

Andean Competitiveness at a Glance

Summary and Introduction

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Background paper examining the state of the Andean region for the
Andean Competitiveness Project

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The global economy offers new opportunities for rapid economic growth but also risks of serious economic failures. Success depends on a sound development strategy that enhances a country's economic competitiveness. Critical elements in the design of this strategy are the formulation and execution of sensible, forward-looking policies; the establishment and strengthening of functioning institutions; and the efficient use of human and physical resources. The Andean countries are at a stage in their development where a new strategy needs to be devised for successful competition in international markets.

The Andean countries are among the most richly endowed in terms of natural resources, but at the same time they are also extremely exposed to natural disasters, as shown by recent events in Ecuador, Peru, and Venezuela. They are also among the worst-performing countries in terms of economic development and growth, both recently and in retrospective. On top of that, they exhibit large disparities in income distribution, something that they share with the rest of Latin America as a very worrisome characteristic.

The prevailing forms of production and competition in the Andean region are inadequate for the 21st century. Exports are heavily concentrated on products that embody an abundance of natural resources, much of the labor force still has very low educational qualifications and savings and capital accumulation have been low by international standards. Home-grown science and technology play very little role in the economic process. And none of the economies is adequately part of the new information technology revolution. These characteristics are not conducive to dynamic economic growth in the modern knowledge-based economy. The reliance on primary products and traditional production methods also threatens the physical environment in much of the region, and thereby the sustainability of development for future generations. Some of the countries in the region are in an acute economic crisis, where there is little doubt about the need for a new strategy. Even in the relatively more dynamic economies of Bolivia and Peru, however, the evidence suggests the need for changes to enhance competitiveness with the rest of the world.

The purpose of the Andean Competitiveness Project is to find some key areas of intervention for these countries to strengthen their competitive position so they can break away from the vicious circle of slow growth and instability, and move into a sustainable path of continuous growth and social progress. Recent experience shows that these countries can produce this kind of change. Just a few years ago Bolivia was a paramount case of instability and economic deterioration. After little more than a decade it ranks among the most stable countries in the region and has experienced continuous—albeit slow—growth.

This paper attempts to set a reference point at the onset of the project. It is an outside view of how these countries stand today as compared to other Latin American countries, other developing countries, and the rest of the world in general, in areas that are considered critical for the competitiveness of the

¹ This paper draws heavily on the background papers prepared for the Andean Competitiveness Project. Larry Rosenberg and Matías Braun made very helpful comments and suggestions on earlier versions. The authors are solely responsible for remaining errors and omissions.

region. Some of these characteristics are given—a very dramatic geography, for instance—and we can think only in terms of policies to overcome the challenges they pose. Others must be addressed over the long term—education is the most evident—but policies must be put in place today so that current and future generations can have an opportunity for better performance. Many of the region's characteristics, however, can and must be addressed in the short term with a reasonable hope that we might observe positive results in a not-so-distant future.

1. GEOGRAPHY AND NATURE

As John Gallup explains in his paper, one clearly dominant feature of these countries, which sets them apart from any other group of countries, is their unique geographic situation. These are rugged, very fragmented countries, with at least three clearly defined zones in each of them: the coastal range, with a large population and a tropical climate; the highlands, with difficult access and also a large human presence; and the Amazon rain forest, sparsely populated and with very few connections to the outside world.

The populations in the three regions have different ethnic backgrounds: in the coastal range most of the people have Spanish or African ancestors, while in the "Sierra" the descendants of the aboriginal tribes are dominant, with very little mingling with the other races. Finally, in the jungle there are the indigenous groups, along with a few settlements of people from the rest of the country. But not only mountains are a cause of isolation: Bolivia's problems are made worse by being landlocked.

Geography has significant effects in a range of economic dimensions. It has a direct impact on economic performance of the agricultural sector, with tropical yields growth being significantly lower than non-tropical yields. Latitude also has a significant correlation with incidence of disease, with the Andean countries faring worse than otherwise comparable countries.

