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POLICY NOTE ON LATIN AMERICA

REVIVING INVESTMENT: NEW OPPORTUNITIES, NEW PLAYERS

INVESTMENT
ENERGY *RISK MANAGEMENT*
INFRASTRUCTURE INNOVATION
POPULATION GROWTH *MIDDLE CLASS*
GREEN GROWTH COMMODITIES
SKILLS REGULATIONS *TRADE*
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Reviving investment in Latin America: New opportunities, new players

Latin America is facing a challenging economic outlook, amid slowing global growth and rising signs of protectionism. This note provides insights and suggested policy recommendations from the private sector on ways to enhance trade relations and new investment partnerships, as well as how to support a transition to higher-value goods and services. It gives an overview of economic and business trends in Latin America, highlights public policy efforts to promote trade and investment, and offers private sector insights on opportunities and bottlenecks in areas such as infrastructure, innovation and skills. The analysis builds on discussions at the OECD Emerging Markets Network (EMnet) meetings on doing business in Latin America, held on 3 June 2016 in Paris, France, and in Cartagena de Indias, Colombia, on 27 October 2016 as well as on the analysis of the *Latin American Economic Outlook 2016*, in addition to desk research and bilateral discussions with EMnet members.

Key messages include:

- Investors view the progress of the Pacific Alliance regional initiative as positive in opening up investment opportunities in member countries and see the developments of the EU-Mercosur Free Trade Agreement under negotiation as encouraging.
- Transport and logistics costs remain too high in the region, due to factors such as poor infrastructure quality and administrative delays. Infrastructure investment is needed to support further regional trade integration.
- Greater investment in research and development (R&D) and innovation can support productivity improvements and the development of high-value products and services.
- The resource and commodity sectors still offer possibilities. Firms see opportunities in specific sub-sectors with greater value added, such as lithium mining or organic food products.
- Skills improvements are needed to support the necessary upgrading and diversification of industries. Improvements in education-industry linkages and greater vocational training can be particularly relevant and supportive.
- Finally, despite the economic downturn and political instability, investors remain confident in Brazil as a long-term investment destination.

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Table of contents

Growth, trade and investment trends **6**
Regional growth amidst global economic uncertainty 6
A weakened fiscal space heightens risks for countries 7
Trade volumes are weakening and fears of protectionism are rising 7
FDI inflows decline overall but vary by region 9
Many downside risks could threaten growth prospects and trade relations 11
New players and opportunities to encourage investments in the region **14**
New players: China and "multilatinas" 14
New opportunities through trade 15
Towards better public policies to promote effective investment for development **17**
Private-sector insights on reviving investment **19**
Trade integration holds promise 19
Upgrading and innovating to move up value chains 22
Skills and education can support regional development and diversification 26
Business implications of Brazil's economic downturn and political instability 27
Conclusion **30**
References **31**

ABBREVIATIONS AND ACRONYMS

ECLAC	Economic Commission for Latin America and the Caribbean
EMBRAPII	Brazilian Agency for Industrial Research and Innovation
EPM	Empresas Públicas de Medellín
FAO	Food and Agriculture Organization
FDI	Foreign Direct Investment
FTA	Free trade agreement
GVCs	Global value chains
M&As	Mergers and Acquisitions
NAFTA	North American Free Trade Agreement
OECD	Organisation for Economic Co-operation and Development
PENX 2025	The National Strategic Export Plan
R&D	Research and Development
SMEs	Small and medium-sized enterprises
TPP	Trans-Pacific Partnership
UNCTAD	United Nations Conference on Trade and Development

GROWTH, TRADE AND INVESTMENT TRENDS

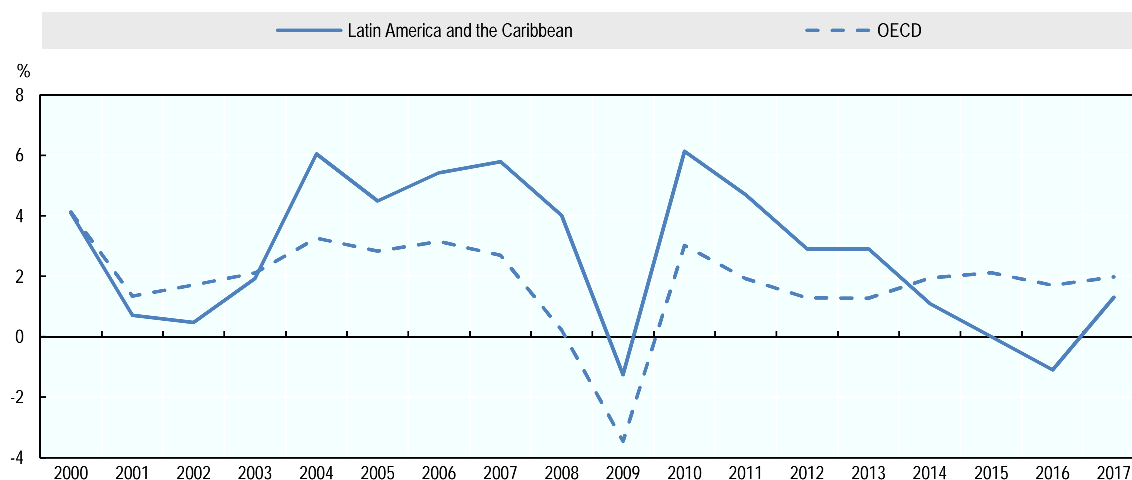
Latin America is facing a challenging macroeconomic outlook, with domestic growth slowing since 2012. The external scenario also is unfavourable; global growth has hovered around 3% since 2012 with a predicted modest increase to 3.5% growth by 2018 (OECD, 2016a). Low global growth is compounded by tightening financial conditions, declining and volatile capital inflows to emerging markets and the end of a once-booming commodities super cycle (OECD/CAF/ECLAC, 2016). With growing global economic and political uncertainty and a pushback against the major tenants of globalisation — free trade and foreign investment (ECLAC, 2016a) — Latin American economies will need to develop alternative policies to boost productivity and growth. The diversity of Latin American economies means that region-wide solutions do not exist; nonetheless, the *Latin American Economic Outlook 2017* highlights the importance of focusing on policy actions that boost physical and human capital while strengthening fiscal positions and improving regional competitiveness (OECD/CAF/ECLAC, 2016).

Regional growth amidst global economic uncertainty

Overall, Latin America is expected to return to positive growth (1.3%) in 2017, though with continued wide variation in economic performance across the region (ECLAC, 2016c) (Figure 3.1). Areas least dependent on commodities are projected to have the highest growth levels. For example, Mexico and Central America should have the strongest average growth as a region (2.3%) in 2017, although rising signs of global trade protectionism are generating uncertainty regarding future regional GDP growth. South American economies that rely heavily on commodities should experience weaker growth, but performance will vary widely. Peru (4.0%), Bolivia (3.8%) and Paraguay (3.8%) are expected to grow the strongest in 2017. Argentina's growth is projected to rebound considerably in 2017 (2.9%) and 2018 (3.4%) as result of economic policy reforms (OECD, 2016a). Brazil should return to positive growth in 2017 (0.4%), a welcomed sign for many countries in the region that depend on trade and investment ties. Although the Bolivarian Republic of Venezuela's (hereafter "Venezuela") contraction ought to continue in 2017 (-4.7%), this is a recovery from 2016 levels (-9.7%). Caribbean economies should grow by 1.3% as a region, with the strongest 2017 performance expected in Saint Kitts and Nevis (5.3%), Guyana (3.8%) and Belize (3.7%) (ECLAC, 2016c).

Figure 1.1. **GDP growth in Latin America and the OECD, 2000-17**

Annual percentage change



Source: OECD (2017), *OECD Economic Outlook: Statistics and Projections* (database), www.oecd.org/eco/outlook/economic-outlook-annex-tables.htm; CEPAL (2016), CEPALSTAT, http://estadisticas.cepal.org/.

A weakened fiscal space heightens risks for countries

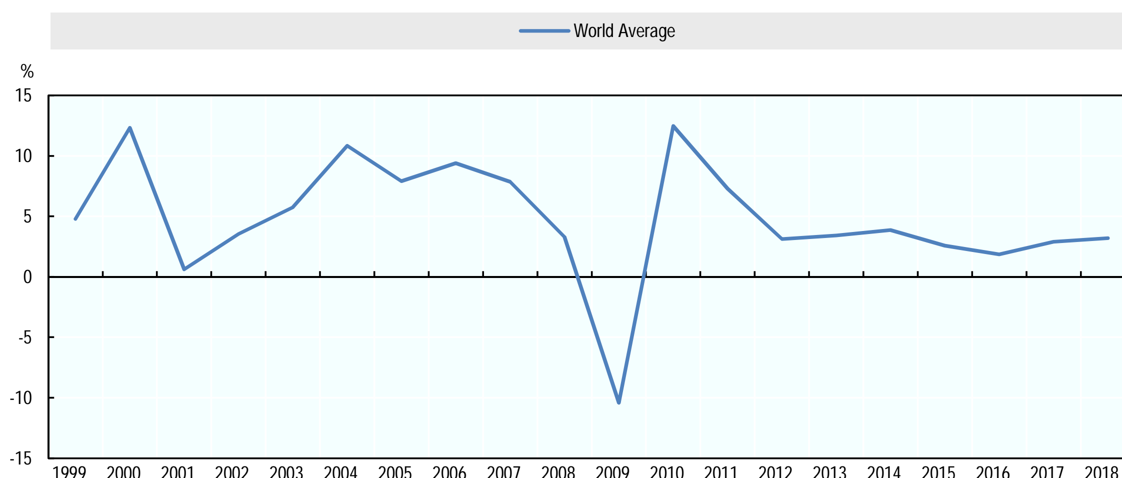
Slow growth, reduced revenues due to low commodity prices and rising debt levels are limiting the manoeuvrability of governments in the region as fiscal deficits widen. Countries also are finding it harder and more expensive to finance public deficits (OECD/CAF/ECLAC, 2016). Governments will need to act carefully to avoid cutting spending in key areas that can promote growth, such as skills and infrastructure. While individual fiscal situations significantly vary, all countries in the region would benefit from improving the efficiency of goods and services provision (OECD/CAF/ECLAC, 2016).

