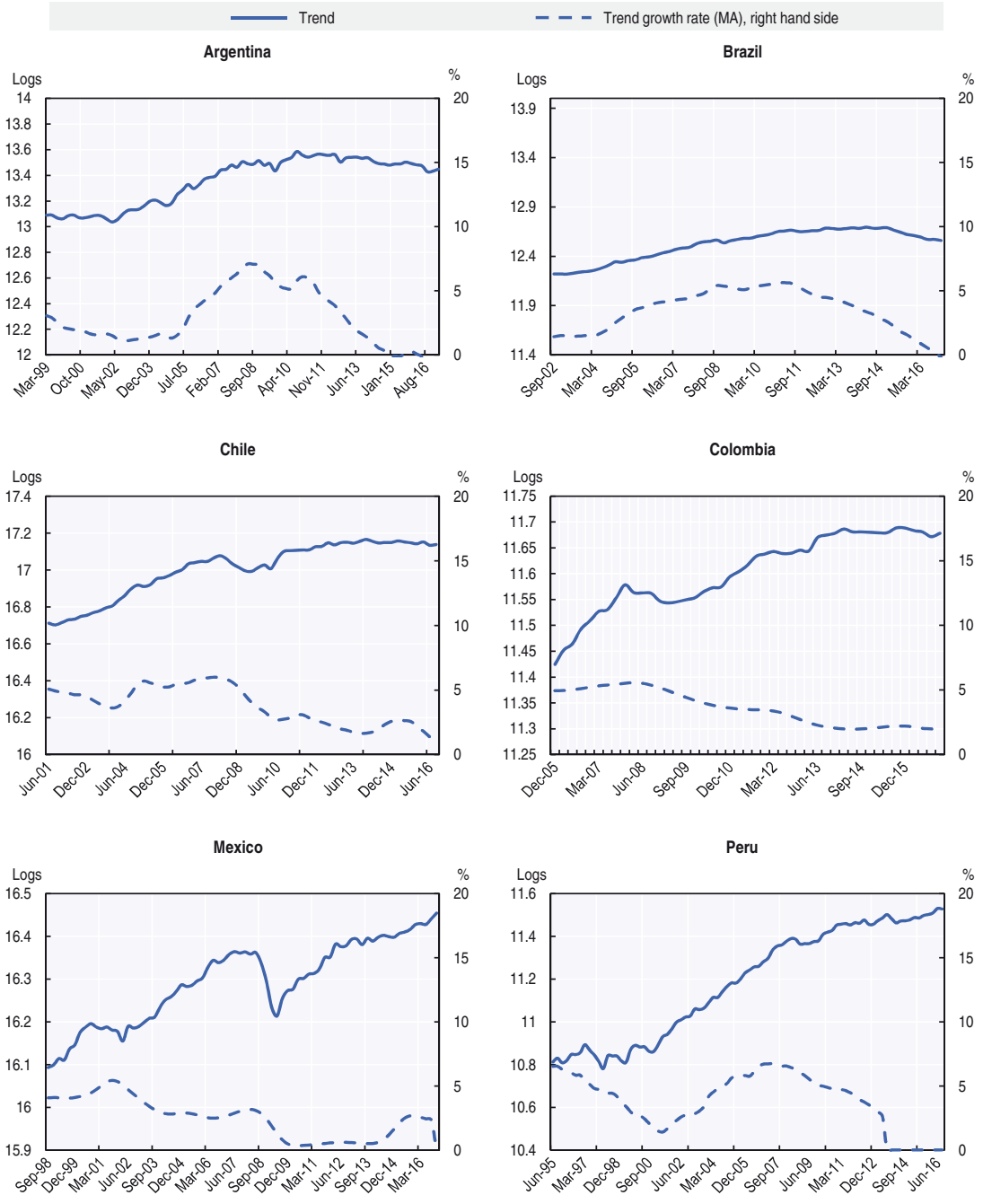
Institutions and openness matter

Growth potential is lower than expected in Latin America and the Caribbean

In spite of the region's cyclical heterogeneity in the short term, trend output has slowed down since 2011 across the region. Medium-term growth projections suggest that potential output in Latin America is less robust than previously thought. Evidence indicates that potential growth is lower than expected, close to 3%. This stands in sharp contrast to the 5% average annual growth rate that characterised the mid-2000s, as highlighted in previous editions of the *Latin American Economic Outlook*. Although the slowdown is common across the region, some heterogeneity exists across countries. For instance, both the magnitude and the date of the fall in potential output growth (trend growth rate) differ across economies of the region (Figure 2.13).

Figure 2.13. **Potential output, GDP trend and GDP trend growth in selected Latin American economies**



Note: See OECD/CAF/ECLAC (2016) for estimation details.
Source: OECD/CAF/ECLAC based on national official sources.
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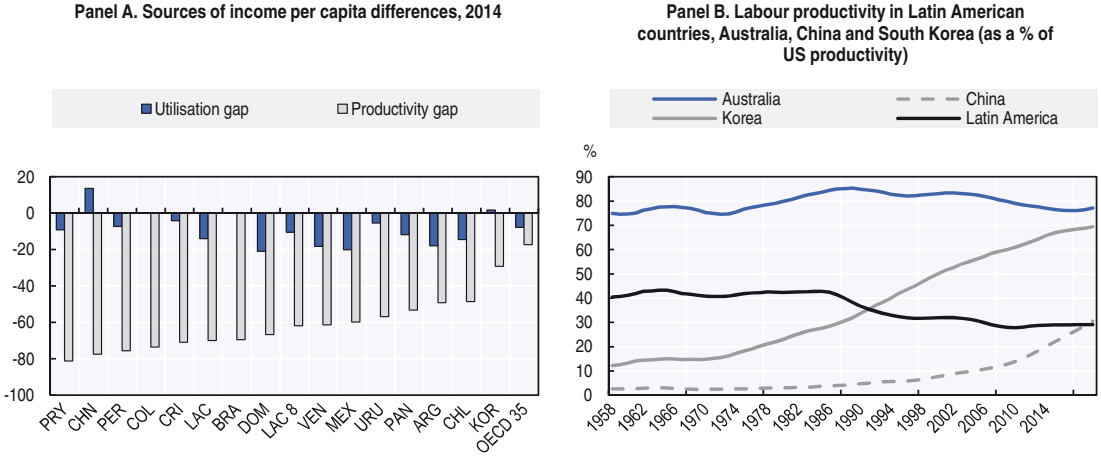
Part of the slowdown is the response of a cyclical retrenchment in investment, as highlighted in OECD/CAF/ECLAC (2016). However, part of the slowdown is also structural. On the one hand, the average investment rate in Latin America reached its lowest point since 2003. Investment accounted for only 19.5% of GDP in 2016, 20.3 percentage points below the average rate of emerging and developing Asia (IMF, 2017a). The regional

average hides a wide dispersion among countries as economies such as Colombia, Nicaragua or Panama invest clearly above the regional average. On the other hand, the region's low productivity and its inability to attain higher income levels is explained by the absence of a more profound process of structural change towards innovation and more knowledge-intensive production. Labour and capital do not easily mobilise from low-productivity firms to high-productivity firms in the region. Around 55% of the working population is employed in the informal sector. Even during expansions, the transition probability from informality to formality remains low (CAF, 2013). This is a major structural drag on productivity. Reallocating capital and labour from low-productivity firms, a key characteristic of informal firms, to high-productivity formal firms could increase total factor productivity between 45% and 127% in Latin America, depending on countries (Busso, Madrigal and Pagés, 2013). Furthermore, Latin American economies present a harder stringency of Product Market Regulation (PMRs) than OECD economies. This acts as a barrier to business dynamism, and labour and capital reallocation. The differences between Latin America and the OECD in PMR are mainly explained by the complexity of regulations and the administrative burdens on start-ups (Barbiero et al., 2015; OECD/CAF/ECLAC, 2016).

The scant contribution of productivity to growth in Latin America is at the heart of the growth gap between the region, the OECD and fast growing Asian economies. Low labour productivity in Latin America explains 70% of the GDP per capita gap between the LAC region and the upper half of OECD economies (Figure 2.14, Panel A). There are important differences across countries. In Paraguay, Colombia and Peru, the productivity gap explains over 75% of the income gap. In Argentina, Chile and Panama, the gap amounts to around 50%. Moreover, labour productivity, measured by GDP produced by an hour of labour, has been declining over the past decade in Latin America, relative to more advanced economies. On average, in 2016, labour productivity in Latin America was merely one-third of labour productivity of the US, even lower than 60 years ago. This is in stark contrast to the performance of high-growth countries in Asia, such as South Korea or more recently China, where relative productivity has surged in recent decades (Figure 2.14, Panel B).

Figure 2.14. **Labour productivity in Latin America, China and the OECD**



Notes: Panel A: Compared with the simple average of the 17 OECD member countries with the highest GDP per capita in 2014 at 2011 purchasing power parities (PPPs) (in mil. USD 2011). The sum of the percentage difference in labour resource use and labour productivity does not add up exactly to the GDP per capita difference since the decomposition is multiplicative. Labour productivity is measured as GDP per employee. Labour resource utilisation is measured as employment as a share of population. Panel B: Share of the US productivity, five-year moving average, PPP.

Source: OECD/ECLAC/CAF based on Feenstra, R., R. Inklaar and M. Timmer (2015), "The next Generation of the Penn World Table", *American Economic Review*, 105(10), 3150-3182, available for download at www.ggdc.net/pwt and Conference Board (2016), *The Conference Board Total Economy Database*.

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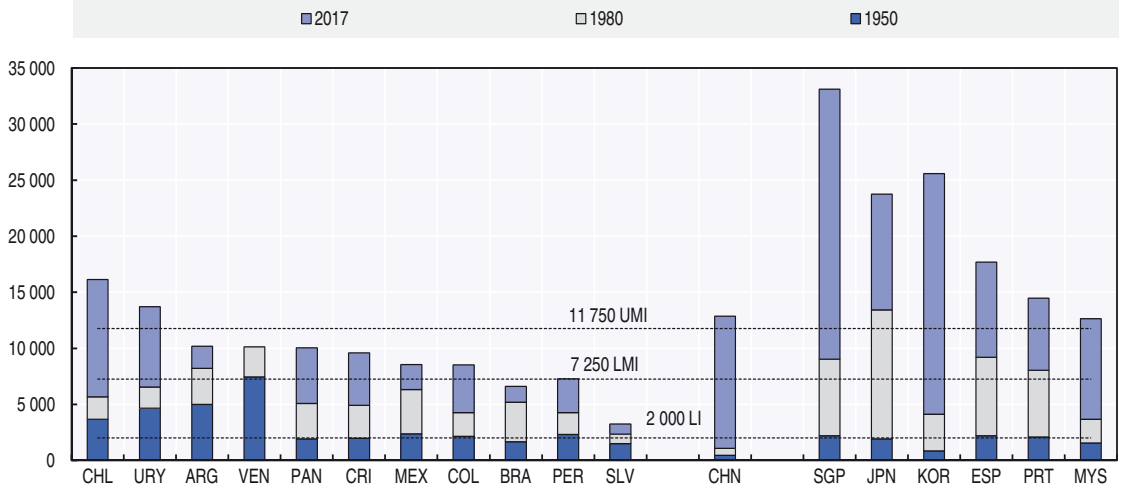
The region needs to address various bottlenecks to overcome the middle-income trap

As Latin American countries reached middle-income levels, growth exhibited a long-lasting slowdown (Felipe, Kumar and Galope, 2017). This is known as the middle-income trap (MIT): after the rapid growth registered at early stages of development, growth stalls as countries reach mid-income levels (Eichengreen, Park and Shin, 2011; Felipe, Abdon and Kumar, 2012; Zhuang, Vandenberg and Huang, 2012; Aiyar et al., 2013; OECD, 2013b). Growth in low-income countries occurs largely when labour is reallocated from low- to high-productivity activities and industries. On the other hand, at middle-income levels countries usually require new engines of economic growth based on capital- and skill-intensive manufacturing and service industries (Kharas and Kohli, 2011).

So far, only Chile, Trinidad and Tobago, and Uruguay have managed to escape the MIT in Latin America as shown in OECD/CAF/ECLAC (2016), following Felipe, Abdon and Kumar (2012) methodology (Figure 2.15). The trap has affected the rest of the region's economies, most of which have suffered recurring episodes of per capita income stagnation, particularly after the 1980s.

Figure 2.15. **Latin America and selected middle-income trap evaders**

GDP per capita, USD PPP 1990



Note: UMI = upper-middle income; LMI = lower-middle income; LI = low income.

Source: OECD/ECLAC/CAF based on Felipe, Abdon and Kumar (2012) and Felipe, Kumar and Galope (2017). Data extracted from International Monetary Fund, *World Economic Outlook Database* (April 2017) www.imf.org/external/pubs/ft/weo/2017/01/weodata/index.aspx and Madison (2010) database www.ggdc.net/maddison/.

