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FACILITATING TRADE AND STRUCTURAL ADJUSTMENT: EXPERIENCES IN NON-MEMBER ECONOMIES

Country Case Study on Ecuador

OECD Trade Policy Working Paper No. 67

by José Duran, Nanno Mulder (ECLAC) and Miguel Ruiz (ESPOL)

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ABSTRACT

This paper is the second of four country case studies which is a part of a broader research programme addressing trade and structural adjustment issues in non-member economies which was conducted as a follow-up to *Trade and Structural Adjustment: Embracing Globalisation* (OECD, 2005) which identified policies for successful trade-related structural adjustment. This paper studies the trade liberalisation experience of Ecuador from the 1970s onwards.

The report consists of 5 main sections; Section 1 provides the introduction, while section 2 provides an overview of Ecuador's economic reforms from the 1970s onwards until the 2000s. Section 3 looks at the structural changes in the economy and trade dynamics behind the changes. Section 4 takes a closer look at structural adjustment in four sectors, the cut-flowers, processed tuna, cereals, and textiles and clothing. Section 5 concludes with lessons learnt. Ecuador provides a case of a country whose trade liberalisation and other structural reforms have led to mixed results. While trade liberalisation has improved resource allocations, macroeconomic instability, incomplete reforms, weak institutions and relatively restrictive (but also highly informal) labour markets have made it difficult for Ecuador to reap the full benefits of trade liberalisation.

Keywords: trade, structural adjustment, liberalisation, liberalization, Ecuador, macroeconomic instability, tariffs, exchange rate policies, import-substitution, cut-flowers, processed tuna, cereals, textiles and clothing.

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The Working Party of the OECD Trade Committee discussed this report and agreed to make the findings more widely available through declassification on its responsibility. The study is available on the OECD website in English and in French: <http://oecd.org/trade>

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TABLE OF CONTENTS

EXECUTIVE SUMMARY	4
1. Introduction.....	5
2. Ambitious first but timid second generation reforms	7
3. Structural change and trade dynamics.....	18
4. The impact of trade reform on particular sectors	28
a) Dynamic exports of flowers	28
b) ... and (processed) tuna exports	31
c) Cereals had difficulty to adjust to structural reforms	33
d) ... as well as textiles.....	35
5. Lessons learnt.....	38
BIBLIOGRAPHY.....	41

Boxes

Box 1: Events leading to the 1998-99 crisis and dollarisation in 2000	16
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EXECUTIVE SUMMARY

Ecuador's experience with trade liberalisation and other structural reforms has been mixed. On the one hand, lower trade barriers have boosted international trade, and, while exports remain heavily dependent on primary resources, in particular oil, several non-traditional products have also gained space. On the other hand, economic growth and poverty reduction have been disappointing due to incomplete reforms and erratic policies linked to political instability and weak institutions. From 1970 to 2006, income per capita growth has been low (1.3% per year on average) and very unstable. Several short spells of high growth were followed by crises, causing major setbacks in poverty rates, particularly during the 1998-99 crisis.

The country implemented relatively late structural reforms to move from inward-looking and import substitution industrialisation policies to a more market- and outward-oriented market policy stance. It did so in two waves. The first was in the early 1990s, after partially failed attempts in the 1980s, when it reduced tariffs (from 37 to 11%) and non-tariff barriers in the context of intra-Andean Community (except Peru) goods trade liberalisation in 1993 and WTO membership in 1996. In addition to trade reform, structural reforms were also implemented in some other areas, such as the financial sector, capital account, and foreign direct investment. Most price controls and subsidies were also eliminated. Nevertheless, macroeconomic policies remained erratic, with frequent changes in the exchange rate regime, lack of control over public spending and debt financed in part through seignorage. Moreover, other key areas remained untouched such as the restrictive (but also highly informal) labour market and the many state-owned enterprises.

A second round of timid second generation reforms was put in place after a major crisis in 1998-99, which culminated in the dollarisation of the economy in 2000. The crisis resulted from various factors, including a banking crisis in part due to insufficient prudent regulation, several external shocks, and weak public finances and expenditure rigidities. Together with the World Bank and IMF, an ambitious list of second generation reforms was formulated. However, only some were implemented, including better supervision of the financial sector, opening of oil sector to foreign investment and measures to improve the solvency of the pension system. No additional trade reform was undertaken, except for the deepening of the preferential trade programme (ATPDEA) with the United States.

The correction of relative price and incentive distortions through partial import liberalisation and other reforms have led to some important structural adjustments. Several new export activities developed within or linked to the traditional comparative advantages (e.g. agricultural products like flowers, broccoli, mangoes and palm hearts, and fish processing). These benefited and boosted production and exports, but others (e.g. cereals, textile machinery and equipment) have had difficulty adjusting to increase in imports. Government support has been limited but crucial, including trade negotiations for better access to the United States (its main export market), subsidised loans, export promotion (CORPEI), and assistance in meeting sanitary and phyto-sanitary requirements in developed country markets. Sectors that lost out in the process of trade opening received little support from the government.

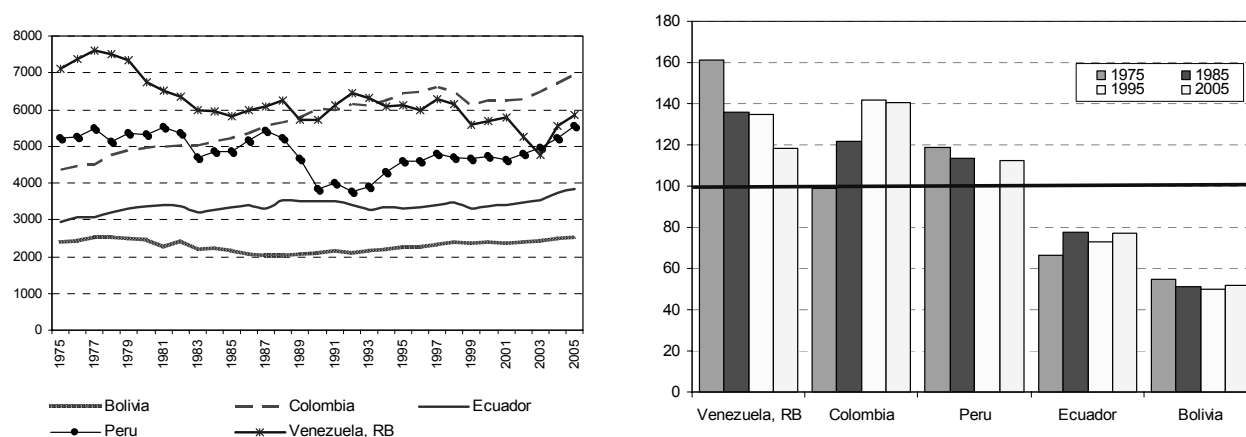
The recent period of sustained economic and export growth, benefiting from high oil prices and relative stability imposed by dollarisation, provides hope for the near future. The medium term prospects

depend crucially on the maintenance of prudent macroeconomic policies and the extension of a preferential access programme with the United States, Ecuador's main trading partner, beyond February 2008, as well as negotiations of free trade agreements with other major partners such as the European Union.

1. Introduction

1. Ecuador is a small (13 million inhabitants) commodity exporting economy whose development in the past decades has been characterised by partial reforms and meagre improvements in living standards due to economic, political and social instability. Despite its substantial natural resource endowments (*i.e.* oil and fertile land), the government's stop-and-go policies have failed to deliver sustainable growth and social equity.¹ From the 1970s to 2005, per capita income has nevertheless slightly increased from below 3,000 to almost 4,000 USD (1.3% per year on average). This mediocre performance, although somewhat better than Bolivia, was below that of the Andean Community² average; and far below that of Colombia (Figure 1).

Figure 1
GDP per capita: Ecuador compared with other members of Andean Community, 1975-2006
GDP per capita in PPP (2000 base) GDP per capita as a share of AC average (AC=100)



Source: Authors' calculations based on World Bank, World Development Indicators.

2. This paper examines the trajectory of trade liberalisation and other reform efforts, and analyses how these reforms - together with macroeconomic management and external shocks - affected the overall economy and some key sectors. Since 1979, when military rule ended and democracy was restored,

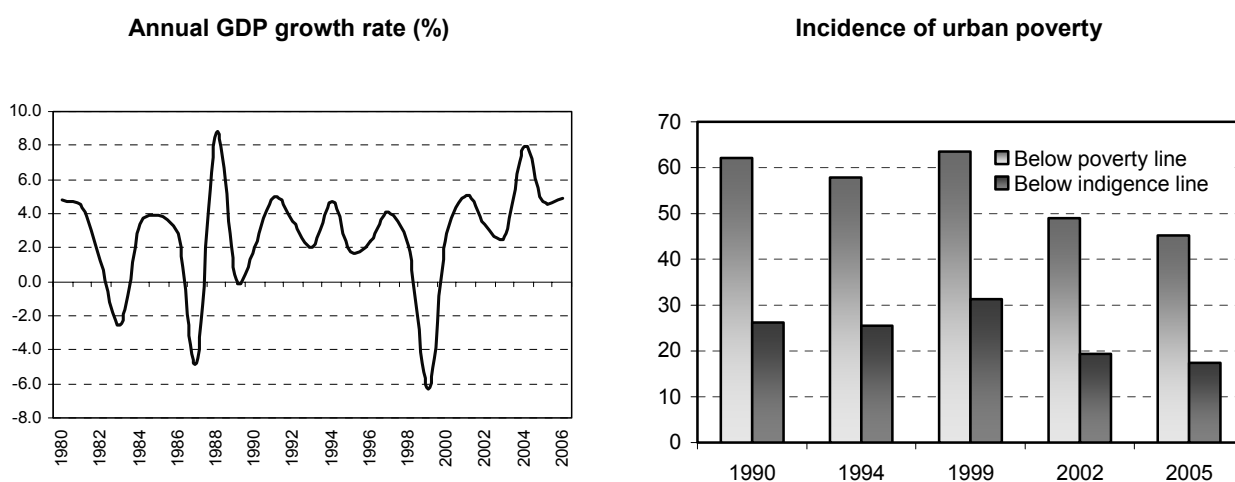
¹ The country has sharp geographical contrasts between the mountains (Sierra), the Coast and the Amazon. The Sierra harbours some 42% of the total population and its agriculture is mainly oriented toward the production of food crops for the domestic market, particularly potatoes, sweet corn, wheat, beans, vegetables and fruits. The Coast has the same share of population as the Sierra and produces the main export crops – bananas, cacao and coffee as well as shrimps. It also produces rice, hard corn, soybeans, sugar and meat.

² The Andean Community (before 1997 called the Andean Group) was created in 1969. Its founding members are Bolivia, Chile, Colombia, and Ecuador. Chile left the Community in 1976. Venezuela joined in 1973, but left in 2006. The Andean Community is one of the most institutionally advanced sub-regional integration schemes among developing countries. Inspired by the integration process in Europe, it has several elements in common such as its supranational character (*i.e.*, Andean laws stand above national laws) and its integration efforts that go far beyond trade (Devlin and Mulder, 2006).

Ecuador suffered multiple adverse events, such as large fluctuations in prices of oil (its main export product) and other commodities, volatile capital inflows and natural disasters. Terms of trade fluctuations, and corresponding variances in export revenues and current account balances, dominated external vulnerability. In combination with poor economic policies, these shocks provoked major economic imbalances, which impacted negatively on economic growth. In total, Ecuador experienced four economic crises (1982-83, 1987, 1989 and 1998-99; Figure 2) and three hyperinflation episodes (1983, 1988-93 and 1999). It accumulated unsustainable levels of external debt, on which it defaulted or suspended payments several times, and confronted multiple banking crises of which the 1998-99 was the most severe as 20 banks defaulted accounting for 40% of total deposits. Economic policymaking has been poor, in part because of very frequent changes in government and even more ministers. Furthermore, Ecuador is perceived as being among the most corrupt countries of Latin America (Fretes-Cibils *et al.*, 2003).

3. Recurring crises aggravated poverty and other social conditions, in particular the 1998-99 downturn. During the latter, formal unemployment increased from 10 to 15%, poverty levels increased (Figure 2) and the income distribution worsened. Rural poor were most affected, causing many to move to urban slums or emigrate. In 2005, 55% of rural households were poor and 29% lived below the level of indigence (extreme poverty, INEC, 2006). Although the swift economic recovery and sustained growth after 2000 has somewhat alleviated poverty, Ecuador remains among the poorest Latin American countries (Table 1). Moreover, Ecuador is among the countries with the highest levels of income inequality in the region.

Figure 2
Economic growth and poverty and indigence levels^a as a % of population, 1980-2006



Source: Authors' calculations based on ECLAC, including *Social Panorama of Latin America 2006*.

^a Someone is "poor" if the per capita income of the household in which he/she lives is below the "poverty line". This is the minimum income the members of a household need to meet their basic needs. Poverty lines are expressed in national currency and based on the cost of a basket of particular goods and services, using the "cost of basic needs" method. The "indigence line" corresponds to the resources households need to satisfy their basic nutritional needs. For more details, see ECLAC (2006).

