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Energy transition can help unlock Latin America's potential from nearshoring

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Summary

- The world is currently undergoing a reorientation of global trade driven by the pandemic and geopolitical shifts, including so-called nearshoring or friendshoring. Latin America and the Caribbean (LAC) is in a seemingly good position to benefit.
- But there are challenges. Despite a high number of trade agreements of LAC countries, the region's integration in international trade and global value chains remains comparatively low, suggesting existing trade agreements are relatively shallow.
- Moreover, LAC continues to grapple with structural weaknesses that drag on trade and reduce its attractiveness for investments in higher value-added sectors like manufacturing and the green economy.
- The bright spot is the energy transition, for which LAC and particularly quite closed South America possesses critical minerals. The need for those may trigger deepening of trade agreements with the EU and US and expansion of intraregional trade.

Shifting trade winds could lift Latin American & Caribbean economy

As the global trade order shifts and governments and businesses seek to strengthen the resilience and sustainability of supply chains through processes like nearshoring, Latin America and the Caribbean (LAC) may have a once-in-a-generation opportunity to strengthen its economy and reduce inequality. Given LAC's geographical proximity to the world's largest consumer market and its relatively strong institutional and cultural ties to both North America and Europe, it's worth considering its integration in new global value chains.

Attracting investment to increase trade competitiveness and integration is necessary to increase LAC's stubbornly low growth potential. While the region has weathered many economic storms over the past years, its growth prospects remain the lowest among all emerging market regions. This is largely due to major structural weaknesses like a challenging business environment, a large informal sector, education and skill shortages, and lagging digitisation. A less well-known factor relates to trade. Despite a high number of trade agreements of LAC countries, the region's integration in international trade and global value chains remains comparatively low. This suggests that not all trade agreements are equal. For trade agreements to have an impact on productivity and economic growth, it matters what and with whom you trade and what you agree in the trade agreement (its scope or depth).

In this research note, we take a closer look into the changes in global value chains and the accompanying opportunities and challenges that face Latin America and the Caribbean. We first take a close look at how LAC fits into the global picture and the composition of LAC's trade. We assess the quality and shortcomings of both. Then taking into account the shifting geopolitical backdrop for international trade, we explore how it impacts LAC trade and close with an assessment of the most realistic opportunities for LAC to

improve its trade competitiveness, both within the region and on the global stage, in the coming years.

High costs of trade limit LAC's integration

Latin America and the Caribbean's structural trade weakness begins with its lack of integration in the global economy and the high costs of that trade. The region set up early internal trade arrangements like the Andean Community Agreement in 1969 and Caricom in 1973 before accelerating integration with the rest of the world along with the establishment of the World Trade Organisation (WTO). This global trade liberalisation process starting in the 1990s led to a range of preferential trade agreements for LAC, largely within the region and to varying levels beyond. Box 1 presents the most significant trade blocs today.

The developments within LAC show that not all trade agreements are equal and provide the same benefits. For starters, the 'depth' of the agreement matters: whether it covers just simple market access for goods, through the removal of tariffs, or if it goes deeper including beyond trade to additional policy areas, like investment flows and environmental regulations. In recent research, *Deep Trade Agreements: Anchoring Global Value Chains in Latin America and the Caribbean,* the World Bank stressed that trade agreements that also reduce non-tariff barriers to trade, such as border compliance, trade finance and insurance costs and regulatory discrepancies, are required to boost trade and economic growth.

Box 1 Main LAC trade blocs

CAFTA-DR: The Dominican Republic-Central America-United States Free Trade Agreement signed in 2004. Central American members encompass Costa Rica, El Salvador, Guatemala, Honduras and Nicaragua. It is the third largest export market in Latin America for the US, after Mexico and Brazil (almost on par). Countries in Central America have an association agreement with the EU since 2012.

CARICOM: The Caribbean Community is a political and economic union of 15 member states and five associated members throughout the Americas and Atlantic Ocean. It came into force in 1973, making it the oldest surviving integration movement in the developing world. It has a trade and investment framework agreement with the US since 1991 and an economic partnership agreement with the EU since 2013.

MERCOSUR: Mercado Común del Sura, or the Southern Common Market, is a trade bloc in South America encompassing Argentina, Brazil, Paraguay and Uruguay established in 1991. Venezuela was suspended in 2016. In 2019, the EU and MERCOSUR reached political agreement on a trade agreement, twenty years after negotiations started. Ratification by the individual countries is still pending due to worries on both sides.