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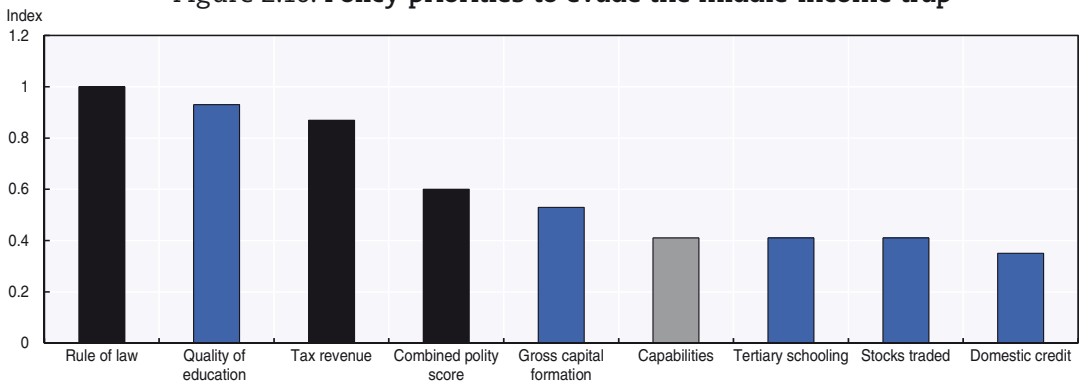
Strong institutions and trade play a key role in overcoming the middle-income trap. Weak institutions might not have an impact at low-income levels, but could dampen growth in middle-income economies (World Bank, 2017a). Further evidence suggests that economies that are successful in overcoming the MIT have rule of law, solid state capacities in the form of sufficient tax revenues and strong democracies (Figure 2.16). Similarly, more open economies have a higher probability of evading the MIT. In this case, countries' ability to export high added-value goods is key to transition from middle to high income. Other key characteristics of countries that have evaded the MIT are the quality of education, an adequate supply of skills, adequate investment levels and developed capital markets (Melguizo et al., 2017; Box 2.5).

Figure 2.16. **Policy priorities to evade the middle-income trap**



Note: Ranking of importance from left to right (Box 2.5).
Source: Melguizo et al. (2017).
StatLink http://dx.doi.org/10.1787/888933650475

Box 2.5. **Policy priorities to overcome the middle-income trap in Latin America**

The empirical literature on development has identified a "middle-income trap" (MIT) as developing economies struggle to adjust to new sources of growth after reaching middle-income levels. For Latin America, this is an especially challenging scenario. Only Chile, Trinidad and Tobago, and Uruguay have become high-income economies in the last six decades. Meanwhile, several other LAC countries, already middle-income as early as 1950, stayed in that income range.

To determine the main policy priorities to overcome the MIT, Melguizo et al. (2017) undertake a linear discriminant analysis that contrasts the experiences of 76 emerging economies and OECD member countries (14 Latin American economies). They compare those that evaded MIT and those that have stayed there since the 1950s. Based on more than 200 000 estimations, their research identifies the top ten variables that best separate upper-middle income (UMI) and high-income (HI) countries evaluated at their "graduation" from the middle-income trap. These variables are rule of law, quality of education, tax revenues, age dependency, degree of democracy, total investment, capabilities (economic complexity index), value of stocks traded, domestic credit provided by financial sector and percentage of complete tertiary education (Figure 2.16).

The study emphasises that the current socio-economic and institutional features of each UMI country and past characteristics of some HI countries are more useful and relevant than others. Consequently, policy priorities differ across economies, and there is no unique development path. Reinforcing their "no one size fits all" argument, they include a synthetic control method for a select group of Latin American countries. In this way, they identify their main policy gaps according to their unique characteristics. This is particularly relevant in a context where budget constraints oblige focusing on a select group of policies that contribute to overcoming the middle-income trap.

Boosting productivity and potential output through trade

The link between trade, productivity and inequality

The relationship between trade and productivity has been examined extensively in economic literature, looking at both different benefits and potential downsides. Following the comparative advantage approach and endowments-based models, the "new trade" theory aimed at understanding the effects of trade structure on firm productivity

(Krugman, 1979). In this perspective, trade liberalisation can raise productivity thanks to the effects of higher competition from imports and a greater variety of intermediate inputs. Following this seminal work, the relationship between productivity and trade has been later explained in the literature through learning-by-doing models (Krugman, 1987), research and development (R&D) spillovers (Rivera-Batiz and Romer, 1991; Grossman and Helpman, 1991), the variety of intermediary inputs (Feenstra, 1994) and exposure to foreign markets (Clerides, Lach and Tybout, 1998).

More recently, the linkages between trade and firm-level productivity have been explored. These consider the effect of firm heterogeneity and the higher efficiency of exporters over non-exporters (Melitz, 2003). As a result of trade liberalisation, only the most productive firms will continue to expand their market share thanks to higher productivity and increasing competition in product markets. Meanwhile, less productive firms exit. More recently, the role of exports on entrepreneurship has been studied, particularly in the context of Latin America (Eslava et al., 2012; Fernandes, Lederman and Gutierrez-Rocha, 2013).

Other potential benefits from trade have been proposed to advocate for trade openness and the overall process of globalisation. Trade and growth are related: relatively open economies grow faster than relatively closed ones. Further, salaries and working conditions are generally better in companies that trade compared with those that do not (OECD, 2012). Trade can provide gains for households through reduced prices and increased choice. Also, trade-related activities, such as *outsourcing* and *offshoring,* can play a key role in boosting growth and raising salaries. Evidence suggests that reducing trade barriers could impact positively on jobs, real wages and exports. FDI-enhanced trade can also bring technological spillovers for domestic firms. In recent years, efforts for understanding the trade-productivity nexus have focused on other firm-level mechanisms. These include learning-by-doing, access to better inputs, organisational improvements at the firm, access to larger markets, and re-allocation or redistribution of resources (Carballo, 2017).

Today, the gains from increasing trade have been questioned, especially in OECD economies. There is the perception that trade can be beneficial for some, especially among certain income groups, but detrimental to others. Global inequality has declined, thanks to the strong income growth of the vulnerable and the middle class in developing and emerging economies, including most of Latin America (Milanovic, 2016). Trade has delivered unprecedented access of goods and services for households in low- and middle-income economies. At the same time, in some OECD member countries, the middle class has not experienced the same expected gains from trade in recent years (OECD, 2017e). Overall, it appears that the ability to reap the trade benefits to reduce inequality is dependent on country specific characteristics and circumstances (IMF, 2017b).

There is a growing gap in productivity and wages between exporting and non-exporting firms. These effects can be heterogeneous across firm size and productivity (Criscuolo and Timmis, 2017a). Moreover, expanding cross-border trade seems to benefit more the skilled, better educated and wealthier individuals in many countries. From the investment perspective, multinational enterprises (MNEs) can be excessively large for small economies and influence the countries' regulatory framework for their own interest. For example, MNEs can shape the investor-state dispute settlements (ISDS) provisions. Together with a mistrust towards unbalanced trade relationships in goods and services, financial interconnectedness can be seen as a detrimental effect and a factor for vulnerability.

There is also a concern, more pronounced in OECD member countries, that trade openness may cause a "race to the bottom" in labour standards (Head and Ries, 2003), environmental regulation and consumer protection (OECD, 2017e). In Latin America, the gains from trade have been more visible when considering the role of commodity exports in improving household revenues across the whole income distribution. Some sectors, however, did indeed lose owing to trade competition, particularly manufacturing.

All in all, the notion that trade systematically implies improvements in living standards deserves further reflection today. Therefore, it is important to provide better answers, not only for improving the region's trade performance, but also for the institutional frameworks where trade policies are implemented. A first step in this direction is to favour an environment where the benefits from trade can materialise through domestic policies. One approach, for example, would be reducing the costs imposed on trading firms, particularly small and young firms, so they can participate in international trade. This would involve ensuring access to efficient and affordable services that guarantee firm competitiveness, which is not the case in Latin America. A second step is to guarantee equality towards trade opportunities for all the population, which goes beyond labour market conditions. On the one hand, this involves active labour market and skills policies. On the other, regional policies could improve, for example, connectivity to local communities and reduce territorial disparities. A third step consists of improving the institutional frameworks for trade, which includes adopting multilateral rules, guidelines and codes. Broader co-operation agreements, including a wider range of issues beyond trade such as transparency, investment, movement of people and competition (the "progressive" provisions), will be essential (OECD, 2017e).

Navigating a more challenging scenario for trade and globalisation

The trade scenario for Latin America has turned increasingly complex. Although global trade has revived in the past year, it remains less robust than in pre-crisis decades. Furthermore, trade and globalisation have been under pressure as there is a growing concern around the world that the benefits from trade and globalisation are not shared by all and that this needs to be fixed (OECD, 2017e). New data sources suggest that people are questioning the achievements, usefulness and global architecture of trade and globalisation (Box 2.6). Overall, there is growing fear that these concerns might lead to a rise in protectionism.

Concerns on growing protectionism are on the rise in G20 economies, but evidence suggests to the contrary. An indication of countries' concern is the use of trade remedies. Between July 2013 and June 2016, World Trade Organization (WTO) members took 507 anti-dumping actions, 43 countervailing measures and introduced 36 safeguards (OECD, 2017f). Although the rhetoric on protectionism might be increasing, G20 countries have not significantly increased the number of new trade-restrictiveness measures over the past decade. Since 2009, G20 economies have applied on average seven new trade restrictive measures per month (compared to an average of six trade-facilitating measures). This is slightly higher than the average from October 2016 to mid-May 2017 of six new trade restrictive measures per month (WTO/OECD/UNCTAD, 2017).

Box 2.6. **Tracking globalisation in real time using Big Data**

The global trade slowdown and trade protectionism have become main concerns for many policy makers. Concerns mount as trade has been one of the main growth drivers over the past few decades. Its recent stagnation has raised questions on whether these are cyclical or permanent trends, and their potential impact on growth.

This box proposes a new way to measure the extent of trade protectionism and the recent global trade slowdown. The global trade trend is tracked in real time using Big Data analysis (Ortiz and Rodrigo, 2017) with information from the Global Database of Events, Language and Tone (GDELT) (Leetaru and Schrodt, 2013). GDELT is an open-source database that extracts and analyses digital news in broadcast, print and web media globally in over 100 languages on a daily basis. Using different dictionaries, several thousands of taxonomies

Box 2.6. **Tracking globalisation in real time using Big Data** *(cont.)*

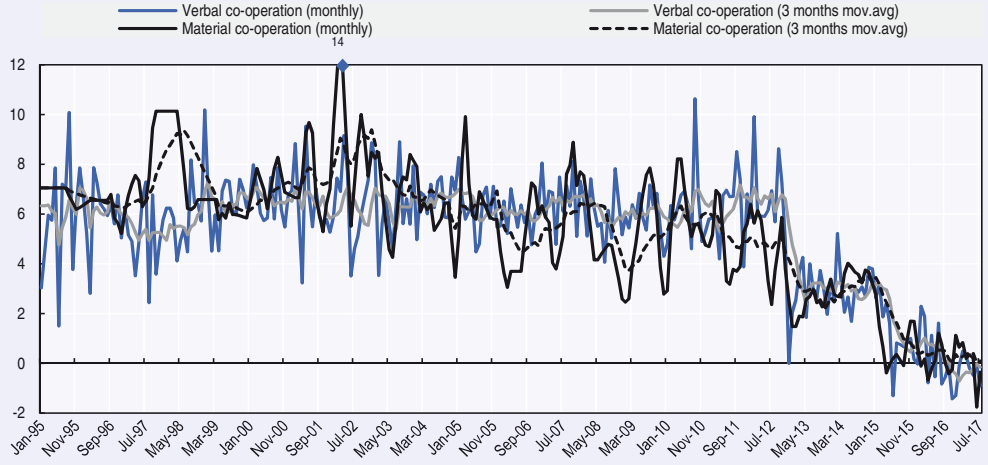
and themes are identified in the news pieces to classify the information. The algorithms used by GDELT also identify thousands of emotions, organisations, locations, news sources and events across the world as well as their average sentiment. Every processed event in GDELT is coded using the Conflict and Mediation Event Observations (CAMEO) event coding system developed by Schrodt and Yilmaz (2007). CAMEO is a broadly used coding scheme to systematise analysis of political and social events and divide them in a scale ranging from material and verbal co-operation to verbal and material conflict.

Using the CAMEO taxonomy in GDELT, BBVA Research developed the "Trade Support index" to track events related with verbal and material co-operation associated with the World Trade Organization (WTO) in the media. Verbal co-operation is associated with events categories that range from making a public statement to engaging in diplomatic co-operation (1 to 5 categories in the CAMEO taxonomy) where WTO is the actor. Material co-operation refers to events in CAMEO categories that range from engaging in material co-operation to easing restrictions (6 to 8 categories in the CAMEO taxonomy) where WTO is also the actor too.

