Latin American Economic Outlook 2014
LOGISTICS AND COMPETITIVENESS FOR DEVELOPMENT

The Latin American Economic Outlook is the OECD Development Centre’s annual analysis of economic developments in Latin America. It is produced in partnership with the United Nations Economic Commission for Latin America and the Caribbean (ECLAC) as well as CAF, development bank of Latin America. Each edition includes a detailed macroeconomic overview as well as analysis of how the global context is shaping economic performance in the region. Each issue also takes an in-depth look at a special theme related to development in Latin America, taking into account future strategic challenges and opportunities. Supplementary material is available on www.latameconomy.org.

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http://dx.doi.org/10.1787/leo-2014-en

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General overview

The external scenario is less favourable for the region due to the downturn in global trade, the moderation in commodity prices and the increased uncertainty surrounding global financing conditions.

The euro area’s weak economic performance, the slowdown in the Chinese economy and its effects on metal and mineral prices, and the impact that the normalisation of US monetary policy will have on international capital markets directly affect Latin American economies. First, demand for exports of the region’s goods and services is forecast to decline due to more moderate growth in global trade. Second, while the prices of imports have remained stable, the prices of Latin America and the Caribbean’s main commodity exports have declined since 2012. These factors have contributed to the deterioration of the trade balance (Figure 0.1), which is lower than in the 1990s, but increasingly more uniform. At the one extreme are the net exporters of oil and gas, which have current-account surpluses, and at the other are the economies of Central America and the Caribbean, which are net importers of commodities and have current-account deficits of more than 10% of GDP. Finally, if the United States tightens its monetary policy, external financing will steadily become more expensive and capital outflows to the region will probably fall, resulting in greater uncertainty and more volatile capital markets.

Figure 0.1. Current account as percentage of GDP of Latin America and the Caribbean

Source: Based on ECLAC (CEPALSTAT) data.
StatLink   http://dx.doi.org/10.1787/888932906350
Although an increase in domestic demand could partly compensate the slowdown in external demand, many Latin American economies are converging towards their potential GDP following an expansionary phase of the business cycle.

Although many of the region’s economies have some monetary and fiscal space for an additional stimulus to compensate for temporary external shocks, the region is faced with a more permanent, widespread economic slowdown that makes it difficult to provide this kind of stimulus. Moreover, several countries are converging towards their potential GDP from an expansionary phase of the business cycle, and some are also faced with supply-side bottlenecks, making them vulnerable to domestic and external imbalances if there is an additional stimulus.

Previous episodes of economic instability in the region are a reminder to be vigilant of expanding domestic credit and changes in fiscal aggregates.

Credit relative to the size of the economy has grown rapidly in most Latin American countries in the last ten years, especially mortgages and consumer credit. The authorities should therefore monitor the amount of credit so they can prevent or mitigate potential booms, which lead to internal and external imbalances. They should take measures to ensure that the financial system remains solvent, avoiding excessive risk-taking and limiting the system’s procyclical nature. Moreover, although current debt levels are sustainable under the baseline scenario, the fiscal space has shrunk considerably in various Latin American countries. This divergence between fiscal balances and indebtedness is the result of a series of factors, including currency appreciation and lower effective interest rates compared to the recorded rate of GDP growth. It is therefore important to design and implement fiscal reforms to create a larger fiscal space and to adopt measures to ensure continued access to sufficient levels of liquidity, whether by accumulating and holding international reserves or arranging contingent credit lines.

The current macroeconomic context further highlights the structural challenges that remain, such as the imbalance between tradeable and non-tradeable sectors of the economy.

Commodities make up 60% of the region’s exports of goods, up from less than 40% at the beginning of the last decade (2000-10). Also, around half the increase in the value of Latin American exports in the 2000s was a result of commodity price rises, whereas in the 1990s it was mainly due to increases in the volume exported. Moreover, the surplus resulting from the concentration of exports in a limited number of commodities has also contributed to growth in domestic sales, which, in line with the decline in domestic industrial production, have led to a rise in imports. Consequently, manufacturing has slowed and the imbalance between the tradeable and non-tradeable sectors has widened.
The challenge of achieving sustainable growth and greater economic diversification comes at a time in which a new “middle class” is emerging.

After a decade in which economic growth was accompanied by a substantial reduction in poverty and improvements to inequality indicators, a “middle class” has emerged in the region. In the emerging economies this “middle class” will grow from 55% of the population in 2010 to 78% in 2025, so it can become a fundamental pillar for further economic development. It will also place new demands on the region’s policy makers for efficient, high-quality public services. To meet these demands countries will need to expand their fiscal space by introducing reforms to increase fiscal revenue and by setting up institutions to ensure that government resources are spent on projects that greatly benefit society. Meanwhile, the deficiencies in the region’s infrastructure and logistics considerably hinder economic growth, and will therefore require additional financial effort by the public sector and substantially better quality spending. In addition to the new demands for public services from Latin America’s “middle classes”, public policies must provide growth in a way that also improves the market distribution of income in the long run. Therefore, the economic structure must create opportunities for more and better jobs and greater productivity for large sectors of society to consolidate the emerging “middle class”.