Trade volumes are weakening and fears of protectionism are rising

Greater regional integration and expanded trade relations can be a driving force for growth, but global trade growth is slow and protectionism is rising. Growth in global trade volumes remains weak and is expected to rebound only slightly in 2017 and 2018 (Figure 1.2).

Figure 1.2. **Change in world trade growth, 2001-18**

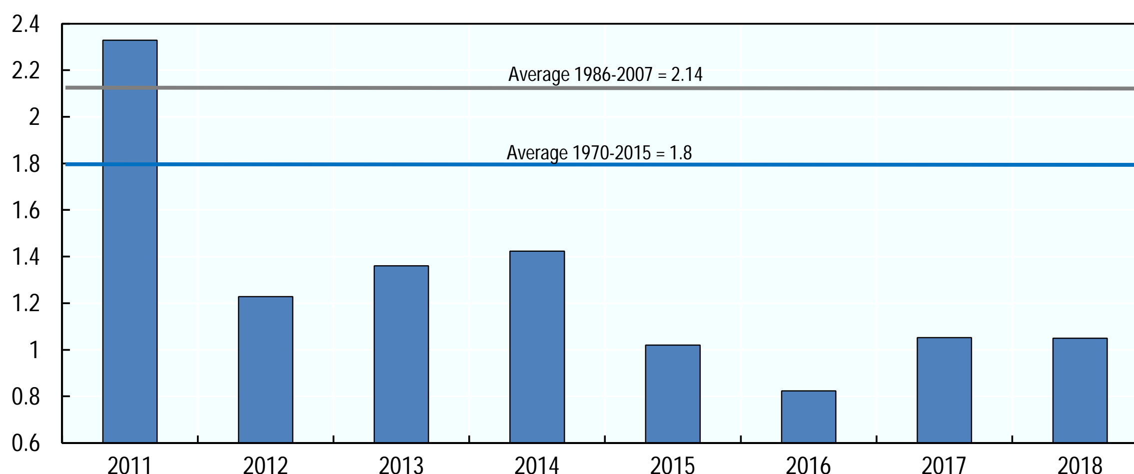
Average percentage change from previous period of export and import volumes



Note: The cut-off date for information used in the compilation of the projections was 16 November 2016.
Source: OECD (2017), *OECD Economic Outlook: Statistics and Projections* (database), www.oecd.org/eco/outlook/economic-outlook-annex-tables.htm.

When related to GDP growth, global trade growth also is stagnant and very weak relative to historic norms (Figure 1.3). This slowdown in global trade growth is cause for concern as it is contributing to the low-growth trap (OECD, 2016a)

Figure 1.3. **Ratio of global trade growth to global GDP growth**

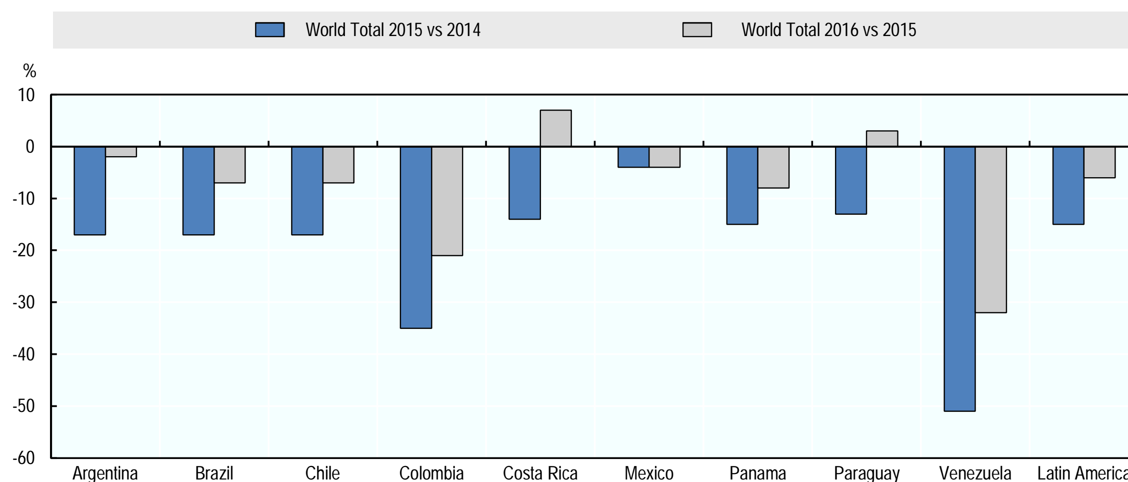


Note: World trade volumes for goods and services; global GDP at constant prices and market exchange rates. Period averages are the ratio of average annual world trade growth to average annual GDP growth in the period shown. The cut-off date for information used in the compilation of the projections was 16 November 2016.
Source: OECD (2016a), *OECD Economic Outlook, Volume 2016 Issue 2*, p. 23, http://dx.doi.org/10.1787/eco_outlook-v2016-2-en.

The reduced global trade has translated into lower trade volume growth in the region (Figure 1.4). The total value of Latin America's exports is estimated to have fallen by 6% in 2016 due to low commodity prices, currency devaluations and appreciation of the US dollar (Giordano, Ramos and Michalczewsky, 2016).

Figure 1.4. **Export growth in selected Latin American countries, 2015 and 2016**

Annual growth rate, percentage



Source: Authors' elaboration based on IDB Integration and Trade Sector with data from official sources, except Venezuela, estimated with data from OPEC and the IMF, cited in Giordano, Ramos and Michalczewsky (2016), *Trade Trend Estimates: Latin America and the Caribbean – 2017 Edition*, https://publications.iadb.org/handle/11319/7984.

Intra-regional trade within Latin America also is showing weak performance, and trade within the region contracted more than trade with China, the European Union (EU) and Asia overall in 2016. The economic slowdown in Brazil also has reduced demand for regional exports to the Brazilian market. For example, Brazil is Argentina's main trading partner. A decline in exports to Brazil of Argentine transport goods was a main contributing factor to a 15% decline in Argentina's trade in South America (Giordano, Ramos and Michalczewsky, 2016). Intra-regional trade is particularly important as it is often more intensive in high value-added products than extra-regional trade and can open markets for more diversified products and exports (ECLAC, 2015). Moreover, intra-regional trade often involves a greater participation of small- and medium-sized enterprises (SMEs), which can support job creation (ECLAC, 2015).

FDI inflows decline overall but vary by region

In 2015, overall foreign direct investment (FDI) into Latin America and the Caribbean declined, with varied performance in its sub-regions. Data from ECLAC (2016b) shows that FDI inflows into Latin America and the Caribbean declined by 9.1% between 2014 and 2015, dropping to USD 179.1 billion. In contrast, the United Nations Conference on Trade and Development (UNCTAD)'s *World Investment Report 2016* (UNCTAD, 2016) puts 2015 total FDI inflows at USD 167.6 billion, or 1.6% less. While there is slight variation between the reports, both agree

that declines in commodity prices, coupled with worsening terms of trade and slow domestic demand, are hampering FDI inflows. Unless otherwise noted, this section uses data from ECLAC (2016b).

FDI to South America hurt by declining commodity prices

South America was particularly affected by the fall in commodity prices, owing to its specialisation in primary goods, especially oil and minerals, and its strong trade with China. Overall FDI flows into the region fell by 14% to USD 131 billion, the lowest level in 10 years. The end of the commodity super cycle decreased FDI inflows for most major South American economies. In Brazil – Latin America's largest economy – FDI inflows shrank by 23% because of uncertainty in domestic markets and a decline in the price of the country's raw material exports. In Chile and Colombia – Latin America's third and fourth largest economies – FDI declined by 8% and 26%, respectively, due to falling metal prices. Bolivia also experienced a 22% decline because of volatility in the country's hydrocarbon sector. Flows to Paraguay and Uruguay decreased by 18% and 25%, respectively, while FDI in Peru fell for the third consecutive year, dropping by 13%.

Only 3 of South America's 10 economies experienced increases in FDI inflows in 2015. While FDI to the oil sectors in Ecuador and Venezuela declined, both countries experienced upsurges in overall FDI inflows of 37% and 153%, respectively, thanks to increases in manufacturing and intra-company loans. The increased FDI inflows to Argentina is a unique case in South America. While FDI inflows rose 130%, this was on the back of unusually low flows in 2014 due to the government's compensation of Repsol (Spain) for the expropriation of its majority-owned subsidiary, YPF S.A. Excluding this transaction, inflows to Argentina posted a more moderate increase of 15% (UNCTAD, 2016), reflecting to some extent a more positive investor attitude.

FDI to Central America and Mexico grew while the Caribbean faltered

Flows to Central America increased in 2015 by 6% to USD 12 billion. Panama was the most important destination of FDI in the sub-region, followed by Costa Rica, Honduras and Guatemala. These countries have had greater capacity to absorb the shock of decreased commodity prices and to move to higher-value manufacturing because Central America is less dependent on natural resources.

