Chapter 5
Conclusions

Terms such as global value chains, globalization of production, and slicing the value added chain have emerged in recent years to describe the co-participation of countries in the design, production, and distribution of a good or service. Some may argue that beyond the semantics and the sometimes catchy terminology, there is not much LAC can learn about policy issues on this topic; after all, the region has been providing raw inputs and natural resource intensive goods to other countries for decades.

LAC is not new to supply chains, but the region has largely missed the recent surge in the international fragmentation of production. While LAC has indeed been a long-time participant in some forms of international production networks, mainly as a supplier of raw materials and basic inputs, the region has not been able to capitalize on the recent surge of production fragmentation in which goods previously produced in one country are sliced up and co-produced in many parts of the world. Experiments with global sourcing started in the 1970s and 1980s by a few firms in the electronics and car industries, as well as by a handful of retailers. Today, fragmentation of production is employed by many companies around the world and by many industries. This new economic reality could create new opportunities for LAC to diversify its presently limited export base.

Global value chains raise the stakes of addressing long-standing policy challenges, such as those related to transportation and logistics. Taking advantage of the new trends in the international organization of production means addressing new challenges and raising the profile of some of the old ones. Take the issue of transport and logistics infrastructure. After the long period of trade liberalization that started in the late 1980s, most LAC countries understand that future gains from trade are likely to be found in non-tariff-related areas, particularly in improving transport infrastructure. The main argument for making progress on the transportation agenda has been the region's high dependence on exports based on natural resources, which tend to have very high weight-to-value ratios. As freight costs are directly proportional to weight-to-value ratios, exporters of natural resource-intensive goods pay relatively more to transport their goods than exporters of lighter-

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weight goods. As such, the former are also relatively more affected by inadequate transport infrastructure that can easily wipe out the rents that countries can extract from their natural resources. This reasoning has underscored the urgency of addressing shortcomings in the region's transport infrastructure. The importance of this argument has certainly not changed; LAC will remain tied to the exploitation of natural resources for many years to come. But participation in GVCs raises the importance of the transport and logistics infrastructure agenda to a new level. For example, firms fragmenting production internationally must reduce the risks associated with the uncertainty and delays in the arrival of any single component to avoid the risk of disrupting the production of the final goods. Accordingly, these firms seek to work with suppliers in locations with adequate transport and logistics infrastructure. Similarly, modern supply chain practices, such as just-in-time delivery services or postponement (the practice of delaying the final customization of a semi-finished good) increasingly require that suppliers commit to swift deliveries with minimum disruptions, which is akin to having good transportation and logistics systems. The importance of an adequate logistics infrastructure is higher for distant countries than for nearby countries as a means of offsetting the impact of distance. This lesson is particularly important for countries in LAC as they seek to join supply chains in Asia or Europe, or develop supply chains within their own region, where distances may exceed those in Asia or Europe. As a result, the importance of addressing limitations in the transport and logistics industries, while already high on the "to-do lists" of many policy makers of the region, has only increased its priority status with the emergence of international supply chains.

Maintaining low levels of protection and furthering integration in the region has become even more important, with the international fragmentation of production. The relevance of low levels of trade protection has also increased with the advent of GVCs. For instance, gains from tariff reductions are magnified when goods cross borders many times, as is often the case in international production networks. Also, as research in this report indicates, to successfully target GVCs—particularly in developed countries—many potential suppliers in LAC will need to import high-quality inputs from other countries to complement their own production. In this way, high levels of protection at home will damage their ability to complement their own skills with the skills and capacities of suppliers in other countries.

A more integrated economic space for the Americas—a long-time aspiration—also becomes more relevant in an era of production networks. Take, for instance, the myriad of trade agreements in LAC, most of which use different rules of origin. When an exporter produces only one good, and most intermediate inputs are sourced domestically, the costs of complying with multiple rules of origin virtually do not exist. But as firms seek to fragment their production among different countries in different trade agreements, the costs of dealing with multiple origins can be prohibitive. Deepening integration in LAC will allow firms to take advantage of the differences in factor prices across countries, enabling them to freely choose the location for each bundle of production according to each nation's comparative advantage.

True, the region might not embark on a deep integration agreement of a continental size in the foreseeable future, but it can still move towards deeper integration—for example, by fostering the convergence of many of the trade agreements currently in place.