These needs are even more pressing in the light of Latin American integration into the context of shifting global wealth, led by the Asian economies.

The current economic climate is characterised by a shift in global wealth towards emerging economies. This transition is mainly a result of China’s and India’s economic modernisation and their integration into the world economy. The size of these economies, in conjunction with their rapid, sustained growth and their strong demand for natural resources, has supported growth in many emerging and developing economies. While at the turn of the century non-OECD economies accounted for 40% of the global economy, by 2010 this figure had risen to 49%, and by 2030 it is projected to rise to 57%. This is in sharp contrast to the contribution made by Latin America and the Caribbean, which remains at the 1990s level of between 8% and 9%.

The emerging economies, including those in Latin America, must avoid falling into the middle-income trap, and this would help them satisfy the needs of their “middle classes”.

A rise in per capita income in emerging economies is bolstered by factors that characterise early-stage economic development, such as urbanisation, demographic shifts, cutting the size of the agricultural workforce, and closing the technology gap. Because these sources of development reach their limits, economies often see their per capita income stall, a phenomenon known as the middle-income trap. The middle-income trap is a source of vulnerability for the emerging “middle classes”,

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which demand more and better public services, and it can reduce social mobility and create a more convulsive social environment.

The increasingly dynamic role of the Asian emerging economies in global shifting wealth is a challenge for the competitiveness of many of the region’s manufacturing industries.

China’s development pattern combines elements such as factor endowments, scale and productivity that considerably bolster the competitiveness of Chinese manufacturing. Latin America, for its part, is faced with systematic problems that make it difficult for the region to raise its productivity due to the limitations of its development model, from structural heterogeneity to low rates of savings. Growing competition from Asia’s emerging economies magnified the impact of these limitations, counteracting some of the natural advantages that some Latin American countries enjoy, such as being located close to the United States. This trend towards de-industrialisation in Latin America caused by endogenous and exogenous factors can be counteracted by the development of new capacities to produce increasingly sophisticated goods.

At the same time, changes to the production structure of Asian economies are bringing new business opportunities to Latin America.

As emerging countries are experiencing a convergence of their income, their production structures are beginning to shift towards more highly sophisticated goods, and they are increasing their imports of labour-intensive goods. New business opportunities are thus arising for the Latin American exporters that suffered most from the economic opening of China and India. One way of estimating the potential of the region’s countries to take advantage of these opportunities is by analysing the diversification of their economies in terms of the number of sectors in which a country has revealed comparative advantages. The other factor to consider is the connectivity of the country’s export basket, i.e. which measures the proximity to goods that are not currently included in the export basket, as well as their degree of sophistication. Connectivity is therefore estimated as a “proxy” variable for proximity, density and number of connections between two goods. Latin America is still experiencing increasing potential returns, both in terms of diversification and in terms of the connectivity of its export basket (Figure 0.2). This gives the region an opportunity to integrate into new global value chains and to make progress in achieving a structural transformation by seeking to export increasingly more sophisticated goods, the production of which has the knock-on effect of enabling other goods to be developed for export.
Latin America needs to diversify its exports by deepening the regional market and capturing more value added.

Two policy options, which are not mutually exclusive, could help diversify exports in a context where it is especially hard to compete with large Asian manufacturers on price. An initial strategy is to deepen Latin America’s internal regional market, which remains far less developed than those of other regions. For instance, trade between Central and South America and among Mercosur countries and those of the Andean Community could increase if they take advantage of the differences among their export profiles. Since trade within the region focuses largely on goods with a higher value added, particularly in intra-industrial trade in manufactured goods, additional trade would also help strengthen the diversification of the region’s exports. A second strategy consists of seeking to capture greater value added in trade. The geographical fragmentation of the production process and the advent of global value chains as a paradigm of the organisational model have changed the rules of diversification. Currently, these production networks allow countries to specialise in specific parts of the production process without needing to take on every step required to complete the production of a good. Moreover, in Latin America such services appear to be a potential source of value added for certain manufacturing industries and primary products.
The region needs to raise its productivity to make its production structure more sophisticated and diversified.