Overall, Mexico was the largest recipient of FDI inflows, which rose 18% to USD 30 billion. The United States is the principal investor in the region, accounting for 52% of FDI, followed by Spain. These flows were mainly directed into manufacturing, which received 50% of total FDI inflows. Future flows might be impacted by potential changes in existing trade arrangements such as the North American Free Trade Agreement (NAFTA).

While not all Caribbean economies are commodity dependent, reduced commodity prices also have affected FDI into some of these. Overall inflows to the region declined 17% to USD 6 billion. The sub-region's main recipient is the Dominican Republic (39%). Caribbean economies can generally be divided into those dependent on tourism and those specialised in natural resources. Accordingly, those that exploit natural resources have been hurt by the fall in commodity prices, while those dependent on tourism have benefited from the US economic recovery.

Outward FDI from the region is also down

Outward FDI from the region totalled USD 47 billion in 2015, down 15% from the previous year (Table 1.1). Chile overtook Brazil in leading outward investment in 2015, followed by Brazil and Mexico. In contrast, outward investment from Argentina and Venezuela declined sharply in 2015. When considering the overall stock of investment abroad, Brazil remains the leader, followed by Mexico.

Table 1.1. **Outward FDI from Latin American and Caribbean countries, 2005-15**

USD millions

	2005-2009	2010	2011	2012	2013	2014	2015	Absolute variation 2014-15	Relative variation 2014-15
Argentina	1 471	965	1 488	1 055	890	1 921	1 139	- 782	-41%
Brazil**	14 067	26 763	16 067	5 208	14 942	26 040	13 498	-12 541	-48%
Chile	5 117	9 461	20 252	20 555	9 872	12 915	15 794	2 879	22%
Colombia	2 786	5 483	8 420	- 606	7 652	3 899	4 218	319	8%
Mexico	6 250	15 050	12 636	22 470	13 138	7 463	12 126	4 663	62%
Trinidad and Tobago	282	0	1 060	1 681	2 061	1 275	717***	145***	25%
Venezuela	1 438	2 492	- 370	4 294	752	1 024	-1 112***	-2 142***	…
Latin America and Caribbean****	32 091	61 302	60 919	55 993	50 465	55 803	47 362	-8 441	-15%

Note: * Simple averages.

** The 2005-09 figure for Brazil does not include reinvestment of profits and is therefore not directly comparable to the figures from 2010 onward.

*** Trinidad and Tobago and Venezuela have only published data for the first three quarters of 2015. The change from 2014 to 2015 is calculated for the first three quarters of both years.

**** For the region overall, variation between 2014 and 2015 for the cases of Trinidad and Tobago and Venezuela was calculated based on only the first three quarters of those years.

Source: ECLAC, based on official figures and estimates as on 27 May 2016, cited in ECLAC (2016b*), 2016 – Foreign Direct Investment in Latin America and the Caribbean*, http://repositorio.cepal.org/bitstream/handle/11362/40214/6/S1600662_en.pdf.

Many downside risks could threaten growth prospects and trade relations

Many risks are generating additional uncertainty for political and economic relations in Latin America. These risks include signs of growing global protectionism, changes in trade relations with the United States, the repercussions of the announced exit of the United Kingdom from the European Union (the "Brexit" process), as well as further slowdown in China. In addition, a persistent decline in growth in the region may reverse the significant progress achieved to reduce poverty and build up the middle class, which led to the recent graduation of Chile and Uruguay from the OECD Development Assistance Committee's list of official development assistance recipients (OECD, 2017b).

The region is sensitive to rising global protectionism

Protectionism is expanding around the world, and the overall stock of trade-restrictive measures is growing. The latest edition of the World Trade Organization (WTO) report on Group

of Twenty (G20) trade measures highlights that of the 1 671 trade-restrictive measures that have been recorded for G20 economies since 2008, only 408 had been removed by mid-October 2016 (OECD/WTO/UNCTAD, 2016). The OECD estimated that in 2016 the number of trade restrictive measures in G20 countries has reached a peak since the outbreak of the financial crisis in 2008 (OECD, 2016a).

Another risk factor is the possible decline of trade relations and partnerships between the United States and Latin America. Many Latin American economies, particularly in Central America and the Caribbean, are heavily dependent on the performance of the US economy and trade relations with the United States.

Mexico, which has benefited greatly from free trade with the United Sates, is particularly sensitive to changes in the US economy or in trade relations. In fact, US imports from Mexico are up 638% from 1993 (pre-NAFTA) (USTR, n.d.). Beyond trade, however, FDI also has been important to Mexico's economy, particularly after the implementation of NAFTA, with the United States being the largest source of FDI in Mexico (Villarreal, 2016a).

NAFTA also has helped Mexico's economy, but uncertainty is increasing regarding the future of the agreement. A study by the World Bank found that it is likely that NAFTA helped Mexico through a number of channels, including faster uptake of innovative technologies from the United States, with a probable positive impact on job creation and job quality. Moreover, the agreement doubtlessly reduced economic volatility and synchronised the business cycles of the United States, Canada and Mexico, making Mexico more prone to benefit from economic developments in the United States (Lederman, Maloney and Servén, 2005; Villarreal, 2016a). Hence, changes to the agreement could have the opposite effect. Although concrete actions have not taken place to date, the new US administration has expressed interest in renegotiating the agreement.

"Brexit" also fuels uncertainty

A lack of clarity regarding the United Kingdom's announced exit from the EU, often referred to as "Brexit", contributes to risk aversion around the world and could reduce the attractiveness of Latin America as an investment destination as investors exercise greater caution. Given this risk aversion, conditions for capital inflows to the region are likely to weaken (OECD/CAF/ECLAC, 2016). Nonetheless, trade links between the United Kingdom and Latin America are minor overall, with only 1% of the region's exports destined to the United Kingdom (ECLAC, 2016a). The implications go beyond trade, however, and Brexit also may have contributed to the depreciation of several Latin American currencies since early 2015, particularly in Brazil and Colombia (OECD/CAF/ECLAC, 2016).

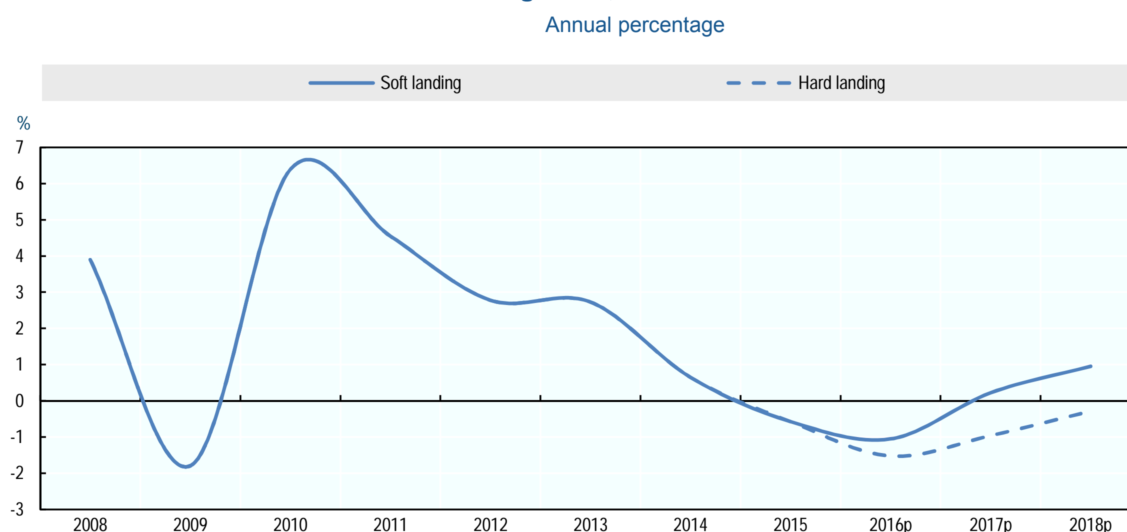
Chinese economic slowdown, coupled with persistently low commodity prices, is a risk

One the major risks for the future growth of Latin America economies is a Chinese hard landing, that is, an extreme slowdown in the Chinese economy. A significant decline in Chinese growth could threaten recovery in Latin America and keep the region in a recession for longer (Figure 1.5). In addition, China is Latin America's third-largest export destination (de la Torre et al., 2015), accounting for 9% of the region's exports in 2014. Latin America already has felt the effects of slower growth in China with the end of the commodities super cycle. Indeed, while the

high price of commodities benefited some Latin American economies in the past, it is now posing a major threat to their continued growth.

Figure 1.5. **Chinese growth scenarios and their impact on Latin American growth, 2008-18**

Annual percentage



Note: Weighted average for Argentina, Brazil, Chile, Colombia, Mexico, Peru, Uruguay and Venezuela. “Soft landing” refers to GDP growth rate projections in China of 6.6% in 2016, 6.4% in 2017 and 6.0% in 2018. “Hard landing” refers to GDP growth rate projections of 5.8% in 2016, 4.3% in 2017 and 3.6% in 2018. Simulations are from a Bayesian Global Vector AutoRegressive (VAR) model for all countries, except for Venezuela, where projections are from an individual model.
Source: Simulations, based on a Global Bayesian VAR model cited in OECD/CAF/ECLAC (2016), *Latin American Economic Outlook 2017*, http://dx.doi.org/10.1787/leo-2017-en.