Pacific Alliance: Trade bloc between Chile, Colombia, Mexico and Peru, established in 2012. Costa Rica is in the process of joining (Ecuador and Panama are LAC candidate member-states). As part of the agreement tariffs on the trade of goods have been gradually phased out. The group also started other forms of regional integration, including visa-free tourist travel, common stock exchange and joined embassies. In 2022, the first free trade agreement between the alliance and a third country, Singapore, was signed. The individual members have FTAs with the US (Chile since 2004, Peru since 2009 and Colombia since 2012) and with the EU (Mexico since 2000, Chile since 2003 and Peru and Colombia since 2013).

USMCA: The United States-Mexico-Canada Agreement came into effect in 2020, replacing the North American Free Trade Agreement which was implemented in 1994 to encourage trade and investments between the US, Canada and Mexico by eliminating most barriers. Strictly not a LAC trade bloc, but important to understand the differences between Mexico and the region's other large markets.

Generally, Mexico and members of the regional trade blocs CAFTA-DR and the Pacific Alliance tend to have deeper agreements, whereas the MERCOSUR countries have shallower ones. In the MERCOSUR, non-tariff barriers to trade affect about two-thirds of the imported goods and three-quarters of the value of these goods, against relatively low barriers in the other blocs. Table 1 shows that the cost of border compliance is quite high in terms of time and money in LAC, but it is clearly skewed by the relatively shallow MERCOSUR trade agreement. For CAFTA-DR members, these costs of trade are even more favourable than East Asia and the Pacific.

Table 1 Cost of trading across borders

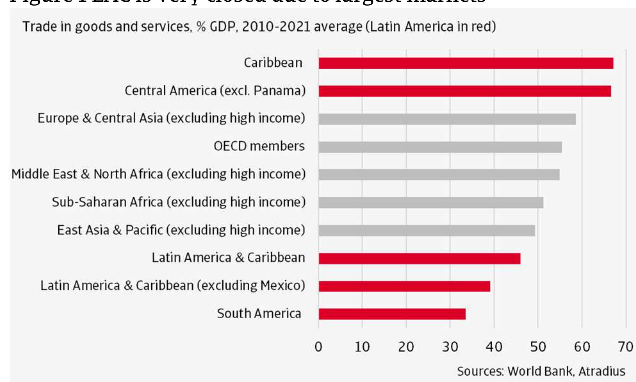
	Border Compliance			
Region	Time to export hours	Cost to export USD	Time to import hours	Cost to import USD
Europe and Central Asia	16.1	10	20.4	158.8
OECD (high income)	12.7	136.8	8.5	98.1
East Asia and Pacific	57.5	381.1	68.4	422.8
Latin American and the Caribbean	55.3	516.3	55.6	628.4
Mexico	20	400	44	450
CAFTA-DR	42.9	355.3	57.7	426.4
Pacific Alliance	60	487.5	70.5	496.3
MERCOSUR	71.5	716.3	30	643.8

Sources: World Bank Doing Business Indicators, 2020 and World Bank 2023

Despite the large amount of trade agreements, the barriers to trade in existing trade agreements are both central causes and effects of LAC's lack of trade openness. Exports plus imports as a share of GDP, a standard measure of trade openness, are at 46% on average in 2010-2021 the lowest in the world (see figure 2). Excluding Mexico, the most open of the region's largest markets, the number would be even below 40% of GDP. This reflects limited trade integration of three of the region's largest markets, Argentina, Brazil, and Colombia. Their average trade openness ranges between 26% and 36% (see figure 3), half that of Mexico, the region's second largest market. Mexico's trade openness increased significantly after the North American Free Trade Agreement (NAFTA, now called USMCA) came into force in 1994. Argentina on the other hand became less open in the past decade, due to an increasingly complex system of import, currency and transfer restrictions.

The disparity in countries' openness to trade can be seen at the subregional level, presented in figure 2. In the global perspective, LAC as a whole is relatively closed to trade. Within LAC, South America is by far the most closed region. Central America and the Caribbean on the other hand are the most open, with average trade openness at 67% of GDP. Particularly for most Caribbean countries, this partly reflects the relatively small size of their economies and limited domestic production capacity, which makes them reliant on imports. But trade agreements with the US, like CAFTA-DR and the trade and investment framework with the CARICOM contributed to these subregion's openness as well.

