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From a short-term economic slowdown to reforms in the long run?

The economic slowdown that began in Latin America in 2010 is continuing.

The region will continue to grow, casting aside fears of a crisis that arose in the second half of 2013 and early 2014. The pace of growth, however, will be the slowest in the past five years (Figure 1). According to forecasts, the region’s economy will grow by 1-1.5% in 2014 (compared with 2.5% in 2013 and 2.9% in 2012), less than the OECD average for the first time in ten years. In 2015, growth is expected to pick up slightly, reaching 2-2.5%. These developments will be driven by the less favourable international climate of the past five years, due to lower commodity prices (especially for metals and minerals), and the economic slowdown in the People’s Republic of China (hereafter “China”). Also of note is the rising cost of external financing and more restrained capital inflow prospects due to the tightening of US monetary policy.

Figure 1. GDP growth in Latin America and the Caribbean and the OECD (annual %)

![GDP growth chart]


StatLink: [http://dx.doi.org/10.1787/888933174156](http://dx.doi.org/10.1787/888933174156)

The differences in economic growth among countries in the region could increase due to the uneven impact of the external context as well as domestic factors. In 2014, the fastest growing economies in Latin America are expected to be the Plurinational State of Bolivia, Colombia, Costa Rica, Ecuador, Panama, Peru and the Dominican Republic, which will grow by between 4% and 7% according to projections. Much slower growth is projected for the region’s two biggest economies: Mexican growth will rebound to around 2.5% (similar to the figure for Chile) and Brazilian growth
will be less than 1%. Finally, Argentina and the Bolivarian Republic of Venezuela are projected to record negative growth. These differences in growth rates among the region’s countries are explained by both the varying impact of the international climate (especially the different changes in commodity prices) and internal factors such as those related to economic management.

Economic growth in Latin America could be lower if the Chinese slowdown worsens and, to a lesser extent, if financial conditions tighten more rapidly in the United States.

In the baseline scenario, the Chinese economy is slowing, but will continue to grow in the coming years. However, although the measures available to China (credit and investment projects) seem to be sufficient to maintain the country’s economic dynamism, they would reverse the rebalancing of growth towards higher consumption, thus increasing the medium-term risks to global demand. Recent monetary-stimulus policies adopted in Europe seem to have reduced the impact of international financial conditions. In the United States, this process is probably the result of a more dynamic economic recovery, which will drive up external demand for Latin America. The situations in Eastern Europe and the Middle East have generated an additional geopolitical risk that could affect international trade and, in the longer term, the energy supply.

The frequent short-term commodity and capital booms have made economic activity in Latin America more volatile without increasing trend growth.

Almost all Latin American and Caribbean countries have experienced periods with large inflows of foreign currency in the form of exports of natural resources (food, minerals and fuels), remittances, short-term capital flows or foreign direct investment (FDI). Referred to hereafter as “commodity booms” when the inflows are significantly higher than the historical average for at least three years, these periods have been particularly frequent in South America. Since the mid-1960s there have been 3.3 booms per country in South America, 1.5 per country in high-income countries and 1.4 per country in Central America and the Caribbean. Each boom contributed 6 percentage points to GDP over the course of nearly three years.

Over the past five decades, the output gap increased during the booms and turned negative afterwards, thus increasing the volatility of economic growth. This was particularly true of booms in short-term capital flows, food and minerals, which have shaped the external environments during the past decade. Moreover, in the countries that experienced the booms, no positive impact on the growth trend was observed either during or after them.
The main concern is that the low growth rates of around 3% for Latin America over the next few years are not indicative of a temporary slowdown but rather of lower potential growth.

Potential growth in Latin America has been estimated at between 3% and 4% a year over the past ten years, which is slightly below the growth recorded during the most recent period of expansion, from 2004 to 2008. However, the slowdown has continued since 2010 as the international situation, which undoubtedly boosted economic activity in the past, has worsened, so the “new normal” for the region may well be lower than previously expected.

In the short run, all Latin American countries should rebuild their monetary and fiscal response capacities to counter the more adverse economic scenario.

