

## **The Andes in Crisis**

### *General Situation*

The Andean Community (ANC) democracies have a history of political or economic instability, but the intensity of sub-regional problems has grown in recent years. Bolivia, Ecuador and Peru have experienced non-electoral changes in government; Venezuela faces an interminable political crisis and polarization leading to economic decline; and Colombia must contend with unchecked violence by numerous groups. Support for democracy and its institutions is weakening everywhere and common economic problems plague the region, among them a foreign debt averaging about 50% of GDP; inequality and social class divisions; a narrow, regressive tax base and weak collection enforcement; and high unemployment (9.5% to 18.5%).

Common street crime is high and growing, as is violence by groups with a political agenda. Colombia has the most acute problem with violence and Ecuador the least; however, Ecuador's weak institutions have caused it to suffer more political crisis. Bolivia has problems similar to Ecuador but is poorer still. Venezuela is suffering a deep, prolonged political crisis that has caused the economy to go into a downward spiral in spite of the country's wealth from oil exports. Peru has had the best economic performance but the poor feel insufficiently benefited by the system and President Toledo's low popularity threatens instability at any moment.

After the failure of the FTAA negotiations to move ahead at the Miami Ministerial last year, the US and the five ANC governments announced that they were committed to free trade negotiations. On March 23, during a visit by Colombian President Uribe to Washington, he and President Bush announced that Colombia and the US will begin talks for an FTA on May 18-19. USTR Zoellick described the negotiations as an opportunity to "advance Colombia's economic reforms and promote investment." US exports to Colombia in 2003 were \$3.8 billion and the stock of investment almost \$4 billion. Colombia and the other ANC countries (except Venezuela) already benefit from the Andean Trade Preference Act (ATPA) as revised in 2002.

### *The Scourge of Narcotics*

Another insidious common theme of the sub-region is the drug trade—trafficking, production, consumption, money laundering, and the corruption and violence that go with them. Colombia is the world's largest producer of cocaine, and it also produces heroin. Peru and Bolivia are also a source of coca leaf and some cocaine. Ecuador and Venezuela do not produce much coca but are important areas for transshipment and money laundering. Efforts to eradicate coca have been successful in Bolivia, Peru and Colombia, but the political cost was high in Bolivia: The policy contributed to demonstrations leading to the ouster of President Sánchez de Lozada and production is growing again. Peru continues to cultivate but has a lower acreage planted than previously. Colombia has reduced its acreage under cultivation but still produces substantial quantities as the government does not control large areas of the national territory. As long as the returns from the simple cultivation of coca for the illegal drug trade cannot be matched by legal crops efforts at crop substitution face an uphill battle.

The huge amount of money generated by the drug trade has resulted in corruption at all levels of Andean society. Internal consumption has grown as well, and violence is

widespread and largely uncontrollable. The influence in the political and justice systems is a threat to democracy. Early on the drug trade was seen as a quick way to make money off of addicted Americans and Europeans. Now the problem poses such serious challenges in Bolivia, Peru and Colombia that its control is imperative to have a normally functioning society.

#### *UNDP Study*

According to a just released study of Latin America by the United Nations Development Programme, "Democracy in Latin America: Towards a Citizens' Democracy," 54.7% of the region's people would support an authoritarian government if it solved their economic problems. The study's authors attribute this phenomenon at least in part to the persistent poverty in the region. In the last 24 years, the percentage of the population living in poverty has increased from 40.5% to 43.9%. Disparities in national income distribution have also widened further. This is especially true in the ANC countries. Moreover, 59% of the political leaders interviewed stated that political parties are failing to fulfill their necessary role. To strengthen democracy, the authors argue, equal and effective protection under the law and adequate funding for social services are indispensable. They recommend giving new value to the content and relevance of politics; building a new legitimacy for the state; promoting greater diversity and flexibility of economic policy options; and considering globalization and its impact as part of the democracy debate.