The Spanish language is common to all five countries, but within the countries, several large indigenous groups maintain their native languages, and many of them are illiterate in Spanish. Geographical barriers within the region contribute to the continuing isolation of non-Spanish-speaking ethnic groups.

The development of adequate infrastructure for transportation and communications is essential for overcoming the challenges posed by the region's difficult geography. However, the available indicators show that transportation infrastructure is very weak. Even worse, as Geoffrey Kirkman points out in his paper, the region lags well behind in the basic infrastructure needed to take advantage of the revolutionary innovations in information technologies that might help to compensate for part of these problems.

The economic history of these countries has been marked by the "colonization" of wild areas in favor of more agricultural land, on one hand, and by the exploitation of primary resources like timber, fish, minerals, and oil. As Jeffrey Sachs and Matías Braun show, in 1996 the Andean region relied on its primary resource base to generate about 86% of its exports earnings, which is by far the largest fraction for any given group of countries, with the exception of some of the Gulf states.

2. GOVERNANCE

The five countries also share a common heritage of being former colonies of Spain, gaining their independence early in the 19th century. In all cases, though, independence failed to bring political stability. A long history of infighting followed, with military and civilian "caudillos" playing a predominant

role. Economic life evolved around a few activities like agriculture and exportable commodities like minerals and other raw materials. Within very poor countries, exploitation of these natural resources was at the origin of considerable large private fortunes. When the tax collection system allowed it, governments were able to share in part of those rents and used them to provide services or jobs, with a very high rate of leakage to unwanted purposes.

Rent-seeking behavior has been a trademark of these countries, starting early in Colonial times, when access to wealth and slaves was granted by the Spanish Crown.

Institutions in these countries have been generally weak and susceptible to capture by special interests. This has resulted in widespread disillusionment with traditional politics and has made the banner of "anti-corruption" quite popular, playing into the hand of many "caudillos" in the past. During the hard times of the last decade this characteristic had a debilitating influence on the traditional parties in almost all the countries of the region.

As Rachel McCleary shows in her paper, the Andean countries rank low in almost all traditional indicators of governance. However, the countries' performance has diverged in recent years, with significant progress in Bolivia and some in Peru, but a marked deterioration in Colombia and Ecuador. Rule of law is generally perceived as weak and somewhat skewed; several countries have embarked on ambitious reforms of their judiciary systems, trying to make them more agile and independent.

Traditional problems of governance have been made worse by the widespread influence that coca production and drug smuggling have had over a range of activities in these countries. Attempts by governments to restore the rule of law have been met with armed responses by the cartels, and violence has risen to very high levels, especially in Colombia, where the presence of guerrilla and paramilitary groups makes the situation even more complex.

3. MACROECONOMICS AND TRADE

Almost all of the Andean countries embraced inward-looking, closed-economy strategies after the great crisis of the 1930s. Government played a strong role, not only in traditional areas like education and health services, but also in infrastructure and even basic industries. Although at the beginning this new path led to economic growth, it also increased dependence on natural resources as a result of overvalued currencies and the high cost of capital and industrial inputs. By the mid seventies or early eighties, productivity growth stagnated or even declined in all major Latin American Countries (Thorp, 1998).

The import substitution era was heavily marked by the distortions introduced by regulations and privileges granted to special interest groups through import licenses, access to subsidized credit, tax regimes, and even through generous price controls.

The expanding economic role of government was a source of continuous and growing pressure on very weak public finances; the fiscal sector became a major source of economic instability. Rising tensions and severe economic crisis followed the inability of successive governments to cope with foreign exchange instability and rising fiscal deficits. Economic performance as a whole deteriorated. In fact, this group of countries ranks as one of the worst performing in the last three decades. As Sachs and Braun show, per-capita output of these countries has grown less than the Advanced Countries, Asia, all other Developing Countries as a whole, and even less than the Rest of Latin America. There are also very worrisome signs of economic stagnation: Four of these five countries have not managed to rise back to the level of real per-capita GDP they had at the beginning of the eighties.