The BBVA Research Trade Support index (from January 1995 to July 2017) measures the media sentiment of articles where verbal and material cooperative events relative to trade are identified. To analyse sentiment, GDELT use "directional" word lists measuring words associated with positive and negative tone as proposed by more than 40 dictionaries and translating each article into English. GDELT uses Natural Language Processing (NLP) techniques to compute the average "tone" of all documents containing one or more mentions to the events in question. The score ranges from -100 (extremely negative) to +100 (extremely positive), although common values range between -10 and +10, with 0 indicating neutral.

The results show that both the trade verbal and material co-operation have maintained a positive tone or sentiment until the recent period when both components have become more neutral. However, the trade material co-operation sentiment deteriorated gradually from the beginning of the century in 2003 and accelerated its fall in 2012, after the financial crisis erupted. At that point, verbal co-operation sentiment joined the sharp deceleration (Figure 2.17). Thus, although protectionism is in the spotlight after a worsening of trade support in 2012, some warning signals from the Material Co-operation index began earlier. The index also shows that it is a worldwide phenomenon, with the People's Republic of China and the US hit most severely by protectionism. Mexico and, particularly Brazil, have been the Latin American countries most affected by the rise of protectionism, according to the index.

Figure 2.17. **Global Trade Support Index in real time**



Source: www.gdelt.org and BBVA Research.

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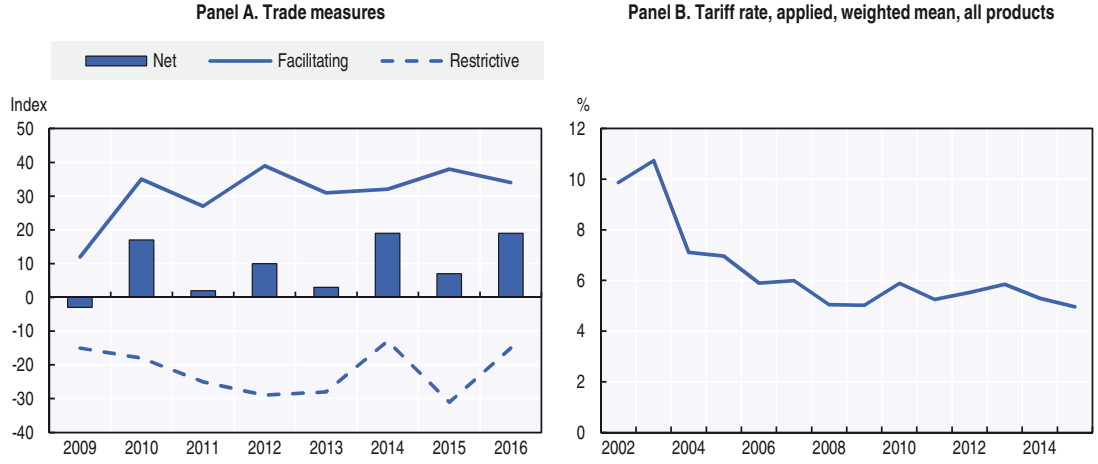
Against a challenging trade scenario, evidence suggests that Latin American economies have continued to open up to international trade. Since 2010, the three Latin American economies that form part of the G20 (Argentina, Brazil and Mexico) have applied more measures to facilitate than to restrict trade (Figure 2.18, Panel A) (WTO/OECD/UNCTAD, 2017). Brazil has been the most active of the three economies with respect to trade measures. However, Mexico follows a similar trend of facilitating more than restricting trade. Argentina's change in trade policy is also noticeable, with an increasing number of trade facilitating measures. The country recently removed export restrictions on soybeans and other products, and plans to phase out export taxes on a large basket of export products. Estimates on the elimination of export barriers for Argentina indicate an effect of 2%-4% in growth (Nogués, 2008). Similarly, the region has continued reducing trade tariffs. In 2010, on average, all products had an applied tariff rate of around 10%. That rate decreased to less than 5% in 2015 (Figure 2.18, Panel B) (World Bank, 2017b).

Figure 2.18. **Trade facilitating and restricting measures and tariff rates in Latin America vs world economies**



Note: Panel A estimated as the sum of trade facilitating and trade restrictive measures for Argentina, Brazil and Mexico. Panel B estimated as the simple mean of applied tariff rates (weighted by product) for Argentina, Brazil, Chile, Colombia, the Dominican Republic, Mexico, Peru and Uruguay.

Source: WTO/OECD/UNCTAD (2017) and World Bank (2017b), *World Development Indicators*.

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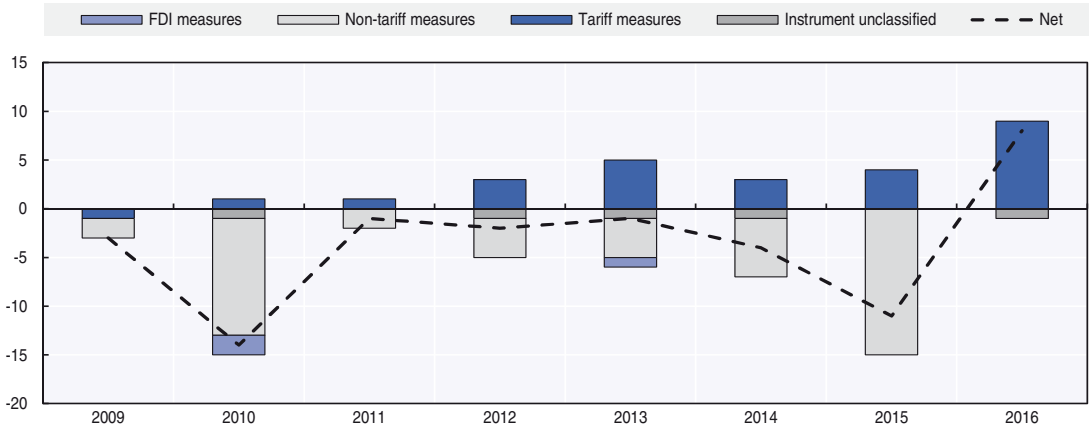
Among Latin American economies, there is no evidence of rising protectionism but non-tariff measures (NTMs) remain as a challenge for further trade openness and regional integration (Figure 2.19). The level of trade and investment measures adopted within LAC economies with their regional peers has remained relatively stable since 2009, with a slightly higher number of trade restrictive measures than liberalising, with the exception of 2016. Among Latin American economies, the majority of implemented trade and investment restrictive measures were NTMs (GTA, 2017).[5] NTMs, including standards, technical regulations and conformity assessment procedures, are not normally aimed at discriminating against imports. However, they can unintentionally undermine trade. In the region, the most prevalent NTMs are associated with non-export subsidies, tariff-rate quotas, local content measures and non-automatic import-licensing procedures. As noted later in this section, there is room for Latin America to improve trade integration by reducing NTM-related barriers and improving harmonisation. On the contrary, the majority of liberalising trade measures were tariff measures, where the region has made considerable progress in reducing tariff rates over the last two decades (Figure 2.18, Panel B).

Figure 2.19. **Net trade and investment facilitating and restrictive measures within Latin America and the Caribbean economies, by type of measure**



Note: Net refers to the sum of trade and investment facilitating measures minus restrictive measures for Argentina, Bolivia, Brazil, Chile, Colombia, Cuba, the Dominican Republic, Ecuador, Mexico, Panama, Peru and Venezuela. Estimates exclude trade remedies according to WTO classification (e.g. anti-dumping measures, countervailing measures and safeguard measures).

Source: OECD/ECLAC/CAF based on GTA (2017), *Global Trade Alert* (database).

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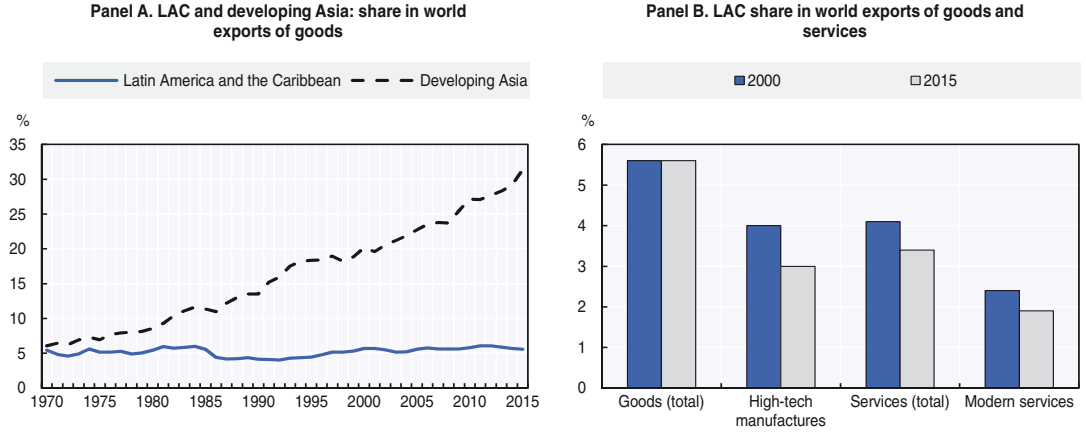
Trade performance must still be improved in Latin America and the Caribbean

There are signs that Latin America has been unable to reap the productivity gains from trade. It has underperformed both in terms of market share and added value over the last decades, according to various indicators. The share of LAC in world exports has stagnated since 1970. The region's participation in world merchandise exports has averaged 5.2% since that year, with minimal variations. It is also below the 6.4% participation of the region to world GDP over the same period (Figure 2.20, Panel A). Such stagnation contrasts with the performance of developing Asia, whose share of world merchandise exports was at similar levels to LAC in 1970 but has steadily grown to 31% in 2015. Moreover, since 2000, the LAC region has lost ground in high technology manufactures and services exports. This includes the so-called modern services such as legal, information and communication technology (ICT) and business (Figure 2.20, Panel B).

Figure 2.20. **Latin American exports as share in world exports**



Note: Developing Asia excludes Western and Central Asia.

Source: OECD/ECLAC/CAF, Panel A based on data from UNCTAD, UNCTADSTAT database. Panel B based on COMTRADE database (goods) and WTO (services).

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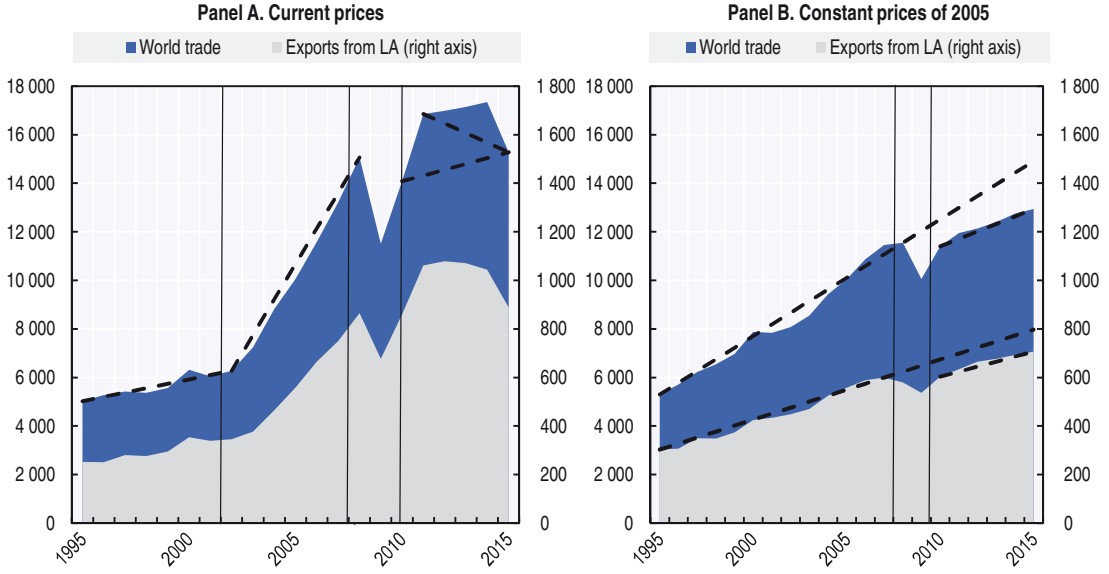
In recent decades, price fluctuations have heavily influenced export performance in Latin America. While price effects have also affected world trade, they have been more acute in the LAC region because of the weight of commodities in most countries' export baskets. For instance, while during 1995-2015 world trade grew 10.2% faster in current than in constant prices, the difference for Latin America was 17.8%. The boom in Latin American exports that preceded the trade collapse of 2008-09 resulted largely from a price effect. Regional exports presented a growth trend of 3.2% from 2009 to 2015 compared with 5.1% per year before the financial crisis (1995-2008) (Figure 2.21) (Giordano, 2016). This suggests the remarkable export growth observed before the financial crisis was mainly due to a hike in commodity prices. The series valued in current dollars (Figure 2.21, Panel A) confirms this analysis. Notwithstanding this, several commodity exporters in the region simultaneously experienced increases in trade volumes.

