ECONOMIC GROWTH CENTER

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Center Discussion Paper No. 85

The Andean Common Market: Gestation and Outlook

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May, 1970

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The Andean Common Market: Gestation and Outlook

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By the mid-1960's the dissatisfaction of several middle-sized Latin American countries with the Latin American Free Trade Association (LAFTA) became acute. Some complained that the three Latin American giants (Argentina, Brazil and Mexico) were reaping most of the advantages of the group. That argument centered on trade balances within the association. Others, eager for a faster integration pace, saw in a sub-regional approach, bringing together countries of roughly equal economic dimension, a useful complement (and goal) to LAFTA and a necessary steppingstone in the construction of a Latin American Common Market.[1]

The formal birth of the Andean group as a sub-region of LAFTA may be dated with the Declaration of Bogotá of August 1966, signed by Chile, Colombia, Ecuador, Perú and Venezuela. The treaty creating the Andean Common Market was only signed nearly three years later, on May 1969. Laborious negotiations have failed to persuade Venezuela to accept the final treaty; Bolivia, which had joined the Andean group during 1967, joined the other four countries in this "Treaty of Cartagena".

This paper will examine the gestation of the Andean Common Market during 1966 through 1969, paying particular attention to issues generally relevant to the formation of customs unions among developing countries. The outlook for the economic impact of Andean integration, as it appears during the first semester of 1970, will be discussed. Most of the arguments which will be developed would apply, a fortiori, to the analysis of the economic effects of a hypothetical Latin American Common Market. This is particularly true for the central thesis of this paper, which argues that the possible trade-creating effects of Latin American integration are substantial, and much larger than commonly assumed in the literature on customs unions among developing countries.[2]

Before turning to these matters, it will be useful to outline the major characteristics of the five Andean countries (Bolivia, Chile, Colombia, Ecuador and Perú) and contrast them with the rest of Latin America.

Some Characteristics of the Andean Five

The Andean Five in 1966 had a population of 49 million, representing twenty per cent of the population of the twenty Latin American republics, and exceeding that of Mexico, and by far those of Argentina and the Central American Common Market.[3]

As shown in Table 1, the Andean population extends over an area covering 23 per cent of the Latin American domain. Total Andean Gross Domestic Product is similar to that of Argentina; had Venezuela stayed in the group the combined GDP would have been roughly comparable to those of Brazil and Mexico.

Latin American mineral production is dominated by Andean countries, even without Venezuela. Of total regional output, for example, they account for 90 per cent of tin, 89 per cent of copper, 52 per cent of zinc, 45 per cent of coal, 41 per cent of lead, 22 per cent of iron (53 per cent including Venezuela), and 7 per cent of oil (83 per cent including Venezuela).

Table 1

Basic Data on the Andean Countries and other Latin American Republics, 1966

	Five Andean Countries	Venezuela	Argentina	Brazil	Mexico	Central American Common Market	Other Republics
Pop. (Million)	48.5	9.4	22.7	83.2	44.1	13.2	22.2
Area (Million)	4.6	0.9	2.8	8.5	2.0	0.4	0.9
GDP (Billion$)	23.0	8.8	22.5	34.4	33.1	5.3	9.1
GDP per capita$	403	878	950	379	677	374	423
Merchandise Exports (Bill$)	2.5	2.4	1.6	1.7	1.2	0.8	1.2
Merchandise Imports (Bill$)	2.6	1.3	1.1	1.5	1.6	0.9	1.6
Mining Output							
Coal (Mill. Tons)	4.0	0.03	0.4	2.4	2.1	nil	nil
Iron (Mill. Tons)	8.1	11.4	0.1	15.8	1.5	nil	nil
Copper (000Tons)	837.7	nil	nil	3.0	74.4	9.9	12.0
Lead (000Tons)	167.9	nil	30.0	20.0	182.1	10.0	nil
Zinc (000Tons)	276.2	nil	26.6	nil	219.2	9.0	nil
Tin (000Tons)	25.6	nil	1.0	1.2	0.8	nil	nil
Crude Oil (Mill M^3)	18.0	195.8	16.7	6.4	20.5	nil	nil
Agricultural Output							
Rice (Mill.Tons)	1.4	0.2	0.2	5.8	0.4	0.2	0.7
Maize (Mill. Tons)	2.6	0.6	7.0	11.4	9.1	1.7	1.0

Table 1 (Continued)

	Five Andean Countries	Venezuela	Argentina	Brazil	Mexico	Central American Common Market	Other Republics
Agricultural Output (cont.)							
Wheat (Mill.Tons)	1.6	nil	6.4	0.6	1.6	nil	0.4
Sugar (Mill.Tons)	1.7	0.4	1.0	4.4	2.[illegible]	0.5	5.4
Cocoa (000Tons)	72.0	22.0	nil	173.3	23.8	9.1	32.1
Coffee (000Tons)	583.7	61.0	nil	1365.6	185.8	335.1	99.4
Cotton L (000Tons)	225	16	114	622	619	230	33
Wool (000Tons)	43.4	nil	200.0	29.0	8.0	nil	86.2
Tobacco (000Tons)	78.3	9.8	42.3	228.3	68.9	11.0	84.6
Beef & Veal (000Tons)	713	165	2653	1460	385	151	615
Pork (000Tons)	182	31	252	590	147	33	110
Milk (Mill.Tons)	3.8	0.6	4.7	6.5	2.6	0.8	2.5
Hen Eggs (000Tons)	124	30	175	510	201	31	62
Industrial Output							
Electricity (000GWH)	20.0	8.9	16.5	35.3	20.9	2.4	7.9
Finished Steel (Mill.Tons)	0.8	0.3	1.3	2.6	2.2	nil	nil
Steel Ingots (Mill.Tons)	1.0	0.7	1.3	3.7	3.0	nil	nil
Pig Iron (Mill.Tons)	0.61	0.35	0.52	2.89	1.40	nil	nil
Cement (MillTons)	5.0	2.1	3.5	5.5	4.9	0.5	1.8
Sheet Glass (Mill.M²)	5.6	nil	7.0*	6.2	12.5	nil	1.9
Caustic Soda (000Tons)	42	10	83	76(1)	110	nil	1.6(1)

Table 1 (continued)

	Five Andean Countries	Venezuela	Argentina	Brazil	Mexico	Central American Common Market	Other Republics
Industrial OUtput (Continued)							
Soda Ash (000Tons)	46	nil	nil	85	140	nil	nil
Sulphuric Acid (000Tons)	270	52	168 (1)	301 (1)	579	nil	150*
Tubes (Mill. Units)	1.1	0.8	2.7	3.7	1.3	nil	0.1
Tires (Mill. Units)	1.7	1.3	2.9	5.2	2.3	nil	0.3
Paper & Board (000Tons)	329	155	479	595	610	11	148
Pulp (000Tons)	422	20	135	619 (1)	353	nil	38
Synthetic Fibers (000Tons)	7.9	5.5	14.8	15.4	11.9	nil	0.9
Beer (Mill.liters)	1144	297	226	766	1166	63	221
Gasoline ($Mill^3$)	5.2	8.5	4.6	6.6	5.6	nil	1.2

Sources: GDP determined by ECLA, Estudio Economico de la America Latina, 1968. (Mimeographed)

All other statistics from Statistical Bulletin for Latin American Vol. V, No. 1.

* Refers to 1963.

(1) Refers to 1965.

Andean output of tungsten, molybdenum, antimony, nitrate and bismuth also dominate Latin American production of those products. Joint policies could give these countries substantial bargaining power and control over the exploitation and marketing of their natural resources, as for several mining products they represent important shares of world trade. Even where those shares are small, a minimum of solidarity can expand the options open to individual countries when dealing with non-Andean firms, as illustrated in the recent dispute between Bolivia and Gulf Oil Company. But more on this below.

Per capita Andean food and fiber production, on the other hand, is below that of the rest of Latin America taken as a whole, as suggested in Table 1. Andean output of rice and wheat accounts for about 15 per cent of the Latin American total, and the proportion is even less for maize, sugar and beef and veal. Although the subregion has been a net exporter of coffee, fruits and fish, it is a net importer of meat, cereals (especially wheat) and dairy products. The help which Andean countries will be able to give each other in making their food and fiber supply more flexible will be limited, although not zero. For example, Perú is an efficient producer and exporter of sugar, while Chile is an inefficient producer and importer of that good. Rich fishing along the Pacific coast, hardwood forests in southern Chile and tropical woods elsewhere also contribute to the Andean natural resource base.

The Andean Five generate 18 per cent of Latin American electricity and account for 21 per cent of cement output, figures roughly in line with their population share. But the Andean manufacturing sector clearly lags behind those of Argentina, Brazil and Mexico in "heavy" branches, such as metallurgy, petrochemicals and machinery and equipment. The Andean output of iron and steel, for example, represents only about 11 per cent of Latin American production. The desire to overcome this lag is one of the motivations for the creation of a subregion which allows for larger markets (and economies of scale), but still keeps out the large Latin American countries which are more advanced in "dynamic" activities. Andean countries with "insufficient markets" prefer to face Brazilian competition in say, steel, after they have had a chance to expand their own activities within the larger subregional market.