Economic crisis brought an opportunity for political and economic change. As in the case of Chile before, both Bolivia and Peru came out of the crisis with major changes in the political and economic system. Both embraced strict stabilization programs, eliminated government interference in most day-to-day economic affairs, eliminated price controls, and opened up their economies to foreign competition. The other countries have also moved in the direction of reforming their economies, albeit at a slower pace. All in all, however, we have now a region that is learning to perform in a more open and competitive environment, where business success is more linked to productivity gains and less to special favors by authorities.

Paradoxically, those countries that suffered the least during the 1980s have been the ones that moved backwards during the nineties. Colombia is probably the most dramatic example: from being among the most stable countries in the whole region, it is now ravaged by violence, with whole areas of the country out of government control. On the economic side it is suffering slow growth and high inflation, and has fallen into chronic fiscal deficits. Ecuador has recently been on the brink of hyperinflation and Venezuela has been in a steady decline for more than a decade, with some short periods of relief when the price of oil was at a cyclical high. The recent economic crisis is a cause for concern, not only because of the ground lost in terms of economic progress, but more important, because it has strengthened those who are advocating a return to pre-market-reform policies.

As Xavier Arcos explains, all of the Andean countries have gone through at least some stages of a market-oriented reform process, moving toward freer and more open economies. Even though this has helped them to diversify away from traditional resource-based exports, there is still a long way to go. It is worth noting that the effort to create a more competitive environment has been partially offset by large capital inflows that caused severe currency appreciation. In the last few years, some of the countries have also been making attempts at fundamental changes in key areas that are seen as preconditions for growth: strengthening the educational system, reforming the judiciary system, etc. In some cases these efforts are being promoted as part of a new strategy for enhancing competitiveness in an integrated world economy.

Still, these countries remain extremely dependent on their natural resource base to generate export revenues, a characteristic that makes them highly vulnerable to primary commodity price shocks. Even though there has been some diversification, as Mumtaz Hussain, Steve Radelet, and Cristina García show, it is still too little to make a significant contribution to macroeconomic stability. On the other hand, the combined effect of ample foreign capital flows during most of the 1990s and continuing natural resource dependence has produced appreciation of the currencies that complicated the development of new exports or import-competing sectors. Trade integration efforts, like CAN, for instance, have helped to capture some economies of scale, but the general state of the Andean economies has offset any significant “microeconomic” gains coming from these efforts.

4. SOURCES OF FUTURE GROWTH

When we look at the sources of past growth for these economies, as Sachs and Braun do, we find that they have relied mostly on the expansion of the labor force, and very little on technical progress. Even capital accumulation has been relatively slow, given their initially low ratio of capital/labor ratios. Given low savings rates and the severity and extent of poverty, the Andean countries have to find a way to grow at rates higher than those of capital and labor. This means that innovation and increasing overall efficiency must be key components in any strategy that hopes to accelerate economic growth in the future.

These countries still have a to build institutions that are essential for fast economic developments. Key among them are well functioning financial and capital markets that can attract long term-savings and mobilize them towards their most efficient uses. The advancements in the seventies, eighties and nineties have been insufficient and many of these countries face severe deficiencies in these area. The last recession has made evident the poor quality of the portfolio of the banking system in all Andean Countries, poor practices in risk evaluation and inadequate bank supervision.

The first generation of economic reforms has brought macroeconomic stability and better signals for resource allocation, and therefore a better environment for economic growth. Competition and markets are slowly but steadily replacing cronyism and bureaucratic controls.

However, the Andean countries are lagging behind in areas that constitute the basis for competitiveness in a much more dynamic world, in which knowledge and innovation are the key sources for rapidly evolving advantages. Urgent action is needed to address the most pressing issues in order for the region not to be left even further behind. Jong-Wha Lee clearly shows in his paper the relatively low levels of educational attainment and achievement in the Andean countries, even when compared to other countries in Latin America. He also notes the underdevelopment of secondary education, which is critical for obtaining a better-trained labor force in the future.