Table 1
Poverty and income Inequality in Ecuador and other Latin American countries, 1994 and 2005

	Poverty (% of total population below the poverty line)			Income and Inequality (2005 or latest year)	
	1994	2005	Change	Income Ratio of Highest 20% to Lowest 20%	Gini Index
Brazil	45.3	36.3	-9.0	28.8	0.613
Chile	27.6	15.8	-11.8	18.4	0.550
Colombia	52.5	46.8	-5.7	27.8	0.584
Costa Rica	23.1	21.1	-2.0	15.1	0.470
Ecuador^a	57.9	45.2	-12.7	19.2	0.531
Mexico	45.1	35.5	-9.6	17.0	0.528
Peru	47.6 ^b	51.1	3.5	16.3	0.505

Source: Authors' calculations based on ECLAC, *Social Panorama of Latin America 2006*.

^a refers to urban areas only

^b refers to 1997.

4. This study is organised in four sections. Section 2 provides an overview of the incomplete reforms that took place since the 1990s, amongst others in the areas of trade, investment, and macroeconomic management. The third section looks at structural changes within the Ecuadorian economy and trade dynamics. Section 4 discusses the experience of structural adjustment in four sectors, of which two success cases and two sectors that had more difficulties. The final section presents some of the lessons learnt from the Ecuadorian experience.

2. Ambitious first but timid second generation reforms

Introduction

5. Ecuador adopted several deep first generation economic reforms in the early 1990s, which were followed by timid second generation reforms in the 2000s after a major crisis. Compared to other countries in the region, Ecuador moved very late (1992) from an inward-looking import-substitution-industrialisation (ISI) model with a predominant role for public intervention to a more market and export oriented development model. In the 1980s several reform attempts were made, but they were short-lived as most attention was on short-run economic stabilisation. In the period 1990-96, the government adopted a big bang approach with several deep first generation reforms to liberalise trade, capital, prices and the financial sector without the introduction of prudential financial regulation. Moreover, reforms in other areas were almost absent, including monetary and fiscal policy, privatisation and labour market policy. Erratic macroeconomic policies, little control over the financial sector, and a series of external shocks led to a major crisis in 1998-99 and dollarisation of the economy in 2000. Subsequently, some second generation reforms were undertaken in the early 2000s. As such there was little continuity in reform efforts, in part because of the frequent regime changes since 1996 (Table 2).

Table 2
Presidents, period and performance indicators, 1968-2006

Presidents	Period	Full term	%GDP (annual averages)	%CPI (annual averages)	%Unemployed (annual averages)
1 José María Velasco Ibarra	Sept. 68 – Feb. 72	No	7.2	8.4	4.2
2 (Guillermo Rodríguez Lara)	Feb. 72 – Jan. 76	Military	12.3	14.9	...
3 Triunvirato Militar	Jan. 76 – Aug. 79	Military	7.1	11.4	...
4 Jaime Roldos Aguilera	Aug. 79 – May 81	No	4.8	13.2	5.7
5 Osvaldo Hurtado Larrea	May 81 – Aug. 84	No	2.8	16.3	6.2
6 León Febres Cordero Rivadenería	Aug. 84 - Aug. 88	Yes	1.9	36.4	8.8
7 Rodrigo Borja Cevallos	Aug. 88 - Aug. 92	Yes	3.8	58.5	7.8
8 Sixto Durán Ballén	Aug. 92 - Aug. 96	Yes	3.0	33.0	8.7
9 Abdalá Burarám	Aug. 96-Feb 97	No	2.4	28.1	9.9
10 Fabián Alarcón	Feb 97 – Aug. 98	No	2.0	37.1	10.4
11 Jamil Mahuad	Aug. 98 – Jan. 00	No	-6.3	60.7	15.1
12 Gustavo Noboa Bejarano	Jan. 00 – Dec. 02	No	3.8	40.9	11.0
13 Lucio Gutierrez	Jan. 03 – Apr. 05	No	4.8	4.0	10.4
14 Alfredo Palacio	Apr. 05 – Dec. 06	No	3.0	4.4	10.9

Source: Authors' calculations based on ECLAC data and Ecuador Central Bank.

6. Ecuador substantially liberalised its imports and exports over the past two decades, but a persistent anti-export bias continues to exist due to remaining trade barriers. It moved from inward-looking and import substitution industrialisation policies to a relatively outward-oriented stance, with the major events being the elimination of all trade barriers for goods trade among members of the Andean Community (except Peru) in 1993 and WTO membership in 1996. Both events led to major reductions of tariffs and non-tariff barriers. Nevertheless, several (uncompetitive) sectors continue to be protected by relatively high tariffs and non-tariff barriers. For example, 1,500 import licenses were still in place by 2006.³

7. This section is structured as follows. It first reviews briefly the developments in the 1970s and failed reform attempts of the 1980s. Subsequently several ambitious first generation reforms of the first half of the 1990s are discussed in the areas of international trade, investment, capital account, financial sector and macroeconomic policies. Subsequently, the period 1995-1999 is examined during which economic, political and social conditions worsened steadily, causing a major crisis and dollarisation of the economy in early 2000. The final part reviews some timid second generation reforms undertaken after 2000.

The 1970s: oil boom and Dutch Disease

8. From the late 1950s until the 1980s, Ecuador followed an import substitution industrialisation (ISI) policy with a strong anti-export bias. Imports of consumer goods were subject to high tariffs while imports for import substituting industries had low tariffs or drawbacks. These industries also received subsidised loans and tax breaks, profited from an overvalued currency and a multiple exchange system for their imports of capital goods and inputs. In contrast, export activities were penalised by high tariffs, taxes (main source of government revenues), an overvalued exchange rate, and retail price ceilings for agricultural products (Sawers, 2005).

³ Recently the number of licenses has been reduced, particularly those related to intra-regional trade in the Andean Community.

9. The discovery of oil in 1967 and the oil boom in the 1970s accelerated Ecuador's economic development. Public revenue windfalls allowed the government to play a more active role in promoting industrialisation through import substitution. There was a strong increase in public subsidies, and manufacturing output grew 10% annually. The country was one of the fastest growing economies in the 1970s: 15% on average per year between 1970 and 1973 and 6.8% between 1974 and 1979. However, rising external debt and oil exports led to the so called Dutch disease, which favoured the rapid expansion of non-tradable sectors such as construction, transport and services and stagnation of non-protected tradables, mainly agriculture. The exchange rate appreciated at an average annual rate of 2.8% between 1973 and 1981. Average annual growth of the agricultural sector was 3%, barely above the rate of population growth, and was particularly low in food and traditional export crops (Janvry *et al.*, 1990).

10. By 1980, Ecuador's economy was a typical small, middle income, agrarian, mineral exporting country: manufacturing represented only 18% of GDP compared to an oil sector of 12%. Agriculture only accounted for 13% of GDP but absorbed 45% of the labour force. Export revenues and a decade of oil boom had bloated the service and public administration sectors at the cost of agriculture. Together with government, the service sector absorbed 57% of GDP. The economy was heavily dominated by utilities, construction, transportation, trade, and services. Moreover, the country had become very vulnerable to fluctuations in oil export revenues and availability and interest of foreign loans. Despite some improvement, high levels of poverty persisted, particularly in the rural areas the landless and small farmers. The urban groups, particularly the medium and high education households and the more urbanised rural non-agricultural group, captured the bulk of the benefits of the improvements in education and health.

Failed reform efforts in the 1980s

11. The simultaneous vanishing of international credit, a rise in real interest rates and a 15% decline in petroleum prices brought about a crisis in the early 1980s. In a first reaction the government tried to curb the current account deficit by imposing import restrictions and finance the deficit by money creation while raising interest rates to mobilise domestic savings. As the public deficit grew larger and inflation rose from 16% in 1982 to 48% in 1983, it became clear that more drastic measures were needed. In 1983 fiscal expenditure cuts were introduced. The balance of payments improved, but a worsening economic recession forced the government to introduce emergency measures. For example, the Central Bank assumed about USD1.5 billion in private external debt (11 per cent of 1982 GDP) in exchange for sucre-denominated debt (known as the "sucretizacion").

12. A new government that took office in 1984 introduced a neo-liberal stabilisation programme. It cut public (investment) spending and adopted measures to liberalise the economy: it removed the emergency import controls introduced in 1982, it abolished administered prices in agriculture, and increased domestic fuel prices and electricity rates. Import tariffs were reduced and quantitative restrictions were eliminated.

13. From an economic point of view the policies succeeded – it reduced imbalances and curbed inflation while reviving growth, notably in agriculture. Nevertheless, the social cost was high: unemployment increased, real wages declined and health and education spending dropped. The stabilization programme was further intensified in 1986 when oil prices fell from \$25 to \$12 per barrel. As political support to sustain the programme was falling, the government implemented a programme of public works. This led to an undesirable increase in public spending and new inflationary pressures.

14. An earthquake in March 1987 destroyed the only pipeline bringing crude oil from the Amazon to the coast and oil exports fell by 35% in 1987. In turn trade and government deficits deteriorated and the economy plunged into crisis. This economic and political chaos in 1987 and 1988 led to a reversal of several reforms in 1989, including an increase in import tariffs (Table 3).

Ambitious first generation reforms in the early 1990s***Substantial trade liberalisation***

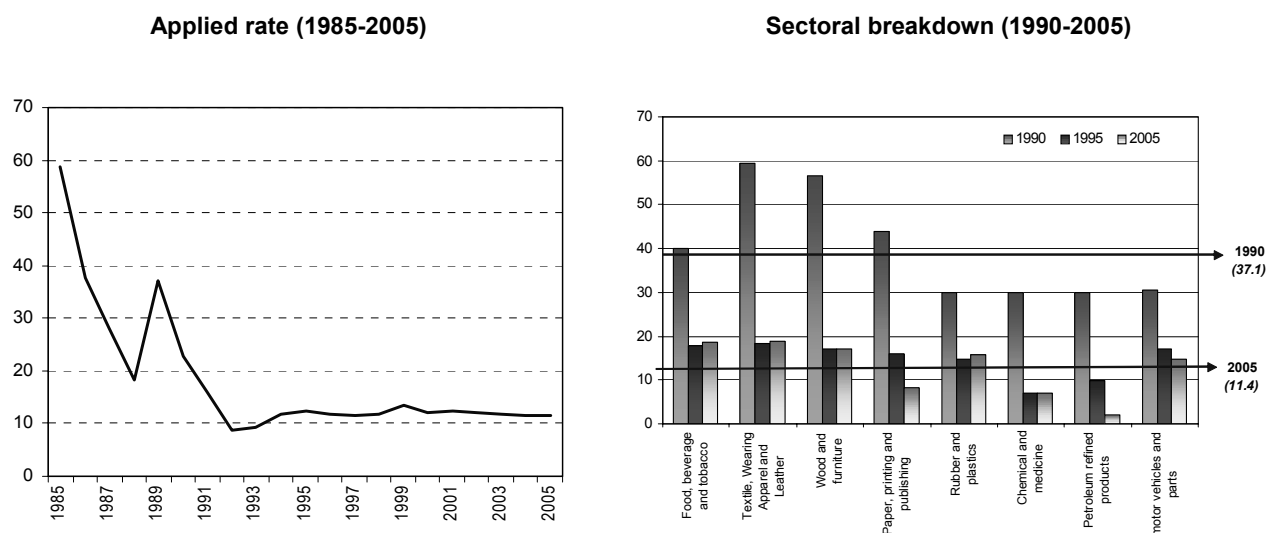
15. A major trade liberalisation was implemented between 1989 and 1994. Tariffs were reduced after 1989, together with major devaluations of the exchange rate. Average tariffs fell from 37% to about 11-12 per cent between 1990 and 1993 (Figure 3), with maximum tariffs reduced from 290 to 20% (excluding automobiles). Moreover, red tape for exporters was reduced as were non tariff barriers. Maritime transport was opened to competition.

Table 3
Trade policy, domestic prices and exchange rate in liberalisation episodes in Ecuador, 1982-2000

Periods and characterisation	Details of Liberalisation in areas of trade, prices and exchange rate
First Stabilisation Programme to contain debt crisis (May 1982-83)	<ul style="list-style-type: none"> • <i>Trade policy</i>: increasing import restrictions • <i>Domestic prices</i>: strong control over prices and subsidies • <i>Exchange rate</i>: “crawling peg” with mini devaluations
Second adjustment program with liberalisation 1988-96	<ul style="list-style-type: none"> • <i>Trade policy</i>: New round of tariff reduction after 1989, following reversal in preceding years; abolition of several import prohibitions, entrance to the WTO in 1996. • <i>Domestic prices</i>: Rapid liberalisation of domestic prices; elimination of price subsidies to small producers and consumers. • <i>Exchange rate</i>: “crawling peg approach” with mini devaluations
Reactivation program after 1998-99 banking and currency crisis (2000 and beyond)	<ul style="list-style-type: none"> • <i>Trade policy</i>: Continuity with negotiation of bilateral trade deals. • <i>Domestic prices</i>: Elimination of gas and electricity subsidy. Dollarisation proves successful in containing inflation. • <i>Exchange rate</i>: Flotation after maxi devaluations in September 1998 and February 1999. Dollarisation since January 2000.