The countries in the region need to strengthen their financial and fiscal framework – some more than others – by expanding their fiscal space. They also need to maintain the credibility of their central banks in running a countercyclical monetary policy, which has tended to be accommodative in the face of weak growth. The measures required to expand their fiscal space will vary from country to country. Some, such as the Central American, Andean countries and Mexico, will need to expand their tax bases, while others, especially in South America, will need to change the composition of their public spending. In the Caribbean, meanwhile, governments need to continue their efforts to ensure that fiscal policy remains sustainable, especially government debt. It is important that all countries set up automatic stabilisers (especially for their expenditure, but also for their revenues) and have access to macroprudential frameworks and stabilising tools, with the conditions for their use clearly defined.

In the long term, this modest outlook is a reminder of the need to move forward in implementing structural reforms to boost potential growth and equality. Key reforms include strengthening education, skills and innovation.

Latin America's productivity in recent years has been disappointing compared with that of both OECD countries and emerging economies. Stronger productivity would lead to more inclusive growth and would reduce the already high inequality and poverty rates. Education and innovation reforms must ensure equal opportunities for access to a complete, high-quality cycle of education and a workforce with better skills thanks to better matches with the labour market. There must also be measures to promote formal employment. The current political context presents an excellent window of opportunity, with 14 presidential elections having been held in Latin America in the three years from 2012 to 2014. The region's well-being, especially in the long run, will depend on whether governments make the most of this opportunity.
**Education, skills and innovation are key factors in achieving more dynamic and inclusive growth**

The *middle-income trap*, whereby GDP growth slows down once an intermediate level of development has been reached, is particularly persistent in Latin America.

Although income in the region was relatively high in the mid-20th century, the countries have made no considerable progress in closing the income gap with advanced economies, unlike certain European and Asian countries that have achieved high-income country status (Figure 2). In Latin America and the Caribbean, only Chile, Uruguay and a few Caribbean countries are high-income countries.

**Figure 2. The middle-income trap in Latin America and the Caribbean**

(GDP per capita, USD PPP 1990)

Note: GDP per capita at PPP in USD at constant 1990 prices. LI refers to low income, LMI to lower-middle income, UMI to upper-middle income and HI to high income.


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Education, skills and innovation are key areas to enable more Latin American countries to escape the middle-income trap and strengthen the region’s *emerging middle class*.

Improvements to the stock and quality of education and skills, together with a stable macroeconomic context and an innovation-friendly environment, determine countries’ capacity to direct their growth models towards higher value-added activities. Investment in human capital drives long-term economic growth and is an essential part of any inclusive-growth strategy. It is therefore necessary to improve equality of opportunity and social mobility by limiting the effect of people’s socio-economic background and informal employment on their access to high-quality education at all levels.
Improving labour skills to adapt to and benefit from shifting wealth

Shifting wealth towards emerging countries has a strong impact on the supply and demand of labour skills.

The integration of China and India alone into the global economy provided 1.2 billion new workers. Initially they had only basic skills, but both countries have vastly increased the percentage of the population with secondary or tertiary education. Thus the percentage of working-age people with secondary or tertiary education in emerging countries rose from 36% in 1980 to 56% in 2010. Meanwhile, this larger stock of skills is allowing some emerging countries to rapidly accumulate technology. This situation makes it more difficult for countries that are competitors and trading partners to define their skills-training strategies, especially in Latin America. On the one hand, demand for commodities discourages the development of knowledge-intensive activities, while on the other, China is competing as the “global factory” (a label that refers to the country’s capacity to develop comparable advantages among a range of manufacturing industries). Moreover, the shifting wealth process has increased demand not only for better skills but also for soft skills, which allow greater adaptability and a more efficient search for competitive niches in a changing environment.

Latin America is the region with the widest gap between skills supply and demand, which adds to a high labour informality.

In Latin America and the Caribbean, 36% of companies operating in the formal economy struggle to find a properly trained workforce, compared to a global average of 21% per country and an OECD average of 15% (Figure 3). The analysis in this publication shows that Latin American firms are 3 times more likely than South Asian firms and 13 times more likely than Pacific-Asian firms to face serious operational problems due to a shortage of human capital.

The automotive and machinery sectors struggle the most to find the skills they need in Latin America. The challenge for those sectors is particularly steep, because they tend to be more sophisticated sectors, with greater connectivity and complexity. They could therefore support the region’s structural change and transformation towards a knowledge-intensive and technology-intensive development model.