#### *Council on Foreign Relations Study*

"Andes 2020," a report by the Council on Foreign Relations, warns that the sub-region is on the verge of collapse. It emphasizes the central role of Colombia—the largest country in the sub-region and the one with the biggest problems—in affecting its neighbors and argues that US policy places too much emphasis on counternarcotics and security in Plan Colombia and the Andean Counterdrug Initiative. The report identifies three imperatives: 1) more equitable distribution of political and economic resources and power; 2) more participation from the international community in regional political, economic, security, social and humanitarian issues; and 3) recognition that regional problems with regional impact call for a regional approach by US policy.

In addition, the report suggests that the US, Europe and other consuming nations accept responsibility for reducing drug consumption. It recommends a gradual transfer of resources away from fighting drugs and guerrillas toward rural and border development, including land reform; strengthening the rule of law through more accountability and transparency; trade and economic development; and a multilateral anti-drug policy. Specific recommendations include: land reform; property tax modernization; land titling acceleration; creation of a special development fund for drug-cultivating countries sponsored by the drug-consuming countries and administered by the World Bank; financial sanctions against drug traffickers and guerrillas; raising the cap on US military and civilian contract personnel allowed to work in Colombia; reforming tax structures to make them progressive; reducing evasion and broadening the tax base, formation of an Andean Customs Union; and expanded security cooperation along border areas.

#### *Effects of a Free Trade Area of the Americas*

An ANC-sponsored study by Miles K. Light of the University of Colorado, "Free Trade of the Americas Agreement Economic Impacts for the Andean Community," concludes that

the sub-region should not expect large welfare gains from the trade in goods. The FTAA would dilute the benefits of the existing Andean Trade Preference Act by allowing access to the US market by all Latin American countries, diverting trade and leading to a drop in Andean exports. The overall impact would be small, but some sub-sectors or products could be especially affected. Those that would benefit include fruits, vegetables, oil seeds, textiles, minerals and energy. Expected to decline are grains and cereals, light manufactures and agro-chemical products. Tariff elimination would cause substantial revenue losses to governments (6% to 12%) which would have to be made up through increases in the VAT or income tax. But the study overlooks some large potential benefits of the FTAA, such as knowledge transfer, services liberalization, product variety and foreign direct investment. These benefits are important to increased productivity, economic growth and welfare and should outweigh trade effects. Real wages should rise for skilled and unskilled laborers even as nominal wages remain flat. National consumption would increase.

### *Bolivia*

Bolivia was once the most chronically unstable country among the ANC nations. Over the past 20 years it achieved gains in democratization and economic liberalization, but geographic, ethnic and class divisions opened wider under the pressure of high indebtedness, anti-coca cultivation campaigns, corruption and factionalism, some by radical anti-democratic forces. President Carlos Mesa, who took office after the ouster of President Sánchez de Lozada, has good popularity ratings but is in a precarious political situation. Periodic demonstrations and demands by diverse groups continue.

Bolivia (population 8.5 million) is a member of the ANC and an associate member of Mercosur. The country was able to reduce its large debt through use of the Highly Indebted Poor Country Initiative in negotiations with the Paris Club (debt repayment obligations were reduced by \$1.2 billion). Bolivia has large natural gas reserves (55 trillion cu. ft.) and sells gas to Brazil and Argentina. However, plans to export gas through Chile were one of the causes of the demonstrations that led to Sánchez de Lozada's downfall. A referendum is planned for this year to decide if the project should go ahead. Bolivia also exports tin, zinc, silver, antimony and gold. Its main agricultural export is soy beans to its ANC neighbors. In 2002 Bolivia exported \$1.3 billion and imported \$1.7 billion. It is dependent on official capital to finance development projects and the deficit in the balance of payments. GDP (\$8 billion) growth was modest but positive at 2.8% in 2002. In an attempt to keep Bolivia on its path of macroeconomic stability and institutional reform while trying to address class divisions and extreme poverty (58% of the population lives in poverty and 24% in extreme poverty), the World Bank announced a lending program of \$300 million for 2004 and 2005.