Latin America has an external gap as a result of the asymmetrical gaps between the countries’ technological capabilities and the frontier set by international best practices. It also has an internal gap as a result of the differences in productivity levels within and among sectors. Indeed, low productivity is one of the main factors preventing the region from creating more value added and achieving sustained growth. The productivity gap between most Latin American and Caribbean countries and the more developed countries is still increasing, Asia’s productivity gap has closed (Figure 0.3). In addition, the regions’ countries have become more heterogeneous in terms of productivity. To reduce the structural heterogeneity and increase productivity, countries in the region will need more diversified and more complex production structures that make greater use of technology. Many of the convergence success stories in the region have been associated with the development of new sectors or business activities. Structural change is therefore essential to narrow the productivity gap with the developed world and to lay the foundations for more inclusive growth.

**Figure 0.3.** Changes in productivity gaps between selected Asian and Latin American countries and the United States (1980-2011) (as percentages, annual growth rates in GDP per worker)

Source: Authors’ calculations based on World Bank, World Development Indicators and CEPALSTAT data. [StatLink](http://dx.doi.org/10.1787/888932906787)
Technological innovation is one of the key elements for promoting structural change and encouraging a dynamic of virtuous economic growth.

Technological advances are one of the key drivers of structural change. There is a direct relationship between the dissemination of general technologies and progress towards a diversified, complex production system. In Latin America, this relationship is insufficiently developed given how far the region lags behind in certain key areas of technology. The region can use new technologies to develop sectors, activities and markets that promote greater economic growth.

Some Latin American countries have a production structure that is heavily concentrated on commodity exports.

Many developed countries that initially had natural resource-based economies used this initial resource as a foundation for developing new, more sophisticated sectors and business activities. These countries used an industrial and economic strategy to channel the income they obtained from natural resources towards a more diversified production structure that made greater use of technology and knowledge. Latin America lags far behind in indicators related to the sophistication of its production, such as technological effort, knowledge intensity and the adaptability of its exports, which are fundamental for promoting structural change.

Latin America’s move from a model based on exporting natural resources to a knowledge-based model integrated into the global economy will improve the quality of employment and help to consolidate the emerging middle class.

In countries where productivity stagnated during the last decade, increases in production were brought about only by a greater absorption of labour. A key component of the structural change needed by Latin America involves transferring labour from low-productivity sectors that tend to have high levels of informal employment to higher-productivity businesses that can generate production linkages and knowledge spillovers. Countries must transform their production base to generate high-quality jobs and promote new business activities that are more technology-intensive and knowledge-intensive.

The re-emergence of industrial policy is a central part of the new development strategy of the Latin American and Caribbean economies.

Developing countries have recently renewed their interest in industrial policies, spurred largely by the successful experience of the Asian countries, which were driven and steered by the public sector during most of their economic transformation. The return of industrial policy in the region must be backed by full legal support and strong policies. Otherwise, the region will not be able to fully participate in the new technology revolution or progress towards a new type of knowledge-based and skills-based specialisation.
The development of industrial policy and promotion of productivity require improvements to logistics, a fundamental pillar of structural change.

The concept of logistics encompasses a range of key elements for production and trade, and is defined as all the services and processes needed to transport goods and services from the point of production to the end consumer. The cost and quality of logistics have fundamental implications for sustainable economic growth. Analyses show that improvements to logistics services could substantially boost labour productivity in the region (Figure 0.4). After taking into account other variables affecting economic growth, there is a significant association between improved logistics performance on the one hand and productivity gains and greater sophistication of exports on the other. More specifically, countries improving their score by 1 in the Logistics Performance Index improve their labour productivity by about 35%.

![Figure 0.4. Logistics and economic performance: Partial correlations](image)

Note: Data for 2012. Partial correlations used GDP per capita as a control variable. Labour productivity is defined as GDP in US dollars per person employed in 2012, adjusted for purchasing power parity (PPP). The Logistics Performance Index is developed by the World Bank. The level of sophistication of the country’s export basket was estimated using the EXPY index (see Chapter 2 for more details). In the legends, Chile and Mexico are included as Latin American countries rather than as OECD countries.

Source: Authors’ work based on The Conference Board Total Economy Database, World Bank (LPI), Comtrade.

StatLink [link] http://dx.doi.org/10.1787/888932906882

Although Latin America has made substantial efforts to increase the number of free-trade agreements, it should invest the same or greater efforts in adopting policies to reduce logistics costs.

Using U.S. trade as a reference, while the average freight costs for trade between the United States and its partners are less than double the tariff costs, in Latin America this ratio rises to almost 9:1. Trade in parts and components, meanwhile, is almost...
50% more sensitive to improvements in logistics performance than is trade in final goods. Better logistics performance is therefore essential to integrate Latin American economies into the global value chains. Reducing logistics costs is also essential to promote trade within the region. Improvements must therefore be made to the standardisation practices relating to the regulation of land transport, and road corridors and logistics solutions need developing to connect Latin American cities and ports together. Finally, cheaper logistics costs benefit SMEs the most, since they are too small to provide all production phases in-house, so they need a business environment with low transaction costs to facilitate business-to-business trade relations. Since jobs and GDP are highly concentrated in SMEs in Latin American countries, any reduction to logistics costs will make the region substantially more competitive.