The region also ranks very low in terms of scientific discoveries and technical innovation, as Calestous Juma and Mirjam Schöning point out in their paper. The region not only devotes too few resources to innovation, even when compared to other developing countries like Argentina, Chile, or Korea, but more worrisome, it also lags behind in developing human resources for research, as well as in basic preconditions for innovation, like protection of intellectual property rights.

When we look into arenas where worldwide innovation is taking place at a very fast pace, like information technologies, we see that these countries are lagging behind in some key infrastructure that is needed to take advantage of these changes. Geoffrey Kirkman shows that even for some basic indicators like telephone mainlines, or the number of computers per person, the region is behind many developing nations. Part of the problem originates in the inability of state-owned monopolies to keep up with technological developments and invest in key service areas like telecommunications and electricity (both generation and distribution). Those countries that have been able to privatize and modernize regulation of public utilities have experienced very fast expansion and renovation in these areas. In some others, new technologies like cellular phones, for instance, have provided a way to bypass the above-mentioned obstacles, albeit at very high costs.

5. SUSTAINABLE GROWTH

The state of the environment and the policies in place are also playing a negative role in the development of competitive advantages by the Andean countries. Some traditional resource-based products are facing threats to their continued access to developed-country markets, because of rising environmental concerns there. Environmental groups in Developed Countries are increasingly striving to limit developing countries' ability to export natural-resource-based products that are not managed in a sustainable way (as defined by developed countries), even though such constraints are not fully compatible with WTO principles. Several developing countries have already signed treaties binding them to environmentally friendly practices in key areas like logging (see Table 10 in Panayotou et al chapter). They are facing problems now because the institutional setting is too weak to deliver the kind of results that are being promised in many cases. On the other hand, and once all players in each

government are consulted, it is not clear whether the countries are truly willing to forego the income and jobs that they are supposed to sacrifice in order to satisfy those demands.

On the other hand and under strong pressure to produce results, policies tend to rely too much on command and control mechanisms, as Panayotou, Lozano, and Boscolo discuss in their paper. These instruments not only rely too much on the skills and honesty of regulators, but also tend to be detrimental to competitiveness, because they impose unnecessary costs on the production process. Besides, they can also jeopardize access to foreign markets as they fail to deliver promised results. They also tend to discourage development of new activities, since such activities might be subject to administrative regulations and controls with high—and difficult to measure—economic impact. Problems are usually compounded by the tendency to adopt very strict environmental standards, more appropriate for rich countries than for countries in which a large fraction of the population is well below the poverty line.

However problematic the actual design and management of environmental policies in these countries, it cannot be forgotten that water and air pollution are serious health hazards, involving high economic costs in many developing countries. Pollution reduction and treatment consumes or at least competes for precious fiscal funds that are also needed to foster education or to develop much-needed transportation infrastructure, for instance. Thus the Andean countries need cost-effective environmental policies, as well as the opening up of these markets for the private provision of public goods and services, under the appropriate set of incentives and regulations.

Moreover, it is also clear that the historical pattern of development of the region has had both negative impacts on the environment, and at the same time made large human settlements vulnerable to natural disasters. Deforestation, water pollution, soil erosion, and destruction of unique natural habitats are common problems to all of these countries. Up to a very short time ago the dominant view of development was that of promoting "conquest and settlement," with natural resources and the environment serving only as items to be exploited. Only in the last few decades has this view that prevailed since the arrival of the "Conquistadores" in the XVI century begun to change. However, a lot of damage has already been done, large cities have grown in unsafe places, streams have been polluted beyond recovery in the short term, and enormous quantities of productive soil have been lost to deforestation and erosion. At the same time, poverty is probably one of the strongest causes of environmental degradation, both in large urban settlements that expand without control and without appropriate infrastructure, and in the countryside, where low-productivity agriculture still grows at the expense of natural habitats. So far, development, however slow in these countries, has been at the expense of the "stock of natural capital", to the point that the future stream of earnings from this type of capital is in serious jeopardy.