While the commodity markets are stabilising, it is likely that high commodity prices will not return in the foreseeable future (OECD/CAF/ECLAC, 2016); accordingly, commodity-dependent economies will need to find alternative investment streams. China is expected to rely more heavily on its services industries to support growth in the coming years than on its manufacturing industries. Although slowing commodity demand presents challenges for some Latin American economies, it also offers an opportunity for Latin American countries to fill the void left by China in low-cost manufacturing; nonetheless, the competition is steep from other emerging economies to fill this void, such as smaller countries in Southeast Asia as well as many African countries. Moreover, Latin America can take advantage of the changes underway in China to diversify its exports towards high value-added and knowledge-intensive products and services (ECLAC, 2015). For example, China’s increasing consumption of products such as processed meat, fish and fruits makes creates opportunities for more added-value exports from Latin America. Prospects for meat, milk or vegetables exporters, such as Argentina, Brazil, El Salvador or Guatemala could be favourable. Countries like Panama or Costa Rica, which have more developed service industries, could offer commercial services (OECD/CAF/ECLAC, 2015).

An economic downturn could reverse social gains and threaten the middle class.

While Latin America has made a great deal of progress within the last 20 years, the current economic trends could put the most vulnerable populations of Latin America, including significant shares of the newer middle classes, at risk of falling back into poverty. An estimated 25-30 million people in Latin America and the Caribbean face a high risk of falling back into poverty, according to data from the United Nations Development Programme (UNDP, 2016). In terms of socio-economic progress, poverty has increased since 2013, with an estimated 29.2% of Latin Americans (175 million persons) living in poverty in 2015 (ECLAC, 2016d).

Growth of the consumer middle class will be limited. This economic weakness already is being felt in the labour markets. In Latin America, unemployment is rising, job quality is declining, wage growth is slowing and informality remains omnipresent (OECD/CAF/ECLAC, 2016). The economic slowdown has particularly affected the already vulnerable youth and female populations (OECD/CAF/ECLAC, 2016). For Latin America to continue building on the progress achieved over the last 20 years, the region will need to ensure that policies are in place that will boost productivity, develop skills, stimulate domestic demand and generate inclusive growth. These actions will contribute to increasing or at least sustaining fairness and well-being within the region in a period of low growth.

NEW PLAYERS AND OPPORTUNITIES TO ENCOURAGE INVESTMENTS IN THE REGION

In a context of low commodity prices and rising global economic uncertainty, investment and trade are essential to jumpstart growth in the region. This section highlights recent developments in investment from China and the region itself and trade relations in Latin America.

New players: China and "multilatinas"

Historically, investments in Latin America have been dominated by Europe and the United States. In recent years, however, China has taken a much more active investment role in Latin America. In parallel, "multilatinas", or multinational firms of Latin American origin, are also emerging as important regional investors.

China is a key trade and investment partner in the region

China has become one of the main trading partners for several countries in the region, so any significant downturn in Chinese demand has consequences. Notwithstanding, Latin America's engagement with China is uneven and tends to be concentrated in a few traditional commodity sectors for exports. Latin America exports raw materials and a few high-value products to China, while Latin American imports of Chinese products are dominated by manufactured goods such as domestic appliances, green technologies and textiles (OECD/CAF/ECLAC, 2015). Commodity exporters have increased their ties to China much faster than manufacturing exporters, which have remained more linked to value chains in the United States. These linkages also vary depending on the types of commodity exported, such as oil, minerals or agricultural goods (OECD/CAF/ECLAC, 2015). Commodity exports to China are concentrated in just a few products.

For example, five commodities together accounted for 73% of the value of all regional sales to China in 2013. These products include copper ores and concentrates, refined copper, iron ores and concentrates, petroleum and soybeans (OECD/CAF/ECLAC, 2015). Additional discussion of the trade relations and value chain integration of Latin America and China can be found in this note's section on private sector insights.

Multilatinas are also a force for investment in the region

Multilatinas are another important group of investors in the region and abroad. Multilatinas are Latin America-based firms that have expanded internationally, even though they often have remained largely focused on Latin America (Aguilar, Sardi Maldueño and Violin, 2015). Multilatinas began investing abroad in the 1990s, and investment surged in the 2000s (Blanco Estévez, 2015). An annual multilatina ranking is prepared by AméricaEconomía, a Latin American magazine. In the 2016 ranking, Mexichem, CEMEX, LATAM Airlines, JBS S.A. and Gruma topped the list (AméricaEconomía, 2016). Multilatinas operate at all stages of the value chain but have the largest presence in food and beverages, natural resources, chemicals, steelmaking, and manufacturing. Brazil, Mexico and Chile have the most multilatinas, and these firms often focus their investments in the region, the United States and Europe (Blanco Estévez, 2015). Internationalisation and diversification of sales were key factors in the 2016 ranking. Firms with greater diversification of revenues in the region and beyond have outperformed companies with more concentrated revenues (Almeida, 2016).

New opportunities through trade

Greater regional integration and expanded trade relations can be a driving force for growth. Efforts for bilateral, regional and global trade agreements are growing, but rising protectionism could threaten progress and momentum. In the face of these protectionist tendencies, a key challenge moving forward is to keep trade open within the region and increase intra-regional trade volumes.

Bilateral free trade agreements continue to expand

Countries in Latin America are using preferential trade agreements to expand trade relations. Sixty-eight preferential trade agreements involve at least one Latin American country, of which 32 are fully intra-regional agreements (OECD, 2016b). New agreements also are under discussion. Uruguay and Chile, for example, signed a free trade agreement (FTA) in October 2016. The expanding use of trade agreements is creating a complex web of regulations and standards. Larger regional trade agreements such as the Pacific Alliance can be a useful tool to consolidate and harmonise these agreements (OECD, 2016b).

The Pacific Alliance is advancing rapidly to further integrate the region

The Pacific Alliance has brought together Chile, Colombia, Mexico and Peru, and is a sign of a renewed effort in regional integration. Together, the four countries form an economic region that in 2015 represented 35% of Latin America's nominal GDP and was home to 224 million people (Villarreal, 2016b). Since its formation in 2011, the Pacific Alliance has moved rapidly to foster greater economic integration, promote free trade and act as a platform for further integration with

other foreign markets. The scope of the Pacific Alliance is deeper than other agreements such as the Trans-Pacific Partnership (TPP) as it goes a step further to include the free movement of people and stock market integration (Villarreal, 2016b).

The Pacific Alliance is prioritising linkages with Asia and building ties with new observers and members. This focus on interaction with the Asia-Pacific region distinguishes the Alliance from other regional platforms such as the Southern Common Market (Mercosur). The Alliance had attracted 49 observer states as of February 2017, including China, France, Germany, Spain, the United Kingdom, the United States and Turkey. Costa Rica and Panama also are candidates to become new members of the Alliance.

Mercosur and Pacific Alliance relations are showing new signs of potential alignment

Mercosur is a sub-regional trading bloc that was created in 1991 with Argentina, Brazil, Paraguay and Uruguay as founding members. Venezuela joined in 2012, and Bolivia is an associate member in the accession process. Mercosur aims to establish a common market. Although trade has increased significantly amongst Mercosur members since the creation of the trading bloc, intra-Mercosur trade has remained a small share of overall trade (Gomez Ramirez et al., 2016).

In a context of global and regional uncertainty, relations between the Pacific Alliance and Mercosur are showing signs of dynamism. Mercosur and the Pacific Alliance have been making efforts to collaborate since 2014 (D'Elia and Ramos, 2016). Momentum continued in 2016, and the change of leadership in Argentina has been supporting a close relationship, given President of Argentina Mauricio Macri's vocal interest in further connections between Mercosur and the Pacific Alliance (Dinatale, 2016). In addition, Argentina became an official observer to the Pacific Alliance in June 2016, and Paraguay and Uruguay already had observer status (ICTSD, 2016).

The EU-Mercosur trade deal is back on the table

Renewed momentum for the long-standing negotiations for an FTA between the EU and Mercosur is attracting attention. EU-Mercosur trade in goods exceeded EUR 88 billion in 2015 (European Commission, 2016). Mercosur and the EU have been negotiating a bi-regional FTA since 1999. Negotiations were suspended in 2004 due to differences regarding trade in agriculture, services and the opening up of public procurement (Gomez Ramirez et al., 2016). Negotiations were re-launched in 2010 with the aim of setting up a comprehensive agreement that would include industrial and agricultural trade, improve customs and trade facilitation, and reduce technical trade barriers. Ten negotiation rounds took place before they paused again in 2012. In May 2016, for the first time since the 2010 re-launch, the EU and Mercosur exchanged offers covering, amongst other areas, market access for goods, services and public procurement (European Commission, 2017a).

EU-Mexico trade relations also are being closely watched

Renewed efforts continue to improve trade relations between the EU and Mexico, which since 1997 have fallen under an Economic Partnership, Political Coordination and Co-operation Agreement. The EU is a considerable market for Mexico. The EU is Mexico's third-largest trading partner after the United States and China, and was Mexico's second-largest export market after

the United States in 2015 (European Commission, 2017b). In May 2016, the EU and Mexico began negotiations to modernise their trade relations. In 2017, to offset the "worrying rise of protectionism around the globe", the EU and Mexico agreed to accelerate negotiations (European Commission, 2017c).

TOWARDS BETTER PUBLIC POLICIES TO PROMOTE EFFECTIVE INVESTMENT FOR DEVELOPMENT

Governments have a key role to play in promoting economic diversification, boosting productivity and improving competitiveness, but they are facing an increasingly challenging external context of lower overall global growth, weak trade volumes and rising protectionism. This section highlights recent public policy actions to support an increase in private investment in the region.