Figure 2.21. **World trade and Latin American exports**

Billions of dollars, 1995-2015



Note: World trade is defined as imports and includes the flows between Euro Zone countries.

Source: IDB Integration and Trade Sector with data from INTrade/DataINTAL, BACI, BLS, COMTRADE, CPB and UNCTAD.

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Latin America's export performance over the last 20 years points towards a global deterioration of its competitive position. Price incentives have led certain economies to become increasingly specialised in commodities, particularly in low value-added primary products, which constitute one of the least dynamic segments of global demand. Mexico and Central America, where industrial products were more prominent, are the exception. Between 2011 and 2015, the volume of exports of agricultural and mineral primary products grew at relatively high rates (5.1% and 4.9%, respectively). These rates were above those during the pre-crisis period in 2008 (4.5% and 4.6%, respectively). At the same time, exports of agricultural and mineral manufactures, which are more elaborate, fell from 4.7% to 0.7% and 1.3% to 0.1%, respectively. This exacerbated a trend for re-primarisation in the post-crisis period. In agriculture, Latin America holds a significant share of the global market (14.6% in agricultural primary products and 9.7% in

agricultural manufactures). However, these categories have experienced falling relative global demand during the last two decades (-2.0 and -1.7 percentage points, respectively). Furthermore, the trend towards re-primarisation has been pronounced. The region, for example, has a greater global share of lower value-added agricultural primary products (4.3 percentage points) compared with that of more elaborate agriculture manufactures (0.8 percentage points). In contrast, industrial manufactures were the only category that contributed positively to the region's competitive positioning. Latin America increased its global market share by 0.6 percentage points to 4.1% in 2015. The gain was mostly due to Mexico, which accounted for three-quarters of the market share held by the region in this product category. The mismatch between the evolution of global demand and regional export supply underlines the fragile and price-dependent trade performance for most countries. This, in turn, reinforces the need for a diversification agenda (Giordano, 2016).

Trade diversification and higher value added remains a challenge

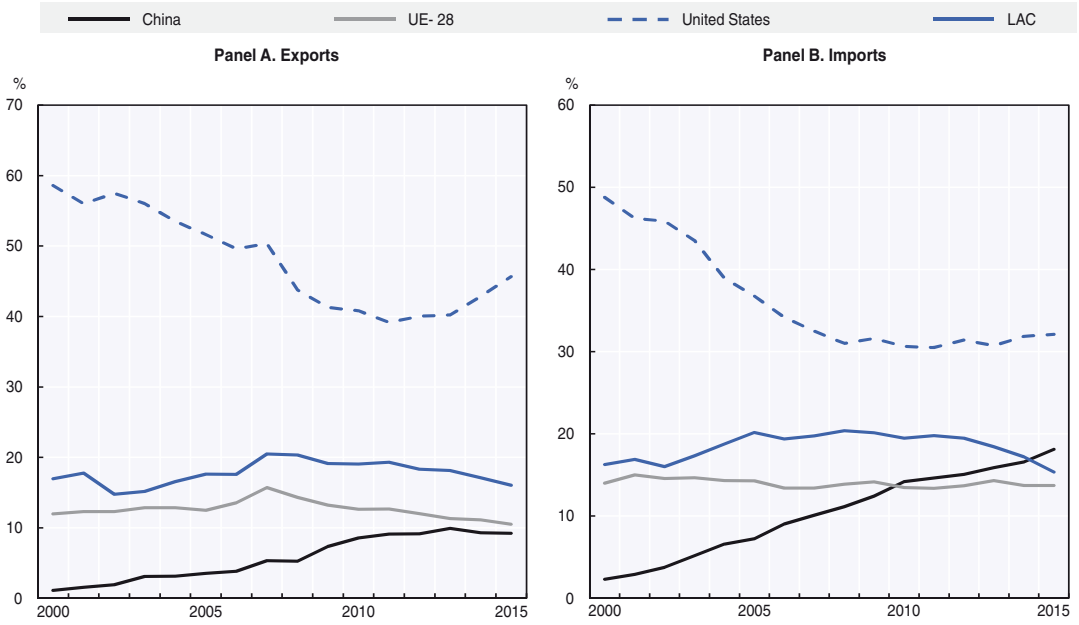
LAC's trade remains concentrated in a handful of its larger economies. Over the last 15 years, more than 70% of total exports and imports have been concentrated in five countries: Argentina, Brazil, Chile, Mexico and Venezuela. Furthermore, Mexico has remained the region's largest exporter and importer, followed by Brazil. In 2015, these two economies accounted for more than 62% of the region's exports and 57% of its imports. Argentina (6.2% of exports and 5.7% of imports), Chile (6.9% and 6.1%) and Venezuela (4.0% ad 3.2%) accounted for a smaller share. A comparison of gross exports with exports in value added for these countries in 2011 shows a similar concentration pattern.

In aggregate terms, LAC continues to trade with the same partners, but new relationships are emerging. Over the last 15 years, the US has remained the region's top trade partner for both exports and imports. However, China has recently emerged as a key partner for the region (OECD/CAF/ECLAC, 2015). While its share in LAC's exports has remained at around 10% over the last three years, China continues to gain ground as an import supplier (Figure 2.22). The share of the European Union in the region's trade has remained mostly flat. Meanwhile, LAC's share in world trade has fallen in recent years owing to the weak performance of intra-regional trade, especially in South America. The trade patterns of Mexico and of the rest of the region continue to be very different. For Mexico, the US remains the dominant trade partner, especially for Mexican exports. For the rest of the region, the main partner is the region itself (with almost a quarter of total exports and imports), followed by the US (with about a fifth of the total). China, which accounts for just 1% of Mexican exports, absorbs 15% of the exports from the rest of the region. By contrast, China is the origin of 18% of imports for both Mexico and the rest of LAC.

The diverging trends followed by South America and Central America reflect both sub-regions' different export patterns. Increased trading links with China and the rest of Asia exacerbated South America's already high dependence on commodity exports, against the background of the commodity supercycle of 2003-11. By contrast, Central American countries and the Dominican Republic have deepened trade and production links among themselves, as well as with Mexico and the US. The development of regional value chains has been supported by the Dominican Republic-Central American Free Trade Agreement (CAFTA-DR) and the Central America-Mexico Free Trade Agreement. Participation in manufacturing networks has allowed Central American countries (Costa Rica being the clearest example) to enter new niches and gradually diversify their exports.

Figure 2.22. **Share of selected partners in Latin America and the Caribbean merchandise trade**

Percentages



Source: OECD/ECLAC/CAF, based on COMTRADE.

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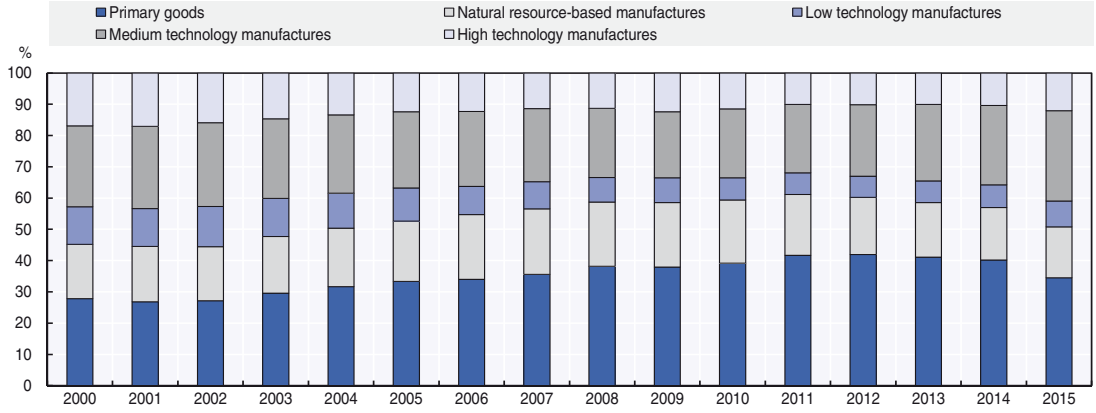
With respect to the region's export basket, the most important change since 2000 was the increased share of primary goods. It climbed from 28% to a peak of 42% in 2012 (Figure 2.23). This reflected high commodity prices during most of that period, but also increased exported volumes that responded to sustained demand from China. Since 2013, the end of the commodity supercycle and subdued Chinese demand reflected in a decreasing share of primary goods in the region's export value, reaching 35% in 2015. Medium-technology manufactures, the second most important export category for the region (and the top one for Mexico), have made an important recovery in recent years. After falling from 26% to 21% over 2000-09, their share in total exports has rebounded, standing at 29% in 2015.

Figure 2.23. **Composition of exports by technology intensity in Latin America and the Caribbean**

Percentages



Source: OECD/ECLAC/CAF, based on COMTRADE.

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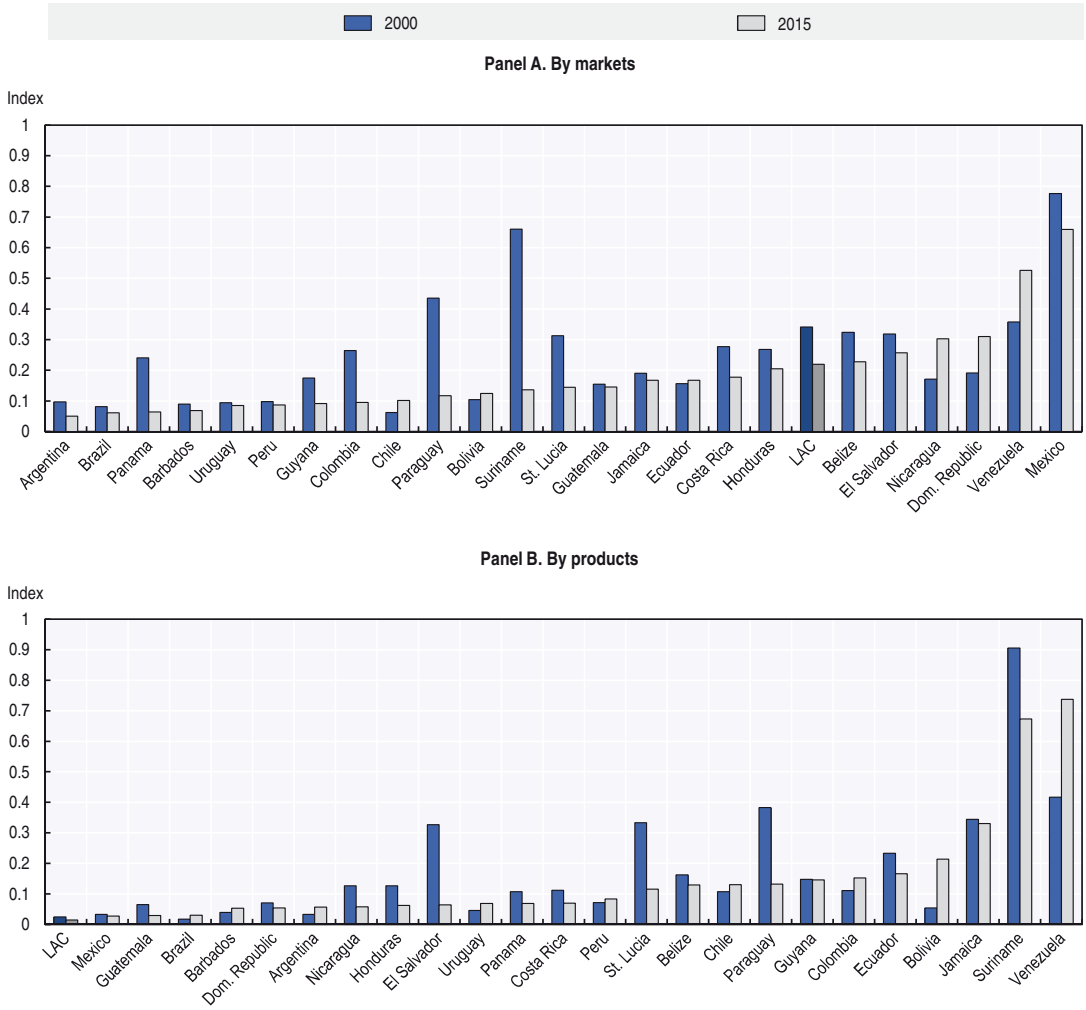
In the last 15 years, the region's exports have become considerably less concentrated in terms of market destination, but more concentrated by product. The Herfindahl-Hirschman index (HHI), a standard measure of trade concentration, shows that only 6 of 24 countries for which data were available decreased their concentration of exports by market over that period (Figure 2.24, Panel A). This mostly reflects the reduced share of the US market and the increased weight of China and other Asian economies. In terms of product concentration, the situation is less encouraging. Between 2000 and 2015, several LAC countries (mostly from South America) significantly increased their concentration index at the product level. This is true for both countries with fairly diversified exports (Argentina, Brazil and Uruguay) and those whose exports are concentrated on a limited range of commodities (Chile, Colombia, Peru, Bolivia and Venezuela). By contrast, all Central American countries, Mexico and the Dominican Republic reduced their concentration by product (Figure 2.24, Panel B).