The post war growth of Andean economies, although not spectacular, has been respectable. Manufacturing output has grown at an average annual rate of 5.7 per cent during 1950-68. Output of electricity has expanded at a yearly rate of 7.4 per cent during 1960-68. With the exception of Ecuador, the GDP of all Andean countries grew as fast or faster than the Latin American average for 1960-66. Merchandise imports and exports, measured in current dollars, grew at a healthy 7.0 per cent per annum during 1959-68. In contrast with the bigger Latin American countries, the participation of foreign trade in Andean GDP has risen since 1950. Intra-Andean trade, however, remains a tiny fraction (3 per cent) of total Andean foreign trade. The relative Andean dynamism could be an important factor in smoothing the frictions and facilitating the adjustments which rapid trade liberalization programs may generate and call for. Note that an annual growth rate of 6 per cent will <u>double</u> industrial output in less than 12 years, roughly the period foreseen as transition to a full customs union.[4]

Andean development problems are similar to those of many other Latin American countries; a population expansion larger than 3 per cent per annum, nearly half of the labor force in primary production (typically at low levels of productivity), askewed income distribution and limited availability of education, health and other social services, especially in rural areas.

The subregion is far from homogeneous, creating many possibilities for further imbalances and frictions on the way to a customs union. Chile has a per capita GNP three times that of Bolivia, for example. (But contrast this with an Argentine per capita GNP ten times that of Haiti.) Chile and Colombia have had many years of tight protectionist measures and overvalued exchange rates, which have brought down the ratio of imports of goods and services in GNP to between 12 and 14 per cent. Perú has maintained a more open economy, and has an import coefficient around 21 per cent of GNP, although it also has a substantial manufacturing sector. Ecuador and Bolivia, the smallest and least developed members of the group, have weak manufacturing sectors and import coefficents far above those of Chile and Colombia. Reluctant Venezuela, with its oil resources, presents many sharp structural contrasts vis-a-vis the five Andeans. To differences in per capita income, manufacturing development and foreign trade participation one should add the heterogeneity of Andean historical experiences with inflation and exchange rate stability. For example, during 1963-68, Chilean consumer prices rose at an annual rate of 28 per cent, those of Perú at 18 per cent, in Colombia at 11 per cent, while smaller rates were registered in Ecuador and Bolivia. Venezuela, of course, has a long tradition of price and exchange stability.

During its early years, the Andean group had more "constitutionalist" political structures than most other South American countries. Presidents Frei, of Chile, and Lleras Restrepo, of Colombia, provided dynamic leadership. Elections to replace both are taking place during 1970, while military governments rule Peru and Bolivia. On the whole, Andean political leadership tends to be more nationalistic and populistic than the Latin American average. Together with the (often exaggerated) fear of becoming industrial satellites of the three big Latin American countries, this fact has been an important force strengthening the political will to create an Andean community within LAFTA.

<u>The Road to Cartagena</u>

The implementation of broad agreements reached in the Declaration of Bogotá was first held up by postponements in the publicized meeting of the Presidents of the American. In February 1967, Raul Sáez, chief Chilean representative to the Andean group at that time, visited the Presidents of Colombia, Perú and Venezuela, trying to speed up action on Andean matters. The meeting of the American Presidents, finally held on April 1967, recognized the desirability of subregional agreements, like that of the Andean countries.[5] In June 1967, a Mixed Commission was created by personal representatives of the Andean Presidents, in a meeting at Viña del Mar, at which time a first draft for the Andean Corporation was also prepared. The second and third meetings of the Mixed Commission were held in Quito (July 1967) and Caracas (August 1967), respectively. In the latter meeting, the entrance of Bolivia into the Andean group and the bases for the subregional treaty were approved. During August/September 19 the LAFTA foreign ministers approved guidelines for the creation of subregional groups within LAFTA, following proposals by the Andean group. At the same meeting, LAFTA gave new signs of weaknesses. At the fourth meeting of the Mixed Commission, held in Lima in November 1967, it was decided to create the Andean Corporation by public treaty, requiring legislative ratification, thus postponing the date when this institution could start operating. The fifth meeting, held in Bogota in February 1968, produced a finished treaty creating the Andean Corporation, and drafts for the treaty creating the common market.

While the treaty creating the Andean Development Corporation was formally signed by the Andean five plus Venezuela in Bogotá, on February 1968, disagreements arose over the draft customs union treaty. During the sixth meeting of the Mixed Commission, held in Cartagena during July 1968, only Bolivia, Colombia and Chile expressed willingness to sign that treaty as drafted. Perú and Venezuela objected to what they regarded as too fast a pace of trade liberalization. Nearly a year later, and after some dillutions of the trade-liberalizing provisions and a bit of horsetrading,[6] the treaty creating an Andean customs union was signed in Bogotá, on May 1969. Venezuela, however, could not be persuaded, and was given until the end of 1970 to join without the need of special negotiations. On July 1969 LAFTA formally approved the treaty as compatible with that organization, and by October 1969 the Treaty of Cartagena had been ratified by enough countries to be formally in effect.

The architects of the Andean group considered that an efficient and rapid path toward economic integration had to rely not only on automatic trade liberalization, but also on institutions which could guide, smooth and plan that process. Thus the key importance given to the Andean Development Corporation.

The Andean Development Corporation

Venezuelan reluctance to sign the Treaty of Cartagena has left the Andean Development Corporation (ADC), as created in February 1968, in a somewhat anomalous situation. Among other things, this first multinational long-term financial institution wholly controlled by Latin Americans is supposed to be located in Caracas. On January 1970 the required minimum of ratifications of the ADC treaty had reached the community's authorities, clearing legal requirements for the beginning of operations of that institution. Whatever the final outcome of Venezuelan relations with the Andean Five, however, the nature of the ADC is unlikely to depart much from what was foreseen in the treaty of February 1968. The institution is supposed to start with suscribed capital of $25 million, wholly supplied by the six Andean countries.[7] The Corporation has the power to issue a wide variety of securities, and counts with great legal flexibility to obtain credits and issue guarantees, if it so wished. The organizers of the Corporation expect to tap new private and public sources of funds, inside and outside the region. Although the instrument creating the Corporation foresees the possibility of having the private sector represented in its board of directors, a possibility which aroused concern in some parliaments, majority control is assured for the six governments. Prodded by Chile, the community authorities have emphasized the dominant role of the public sector in the ADC, and have committed themselves to limit the participation of the foreign private sector in the equities of the corporation.

The Andean Development Corporation is supposed to accelerate integration with its investment policy. It will give special attention to multinational projects and those benefitting the least developed members, Ecuador and Bolivia. (The first president of the ADC will be a Bolivian.) It will not have to wait for projects to be presented for its consideration, as it has the power to study, prepare and carry out projects on its own initiative. As in the case of some national development institutions, it will be able to promote the creation or modernization of enterprises. In short, instead of becoming one more financial institution, it could act as a dynamic engine of integration and development, with an impact far superior to that suggested by its original capital.

Together with the executive regional authority, created by the Treaty of Cartagena and with whom it should have close coordination, the ADC should help plan regional growth. It would help coordinate national investments in social overhead capital, especially regarding "physical integration", and in key industrial branches where economies of scale are very pronounced. The corporation could also be used in some circumstances as the sole representative of the Andean community, as when negotiating with foreign investors and institutions. By issuing Andean bonds in world capital markets it could help diversify the external sources of funds to the region, while in all likelihood improving the credit terms each country faces in isolation. The ADC may also receive concessional loans (aid) from industrialized countries (east and west) and international lending institutions, to be devoted to encouraging integration. While non-Andean participation should remain limited in the creation of an Andean common market, even under the most optimistic assumptions regarding external willingness to help, such foreign cooperation could play a modest positive role if it serves to strengthen and partly finance the budding Andean community institutions, such as the ADC and balance-of-payments clearing mechanisms.

Frictions and disequilibria created by the trade liberalization program could be smoothed by special loans from the ADC for retraining of workers or to give a new start for some entrepreneurs. A wise distribution of loans could also (temporarily) offset politically dangerous regional trade imbalances.

The Treaty of Cartagena

Throughout the negotiations leading to the Treaty of Cartagena, the exact role and speed of trade liberalization has been a source of disagreement, although few, if any, saw in such liberalization the only instrument of integration. Integration of new vs. established industries, planning integration vs. trade liberalization, etc., were some of the forms in which the arguments took shape. To an economist, the substance of much of the debate could be summarized under the pro's and con's of trade diversion and creation.

The final version of the Treaty of Cartagena, while allowing considerable flexibility in the program of trade liberalization and embodying subatential concessions to those fearful of rapid reduction of intra-Andean trade barriers, sets up a non-trival integration pace, so long as the numerous escape clauses are used with moderation. Complete freedom for most intra-Andean trade is scheduled for no later than the end of 1980; all barriers to such trade, including those under exchange control and import licensing, should be permanently eliminated by then. It may be noted that Colombia and Chile had advocated a shorter deadline for total freedom of trade.

Trade in goods included under sectorial complementation agreements (like petrochemicals) will be freed according to the pace specified in such agreements, typically involving new industries. Trade in goods not now produced in any of the Andean five should be freed totally by February 1971. Trade in about 85 products already included in LAFTA's "Common List", many rural products with slight processing, have been scheduled to be freed totally during April 1970. Duties on the intra-Andean trade of all other commodities will be reduced every year by ten per cent of the starting duty, which will be the lowest duty for each product now found in Colombia, Chile or Perú, and in no case exceeding 100 per cent <u>ad valorem</u>. By the end of 1970 all duties will be brought down for each product, to the lowest duty found in Colombia, Chile or Perú; the ten per cent cuts from that duty will start at the end of 1971, so that by the end of 1980 they will reach zero. In other words, contrary to cumbersome LAFTA procedures, trade liberalization could be typically automatic, irreversible and across-the-board.