In addition to the high proportion of low-skilled workers in jobs requiring basic skills, returns to education have been declining. In Latin America, the skills of workers by level of education (primary vs. secondary vs. tertiary) and by job position based on the tasks required (from machine operations to executive roles in companies) are both far lower than in the OECD countries. Furthermore, since 2000 there has been a fall in the returns on education in the region, as measured by the salary premium paid to a worker with a certain level of education compared with a worker with no
education (especially the returns to tertiary over secondary, and to secondary over primary education). These returns are being driven down mainly by temporary factors such as the recent expansion of tertiary education. More permanent factors may also be at work, however, such as the mismatch between the skills offered by the education system and those in demand in the labour markets.

Figure 3. Share of firms identifying an inadequately educated workforce as a major constraint to their operations (% of formal companies, circa 2010)

![Chart showing share of firms identifying an inadequately educated workforce as a major constraint to their operations.](chart.png)

Source: World Bank, Enterprise Surveys, Washington, DC, data extracted in August 2014. [StatLink](http://dx.doi.org/10.1787/888933174171)

High labour informality affecting workers and the business community, is another factor. More than half the Latin American workforce, including middle-income workers (the “emerging middle class” or “middle sectors”) work in the informal sector, making them vulnerable to drops in income, unemployment caused by lower economic growth, and the risks posed by illness and old age. Indeed, there is some evidence that workers in the informal economy are paid less than workers in the formal economy with comparable jobs and the same level of education.

Various courses of action are needed in the education system and in technical training programmes to improve job skills. Public–private sector co-operation is essential.

In the short term, investment must be made to improve education programmes and vocational education and training. General or soft skills are particularly important, since they provide labour market access at the end of the training period and allow current workers to adapt to a changing labour market by updating their skills and favouring their mobility. Participation and co-ordination with the private sector is very important, since it can offer guidance on current and future business demands and provide training directly in the workplace. Finally, it is important to establish national and regional qualifications frameworks for the recognition and transferability of skills acquired in formal and informal settings.
Educating citizens for inclusive growth

Education leads to economic growth, social inclusion and greater equality.

A good education and training system can develop the population’s skills and create greater equality of opportunity. Latin America needs to understand education as a vector for greater social cohesion and more inclusive growth, since the region’s development will be shaped largely by the policies it adopts in this area.

Latin America has taken great strides in education investment and coverage, but challenges remain, especially in increasing pre-primary education coverage and reducing the drop-out and repetition rates.

Total public investment in education has risen considerably in recent years and now accounts for more than 5% of GDP (vs. 5.6% average for OECD countries in 2012). As a result, there is now almost universal access to primary education (91% of the region’s potential population, compared with 97% in the OECD countries). There has been a marked increase in school life expectancy, from 8 years in 1971 to 13 years in 2012 (in the OECD it increased from 11 to 17 years during the same period). However, coverage remains low in pre-primary education (66% of the pre-primary aged population in Latin America in 2012, compared with 83% in the OECD). This figure is particularly important, because pre-primary education is beneficial for the rest of one’s education cycle: secondary-school performance improves by the equivalent of almost a full school year among those who attended pre-primary education. Similarly, enrolment remains low at higher levels of education: 74% in secondary education (vs. 91% in the OECD countries) and 42% in tertiary education (vs. 71% in the OECD countries). Progress in increasing enrolment in the region has been slow compared with that of some Asian countries. China, for instance, had slightly higher secondary-education enrolment rates than Latin America in 2012 thanks to a 140% increase since 1990, compared with a 50% increase in Latin America over the same period.

Furthermore, government expenditure per student in Latin America remains below the average for the OECD countries. Expenditure on secondary education, for instance, represents 18% of GDP per capita in Latin American countries, compared with 26% in the OECD countries. However, a substantial proportion of financing for education in the region is private (40% in Chile and 35% in Colombia, vs. 16% in OECD countries). Policies to reduce the drop-out and repetition rates in secondary and tertiary education are a priority for a region where a fifth of students do not continue past primary school, compared with only a tenth of students in other emerging regions.
One of the major unresolved problems is the need to increase the impact of education investment on quality and performance.

Brazil and Mexico sit alongside Tunisia and Turkey as the countries that have made the most progress in secondary-education performance (15-16 year-olds), increasing their scores in the OECD’s PISA tests (Programme for International Student Assessment) by between three and four points a year since 2003. Nevertheless, there is still a huge gulf between the performances of Latin American students and those in OECD countries, amounting to almost two years of schooling according to the 2012 PISA tests. The region’s modest results are caused not only by the students’ socio-economic background, but also by factors related to school activities, such as classroom hours and teachers’ expectations of students’ performance. These factors are less relevant in OECD countries, where the quality of teachers has a greater impact on results.

