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by

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Economic Prospects for the Andean Group

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While the Andean Group integration scheme, recently formed by Bolivia, Chile, Colombia, Ecuador and Peru, will not solve its members' economic problems, it has considerable potential for being on balance an improvement. This paper discusses the alternative to which integration should be compared, outlines some of the major benefits which may be expected from integration and some factors which place bounds on the Andean potential for success, and analyzes some key issues which, once decided, will determine the extent to which the potential is realized. These issues concern the common external tariff, trade liberation, exchange rate policies, allocation of new industry, foreign private investment, the Andean Development Corporation, and Venezuelan entry into the union.

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ECONOMIC PROSPECTS

FOR THE ANDEAN

GROUP

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May 1972

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> Like agrarian reform and chastity, economic integration tends to be extolled in principle but resisted in practice, and its advocates tend to oversell its virtues. (Felix, 1970)

Introduction

The Andean Group integration scheme is not a panacea which will solve its members' economic problems. It is unlikely to generate the rapid self-sustaining growth which they have hitherto been unable to achieve. Nevertheless it has considerable potential for being on balance beneficial. This paper discusses the alternative to which integration should be compared, outlines the benefits which may be expected from integration, examines some important factors which place bounds on the Andean potential for success, and analyzes several of the key issues which, once decided, will determine the extent to which this potential is realized.

The alternative to integration

Any attempt to evaluate the net benefits from economic integration necessarily implies comparison with some hypothetical alternative situation. In the case of the Andean Group two main alternatives may be considered. On one hand, it may be assumed that in the absence of integration member countries would continue to follow the strategy of national import substitution which they pursued in the 1950's and 1960's. This implies moving further and further into heavy, technologically sophisticated industries which make intensive use of the scarce factors of production capital and skilled labor, but provide little employment for the abundant unskilled labor.[1] Alternatively, it may be assumed that in the absence of the Andean Group each country would be forced to realize that continuing national import substitution is no longer a viable strategy, and would shift emphasis towards promoting labor-intensive exports and eliminating the bias against agriculture. Such a policy, which could be implemented by reducing and rationalizing tariff structures, correcting overvalued exchange rates, and eliminating distortions in relative factor prices, would be more in line with current Andean comparative advantage, and could significantly improve long-term Andean prospects for development. Whether or not the formation of the Andean Group is likely to be on balance beneficial depends critically upon which of the two alternative-situation assumptions is judged to be more realistic. If countries would otherwise have continued with national import substitution, the Andean Group probably represents on balance a modest improvement. On the other hand, if countries would otherwise have switched to a more outward-oriented strategy, the Andean Group may well be regarded as on balance detrimental, since by opening up new avenues for regional import substitution it delays this shift of emphasis for another ten or twenty years. I agree with Diaz-Alejandro (1970) in tending to believe that the former assumption is probably the more realistic one.[2]

Prospective benefits from integration

1. Effects on existing industries

Some writers have argued that only relatively minor gains may be expected from liberating trade in traditional products among less developed countries, because the potential costs in terms of dislocation of existing industries to a large extent offset the potential benefits from increased competition and specialization, longer production runs, and lower prices to consumers.[3] On closer examination, however, at least in the context of the Andean Group and probably in other less developed areas as well, the foundations upon which this argument rests do not appear to be sound.[4]

The gains from freeing trade in existing industries in an integration scheme are likely to be greater the more actually similar but potentially different are member countries' industrial structures, the more stringent are pre-union restrictions on trade (tariffs, import licenses, etc.), and the more divergent are production costs for similar goods in different countries.[5] Let us examine these three conditions in the context of the Andean Group. First. Andean industrial structures are currently relatively similar; for example, all countries are relatively self-sufficient in light consumer goods, having diverted trade from foreign suppliers to domestic producers some time ago. The proportions of direct and indirect national value added in particular sectors of the Chilean economy correspond closely to those in Colombia and Peru; rank correlations using a 23 sector breakdown for these three countries are all significant at the six per cent level or better.[6] At the same time, the Andean economies are potentially complementary because there is as yet little intra-sector specialization -- this will be discussed shortly. Second, pre-union tariffs and other barriers to trade are high in the Andean Group, tariffs alone averaging from 50 per cent (Bolivia) to 170 per cent (Chile). Tariffs on products of existing industries are particularly high; in Chile the average pre-union tariffs on beverages, clothing and footwear, food products, textiles and wood products are 388, 283, 268, 190 and 172 per cent respectively. Import licensing, exchange controls and prior deposits are in force in several Andean countries. Third, the sketchy data that are available indicate that prices of similar products vary by as much as 100 per cent from country to country.[7] It seems, then, that intra-Andean trade has been kept at less than 5 per cent of total trade by tariffs and import licensing rather than by any lack of profitable possibilities for commercial interchange. This is illustrated by the existence of significant amounts of smuggling along several Andean borders, including those between Colombia and Ecuador, Colombia and Peru, Peru and Bolivia, and Colombia and Venezuela. While part of this smuggling deals with non-Andean goods, a significant part handles Andean textiles and other consumer goods.[8]