Sources: Naranjo (1999), Vos (2000), FAO (2001) and Vicuña (2006).

Figure 3
Ecuador: Average import tariff rate: 1985-2005



Source: Authors' calculations based on TRAINS data base.

16. In January 1993, goods trade among members of the Andean Community was largely liberalised. In 1995, Ecuador and three other members (excluding Peru) of the Andean Community adopted a common

external tariff (CET) with 4 tariff levels of 5, 10, 15 and 20%. The tariff structure has maintained its “escalation” as an incentive to produce value added goods, with low tariffs for intermediate inputs and high tariffs for final consumption goods. Similar to other Andean Community members, Ecuador has applied a set of exceptions to more than 1,400 tariff headings of the product category of the 0-15% range.

17. Another hallmark was Ecuador’s swift entrance to the WTO in 1996, implying several new commitments to liberalise its trade regime.⁴ This meant the introduction of tariff ceilings equal to the CET plus 10% except for cars, chemicals, and specific agricultural and agro industrial products. Average tariff bindings were 20% for non-agricultural goods and 26% for agricultural commodities, with minimum and maximum bindings varying between 5 and 40% for the former category and between 5 and 86% for the latter (Kennett *et al.*, 2005). Several import prohibitions for used cars, textiles and clothing and other goods were abolished. It also committed to eliminate all subsidies before accession and not to introduce them afterwards. Ecuador also started to enjoy tariff concessions as a member of the General System of Preferences. The country maintained tariff quotas for 14 sensitive agricultural products.

18. Since 1991, Ecuador (and other Andean Community members) has also benefited from duty-free access for many products to the US market under the Andean Trade Preference Act (ATPA). In August 2002, trade preferences were broadened but made conditional under the Andean Trade Promotion and Drug Eradication Act (ATPDEA).⁵ This Act is scheduled to expire end-February 2008. The conditionality depends upon both commercial and non-commercial requirements, partly related to fighting drugs. Ecuador has never forfeited any benefits under the ATPDEA through non-compliance with these conditions (WTO, 2005).

19. As elsewhere, agriculture remains one of the most sensitive sectors for trade opening. Together with other Andean Community members, it introduced variable tariffs also known as the Andean Price Band System in 1996. This system applies to about 150 product headings, and sets tariffs that vary between 35 and 95% depending on the product and prevailing international prices. Its aim is to protect producers and consumers against price fluctuations by introducing a floor and a ceiling. If an international price is below (above) the floor (ceiling) price, the common external tariff is applied plus a surcharge (discount). When the reference price is between the ceiling and floor prices, the common external tariff rate is applied. The value used to calculate tariffs on products is the reference price defined by the General Secretariat of the Andean Community. Fretes-Cibils *et al.* (2003) have questioned the efficiency of these bands, as many have failed to achieve price stability, lack transparency and have an upward bias hurting (poor) consumers.

20. Ecuador also applies tariff quotas, managed by the Ministry of Agriculture (MAG), Ministry of Foreign Trade, Industrialization, Fisheries and Competitiveness (MICIP), and the Ministry of the Economy and Finance. Quotas are assigned to importers on the basis of their historical consumption, depending on an interministerial agreement. Tariff quotas are applied together with a national output absorption requirement: only importers that have purchased a share of national output are authorised to import the product under the tariff quota. These purchases must be done through the National Agricultural Product Exchange Corporation (*Bolsa Nacional de Productos Agropecuarios*), which is a private non-profit institution that regulates the marketing of agricultural products (WTO, 2005).

21. Several other trade restrictions continue to remain in place and form a strong anti-export bias. These have the form of tariffs, that protect particularly import-substituting sectors, and non-tariff barriers such as import prohibitions, import licenses, custom procedures or valuations, technical regulations, etc.,

⁴ It took Ecuador only 32 months from the date of the submission of its Memorandum to the date of accession, which was considerably speedier than later joiners (Kenneth *et al.*, 2005).

⁵ Under the ATPDEA duty free access was extended to 700 new products: textiles and clothing, footwear, petroleum and petroleum derivatives, watches and clocks, leather goods and certain processed tuna products. (Durán, 2006).

that support or subsidise certain sectors at the expense of export oriented sectors (Fretes-Cibils *et al.*, 2003).

22. All in all, Ecuador continues to have a moderately restrictive trade regime. Although average tariffs are relatively low, the wide dispersion of tariff rates and the multiple and selective non-tariff barriers are distorting the allocation of resources.

Freeing foreign investment and capital account

23. Foreign direct investment (FDI) and the capital account were liberalised in the early 1990s, after some failed attempts in the 1980s. The first step towards FDI liberalisation was taken in 1984, when several restrictions were removed under Agreement 24 of the Andean Pact, including the opening of the oil and mining sectors to foreign investors. But in 1988, some controls on FDI were reinstated, tax advantages for foreign investors eliminated, and tendering rules tightened. In 1991, Decision 291 of the Andean Community, which, as all Decisions of the Andean Community stands above national law, was adopted to open Andean countries to FDI and other capital account transactions. Subsequently, the 1997 Law on Promotion and Guarantee of Investment was approved and special provisions in the new 1998 Constitution consolidated the FDI liberalisation process. These provide foreign investors with national treatment, guarantees against expropriation and superiority of international treaties above national laws.

24. The current FDI regime is relatively liberal. Entry and establishment is free except for the fishing industry where approval is needed from the National Fishing Institute.⁶ There are no ownership restrictions, except for the oil sector where all private investors must form production agreements with the state oil company. Foreign companies receive national treatment, can repatriate profits and proceeds of disinvestment and can acquire land and buildings outside preserved areas.

25. FDI inflows have increased over time but remain heavily concentrated in the oil sector, accounting for 80% of total FDI (Table 4). FDI has remained below potential, particularly compared with other members of the Andean Community. For example, Bolivia whose economy is smaller and has a lower per capita income, showed a substantially larger increase in FDI inflows in the 1990s (UNCTAD, 2001). One explanation for low investment inflows is the little progress made in privatisation of state enterprises.⁷ Other factors that hinder FDI, according to an UNCTAD survey (2001) among foreign investors, are political and economic instability, and corruption.

⁶ Although non-renewable resources are owned by the State, they can be exploited by foreigners. The State also has exclusive rights in other areas (UNCTAD, 2001).

⁷ Few state-owned enterprises have been privatised over the last decades. From 1992 to 1996, a legal framework was put into place for the privatisation of state enterprises. This framework was used to privatise some small state companies for air transport (Ecuadoriana), cement, fertilisers and sugar refining. Subsequent regimes have made attempts to privatise larger state companies without success. Instead some sectors with state monopolies have been opened for private (foreign) companies with some success such as in telecommunications.

Table 4
Foreign direct investment: Millions of dollars and share of GDP and by sector,
1993-1995, 1996-2000, and 2001-2005

	USD (Millions)			Share in GDP		
	1993-1995	1996-2000	2001-2005	1993-1995	1996-2000	2001-2005
Manufactures	65	23	56	0.4	0.1	0.2
Natural Resources	359	585	1 150	2.0	2.9	4.0
Mining (especially oil) %	72%	83%	81%	2.0	2.8	3.9
Services	71	84	226	0.4	0.4	0.8
Total	496	692	1 432	2.8	3.4	5.0

Source: Authors calculations on the basis of Central Bank of Ecuador and ECLAC databases.

Financial sector liberalisation with little supervision

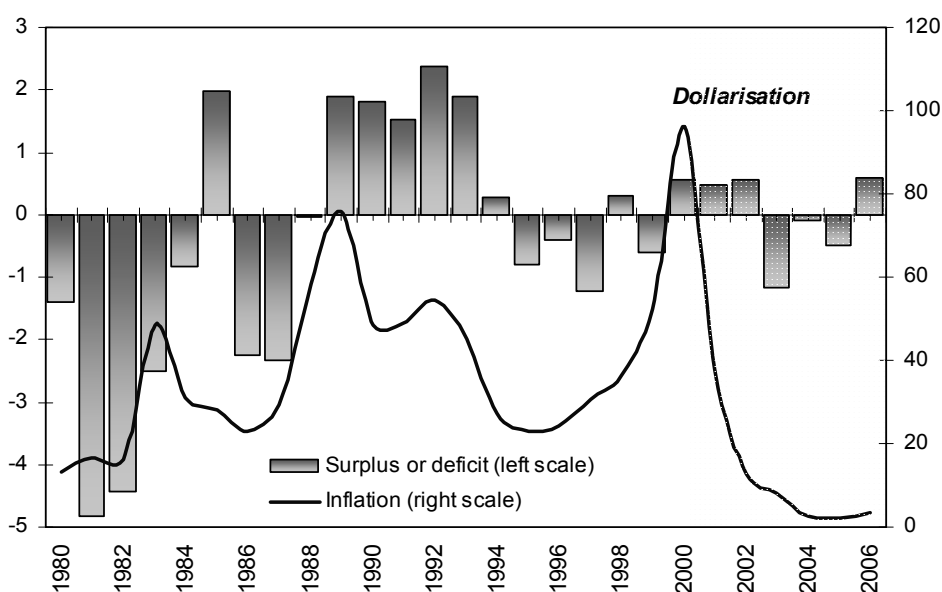
26. The financial sector was liberalised during 1992-94 but supervision remained weak. In 1992, the interest rate policy was relaxed. The 1994 Law of the Financial System Institutions freed entry and exit of (foreign) institutions to the financial sector, which led to a substantial increase in the number of banks and financial transactions, but without improving prudential supervision. Deposit holders and bank managers took excessive risks counting on central bank support should loans fall through.⁸ The Superintendency of Banks and Insurance (SBS) failed to step-up prudential regulation, did not control off-shore branches (which were effective in circumventing regulations and controls), and could not prevent the 1998-99 crisis (Jacome, 2004).

Erratic macroeconomic policies

27. From the 1980s to 2000, Ecuador experienced a stop-and-go process with erratic macroeconomic policies (i.e. fiscal, monetary and exchange rate policies). There were successive cycles of monetary tightening followed by expansions with medium to high inflation. Also, spells of tight fiscal policy were overtaken by uncontrolled increases in public spending resulting in major deficits and spiralling debt burdens leading to several defaults or temporary suspensions of payments (Figure 4). Uncontrollable fiscal deficits and debt burdens made a “normal” conduct of monetary policy almost impossible, as it obliged the Central Bank to finance part of the burden through seignorage, which pushed up inflation and accelerated successive devaluations.

⁸ The multiple bail-outs in the 1980s likely contributed to the moral hazard problem.

Figure 4
Annual average inflation (%) and fiscal deficit as % of GDP, 1980-2006



Source: IMF, International Financial Statistics; 2004-06 fiscal deficits are ECLAC estimates.

a) Fiscal policy and debt management

28. During the 1980s and 1990s, difficulties in fiscal policy management made it impossible to achieve economic stability. Recurrent failed attempts of fiscal adjustment were followed by periods of lax spending control that created a vicious circle of uncertainty around the public commitment to control inflation (Jacome, 2004). Government revenues, heavily dependent on oil revenues, showed large fluctuations corresponding to volatile oil prices. Public spending was under strong pressure from increasing wage bills and debt service payments, despite several defaults and rescheduling agreements. In 1982-84, external debt was renegotiated with commercial banks and the Paris Club, while external private sector debt was nationalised (*sucretización*). After a temporary suspension of debt and interest payments in 1987, a cap was set on interest payments (30% of exports) but this did not bring sufficient relief. New settlements were negotiated as part of the Brady Plan⁹ and with the Paris Club in 1990 and 1992. In 1999, another default was declared (Vos, 2001). Public spending reform was also hindered by extensive revenue earmarking (50% of revenues) established in the Constitution. Nevertheless, price controls and subsidies were gradually eliminated over the 1990s.

b) Exchange rate policies

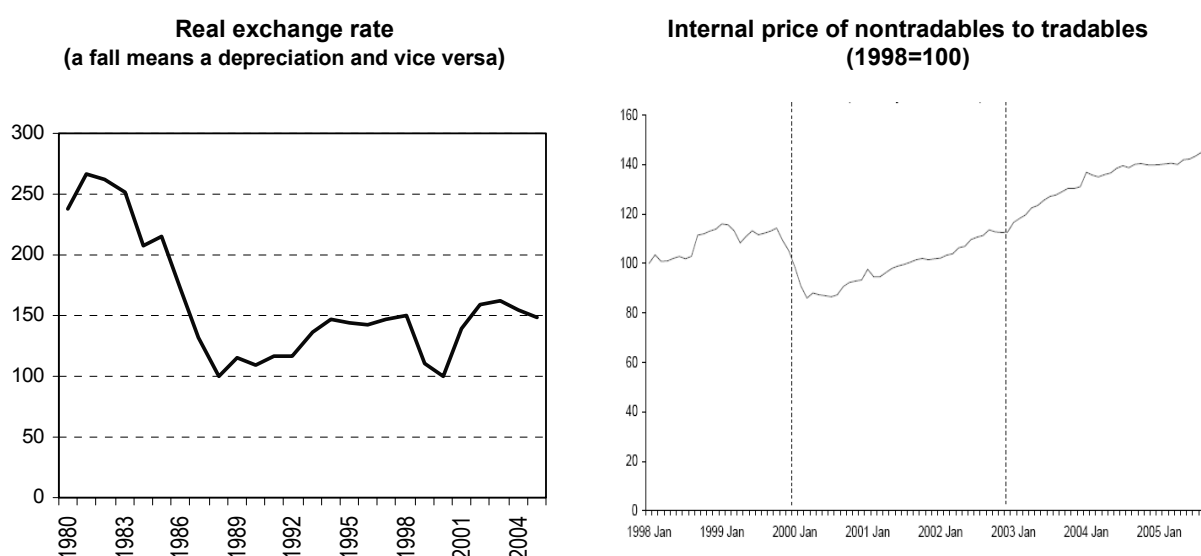
29. Ecuador frequently switched its exchange rate regime in the period under study. In 1983 it moved from a fixed exchange rate to a crawling peg regime with frequent mini-devaluations to adjust the real exchange rate. In the meantime multiple exchange rates were maintained until the early 1990s. During most of the 1990s, it established a managed float within a pre-determined band, using the exchange rate as a nominal anchor to cut inflation. Between 1992 and 1996, this policy was successful in reducing inflation

⁹ The Brady Plan reduced the external debt burden from 88% in 1994 to 78% in 1995 (Vos, 2001).

by half although it led to a strong real appreciation of the currency. In 1999, it moved to a free floating regime which lasted one year until the economy was dollarised.