Governments are stepping up efforts to diversify exports and promote investment

In a period of economic downturn and low commodity prices, governments such as those of Chile, Peru and Argentina are focusing on investment promotion and export diversification. In 2015, Chile passed a new Framework Law for Foreign Investment, which provides a legal and institutional framework for investment promotion in Chile (InvestChile, 2015). The new approach has a more proactive investment strategy and the investment promotion agency has been modified to facilitate further foreign investment (OECD, 2015a). In 2015, Chile also launched its new investment promotion agency, InvestChile, which was to focus on priority sectors to attract FDI, notably: mining services, higher-value food products, sustainable tourism, energy and logistics infrastructure, and technological services (InvestChile, 2016). In Peru, the Ministry of Foreign Trade and Tourism (MINCETUR) launched the National Strategic Export Plan (PENX 2025) in 2015. PENX 2025 is part of the larger PENX programme, which focuses on internationalising firms and diversifying markets, diversifying exports, facilitating trade, and promoting an "export culture" (MINCETUR, 2015). Although Argentina experienced a recession in 2016, the government has stepped up efforts to enact reforms to remove restrictions on trade and capital mobility, increase transparency, and improve relations with creditors. As these reforms take effect, investment is expected to rebound and improve growth in 2017 and 2018 (OECD, 2016a).

Greater promotion of innovation is needed

The region needs increased investment in innovation to support productivity improvements and diversify the economies towards more value-added sectors and new technologies. Latin American governments and companies invest much less in R&D compared to OECD economies (Table 1.2).

Table 1.2. **Innovation indicators, Latin America and selected OECD countries, 2014**

	R&D (% of GDP)	Private-sector investment in R&D (%)	Researchers per 1 000 employees	Number of scientific publications (2013)	Patents granted (2012-14)	High-tech exports (% of manufacturing exports, 2014)
Argentina	0.61	21.44	2.64	8 053	217	2.11
Brazil	1.15*	40.35	1.35*	48 622	878	4.15
Chile	0.39	31.96	0.9	5 157	153	0.63
Colombia	0.23	31.71	0.34*	4 455	62	1.53
Mexico	0.5	23.76	0.78	13 112	555	17.21
Peru	0.2*			647	9	0.41
Australia	2.11	61.91	8.59*	47 805	5 718	3.14
United States	2.74*	60.85	8.34*	412 541	329 613	12.78
Finland	3.17	53.53	14.18	10 156	3 815	10.9
Israel	4.11	36.54	17.62*	11 300	8 393	25.11

Note: Data marked with an asterisk (*) are the most recent available. Number of patents granted refers to those granted by the United States Patent Trademark Office in 2012-14.

Source: OECD (2016c), *Start-up Latin America 2016*, http://dx.doi.org/10.1787/9789264265660-en.

Some governments are making a specific effort to develop technologies and promote start-ups. In Brazil, the Ministry of Science, Technology, Innovation and Communications (MCTI) launched the 2016-19 plan for science, technology and innovation, which seeks to position Brazil amongst countries with good environments in these three fields and focuses on 11 strategic areas including aerospace and defence, biomass and the bio-economy, digital industries, energy, health and water (MCTI, 2016). The Brazilian Agency for Industrial Research and Innovation (EMBRAPII) was set up in 2013 to help translate technological research into product innovation. EMBRAPII is based on the model of Brazilian Agricultural Research Corporation, Embrapa, and is designed to establish better connections between technological research and demand. One of their activities is to develop public-private research, development and innovation networks (OECD, 2015b).

Colombia is taking action to increase research and innovation and promote start-ups. To increase resources for innovation, Colombia reformed its General System of Royalties in 2012. Through the reform, earnings from natural resource exploitation are now allocated more evenly, with 10% directed to a Science, Technology and Innovation Fund (OECD, 2016d). Due to these resource inflows, investment in R&D and innovation is expected to triple in the coming years (Hernández et al., 2016). “Ruta N” in Medellín, Colombia is a particular example of an innovation promotion initiative at the city level. The mayor’s office, in association with Empresas Públicas de Medellín (EPM) and UNE Telco, launched Corporation Ruta N, known simply as “Ruta N.” This public joint venture promotes entrepreneurship through programmes, training and infrastructure to support start-ups (OECD/CAF/ECLAC, 2016).

Chile is developing strategic industries

Chile is making particular efforts to develop strategic programmes (*Programas Estratégicos*) to promote co-ordination between the public and private sectors in high-growth industries to encourage the emergence of clusters (OECD, 2015a). These industries include renewable energy, food, advanced manufacturing and tourism. The OECD has been cautious on cluster-based programmes as they can be distortionary. Focusing on specific industries can, however, be a useful strategy if this includes co-operation between industry and science, and promotes dialogue between government and the private sector as well as between companies (Dougherty, 2015).

The OECD has highlighted that governments can modernise traditional industrial policy, which has often focused on picking specific industries or subsidising particular markets, by adopting a broader or more horizontal approach that can improve the environment for a wider range of investments (Warwick, 2013). Initial analysis of Chile's programme indicates a similar approach (OECD, 2015a). Some of the downsides of traditional industrial policy could be reduced through a "soft" industrial policy that encourages interaction between government and industry players to define priorities (Warwick, 2013).

Improving productivity remains a pressing challenge

Faced with slowing economic growth, policies to improve productivity are crucial for Latin America. In 2016 the OECD launched a Latin America and Caribbean Regional Programme to support reforms with three key regional priorities of increasing productivity, advancing social inclusion, and strengthening institutions and governance. Investments in cross-cutting areas that can enable productivity gains such as infrastructure, education, tax policy and anti-corruption are crucial. A number of areas exist where public polices can facilitate private sector investment that can support productivity through, for example, competition policies and investments in innovation and the digital economy (OECD/IDB, 2016a). Governments can also establish public institutions dedicated to finding ways to improve productivity through policy design, evaluation and reform. Since 2013, Mexico and Chile have both established Productivity Commissions (OECD/IDB, 2016a) and Chile launched a specific "Productivity Agenda" for the 2014-18 period.

PRIVATE-SECTOR INSIGHTS ON REVIVING INVESTMENT

Despite the challenging macroeconomic context, firms still see opportunities in the region. Companies see greater trade integration, upgrading and diversifying industries, and matching skills with labour market needs as the most important priorities in the region.

Trade integration holds promise

Despite its importance and optimism for future progress, trade integration remains persistently low in Latin America. Companies are confident that further trade integration can be a way to diversify export markets in a period of economic slowdown. The Pacific Alliance was highlighted as a recent initiative for trade integration that could support investment and the deepening of value chains in the region. Businesses also see strong momentum for a trade agreement between Mercosur and the European Union. Nonetheless, infrastructure improvements are needed to

support trade expansion, and companies underscored reducing transport costs and improving logistics networks as indispensable to boosting trade and development.

Companies see the expansion of free trade agreements as a way to diversify export markets

Firms highlighted the case of Chile, which has engaged in many bilateral FTAs as a useful tool to expand and diversify export markets. Chile has more than 20 bilateral free trade or preferential trade agreements in force (OAS, 2016), which have helped to diversify its exports. Chile's 2014 exports were dominated by Asia (China, 25%; Japan, 10%; and Korea, 6.3%), the United States (12%) and Brazil (5.3%) (MIT, 2016). This contrasts with Argentina, which has less FTAs in place and where trade in 2014 focused on Mercosur countries, notably Brazil (20%), Venezuela (2.9%), Uruguay (2.1%) and Paraguay (2%). While China (6.5%) and the United States (6%) are key trading partners for Argentina, they play a much less significant role than in the Chilean case (MIT, 2016).

Optimism continues that the Pacific Alliance will support business opportunities

The Pacific Alliance is perceived by companies attending EMnet events as pragmatic, dynamic and supportive of business. Firms consider the Pacific Alliance committed to learning from best practices. They appreciate the presence of a Business Council within the Pacific Alliance. Created in 2013, the Business Council of the Pacific Alliance is composed of the business associations from the four Pacific Alliance member countries. It provides recommendations regarding the progress of economic integration initiatives and suggests areas for future co-operation. The Business Council can provide "real world" feedback, facilitate integration and promote dialogue. As the Pacific Alliance advances its integration efforts, firms see it as supportive of growing participation in global value chains and as useful for increasing intra-regional trade in Latin America. Pacific Alliance members have harmonised their rules of origin for trade to allow for the "accumulation" of origin, which can support the development of regional value chains and encourage exports (Marczak and George, 2016). Accumulation of origin can facilitate trade as it allows for inputs from a member country to be used in another member country to be considered as domestic input. It can therefore help to improve regional trade integration and establish more backward linkages, i.e. using inputs from members to produce exports.

Businesses welcome the negotiations of the EU-Mercosur Free Trade Agreement

Despite years of negotiations and many setbacks, firms are strongly optimistic that the conditions are now more favourable to achieve an EU-Mercosur Free Trade Agreement. In April 2016, the EU and Mercosur exchanged offers for the first time since 2004 regarding market access, with negotiations following in September 2016. The momentum is expected to continue at the next round of negotiations, which will take place in Buenos Aires in March 2017. Companies see a new commitment to business and open trade in Brazil and Argentina. The EU is the main trading partner for Mercosur and represented 21% of Mercosur's total trade in 2015 (European Commission, 2017a).