The theory of intra-sector specialization and experience in other integration schemes suggest that the disruption caused by trade liberation may well be relatively unimportant. Assume for a moment that tariffs are removed for intra-Andean trade in textiles, footwear and woolen clothing, all labor-intensive industries. It might now be feared that textiles would soon be produced only in Colombia, footwear only in Chile and woolen clothing only in Ecuador if these are the most efficient producers of the three products respectively.[9] This might be a reasonable expectation if "textiles," "footwear" and "woolen clothing" were homogeneous products. But of course they are not. There are more than three hundred different seven digit "items" under textiles in the NABALALC tariff classification, and over one hundred under footwear and woolen clothing. Furthermore, each "item" is composed of many, even hundreds, of sub-items or products. For example, "exterior clothing for men and children" is a single seven digit "item". Therefore, instead of one country dominating the whole heterogeneous sector "textiles" ("footwear", "woolen clothing") it is more likely that intra-sector specialization would occur, each country specializing in particular sub-items within each sector.

Such intra-sector specialization did in fact occur after trade was liberated in the Central American and European Common Markets.[10] On the aggregate level, studies by Balassa (1966) for Europe and Willmore (1972) for Central America indicate that in both Common Markets the degree of intra-sector specialization in each member country increased significantly after, and probably as a result of, the lowering of intra-union barriers to trade in existing industries.[11] There are no examples of declining manufacturing industries in any of the countries, nor was there a wave of bankruptcies. Indeed, in Europe the number of bankruptcies has fallen since the establishment of the Common Market.

Evidence at a more disaggregated level supports and illustrates these findings in both Common Markets. For example, in Central American clothing production (see Table 1) Guatemala has specialized in and exports synthetic stockings and knitted clothing of synthetic fibres, El Salvador exports cotton stockings, women's interior clothing and men's and children's hats not of felt or asbestos, Costa Rica is the second exporter of synthetic stockings and women's interior clothing and the main exporter of synthetic underclothing and pyjamas, and Honduras is the second exporter of synthetic underclothing and pyjamas. The pattern is similar in shoes, textiles and processed food products. There are factories producing men's leather shoes in El Salvador, men's plastic shoes in Honduras, and women's shoes in Nicaragua; plants specializing in different types of cotton textiles in El Salvador and Guatemala; a biscuit bakery in Costa Rica and a candy factory in Guatemala, and so on.[12] In Europe intra-sector specilization has occurred even in such relatively homogeneous commodities as steel and pulp and paper (Tables 2 and 3), and in labor-intensive commodities of interest to the Andean Group such as leather footwear, textiles and clothing (Tables 4 and 5).[13]

2. Effects on new industries

The main effect of liberating trade in new industries in the Andean Group is to increase the size of the "domestic" market, enabling plants of more economical size to be built and economies of scale to be more fully utilized. Economies of scale may be obtained through the construction of larger plants to produce a single product (economies of scale in the traditional sense), through reducing product variety

Table 1
Intra-industry specialization in the clothing, footwear and processed foods industries, Central American Common Market, 1965

Item Description	Volume of 1965 intra-CACM trade (thousands of CA pesos)	Percentage of intra-CACM imports accounted for by major supplying country or countries
Clothing		
Women's Stockings, synthetic fiber	599.5	64.4 - Guatemala 34.4 - Costa Rica
Stockings, cotton	188.9	77.5 - El Salvador
Clothing (orlon), knit of synthetic fiber	604.7	70.3 - Guatemala
Underclothing and pajamas (excluding knit) of synthetic fiber	393.1	45.2 - Costa Rica 30.4 - Honduras
Hats (excluding felt or asbestos) for men and children	354.8	81.8 - El Salvador
Women's brassieres, corsets and similar articles	513.8	43.1 - El Salvador 35.5 - Costa Rica
Footwear		
Sport shoes, leather	2,302.3	59.3 - El Salvador
Sport Shoes, cloth	749.7	42.7 - Guatemala 39.6 - Nicaragua
Shoes of plastic materials (excluding house slippers)	1,166.2	45.0 - Nicaragua 25.6 - El Salvador
Processed foods		
Chiclets and gums	1,655.3	95.7 - Guatemala
Chocolates and preparation	266.7	72.2 - Costa Rica
Toasted wheats, oatmeal and related preparations (including breakfast foods)	949.7	91.1 - Nicaragua
Biscuits	1,022.1	65.1 - Costa Rica

Source: Data from the International Bank for Reconstruction and Development.