30. The real exchange rates showed large swings since 1980 (Figure 5). The real exchange rate suffered major depreciations in the 1980s and 1999-2000, and appreciations in the 1990s and 2000s. Under certain hypotheses, the real exchange rate also equals the ratio of nontradable prices (excluding administered prices) to tradable prices. This relative price ratio has increased steadily over the past few years.¹⁰ This means that the tradable (export) sector has become less attractive for domestic investors compared to the nontradable sectors including most services as returns are comparatively higher in the latter.

Figure 5
Real exchange rate and prices of tradables and nontradables, 1980-2006



Source: IMF and Central Bank of Ecuador

Euphoria until 1995 followed by crisis and dollarisation

31. Incomplete reforms and erratic macroeconomic policies in the second half of the 1990s created the roots of the 1998-99 crisis and subsequent dollarisation. The stabilisation of the economy after the reforms of the early 1990s (with inflation falling to 22% in 1995, increasing capital inflows and a credit boom), was short-lived as the country was hit by a series of shocks in the middle of the decade, particularly a short war with Peru and the Mexican Tequila crisis. Capital left the country and created financial

¹⁰ The real exchange rate is defined as (in logarithms) $q = e + p - p^*$, with e , p and p^* being the exchange rate, and the domestic and foreign *total economy* price levels, respectively. This equation can be decomposed in two parts: $q = q_e + \alpha [(p_t - p_n) - (p_t^* - p_n^*)]$ with α being the share of the nontradable sector in GDP. $q_e = e + p_t - p_t^*$ is the real exchange rate in the tradable sector, and $[(p_t - p_n) - (p_t^* - p_n^*)]$ the difference between the tradable and nontradable price differentials of two countries. Assuming the law of one price in the tradable sector, a constant share on nontradables in GDP across countries, and a 'given' foreign price differential between tradables and nontradables, the real exchange rate becomes $q = p_t - p_n$.

instability. Simultaneously, fiscal revenues stagnated due to falling oil prices¹¹, while fiscal spending increased due to rising public wages and pressure from debt service payments, as most public debt was denominated in USD and the exchange rate depreciated. Extensive earmarking also hindered fiscal adjustment. To finance the increasing fiscal gap, domestic bonds were issued, raising the domestic public debt from 2 to 20% between 1990 and 1998, and the total debt to 90% of GDP in 1998. Monetary policy authorities lost its ability to contain inflation. The pre-announced crawling exchange rate band used by the central bank lost its effectiveness in influencing market expectations as parameters increasingly detracted from their pre-announced levels between 1995 and 1998. As a consequence, credibility was lost, the currency depreciated, inflation accelerated and economic agents shifted their assets to the US dollar. By end-1997, foreign currency deposits accounted for two thirds of total deposits. At the same time, USD denominated loans charging lower interest rates, grew rapidly and surpassed sucre-denominated loans in volume by mid-1998. Unsuccessful attempts to contain a banking and currency crisis (Box 1) led to the dollarisation of the economy in early 2000.

Box 1: Events leading to the 1998-99 crisis and dollarisation in 2000

The liberalised financial sector, lax surveillance and poor banking practices aggravated the economic situation after 1995. In the few years before, credit boomed in part responding to a reduction of reserve requirements in 1994. Banks engaged in risky operations with foreign currency transactions with asset-liability, maturity and currency mismatches. After a reversal of capital flows in 1995, the central bank boosted the interest rate to support the currency. This was successful, but caused liquidity problems for several banks which in turn had to be assisted by the Central Bank with subsidised loans in 1996.

From 1997 to 1998, Ecuador was slowly drawn into a crisis, in part because of external factors such as falling oil prices. Moreover, in those years El Niño caused heavy rainfall and floods which destroyed vast agricultural areas, cut production and exports, with damage of around 15% of GDP according to ECLAC estimates. Ecuador was also hit by the Russian and subsequent Brazilian crisis. In this context, expectations about the economic outlook worsened and further hurt the financial system.

The banking crisis started in 1998 when a small and a middle-sized bank were closed and only small savers received a reimbursement of the limited deposit guarantee. This caused people to panic and led to a massive withdrawal of their deposits. Several banks could not honour their obligations and needed emergency loans from the central bank which by the end of 1998 reached 30% of the money base. In December 1998, a Guarantee for Deposits Agency was created to re-establish stability in bank liabilities, while a month later a 1% transaction tax was introduced. The latter measure badly hurt the financial system.¹ Several banks closed late 1998 and early 1999, but deposits were repaid only with a delay. This imposed a loss on depositors due to inflation and currency depreciation, damaged the credibility of the credit guarantee and accelerated the contagion.

In 1999, the banking and currency crisis worsened steadily. As foreign reserve levels fell and pressure on the exchange rate increased, the central bank let the currency float in February. The currency devalued 50% during January and February, hurting the banks' unhedged foreign currency debtors and subsequently the banks' equity and solvency. In March the government imposed a freeze on bank deposits, and asked foreign auditors to assess the banks' soundness. Their findings showed major discrepancies with those of the national regulator, and led to the closure of more banks. Deposits were unlocked by mid-1999, and without confidence restored the deposit run further intensified. The suspension of the government's debt payments in September 1999 led to even worse market sentiments, further withdrawals and currency depreciation. From October to November 1999, the exchange rate jumped from 18,000 to 20,000 sucres per USD, and then to 26,000 within a few days. Inflation was accelerating to above 100% on an annual basis, with hyperinflation around the corner.

Amidst this severe economic, banking and currency crisis, the government decided to dollarise the economy in January 2000. The conversion rate was set at a high level, which meant a de facto maxi devaluation. Although the preconditions for dollarisation were not in place, it succeeded in stabilising the financial system and avoiding a deeper economic crisis. This was partly thanks to a turnaround to positive expectations related to a change in President, higher oil prices and multilateral financial support assisting domestic economic management.

¹¹ Oil revenues accounted for one third on total fiscal income. The fall in oil prices led to fiscal losses of 4% of GDP in 1998-99 (Jacome, 2004).

To conclude, the crisis in Ecuador was exacerbated by three factors. First, the absence of a legal framework to prevent and deal with banking crisis led to the adoption of inefficient, costly measures that were unable to turn around the course of events. Second, weak public finances, expenditure rigidities and political economy constraints made it impossible to formulate a coherent rescue plan that could gain foreign approval and assistance. Third, pre-crisis extensive dollarisation of the financial sector quickly affected its solvency when the exchange rate depreciated.

¹ The measure which was imposed in the middle of a liquidity crunch made banks collapse even faster as the measure (1) exacerbated the pressure on the exchange rate as agents sold the Sucre to store money in foreign currency outside the system, and (2) accelerated deposit withdrawal as agents preferred transacting money outside the financial system.

Source: Jacome, 2004.

32. Another fruit of dollarisation is the faster increase in new types of (non-traditional) exports (see below) whose share in non-oil exports increased from 30 to 50% between 1997 and 2005. Relative macroeconomic stability had also facilitated planning and decision making.

Timid second generation reforms in the early 2000s

33. The Law on Economic Transformation adopted in 2000 by the new government following dollarisation included plans to implement second-generation reforms in many areas, including the financial system, fiscal policy, the labour market and the oil sector. However, outside the financial sphere, few reforms have actually been adopted.

Improved supervision of the banking system

34. Several reforms were approved to step up banking supervision. These include improvements in solvency information of banks, improved on and off-site supervision procedures with the introduction of best-practice risk analyses, and introduction of new mechanisms to assess liquidity, operational and credit risks. The national regulator (SBS) also consolidated its operations to improve its supervision efficiency. Other measures include the elimination of the financial transaction tax, the introduction of a reserve fund to guarantee deposits of public and private banks, and a ceiling on banking fees.

35. All in all, the financial sector is now relatively open and increasingly better supervised. There are no restrictions on cross-border supply or consumption abroad of banking services. Banks and resident firms and persons may make deposits in banks established abroad or receive loans from them. There are no limits on foreign participation in the equity of banks, whether existing or new. Banks may offer many types of services. Foreign banks may establish subsidiaries, branches or representation offices in the country, subject to an authorisation from the Superintendency of Banks and Insurance (WTO, 2005).

Fiscal policy

36. In 2002, a fiscal responsibility law (FRL) was adopted which among other issues, capped real expenditure growth of the central government and created an off-budget oil fund (FEIREP) with revenues from sales of heavy crude. The resources of the fund were to be used for debt buybacks, revenue stabilisation and social spending. The FRL however was met only once, in 2003 and revised in 2005. In 2005, the FEIREP was incorporated into the budget, and corresponding revenues were redirected towards social spending, economic reactivation and other projects. Nevertheless, targets to reduce the non-oil deficit and public debt were respected (IMF, 2006).

Other reform areas

37. Reforms in other areas include, with the year executed in parentheses (IMF, 2006):

- *Oil sector (2000)*: a reform facilitated private sector participation in up- and downstream activities, which led to construction of a privately owned pipeline to transport heavy crude. This doubled the nation's oil transport capacity and private production of oil. However, no private investment took place in downstream activities.
- *Labour market (2000)*: this reform somewhat relaxed hiring practices, allowing for hourly and temporary contracts. Also, various mandatory benefits of the remuneration package were unified¹², which broadened the base for social security contributions and salary-related taxes. These changes were introduced over a 5-year period and had the unintended effect of increasing labour costs for employers (IMF, 2006). Cumbersome labour legislation could be highly distortive,¹³ but as enforcement is not stringent, only some employers consider these as an obstacle.
- *Social security (2001, 2005) and civil service (2003)*. The first include various measures to improve the solvency of the pension system, including an increase in the minimum retirement age and the introduction of a two-tier structure with a compulsory solidarity part and a compulsory saving regime. The second unified different elements of public wages and eliminated pay discrepancies for similar jobs for a quarter of public employees, excluding teachers, health workers and military.

3. Structural change and trade dynamics

Structural change

38. Substantial changes took place in the sectoral composition of the Ecuadorian economy, particularly after the country opened to trade in the 1990s (Figure 6). While the share of industry remained stable over time (with fluctuations), those of agriculture and services show opposite trends. The changes in the composition of the economy accelerated after goods trade liberalisation in the Andean Community in 1993, and WTO membership in 1996. Looking at changes at the detailed level from 1993 to 2005, oil&gas and telecoms increased most their share, followed by cut flowers and processed fish. Sectors that lost share in GDP are several services, followed by cereals and textiles. In the last case, the downturn was dramatic over the longer term, from 11% in 1984 to 2.1% in 2004.

39. Recently, mining and manufacturing output and employment have increased considerably (Figure 7). The big increase between 2004 and 2005 is explained by the boost of oil output in nominal USD due to the rise in the oil price.