Figure 2.24. **Export concentration by markets and products in Latin America and the Caribbean**

Herfindahl-Hirschman indices



Notes: Values for 2015 for Honduras, St. Lucia and Suriname correspond to 2014. For Venezuela, they correspond to 2013. Values for 2000 for the Dominican Republic correspond to 2001.

Source: OECD/ECLAC/CAF, based on data from COMTRADE.

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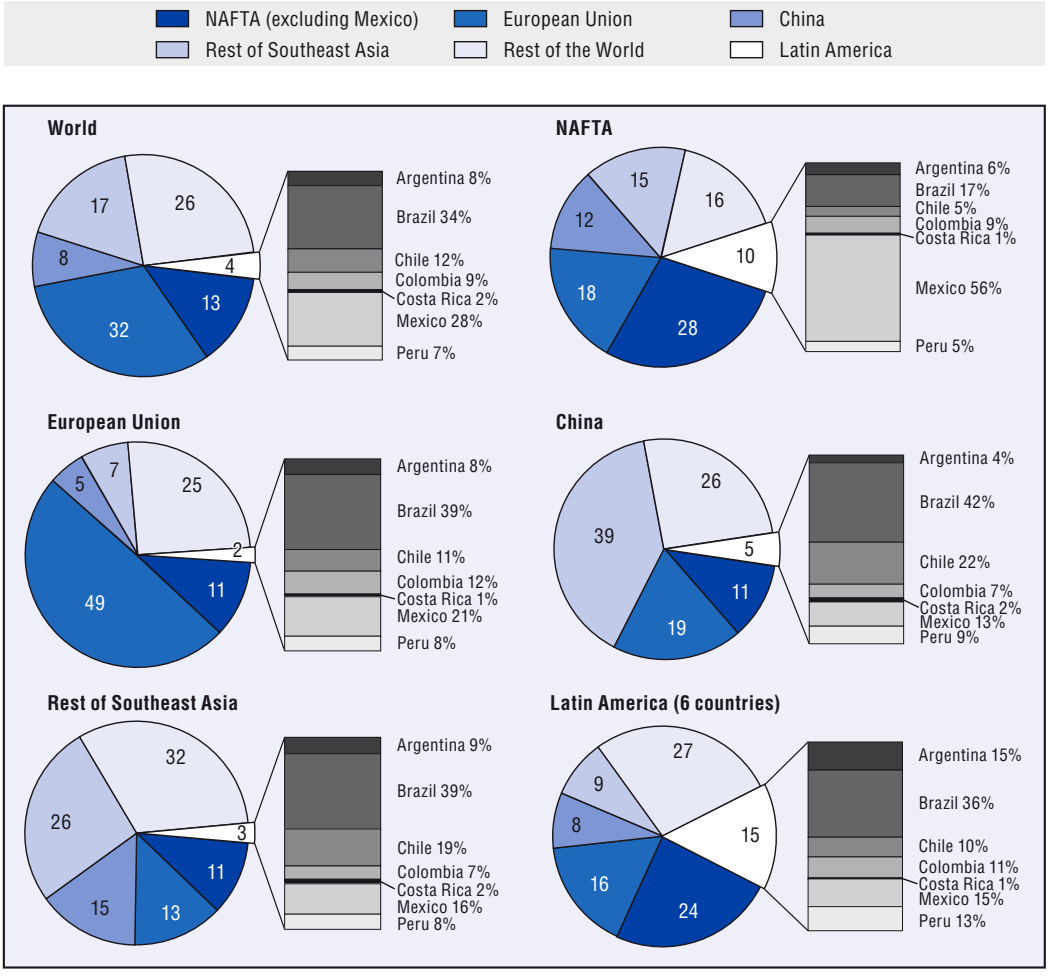
Latin America must speed up integration into regional and global value chains

Latin America's integration into GVCs has been weak. The region's participation as a source of foreign value added in world exports (forward linkages) remains negligible, while the share of foreign value added in Latin American exports (backward linkages) is considerably lower than that of other regions. The seven Latin American countries[6] for which data are available had a joint participation of only 4% as origin of the foreign value added embodied in world exports in 2014 (compared with nearly 3% in 1995) (Figure 2.25). The region's share is higher in NAFTA's exports (10% in 2014, compared to around 6% in 1995). This is largely explained by Mexico's forward linkages with its North American partners (particularly the US). Globally, Brazil is the region's main contributor of foreign value added into world exports (one-third of the region's total in 2014), followed by Mexico (with nearly 30%). This level of concentration is similar to that of gross exports, analysed previously in this chapter, which shows Brazil and Mexico as the region's largest exporters.

Figure 2.25. **Foreign value added in gross exports by geographical origin, 2014**

Percentages



Notes: The percentages in brackets next to the name of each exporting region indicate the share of foreign value added in the region's gross exports in 2014. Latin America (six countries) comprises Argentina, Brazil, Chile, Colombia, Costa Rica and Peru. Mexico is included in the NAFTA region.

Source: OECD/ECLAC/CAF on the basis of OECD/WTO (2015), *Trade in Value-Added (TiVA)* input-output tables (database).

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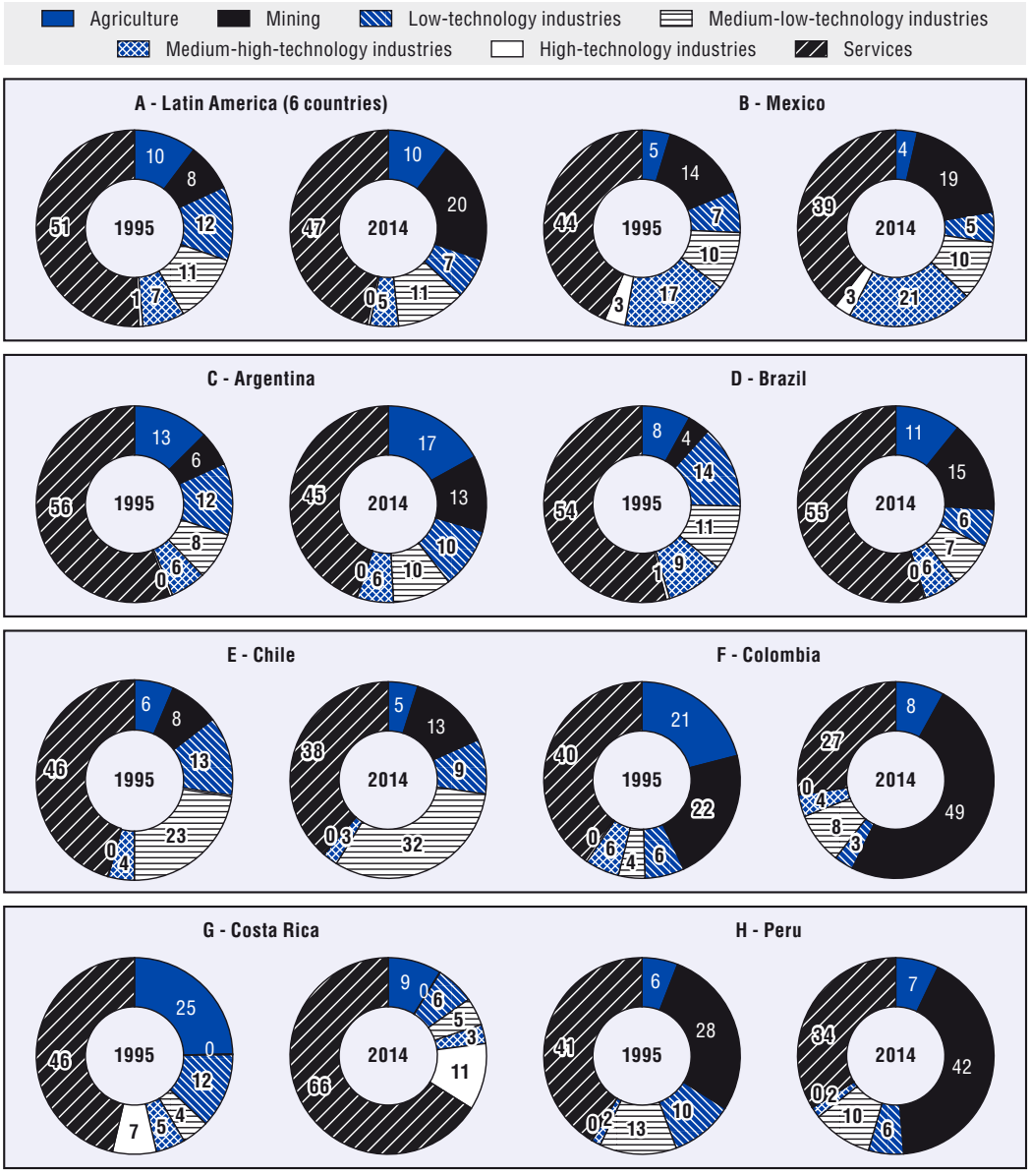
Along with low levels of forward linkages, Argentina, Brazil, Chile, Colombia, Costa Rica and Peru also have considerably lower backward linkages than other regions, particularly the European Union and Southeast Asia. In 2014, only 13% of the value exported by these six countries was generated in other economies. This compares with 19% for NAFTA countries and some 30% in the case of the European Union, China and the rest of Southeast Asia. However, within Latin America, Costa Rica and, to a lesser extent, Chile exhibit considerably higher levels of backward linkages than the other four countries (26% and 19% of gross exports, respectively, in 2014). Mexico, integrated into the NAFTA region, also has a relatively high share of foreign value added in its gross exports (33% in 2014).

Figure 2.26. **Domestic value added in third countries' exports by sector of origin in Latin America**

Percentages



Notes: Latin America (six countries) comprises Argentina, Brazil, Chile, Colombia, Costa Rica and Peru.

Source: OECD/ECLAC/CAF on the basis of OECD/WTO *Trade in Value-Added (TiVA)* input-output tables (database).

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Intra-regional links are particularly weak in Latin America, in contrast to the strong role of regional value chains in Europe, Southeast Asia or North America (OECD, 2015; Cadestin, Gourdon and Kowalski, 2016; Criscuolo and Timmis, 2017a). This pattern is reflected in the relatively low proportion of the foreign value added in Latin American countries' exports that originates in the region itself. In 2014, only 15% of the foreign value added embodied in exports from Argentina, Brazil, Chile, Colombia, Costa Rica and Peru was generated in the region (i.e. these six countries plus Mexico).[7] For Mexican exports, 45% of foreign value added came from the NAFTA region, while only 3% originated in the other previously mentioned Latin American countries. For the European Union, China and the rest of Southeast Asia, intra-regional value added represented around 40% or more of the total (Figure 2.25).

Latin American countries' participation in GVCs is also characterised by a high concentration of forward linkages in primary sectors (agriculture and mining) and low- and medium-low technology industries, in line with these countries' overall export patterns (Figure 2.26). In 2014, 30% of the value added from Latin America (six countries) in third countries' exports originated in primary sectors (mostly mining). Meanwhile, 18% was generated in low- or medium-low technology manufacturing sectors (in 1995 these shares were 18% and 23%, respectively). The contribution of services, although decreasing, remains significant (47% in 2014 for the Latin America [six countries] aggregate). This is particularly true for wholesale and retail trade, R&D and other business services, and, to a lesser extent, transport and storage. Costa Rica stands out in the region for a significantly larger participation of high technology industries (computer, electronic and optical equipment) in the country's forward linkages (11% in 2014).