Note: One C.A. peso = one U.S. dollar.

Table 2

Intra-industry specialization in the steel industry, European Economic Community, 1952-66

Steel products in which particular countries have specialized

Belgium-Luxembourg:	hot strips, bands.
France	: rolled wire.
Germany	: non-coated plates of 3 mm. or more.
Italy	: tin plate; transformer and dynamo plate.
Netherlands	: tin plate; non-coated plates of less than 3 mm.

Products in which no single country specialized: railroad rails, heavy sections, wide flats, and bar steel.

Source: Michael Adler, "Specialization in the European Coal and Steel Community", Journal of Common Market Studies, VIII, 3, March 1970, Table IV and p. 189.

Table 3

Intra-industry specialization in the paper and board industry, European Economic Community, 1969

	Thousands of metric tons						Per cent		
	Production	Exports to EEC countries	Imports from EEC countries	Total exports	Total imports	Apparent consumption =1+5-4	Production as % of apparent consumption	Exports as % of imports	$\frac{\lvert X-M \rvert}{X+M} = \lvert 4-5 \rvert / 4+5$
	1	2	3	4	5	6	7	8	9
BelgLux	723	281	293	332	644	1,034	69.9	51.6	32.0
France	3,997	216	281	318	986	4,666	85.7	32.3	51.2
Germany	5,181	326	524	461	2,733	7,453	69.5	16.9	71.1
Italy	3,438	98	56	264	373	3,547	96.9	70.8	17.1
Netherlands	1,608	477	243	595	747	1,760	91.4	79.7	11.3
Total	14,947	1,397	1,397	1,970	5,483	18,460	81.0	35.9	47.1

Source: OECD, The Pulp and Paper Industry in the OECD Member Countries, 1969-70, OECD, Paris, no date. Table 2 of text and Appendix Table 48.

Table 4

Intra-industry specialization in the leather footwear industry, European Economic Community, 1968

	Production	Exports to EEC countries	Imports from EEC countries	Total exports	Total imports	Apparent consumption =1+5-4	Value of total exports	Value of total imports	Production as % of apparent consumption	Exports as % of imports	$\frac{\lvert X-M \rvert}{X+M}$ =|7-8|/7+8
	Thousands of Pairs						Thousands of U.S. dollars		Per cent		
	1	2	3	4	5	6	7	8	9	10	11
BelgLux	11,835	1,841	9,982	2,633	10,692	19,889	12,414	38,453	59.5	32.3	51.2
France	124,000	7,718	8,852	19,037	9,540	114,503	70,276	42,391	108.3	165.8	24.7
Germany	119,146	3,741	40,083	10,584	43,867	152,429	53,710	135,540	78.2	39.6	43.2
Italy	227,000	55,543	314	137,846	997	90,151	418,071	2,377	251.8	17,588.2	98.9
Netherlands	22,756	3,108	8,612	4,864	9,422	27,314	18,768	33,742	83.3	55.6	28.5
Total	504,737	71,951	67,843	174,969	74.518	404,286	573,239	252,503	124.8	227.0	38.8

Source: OECD, The Hides, Skins and Footwear Industry in OECD Countries: 1968-69 Statistics, Paris, 1970, Table 15, and Annex III, Table 1.