Figure 1 LAC is very closed due to largest markets



That said, despite their relatively high openness, even these subregions within LAC do not fully use their potential. Research by the World Bank shows that LAC also under-trades relative to its predicted potential, accounting for trade fundamentals such as distance to markets, special trade arrangements, common language, and partner's economic size. Bolivia, Chile, Mexico, Nicaragua and Paraguay are notable exceptions.

Latin America and the Caribbean also stands out in a negative light for its developments in intra-regional trade. In the two decades since China joined the WTO, the share of intra-regional exports in total exports of goods has fallen from the second highest (18.5%) to the second lowest (14.8%) among emerging markets after the Middle East (see figure 2). Meanwhile Emerging Asia has moved from second lowest position to the highest position. But at 22.5% this Is still below shares in advanced trade blocs in North America (45%) and the EU (60%). World Bank research (2019) shows that intra-regional trade in LAC is mostly between countries with *similar* structures. Such agreements often result in trade diversion, rather than in trade creation in which new trade that would not exist without the trade agreement is created.

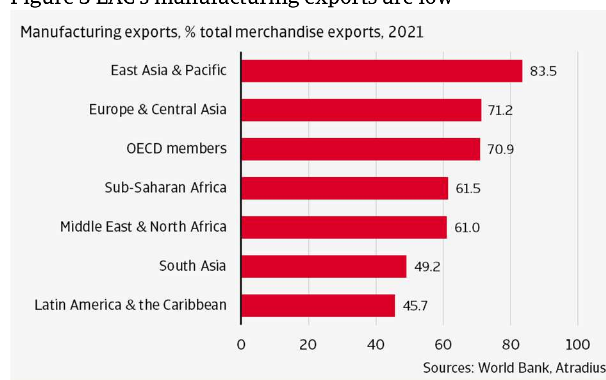
Figure 2 LAC's intra-regional trade has declined.

Struggling to move up the value chain

More trade openness could help to boost Latin America's growth potential, but Latin America also needs to improve the *quality* of that trade. The composition of trade and nature of trade agreements are critical factors in the transfer of knowledge and technology to increase economic efficiency and productivity, and here we also see room for improvement. Research shows that for emerging market economies, so-called South-North trade contributes more effectively to raising potential growth than trading amongst each other. But only Mexico, CAFTA-DR, and the OECD countries of the Pacific Alliance have significant agreements with the US or EU. MERCOSUR, the region's largest trade bloc does not. Expanding these trade ties could help the transfer of technology and stimulate innovation to develop the region's manufacturing sector.

With regard to the composition of trade, Latin America stands out with high shares of food and commodities and a low share of manufacturing in merchandise goods compared to other regions (see figure 3). World Bank data show that at 45.7% in 2021, the region's share of manufacturing is the lowest among all regions. Worse even, this share is down from 55.2% in 2000. Additionally, Latin American countries mostly export low-technology manufacturing goods. This indicates that moving up the value chain and participate in global value chains is quite a struggle for the region.

Figure 3 LAC's manufacturing exports are low

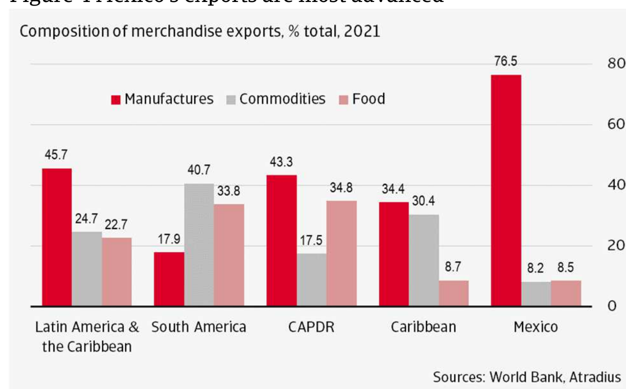


The small share of manufactures in LAC trade partly reflects the legacy of general policy choices after the outbreak of the Second World War. This forced other countries to industrialise as the war restricted access to manufacturing imports. But different from, for example, East Asia, these industrialisation processes in LAC were mainly domestically oriented. Commodities continued to dominate exports. As a result, the small size of most domestic markets and lack of exposure to international competition constrained the development of the manufacturing sector both in size and level of innovation. But it also reflects a policy divide within the region, and particularly between the three largest countries since the 1990s.