The liberalization program also commits the countries to the "stand-still" principle, i.e., no new restrictions of any kind may be introduced in intra-Andean trade.

This program is qualified in several ways to take into account sundry fears of trade liberalization. Each country can present "lists of exceptions". These escape clauses are least generous to Chile and Colombia, the champions of trade liberalization. Rural products have their own special escape clauses. Bolivia and Ecuador will not have to start cutting tariffs by ten per cent until the end of 1976, dragging it until the end of 1985, although their exports to other Andean countries will benefit from an accelerated program of liberalization. The production of some goods may be "reserved" for Ecuador and Bolivia, in which case the liberalization of their trade may be delayed. And so on; clearly, the pace of trade liberalization will depend on the use or abuse which will be made of escape clauses of various kinds.

The Treaty of Cartagena foresees the approach toward a common external Andean tariff in two steps. By the end of 1975 a minimum common external tariff should be established; by the end of 1980 the countries should have completed the transition toward the same tariff. As in the liberalization program, Bolivia and Ecuador are covered by special provisions, allowing them a more leisurely schedule. The Treaty says little about the target level of the common external tariff.

The Treaty also touches upon industrial and rural programming, physical integration and social overhead capital, financial and monetary cooperation, and the coordination of development plans and of policies toward local and foreign capital. It stresses the need to distribute fairly gains from integration and reduce regional income inequalities (special provisions for Bolivia and Ecuador take a good share of the Treaty).

But, perhaps wisely, nothing very concrete is said on these matters. Rather, a good deal of decision-making power is given to institutions created by the Treaty. The burden of work will fall on a technical body (the Junta), made up of three members with their own staff, charged with acting only on behalf of Andean community interests, and who will receive no instructions from individual countries. The first members of the Junta have already been named, and are installed in Lima. They will be responsible to a Commission made up of representatives of each of the member governments, most of whose decisions will require the affirmative vote of 4 out of the 5 Commissioners. Consultative groups including representatives of entrepreneurs and trade unions, will advise the Commission and the Junta.

These community authorities, together with those of the ADC, will face the difficult task of defining clearly and finding a workable equilibrium among the several community goals, such as economic efficiency, geographical balance, integration, a fair income distribution and greater regional autonomy, while minimizing the sovereignty each country yields to the new decision makers. Community authorities will be supported in their efforts by specialized regional agencies, such as the United Nations' Economic Commission for Latin America and the Latin American Institute of Economic and Social Planning.

Outlook for the Andean customs union: Trade creation.

Although it is commonly asserted that analysis focusing on trade diversion and creation is irrelevant for integration among less developed countries, arguments given to support such assertions are unconvincing in a Latin American context. At best they indicate the need to supplement the analysis with other considerations regarding economies of scale, bargaining power, etc.

It is also important to specify the alternative to which a customs union outcome is being compared. Ideally, trade diversion and creation should be measured with respect to, not the pre-customs union situation, but the conditions which would have existed in each country without a customs union. It does not seem unreasonable to suppose that in the Andean case the most likely alternative to a customs union is the continuation in each country of protectionist policies not very different from those now in effect.

Even granting this basic assumption, the precise economic impact of the customs union will depend, among other things, on the actual speed and nature of trade liberalization (i.e., which products are freed first), and of course on the level and structure of the new common tariff.

An optimistic scenario would include across-the-board trade liberalization, with few exceptions, with the Andean countries taking this opportunity to reshape and rationalize their system of protection. A common external tariff with duties averaging, say, around 30 per cent *ad valorem*, and the elimination of most quantitative restrictions over foreign trade could be foreseen in this scenario.[8] Under these circumstances, which would also require a more flexible exchange rate policy, the Andean customs union would become a politically feasible way to improve overall foreign trade policies, as trade would be liberalized not only among Andean countries, but also, on balance, with the rest of the world.

It is more likely that the subregion will move faster in liberalizing commodities produced by activities new to the zone (as already indicated in the Treaty of Cartagena), and that the eventual common tariff will be closer to an average of present direct and indirect levies on imports, weighted in favor of the higher duties.[9] However, even under these circumstances, but assuming that the 1980 target for "nearly" complete trade liberalization is kept, the gross trade-creating effect of the Andean customs union will be large. The basic reason is that these countries have already come close to achieving self-sufficiency in a number of "light" manufacturing activities, such as food-processing, textiles, leather products, etc. Most of the trade on these goods was long ago diverted from foreign suppliers toward domestic producers; each country carried out this process on its own, although with different degrees of efficiency. Table 2 shows the extent to which import substituting industrialization has advanced, especially in Colombia, Chile and Perú. By 1970, the participation of imports in total manufactured supplies must be around 15 per cent for the three countries taken as a whole. It has been estimated that in 1968 the share of domestic manufacturing in the GDP of the Andean five reached 21 per cent, ranging from 27 per cent in Chile to 14 per cent in Bolivia. Clearly, common market discussions which neglect the industrialization already accomplished are seriously flawed.

Sketchy data indicate that there exists a great variety from country to country in the prices and costs of many of the goods already produced within the Andean community, suggesting that there is considerable room for a more efficient pattern of regional production and trade.[10] In other words, regarding most of manufacturing the Andean countries, especially the major ones, are actually very similar, but potentially very complementary. As trade restrictions sometimes have shut out completely from one Andean country a commodity which it does not produce, but which is produced in another country of the subregion, the liberalization of regional trade will also allow consumers wider choice. Colombians may be able to enjoy Chilean wine while Chileans may purchase Colombian textiles of a type not available in Chile. The same may be said about trade in services, from tourism to shipping and air freight.

By 1980, then, the share of imports from non-Andean sources in total supplies of "light" manufacturing products is unlikely to be lower than it is not (excepting for Bolivia), but the share of imports from Andean partners in such supplies for each Andean nation is likely to be substantially higher. This, of course, will be a clear indication that trade creation has taken place in these commodities.[11] This aspect of the Andean customs union may be viewed as consolidating and rationalizing the industrialization accomplished during the last thirty years, especially in "light" industries. It could signal that these activities and their entrepreneurs are no longer infants, and that they are ready to face Latin American competition and are almost ready to face world markets. In some lines the larger Andean base may induce larger exports to the rest of the world.

It would be a mistake to regard the present low figures of intra-Andean trade[12] as evidence of the low potential trade creating effects of the common market. That they reflect to a large extent past national policies of import-substitution, which have artificially depressed intra-Andean trade by inefficient duplication of production facilities, is dramatically illustrated by massive smuggling along several Andean borders, such as those between Colombia and Venezuela, Colombia and Ecuador, Colombia and Perú, and Perú and Bolivia. Part of that smuggling deals with non-Andean goods, but a substantial part handles Andean textiles and other consumer goods. Indeed, market pressures along these borders have motivated during the post war schemes for "border integration", especially along the Colombo-Venezuelan and Colombo-Ecuadorian frontiers.[13] It may be noted that these market pressures have been potent in spite of the neglect of economic overhead facilities near frontier zones, a neglect arising from old and petty suspicions and fears. If the trade liberalization program foreseen in the Treaty of Cartagena comes off anywhere near schedule, officially recorded intra-Andean trade is very likely to witness phenomenal growth rates during the 1970's.

Trade liberalization is also likely to have other positive effects on welfare, some, but not all, related to the static trade-creation gains. Greater competition among established "light" activities, most of which produce goods weighing heavily on working class budgets, should reduce their relative prices, contributing toward a better income distribution.[14] In more than one Andean country, important wage-goods are often produced under near-monopolistic conditions. The new competitive climate should also induce entrepreneurs in these activities, who often have been lulled into a fat oligopolistic tranquility by excessive protection, to become truly modern managers on the lookout for cost reducing innovations, and who will be able to operate successfully not only in large Latin American markets, but also in new export markets in the rest of the world. The time has come for the Latin American entrepreneur in "vegetative" activities to become a leader in the intorduction of new technology and new management techniques, if necessary be creating new pan-Andean multinational firms. It may turn out that greater competitive pressures may keep previously overprotected entrepreneurs and trade unions from capturing, as in the past, most of the productivity advantages of the modern sectors of the economy, thus leading to a wider distribution of the gains from modern technology, and higher employment-output growth elasticities.

In some Andean entrepreneurial and academic circles the program of automatic and general liberalization of intra-Andean trade raises fears and resistances. Many perfer to limit the activities of the common market to agreements regarding the establishment of new regional import-substituting (or trade-diverting) activities. It is feared that freeing trade in goods produced by "vegetative" and other established activities could lead to disorderly competition and unemployment and excess capacity in many branches of production. This is the same type of fear which existed in France and Italy when the European Common Market was proposed.[15] Often these fears are inconsistent, as when all Andean producers of a given good claim to be less competitive than other producers in the zone, and they are usually grossly exaggerated. Relatively capital-rich countries complain about cheap foreign labor, while labor-rich countries complain about cheap foreign machinery. Relatively open economies complain that they are at a disadvantage because they started late in their industrialization, while entrepreneurs in relatively closed economies ask for more time to get used to competition.