Table 5

Intra-industry specialization in manufactured textile goods and clothing, European Economic Community, 1968

	Textiles				Clothing			
	Thousands of U.S. dollars		Per cent		Thousands of U.S. dollars		Per cent	
	Total Exports	Total Imports	Exports as % of Imports	$\frac{\lvert X-M \rvert}{X+M} = \frac{\lvert 1-2 \rvert}{1+2}$	Total Exports	Total Imports	Exports as % of Imports	$\frac{\lvert X-M \rvert}{X+M} = \frac{\lvert 5-6 \rvert}{5+6}$
	1	2	3	4	5	6	7	8
BLEU	714,400	353,200	202.3	33.8	188,100	142,800	131.7	13.7
France	760,900	418,100	182.0	29.1	294,700	174,900	168.5	25.5
Germany	1,000,600	1,089,700	91.8	4.3	313,300	539,400	58.1	26.5
Italy	785,200	225,400	348.4	55.4	618,500	51,900	1,191.7	84.5
Netherlands	557,100	541,100	102.9	1.5	114,900	318,600	36.1	47.0
Total	3,818,200	2,627,500	145.3	18.5	1,529,500	1,227,600	124.6	10.9

Source: OECD, Textile Industry in OECD Countries 1968-69, Paris 1970. Tables 24, 37.

in individual plants (horizontal specialization), and through the manufacture of parts, components, and accessories of a particular product in separate establishments (vertical specialization).[14] The first type of economies of scale is particularly important in heavy industry -- steel, chemicals and petrochemicals, petroleum refining, electric power, pulp and paper. Production of steel ingots in a plant with annual capacity of 500,000 tons costs 18 per cent more, and in a plant with 250,000 tons capacity 33 per cent more, than in a plant producing one million tons per year. No Latin American country has a steel plant of optimum size, and only in Brazil and Mexico does total national steel production exceed one million tons per year. Compared to optimum size mills of 200 tons a day capacity, the cost of producing pulp and paper increases by one-fourth in mills producing 100 tons per day, and by two-thirds in mills producing 50 tons. Most Latin American mills have a daily output of 50 tons or less. In petrochemicals a large plant twice the size of a small one costs only 50 per cent more to build, and uses only 15 per cent more labor. Colombian petrochemicals plants are on average one-fifth of normal world size.[15]

Horizontal specialization, or reduction of the number of different products produced in a single plant, may be important in new industries, such as machine tools and shipbuilding as well as in textiles, clothing and footwear. It enables lengthening of production runs, use of more specialized machinery, and increases in efficiency. To give one example, prior to the formation of the Central American Common Market a North American pharmacuetical company maintained plants in all five countries, producing small amounts of drugs and medicines for the domestic markets. Since the removal of intra-area tariffs the firm has found it profitable to continue operations in all five plants, producing a different line of products in each plant and shipping throughout Central America.[16] Vertical specialization may be important in industries producing durable consumer goods, machinery and transport equipment. In the Andean Group potential gains from vertical specialization are particularly great in automobile production, where the interchange of parts, components and accessories has hitherto been limited.

Limitations on the potential success of integration

The first fundamental factor limiting the potential succes of the Andean Group is its small economic size. Chile, Colombia, Peru, Ecuador and Bolivia have a combined gross domestic product approximately equal to that of Argentina. With Venezuela included the Group's economic size rises to a little less than that of Brazil or Mexico, but it is still less than half that of Italy, less than one-tenth that of the original six members of the European Economic Community, and less than one-twentieth that of the United States. This places significant limits on the scope for efficient regional import substitution.

Second, transport and communications in the Andean Group are underdeveloped and costly. Because of the ruggedness of the terrain and the large distances between population centers, overland access between the Andean countries is poor, and ninety-nine per cent of all goods traded between member countries are carried by sea. Because of the long distances involved, high intra-country transport costs and high Andean port charges, the cost of shipping an average bundle of goods between Andean capital cities is up to seven times greater than similar costs within the European Economic Community (E.E.C.). A three-minute telephone call from Bogota to the other Andean capitals is much more time-consuming to place, and costs four to eight times more than similar calls between E.E.C. cities. "Same-day" business trips between Andean cities are in many cases not possible because of long flying times or infrequent services; where they are feasible they are two to three times as expensive as similar trips between E.E.C. cities.[17]

Third, partly because of these transport and communications problems, information concerning product costs and prices in one country are not freely available in other countries. Since there has historically been little need to gather and exchange information the institutional and other channels for such interchanges are under-developed.

Finally, despite many similarities between the Andean countries, the subregion is far from homogeneous. Income per head in Chile is three times that in Bolivia. Chile and Colombia are significantly more industrialized than Bolivia and Ecuador. Chilean rates of inflation averaged over 25 per cent in the 1960's, compared with rates of 5 to 10 per cent in Colombia and Peru and less than 5 per cent in Bolivia and Ecuador. On the political front, at time of writing in 1972 Chile and Peru both have socialist-oriented governments, Colombia and Ecuador have conservative-capitalist governments, and the Bolivian government recently changed from far left to right of center. The disparities in level of development between the richer and poorer members could well lead to problems in the distribution of benefits within the union, particularly if "backwash" should begin to occur.[18] At the same time, the marked differences in political orientation between member governments raise a series of difficult questions. Is it possible for a country in which the state dominates the industrial and foreign trade sectors to integrate successfully with an essentially private enterprise economy? How should disputes over "hidden production subsidies" be dealt with?[19] What is the meaning of a "common" external tariff if a state trading agency does most of one country's buying and selling? Can such an agency be required to pay tariffs or to behave "as if" it paid tariffs?[20] The answers to these and similar questions will have a large bearing on the potential success of the Andean group.