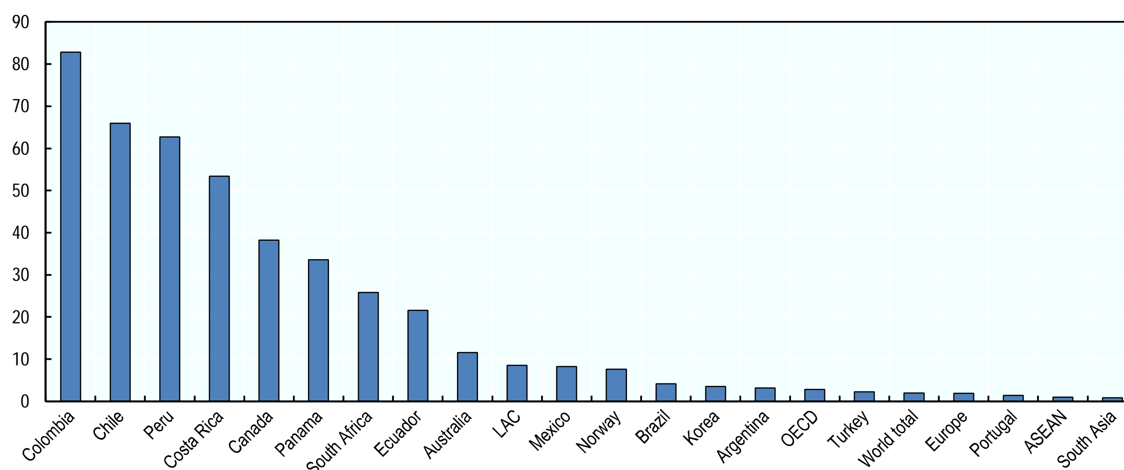
Despite trade integration, tariffs and transport costs remain too high

Although firms recognise the progress made by regional trade platforms such as the Pacific Alliance, tariffs remain high and trade within the region could be increased. Average tariffs in Latin America are more than double the OECD average. Firms confirm these challenges in intra-regional trade and tend to source intermediary goods from outside the region. Regional trade integration in Latin America is weaker than in other regions. In 2014, only 17% of Latin America's total exports remained in the region, compared with 63% of the EU's and 52% of Asia's remaining in their respective regions (OECD/CAF/ECLAC, 2015).

Companies stress the weaknesses in transport infrastructure and its implications for trade integration. Indeed, poor transport performance is the main factor in the region's overall poor logistics performance. Transport costs in Latin America far exceed the OECD average (Figure 1.6). To take advantage of regional integration efforts such as the Pacific Alliance, transport and logistics costs will need to be reduced (OECD, 2015c).

Latin American exports are particularly dependent on logistics performance. In fact, 57% of exports in Latin America are perishables or products that require high logistics performance, which is three times more than the OECD average (OECD/CAF/ECLAC, 2015). Furthermore, the types of products that dominate the region's trade, such as natural resources and agricultural goods, are also particularly time-sensitive and logistics-intensive (OECD/CAF/ECLAC, 2013). Improved roads, railways, ports and airports are needed. Additional areas for improvement include modernising storage facilities and enhancing the efficiency of customs and certification programmes (OECD/CAF/ECLAC, 2015).

Figure 1.6. **Ratio of freight costs to tariffs, 2012-15**



Note: Calculations are based on imports from the US market. The figures show the ratio of freight cost to tariffs on imports from the United States. ASEAN: Association of Southeast Asian Nations. LAC: Latin America and the Caribbean region, consisting of 21 countries. Values are calculated as the median of 2012-15 values.
Source: Based on 2016 data from the US Department of Commerce, Census Bureau cited in OECD (2016e), *Multi-dimensional Review of Peru*, http://dx.doi.org/10.1787/9789264264670-en.

Upgrading and innovating to move up value chains

Firms find that a key challenge in Latin America lies in how to transform the region into a production base and go beyond simply a consumption market. To accomplish this, the region will need to expand and diversify production as well as increase the amount of higher value goods and services. Latin America already is home to globally leading companies in certain sectors such as the Brazilian firm Embraer(airplanes), and the Mexican firm Softtek (IT services provider).

Latin America is faced with a challenging external environment and new signs of growing global protectionism. Companies feel that during the boom years of high commodity prices, Latin American countries did not take advantage of windfalls to invest in productivity improvements and in diversifying the economy. During the EMnet meeting, firms stressed that opportunities still exist in natural resources and commodity sectors, but they are increasingly found in niche or higher-value products. Greater integration into global value chains (GVCs) and more investment in innovation also are seen as tools to upgrade and diversify.

Furthermore, tax systems that treat domestic and international investors equally also can support the expansion and deepening of value chains in the region. In particular, firms have noted that tax incentives to domestic industries can inadvertently harm prospects for expansion, because wherever tax systems provide particular support for domestic producers versus their foreign competitors, the incentive is little to go beyond national borders. In addition, formalisation of production and trade is often required, as the continued prevalence of untaxed sales or imports does not support the emergence of legitimate businesses that can help grow the domestic economy and later expand it internationally.

Opportunities remain in the resources sector despite the commodity slowdown

Despite falls in commodity prices, firms argued during the EMnet meeting that opportunities are still promising for investment in traditional Latin American resource sectors. Latin America is home to vast mineral reserves in copper, iron, silver and tin (Perotti and Coviello, 2015). Prices for oil as well as non-energy commodity prices continued to decline in 2016, though the latter experienced a less severe price reduction than the former (OECD/CAF/ECLAC, 2016).

In this context, lithium and potash were highlighted as commodities with favourable prospects in certain locations. Lithium is used in batteries for electric vehicles, power storage and portable electronics. Demand is expected to grow significantly, and South America is home to substantial lithium resources. It is estimated that the region, notably Argentina, Bolivia and Chile, holds half of the world's identified available resources (O'Brien and Nickel, 2016). Resource developers highlighted particular lithium mining opportunities in Argentina. Investment opportunities for potash were also highlighted. Notably, Brazil has domestic potash endowments but imports 90% of its potash requirements (Brazil Potash Corp, 2015). According to the Food and Agriculture Organization, global demand for potash is projected to grow by 2.5% annually between 2015 and 2019 (FAO, 2016a). Developing potash resources in Brazil is an effort to promote self-sufficiency over the long term, and firms find this to be a potentially attractive investment opportunity that promotes the development of national resource endowments.

Speciality agricultural products and exports to China could hold promise

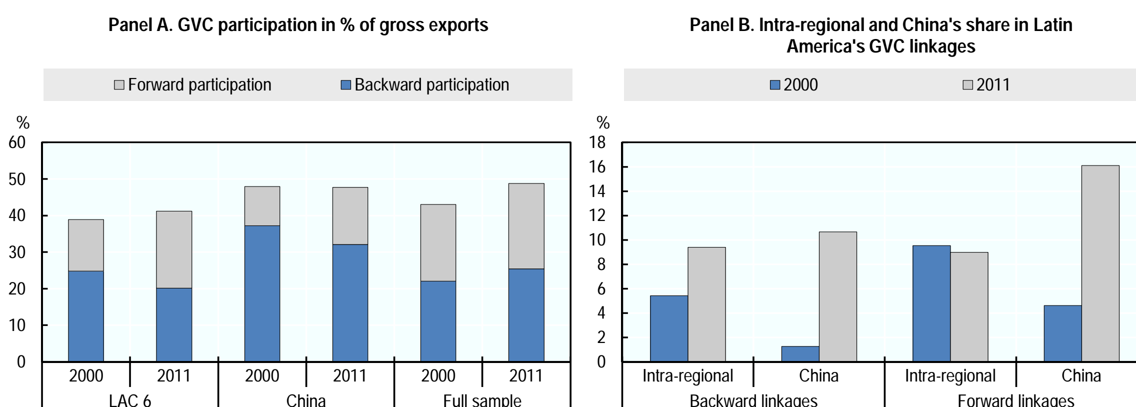
The market is growing for organic products and meat. The Latin America and Caribbean region has 15% of the world's organic land, led by Argentina, Uruguay and Brazil (Willer and Lernaud, 2016). Key export products include bananas, cocoa and coffee. In terms of total numbers of organic growers, Mexico, Peru and Paraguay are amongst the top ten countries in the world (Willer and Lernaud, 2016). The market for organic food and drinks has increased from USD 15.2 billion in 1999 to 80 billion in 2014, with 90% of sales in Europe and North America (Willer and Lernaud, 2016). Demand from China also could boost exports of food products. Expected increases in Chinese consumption of processed meat, fish and fruit could provide attractive export opportunities for Latin American producers (OECD/CAF/ECLAC, 2015).

Lack of integration into global value chains is a pressing challenge

Firms note a global outlook is lacking for locally produced goods and services, yet such an outlook is needed for greater regional and international expansion. This coincides with trends in GVC integration in the region highlighted in recent OECD work. In a study of trade linkages between Latin America and China from 2000 to 2011, Latin America's participation in GVCs was found to have improved, though remaining under the global average, while China performed close to the global average (Figure 1.7, Panel A). China's growing participation in Latin American GVCs is striking. In 2000, China had 1% of the region's share in backward value chain linkages, which increased to 11% in 2011, while China's share in forward linkages rose from 5% to 16% (Figure 1.7, Panel B). In both forward and backward linkages, China plays a larger role in GVCs than the region as a whole.

Latin America is showing an unbalanced trade relationship with China where the region also tends to export commodities and lower-value products and import higher-value goods. Indeed, commodities represent 73% of exports to China, versus 41% of worldwide sales from the region. Furthermore, Latin America exports few manufactured products to China (6% of exports compared to 42% of global exports), while heavily importing Chinese manufactured products. Of Latin American imports from China in 2013, 91% were manufactured goods, compared with 69% of its global imports (OECD/CAF/ECLAC, 2015).