6. REGIONAL CHALLENGES AND ACP AGENDA

The challenge ahead is to find ways out of these vicious circles, to discover new development alternatives, to devise creative policies that will reinforce and give direction to market forces, and to build political support to turn crises into opportunities for change.

The experiences of Chile, Bolivia, Peru and other developing countries in different regions show that change is possible. We need to examine the successful experiences of some other developing countries and extract from them those elements that are applicable to the Andean countries, and explore totally new roads, as well.

In this introduction we would like to point to some of the areas that the different chapters have suggested as possible alternatives to explore.

On the macroeconomic side the whole issue of natural resource dependence and its impact on stability is predominant. This means that we have to deal with the shocks that arise from a very concentrated and vulnerable export pattern that exists today. Diversification is a key issue: Should the Andean countries transfer resources from traditional primary sectors? Or should they focus their energies on controlling the negative side effects and vulnerabilities associated with dependence on natural resources? Should they correct the market imperfections that led to that?

Related to the former questions, there is also the issue of what is the type and degree of diversification that these countries need in order to integrate successfully in a very dynamic world economy. There is no obvious answer to this question and much will depend on the capacity of each country to provide the necessary human and infrastructure resources required to develop truly competitive world class sectors. On the other hand, supply-side constraints might also put a limit to the capacity to absorb financial resources in other areas or productive sectors. We have to find what are the relevant constraints for diversification. What role may be played by the educational system and by science and technology policies in this strategy? How can business, government, and other sectors promote diversification of the country's economy in a way that will best promote economic growth and stability? At the same time we have to formulate policies that will be able to withstand the long tradition of rent-seeking that has afflicted these societies for a very long time.

Trade and foreign investment strategies and policies should be reviewed, analyzing successful international experiences and seeking ways to adapt them to the region's institutions and culture. Especially important in this respect is an analysis of the forces that motivate multinational corporations to locate in a given place, and to design policies accordingly.

It is clear that in order to be able to secure a steady stream of resources to support the new reforms, we have to strengthen public finances and institutions. This is necessary to ensure the persistence of government efforts, as well as for macroeconomic consistency. Other key institutions to examine are those dealing with monetary and exchange rate decisions, as well as the supervision of banks.

We must also examine three aspects of the role of capital markets: first, as providers of the necessary funds to finance the development of new activities and to mobilize resources toward the new sectors and clusters that will be the basis for new sources of competitiveness; second, as a possible source of instability, when international capital flows are confounded by short-term signals and investors lose a long-term perspective on these countries; and third, as a means of diversifying away from natural resources, by investing the proceeds coming from the exploitation of exhaustible resources in a truly diversified portfolio.

On the microeconomic side we have to look into new ways to develop the necessary infrastructure to develop new opportunities for competitiveness. Given the fragmentation that these countries suffer, the issue of mobility of resources, outputs, and information seems to be a key dimension. The role of private financing, construction, and operation must be explored.

The countries' readiness to absorb new information technologies should be addressed by identifying the main obstacles to the dissemination and adoption of these new technologies, as well as by crafting proper policy initiatives. Educational and science and technology policies must be similarly reviewed. Specific actions by government agencies that can induce innovation in the private sector must also be analyzed.

The project should consolidate existing information about new areas or activities that might constitute the basis of clusters of competitive and mutually supportive industries and services. At the

same time, it should explore in a systematic way those distortions that produce false market signals or increase substantially the cost of doing business in each country. Proper benchmarks for comparisons should be generated.