### *Colombia*

Colombia is the largest country in the ANC in terms of both area and population (44 million) and is well endowed with natural resources (oil, minerals, agriculture, hydroelectric potential) and human resources. Colombia has not known internal peace for decades. The country is torn apart by fighting among insurgent Marxist guerrilla groups (FARC and ELN), paramilitaries (AUC), the armed forces, drug trafficking cartels, violent criminals and kidnappers, and the police. More than 100,000 people have been killed in the conflict since 1980. In spite of the violence, Colombia has had sound macroeconomic management and has avoided hyperinflation, excessive indebtedness or

economic collapse. A corrupt political system has continued to function and even managed some reforms. The inauguration of President Alvaro Uribe in August 2002 renewed hope of winning or at least ending the war, and the president's honesty and effectiveness have restored some faith in institutions and the political system.

Colombia always had sound macroeconomic management, and it has managed to turn in a sound economic performance under political and security conditions that would have caused a severe economic crisis in other countries. Nonetheless, the prolonged internal strife has left an estimated 67% of the population living in poverty. Inequality is also high: 20% of the population receives 60% of the income. GDP growth was 1.7% in 2001 and 2.2% in 2003 (GDP is about \$85 billion). Also in 2002, inflation was low and unemployment dropped to 14%. The government's economic program was supported by loans from the World Bank (expected to commit \$3.3 billion for projects from 2003 to 2006) and the Inter-American Development Bank. In addition, the government signed a \$2 billion two-year standby loan with the IMF in June 2003. Colombia's imports in 2001 were \$12.7 billion and its exports were \$14.5 billion. Colombia exports coal (it has the largest reserves in Latin America--6.5 billion tons), oil, coffee, flowers, gold, nickel and semiprecious gems. In spite of the security risk, the stock of foreign direct investment is about \$23 billion, not including petroleum and portfolio investment.

### *Ecuador*

Ecuador (population 13.4 million) is a poor country with weak institutions and an unstable political environment. Despite large exports of oil, bananas (it is the world's leading exporter of this commodity), shrimp, fish and fish products, flowers and wood, it has not been able to reduce poverty. Between 60% and 70% of the population is classified as poor. Ecuador is the largest source of illegal immigration to the US from South America. A severe economic crisis in 1999, worsened by El Niño, resulted in demonstrations that forced the removal of President Jamil Mahuad in January 2000. Vice President Gustavo Noboa ruled until the election of Lucio Gutiérrez in late 2002 with the support of indigenous groups pushing populist policies. Since then, Gutiérrez has appointed respected professionals to his economic cabinet and the implementation of sound fiscal policies has caused tensions with left-wing and indigenous groups.

The economy recovered under Noboa, who dollarized the economy despite the role of this proposal (along with a 7.3% drop in GDP and 52% inflation) in the protests that drove out Mahuad. Dollarization has contributed to economic stability but continues to draw opposition from the political left. In fact, Ecuador has had admirable economic growth with only one downward dip in 2003: 2001-5.1%, 2002-3.4%, 2003-1.7% and 2004-4% (projected). A new IMF standby loan agreement for \$205 million was negotiated in March 2003. Sound economic policies with external support, assisted by high oil prices and completion of the second trans-Andean oil pipeline in 2003, have allowed Ecuador to progress while servicing a high external and internal debt. Ecuador faces many challenges—declining oil reserves, deforestation, overfishing, extensive poverty and incursions from guerrillas in Colombia—in keeping its economy on an even keel.

### *Peru*

With its successful economic performance, Peru (population 21 million) should be the exception to the generalized crisis in the Andes. The country underwent major

macroeconomic policy shifts in the 1990s, the deficit and inflation were under control, employment was growing, and the debt burden (48% of GDP) was less than in most neighboring countries. Democracy was restored after the ouster of President Alberto Fujimori in 2001 and the election of President Alejandro Toledo. The new president has generally run a transparent, accountable and democratic government seeking to respect human rights and redress some of the abuses inflicted on the population in the anti-terrorist war of the 1990s. Nonetheless, Toledo has suffered abysmal popularity ratings (currently about 7%). The causes of his unpopularity range from dishonesty in his private life and perceived nepotism to a resurgence of Shining Path guerrillas and impatience with the slow trickle-down effects of his economic policies (54% of Peruvians live in poverty and 24% in extreme poverty).