Within the region, Mexico has been most successful in moving up the value chain, as part of its trade agreement with the US and Canada in 1994. At 77% in 2021, Mexico has the highest share of manufacturing in merchandise exports in LAC (see figure 4). Moreover, these exports are also most advanced: 80% are medium or high technology goods, illustrating the importance of South-North trade. As a result, Mexico is the only LAC country that is well integrated into advanced manufacturing global value chains. Trade agreements with the US also helped most countries in Central America and the Caribbean to upgrade their exports to manufacturing, with CAFTA-DR members El Salvador, Costa Rica and Dominican Republic being most successful. Their shares of merchandise exports are above the LAC regional average and range between 75% (El Salvador) and 57% (Dominican Republic). Of these countries manufacturing exports are most advanced in Costa Rica (medical devices, aerospace, computer & electronic components, and pharmaceuticals), followed by Dominican Republic (medical and optical devices, electronics and

pharmaceuticals) and El Salvador (textiles, chemicals, rubber and plastics).

Figure 4 Mexico's exports are most advanced



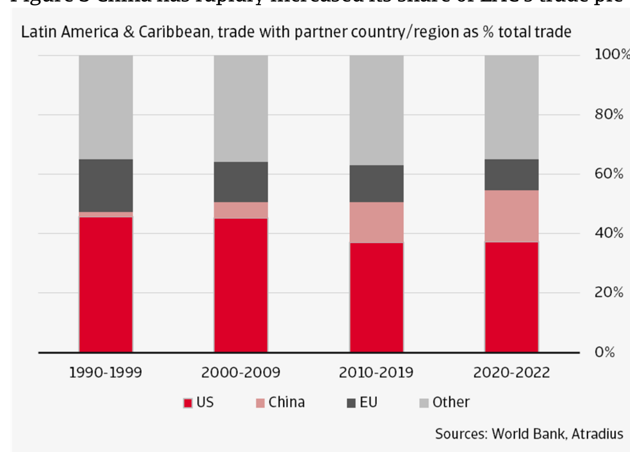
Overall, most countries in Central America and the Caribbean have a higher share of manufacturing in merchandise exports than commodity rich South America. This subregion is struggling the most in moving up the value chain, with a share of manufacturing in merchandise exports at 18%. Quite strikingly, this share has significantly declined over the past two decades. In South America, Brazil has the highest share at 25%, but this is down from 57% in 2000. A similar, but less sizeable development took place in Mexico: its share of manufacturing in merchandise exports fell from 85% to the current 77% over the same period. This reflects the rise of China after joining the World Trade Organisation in 2001. As China became the world's manufacturer, South America provided the raw materials and lost competitiveness in manufacturing; to a lesser extent, so did Mexico. However, the lagging behind of South America with regard to openness and value added is not just a matter of the rise of China and the region's comparative advantage in commodities. In all countries in this subregion, the share of manufacturing continued decreasing after the end of the commodity boom years of 2003-13 (Paraguay was the exception, but here the share increased from a very low level). It also reflects the policy divide in trade agreements that MERCOSUR lacks integration with advanced markets.

Nearshoring poses challenge and opportunity for LAC

The pandemic and geopolitical shifts – namely rising trade tensions between China and the West and the outbreak of war in Ukraine – are prompting governments and companies worldwide to reduce vulnerabilities in essential supply chains. The US-China rivalry is the most significant development here for Latin America and the Caribbean, as both the US and China are major trade and investment partners for the region.