Figure 3.7. **Global value chains in Latin America and China**



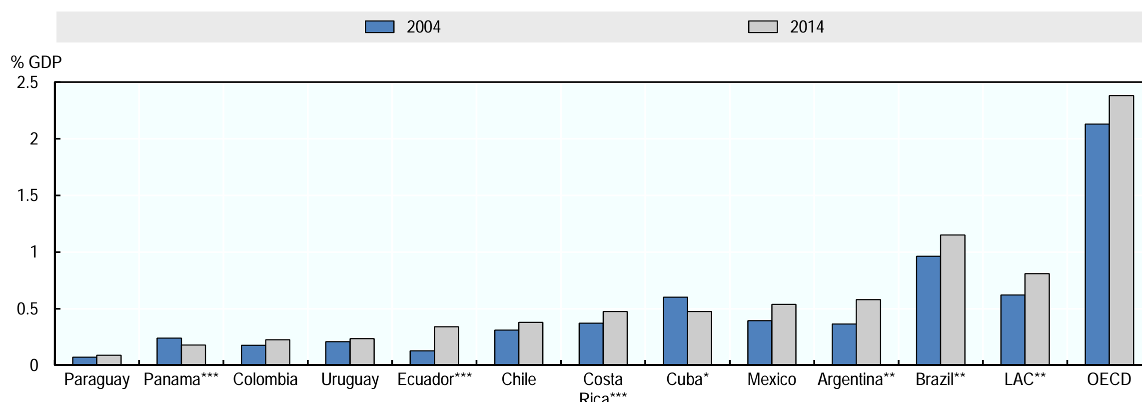
Note: "LAC 6" refers to only Argentina, Brazil, Chile, Colombia, Costa Rica and Mexico, due to data availability. "Full sample" covers 61 high- and middle-income countries.
Source: OECD/CAF/ECLAC calculations based on 2015 OECD/WTO TiVA data, cited in OECD/CAF/ECLAC (2015), *Latin American Economic Outlook 2016*, http://dx.doi.org/10.1787/leo-2014-en.

Integration into GVCs also can be facilitated through adherence to international standards. Consequently, domestically produced goods can be exported and easily used as inputs elsewhere. An example that was noted is that of the Brazilian wine industry, which sometimes uses standards that are different from those of North America, China or Europe. These differences can make it hard for foreign companies that adhere to other standards to export to Brazil and also make it difficult for Brazilian producers to export directly-usable products for bottlers and wine blenders in those foreign markets.

More and faster public and private investment in innovation is required

Latin America faces a low level of innovation capital, which can limit its development prospects. Brazil, for example, leads Latin America in terms of R&D spending, yet the country's relative levels of investment are minimal when compared to OECD economies (Figure 1.8). Notably, Brazilian firms spend ten times less on organisational capital and four times less on R&D compared to companies in the United States (OECD/IDB, 2016a). To encourage investment in R&D, governments can provide direct support via grants or contracts, or indirect incentives such as tax cuts. Given the stress on public finances, governments are often prioritising policy mechanisms that limit the amount of public spending in the short term and are increasingly turning to procurement and tax incentives to support R&D and innovation (OECD, 2016f). The ideal mix of incentives will depend on the specific country context and the types of barrier that a support measure is designed to overcome. Recent OECD analysis of cross-border R&D and innovation investment by multinational firms in cities found evidence of additional important factors to attract knowledge-intensive investment (Belderbos et al., 2016). Notably, the international connectivity of a given city, through airport infrastructure and the ability to engage in knowledge transfer and research exchanges, is an important element. Furthermore, the presence of local universities with research programmes in relevant fields can help to attract R&D investments (Belderbos et al., 2016).

Figure 1.8. **Investment in R&D in selected countries, 2004 and 2014**



Note: Data marked with a single asterisk (*) are for 2013, those with a double asterisk (**) are for 2012, and those with a triple asterisk (***) are for 2011.
Source: OECD (2016c), *Start-up Latin America 2016*, http://dx.doi.org/10.1787/9789264265660-en.

Firms also highlight the importance of investment in supportive infrastructure such as broadband and policies to encourage innovation and the diffusion of new technologies. Latin America has made great progress in expanding Internet access, yet gaps remain. The share of the population connected to the Internet more than doubled in Latin America from 21% in 2006 to 47% in 2013, while remaining low compared to the OECD average of 79% (Katz, 2015). Nonetheless, an estimated 300 million people remain without access to the Internet (OECD/IDB, 2016b). The OECD publication *Broadband Policies for Latin America and the Caribbean: A Digital Economy Toolkit* is intended to help governments design coherent policies to support broadband (OECD/IDB, 2016b). To promote greater business uptake of broadband, it recommends that governments make the Internet open and available, promote a regulatory environment conducive to e-commerce and support the creation of digital content in local languages.

Broadband, however, is just one part of a larger system. Companies stress that improvements in infrastructure should be accompanied by a regulatory environment that supports competition, trade and investment as well as the necessary human capital. This is line with OECD work in *Boosting Productivity and Inclusive Growth in Latin America* that highlights that market competition is necessary to push firms to constantly improve and upgrade their product offerings and processes (OECD/IDB, 2016a). Skills policies also are needed to ensure the availability of human capital to innovate and take up new roles. Education and skills are discussed further in the section below.

Finally, as far as innovation is concerned, the speed of change remains an issue for both governments and firms. Participants noted that companies are aware of the importance of innovation but often underestimate the speed with which innovation has to be achieved. Governments may lag behind innovation if they focus too heavily on a single industry rather than promote an overall environment conductive to investment and innovation.

Firm-level innovation is happening at all stages of the value chain

Companies cautioned against taking an overly narrow view of innovation to reflect only high-tech companies in Latin America. They pointed to business strategies to promote innovation by promoting exports as well as by expanding internationally, a strategy highlighted by EMnet participants. By expanding outside of home markets, companies are able to learn and innovate in their processes within new contexts. Firms can innovate at any stage of the value chain and often do so in specific processes within traditional industries. For example, in 2014 the French tire company Michelin acquired Sascar, a Brazilian firm specialised in digital management of trucking fleets. This acquisition strengthened Michelin's capabilities in connectivity platforms, known as telematics, for trucks (Michelin, 2014). In Chile, the Strategic Programmes launched in 2015 offer technological roadmaps with the aim of improving productivity and competitiveness in traditional sectors such as mining and logistics, in addition to newer fields such as solar energy and information and communications technology products (OECD, 2015a).

Skills and education can support regional development and diversification

A closer relationship should be formed between universities and businesses

Companies stressed the importance of partnerships and alliances between the business community and universities. Overall, observers pointed to a general misunderstanding or underestimation of the relevance of the former to the latter and vice versa. In particular, academia will place less importance on the profitability of a potential innovation and focus less on marketing its advances. Furthermore, businesses may not prioritise R&D until they are in urgent need of a new product or solution. Building partnerships and alliances to communicate respective advances and future needs can help both businesses and universities move forward.

Firms are already taking steps to build partnerships with universities. For example, French electricity firm Schneider Electric formed a partnership with the French Ministry for National Education, Higher Education and Research and the Escuela Tecnológica Instituto Técnico Central (ETITC) in Colombia. The partnership will establish a training centre in Colombia to enhance skills and promote knowledge sharing in the energy field (Schneider Electric, 2015). In addition, as part of their collaboration agreement with the National Autonomous University of Mexico (UNAM), the Chinese telecommunications company Huawei is set to train and certify students and professors in new technologies (Huawei, 2014).

Developing a more flexible skill set rather than promoting specific careers could be useful

Technology is changing the way we work, the types of jobs that humans will do and the needed skills. For example, fewer employees are required in some traditional sectors and professions that have been automated, such as in certain customer services. The private sector cannot necessarily predict what jobs they will hire for in the future, but they can often estimate what types of skills will be important.

English language skills, emotional intelligence and the ability to work with new technologies will be needed for future jobs. Companies see a role for governments to support a more flexible development of skills rather than a narrow focus on specific professions that may lose their relevance in the future.

Latin America must not forget the importance of productive development policies and of aligning skills with these policies

Companies stressed that Latin America still needs to do more to develop clear long-term productive development policies and promote relevant skills. While discussion of the digital economy is increasing, firms emphasised the importance of promoting industrial development (e.g. manufacturing and services) in parallel. Furthermore, the supply and demand of skills are often mismatched. Firms noted that skills assessments are often conducted after a policy is createdd, rather than including analysis of skill endowments and educational trends in the design-phase. This lack of consideration can result in industrial policies that will be difficult to implement as they are incompatible with available skills.

Business implications of Brazil's economic downturn and political instability

At the EMnet Latin America meeting in June 2016, the economic situation in Brazil was a key concern and core topic of discussion. Although the economic and political instability in Brazil was being watched closely, prospects still remained for both short- and long-term investors. In addition to the overall global economic downturn and persistent declines in commodity prices, currency depreciations and heavily dollarised debt are straining corporations and financial services companies. The political crisis also was highlighting the importance of reducing corruption. In this context, Brazil's instability was creating opportunities for mergers and acquisitions.

Declines in major Brazilian firms, which were major drivers of investment, are worrying for investors

Brazilian firms are cutting investment plans in response to the economic downturn. Major firms such as Petrobras have made significant cuts to their investment plans and outlook. Petrobras, Brazil's state-owned oil company, accounts for a significant share of national investment and concern is growing regarding the ramifications of the slowdown on the company's investment plans. In 2016, Petrobras further downgraded its investment plans (Petrobras, 2016). Petrobras' investments support a wide range of supplier and construction companies. For example, the Brazilian oil-rig operator Sete Brasil Participações filed for bankruptcy protection in April 2016 with BRL 18 billion (Brazil reales), or approximately USD 5.1 billion, in liabilities. Petrobras was Sete's only client, and it cut the number of rigs it had planned to lease from Sete significantly (Marcelino, 2016).