Box 2.7. **Latin America's faltering manufacturing competitiveness: What role for intermediate services?**

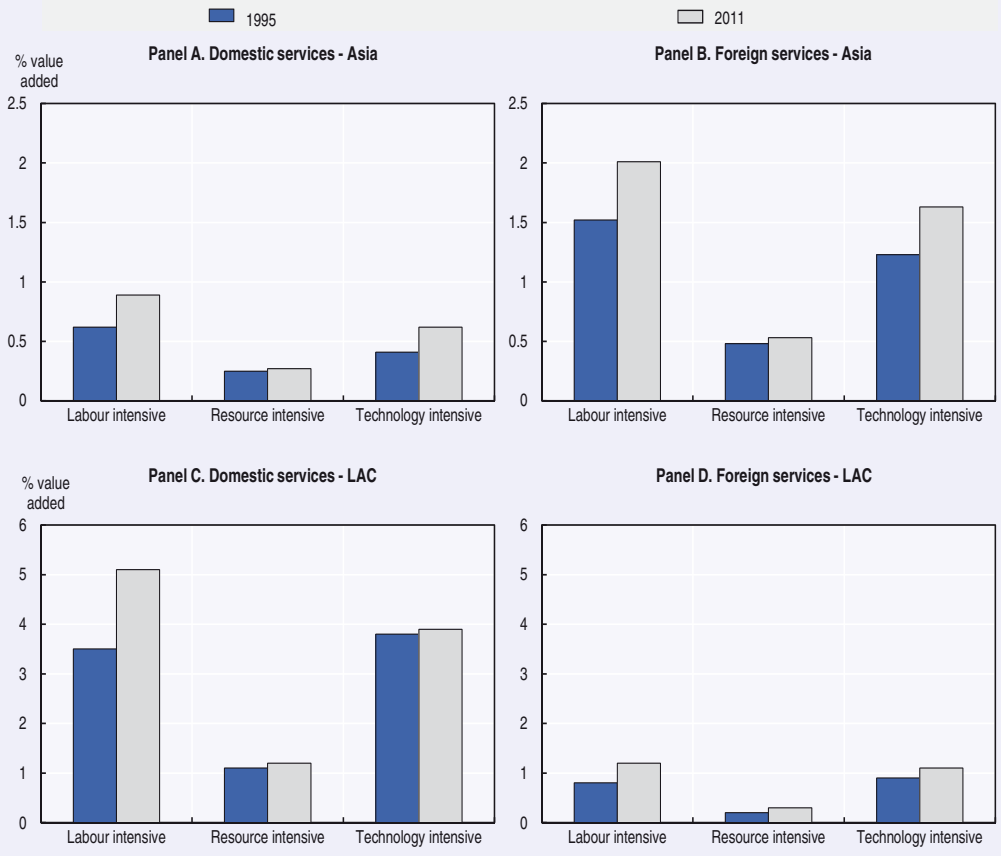
From 1990 to 2016, Latin America's share in global exports of manufactures stagnated around 5%. The region slightly gained market share in global trade in medium-tech manufactures, but lost in global trade of resource-based, low- and high-tech manufactures. This disappointing performance differs strongly from that of developing Asia (Association of Southeast Asian Nations [ASEAN], China and India), which increased its global exports share from 23% to 37% during the same period.

Latin America's underperformance in manufacturing trade is often explained by its growing specialisation in natural resources. However, the stagnant performance in global manufacturing exports could also be due to the insufficient incorporation of high quality domestic and foreign intermediate services in manufacturing. A growing literature shows that a country's manufacturing export performance depends critically on its degree of (business) "servicification". Evidence on OECD member countries shows that servicification is a key condition of successful manufacturing export performance and diversification. Logistics and information technology facilitate the movement of goods and information between segments, R&D, innovation and other intermediate services. They also improve the productivity of firms; contribute to the diversification, differentiation and value of products; overcome domestic market barriers; and outsource non-core inputs and services. Thus services play a key role in manufacturing-dominated GVCs. Baldwin, Forslid and Ito (2015) and Lodefalk (2015) studied the issue through international input-output tables, micro firm-level data and case studies. They confirm the growing value of added share of services in manufacturing production and exports in France, Germany, Sweden, the US and other OECD member countries. Manufacturing

Box 2.7. **Latin America's faltering manufacturing competitiveness: What role for intermediate services?** *(cont.)*

in emerging economies is increasingly connected to foreign services. However, there is no clear pattern for emerging economy domestic linkages between manufacturing and services (Criscuolo and Timmis, 2017b). Similarly, there is a knowledge gap with respect to the servicification of the mining sector and other resource-intensive sectors. Overall, few studies have been conducted in this area on the region.

Figure 2.27. **Content of domestic and foreign services in exports (percentage value added)**



Source: OECD/ECLAC calculations, based on WIOD Input-Output tables and TiVA (2017).
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Using input-output tables and case studies, Avendano, Bontadini and Mulder (2017) explore whether the incorporation of a range of services could revitalise Latin America's manufacturing export performance. In particular, they use the 2016 version of OECD's TiVA database, focusing on seven countries from the region (Argentina, Brazil, Chile, Colombia, Costa Rica, Mexico and Peru). Using data from between 1995 and 2011, the study compares domestic and imported intermediate services value-added contents of manufactures exports of the seven LAC countries and eight ASEAN countries (Brunei Darussalam, Cambodia, Indonesia, Malaysia, Philippines, Singapore, Thailand and Viet Nam). In addition to the total contents of services, it analyses business services that are of strategic importance to improve the manufacturing sector's international competitiveness.

Box 2.7. **Latin America's faltering manufacturing competitiveness: What role for intermediate services?** *(cont.)*

The study builds on the approaches of Evangelista, Lucchese and Meliciani (2015), Francois and Woerz (2008) and Wolfmayr (2008). It carries out panel regressions to test whether intermediate services intensities of manufacturing sectors help explain their export performance in terms of either global export market shares or other trade performance variables such as the degree of product diversification. The modelling considers control variables such as the unit labour cost, the share of each country in global patents per sector, openness of specific intermediate service sectors and direct exports of these services. It distinguishes between three groups of manufacturing industries: natural resource-intensive, labour-intensive ones and technology-intensive. It also compares the role of services in LAC and ASEAN. Preliminary results suggest the content of domestic and foreign services in Latin American exports is not necessarily too different from ASEAN countries. However, some intermediary services, in particular those associated with business services and logistics, are the most strategic for export performance of the manufacturing sector.

Structural factors, alongside trade and investment policies, explain the region's slow integration into global value chains

GVCs result from the fragmentation of production of goods and services into distinct stages in diverse countries. They have transformed world trade thanks to decreasing transport costs, advances in information technologies and trade liberalisation. Recent evidence points to the changes of the structure of GVCs (Ahmad et al., 2017).[8] They can play a role in the catch-up of firms, but are also heterogeneous across firms and countries (Criscuolo and Timmis, 2017a). With nearly 80% of total world trade and despite the recent slowdown in trade for intermediate goods, GVCs remain fundamental to countries' trade performance.

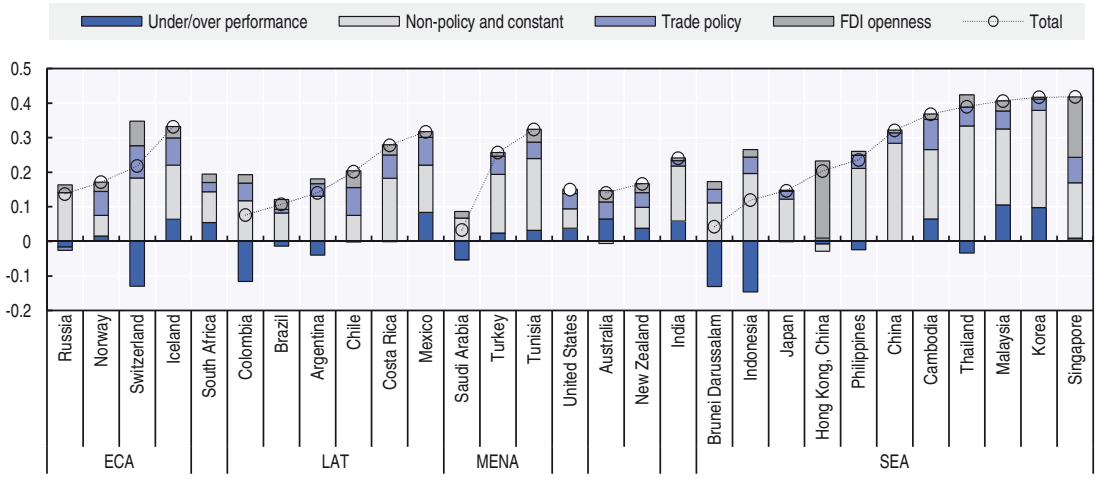
Despite some modest improvements, most Latin American countries remain on the periphery of global production networks. Latin America's participation in GVCs is considerably lower than those of other regions, mainly owing to the lower backward linkages. In addition to low GVC integration, the share of intra-regional trade in intermediate and final goods in Latin America is low compared with other regions. However, it is more present in intermediate than in final goods.

Structural factors, but also trade- and investment-related policies, are important for explaining the low integration of most Latin American economies into GVCs. Recent evidence on the determinants and economic effects of GVC participation in emerging economies offers some guidelines for improving Latin America's performance in global production networks. To the extent that efficient integration into GVCs is important for raising productivity levels, governments in the region are analysing how certain factors can facilitate this process.

Traditional determinants of GVC participation include geographical location, distance to manufacturing hubs, gross domestic product and market size. However, other policy-determined factors seem to be important as well. These include import tariffs (both domestic and with trade partners), engagement in preferential trade agreements (PTAs) and openness to inward FDI. The most important factors explaining GVC integration

into Latin America and other regions appear to be structural, but trade and investment policy also affect it (Kowalski et al., 2015; Cadestin, Gourdon and Kowalski, 2016; Figure 2.28). This also suggests some important differences within countries. While import tariffs (domestic and in export markets) are relatively low, the PTA coverage is better in some countries (Mexico, Chile, Costa Rica) than in others (Argentina, Brazil). Restrictiveness to foreign investment in some sectors seems also to undermine the capacity of some countries to integrate GVCs. Also, unobserved factors can boost or hamper GVC participation (Cadestin, Gourdon and Kowalski, 2016).

Figure 2.28. **Relative contribution and impact of policies on GVC integration, 2011**



Note: ECA refers to European and Central Asian countries, LAT refers to Latin America, MENA refers to Middle East and North Africa and SEA to South East Asia.

Source: OECD (2015); Cadestin, Gourdon and Kowalski (2016).

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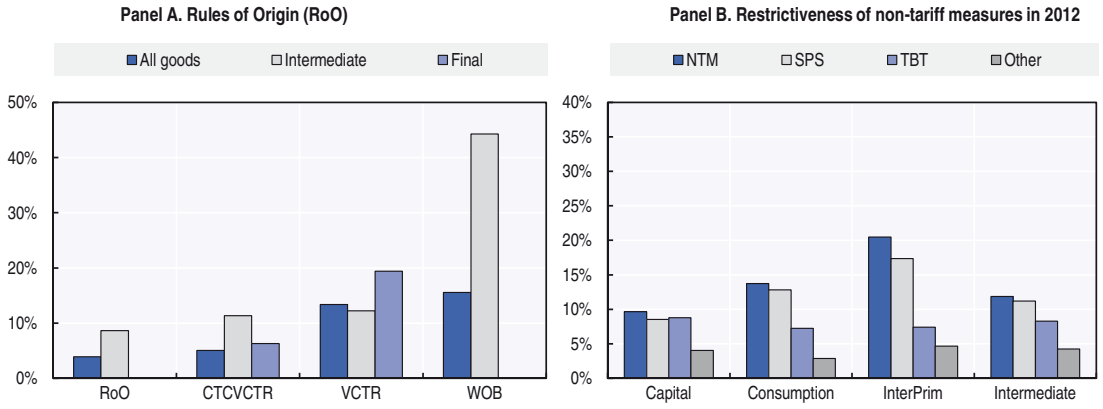
Logistics and infrastructure performance, trade facilitation and institutional quality are important factors for explaining integration of countries into GVCs. The impact of different policies on GVC integration has been studied in recent years, providing some further evidence on integration-enhancing factors. Geographically fragmented production processes are increasingly sensitive to trade costs. Less than 10% of trade costs can be attributed to tariffs, and between 10% and 30% to geographic and cultural factors. However, the bulk of indirect trade costs is related to trade procedures, maritime connectivity, access to ICT services (Box 2.7) and the regulatory environment. Latin America has some of the highest trade costs in the world (OECD/CAF/ECLAC, 2013; Cadestin, Gourdon and Kowalski, 2016).

The OECD Trade Facilitation Indicators (TFIs) provide a basis for governments to prioritise trade facilitation actions (Moïsé and Sorescu, 2013). A number of countries in the region (including Colombia, Peru, Mexico and Chile) have light regulatory burdens on firms, which are considerably higher in Venezuela and Bolivia. Protection of Intellectual Property Rights (IPR) shows a similar degree of heterogeneity in the region. With few exceptions (Panama, Chile, Uruguay) efficiency of customs procedures is low. With a more volatile demand from GVCs, and the need to adapt to changing market conditions, Latin American countries require appropriate logistics and infrastructure standards to respond.

The harmonisation and re-design of Rules of Origin (RoO) could considerably improve the participation of Latin American countries in global production networks.