GDP is now valued at \$61 billion and GDP growth, after dipping to 0.5% in 2001, was 5.4% in 2002 and about 4% in 2003. This corresponded with reducing the fiscal deficit to 2.2% of GDP in 2002 and 1.9% in 2003. Inflation is in the 2% range. In 2003 exports (oil, copper, zinc, gold, fish) were \$8.4 billion and the balance of trade was in surplus. International prices for minerals and metals rose, buoyed by strong world demand. Peru has continued to comply with targets set in the Peru-IMF standby agreement and President Toledo has maintained good relations with the Inter-American Development Bank and the World Bank, which plans a \$920 million lending program from 2003 to 2006.

Progress has been made on the social front. The mortality rate for children five and under has dropped 2.4%, more children are studying and staying in school longer, and the incidence of diarrhea and other diseases has dropped as clean water has been made more available. But important challenges remain, among them reform of the inefficient and corrupt justice system, improving public administration and reducing poverty. The ATPA extension and negotiation of a FTA with the US offer possibilities for growth and job creation based on greater trade and investment.

### *Venezuela*

Venezuela (population 24 million) is blessed with the largest petroleum reserves in South America, as well as important reserves of nickel, gold, diamonds, bauxite, iron and hydroelectric potential. Over the years it has chosen to consume its wealth through low prices rather than invest it in human and physical infrastructure. There has been some progress, including a reduction in the incidence of some diseases, more children in primary school, improved access to water, and lower infant mortality. But from 1995 to 2002, the percentage of Venezuelans living in poverty grew from 39% to 48%.

Corruption of the traditional political parties led to the election of convicted coup plotter and ex-Colonel Hugo Chávez in 1998 and his re-election in 2000. Although the Chávez government has made many welcome reforms, its confrontational, demagogic and radical style has alienated important sectors of society, including business, the Catholic Church, organized labor and political parties. The result has been extreme political polarization of the population, a prolonged effort to recall the president and drastic declines in all economic indicators. The economic crisis continues and will not be resolved so long as the political crisis persists.

The Venezuelan GDP declined by 8.9% in 2002, and a general strike called by the political opposition and labor unions caused a further large drop in the first quarter of 2003. There was some recovery after the strike but the economy remains stagnant or in decline in most sectors. Current high oil prices have allowed the government to survive and to channel resources to its political base—the urban poor. Oil represents 73% of exports and about 50% of government budget revenues. The government has been able to accumulate foreign exchange reserves (about \$19 billion in late 2003) through the imposition in February 2003 of foreign exchange controls. In mid 2003, official unemployment was at 17.8%, with more than 53% of the labor force employed in the informal sector. Inflation was 27% in 2002 and more than 32% in 2003. The foreign debt was \$32.5 billion in 2002 and the internal debt is growing as a result of the economic crisis. The World Bank is implementing an Interim Country Assistance Strategy that plans to lend \$300 million from 2003 to 2005.

### *Observations*

The Andean countries have severe economic and political problems that are chronic and deep rooted. Nonetheless, they seem to be coping and there is reason to believe they will work through them with proper leadership and outside help. At the same time, the societies are so close to the edge that one or two serious incidents could plunge them into chaos or authoritarianism. Recommended changes in US policy may offer some improvement in the effectiveness of outside assistance. Cooperation on security issues among neighbors, especially Brazil, could play an important role in turning the tide against Colombia's Marxist insurgency, drug traffickers, paramilitaries and violent criminals. However, the most important determinant of progress will be domestic policies and leadership and how each country's population faces its challenges. That story is being written in daily actions and decisions in each Andean country.

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