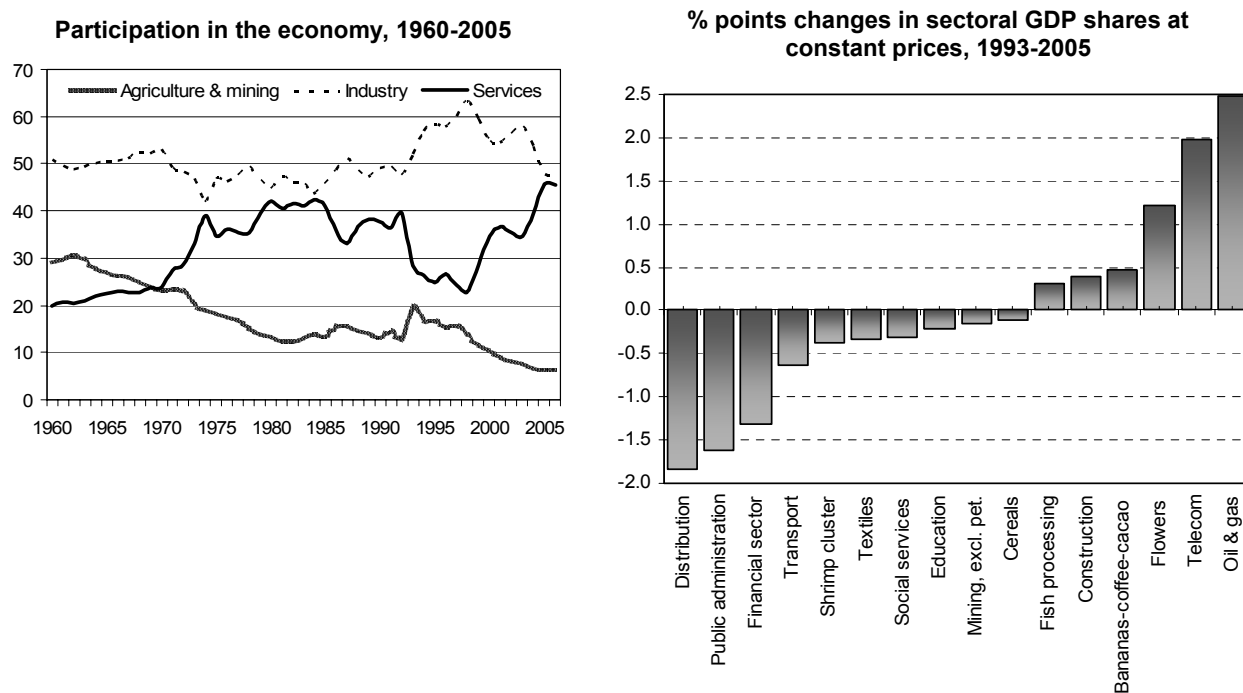
40. The output and employment structures of manufacturing also changed considerably (Tables 5 and 6). The most remarkable trends are: the initial loss but later impressive recovery of food and beverages, accounting for 45% of employment in 2004 (INEC, 2006). In contrast, textiles, shoes, tobacco, furniture, metallic products, electrical machinery and transport equipment have lost shares in both output and employment. These sectors had difficulty adjusting to the reduction of high tariff barriers and new

¹² Prior to unification, there was a complex system of mandated benefits whose administration was complex and cumbersome. It included additional months of salaries and allowances for cost-of-living and transport, some of which were lump-sum while others were linked to the minimum wage.

¹³ That is, it was estimated that the wage difference between complying and non-complying firms is only about 8%.

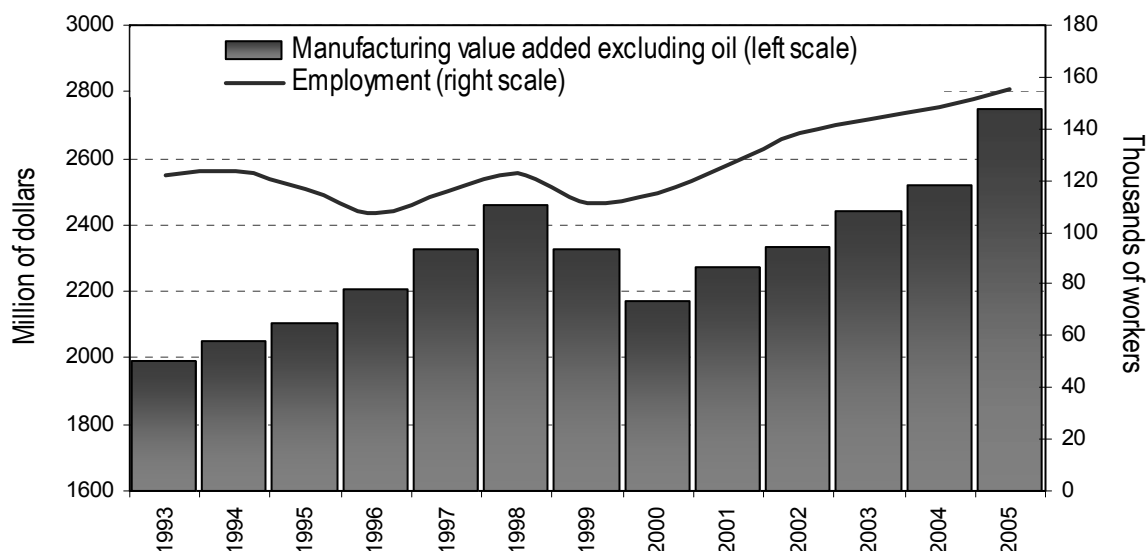
competition, mainly from other Andean countries and Asia, and contraband trade. Several other trends stand out. The petroleum sector has boosted its output share, but reduced its share in employment. Chemical products, plastics and rubber also created many jobs recently, despite their employment share reduction in the medium term which is “distorted” by the increase in the petroleum share.

Figure 6
Changes in sectoral GDP shares, 1960-2005



Source: Authors' based on Central Bank of Ecuador, National Accounts, and World Bank, *World Development Indicators*.

Figure 7
Trend in employment and value added in mining and manufacturing (excluding oil)
(In millions of constant 2000 US dollars and thousands of workers)



Source: Authors based on Central Bank of Ecuador, *UNIDO Industrial Statistics* (1984-2000), and INEC (2001-2005). 2005 values are preliminary national figures based on a survey of industrial establishments with more than 10 employees.

Table 5
More and less dynamic sectors in Ecuador: From 1985 or around year to 2005 or most recent year

<i>Production and Employment performance</i>						
	PRODUCTION			EMPLOYMENT		
	Sectors	Share in total (2005)	Annual growth rate	Sectors	Share in total (2004)	Annual growth rate
Dynamic	Cut flowers	16.5% ^a	19.7 (1993-2005)	Cut flowers
	Preserving and processing of fish	9.2% ^b	7.0 (1985-2004)	Preserving and processing of fish	14.3 ^b	10.4 (1995-2002)
	Footwear	0.4% ^c	7.1 (1985-2004)	Wearing apparels	4.9 ^b	4.5 (1995-2004)
	Wearing apparels	0.9% ^c	6.3 (1985-2004)	Footwear	1.6 ^c	4.6 (1995-2004)
Stagnant	Cereals	10.3% ^a	2.0 (1993-2005)	Textiles	6.0 ^c	-2.4 (1985-2004)
	Textiles	2.1% ^c	-1.4 (1985-2004)	Leather and related products	0.4 ^c	-2.7 (1985-2004)
	Leather and related products	0.2% ^b	-2.5 (1985-2004)	Wood manufactures	2.6 ^c	-2.1 (1985-2002)

Source: Authors on the basis of UNIDO Industrial Statistics 3 digit (2006) ISIC Rev 2; mapping of Rev 3 to Rev 2; Ecuador Central Bank production breakdown, and INEC Statistics from Manufacturing and Mining 2004 survey CD-ROM and webpage public information. (www.inec.gov.ec).

^a Share in total agriculture production: ^b Share in total industry, and 2002 data: ^c Share in total industry, and 2004 data

41. In summary, there are several “winner” and “loser” sectors from trade opening, even though the term losers should be interpreted with care as it may simply indicate that Ecuador is moving out of sectors in which it has no comparative advantage (Table 4). In agriculture, cut flowers stand out as a winning sector, whereas cereals were less successful to adjust to trade and other structural reforms (see below). Although cereal output growth was positive between 1993 and 2005, its performance was well below the rest of the agricultural sector and as a consequence its output share dropped over time.

42. While oil constituted 45% of exports in the period 2001-2004, exports have become more diversified in terms of products. From the 1980s to 2002, the share of non-traditional products¹⁴ in total exports increased from 8% to 31%, but fell again to 22% in 2005 in the context of the oil price boom which inflated the share of oil products. The largest boost of new types of exports was given by (the run-up to) Andean trade liberalisation in 1993, which provided an enlarged market. But this stimulus levelled in the second half of the 1990s due to stagnating demand in the other Andean countries (Vos and Leon, 2003). All in all, export dynamics continues to depend in large part on natural resource exports and the corresponding terms of trade. The change in the composition of imports clearly reflects consequences of greater trade opening in terms of the increasing share of consumer goods. The increase in the share of fuels between 2001 and 2005 corresponds to price increase of fuels, which Ecuador imports from mostly Colombia and Chile.

Table 6. Ecuador: Changes in Employment and Output Structure in Manufacturing (In percentages of total)

	Employment					Value Added				
	1984	1990	1995	2002	2004	1984	1990	1995	2002	2004
311+313 Food and beverages	27.4	30.9	35.1	46.5	45.0	30.2	33.0	25.9	30.6	31.9
311 Food products	22.3	24.3	29.4	38.3	38.6	25.5	28.8	19.7	16.9	22.1
313 Beverages	5.1	6.6	5.7	8.2	6.4	4.6	4.2	6.2	13.8	9.8
314 Tobacco	1.2	0.7	0.3	0.4	0.4	1.5	0.8	0.2	0.5	0.2
321 Textiles	15.6	13.0	9.3	6.3	6.0	11.0	10.7	5.5	3.1	2.1
322 Wearing apparel, excl. footwear	3.3	3.4	3.6	3.8	4.9	1.0	1.4	0.8	1.0	0.9
323 Leather products	1.0	0.9	0.7	0.4	0.4	0.6	0.8	0.2	0.1	0.1
324 Footwear, except rubber or plastic	1.0	1.5	1.3	2.0	1.6	0.5	0.6	0.7	0.7	0.5
331 Wood products, except furniture	3.0	2.9	3.2	2.3	2.6	1.7	1.7	1.7	1.7	1.3
332 Furniture, except metal	3.0	2.8	2.5	0.5	3.5	1.5	1.4	0.9	0.2	1.0
341 Paper and products	3.2	3.6	4.4	4.5	4.3	3.7	4.4	2.9	3.4	2.8
342 Printing and publishing	3.3	3.7	3.3	3.2	3.2	3.4	3.0	1.8	2.1	4.3
351+352 Industrial chemicals	7.0	7.3	6.3	5.3	5.4	7.6	11.3	4.1	6.4	3.2
353 Petroleum refineries	1.5	1.5	2.2	2.1	1.8	2.8	1.8	38.9	29.9	33.4
354 Miscellaneous petroleum and coal	0.2	0.2	0.1	0.0	0.0	1.0	0.9	0.0	0.0	0.0
355+356 Rubber and plastic	6.3	6.7	7.6	5.4	5.3	6.0	5.7	4.0	3.6	6.6
361+362+369 Non-metallic mineral products	6.8	5.9	4.8	4.8	4.6	11.2	8.3	5.3	6.6	4.3
371+372 Iron and steel, non-ferrous metals	1.5	1.6	2.0	1.9	1.9	2.7	2.6	1.1	1.2	2.5
381 Fabricated metal products	6.5	6.0	4.8	3.1	2.9	5.7	4.9	1.9	3.0	1.9
382 Machinery, except electrical	0.8	0.6	1.8	0.9	2.8	0.4	0.3	0.7	0.5	1.0
383 Machinery, electric	4.1	3.7	3.1	3.2	0.9	4.3	3.7	1.6	2.7	0.9
384 Transport equipment	1.7	1.9	2.5	2.7	2.3	2.0	2.0	1.7	2.4	0.8
385 Professional and scientific eq	0.5	0.5	0.1	0.2	0.1	0.5	0.4	0.1	0.1	0.0
371+390 Other manufactured products	0.9	0.7	1.0	0.4	0.1	0.6	0.4	0.2	0.3	0.2
Total employment (000s workers)	94	112	117	139	148					
Total Value Added (million current US\$)						1130	1196	2445	2805	5375

Source: Authors' calculation based on UNIDO *Industrial Statistics 3 digit* (2006) ISIC Rev 2; mapping of Rev 3 to Rev 2; and INEC Statistics from Manufacturing and Mining 2004 survey CD-Rom and webpage public information. (www.inec.gov.ec).

¹⁴ According to an official Ecuadorian definition, Non-traditional products are those that were not exported before the 1980s. (see http://www.sica.gov.ec/agronegocios/nuevas%20agroexportaciones/panorama/panorama_nt.htm.) Examples of non-traditional agricultural products include flowers, broccoli and some fruits, while non-traditional industrial products include canned fish and fruits, processed wood, and textiles.