China has been the region's fastest growing trade partner over the past decades, substituting some of the trade with the US and EU. While figure 5 shows the US is clearly the largest trade partner of the region, 70% of that trade is bilateral with Mexico. Excluding Mexico, trade with the US only accounts for 11% of the rest of the region's trade, below China's share of the 17%. China has become a more significant trade partner in terms of both exports and imports than the US in some countries, especially commodity-rich ones in South America. But China's role has also grown in Central America and the Caribbean, recent years. Chile, Costa Rica, Peru and recently Ecuador have free trade agreements with China, and Panama and Uruguay are planning treaties. Due to the regional trade bloc, Dominican Republic-Central America-United States (CAFTA-DR), the US is by far the largest export destination for countries in Central America, but China is their second largest import partner. The importance of China in this subregion might increase further. Almost all countries that are a member of the DR-CAFTA trade bloc between the US and countries in the region have switched diplomatic ties from Taiwan to China. So did Panama. In LAC, only Belize, Guatemala and Paraguay still have diplomatic ties with Taiwan instead of China.

Figure 5 China has rapidly increased its share of LAC's trade pie



While China has been the largest growth partner in trade over the past decades, the dynamics limit further developmental gains for LAC countries. As discussed earlier, commodities dominate LAC-China trade which offer limited value-added for domestic economies. The relatively low competitiveness of other exports from LAC and the reduced attractiveness of traditional natural resource extraction due to climate change both drag on investments into LAC. As the geopolitical landscape shifts and demand for new resources to fuel the energy transition picks up, shifting focus to improving trade relations with the US and EU and increasing the value added of domestic manufacturing would increase much-needed FDI inflows for the region – offering opportunities to move up the global value chain.

The US-China rivalry and the EU's strive to reshape its supply chains have major ramifications for the US and EU's foreign policies that could offer opportunities for Latin America and the Caribbean. Reducing dependence on China for crucial materials for the energy transition is of particular priority. China's current share in the refining of such minerals is for instance 100% for natural graphite, over 90% for manganese and almost 60% for lithium. In 2021 for instance, both the US and the EU launched a series of policy initiatives aimed at raising the autonomy of strategic industries such as semiconductors, electric batteries, pharmaceuticals and critical minerals. To date, evidence of a major reorientation of global value chains is absent – due to high costs among other reasons – but this might change once investors judge the disruptions to the global value chains to be more permanent. Proximity to the US and improved labour cost competitiveness make LAC an attractive candidate for nearshoring. Estimates by the Inter-American Development Bank (IDB) suggest that nearshoring could add an annual USD 78 billion to the region's exports of

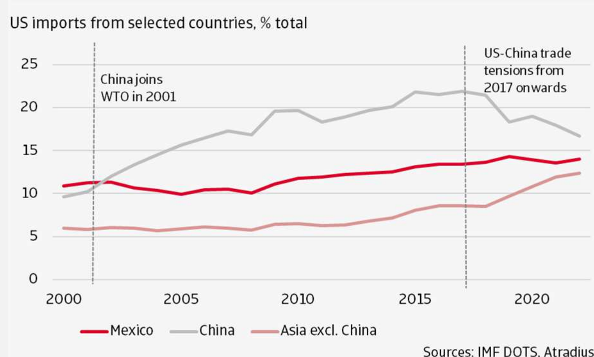
Box 2 Mexico and nearshoring

Different research suggests that Mexico is best placed to benefit from nearshoring. It shares a 3,000-kilometre border with the US and is a member of USMCA, one of the world's largest trade networks. Mexico already has a solid foundation to reap the most rewards from nearshoring with 13 FTAs encompassing 50 countries, integration in advanced global value chains and competitive labour costs. Currently, hourly wages of manufacturing in Mexico are USD 2 below those in China. The IDB (2022) estimates that nearshoring in Mexico could add USD 35.3 billion annually in exports of goods.

Recent developments suggest that Mexico has indeed made some progress with nearshoring: exports of goods to the US have grown by 56% since the start of the trade tensions between the US and China in 2017 as US companies such as Walmart started buying goods from Mexico or opened factories in Mexico (MGA Entertainment) instead of China. Also, foreign direct investment (FDI) inflows in Mexico set a new record of USD39bn in 2022 and remained strong in the first quarter of 2023. Some European manufacturers, especially in the automobile industry like BMW, are for instance. opening new manufacturing facilities in Mexico to benefit from lower labour costs and closer proximity to the US consumer market.