Regulations often undermine the high density of intra-regional and extra-regional PTAs in Latin America. Recent evidence points to RoO as a sensitive factor (Powell, 2017). Rules of origin establish the conditions of a product to be eligible for preferential access to a PTA. From the perspective of GVCs, RoO have been found to have a negative effect for extra and intra-PTA value chain formation. On average, RoO are estimated to have tariff equivalents of around 9% for imports of intermediate products in the region (Cadestin, Gourdon and Kowalski, 2016). To overcome these effects, a more flexible approach to rules of origin has been useful, as exemplified by some countries in the region with higher levels of GVC participation (e.g. Mexico). A renegotiation of product-specific RoO and an improvement of the RoO architecture through amendments to certification, *de minimis* and cumulation rules can help improve flexibility. But this process can be time-consuming and costly. Another option would be to reduce tariffs on a most-favoured nation (MFN) basis. This is especially relevant since average MFN tariffs on intermediate products are below the 8.6% threshold, an estimated tariff equivalent of RoO (Cadestin, Gourdon and Kowalski, 2016). This may suggest that the average protection of MFN tariffs to intra-PTA providers is lower than the costs of compliance of RoO. Some agreements, including the Pacific Alliance, have already introduced more inclusive schemes, such as allowing full cumulation across PTA partners and cross-cumulation of RoO between overlapping PTAs.

Figure 2.29. **Estimated ad valorem equivalent of Rules of Origin and restrictiveness of non-tariff measures in Latin America**



Notes: RoO (Rules of Origin), CTC (change in tariff classification), VCTR (value content of technical requirement), WOB (wholly obtained rule), NTM (non-tariff measures), SPS (sanitary and phytosanitary measures), TBT (technical barriers to trade).
Source: Cadestin, Gourdon and Kowalski (2016), based on TiVA, CEPII and UNCTAD/World Bank (2017).

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To improve participation in GVCs, Latin American countries can address the effect of non-tariff measures (NTMs), including standards, technical regulations and conformity assessment procedures. Although regulations and standards are not supposed to discriminate against imports, evidence shows they can become more restrictive than necessary. While countries apply different standards and regulations to protect their domestic consumers, the use of diverging national standards can undermine the countries' capacity to participate in global production. Recent evidence suggests that NTMs can be detrimental for GVC integration into Latin America. Indeed, it argues that NTMs can be equivalent to a tariff of 20% for primary intermediary products and 12% for processed intermediates (Cadestin, Gourdon and Kowalski, 2016, Figure 2.29).

This could explain why countries in the region with restrictiveness through non-tariff measures tend to be less integrated into GVCs. Mutual recognition and the harmonisation of technical regulations or conformity assessment procedures can be effective facilitation mechanisms to reduce these costs and to promote convergence of standards in the medium term. International standard setting that takes into account different development models and national approaches will be essential in this process (OECD, 2017f).

The region can focus on specific sectors to better integrate into global value chains

Some sectors have more potential for Latin America to integrate into regional and global value chains. The development of textile and electronics, for example, can propel the inclusion into the automotive industry and thus into global and regional value chains. This sector is particularly promising as vehicle production has been outsourced to Argentina, Brazil and Mexico. Together, in 2015 these three countries accounted for 7.2% of global vehicle production (Ministry of Treasury and Public Finance, Argentina, 2016). Other economies such as Peru, Chile or the Dominican Republic have already taken steps to better integrate into the automotive industry. Peru is striving towards further developing capacities in areas such as tyres (rubber products) and textiles to increase linkages with the automotive chain. Chile is developing an industry in vehicle parts and the copper industry provides unexploited opportunities for more linkages with the automotive chain, especially with Mercosur. The Dominican Republic has highlighted footwear and leather-good clusters as areas of potential linkages with the automotive chain (OECD, 2016).

Other sectors could also present strong opportunities to integrate into GVCs beyond natural resource-based products. An analysis based on revealed comparative advantage (RCA) indices shows that Latin American countries' potential as sources of foreign intermediates for NAFTA, the European Union and Southeast Asia would go beyond natural resource-based products (Zaclicever, 2017). Table 2.2 presents the industries in which the main Latin American providers of imported inputs for the three GVCs (Argentina, Brazil, Chile, Costa Rica, Mexico and Peru), which accounted for around 90% of the region's gross forward linkages in 2011, have a RCA in those markets. In particular, Brazil, Costa Rica and Mexico show competitiveness in some of the more technology-intensive industries (e.g. motor vehicles; electrical machinery and apparatus, n.e.c.; or computer, electronic and optical equipment; depending on the country) (Zaclicever, 2017). However, this competitiveness has not necessarily translated into a significant participation of these industries in the region's forward linkages with GVCs. A similar analysis was conducted in the Pacific Alliance, where potential sectors for integration have been located in intermediate/capital goods (e.g. plastics, paper and cardboard), as well as consumer goods (e.g. perfume and cosmetics, cereals and flours, and food derivate products) (Hernandez et al., 2015).

Table 2.2. **RCAs in forward linkages with GVCs, 2010-11**

Exporting country	Factory North America	Factory Europe	Factory Asia
Argentina	Basic metals; textiles; agriculture; food products, beverages and tobacco; mining and quarrying; wood and wood products	Food products, beverages and tobacco; chemical products; textiles; agriculture	Agriculture; food products, beverages and tobacco; textiles
Brazil	Basic metals; motor vehicles; chemical products; agriculture; rubber and plastics products; pulp, paper and paper products; food products, beverages and tobacco; textiles; other non-metallic mineral products; mining and quarrying; wood and wood products	Agriculture; basic metals; food products, beverages and tobacco; mining and quarrying; pulp, paper and paper products; textiles; wood and wood products	Mining and quarrying; agriculture; pulp, paper and paper products; food products, beverages and tobacco

Table 2.2. **RCAs in forward linkages with GVCs, 2010-11** *(cont.)*

Chile	Basic metals; wood and wood products; agriculture; pulp, paper and paper products; food products, beverages and tobacco	Basic metals; mining and quarrying; pulp, paper and paper products; wood and wood products	Basic metals; mining and quarrying; pulp, paper and paper products; wood and wood products
Costa Rica	Computer, electronic and optical equipment; rubber and plastics products; agriculture; food products, beverages and tobacco	Computer, electronic and optical equipment; agriculture	Computer, electronic and optical equipment; electrical machinery and apparatus, n.e.c.; agriculture
Mexico	Motor vehicles; electrical machinery and apparatus, n.e.c.; other non-metallic mineral products	Computer, electronic and optical equipment; electrical machinery and apparatus, n.e.c.; other transport equipment; mining and quarrying	Basic metals; mining and quarrying; electrical machinery and apparatus, n.e.c.; motor vehicles
Peru	Basic metals; agriculture; food products, beverages and tobacco; wood and wood products	Basic metals; mining and quarrying; agriculture; food products, beverages and tobacco	Mining and quarrying; basic metals; food products, beverages and tobacco; wood and wood products

Notes: Industries are ranked, from highest to lowest, on the basis of their share in countries' gross forward linkages with the GVC.
Source: Zaclicever (2017), on the basis of input-output data from the OECD's ICIO tables, and trade data from the Centre d'Études Prospectives et d'Informations Internationales (CEPII), Base pour l'Analyse du Commerce International (BACI).

Skills-based sectors, in particular certain high-tech niches and services, are another area where the region could further integrate into GVCs. Improving basic abilities such as literacy, numeracy and problem-solving skills are essential to develop a service industry such as marketing, branding and customer service, as well as the tech industry (OECD, 2017g). For the same reason, it is also critical to refine skills that can benefit the professional environment, such as managing capacities and communication. Similarly, to specialise in the most technologically advanced industries, countries require workers to complement their cognitive skills with the development of appropriate social and emotional aptitudes such as communication and organisation. A country with a skills mix that is well aligned with the requirements of technologically advanced industries can specialise in these industries on average 8% more than other countries (OECD, 2017g). However, Latin America faces a wide skills gap, not only in technical skills, but also in communications and management. Colombia, for instance, has a deficit of 15 000 telecommunication and software engineering professionals, which could rise to 90 000 by 2018. In Peru, 67% of employers declare having trouble filling positions, especially those requiring language skills (Pezzini and Schleicher, 2015).

Regional integration, an effective policy to upgrade and diversify under a challenging global trade environment

The current economic context highlights the urgency for more efficient regional integration. Recent developments on trade agreements and consolidation of intra-regional trade in other regions, particularly Asia, highlight the need for an integration agenda in Latin America, in the form of open regionalism (Bown et al., 2017) or deep integration (OECD/CAF/ECLAC, 2015; IMF/World Bank/WTO, 2017). The end of the commodity supercycle, the sharp deceleration of regional growth, political changes in some key countries of the region, and concerns about a growing protectionism in some key markets have combined to bring a renewed sense of urgency to strengthening regional integration. There are several possible avenues to do so. One promising path is the possible convergence between the region's two largest integration agreements, the Pacific Alliance and Mercosur (Box 2.8). Combined, they account for more than 80% of the region's population and for 90% or more of its GDP, trade and FDI flows. This means that any agreements between them could act as a powerful catalyst of region-wide integration. The convergence process is still at an early stage and not expected to lead in the short term to any formal trade negotiations. Instead it will proceed in

an incremental way, starting with work on areas such as customs co-operation, trade facilitation (for both goods and services), cumulation of origin and digital certification of origin.[9]

Box 2.8. **Mercosur and the Pacific Alliance: A future rapprochement?**

The continent's largest trade platforms, Mercosur and the Pacific Alliance, represent over 90% of the region's GDP. This makes the prospect of integration not only a potential for growth, but also a boon for extra-regional trade negotiations. Established in 1991, Mercosur is a customs union originally compromised of four Southern-cone countries (Argentina, Brazil, Paraguay and Uruguay). Venezuela joined in the group in 2012 but its membership is suspended since late 2016. Mercosur allows intra-bloc duty free trade (except on the auto industry and sugar) and levies a common external-tariff (0-20%) on non-member countries. The Pacific Alliance, established in 2011 and composed of Colombia, Mexico, Peru and Chile, is a process of open and regional integration. It is based on a liberalising agenda in the areas of trade in goods and services, capital markets and investment. Moreover, some provisions have been adopted to ease short-term people flows migratory flows. In this context, the integration between the Pacific Alliance and Mercosur, which started to be discussed in April 2017, could propel LAC's participation in GVCs and regional integration forward and scale-up its role in the global trade arena. Working together, they could consolidate their respective platforms and strengthen certain areas.

Brazil and Argentina met in February 2017 to lay the groundwork for homogenising Mercosur's commercial measures such as the creation of common regulatory convergence. Meanwhile, the Pacific Alliance has made great strides in the area of trade facilitation. By interconnecting its members' electronic single windows for foreign trade, since July 2016, all four countries can electronically exchange phytosanitary certificates. Since May 2017, they have been able to digitally exchange certificates of origin. By 2018, the Pacific Alliance aims that all foreign trade transactions within the group be done digitally through the Customs Declaration. Moreover, the four countries are working towards the mutual recognition of their respective Authorised Economic operator schemes and expect to sign an agreement to that effect during the second half of 2017. The Pacific Alliance, however, lacks many common regulatory standards. This gap, combined with geographical obstacles and poor or lacking public infrastructure, hinders the ability of small and medium-sized enterprises (SMEs) to integrate into domestic, regional and global markets (Jarrín and Pica, 2016).

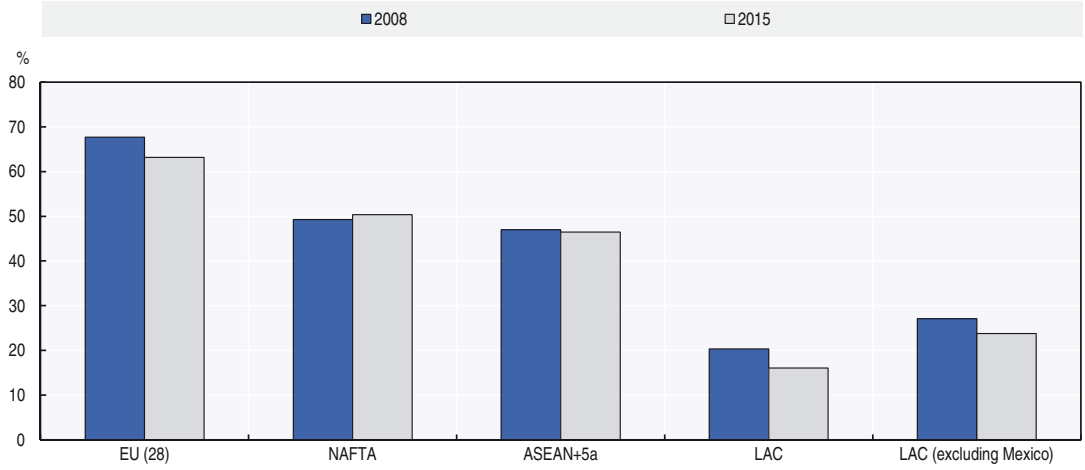
Against this background ministers and technical-level officials from both groups are meeting regularly to discuss possible co-operation in six areas: *i)* trade facilitation and single windows for foreign trade (VUCEs); *ii)* regional value chains; *iii)* cumulation of origin; *iv)* trade promotion and SMEs); *v)* non-tariff barriers; and vi) facilitation of trade in services.