No doubt the elimination of barriers to Andean trade will increase competitive pressures on all producers, even if it also expands their markets. But the transition toward a new situation will not be as violent and destructive as it is often painted. In the first place, the reduction of tariffs will be gradual, perhaps too much so, and gradual enough to allow for the maturing of any "infant industries" which may remain, especially in Perú, Ecuador and Bolivia. Secondly, neither entrepreneurs nor consumers change their plans quickly, either because of capacity limits and marketing delays, or because of habit and inertia. Thus the early years of the common market will give entrepreneurs a chance to adapt to the new conditions, without the threat of an immediate catastrophe. Finally, as has been noted, Andean manufacturing has been expanding at a fast rate. In this environment adjustment is easier than in a context of stagnation; many relatively inefficient firms may simply have to reduce their expansion and change their output mix, sometimes without having to face reductions in their absolute level of aggregate output and employment. The marginal increments to output will thus be produced by the more efficient plants, without necessarily creating excess capacity. The threat of competition may often lead to gains in efficiency without being accompanied by actual increments in trade flows.

In spite of these arguments, fears about trade liberalization will persist. Indeed, in some cases, and in spite of fast growth, economic efficiency may indicate the advisability of closing down plants and reallocating their labor force. As the Andean authorities seem to be aware, it will be useful to have generous programs set up by the ADC to grant credits and retraining facilities to entrepreneurs and workers severely hurt by intra-Andean competition, and willing to shift to other activities.

This insurance against excessive adjustment costs to trade liberalization and against an unequitable distribution of that burden, seems perferable to the pleas for detailed "planning" often heard from critics of the trade liberalization program. It is only superficially paradoxical that after a decade characterized by the acceptance of planning in Latin America, the Andean group should propose a rapid and automatic liberalization of subregional trade in many products. It is precisely because in mixed economies planning, whether national or regional, should concentrate on priority activities where market forces operate either weakly or perversely, that the market should be given a large share of the responsibility for accelerating integration in activities, such as "light" industries, where market forces can be expected to work reasonably well. One of the surest ways of stopping economic integration is to insist that before each step is taken, exhaustive and detailed studies should be prepared industry by industry, so that some central authority can take a decision on the basis of such studies. (Data in most of these studies are likely to be obsolete by the time they are completed.) Given the difficulties Latin American countries have had building up planning at the national level, the project of guiding each step of integration from a master plan covering five countries is foolhardy. It should also be borne in mind that in most cases it is difficult to predict ex-ante which country should specialize in which activity. Economic history teaches us that often socially profitable specialization comes from bold initiatives of (private and public) entrepreneurs, which may not have met with the approval of central authorities. The executive regional authority directing the steps of the Andean group would, therefore, do well to limit its regional planning to a few critical sectors and policies, establishing for the rest general "rules of the game."[16] This "modest" agenda will keep them quite busy.

Trade diversion

As shown in Table 2, imports still weigh heavily in the total Andean supply of goods produced by "dynamic" industries. For the countries taken individually, import substitution in these industries has been or could be very expensive, due to smallness of market. The effort will be less costly when new plants produce for the whole Andean community; in some cases, the larger market may in fact make regional production competitive with foreign goods even without protection.[17] In any case, it is to be expected that protection will be given to these infant inudstries by the common external tariff, and that the regional output of paper, pulp, petrochemicals, metals, machinery, equipment, etc., will expand at a faster rate than their imports from non-Andeandsources. Because of the economies of scale which characterize many of these activities, a proliferation of plants would not be desirable. Joint regional planning plus a common external tariff which does not wholly eliminate foreign competitive pressures may be the best instruments available to avoid excessive regional costs in those new industries. The presumption in favor of the central planning of many of these "heavy" activities (e.g., steel), is strengthened by the fact that already they are handled by public enterprises in Andean countries.

Some trade diversion is bound to occur in the dynamic branches of manufacturing. Such trade diversion, or regional import substitution going beyond that which would occur under ideal neo-classical assumptions (free trade, equilibrium exchange rates,etc.), is a cost which the Andean countries appear willing to pay for having a more diversified industrial structure and for achieving non-economic goals. These targets are seldom spelled out carefully, but they go beyond a naive "desire for industry". They are motivated partly by a wish for greater autonomy vis-a-vis the powerful world economic centers, partly by a desire to avoid the uncertanities of international trade, and also by an intuitive preference for "heavy" intermediate and capital goods industries, which are supposed to accelerate capital formation, technological change and "backward linkages". A fundamental task for subregional planning will be to spell out clearly what long run benefits are expected to flow from different kinds of trade diversion, and to minimize, for a given desired degree of diversification and subregional autonomy, the costs of that trade diversion, by careful selection of industries to be given special protection. This new stage of import substitution at the regional level should avoid the mistakes made in the old stage of import substitution at a national level. This is of particular importance due to the nature of the goods subject to the new import substitution As pointed out, they are intermediate and capital goods. Inefficiencies in those activities will also affect all other Andean industries relying on them for inputs, including exporters.

Import substitution at the regional level will be guided mainly by complementation agreements in key industrial areas, such as petrochemicals, basic metals, automotive industry, etc. Most progress up until now has been registered in petrochemicals, electronics, and metals in general. The agreement on petrochemicals, already signed by Bolivia, Colombia, Chile and Perú, covers 23 important products, whose production is allocated among the participating countries.[18] Petrochemicals offered a promising area for this type of arrangement, as Andean countries had not yet invested heavy sums in their production, although several were at the verge of doing so.

As here the choice appears to be only between national and regional import substitution, clauses of the agreement limiting entry are a small price to pay to avoid proliferation of very uneconomical small plants, so long as the community authorities keep common tariff levels which maintain some foreign competitive pressure, beyond a reasonable margin of protection. Given the politico-economic dynamics of tariff setting, it may turn out that the starting restrictions on firm entry will result in the long run in smaller tariffs; the open entry policy followed by many Latin American countries in the automotive industry certainly does not provide a good model to follow, meretricious sloganeering about "free competition" notwithstanding.

An Andean group limited to promoting subregional trade only for new industries would reap exiguous gains from that customs union. Gains may still exist compared with a situation in which each country carried out that import substitution in isolation. But the growth of intra-Andean trade and its impact on Andean overall expansion would remain relatively minor; note that for the Andean Five taken as a whole imports are already only about 11 per cent of GDP, according to Table 1, and that only part of those imports can "reasonably" be substituted for local output during the next ten years. Brazil and Mexico, with GDP's larger than that for the Andean Five, have import coefficients of about 5 per cent of GDP (also according to Table 1), and even with their large markets import substitution has not always yielded satisfactory results.[19] In short, it is difficult to visualize significant Andean economic integration without trade liberalization across the bbard; without it the whole impetus toward the creation of an economic and political community will wither.

Outlook for Andean policies toward intra-Andean factor movements.

Discussion so far has been limited to commodity trade. One may wonder whether it is desirable for the subregion to liberalize also movements of labor and capital within the area. The Treaty of Cartagena is vague on this point, and does not set up a time table for factor movement liberalization comparable to that for trade. This is wise.

Based on the historical experience of Southern Italy and the United States South some observers point out the danger that a common market could lead to the immiseration of a member country. But those examples refer to situations where the common market was accompanied by a free flow of labor and capital. In a customs union including only trade in goods and services, mindful of the dangers of excessive trade-diversion, and where the balance of payments constraint limits how much a country can import from its partners and the rest of the world, the possibility of immiseration is negligible. A flexible exchange rate can always insure balance in the international accounts, and export taxes can handle the danger of unfavorable terms of trade effects. But with completely free flows of labor and capital, no such rapid adjustment mechanisms exist. This is why, given present nationalisms and while political and social Andean solidarity is still in its infancy, the flow of factors across frontiers should be limited (and controlled). Note the frictions which legal and illegal Colombian migrations into Venezuela have created. Other examples include Chilean, Bolivian and Paraguayan migrations into Argentina, and Bolivian migration into northern Chile. Even under those controls fears of "dismemberment" (in the sense that with integration some regions of the country may become economically linked more closely with regions of other countries than with their own national capital as well as fears of invasion of cheap foreign labor may persist. And indeed new economic patterns are likely to emerge, say along the Chile-Perú and Colombia-Ecuador frontiers as a result of trade liberalization.

Community authorities could nevertheless profitably encourage certain types of intra-Andean factor movements. While none of the member countries suffers from shortages of unskilled labor, specific bottlenecks in skilled categories often develop, and could be relieved by pooling Andean availabilities of such skills into one common market. Fresh investments into "human capital" could be jointly planned, especially in the fields of higher education and scientific and technological research, and this will call for some labor mobility within the zone. Regional "centers of excellence" for research into matters of special Andean interest, such as geology, copper and tin technology, etc., could be established with the help of the ADC, and by pooling Andean talents.