Outstanding issues to be resolved

Several key issues which must be resolved during the first five or ten years of the operation of the Andean Group will largely determine the extent to which it is able to realize its potential as an integration scheme. They cover the following areas: common external tariff, trade liberation, exchange rate policies, allocation of new industry, foreign private investment, Andean Development Corporation, and Venezuelan entry.

1. Common external tariff

The Cartagena Agreement lays down that the Andean common external tariff must be agreed upon by 1975 and implemented by 1980, but says little about its average height or structure. If the common external tariff resembles prior national tariff structures (which are high and grant significantly different nominal and effective protection to different activities) the bias towards import substitution is likely to continue since export subsidies or a magnitude sufficient to offset this bias are unlikely to be introduced. On the other hand, should a low, relatively uniform common external tariff be adopted this bias towards import substitution may be corrected. In the negotiations over the common minimum external tariff, Chile and to a lesser extent Colombia argued for relatively high tariffs to protect their more complex manufactured products, but they were opposed by Bolivia, Ecuador and to a lesser extent Peru, who recognized that under such a system they would be paying implicit income transfers to their more developed partners.[21] The Junta of the Cartagena Agreement apparently favors relatively low and uniform tariffs, but to date it has not felt able to take a strong stand on the issue. The common minimum external tariff which was finally agreed upon in December 1970 is lower and less varied than prior national tariff structures, but it is doubtful whether it is low enough to swing emphasis away from import substitution. It is difficult to predict the height and structure of the common external tariff which will finally be agreed upon.[22]

2. Trade liberation

Under the Cartagena Agreement intra-Andean tariffs on most products are to be gradually reduced to zero over a ten-year period beginning in 1970. However, each country is permitted to protect some of its domestic producers from sub-regional competition by placing a certain number of seven digit "items" on its national "list of exceptions"; these lists remain in force until 1985. Colombia and Chile are each allowed to except 250 items, Peru 450, Ecuador 600 and Bolivia 350 items plus 50 (five digit) sub-positions. Some 1,000 of the total of 5,850 tariff items appear on one or more of the five exceptions lists presented to the Junta in December 1970. Unfortunately, these 1,000 items include many if not most of the currently produced products having greatest potential for trade expansion in the Andean Group -- textiles, clothing, footwear, wooden furniture, glass products, etc. Although some items appear to have been included at the last minute as a bargaining stratagem, many items were placed on lists of exceptions because of fears that a lowering of tariffs would force domestic producers out of business.[23] In several important cases these fears were inconsistent; for example, nine textile items and two items covering all cotton outer clothing for men and children appeared on all five lists (Table 6). Furthermore, as we saw above, trade liberalization in traditional products

Table 6

Some important textile and clothing items appearing on five Andean national lists of products to be excepted from trade liberation, December 1970

Textiles	
51.04.1.99	Other textiles of synthetic fibers
51.04.2.99	Other textiles of artificial fibers
55.09.0.01	Other textiles of unbleached cotton
55.09.0.99	Other cotton textiles
56.05.1.01	Yarns of unprocessed synthetic fibers for retail sale, of polymers
56.05.1.02	Yarns of unprocessed synthetic fibers for retail sale, of polyester
56.05.2.01	Yarns of unprocessed synthetic fibers for retail sale, of viscose
56.07.0.01	Textiles of discontinuous synthetic fibers
56.07.0.02	Textiles of discontinuous artificial fibers
Clothing	
61.01.0.01	Exterior clothing for men and children, cotton
61.01.0.99	Exterior clothing for men and children, not of cotton

Source: INCOMEX, *Lista consolidada de excepciones de los paises del Grupo Andino*, Bogota, mimeo, 1971.

is likely to be followed by intra- rather than inter-sector specialization, with correspondingly less likelihood of large-scale disruption of industry. Hence, unless negotiations are held to remove some of the more important items from exceptions lists, one of the most important potential benefits from integration will have been lost. Despite the fact that such negotiations are not explicitly provided for in the Cartagena Agreement, it is almost certainly within the Junta's powers to take the first step in sponsoring them.