A second major challenge is the need to reduce socio-economic, gender and urban/rural inequalities in the provision of and access to education.

In Latin America, the socio-economic background of students and of the school have a marked influence on access to education, performance and completion. Only 56% of those in the lowest income quintile attend secondary school and only 9% continue into tertiary education, compared with 87% and 46%, respectively, for those in the highest income quintile. In the PISA 2012 tests, in Latin America almost 30% of the variation in students’ results in secondary education was associated with socio-economic factors, compared with an average of 26% in OECD countries (Figure 4). As a result of these performance differences associated with socio-economic and cultural factors, students in the lowest income quartile fall two years behind those in the highest income quartile.

The performance differences between public and private education are another reason why the objective of equity should be at the heart of countries’ agendas. The experience of the OECD countries shows that providing equity is perfectly compatible with improving performance. Education policy makers should also address inequalities between rural and urban students. The consequences of those inequalities often extend beyond school performance and gender inequalities: drop-out rates are high among boys, while girls are less motivated and less confident in mathematics. According to the PISA 2012 results, the poorer performance by girls in mathematics is equal to half a year of schooling.
Figure 4. Student performance and equity in secondary school
(PISA 2012)

Note: Latin America (“LA”) comprises Argentina, Brazil, Chile, Colombia, Costa Rica, Mexico, Peru and Uruguay. “Others” comprises Albania, Bulgaria, Croatia, Dubai, Hong Kong (China), Indonesia, Jordan, Kazakhstan, Latvia, Liechtenstein, Lithuania, Macao (China), Malaysia, Montenegro, Qatar, Romania, Russia, Serbia, Shanghai (China), Singapore, Chinese Taipei, Thailand, Tunisia and United Arab Emirates. The percentage change in mathematics performance explained by the economic, social and cultural status of students and schools is obtained from a student-level regression where the explanatory variables are the economic, social and cultural status of the student and that of the school.

Source: Authors’ calculations based on data from OECD/PISA 2012. [StatLink](http://dx.doi.org/10.1787/888933174184)

Education policies must continue to address the challenges of quality and equity at all stages of the education cycle, both in terms of coverage, and especially performance.

Governments should allocate more resources to early education to further broaden its coverage. They should also press on with reforming early childhood care systems, improving childcare services and training for childcare professionals. In these areas, developing soft skills such as interpersonal skills and perseverance from an early age is essential for integration into the labour market and society in general. In primary and secondary education, governments should bolster policies that provide incentives to retain and motivate high-quality teachers by introducing stringent new recruitment procedures, bringing continuity to teacher training and ensuring that remuneration matches teachers’ training and experience. The experiences of OECD countries such as Korea and Japan show that policies focused on the quality of teachers have a greater impact than those focused on reducing class sizes. School policies that do not necessarily require large-scale resources, such as promoting a learner-friendly disciplinary environment and providing opportunities for all students, have proved to be effective. Among these policies, better mechanisms to identify struggling students who are more likely to drop out are vital.
Generally, educational resources need to be allocated for the purpose of reducing inequalities by targeting students from poorer socio-economic backgrounds. Latin American countries currently have better educational resources (books, instructional material and laboratories) in schools with students from wealthier socio-economic settings (Figure 5). Some of the best-performing OECD countries in the PISA tests, such as Estonia, Finland, Germany, Korea and Slovenia, tend to distribute educational resources more equitably. Successful school systems in the OECD have sought to balance the distribution of staff, ensuring that struggling schools have a sufficient number of highly qualified teachers.

Figure 5. Correlation between the quality of schools’ educational resources and students’ socio-economic status in selected Latin American and OECD countries (values between 0 and 1 for 2012, where 0 = no impact and 1 = total impact)

Note: Latin America (“LA”) comprises Argentina, Brazil, Chile, Colombia, Costa Rica, Mexico, Peru and Uruguay. “Schools’ educational resources” refers to aspects such as scientific laboratory equipment, instructional material, computers, software, Internet connections and library material.