The Treaty of Cartagena refers to the importance of creating Andean-owned multinational corporations, able to operate with similar ease in the five countries. These are likely to include public, private and mixed enterprises, and will of course require, as in the case of the ADC, some intra-Andean capital movements. In some cases, joint ventures could be undertaken with non-Andean Latin American companies,[20] or with those of industrialized countries (more on this below). Andean planners are conscious of the failure of the European common market authorities to provide leadership in the creation of all-European firms; they do not want to repeat their weak performance. Before December 1971 the Commission, following the advice

Table 2

Imports of Manufactures expressed as Percentages of Total Supplies of Manufactured Products

	Bolivia 1960	Colombia 1965	Chile 1965	Ecuador 1960	Peru 1965
Total	58	10	17	41	25
I. Foodstuffs, beverages tobacco, textiles, clothing, wood and leather products.	40	1	8	11	10
II. Paper and rubber and their products, chemicals, non-metallic minerals, basic metals.	66	22	11	65	27
III. Petrochemicals	56	5	14	15	19
IV. Machinery and equipment, metal-working.	79	46	51	95	70
V. Printing and publishing, other manufacturing.	65	10	26	51	33

Source: Adapted from Edmar L. Bacha, "Venezuelà y El Grupo Andino. El Problema y las Alternativas", El Trimestre Economico, Vol. XXXVII (1), No. 145, January-March 1970, P. 160, Table III. "Total Supplies" refer to imports plus domestic output.

of the Junta, is scheduled to adopt a uniform regime for the creation of Andean multinational firms. As put by Paul N. Rosenstein-Rodan: "One measure of wealth is the waste one can afford. Latin America is not as rich as Europe. In the field of multinational corporations it can and it should do better."[21]

If trade liberalization proceeds as scheduled, it will be desirable to start preparing the way, during the 1970's, for a closer post-1980 economic union. An important element in such a union will be an active and increasingly free Andean capital market, open primarily to Andean public and private enterprises. It will also be desirable to create Andean financial assets which will be able to attract funds from medium-and small-sized savers, thus offering alternatives to foreign assets, such as mutual funds, which threaten to become an important drain of Andean investable funds. Gradual harmonization of fiscal, monetary, and social security policies, as well as ad hoc mechanisms, also vaguely pledged in the Treaty of Cartagena, will encourage such a trend.

But harmonization of such policies need not receive the top priority which should be given to creating Andean multinational firms and to coordinating Andean policies toward foreign traders and investors. In other words, it would be premature, and potentially harmful, to attempt during the 1970's to transform the Andean subregion into a single currency area, with free factor movements and common monetary and fiscal policies. In particular, it would be a mistake to try to freeze exchange rates, even if all countries in the region had rates of inflation similar to each other and to those of "the rest of the world". It is clear that, given unequal inflationaty conditions in different countries, it would be foolhardy to attempt making the region into a unified currency area, while waiting for the end of inflation, say in Chile, is likely to postpone indefinitely and unnecessarily the integration efforts. But even without inflation, trade liberalization and the convergence toward a common external tariff may induce structural changes requiring adjustments in the real exchange rate of several countries. At a time when these countries are giving up national control over policy instruments (i.e., tariffs and import controls) much used in the past for balance of payments adjustments, there will be a greater need, at least during a transition period, for a more flexible exchange rate policy in each country. It should be borne in mind that the Andean integration process will hopefully be accompanied, at least in countries such as Chile and Colombia, by a rationalization and lowering of protection vis-a-vis the rest of the world. The Junta, of course, should adopt general guide-lines to reconcile national exchange rate flexibility with community needs.

<u>Outlook for Andean policies toward non-Andean traders and investors.</u>

One of the expected benefits from the creation of the Andean subregion is typically summarized by the expression "increase in bargaining power". For example, in the commercial field it is to be expected that the Andean Five acting in unison will be in a stronger position when dealing, say with European Common Market, than if each country negotiated in isolation.[22]

A very important application of the principle of greater bargaining power by joint action is expected to take place in dealing with direct foreign investors. Here the objectives are not only economic and in the narrow sense, but also include obtaining greater Andean control over its economy.

Many in the Andean countries, and in the rest of Latin America, fear that the creation of a common market will lead to a massive inflow of foreign multinational corporations, which are better equipped than national firms and even Andean multinational firms, to take advantage of the broader economic space. Such a massive inflow, even when favorable to economic growth, will have undesirable political and social effects.[23] This fear has been partly responsible for delaying Latin American integration efforts. The Treaty of Cartagena meets this issue openly, and established that by the end of 1970 the Community should adopt a common policy toward direct foreign investment, as well as toward foreign patents, licenses and royalty agreements.

Comprehensive data on actual direct foreign investment in the Andean Five are lacking, but it is clear that most of it is in petroleum, mining and smelting, continuing a tradition going back to the early days of the Spanish conquest of the Andean highlands. Of the total 1968 book value of U.S. direct foreign investment in the three largest Andean countries (Chile, Colombia and Perú), at least 60 per cent was in those activities.[24] Japanese investors have recently also shown keen interest in the mineral resources of these countries, which could be labelled Pacific as well as Andean. U.S. Department of Commerce data, however, indicate that U.S. direct investment in manufacturing has grown faster than other items; while such investments amounted to only 8 per cent of total book value of U.S. direct investments in Chile, Colombia and Perú in 1950, their share had reached 16 per cent by 1968. It is noteworthy that in spite of the smaller national markets in those countries compared to

Argentina, Brazil and Mexico, during 1950-68 U.S. manufacturing investments in the two groups of countries grew at roughly the same average annual rates (9.5 per cent for Chile, Colombia and Perú, and 9.0 per cent for Argentina, Brazil and Mexico).[25] For both groups of countries, the rate of expansion in the book value of those manufacturing investments was faster during the 1960's than during the 1950's, in spite of the fears provoked by the Cuban Revolution. Recent experience in Perú, where the Southern Perú Copper Corporation was willing to sign an agreement with a government which shortly before had nationalized, allegedly without "prompt and adequate" compensation, assets of the International Petroleum Company also indicates that in spite of the public diffidence shown by foreign investors and their demands for "favorable climate", the Andean countries are regarded as attractive places where to invest. The bargaining power and room to manoeuvre of these countries is, therefore, greater than what one would think by reading business and popular journals.

That bargaining power is probably strongest in the field of natural resources. It could be further strengthened by a closer coordination and eventual merger of the national public enterprises which now act in minerals, oil, transport, communications and electricity. Programs such as "Chileanzation" and "Peruanization" of copper could probably gain in bargaining strength, as well as efficiency, by their joint planning. The fact that several industrialized regions, such as Japan, the U.S., and Western and Eastern Europe are each interested in obtaining access to raw materials naturally strengthened the Andean hand.

New forms of association with foreign investors in manufacturing and other enterprises can also be developed under better conditions if Andean countries act jointly and/or establish common "rules of the game". These are likely to be closer to those of, say, Mexico than the more liberal regulations of Argentina and Central America, and they are also likely to include a closer look at the accounting arrangements on such matters of royalty and other fee payments between subsidiaries and head offices abroad. The curious phenomenon of continued foreign investment into branches which show systematic accounting losses has caused considerable interest in Andean circles. The foreign ministers of the Andean Five, meeting in Lima on November 1969, reaffirmed that it will be Andean policy to encourage preferentially Andean entrepreneurs, and to control foreign investment. It is likely that certain fields, such as most "vegetative" and key "dynamic" branches of manufacturing, as well as banking, communications, etc., will be increasingly reserved for public and private Andean entrepreneurs. This trend is already marked in Perú, Bolivia, Chile and Colombia.

As noted earlier, the trade field also offers potential regards to joint Andean policies, not only when dealing with trade blocs such as those of Western and Eastern Europe, but also in dealing with the larger LAFTA countries, and with the rapidly expanding Japanese and Australian markets, which share with the Andean countries the Pacific basin.[26] One may ask whether Andean (and Latin American) bargaining power should be used to obtain <u>regional</u> trade preferences from the United States. On this point Colombia and her partners appear to have different views. It should be noted that during the 1960's Andean international trade has become geographically more diversified; schemes for U.S. regional preferences would jeopardize such gains and would also hamper Andean freedom to bargain with direct foreign investors. It is difficult to visualize, for example, the political feasibility of a situation where, say, Italian investors within the Andean group would export to the U.S. market taking advantage of U.S. regional preferences.

Pooling of Andean foreign exchange reserves, combined with expanded cooperation among the five Central Banks, could decrease Andean vulnerability to fluctuations in foreign exchange earnings from the rest of the world. A first step may be the pooling of the newly created Special Drawing Rights.

Andean documents and declarations have been careful to emphasize that their activities and actions are compatible with the march toward a pan-Latin American common market, and they often assert that the creation of the subregion will accelerate such march. Yet, it is clear that the Andean working hypothesis is that no such a market is yet in sight, and that LAFTA will continue developing at a very slow pace. On the other hand, the Andean group is often eyed with misgivings by other LAFTA members.

While it is unlikely that the Andean group will be joined in the immediate future by other countries (excepting Venezuela), it is possible that it will develop special links with Central America and the Caribbean regions; Colombia has shown particular interest in these areas, having shores both on the Pacific and the Caribbean.[27]

<u>Possible future difficulties and dangers of the Andean Group.</u>

Looked at from the viewpoint of each participating country, expected benefits from the creation of the subregion are of two major types. One group of benefits will arise from the favorable long run effects of trade creation, greater bargaining power vis-a-vis the rest of the world, possible improvements in subregional external terms of trade, etc. These benefits over the long run, are <u>not</u> obtained at the expense of partners in the subregion. The other type of benefits will, for a substantial period of time, be obtained at the expense of subregional partners. When an industry, heavily protected by the common external tariff, is set up in a given country, such country may benefit from having that activity, but only at the expense of consumers (and/or public revenues) of custom union partners. The benefit to that country, neglecting for a moment <u>quid pro quos</u>, is equivalent to an improvement in its terms of trade exactly matched by a worsening of partners' terms of trade. Unless such "infant industries" mature so as to make its regional protection superfluous, the situation will persist indefinitely.