3. Exchange rate policies

The Cartagena Agreement states broadly that "exchange, monetary, financial and fiscal policies" shall be harmonized, but does not specify how or when this should be done. There are at least two possible interpretations of exchange rate harmonization. First, as in the European Economic Community there may be agreement to maintain fixed exchange rates and to consult with other union members when a parity change is desired ("no-devaluation-without-consultation"). Second, there may be agreement that each country will adopt a crawling peg system, and will devalue pari passu with its own rate of inflation on a week-by-week basis, consulting with other members if it desires a faster or slower rate of devaluation ("devaluation-in-step-with-inflation"). The existence of significantly different rates of inflation between Andean countries (Chile over 25 per cent, Colombia 5 to 10 per cent in the 1960's) and in particular countries at different points of time (Colombia 5 to 8 per cent from 1968 to 1970, over 15 per cent in 1971) make harmonization of the "no-devaluation-without-consultation" type undesirable in the Andean Group. Indeed, if such a policy were adopted, it is conceivable that Colombia's loss from being forced to abandon its crawling peg system could be so great as to outweigh its other gains from participation in the Andean Group. This could cause Colombia to consider withdrawal, which would threaten the whole structure of the union. On the other hand, should harmonization of the "devaluation-in-step-with-inflation" type be adopted the potential gains to all members are great. In either case, the period of the 1970's should be one of greatly increased exchange rate flexibility, since during the transition period tariffs and the degree of overvaluation of exchange rates will change significantly in at least some countries. Failure to introduce such flexibility would lead to the emergence of balance of paymnets problems, which could put intolerable stresses on the union.[24]

4. Allocation of new industry

At the December 1970 Andean Group meetings in Lima, about 30 per cent of all products were set aside("programmed") for allocation among member countries by means of intergovernmental negotiation. Several important sets of decisions which have yet to be made will determine the economic consequences of this industrial allocation arrangement for the Andean Group. First, common external tariff rates have to be established on programmed industries. If these tariffs are set in conjunction with tariffs on all other commodities, and if they are on average low and relatively uniform, mistakes in allocating industries may not have serious consequences. (Some mistakes must inevitably occur given the lack of data on which to base decisions). On the other hand, if the protection granted to allocated industries is relatively high, the costs to Andean consumers, industrial users, and indirectly to workers[25] could be significant. Further, distributional problems could arise if the average tariff protection granted to one country's allocated industries differs significantly from that granted to others. Second, a decision must be made on whether to continue allocating industries in single-industry packages, as hitherto, or to switch to considering several industries as part of one package. Adopting the latter approach would enable a more rational allocation of industry. For example, instead of each country being allocated an undersized petrochemicals plant, all petrochemicals production could be allocated to one or two countries,with the other countries being given other products. Third, the length of time taken by the negotiations will be important. If they are allowed to drag on for years and years some plants could well become obsolete before they are allocated, and the entire allocation scheme could become a dead letter as did a similar Central American scheme during the 1960's.[26]

5. Foreign private investment

At the Lima meetings in December 1970 the Andean countries agreed (Decision 24) to adopt a common attitude towards foreign investment. All new foreign investors must commit themselves to place on sale for acquisition by national investors 51 per cent of their shares within fifteen years. The impact of this provision on new foreign invstment flows has yet to be seen, and could have important implications for the future of the Andean Group. For example, should new foreign private investment in Colombia fall substantially the Colombian government may be tempted to take a relatively broad view of the escape clauses incorporated in Decision 24, which in turn would be likely to annoy the Chileans and Peruvians, who took a relatively hard line against foreign private investment in the early Andean negotiations.[27]

6. Andean Development Corporation

The Andean Development Corporation was established to encourage the creation and modernization of multi-national enterprises, and to provide a channel for extra funds which are attracted by integration. If it is able to attract funds which would not otherwise have been available, and if it uses its resources judiciously to promote distributional goals as well as growth, the Corporation could play a significant role in the integration process. It is too early to know whether this is likely to happen.