Trade dynamics

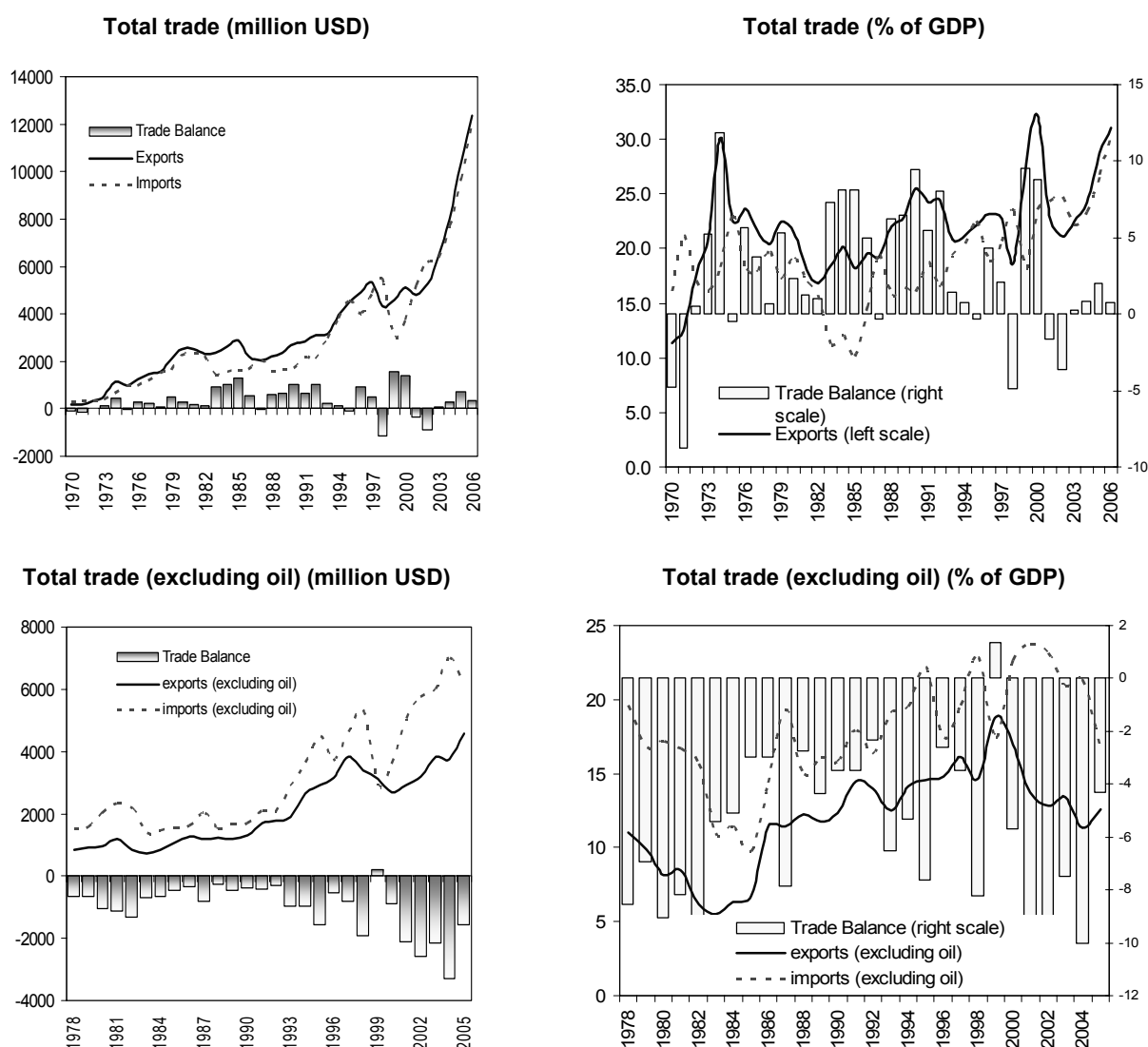
43. The reduction of import (and export) barriers has triggered an increasing participation of Ecuador in world trade, raising the share of exports and imports over GDP from 27% in 1970 to over 62% in 2006 (Figure 8). Indeed, exports have been a major source of GDP growth. The increasing share of trade is determined in large part by oil, representing between 50% and 60% of exports (Figure 9). Without oil, the trade share would be substantially less: while it increased from 30 to 40% of GDP between 1978 and 1990, it fell again to below 30% in 2005.¹⁵ The country's trade balance has been positive for most years, thanks to petroleum exports. When these are excluded, however, the balance has remained negative for almost all years, despite the emergence of non-oil exports.

44. Non-oil export growth took off in 1991 and grew at around 17% per annum until 1997 when it flattened out. When considering that tariff cuts started in 1985, the lack of export response until the early 1990s is quite remarkable, reflecting the difficulty for new exports to take off in the context of economic and financial turmoil in the second half of the 1980s. Only when the economy somewhat stabilised in the early 1990s, did new exports emerge, such as cut flowers and processed tuna. A second non-oil export boom has occurred after dollarisation of the economy in 2000, which also provided more stability and predictability for exporters as well as a more depreciated exchange rate.

45. The import response to lower tariffs was also delayed. The applied import tariff was cut already quite substantially between 1985 and 1988, but imports only started to grow substantially after 1990. The key reason for this delayed response was the macroeconomic turbulence of the late 1980s which held back import demand.

¹⁵ Here, oil and derivatives were excluded from trade but not from GDP. When this sector is also excluded from GDP, the trade would increase substantially (for example in 2000 from 40 to 50% of GDP).

Figure 8
Exports, imports and trade balance, 1970-2006



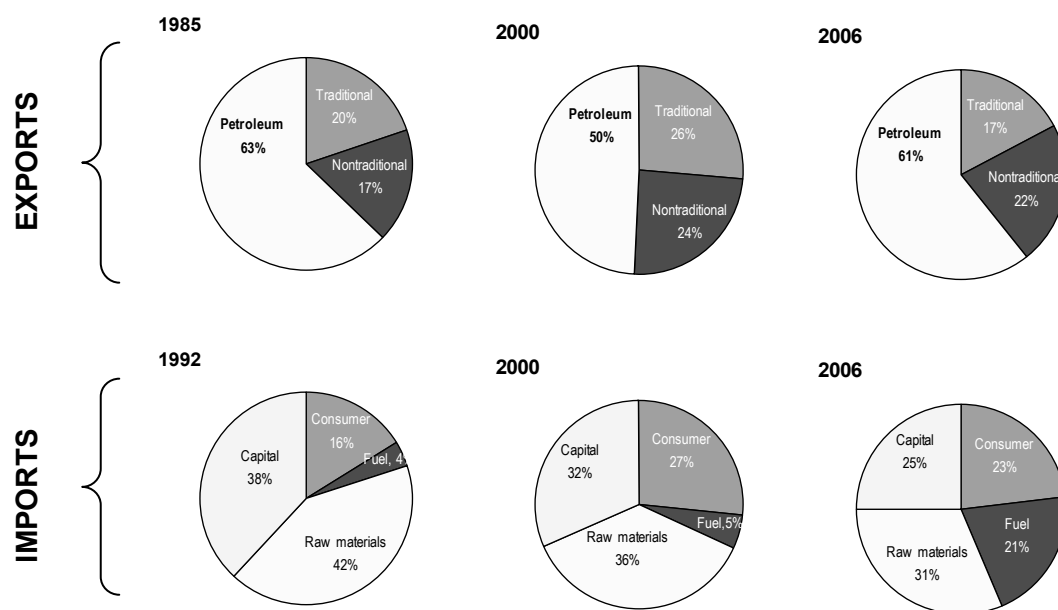
Source: Authors' calculations based on COMTRADE and Central Bank of Ecuador.

46. The trends in non-oil exports are illustrated in Table 7 and Figure 9. The share of traditional export products has been reduced by half after 1990, representing only 17% of exports in 2006. Bananas represent the bulk of this category. Ecuador continues to be the world's major banana exporter and as such is an international price setter. Exports of coffee and cacao have become less important over time. Another interesting trend is the substitution of (traditional) fresh fish exports by (non-traditional) processed fish (tuna) exports. In terms of dynamics over time, non-traditional exports grew fastest in periods of relative macroeconomic stability (first half of 1990s and 2000s), and suffered less from the 1998-99 economic crisis than traditional exports (Figure 10).

Table 7. Export Structure, 1988-1990, 1998-2000 and 2003-2005

Products & codes	1988-1990	1998-2000	2003-2005
Traditional products	42.7	39.1	23.0
bananas (0573)	16.4	21.3	14.6
fish and crustaceans (034+035+036)	16.6	15.1	5.8
coffee and derivatives (071)	6.7	1.7	1.0
Cacao (072)	3.0	0.9	1.5
Non traditional products	10.3	26.5	27.0
cut flowers (2927)	0.4	3.7	4.5
fish & crustaceans prepared or preserved (0371+0372)	1.2	5.5	5.2
Textile & apparel industry (65+84+26)	0.8	1.5	1.2
cereals (04)	0.2	0.6	0.3
Others non traditional exports	7.8	15.2	15.8
Petroleum (333, 334 and 335)	47.0	34.4	50.0

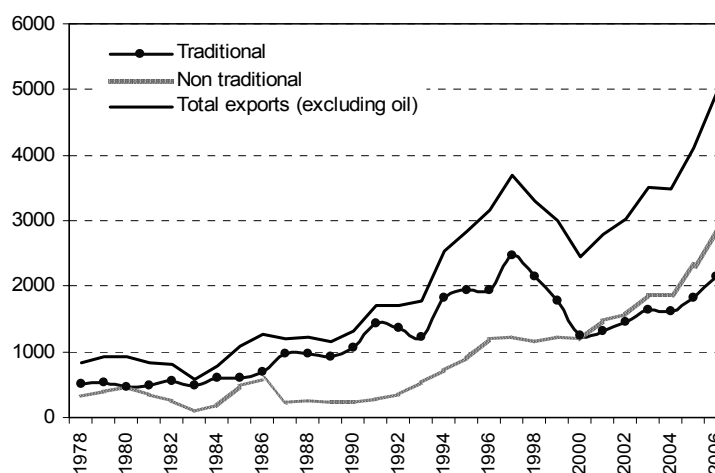
Source: Authors' calculation based on COMTRADE CUCI Rev. 2

Figure 9 Composition of trade by products, in percent, 1985, 2000 and 2006

Note: non-traditional products are those that were not part of exports before 1980.

Source: Authors' calculations based on COMTRADE.

Figure 10 Growth of traditional and non-traditional exports (excluding oil), 1978-2006 (million USD)

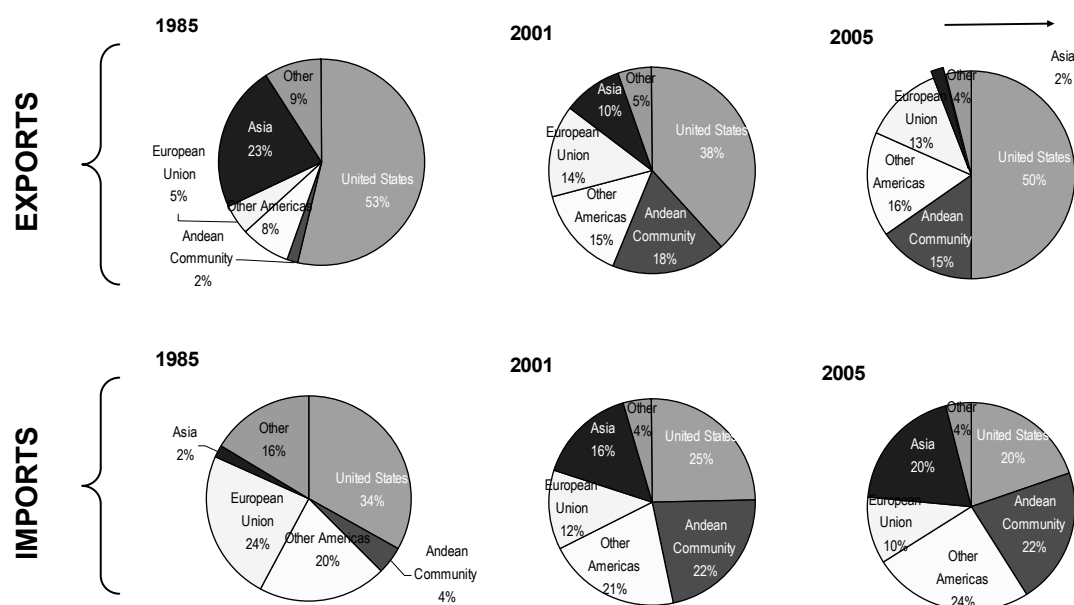


Note: non-traditional products are those that were not part of exports before 1980.
Source: Authors' calculations based on COMTRADE.

47. From 1992 to 2005, exports to the United States grew faster than to other countries, aided by improvement in market access, particularly of raw materials and their derivatives, agricultural and horticultural products (broccoli, flowers, seafood, and oil derivatives) (Figure 11).

48. Export destinations have become more concentrated, with the United States increasing its share in exports to about half, while import origins have become more diversified. A remarkable trend is the larger role of the Andean Community (CAN), which has become Ecuador's second largest market. Peru has emerged as a key export market and Colombia as a strategic source of imports. The Andean Community has generated trade flows, but the overall effects are mixed in part because of Ecuador's increasingly negative trade balance with its Andean partners. Also, opposite trends of the relative importance of Asia are noteworthy, with an increasing share in imports but a declining one in exports.