Naturally, each country will be expected to return the favor regarding the second type of benefit, and thus incur in corresponding costs to subsidize the protected regional industries located in partner countries. But there are likely to be other costs, mainly of a short- or medium-run nature. These can be summarized under the label of "burden of adjustment", and are usually neglected in textbook discussions of long run economic mechanisms. They include possible costs of resource reallocation arising from trade creation and balance of payments adjustments, as well as induced changes in national tax and policy-making systems. Throughout history, the politically powerful have tended to thrust the burden of adjusting to changing world economic conditions onto the politically weak; when supply and demand conditions favor the strong, the adjustment burden is proclaimed to be the inevitable price of progress exacted by a blind market, an argument brushed aside on grounds of "political realism", to be accepted by all "reasonable" men, when economic trends threaten to hurt the interests of the strong.[28] This argument, rather than vague fears of cumulative tendencies toward uneven development, provides substance to the suspicions of the politically weakest countries within common markets.

Providing even a general accounting framework to keep track, for each participating country, of all these possible costs and benefits of a common market is a most difficult task. Hence the high probability of frictions, complaints, delays and arduous negotiations in the formation of custom unions, especially among developing countries. Strong political leadership and solidarity is needed if the project is to advance significantly; it is not yet obvious that such leadership and solidarity will be steadily applied in the Andean context. It could be argued that most of the leadership of participating countries has not yet fully realized the full implications of the Treaty of Cartagena, and they may back down when the time comes for concrete actions, such as the lowering of important protective tariffs. Colombia and Chile will have different Presidents after 1970, and the future Andean political picture and enthusiasm for integration may look quite different from that at the time of the Declaration of Bogotá. Both LAFTA and the Central American Common Market have shown, unfortunately, the relative political weakness of signed and sealed economic pacts, which are no match for the furies of petty and archaic chauvinism. Unfortunately, there are plenty of old quarrels and animosities among Andean nations (to name but a few, the borders between Chile and Bolivia and Perú, and between Perú and Ecuador, can still arouse strong emotions), which could be manipulated to generate severe frictions. Furthermore, it is possible that some of the countries within the subregion will take a sharply more leftward course than their neighbors, especially regarding central planning of economic activity. In that case, the meshing together of economies with very different degrees of private market activity with further tax regional ingenuity and solidarity.

The potential difficulties of the Andean scheme have been foreshadowed by the unsuccessful negotiations to convince Venezuela to sign the Treaty of Cartagena. Venezuelan objections to that Treaty involve fear of *both* trade creation and diversion, coupled with preoccupation with the possibility of large and chronic deficits of Venezuela *vis-a-vis* the Andean Five. This preoccupation is rooted in the peculiar price-cost structure of the oil-rich Venezuelan economy; indeed, calculations using recent exchange rates confirm across-the-board Venezuelan competitive disadvantages with respect to at least Chile.[29] But even assuming that somehow (perhaps using dual exchange rates, or similar schemes), the Venezuelan-Andean Five trade could be equilibriated,it is likely that Venezuelan misgivings would persist. Vis-a-vis the Andean Five, Venezuela is likely to have oomparative disadvantage in labor-intensive activities, such as textiles, which have expanded behind import controls only relatively recently. Firms in such industries, nearly all private, take a dim view of the threat of Colombian and Chilean competition. But many Venezuelan firms, public and private, also have a more economically legitimate case against the Cartagena program. Traditionally, they have imported capital and intermediate goods at prices prevailing in world markets (duties being generally low on those products); moves toward a common external tariff are almost certain to raise those prices for Venezuelan buyers, to induce diversion of their purchases toward Andean producers of those goods, not all of which would be Venezuelan. Adding to the opposition of Venezuelan private entrepreneurs to the Treaty of Cartagena is their estimation that Venezuelan activities likely to benefit from trade diversion are partly or totally publicly owned, such as in petrochemicals and steel. Some Andean observers have also remarked that the large influence of foreign investors in the Venezuelan economy presents an additional reason for Andean-Venezuelan incompatibility, echoing British-Continental difficulties in Western Europe.

The Andean common external tariff is also likely to imply an increase in many Peruvian, Bolivian and Ecuadorian tariffs (or of import controls expressed as equivalent tariffs), even if they result in decreases in tariffs or tariff-equivalencies for Chile and Colombia. Indeed, for a while Peruvian agreement to the Treaty of Cartagena was in doubt, for reasons similar to those given by Venezuela for rejecting the Treaty. The two weakest countries, Ecuador and Bolivia, face potential trade diversion not only in products of "dynamic" or new industries, but also, as suggested by Table 2 especially for Bolivia, in simpler manufactured products. But these two countries, comprising only 19 per cent of the Andean Five population, have received a considerable number of theoretical safeguards and assurances in both the Treaty of Cartagena and the ADC. Indeed, there is a danger that the ADC may neglect socially profitable actions elsewhere for the sake of concentrating on projects benefitting Bolivia and Ecuador. Integration, as noted by C.P. Kindleberger, calls for contributions according to ability to pay (and here Bolivia and Ecuador have a smaller burden), and investments according to some calculation of pay-off. Offsetting trade diversion costly to Ecuador and Bolivia with inefficient investments in these countries will not encourage growth in the subregion.

While it may be difficult to be precise about all of the costs and benefits of integration for each Andean country, certain aspects may be roughly quantified. The real costs of regional trade diversion, for example, should be distributed in a conscious fashion among the member countries. Reciprocity should not be defined with respect to an equal expansion of regional imports and exports in each member country, nor with equal expansion of trade in manufactured goods. Rather, it should refer partly to a fair distribution of the real costs arising from trade diversion. For example, suppose that Peruvian imports and exports to the Andean group increase by the same amount, but that its exports are made up by goods which it could sell in world markets at the same prices it receives from Andean customers (e.g., cotton), while its imports are made up by goods which Peru previously imported from world markets at lower prices (e.g. machinery). Although its regional trade is balanced, it could hardly be said that Perú is benefitting from the common market or that it is receiving reciprocity for its purchases of Andean products, whose prices (at least for a while) are higher than those in world markets. Reciprocity could be reestablished, ceteris paribus, if Peru exported to the subregion goods whose prices were also above those in world markets, in an amount which compenstaed the real costs of diverting its imports from world to Andean exporters.[30]

Using this approach to reciprocity, and combining it with estimates of adjustment costs, regional authorities could make rough calculations of what each country obtains, net, from integration. Even if rough-and-ready, such calculations may help to foresee difficulties and avoid frictions. In particular, by keeping tabs on the costs of trade diversion, it may avoid some of the situations obtained in Central American Common Market, where, for example, Nicaragua has felt victimized by subregional import substitution.

Indeed, the biggest danger of the Andean project is that, under pressure from vested interests, it may be turned into a mercantilistic mechanism to promote exclusively import substitution at the regional level, perhaps with the excuse of supporting overvalued exchange rates (disguised under the argument of closing the foreign exchange gap). Although economies of scale will help to reduce the real costs of some new industries, it may still leave unit costs in many activities way above world market costs. Under these circumstances rapid and efficient Andean growth will require an expanding volume of exports to the rest of the world, to finance growing imports of capital and intermediate goods whose production in the region may still be uneconomical. As the experience of import substitution at the national level shows, the creation of inefficient intermediate and capital goods industries will have negative cost-push effects throughout the economy, and especially on non-traditional exports. Countries with a long tradition of export promotion, such as Perú, will do well to keep a sharp eye on the level and structure of the common external tariff.

Excessive emphasis on inefficient Andean import substitution will also create vested interests which will later oppose a wider Latin American common market. If an Andean steel industry develops without reaching the efficiency of, say, that of Brazil, it will generate pressures opposing further integration. (*Ceteris paribus*, the smaller the economic space covered by a common market, the greater the danger that it will lead to costly trade diversion; thus the pity of not having the rich Venezuelan market within the agreement.) In the same way that the old import substitution at the national level created vested interests now opposing regional trade liberalization, there is the risk that the new regional import substitution will generate interests which later on will oppose a wider Latin American integration. The best way to guard against this risk is to promote regional import substitution only in activities where one can be reasonably sure that acceptable levels of efficiency will be reached after a few years of "learning by doing".[31]

A quick look at a map will show that the Andean group is not, *prima facie*, the most reasonable one which could have been devised from a viewpoint of economic efficiency. For example, it makes more economic sense to accelerate integration of the Chilean automobile industry with that of Cordoba in Argentina, rather than with those of Colombia or Venezuela. Only one of the Andean countries (Perú) has frontiers with all of its four partners. As a group, the Andean Five have more trade with other LAFTA countries than with each other.