Understanding environmental policies is also critical if we are to address in a fully comprehensive manner the long-term competitiveness of the Andean countries. Two areas of analysis stand out as very important: (a) assessing the right means and intensity of using the resource base, and (b) crafting a well-functioning relationship between environmental policy and the cost of doing business in each country. Environmental policies can generate substantial inefficiencies in the economic system and, on the other hand, their absence can also be extremely harmful for development. The capture and application of economic rents coming from the extraction of natural resources, both to reduce short-term vulnerability to terms of trade shocks, as well as to diversify away from them, is another important issue, which interacts with both the macroeconomic and environmental dimensions of the project.

In the end, however, the ability of the Andean countries to carry out the initiatives and policies needed for improving competitiveness will depend critically on the capacity of the institutions to design, approve, and put them into practice. For this very practical purpose, we should address the issue of governance in at least a very limited sense: How do we get working institutions capable of delivering consistent macroeconomic and fiscal policies, effective regulatory policies, adequate taxation and revenue collection; and educational and scientific policy reform initiatives.

This is not an easy challenge in a region marked by severe income inequality and racial differences. However, these countries must confront their problems and find their own way to integrate themselves in the dynamic segments of the World Economy. The Andean Competitiveness Project should be seen as an instrument to raise awareness on these issues and to help find that way.

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APPENDIX: COMPETITIVENESS IN THE ANDEAN COUNTRIES

1. These countries rank very low in terms of general indicators of competitiveness. The *Global Competitiveness Report (GCR) 1999* puts them between 51st and 58th place (within a sample of 62), with Peru the only exception (36).
2. They also rank low in terms of economic growth, with an average rate of growth of only 1.5% for the period 1992-98 (average rate of growth of the individual countries). This rate is even lower than the average rate of growth of Latin America as a whole, not to mention the fastest growing group of countries in the Developing World.
3. These countries have low—even negative—growth in total factor productivity. This worsened in the eighties, in the aftermath of the debt crisis.
4. According to the GCR (1999), the weakest aspects in competitiveness for the region (absolute and relative) are technology, institutions, finance, infrastructure, and management. There are, of course, some variations, with some countries worse than others in each category, but the point is clear: these are areas of major deficiencies. Unfortunately these are areas in which changes occur over time, and short-term results are highly unlikely.
5. The areas of relative strength in the region are openness, government and—in some cases—labor market conditions. It is important to note, though, that in areas like import tariffs the region still ranks below average (i.e. with average tariff rates higher than in most countries), with Bolivia the only exception. We have to recall, though, that these rates are substantially lower than the ones prevailing in the sixties and seventies, a fact that might make these countries less aware of the need for further reductions.
6. The region also has to deal with the fact that it is perceived as a high-risk area by international lenders and investors, which will make financing a major increase in domestic investment more difficult.
7. One striking feature of the Andean countries is that they rank at the bottom in terms of transportation and communication infrastructure. This is especially serious given their geography and must be considered a major obstacle for developing a more competitive structure.
8. Even though we do not have comprehensive data on human capital, there is enough evidence to show that these countries also suffer severe disadvantages in this area. Levels of formal education are generally low and there is a large proportion of the population that is illiterate in Spanish. Infant mortality rates are 3 to 9 times higher than in the USA, and even compared with other Latin American countries, like Chile for instance they fare very poorly.

GLOBAL COMPETITIVENESS INDICATORS 1999
(relative position in global ranking)

	Global Index
Bolivia	55
Colombia	54
Ecuador	53
Peru	36
Venezuela	50
Avg. Andes	49.6

Source: Global Competitiveness Report. 1999

	Open-ness	Govern-ment	Finance	Infra-structure	Tech-nology	Manage-ment	Labor	Insti-tutions
Bolivia	41	34	56	54	59	59	54	58
Colombia	49	55	52	48	57	43	58	53
Ecuador	44	38	54	55	58	51	44	54
Peru	38	10	40	39	52	49	22	44
Venezuela	39	37	48	52	50	47	52	57
Avg. Andes	42.2	34.8	50.0	49.6	55.2	49.8	46.0	53.2

Source: Global Competitiveness Report. 1999