However, although Mexican exports to the US have increased, both in value and as a share of Mexican exports, Mexico's share in US imports so far has not. It is pretty stable around 13.5% since 2016 (see figure 7). In other words, the increased Mexican exports is the result of overall higher import demand from the US. Meanwhile, the share of other Asian countries in US imports has increased from 8.6% in 2016 to 12.4% in 2022. This suggests that US companies have so far been rerouting supply chains to allies in Asia, particularly southeast Asia, instead of Mexico. The fact that 90% of the higher FDI inflows came from reinvestments from established companies, rather than new, greenfield, investors supports this. This bias is in part due to policy uncertainty in Mexico. For instance, there have been several conflicts recently between Mexico and the US and Canada under the USMCA. These concern an announced reform by Mexico to the mining law, a decree that limits imports of genetically modified corn and the administration's energy policy, prioritising the state-controlled power utility company over electricity generated by the private sector. Although these conflicts have so far not scared established foreign investors in Mexico, they have particularly raised investments in the – media & financial - services sector, with investments in manufacturing slowing. This is one of the reasons why Mexico's manufacturing sector has been stagnant since its recovery from the pandemic.

Figure 6 US opting for rerouting lost-Chinese trade with Asia instead of Mexico



goods and services, with opportunities in particularly sectors such as automotive, textiles, pharmaceuticals, and renewable energy. The associated strengthening of integration in international trade, exchange of knowledge, technology and financing (foreign direct investments) would benefit the region and could lift its growth potential. However, as we outlined above, the current state of trade in Latin America and the Caribbean poses substantial impediments to seizing these opportunities.

Energy transition can help unlock gains from nearshoring

From the above we can see that only a few countries stand to benefit in the coming years from potential near- or friendshoring. Mexico and the CAFTA-DR countries are the best positioned countries in Latin America and the Caribbean to benefit from these trends in terms of trade agreements with and geographical proximity to the US. Within CAFTA-DR, Costa Rica and Dominican Republic stand out given their more advanced manufacturing production. In South America, the OECD members, Chile and Colombia, would be well-positioned to benefit from nearshoring or friendshoring, as they have free trade agreements with the US and the EU.

Most other countries in South America have seemingly lower prospects when it comes to nearshoring or friendshoring, considering the lack of trade agreements with the US or EU. However, we see opportunities for these countries to expand their trade. The energy transition could trigger this.

Firstly, the energy transition could push free trade agreements with the US and the EU as these regions aim to reduce dependence on China for raw and processed commodities. Many South American countries are rich in critical minerals such as lithium (Argentina, Bolivia, and Chile), copper (Chile, Peru), nickel and graphite (Brazil) that are strategic for the energy transition. Diversifying supply chains through near- and friendshoring, especially for strategic resources for the energy transition, may motivate the US and EU to deepen trade ties with LAC.

Free trade agreements with the US and the EU might facilitate near- and friendshoring that could lift the value added of that trade. The updated FTA between Chile and the EU, concluded end-2022 (still needs to be signed and ratified) and the agreement to prepare a 'strategic partnership' for raw materials are positive examples in this respect. A key aspect of the 'strategic partnership' is to create added value in Chile. This example might facilitate the long-awaited ratification of the FTA between MERCOSUR and the EU. The EU is now waiting for a MERCOSUR response to an addendum it wants to add on sustainability and climate change commitments due to deforestation concerns. This offers an opportunity for the MERCOSUR to demand from the EU to create more added value in the MERCOSUR countries.

Secondly, the energy transition could expand intra-regional trade, especially within South America. One promising example is of Brazil's state-oil company Petrobras which

has recently signalled interest in Bolivia's lithium resources to help Brazil to migrate toward electric vehicles and the production of batteries. As the demand for cross-border trade increases, the pressure to reduce the high costs of that trade and other non-tariff barriers also increases.

Limited prospects in the absence of significant domestic development

While the energy transition and near- and friendshoring offer opportunities for Latin America and the Caribbean, they are both gradual processes that do not offer any quick fix for lifting productivity and potential economic growth. Mexico, the most promising destination for nearshoring, is a case-in-point (see box 2 on Mexico and nearshoring). International trade and investment need to be supplemented by measures to create a business environment that is more conducive to domestic investments.

Prioritising the deepening of new and existing trade agreements, boosting intra-regional trade and the reducing high trade costs are key to integrating LAC in global value chains and lifting productivity and economic growth. Infrastructure, regulatory and administrative bottlenecks need to be removed for this to happen, but they are not a substitute for domestic reforms aimed at lowering transaction costs, increasing market contestability, and boosting public sector efficiency.

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