Besides these long run preoccupations, the Andean group faces difficult adjustment problems in the short and medium run. As trade restrictions are lifted, there is no assurance that the regional trade flows forthcoming will be balanced. Some countries will developed surpluses and other deficits *vis-a-vis* the region. This (very likely) possibility arouses considerable anxiety among the member countries. Several devices have been proposed to deal with it: faster-than-scheduled duty reductions in surplus countries and the opposite for deficit countries, the creation of a payments union with generous swing credits, a system of different exchange rates for intra- and extra-regional trade, special lending policies by the ADC, etc. Many of these devices will be useful in decreasing the negative political impact of severe regional imbalances in trade flows, especially if they also involve sharp disparities in the expansion of intra-Andean manufactured exports. But more fundamentally, it should be recalled that true reciprocity need not necessarily involve balanced regional trade flows (nor balanced trade in manufactured goods), and that so long as the overall *global* balance of payments of a country is kept in equilibrium, a deficit with a region will be compensated by a surplus with the rest of the world. Old-fashioned mercantilistic notions should be discarded when dealing with these issues, as attempts to force strictly balanced regional flows could lead to severe inefficiencies. It remains true, however, that the Andean countries will have to rely on exchange rate variations as a tool to maintain *global* balance of payments equilibrium, to a much greater extent than it was done in the past. In the future, each Andean country will lose independent control over tariffs and other trade restrictions, which in the past were often used as tools to secure balance of payments equilibrium. Leaving aside painful income mechanisms of adjustment, only exchange rate policy is left to bring about a desired global target in the balancedof trade. It is to be hoped that exchange rate movements will be preferred to a slowdown in the trade liberalization agreements, or to extreme and sustained efforts to force regional trade balance. At any rate, intra-regional trade starts at such a low fraction of total international trade of these countries, that even (proportionally) very large deficits or surpluses with the region will have a small impact on the overall balance of payments of each country, at least during the early years of the common market.

Trade liberalization and the movement toward a common external tariff is likely to have a negative impact on public revenues, at least in some of the Andean countries. But this development should not be difficult to handle, and could motivate much needed fiscal reforms. A fair division of funds collected under the common external tariff, a subject on which the Treaty of Cartagena is silent, should not be difficult to devise.

The low present figures for intra-Andean trade indicate that great efforts will have to be made in establishing new trade and commercialization contacts and channels. The transportation, financial and psychological "overhead" of trade will have to be built almost from scratch, often with the help of the ADC. On the other hand, intra-Andean transport should be facilitated by a wide "road" formed between them by the Pacific, the Panama Canal and the Caribbean. Most of the Andean population centers are located on or near one of those bodies of water.

Some conslusions

Because of their journalistic visibility and glamour, there is a tendency to expect too much from integration efforts. Even with Venezuela, the Andean group would only come to about the economic size of Mexico and Brazil. One must remember that the great "common markets" of Brazil and India have contributed only modestly to solving the development problems of those countries. In particular, the Andean integration effort is unlikely to change significantly the welfare of the poorest half of the Andean population, whether located in the bigger or smaller countries. It may lower the prices of some wage-goods, but it may also, by itself, tend to concentrate income in some new sectors. National planning offices, rather than subregional authorities, will remain responsible for monitoring what is happening to the incomes of the lowest half within each country, and of trying to improve them. The less important target of reducing the income gaps among the Andean countries will of course remain a preoccupation of subregional bodies.

While not a panacea for all of the economic and social ills of the subregion, a properly handled Andean customs union can raise the growth rate of each of the participant countries significantly above what those rates would be if each country followed in isolation an import substitution policy similar to those of the 1950's and early 1960's. It could do this be increasing the efficiency of already established industries, by taking advantage of larger scale in selected new import substituting efforts, by increasing Andean bargaining power in world commerce and finance, and by creating a climate conducive to faster technological change, improved management and a bolder attitude toward foreign markets.

It is difficult at this stage to be precise about the addition to the growth rate which the Andean plans could bring about. It may be guessed that it could be as high as one percentage point, on average, throughout the next fifteen years, although its beneficial effects will be felt most strongly during the latter part of that period. But even if the per capita growth rate with integration is only 2.7 per cent per annum, compared with a 2.0 per cent rate without integration, by 1985 that difference would mean a per capita GDP of $650 rather than one of $585. Contrary to the situation in most of Africa and Asia, the Latin American per capita income base is such that apparently small changes in per capita growth rates can make the difference between breaking into the income category of, say, Italy, within a reasonable time span, or remaining in the semi-industrialized stage Argentina has been for the last forty years. It should also be remembered that the Andean scheme should bring these countries closer to their non-economic goals, such as greater regional autonomy vis-a-vis the rest of the world.

So with all of its limitations and dangers, the Andean program appears as a worthwhile and exciting undertaking, which should be politically feasible. One can apply to it what Paul N. Rosenstein-Rodan has written about Latin American integration:

> It is an idea that once launched will not and cannot perish. It may suffer agonizing delays, create many difficulties, but it offers such obvious advantages to all that we should despair of human reason if narrow nationalistic instincts were to stop it .32

Notes

* Earlier drafts of this paper have benefitted from comments by Charles P. Kindleberger, Osvaldo Sunkel and Raul Saez. Paul N. Rosenstein-Rodan first urged me to study the evolving Andean group. Several of the ideas presented in this paper were sketched in my "El Grupo Andino en el proceso de integracion latinoamericana", Estudios Internacionales, Year 2, No. 2, July-September 1968, pp. 242-57.

1. For a discussion of LAFTA history see Miguel S. Wionczek, Editor, Economic Cooperation in Latin America, Africa and Asia: A Handbook of Documents, (Cambridge: The M.I.T. Press, 1969), Chapter One.

2. See, for example, C.A. Cooper and B.F. Massell, "Towards a General Theory of Customs Unions for Developing Countries," The Journal of Political Economy, Vol. LXXIII, No. 5, October 1965, pp. 461-76; and Donald C. Meade, "The Distribution of Gains in Customs Unions Between Developing Countries", Kyklos, Vol. XXI, Fasc. 4, 1968, pp. 713-36. As Meade puts it: "...we would agree with the appraisal of R.L. Allen that customs unions among developing countries 'are all fundamentally protectionist', in the sense that they are designed to facilitate the expansion of output in lines where money costs of production are now and are likely to remain above world prices". (p. 718). It should be noted that Meade writes on the basis of African experience.

3. Compare also with the 1966 populations of the proposed Maghrel group (32 Million, including Morocco, Algeria, Tunisia and Lybia), that for East Africa (29 Million, including Kenya, Uganda and Tanzania), Nordek (17 Million, including Denmark, Iceland, Norway and Sweden), and the Caribbean Free Trade Association (CARIFTA, including several of the smaller Antilles, about 5 Million).

4. Data in this paragraph obtained from several issues of Economic Commission Latin America (ECLA), Notas sobre la Economia y El Desarrollo de America Latina, and International Financial Statistics. During 1967 and 1968 Andean growth seems to have declined relative to that of the rest of Latin America

5. The meeting of the Presidents also solemnly pledged that a Latin American Common Market would be created within no more than 15 years, starting in 1970. Neither then nor now was that pledge taken seriously by either the signataries nor anybody else. The Alice-in-Wonderland atmosphere of panamerican meetings reached an all time at those sessions.

6. For example, it is said that Peru finally decided to sign only after Lima was chosen as the headquarters for the treaty secretariat. Colombia had very much hoped Bogota would be chosen.

7. The shares of Bolivia and Ecuador are smaller than the (equal) shares of Colombia, Chile, Peru and Venezuela. An earlier proposal establishing shares according to contributions to the Interamerican Development Bank, which would have meant that Venezuela provided the largest share, was dropped at the request of Peru, which in the IDB has a smaller contribution. Earlier proposals to speed up the creation of the ADC by circumventing the need to obtain Congressional approvals were also shelved.

8. The following are simple arithmetic means of the approximate incidence in ad valorem terms of duties and charges applied by Andean countries (except Bolivia) to imports during the early 1960's:

	Chile	Colombia	Ecuador	Peru
Primary commodities and capital goods	58%	64%	35%	18%

	Chile	Colombia	[illegible]	Peru
Semi-manufactured and durable Consumer goods	96	48	56	25
Current consumer manufactures	328	247	117	72
<u>Overall Average</u>	138%	112%	62%	34%

Data obtained from Santiago Macario, "Protectionism and Industrialization in Latin America," Economic Bulletin for Latin America, Vol. IX, No. 1, March 1964, p. 75, Table 5. In recent years Venezuela has relied heavily on quantitative restrictions to promote import substitution.

In the petrochemical complementation agreement, signed in August 1968 by Bolivia, Colombia, Chile and Peru, minimum preference margins vis-a-vis third countries of 15%, 25% and 50% were agreed upon for primary, intermediate and final petrochemical products, respectively.

9. The Central American Common Market has ended up with a tariff higher than the average of the individual countries' pre-integration duties.

10. Some examples of price disparities within the Andean group may be given. The following indices refer to prices for different goods in the Andean countries where the Chilean price is set equal to 100 for each product. The indices are based on dollar prices, obtained by applying a purchasing power parity exchange rate to the prices expressed in local currencies. The prices refer to 1962.

	Bolivia	Colombia	Ecuador	Peru
Beer	102	64	111	98
Footwear	85	77	88	134
Cotton Cloth	55	48	53	88
Woolen Cloth	195	100	175	114
Soap	154	49	127	76

	Bolivia	Colombia	Ecuador	Peru
Light bulbs	123	119	70	107
Washing machines	94	77	100	56
Radio	71	50	121	80
Aspirin	138	194	244	581

These data do not necessarily reflect costs as they may be biased by different tax systems and mark-ups; furthermore, using other exchange rates, different results will be obtained. But together with other bits of information, they suggest a rich pay-off to specialization and increased trade within the Andean group. Indices computed from United Nations, El Proceso de Industrialización en América Latina, Statistical Appendix, pp. 89-92. The main body of that publication also notes price and cost differences among Latin American countries; see its pp. 107, 121 and 253.