Source: Authors’ work based on data from OECD/PISA 2012. http://dx.doi.org/10.1787/888933174195

OECD countries such as Norway and Portugal and also some from Latin America such as Chile and Uruguay have greatly improved their policies on internal and external school evaluation. These evaluations must involve both students and teachers and be used for training purposes. These measures also need to be extended beyond the confines of the classrooms and systems need to be developed to measure skills of adults. Finally, in tertiary education it is crucial to improve assessment and accreditation systems to prevent fragmentation between universities in order to raise quality.

These changes will only be successful if they take into account the institutional structure and the stakeholders involved and provide a medium- and long-term scheme to measure their impact. Building leadership in schools around the head teacher or a critical mass of teachers is essential for successful implementation.
Innovation as an input of productive-development policies

Efforts to improve education and skills will only raise labour productivity, create high-quality jobs and reduce the size of the informal economy if they are supported by greater innovation.

Development depends on each country’s capacity to build the right skills to innovate and inject innovation into the productive system. This dependence is augmented by the fragmentation of production and the development of global value chains, making innovation a central factor in the development of competitiveness. Given the complementarity between innovation on the one hand and education and skills on the other, Latin American countries should update their policy agendas on science, technology and innovation, fostering regional co-operation to underpin national efforts.

Although investment in research and development (R&D) has increased, the stock of knowledge-based capital – an additional measure of skills – is significantly lower in Latin America than in the OECD economies.

Inclusive growth requires more and better innovation. “Knowledge-based capital” is an additional indicator of skills, measuring the capacity to innovate and disseminate innovation. The stock of knowledge-based capital is far lower in Latin America (13 % of GDP) than in OECD countries (30% of GDP). Furthermore, in Latin America it consists mainly of the stock of tertiary education, whereas in the OECD countries it consists mainly of R&D expenditure (Figure 6). These situations illustrate why it is important to strengthen ties between higher education institutions and the private sector in the field of science and technology to better steer and promote R&D activities. It is of paramount importance to strengthen developments in governance for science and technology institutions so that an efficient, comprehensive institutional framework can be developed to disseminate technology and innovation. More attention needs to be devoted to the complementarity between Latin America’s education system and innovation capacity.

R&D investment in Latin America remains significantly lower than in the OECD economies, and a large share of the investment is by the state, as shown by the OECD studies on innovation policies in Latin America (Colombia, 2014; Peru, 2011; Mexico, 2009; and Chile, 2007). Businesses in the region spend little on R&D, mainly because of conditions that limit the profitability of such investment. In particular, total R&D expenditure in Latin America stood at around 0.4% of GDP in 2010, with private R&D representing around a quarter of the total. Attracting FDI provides an opportunity to develop skills and innovation in Latin America, but only if the investment flows are more closely tied to policies on innovation and structural change. FDI can be understood as a vehicle for innovation, since it enables the introduction of new technologies and potential technology spillovers. Moreover, FDI creates ties with
external markets that can promote the adoption of technology, since those markets have more stringent competitiveness requirements in terms of price and quality. However, for these positive effects to become a reality, investment needs to be channelled towards the most technology-intensive sectors, and beneficiary countries need an environment that is conducive to positive externalities. Greater efforts must therefore be invested in designing strategies to attract more R&D-intensive FDI and build upon some of the recent positive trends. Currently, R&D projects receive only 2% of investment in new facilities (greenfield investment) in the region, compared with an average of 4% in OECD countries. Furthermore, the institutional environment and policies must prevent new technologies from becoming an enclave with scant linkages to the rest of the production system.

Figure 6. Level and composition of knowledge-based capital, Latin America vs. OECD countries (% GDP)

Source: Authors’ work based on De Groot (forthcoming), “Innovation capital in Latin America: A first attempt at analyzing the region’s competitive strengths in innovative capacity”, Working Paper, ECLAC Division on Production, Productivity and Management.

Industrial and production development policies should focus on the acquisition of skills in new technologies and on innovation in order to achieve economic, social and environmental sustainability.

Case studies in Argentina and Brazil show the need to develop policies that allow greater co-operative efforts between small and medium-sized enterprises (SMEs) and larger firms, fostering greater access to technology and major markets. Sustainability-related innovations are desirable because of their positive externalities on the environment and because they offer competitive advantages for international integration.
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ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT (OECD)

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

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

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

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

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Latin American Economic Outlook 2015

EDUCATION, SKILLS AND INNOVATION FOR DEVELOPMENT

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

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