**Improving logistics performance is essential because the share of logistics-intensive or time-sensitive exports in Latin America is three times that of the OECD economies.**

By measuring logistics intensity in each economic sector based on the cost or time invested, one can measure the impact of logistics performance on each sector. Latin America’s production structure is more sensitive to logistics performance than that of the OECD countries. On average around 57% of the region’s total exports are time-sensitive or logistics-intensive, compared to an OECD average of 17%. The region’s specialisation pattern means there is a high involvement of logistics-intensive natural resources, as well as agricultural products and garments, which are sensitive to the transport time to the destination. Logistical challenges, therefore, greatly hinder the region’s competitiveness.

**The infrastructure deficit is a factor behind the region’s poor logistics performance.**

The biggest infrastructure gap is in the transport sector, as in some Latin American countries domestic transport costs per container are among the highest in the world. Logistics costs in the region represent 18-35% of a product’s value, compared to around 8% in the OECD countries. Road transport is the area where the region lags furthest behind, with standards below those of middle-income countries. Also, the insufficient co-modal transport options in Latin America increases logistics costs by up to 57% and reduces the region’s competitiveness and capacity for international integration. The strong concentration on road transport, as opposed to other, more efficient modes of transport (15 times higher than in the United States), also affects complementarities among the different modes of transport in the region. Finally, the poor regulatory and institutional capacity in Latin America’s concessions system prevents governments from obtaining all the benefits they would have hoped for from additional private investment in infrastructure.
While transport infrastructure is the main factor behind the low logistics performance, some “soft” solutions could considerably reduce logistics costs.

Latin America needs to adopt a series of policies to improve both “soft” and “hard” aspects of logistics. The “hard” components are associated with transport infrastructure, which, given the costs involved, will be hard to change in the short run. It is therefore necessary to accompany the measures aimed at “hard” components with improvements to “soft” aspects that are linked to strengthening the institutional structure and improving governance as part of an integral logistics policy offering modern storage facilities, more efficient customs and certification procedures, and the use of new information and communication technologies. Measures are also needed to boost competition in the transport sector. These elements can be used to encourage efficient use of available infrastructure and thus reduce logistics costs.
ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT (OECD)

The OECD is a unique forum where governments work together to address the economic, social and environmental challenges of globalisation. The OECD is also at the forefront of efforts to understand and to help governments respond to new developments and concerns, such as corporate governance, the information economy and the challenges of an ageing population. The Organisation provides a setting where governments can compare policy experiences, seek answers to common problems, identify good practice and work to co-ordinate domestic and international policies.

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The OECD Development Centre was established in 1962 as an independent platform for knowledgesharing and policy dialogue between OECD member countries and developing economies, allowing these countries to interact on an equal footing. As of July 2013, 18 non-OECD countries are full members of the Centre’s Governing Board. The Centre draws attention to emerging systemic issues likely to have an impact on global development and more specific development challenges faced by today’s emerging and developing countries. It uses evidence-based analysis and strategic partnerships to help countries formulate innovative policy solutions to the global challenges of development.

For more information on the Centre and its members, please see www.oecd.org/dev.
ECONOMIC COMMISSION FOR LATIN AMERICA AND THE CARIBBEAN (ECLAC)

ECLAC is one of the five regional commissions of the United Nations. ECLAC was founded in 1948 for the purpose of contributing to the economic development of Latin America and the Caribbean, coordinating actions to promote that development and reinforcing economic ties among the region's countries and with other nations of the world.

Over the years, the institution's in-depth analysis of the region has taken the form of two main lines of action: economic and social research and the provision of technical cooperation to Governments. The Commission's ongoing concern for growth, technical progress, social justice and democracy has characterized the integral approach towards development that now forms part of the legacy of its rich intellectual tradition.

The 33 countries of Latin America and the Caribbean are member States of ECLAC, together with the United States, Canada, and several European and Asian countries that have historical, economic or cultural ties with the region. The Commission thus has a total of 44 member States. In addition, 12 non-independent Caribbean territories hold the status of associate members.

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CAF is a multilateral financial institution whose mission is to support sustainable development and regional integration in Latin America. The Institution's shareholders are the following: Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Dominican Republic, Ecuador, Jamaica, Mexico, Panama, Paraguay, Peru, Portugal, Spain, Trinidad & Tobago, Uruguay, Venezuela and 14 private banks within the region.

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