Figure 11
Composition of trade by destination and origin, in percent, 1991-2, 2001 and 2005

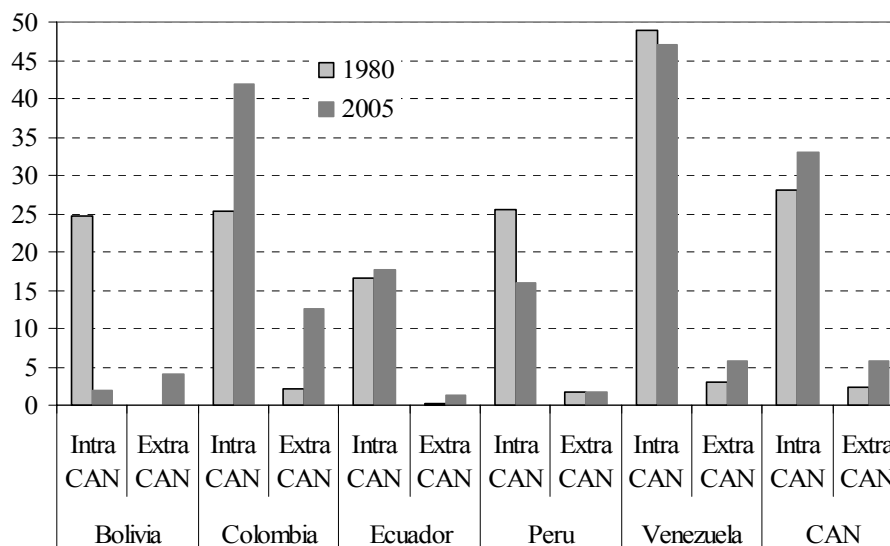


Source: Authors' calculations based on Central Bank of Ecuador and IFS, Direction of Trade Statistics, Yearbook 1987

49. A remarkable feature of Ecuadorian trade with other members of the Andean community is the higher content of manufactures compared to extra-regional trade, although it is lower than for other members (Figure 12). Notwithstanding that some of these manufactures are based on natural resources, or have low technology content (such as basic metals, food products, oil derivatives), there is also a substantially higher share of medium and high-tech content manufactures. Moreover, intra-CAN trade has a considerably higher share of the intra-industry type.¹⁶ This indicates that intraregional integration contributes to achieving the necessary scale economies to produce certain types of manufactures that may facilitate eventual extra-regional exports.

¹⁶ Intra-industry trade refers to the trade (exports and imports) of products belonging to the same industry. That is, a country exports and imports the same kinds of goods and services. This type of trade, as opposed to inter-industry trade meaning the exports and imports of different products, is associated with higher economic growth because it requires the differentiation of products, increases in productivity and economies of scale.

Figure 12
Share of medium and high tech manufactures in Intra and Extra Andean Community (CAN) exports, in percent, 1980 and 2005



Source: Authors' calculations based on COMTRADE.

Alleviating the negative impact of trade liberalisation and other structural reforms

50. The government put limited efforts in addressing the social and other negative consequences of both the trade and structural reforms in the 1980s and the early 1990s. Trade liberalisation was not carried out in an isolated manner, but accompanied by various other structural reforms, including the withdrawal of price controls and diverse forms of subsidies and (agricultural) support. The broad reforms aimed to increase the role of market mechanisms, which was expected to boost economic growth.

51. The results of structural reforms in terms of economic growth, poverty alleviation and reduction of income inequality were rather unsatisfactory until the aftermath of dollarisation in 2000. While the liberal policies of the 1980s benefited the state and some rural interests, the urban sector and industrialists suffered. The reforms of the 1980s benefited particularly the export sector in the Coastal areas (Janvry *et al.*, 1991). From 1980 to 1999, household real incomes deteriorated, except between 1993 and 1996. Unemployment increased, real wages fell and health and education spending was cut especially hitting the urban poor. In retrospect, carefully targeted measures to compensate the urban poor may have allowed the stabilization programme in 1984-88 to enjoy more public support.

52. Structural reforms also seem to have increased income inequality, especially throughout the 1990s. Trade reforms augmented the skill- intensity of production in most traded and non-traded goods sectors and increased the wage gap between skilled and unskilled workers. Employment growth was highly volatile, and it seems that on average more workers have been pushed into the informal sector (National Committee of SAPRI in Ecuador, 2001).

53. Social spending highly fluctuated throughout the 1980s and 1990s around a downward trend, which was only reversed after 2000. Downward adjustments were most important during the late 1980s and second half of the 1990s, while there was a recovery in the early 1990s. After dollarisation, social spending recovered as a share of GDP, and more emphasis was put on conditional income transfers and

social assistance to the most vulnerable groups. In the context of a few reforms that particularly hit the poor, such as the elimination of gas and electricity subsidies in 1998, specific compensation was given (Vásconez *et al.*, 2005).

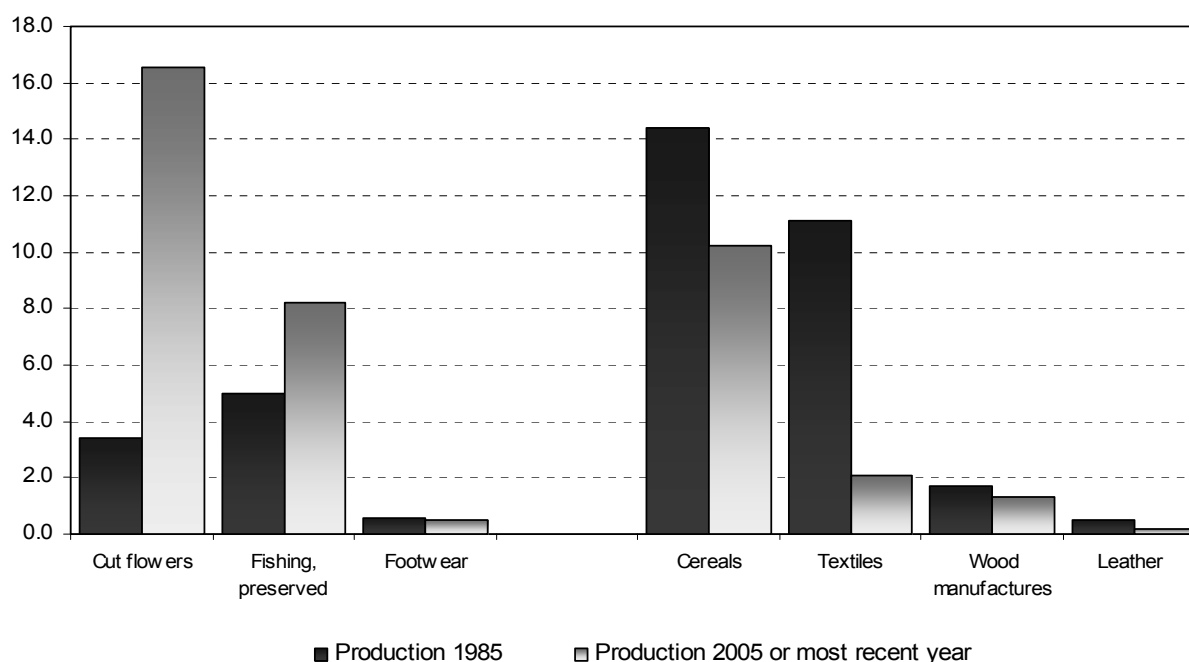
4. The impact of trade reform on particular sectors

54. Trade liberalisation and the subsequent re-alignment of (price) incentives have induced substantial structural adjustments in the economy, with gains of several nontraditional products and “losses” in several traditional sectors. In addition to oil, several agricultural, fishing and processed food industries have benefited most, as suggested by their huge expansion of production and net exports. These include products like cut flowers, broccoli, hearts of palm, mangoes, shrimps and fresh and processed tuna. In contrast, sectors that seem to have suffered most, as indicated by their sharply deteriorating (negative) trade balance and falling share in production are cereals (e.g. wheat, barley), textiles, chemicals, and several types of machinery and equipment. It is remarkable that the bulk of structural change took place between 1996 and 2005, several years after the tariff reductions (1985-88 and 1990-93).

55. Below two “dynamic” and two “stagnant” sectors are examined in more detail, to understand which factors contributed to their success or failure. The winning (losing) sectors are those that increased (reduced) their share in agricultural or manufacturing production between 1985 and 2005 (Figure 13).

Figure 13
Structural change in Ecuador: 1985 and 2005

(Share in total manufacturing/agricultural production)



Source: Author's basis on UNIDO and Central Bank of Ecuador.

a) *Dynamic exports of flowers ...*

56. The flourishing cut flowers sector has reached 10% of total non-oil exports and employed around 70,000 persons directly and another 140,000 workers indirectly in 2006; exports have increased by more

than 16% per year over the last two decades (Figure 14). Ecuador has typical natural comparative and competitive advantages for flower cultivation: optimal sunlight because of its location on the Equator, abundant water supply, excellent soil and air conditions at altitude (2,800-3,200 meters), and a large variety of microclimates that differ according to altitude, rainfall, and wind to grow a large variety of flowers. Roses, more than 300 varieties, account for more than three fourths of total flower exports.

57. After failed attempts in the 1970s¹⁷, the flower industry took off in the early 1980s aided by various factors. In that period, farmers were looking for new products to diversify their production and export base in the context of declining profitability and production of traditional crops such as barley, potatoes, and wheat. In 1983 an ex-manager of the Central Bank and his partner started a flower plantation after visiting Colombia, which at the time was already a major flower exporter, with credit from the National Financial Cooperation. In 1985, there were three companies that cultivated 25 hectares close to Quito (Cumbayá) and exported 30,000 boxes of flowers. The industry continued growing rapidly, with help of subsidised loans, in part from the IADB and World Bank, aimed at diversifying the country's export basket. Flower cultivation started in poor rural areas with inexpensive land and abundant cheap labour. The entrepreneurs were highly qualified businessmen and agronomists. Foreign investment, starting with Colombian flower producers, who left home due to difficult circumstances,¹⁸ was crucial to transfer technology.

58. Public policies contributed little to the development of this sector in the 1980s, except for subsidised loans and a short period of macroeconomic and political stability. In the 1980s, this sector received a sizable proportion of the loans provided by the National Financial Corporation aimed at the diversification of production and exports. The 1989-94 period of major trade reforms and macroeconomic stability was also crucial for the flower export boom (Sawers, 2005). Trade liberalisation in that period substantially reduced the anti-export bias by easing restrictions on imports of intermediate inputs, simplification of documents and administrative procedures required of exporters, and the adoption of a more favourable code for foreign investment. Moreover, the stable economic and political climate and a competitive exchange rate during that period also helped planning of investment in flower cultivation and exports.

59. The success of the industry is also linked to the development of a cluster around flower cultivation with various forward and backward linkages and key participation of international technological leaders. Examples include introduction of metal greenhouses and plastic roofs, innovation linked to the development of new plant varieties (partly with Dutch investment), computer driven drip irrigation systems (by Israelis), a pesticide industry for flowers (with US participation), and management advice (by Colombians). Ecuador was among the first targets of the global flower industry. Foreigners also own more than half of all flower producers.¹⁹

¹⁷ Two separate attempts by two businessmen failed because of a lack of refrigeration facilities, absence of regular air transport services, frequent refusals by flower purchasers to buy at their export destination (mainly Miami) and strong competition from Colombia. Moreover, one firm also went bankrupt because of serious labor disputes while the second entrepreneur withdrew from this sector to work in banking. Despite the failures, these experiences showed that Ecuador had a very favorable climate for flower cultivation (see www.expoflores.com/contenido.php?menu_2=1 and Hernández *et al.*, (2007).

¹⁸ Flower productions and exports in Colombia took off between 1967 and 1973, when the government eased import restrictions and devalued its exchange rate. Its larger population and higher income per capita compared to Ecuador created a sizable class of entrepreneurs. From 1973 to the 1980s, a policy reversal with increased trade protection and an overvalued currency, together with increasing security problems created a very difficult business environment.

¹⁹ Colombians own about 20-25% of firms, followed by Americans (15%) and Dutch and Germans (another 15%), according to CORPEI.

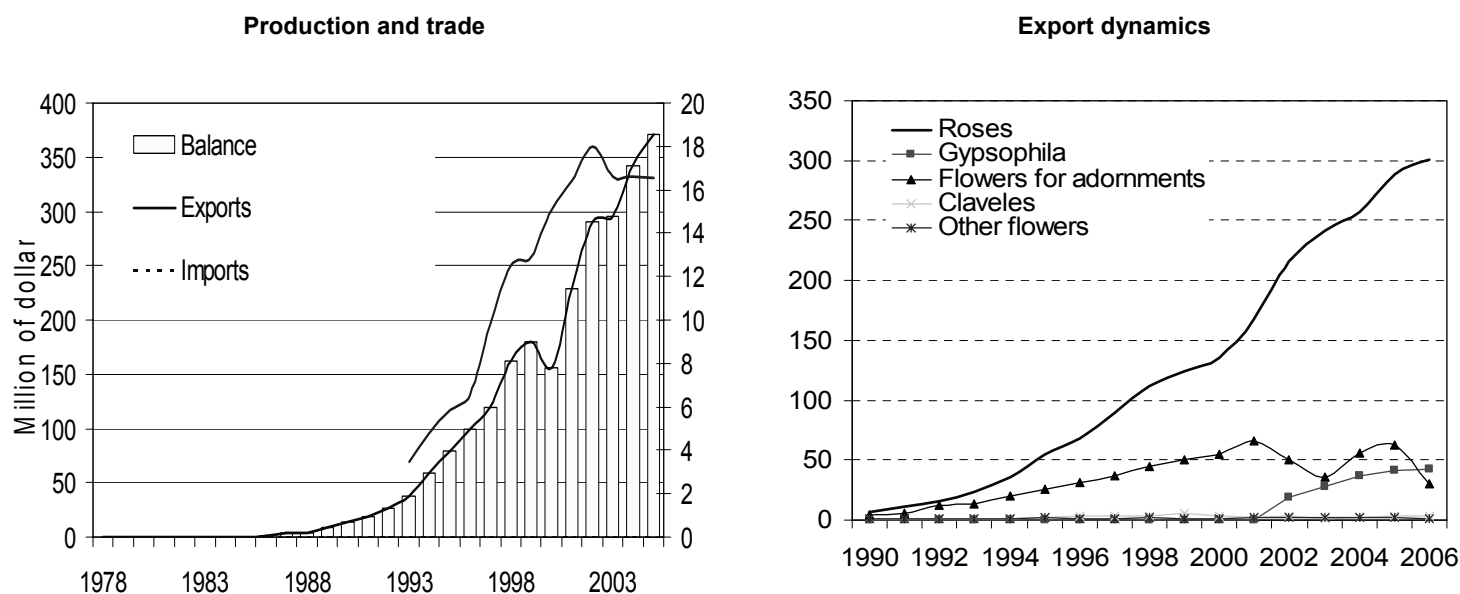
60. Export promotion by CORPEI, a non-governmental organisation, and other technical assistance was crucial to boost flower exports. CORPEI produced market studies, co-financed trade shows and missions and assisted exporters in establishing contacts abroad. Technical assistance was also provided and financed with development aid (partly from the United States) and credit lines of the IADB. The latter were used in part to upgrade phytosanitary standards and obtain certification in Ecuador's major export markets.