7. Venezuelan entry

Finally, the question of Venezuelan entry to the Andean Group and the terms on which such entry may be made remain to be decided. Venezuelan entry would enable greater utilization of economies of scale, and increased specialization and competition. Venezuela itself would be enabled to decrease its dependence on petroleum, which accounted for over 90 per cent of total exports in the late 1960's; iron was 5 per cent and all other goods accounted for only 3 per cent. In particular, it would secure a market for its young but ambitious petrochemical complexes, its growing steel industry, its aluminum, and possibly its hydroelectric potential. The main opposition to Venezuelan entry hitherto has come from groups of Venezuelan businessmen who fear that they would be unable to compete with other Andean countries in labor-intensive industries. To the extent that their apparent cost disadvantages are a reflection of Venezuela's oil-export-based exchange rate rather than protectionist-induced inefficiency, this is a real problem. It may be necessary to adjust the multiple exchange rate system to solve it satisfactorily.

Summary and conclusions

The Andean Group integration scheme is no panacea for its members' economic problems. Formation of the union may even be regarded as on balance detrimental if governments would have been forced to move to more outward-oriented policies in its absence. On the other hand, if (as seems more likely) governments would have continued to follow policies of national import substitution, the Group has considerable potential for being on balance beneficial. Contrary to the suggestions of several writers, liberating trade in existing industries could yield important benefits: increased competition, intra-sector specialization, introduction of more specialized machinery, lengthening of production runs, and lowering of prices to consumers.

Integration should enable new industries to be established in a more rational manner, with greater advantage being taken of economies of scale. Key factors limiting the potential succes of integration are the small aggregate economic size of the Group, underdeveloped and costly transport and communications, lack of information concerning one country's costs and prices in other countries, differences in levels of development and per capita income between members (which could lead to problems in equitably distributing the gains from union) and differences in the political and social orientation of member governments (which could lead to friction over the implementation of the common external tariff and disputes over hidden production subsidies). Several key issues have still to be resolved in the Andean Group. The areas they cover include the height and structure of the Andean common external tariff; the extent to which important products of existing industries are removed from national lists of items to be excepted from trade liberation; the amount of flexibility that is introduced into exchange rate policies during the period of transition to union and the type of harmonization of exchange rates (if any) that is adopted after this period is over; the procedures to be followed in allocating new industries among members; the reactions of foreign investors to the common Andean code on foreign private investment and the effects of these reactions on the policies of Andean governments; the performance of the Andean Development Corporation; and the prospects for Venezuelan entry into the Group.

Decisions on these issues will play a major role in determining the extent to which the Andean Group is able to realize its potential as an integration scheme.

Footnotes

1. For example, between 1958 and 1967 in Colombia investments in "derivatives of petroleum and coal" (petrochemicals and petroleum refining) amounted to over 200 million dollars, but the number of persons employed in that sector actually declined by over 300. (DANE, 1970, pp. 141, 166). Petrochemicals also performed poorly in terms of foreign exchange saved and earned, degree of international competitiveness, and value of output compared with potential investments in more labor-intensive industries, Morawetz (1972c)

2. Diaz-Alejandro (1970, p. 14) states:

   > "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."

3. See for example Cooper and Massell (1965) and Mead (1968).

4. This point has been recognized by Balassa (1971) and Diaz-Alejandro (1970).

5. Meade (1955), Lipsey (1960).

6. Morawetz (1972c)

7. Price data do not necessarily reflect costs since they may be biased by different tax systems, profit rates and degress of exchange rate overvaluation. See Bacha (1970) and Diaz-Alejandro (1970).

8. Diaz-Alejandro (1970). Smuggled Ecuadorean woolen ruanas are peddled openly and in considerable quantities on the streets of Bogota.

9. Many textile, footwear and wolen clothing items appear on four of the five national .ists of products to be excepted from trade liberation, reflecting such fears.

10. Intra-industry specialization like that which occurred in the European Common Market as a whole also occurred within Belgium-Luxemburg after formation of the Benelux customs union. See P.J. Verdoorn, "The Intra-Bloc Trade of Benelux," cited by Balassa (1966, p. 470, no. 6).

11. Balassa (1966) and following him Willmore (1972) use two methods to measure the degree of intra-industry specialization. First, they use rank correlation coefficients to estimate the increasing or decreasing uniformity of members' export pattersn. Second, they calculate the following formula for each member country:

$$Z = \frac{1}{n} \Sigma \frac{|X_i - M_i|}{X_i + M_i}$$

where X_i and M_i refer to the intra-union exports and imports of commodity category i, and n is the number of the commodity categories considered (91 in Europe, 59 in Central America). Inter-industry specialization yields Z close to unity, since a country would either export or import any given commodity. By contrast in the case of intra-industry specialization Z would tend towards zero, since exports and imports would tend toward equality within each category.