See also Edmar L. Bacha, "Venezuela y El Grupo Andino", op. cit., Table I, p. 157, Price disparities are also marked in such basic inputs as steel and chemicals.

It is at first sight breathtaking that the Andean five have plunged ahead with their plans in spite of the lack of exact data on cost differences, effective rates of protection, economies of scale, etc. The not-unreasonable counter to this timidity is that the flexibility of the Treaty coupled with strong policy-making community institutions are more efficient weapons in handling uncertainty than time-consuming studies.

It may be noted that while the prices of most Andean "light" industries compare unfavorably with world prices at going exchange rates, it is not clear how they would perform under exchange rates corresponding to free trade conditions, which would also allow them access to their inputs at world prices. In other words, some of these activities may be quite efficient, even at world market prices, but several domestic price distortions may then appear otherwise.

11. See Edwin M. Truman, "The European Economic Community: Trade Creation and Trade Divesrion", Yale Economic Essays, Volume 9, No. 1, Spring 1969, especially pp. 202-208. Existing data does not warrant a precise quantification of the likely static gains from trade-creation. But to the agrument that quantification of such gains inevitably has yielded meagre results the following observations can be made: (a) differences in effective rates of protection among Andean countries are large, and suggest differences in costs greater than those found elsewhere; and (b) it should be recalled that expressions approximating these welfare gains have as one of their terms the squared values of the taxes removed as a result of the creation of the common market. As already noted, these taxes are quite high in most Andean countries. In the case of the total removal of a tax on goods already imported from a country in the common market, the welfare gain can be approximated by:

$$1/2\ [\ (pq) \cdot t^2 \cdot E]$$

where t represents the ad valorem tax removed, E the absolute value of the price elasticity of demand, and (pq) the value of expenditures on the imported good.

12. According to data obtained from the International Monetary Fund, Direction of Trade (several issues), the following are the precentages of intra-Andean trade (excluding Venezuela) in the total merchandise trade of each country:

	Exports		Imports	
	1961-63	1964-66	1961-63	1964-66
Bolivia	0.5	1.2	4.3	3.1
Chile	1.1	1.2	5.2	4.6
Colombia	1.2	2.1	1.3	2.6
Ecuador	7.0	6.2	2.3	3.7
Peru	4.8	4.0	1.9	2.6
Total Andean	2.8%	2.7%	2.8%	3.3%

The annual value of intra-Andean trade (exports plus imports) was about $140 million during 1964-66. These data do not attempt an estimation of smuggling.

13. These schemes have been actively discussed since the late 1950's. But it has proved very difficult to plan for "border integration" in isolation from a full customs union among participating countries.

14. But the net effect of integration on income distribution is ambiguous.

15. See Bela Balassa, "Integration and Resource Allocation in Latin America," (forthcoming). This paper also stresses the gains to be achieved by greater competition among already established Latin American industries. See also Tibor Scitovsky, Economic Theory and Western European Integration (London: Unwin University Books, 1962), for an analysis stressing the gains to be achieved by greater degrees of competition within a Western European context. While that experience is not directly applicable to Latin America, it is not irrelevant to the area either. The Chilean and Colombian industries of 1970 are not far behind those of Italy in 1957. It is curious that, within a pan-Latin American context, the small countries fear that the big three will reap most benefits from integration, while Argentina, and Brazil also

show reluctance to press for a common market, sometimes arguing the primacy of "national integration", a label which at best refers to a geopolitical concept, at worst is a meaningless semantic trick.

16. It could be argued that price and costs distortions are so great within Andean economies that partial trade liberalization may lead to intra-Andean trade flows unrelated to real cost advantages and disadvantages. This argument can be used to propose either strict central planning of integration or its postponement until after the distortions are reduced or eliminated. The empirical underpinning of this thesis, however, is shaky. Nevertheless, trade flows arising from the early rounds of tariff-cutting should be scanned by the community's secretariat for evidence on this point.

17. It may be argued that in that case any one country could have started producing the commodity in large scale, exporting the surplus to world markets, without the need for a regional group. But this argument neglects the smaller risk involved in producing for a regional group in contrast with producing for the world market. On the other hand, one should be on guard against overly optimistic ex-ante engineering studies, which almost always turn out, ex-post, to have underestimated the competitive disadvantage of domestic output vis-a-vis the world market, or to have overestimated the ability of new activities to keep up with productivity increases in the rest of the world.

18. For details of the petrochemical agreement see Banco Nacional de Comercio Exterior, Comercio Exterior (Mexico, D.F.), January 1968, pp. 10-11.

19. Cf. Edmar L. Bacha, "Venezuela y el Gruop Andino...", op. cit., pp. 159-162. Bacha also stresses the difficulties to be expected in negotiating complementation agreements for new industries, noting the experience of the Central American Common Market on this matter, and the inflationary cost-push arising from inefficient import substitution.

20. Andean efforts to set up a regional electronics industry (mainly in radios and television sets) are reported to include a joint venture with the Mexican Majestic group, which in return for a minority interest will supply the technical backing. See Business Week, March 21, 1970, p. 49. The multiplication of contracts among Andean entrepreneurs during the last few years, it may be observed, has been remarkable.

21. Paul N. Rosenstein-Rodan, "Multinational Investment in the Framework of Latin American Integration", in Inter-American Development Bank, Multinational Investment in the Economic Development and Integration of Latin America (Round Table, Inter-American Development Bank, Bogota, Colombia, April 1968, p. 87).

22. There was talk of joint Andean participation in the 1970 World Fair at Osaka, Japan. This idea, however, was abandoned.

23. For a more detailed discussion of the issues raised by direct foreign investment in Latin American development see my "Direct Foreign Investment in Latin America", in Charles P. Kindleberger, Editor, The International Corporation (Cambridge: The M.I.T. Press, 1970).

24. Data obtained from U.S. Department of Commerce, Survey of Current Business, October 1969. The 1968 book value of all U.S. direct investments in those three countries is put at $2.3 Billion. Of all U.S. direct investments (book value) in Mining and Smelting in Latin America, 72 per cent are in Chile and Peru.

25. The book value of <u>all</u> U.S. direct investments in Chile, Colombia and Peru grew during 1950-68 at an annual rate of 5.5 per cent.

26. According to the International Monetary Fund, <u>Direction of Trade</u>, the recent geographical percentage structure of Andean foreign trade has been as follows (excluding Venezuela):

	Exports (f.o.b.)			Imports (c.i.f.)		
	1961-63	1964-65	1966-67	1961-63	1964-65	1966-67
U.S.A.	41.7	38.3	36.3	43.2	42.5	40.8
United Kingdom	10.4	8.9	9.7	6.5	5.9	5.2
Japan	5.1	6.7	7.4	3.9	4.5	5.1
European Common Market	25.6	27.5	28.3	21.8	19.5	20.7
Latin America	7.1	7.7	7.4	11.7	14.2	14.9
Others	10.1	11.0	10.9	13.0	13.6	13.3

The figures for "Latin America" include intra-Andean trade; compared with those given earlier for that trade they indicate greater flows between Andean and other LAFTA countries than within the group. But they also reveal the large and growing deficit between the Andeans and the rest of LAFTA, which has troubled the subregion.

27. See Rodrigo Botero, <u>La Comunidad Económica Caribe & Andina</u> (Bogota: Ediciones Tercer Mundo, 1967). See also Marcos Kaplan E., <u>Problemas del Desarrollo y de la Integración de América Latina</u> (Editorial de la Universidad de Chile, Escuela de Derecho de Valparaiso, 1967).

28. Consider in this light the asymmetrical reactions of the United States and Western Europe to increases and decreases in the prices of coffee, copper, textiles, etc. Aid flows from the strong to the weak can then be viewed as partial compensation for trade asymmetrics.

29. See Edmar L. Bacha, "Venezuela y El Grupo Andino", Op. Cit., especially Table II.

30. This way of viewing reciprocity may also be found in R. French-Davis and K.B. Griffin, Comercio Internacional y Políticas de Desarrollo Económico, (México: Fondo de Cultura Económica, 1967), pp. 196-198. If Δp is the difference between Andean prices and those in world markets (assumed to be a positive amount), then:

$$q_1 \cdot \Delta p_1 = q_2 \cdot \Delta p_2$$

is the condition for true reciprocity, where the q's represent quantities imported from the region (subscript 1) and quantities exported to the region (subscript 2), for any country in the group. See also D.C. Meade, "The Distribution of Gains in Customs Unions between Developing Countries", Kyklos, Vol. XXI, 1968, Fasc. 4, pp. 713-734, where the same formula is proposed as a guide for true reciprocity.

31. It has been suggested, especially by Paul N. Rosenstein-Rodan, that the Andean countries at their first integration efforts avoid a common external tariff, essentially creating a free trade zone coupled with ad hoc complementation agreements. If the latter are well planned, this proposal could avoid many of the dangers of trade diversion, especially for Peru and Venezuela.

32. Paul N. Rosenstein-Rodan, "Multinational Investment in the Framework of Latin American Integration," Op. Cit., p. 33.