A more integrated region does not have to be viewed solely as an instrument to develop supply chains originating in Latin America. Deeper integration in LAC does not exclusively favor the development of supply chains among Latin American countries. A deeply integrated region could also serve as a platform to enhance trade and investment ties with third countries. For instance, exploiting production complementarities within the bloc will help LAC countries reach other markets with more competitive goods. Likewise, a more integrated economic space will encourage the attraction of investment and production blocks from outside LAC, which will subsequently be sliced and shared among the countries of the region.

Tariff escalation is still common in many parts of the world, **which limits LAC countries' access to higher value-added segments of supply chains**. In the area of trade policy, gaining access to supply chains in other regions will require addressing the still widespread practice of countries imposing low duties on raw inputs and materials and higher duties on higher value-added segments of the supply chain—the so-called tariff escalation problem. The existing scheme, which is still common in many developed countries, clearly generates disincentives for countries in LAC to move beyond the supply of raw materials and join supply chains in developed countries, particularly with higher value-added content.

Contracting institutions can be a source of comparative advantage, **particularly for countries seeking to join international supply chains**. The emergence of global value chains has brought to the forefront issues that policy makers had often overlooked previously. One of them is the notion that the quality of contracting institutions can shape the geographical location of fragmented production and thus the capacity of the country to join international production networks. Ambiguous practices and uncertainty in contract enforcement can generate distrust between parties of different countries, limiting their willingness to engage in cross-border transactions. While contractual frictions can certainly undermine any international transaction, including the exports of final goods, they can be particularly harmful for transactions in global supply chains, where suppliers must often customize their production to the specifications of particular buyers, and where the parameters governing such specifications are typically set up in contractual agreements. Research in this report shows that global firms can be reluctant to form partnerships with local suppliers located in countries where there is uncertainty and ambiguity in contracting practices.

One could argue that the lack of contract enforcement is not necessarily a relevant issue because many global firms open their own affiliates in the host country where they operate, rather than rely on dubious contracts with local suppliers. This is not true. For one thing, evidence shows that in some industries, offshoring takes place almost exclusively through independent local suppliers rather than through FDI; local firms in countries with weak contracting institutions will not have opportunities to become suppliers in those industries. For another thing, even if multinationals resolve potential quarrels with their own affiliates internally, they may still need adequate contracting institutions in the host countries where they operate. For instance, the affiliate might need to tap local suppliers to pursue part of its businesses; therefore, a location where local suppliers do not respect contracts, and where local courts do not enforce them, will hardly be an attractive location for doing business. In this report we have presented evidence that LAC has subpar contracting institutions when compared to other regions, making this a clear area for policy action.

Service offshoring also represents an opportunity for export diversification. Global firms co-locate in other countries not only bits of production processes, but also an array of different services that were traditionally performed in-house, such as accounting, auditing, bookkeeping, research and development, and design, among others. Research in this report indicates that even though most of these services can be delivered electronically, proximity continues to be important. This creates an opportunity for LAC vis-à-vis Asia or Europe, particularly for targeting the US market with business functions that tend to require similar time zones or that involve specific customization to the client's needs and for which proximity is an important factor.

Exporting GVC-related services requires not only adequate skills but also a sufficiently large pool of skilled individuals. The export of certain business or knowledge-intensive services might demand specific skills that can change quickly over time. This report presents results that indicate that not only the quality but also the quantity of skilled individuals is important. But sustaining an adequate pool of skills can be challenging. For instance, educational curriculums might not keep up with rapid changes in business practices, thus generating mismatches between demand for specific capabilities and the skills acquired in the educational system. Many countries have successfully addressed this problem by forming alliances between the private sector, academia, and the public sector to ensure that students are taught the skills that employers need. The lack of an adequate pool of skills can also be addressed, at least temporarily, by employing foreign individuals, a policy that requires reducing restrictions on the entry of professionals from other countries.

Access to global supply chains can be seriously hampered by information deficiencies. It is already well established in the literature that international trade transactions can be hampered by information problems. The lack of adequate information is at the root of many failed attempts to export final goods, but it can be particularly problematic for exporting inputs in international production networks. The information flows typically required to match a buyer and a supplier in an international supply chain can be vast: many suppliers need to customize their production to the requirements of particular buyers, while buyers need to convey this information to the suppliers and make sure they are capable of delivering the product with the correct specifications. As a result, lack of information can easily keep potential suppliers on the sidelines, with buyers relying on a few known providers.