12. This specialization has often been based on the availability of entrepreneurial skills at particular locations rather than on more traditionally comparative advantage factors.

13. Note that even Italy, one of the world's largest exporters of textiles and clothing specializes in particular lines, and imports over 275 million dollars worth of these items annually. In Latin America clothing and textile imports are usually less than 1 per cent of domestic consumption, and exports are almost non-existent.

On the basis of the evidence presented in the text, it seems reasonable to assume that any disruption caused by the removal of barriers to trade in existing industries in the Andean Group would be relatively minor. Furthermore, intra-Andean tariffs are to be reduced gradually over a ten year period, allowing businessmen sufficient time to adjust. Nevertheless, at least a few firms will inevitably be forced to close as a result of trade liberalization. It may be desirable for the Andean Development Corporation to establish a compensation fund in order to equitably distribute the burden of adjustment in such cases.

14. Except where otherwise indicated, the discussion of economies of scale that follows draws on Balassa (1971), whose sources include ECLA, A Study of the Iron and Steel Industry in Latin America, and ECLA, Programming Data and Criteria for the Pulp and Paper Industry.

15. "Petrochemicals: A Survey", The Economist, Oct. 3, 1970, p. 14; and Morawetz (1972e).

16. Hansen (1967, p. 43).

17. For a detailed analysis of Andean transport and communications problems see Morawetz (1972b).

18. For a detailed analysis of the benefit distribution problems which may be expected to arise in the Andean Group see Morawetz (1972d). The recent discovery of oil in Ecuador, which post-dates the drafting of the Cartagena Greement, has led some Colombian political figures to argue that the Agreement should be renegotiated to take account of Ecuador's improved economic prospects.

19. Such hidden or indirect subsidies may exist not only in state-controlled enterprises but also in private firms. The largest Colombian steel-producing enterprise, now a fully private concern, sells its output at little above world prices and is able to make positive profits even though its plant is significantly smaller than optimal size. This is apparently possible because a large part of the firm's capital costs were financed by the obligatory purchase by all Colombian taxpayers of shares which yielded no return for more than a decade -- an "indirect" subsidy.

20. State trading agencies in countries both within and outside the Communist bloc have taken political considerations into account in their choice of trading partners. For example,

> Egypt's trade with Iraq has fluctuated in direct proportion to the temperature of relations between the two countries. The recent sale to Iraq of fifty buses built by the Nasr company in Egypt was as much a demonstration of Iraqi-Egyptian unity as a commercial transaction ... It is no accident that Egyptian exports to Algeria rose from Ŀ 29,000 in 1962 to Ŀ 875,000 in 1963, the first full year of independence, and to Tunisia from Ŀ 84,000 in 1962 to Ŀ 385,000 in 1963 when President Nasser and President Bourgiba were reconciled after a long period of estrangement. (Mansfield 1969, pp. 169-70)

21. I have argued elsewhere that the negotiations to determine the common minimum external tariff appear to have been used as a "dry run" for the common external tariff negotiations (Morawetz 1972c).

22. For a more detailed analysis of the Andean common external tariff see Morawetz (1972c).

23. It is worth noting that Costa Rica, Honduras and Nicaragua expressed similar fears before the liberation of trade in Central America, and have since been proved wrong. In Europe, France, Italy, Germany and Luxemburg all expressed fears that they would not be able to survive competition in the European Coal and Steel Community, but again all have been proved wrong, as is shown by Table 2 (Adler 1970).

24. The arguments of this section are developed more fully and rigorously in Morawetz (1971).

25. A high cost producer of intermediate goods creates indirect unemployment in industries using its product as an input. For example, despite the fact that U.S. textile quotas apply far more strictly to cotton than to synthetic textiles, Colombia exported only cotton textiles to the U.S. in the late 1960's. This was because Colombian textile manufacturers were forced to purchase their synthetic fibers at twice world prices from high-profit highly protected Colombian subsidiaries of European synthetic fiber manufacturers. These companies in turn had to buy their inputs from Colombian petrochemicals producers, whose prices were often twice world prices because their plants were on average one-fifth of world size and because imports of many petrochemical products were prohibited. The resulting "indirect unemployment" in the Colombian synthetic textile industry may be regarded as a direct result of the excessive protection granted to petrochemicals and synthetic fiber producers (Morawetz 1972e).

26. The Andean industrial allocation scheme is analyzed in detail in Morawetz (1972d).

27. The full text of Decision 24 is reproduced in full in Morawetz (1972a).

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