Despite the crisis, capital flows into Brazil and acquisition opportunities continue

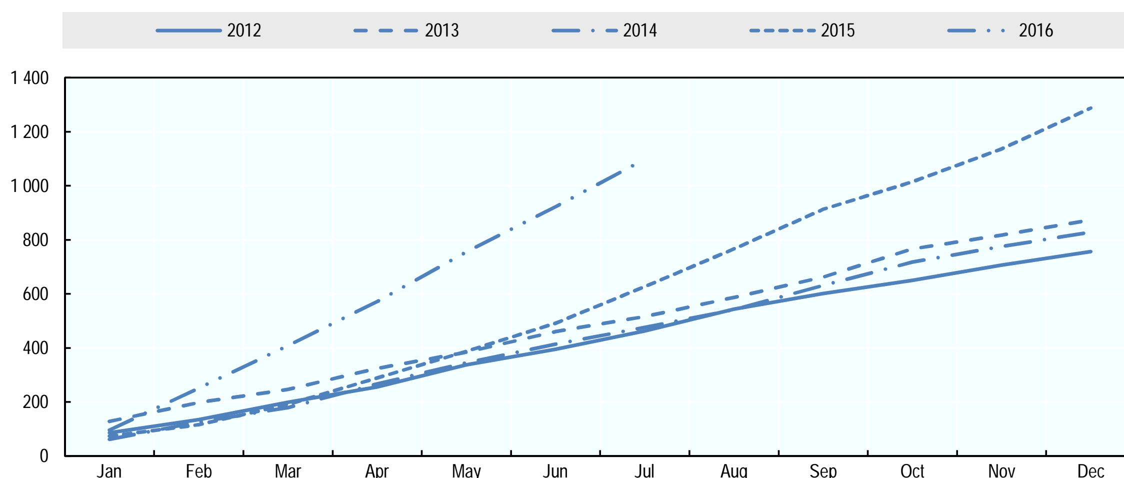
Given the challenging economic environment, many firms are selling assets to reduce debt during this period of uncertainty. For EMnet participants, the situation is not all negative. For example, the slowdown offers an opportunity to acquire and redevelop assets from firms that are deleveraging; Petrobras and Vale alone are expected to sell as much as USD 20 billion in assets to reduce debt (Lewis and Jelmayer, 2016). Oi, one of Brazil's major telephone operators, filed for bankruptcy protection in June 2016 with BRL 65 billion (approximately USD 19 billion) in debt. This is the largest bankruptcy filing on record for Brazil (Pearson, 2016). Many other local and international firms are restructuring, such as the construction and engineering conglomerate OAS and Shree Renuka do Brasil Participações Ltda, the Brazilian subsidiary of the Indian sugar

company Shree Renuka Sugars. MMX, the mining company owned by Eike Batista, sold two iron ore mines as part of its bankruptcy recovery to a Singaporean trading house, Trafigura, and Mubadala, an Abu Dhabi investment company (Valor International, 2016).

In addition, general financial stress can open takeover opportunities at competitive prices. In early 2016, the private debt to GDP ratio increased considerably, and debt from the non-financial private sector was higher than 70% (OECD, 2016a). The number of firms seeking bankruptcy protection took a steep rise from about 800 filings in 2014 to about 1 300 in 2015, but these totals are on track to be exceeded given that about 1 100 filings were recorded only in January to July 2016 (Banco Central do Brasil, 2016) (Figure 1.9). Chinese companies, for example, are actively acquiring firms in Brazil and have spent USD 11.9 billion doing so (Hornby and Leahy, 2016). Participants tended to be optimistic about Brazil in the long term and considered this to be an attractive moment to increase investment.

Figure 1.9. **Corporations in judicial recovery in Brazil**

Cumulative requests by year



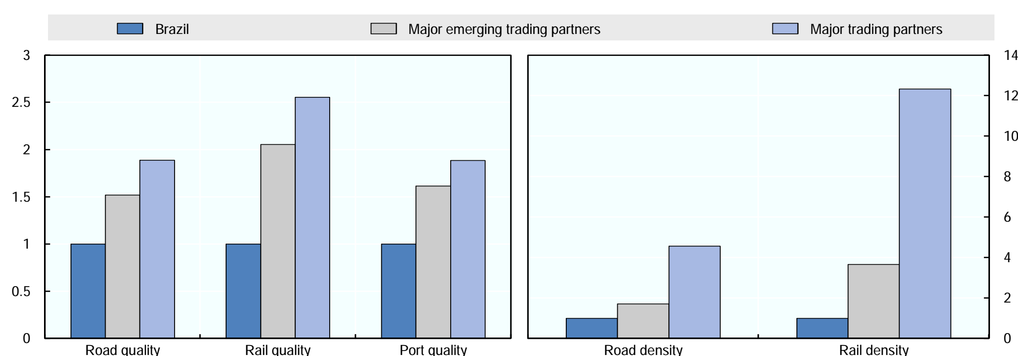
Source: Banco Central do Brasil (2016), *Financial Stability Report*, http://www.bcb.gov.br/?fsr201609.

Firms see particular opportunities in Brazil's infrastructure concession regime

Brazilian infrastructure is an area with great needs and significant opportunities for the private sector. Brazil's infrastructure sector requires investment, and transport and logistics costs are high (OECD, 2015d). The World Economic Forum's (WEF) Global Competitiveness Index 2016-2017 ranked Brazil 72nd out of 138 countries for infrastructure quality and connectivity (WEF, 2016). Brazil is facing much lower infrastructure quality than its key trading partners (OECD, 2015d). Notably, Brazil's 15 largest trading partners have infrastructure scores that are twice as high as Brazil on average (Figure 1.10).

Figure 1.10. **Brazil's infrastructure relative to its major trading partners**

Normalised to 1 for the value of Brazil



Source: OECD (2015d), *OECD Economic Surveys: Brazil 2015*, http://dx.doi.org/10.1787/eco_surveys-bra-2015-en.

Infrastructure investments via concessions offer opportunities for private investment, which can help to compensate for strained public finances. Private investment through concessions offered in the 1990s helped to eliminate infrastructure gaps in the electricity and the telecommunications sectors (Garcia-Escribano, Góes and Karpowicz, 2015). Concessions have been making steady progress under the two editions of the country's accelerated growth pact programme (*Programa de Aceleração do Crescimento* – PAC), and particularly since 2013 with the resumption of the Logistics Investment Programme. A second stage of this programme was launched in 2015, containing planned investments of BRL 70 billion to be invested by 2018, and another BRL 130 billion in subsequent years (OECD, 2015d).

Brazil has strengths in certain sectors such as agriculture and forestry

Not all sectors are facing downturn in Brazil; during the EMnet meeting, participants highlighted strengths in agriculture and forestry as examples of resilient industries. Despite economic turmoil, Brazil's agricultural sector continues to drive growth and has favourable prospects. While some global food and agriculture markets are expected to slow down or decline, Brazil's output of many agricultural products is anticipated to increase. For example, global meat production is expected to stagnate, but Brazil will continue to intensify its output and lead global export expansion (FAO, 2016b). Biodiesel demand is expected to continue. Nearly half of the global growth in agricultural areas harvested is expected to come from Brazil and Argentina, driven by growth in soybeans (OECD/FAO, 2016). By 2025, Brazil has been projected to be the largest soybean and sugar producer in the world. Favourable growth prospects are expected for cotton as well as for aquaculture (OECD/FAO, 2016). In addition, the forestry sector also has been resilient during the economic downturn. For example, the planted tree industry grew by 3% from 2014 to 2015 to reach BRL 69 billion (IBÁ, 2016). Wood pulp producers such as Fibria and Klabin also have performed well.

The corruption crisis is deep but could also generate positive momentum for future reforms

The corruption crisis that engulfed Brazil, known as "*Operação Lava Jato*'' or Operation Car Wash, has expanded in size and scope to dwarf previous scandals. The Lava Jato case was initially an investigation into money laundering at gas stations and car washes. Over time it expanded to include allegations of corruption in the state-owned oil company Petrobras, whose officials are accused of accepting bribes in exchange for awarding contracts to construction companies at inflated prices. Investigations have reviewed BRL 6.2 billion in bribes paid, resulting in estimated losses to the state of BRL 29-42 billion (Leahy, 2016). The corruption scandal has also involved the Brazilian construction firm Odebrecht, which in December 2016 signed a leniency deal with the Brazilian, US and Swiss legal authorities and agreed to pay a fine for violating corruption laws (Odebrecht, 2016; EIU, 2017).

Though the current political instability has generated a significant business risk in Brazil, companies stressed that the political crisis is felt most at the level of the central government, while activities at the subnational and municipal levels continue to function. Given the depth of the corruption scandal, however, companies believe it can open up space for meaningful reform, potentially helping to increase transparency and strengthen institutions.

CONCLUSION

This is indeed a challenging moment for Latin America. The region needs to upgrade, diversify and innovate quickly to catch up with the global economy. Although commodities will continue to provide a source of revenue for many countries, high commodity prices are unlikely to return soon. In this period of downturn and weakened government spending capacity, partnerships with the private sector can be particularly valuable. This can be particularly relevant in key enabling areas, such as for example logistics and transport infrastructure development.

In this period of global uncertainty and rising protectionism, firms are watching trade policy closely and underscoring the need for open trade to support sustainable economic development. Economic diversification is of crucial importance at this moment, and companies support government efforts to promote innovation and encourage higher value-added products and services. It is essential to ensure that regulations can support businesses and encourage investment. Improved business-university partnerships and better matching of skills to labour market demands can supplement and strengthen these efforts to overcome uncertainty.

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