Public policy can help reduce information problems and improve visibility and credibility. Policies for addressing information problems in international trade traditionally fall on the shoulders of export promotion organizations (EPOs). As evidence in this report shows, however, EPOs are not always able to understand the complexities of many supply chains. In general, the effectiveness of EPOs' actions in helping firms become part of GVCs is proportional to their success in gathering information regarding the structure of supply chains, their modes of operation, and their specific conditions.

Another policy option to reduce information gaps consists of promoting environments that facilitate exchanges of information between players in the industry or across industries. Programs could consist of some form of coaching, whereby a group of potential exporters meets with firms that have achieved success in the international markets. Alternatively, the government could help organize exchanges where the information gap is filled by current or retired staff from international buyers. Yet another approach is for representatives of the local firms to go abroad to visit the facilities of global firms.

Some information gaps can also be addressed by improving visibility through certifications. It is well known that global firms screen potential suppliers for compliance with relevant standards in their respective supply chains. The public sector could assist in promoting the establishment of local certification agencies. Local certifications, however, could have minor or no effects if the global buyers do not know about them or are skeptical of their value; therefore, establishing links with standards and certification institutions in developed countries might also be required.

Firms in LAC that cannot join global supply chains on their own would benefit from policies that promote collaboration or consolidation among themselves. Evidence from this report indicates that firms seldom join international production networks on their own. Instead, these firms often leverage resources with other firms to achieve certain capabilities, address common barriers, or pay for the fixed costs of activities, such as attending an international trade fair. One area for potential public action, then, is to help create mechanisms whereby firms can cooperate, such as business associations. Since some existing business associations are weak or are designed for rent seeking, governments could support sectors that want to improve their organization or help create new associations when common interests may extend beyond sectors.

Governments can also support the consolidation of interested firms. Evidence presented in this report, for example, indicates that government-designed programs for mergers and acquisitions have been helpful in encouraging companies to grow their businesses and shorten the time to acquire capabilities.

In some situations, purely inter-firm collaboration will not be enough. Cooperation between the public and private sectors might be required, particularly when a specific public good or the resolution of some coordination problem facilitates access to a GVC.

Some local firms, **particularly many SMEs**, **will not be able to join GVCs by exporting directly. But they can still access GVCs by serving global firms located in their own countries**. Instead of dealing with the hassles of exporting on their own, firms—and particularly SMEs—could join global supply chains and take advantage of the increasing fragmentation of production by becoming upstream suppliers of international companies located in their home countries, which themselves are inserted in GVCs. Countries in various parts of the world have been pursuing programs to foster such linkages between global firms located in their territories and their local suppliers. A review of some of these experiences suggests the following general lessons: (i) programs based exclusively on matchmaking services seem to have more limited effects than programs that also provide complementary support to the suppliers, such as training; (ii) most successful linkage programs are founded on merit-based selection criteria; (iii) any assistance to the supplier should be based on transparent diagnosis and auditing processes; and (iv) a pilot program may be the best way to start, followed by periodical reviews to fine tune objectives, strategies, targets, and action plans.

Exploit synergies through a coordinated approach. As shown in many parts of this report and also in this summary chapter, accession to international production networks might be hampered by multiple shortcomings and market failures. In this respect, it is important to note that suboptimal outcomes might arise when market failures in different areas are not addressed in a structured and consistent way. This requires that interventions be coordinated as much as possible so as to take advantage of potential complementarities. As multiple government agencies with different mandates, strategic views, and agendas might be responsible for the different policies, some form of coordination among these agencies would be desirable. One option is to create a body within the government, charged with coordinating the efforts of various agencies. In some countries these bodies have arisen to foster competitiveness. The design and architecture of such a body could remain flexible, incorporating relevant agencies as needed; it would be unreasonable to expect governments to be able to identify all possible market failures affecting GVC insertion in all the sectors of the economy. A more realistic approach would be to forge a clear channel of communication with the private sector for airing concerns and presenting proposals to agencies operating within such a government body.