Despite almost 60 years of efforts, LAC regional economic integration remains far from its full potential. Just 16% of total LAC exports are destined for the regional market. This is well below the intra-regional trade coefficients of the world's three major "factories" (Figure 2.30). Regional integration is also important for manufacturing, as its intermediate sourcing patterns tend to be particularly sensitive to distance. LAC's low level of intra-regional trade and generally scarce intra-regional production networks are a result of multiple factors. These include the region's vast size, geography, poor transport infrastructure,[10] the gravitational pull of the US economy on Mexican and Central American trade flows, and the similar commodity endowments of several South American

countries. Intra-regional trade and investment are further complicated by the high level of fragmentation of the regional market. Specifically, the institutional architecture of LAC economic integration is made up of several sub-regional mechanisms plus a large amount of mostly bilateral agreements linking members of those mechanisms. Trade integration should also call for the regional development of services inputs in natural-resource sectors. As members of a commodity-rich region, participating countries can further promote services tackling natural-resource industries, while at the same time favour product diversification.

Figure 2.30. **Share of intra-group exports in total exports**

Percentage



Notes: ASEAN + 5 includes China, Japan, Korea, Chinese Taipei, Hong Kong (China) and the 10 members of ASEAN.
Source: OECD/ECLAC/CAF, based on data from COMTRADE.
StatLink http://dx.doi.org/10.1787/888933650741

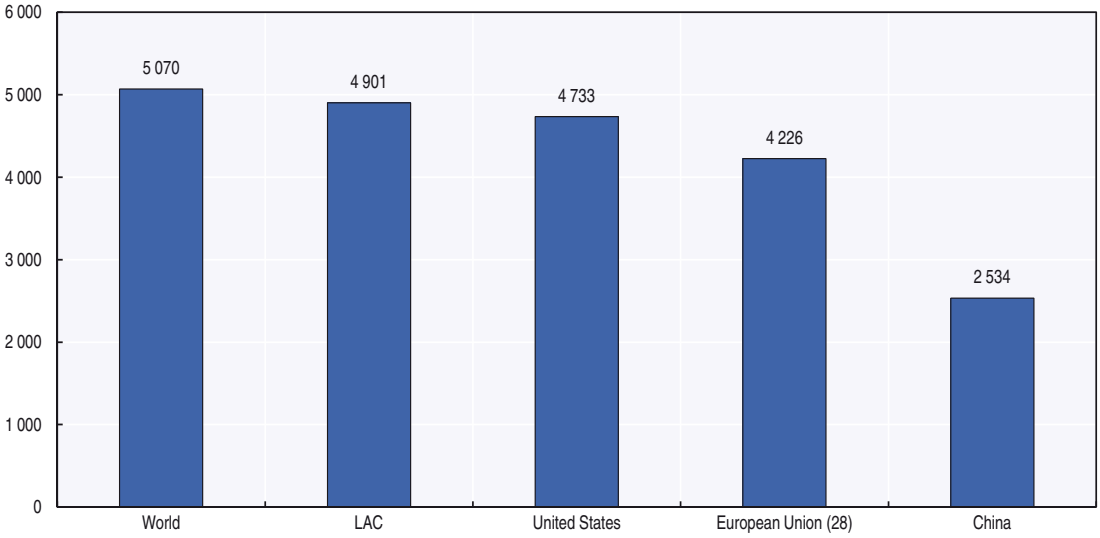
Despite these challenges, the region has made substantial progress in the removal of tariffs to intra-regional trade. The design of RoO is moving towards capturing the full gains associated with this liberalisation. Yet challenges remain in the removal of regulatory barriers. About 80% of intra-regional trade already benefits from trade preferences, a share that will increase in the coming years as the tariff phase-out schedules of the different agreements kick in. However, the remaining 20% includes some key bilateral relationships, most notably those of Mexico with Argentina and Brazil.[11] More importantly, the region as a whole has made little progress in the removal of non-tariff (regulatory) barriers to intra-regional trade and investment. These barriers include inconsistent technical, sanitary and phytosanitary standards; discrimination against regional suppliers in government procurement; and cumbersome customs procedures. Obstacles in the areas of non-tariff barriers and infrastructure development may represent greater obstacles to the formation of regional value chains than tariffs (Cadestin, Gourdon and Kowalski, 2016; Bown et al., 2017; ECLAC, 2017c). In short, the region remains far from being a single integrated area with a common set of rules for trade and investment.

The region needs to work further on harmonising rules of origin and regulatory frameworks for the exchange of goods, services and endowments for production (e.g. electricity) (Powell, 2017). It also requires adoption of international standards and export certifications, particularly in agro-food. Reducing Latin America's high-trade costs remains a challenge for regional integration, where the improvement of infrastructure, logistics and customs procedures is critical. Nearly 57% of Latin American exports consist of perishable or logistics-intensive products, three times more than the OECD average (OECD/

CAF/ECLAC, 2013). Other complementary policies can also strengthen regional integration efforts, particularly in the area of coordination of domestic capital makers (IMF, 2017c).

Tapping on the large unexploited potential offered by regional integration is probably the most effective policy response that LAC countries can adopt faced with a challenging global trading environment. There are several reasons for this. First, despite absorbing just 16% of the region's total exports, the LAC market accounts for much larger shares of manufacturing exports for most countries. Second, the regional market is the most conducive to export diversification, absorbing the highest number of exported products (Figure 2.31). Third, LAC remains the most important market (often the only one) for the region's SMEs, which in turn account for the large majority of its exporting firms. Fourth, because of the advantages offered by geographical proximity, language and cultural affinities, the region is also the most natural space for LAC countries to enter international value chains. Fifth, more dynamic intra-regional trade would reduce the region's high vulnerability to volatile commodity prices and to changing economic and political circumstances in other markets. Lastly, a more integrated regional market would enhance LAC's position in trade negotiations with extra regional partners.

Figure 2.31. **Number of products exported to selected markets in Latin America and the Caribbean, 2015**



Notes: Products are defined at the 6-digit level of the Harmonized Commodity Description and Coding System.
Source: OECD/ECLAC/CAF, based on data from COMTRADE.
StatLink http://dx.doi.org/10.1787/888933650760

A more integrated regional market would enhance LAC's position in trade negotiations with extra regional partners. Comply with existent agreements has been an objective with different platforms in the region, including the Pacific Alliance, Mercosur and the CAFTA-DR. Regional platforms such as Mercosur, the Latin American Integration Association (ALADI) and the Pacific Alliance can play an important role to promote coherence in the region's regulatory frameworks for trade and investment. These platforms can also maximise preferences from existing regional agreements; despite the proliferation of trade agreements, they have not been completely capitalised (IDB, 2016). By improving coherence, the region can reduce barriers to trade and be more coherent when negotiating with extraregional partners, in particular China and the European Union (OECD/CAF/ECLAC, 2015). A call for speedier progress on the regional integration agenda does not mean lessening efforts to improve the region's access to key extra regional markets.

Rather, regional and global integration can, and should, reinforce each other. For example, both the Pacific Alliance and Mercosur are simultaneously pursuing agreements with extra-regional partners and moving forward with their convergence efforts (Box 2.8).

Conclusions

LAC is expected to emerge from a two-year recession in 2017. External factors are contributing to this small rebound with the improvement in the global economy and the stabilisation of commodity prices. This recovery is not exempt from risks, as an environment of uncertainty and possible external and domestic shocks could derail it. In the short term, growth paths vary from one country to another, reflecting differences in exposure to external shocks and soundness of the domestic policy. The scope for demand policies to stimulate growth remains limited. However, some space for monetary policy is opening in some South American economies, thanks to lower inflation rates. The space for fiscal policy is limited as most countries need further adjustments to stabilise debt. In the medium term, estimates indicate that potential growth is lower than expected and most of the Latin American and Caribbean economies seem to be tangled in the middle-income trap. Low productivity growth is at the heart of low potential growth, with the region failing to undertake structural changes towards innovation, competition, and more knowledge-based economies.

Trade and deeper, more effective regional integration are channels to increase productivity and thus, potential output growth. Gains from trade can translate into more productive firms or broader choice for households. However, the potential effects of trade on inequality also need to be considered. Today, Latin America has ample room to look for a more diversified economy, upgrade the services content of exports and deepen regional integration. While the number of trade partners has increased, the region continues to trade mostly primary goods. With such trade structure, there is potential for promoting sectors that respond better to the demands of natural resource-intensive industries, particularly services. In a global context of lower trade of intermediate goods, the region's integration into global value chains is still weak and remains in the periphery of global production networks. Beyond well-known factors, such as lack of infrastructure development and the weak productive capacity, Latin America's limited integration to GVC's can be explained by policy-determined factors such as import tariffs, the use of preferential trade agreements and low openness to FDI. Similarly, GVCs are highly sensitive to cost. LAC has some of the highest trade costs, which are further increased through the lack of harmonised Rules of Origin and through non-tariff trade measures, including technical barriers to trade, phytosanitary conditions and other standards. Setting up regional and international standards will require acknowledging the different development agendas in the region.

Overall, the region faces the need to adopt institutional reforms to build the pillars of a growth model that promotes inclusion and can guarantee sustained socio-economic progress. This entails mainly expanding the potential output through increases in productivity, and adopting structural policies to overcome the middle-income trap.

Notes

1. For instance, the 2017 edition focused on fiscal policy to boost investment and inclusive growth (OECD/CAF/ECLAC, 2016). Similarly, the 2016 edition analysed the effects of a possible slowdown in China and the effects on the LAC region (OECD/CAF/ECLAC, 2015). The 2015 edition studied the effect on the region of temporary resource booms (OECD/CAF/ECLAC, 2014).
2. These results should not be seen as predictions, but more as illustrations of the potential impact of two extreme scenarios over the region.
3. The negative effect on mineral manufactures may be due to the long-term investments common in the sector, and result in a more inelastic supply response. For example, in the face of losses of competitiveness experienced in periods of appreciation, firms continue to export to cover high fixed costs.
4. An increase of 0.01 standard deviations in the variation of the real exchange rate produced a reduction of real exports of manufactures of 0.97%.
5. The Global Trade Alert (GTA, www.globaltradealert.org) documents acts from various states that affect foreign commercial interests in a publicly available online database (GTA, 2017). This initiative, run from the University of St. Gallen, Switzerland, was launched in June 2009. At that time, it was feared the global financial crisis would lead governments to adopt widespread 1930s-style beggar-thy-neighbour policies. Although global in scope, the GTA gives particular attention to the policy choices of the G20 governments since their leaders made a "no protectionism" pledge in Washington, DC in November 2008. As of July 2017, the GTA database includes entries for over 11 000 state acts. Each is classified using an extensive taxonomy, including timing of the action, instrument used and sectors or product affected.
6. Argentina, Brazil, Chile, Colombia, Costa Rica, Mexico and Peru are the Latin American countries for which information is available in the *Trade in Value-Added (TiVA)* database of the Organisation for Economic Co operation and Development (OECD) and the World Trade Organization (WTO), on which this subsection is based. The most recent year for which information is available is 2014.
7. Within Latin America (six countries), Brazil, Costa Rica and Peru show the lowest backward intra-regional links, having sourced from the region only around 8%, 11% and 13%, respectively, of the foreign value added in their exports in 2014. For Argentina, Chile and Colombia, the region's share was 22%, 28% and 18%, respectively.
8. See Ahmad et al. (2017) for a recent review on the use and interpretation of GVC indicators.
9. See "Meeting of Foreign Ministers Mercosur-Pacific Alliance: Joint Communiqué", Buenos Aires, 7 April 2017, at www.mrecic.gov.ar/en/meeting-foreign-ministers-mercosur-pacific-alliance-joint-communique
10. According to a recent World Bank study, almost 70% of the region's roads are unpaved, compared with less than 30% of unpaved roads in East Asia (Bown et al., 2017). Similarly, the quality of infrastructure in LAC is below that of export rivals (IMF, 2017b).
11. Mexico's trade with Argentina and Brazil is conducted on a non-preferential basis, with the partial exception of the automotive sector. In 2015, Mexico and Brazil started negotiations towards a comprehensive trade agreement that would liberalise trade in most goods and include commitments in areas such as services and government procurement. Negotiations towards a similar agreement were launched in 2016 between Mexico and Argentina.

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