61. Changes in the global flower sector also accelerated exports. Cheaper air and road transport led to a reorganization of the industry aiming at minimizing production instead of transportation costs. In turn, flower production moved from cold locations (e.g. northern part of the United States) to warm countries that can produce year-round such as Colombia and Ecuador. Demand from the United States, being Colombia and Ecuador's major trading partner, increased steadily. Distribution was constantly upgraded, with Miami and Aalsmeer (Amsterdam) becoming central hubs capable of clearing customs, auctioning, repackaging, and reshipping millions of flowers per day.

62. Finally, improved market access, particularly of the United States, was also crucial to boost flower sales abroad. In 1992, the United States eliminated the 7.8% import tariff for Ecuador as part of the Andean Trade Preference Act (ATP). In 2002, the ATP was deepened and linked to drugs elimination (ATPDEA). Ecuador partially succeeded in diversifying its export markets, for example to Russia, catering to specific markets (Superintendencia de Bancos y Seguros del Ecuador, 2006).

63. The flower sector faces several challenges. One threat is the possible ending of the tariff-free entrance to the US market under the ATPDEA in February 2008. Although the tariff that would be imposed is not very high, Ecuador would lose a substantial part of its US market share to Colombia which has duty (and administration) free access under a recently signed free trade agreement. Another major challenge remains the poor quality of logistics such as roads and air transport, with corresponding sales and export losses reaching over 40%.

Figure 14: Flowers: Production and trade dynamics, 1978-2006



Source: FAOSTAT, Comtrade.

b) ... and (processed) tuna exports

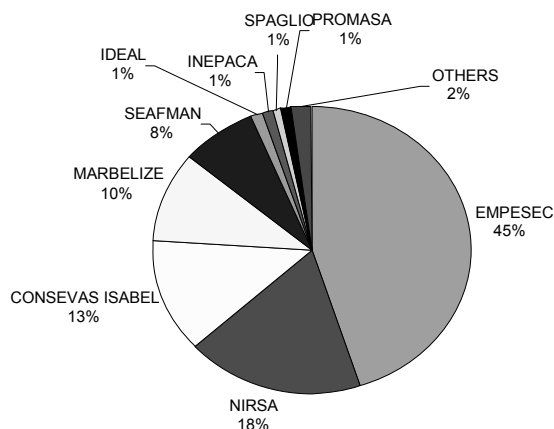
64. The fishing and fish processing industries, particularly those of tuna, have also developed into a very successful export industry whose origins date back to the 1940s. As such, Ecuador exploits well its extraordinary competitive and comparative advantage in this industry.²⁰ These industries employ around 400 thousand people, of which the majority work in small-scale fishing distributed over 139 ports with around 15 thousand small boats. Moreover, Ecuador also has a modern industrial-type fishing fleet of about 250 ships spread over four major ports. Fish processing includes four sub-sectors: frozen (shrimps, tuna and other types), canned (tuna), and fish meal. The processing plants meet the high quality standards needed for certification and exports to advanced countries, which have also made them attractive to vessels sailing under foreign flag. About half (180 out of 350 thousand tons in 2006) of the processed tuna is delivered in Ecuadorian ports by foreign ships.

65. Exports of processed fish increased at high rates (20% per year on average between 1990 and 2005, Figure 16), while those of fresh fish grew by 8% per year. Both reached almost 10% of non-oil exports in 2005. Most tuna exports are canned (60%), while the rest are frozen or fresh (refrigerated). The United States is the most important export market for tuna, absorbing more than two-thirds of total exports. Canned tuna exports to the United States benefited from production and delivery problems of the Mexican tuna sector in 1999. Japan, Spain and the United Kingdom account for another 15%.

66. Tuna fishing and processing, a well operating coordinated cluster, is one of the most successful parts of the fish industry. The tuna cluster is concentrated (over 90% of production) in the port of Manta, whose origins go back to the late 1940s. The cluster comprises a whole range of firms that support the tuna activity, including maintenance, logistics, finance, etc. Each job in the tuna fishing or processing creates seven indirect jobs elsewhere in the cluster. The Ecuadorian tuna fishing fleet consists of about 100 ships, which is the largest of all Pacific countries including Mexico. The tuna processing industry produces daily about 450 tons and is very concentrated, with five firms accounting for 90% of canned tuna exports (the largest accounting for about one third in 2003-05) and 80% of fresh and refrigerated tuna exports, while two firms account more than two thirds of the frozen tuna exports (Figure 15). The large majority of processing firms is Ecuadorian, but several have minority participations or joint ventures with companies from Colombia, Spain, Japan, and Venezuela. Several of these have been established in 1970s, and have been key to transfer know how and technology. Foreign investment in new fishery activities is allowed only where this includes processing in industrial plants. Moreover, prior approval is required from the National Fishing Institute, responsible for the control and protection of fishing resources.²¹ Tuna processing tripled its share in manufacturing employment and value added from 5 to about 15% between the late 1970s and 2005.

²⁰ Ecuador has abundant fish supplies. According the Inter-American Tropical Tuna Commission, Ecuador has the largest volume of fish of all coastal American waters of the Pacific. The combination of the cold Humboldt Current and warm el Niño Current create an ideal maritime environment for the reproduction and coexistence of the large variety of fish. These circumstances allow round-year fishing, compared to for example 1-2 months in the coastal waters of Peru.

²¹ Moreover, entry is prohibited in small-scale fishing, and to shrimp and lobster trawlers flying foreign flags (WTO, 2005).

Figure 15: Ecuador, Total exports by firms

Source: Central Bank of Ecuador

67. The tuna cluster has received substantial support from the government. The government built the first refrigerated processing plant in 1949 which started exporting to the United States in 1952. The big push came after the adoption of the Law on Fishing and Fisheries Development which provided the sector with subsidised loans. These were used to modernise its fleet and shift from wooden to metal ships. Moreover, the cluster received favourable tax and tariff treatment. Between 1990 and 1992, these types of support were phased out as they were not compatible with Andean integration and WTO rules, except for sales of domestically produced canned tuna which remains still exempt from value added tax. Another major contribution to the cluster's development was the National Institute of Fisheries (INP), founded in 1959 with support of the FAO and is considered a benchmark in Latin America. The INP works together with their counterparts in the major importing countries (United States, European Union) and are authorised by the latter to control quality and grant certification to tuna fishers and processors. It applies for example the HACCP (hazard analysis on critical control points), required by the US Food and Drugs Administration. Moreover, it provides key information to tuna fishers on type and volume of biomass, water and soil quality, studies on native species, etc. Another important body is the National Council for Fisheries Development, which also has private sector representatives. This Council has developed policies and amendments to the Fishing Law, and sets catch quotas on the basis of technical reports of the INP and decisions taken by the Inter-American Tropical Tuna Commission (IATTC), which are well respected. The sector also benefited from official development aid of the United Kingdom for more than two decades.

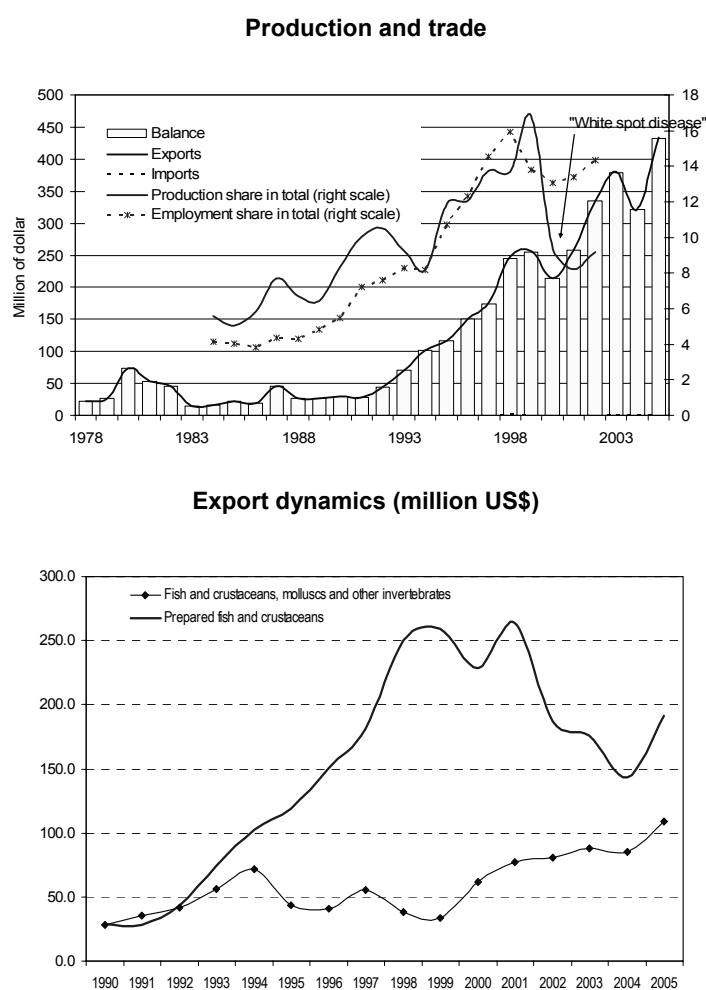
68. Other factors have also contributed to the successful development of tuna fishing and processing. First, the relatively high quality of on-the-job training of fishermen, particularly in the port of Manta. These fishermen not only work in Ecuador but also in neighbouring countries and elsewhere and have contributed to wide dissemination of Ecuador's capabilities in this area. Second, sanitary requirements by Ecuador's main trading partners which require tuna to be processed at the port where the fish is unloaded.

69. The tuna sector faces important challenges. Tuna exports to the United States are threatened by the non-renewal of the ATPDEA after February 2008, which currently provides free access to its market. Non-renewal may lead to imposition of higher tariffs²² and loss of market. Another challenge is cost containment: costs have increased in the last few years and it is increasingly difficult to remain competitive

²² The US tariffs applying to tuna imports are: 35% canned in oil, 12.5% canned in water and 0% in pouch.

vis-à-vis low cost producers such as Thailand. Moreover, it faces increasing competition from new exporters such as China, which has an advantage over Ecuador as it is not subject to the international agreement on the conservation of dolphins and turtles. To increase efficiency and lower cost, it is necessary to modernise the fishing fleet, reinforce research efforts at the National Fishing Institute, improve the skills and management, reinforce links with multinationals and diversify export markets.

Figure 16: Processed fish: Production and trade dynamics



Source: FAOSTAT, Comtrade.

c) Cereals had difficulty to adjust to structural reforms ...

70. The decline of cereal cultivation (Table 8, Figure 17) was caused not only by trade liberalisation, but also by land reform, major reductions in agricultural support and other factors. Trade liberalisation reduced the protection of the cereal sector, including through the replacement of import prohibitions for several products (wheat, barley, rice, soya) by tariff quotas which was a precondition for WTO entry in 1996. Nevertheless, cereal production has remained protected by variable, world-price-dependent, import tariffs and tariff quotas with domestic purchase obligations for large domestic consumers of corn and wheat. These protections have not prevented substantial wheat imports from mainly the United States (in

large part for free under the PL-480 Alliance for Progress programme since 1985) and barley imports from Colombia. The cheaper (free) wheat imports put downward pressure on prices, which made its cultivation unprofitable. Andean goods trade liberalisation in 1993 led to a surge of imports of Colombian malt, which substituted the demand for domestic barley. Production also became less efficient due to land reform in the 1960s and 1970s, which redistributed large *haciendas* in small plots reducing the scale of production, particularly for wheat and barley. The cereal sector was also heavily affected by floods because of heavy rainfalls (el Niño) in 1997-98. Wheat cultivation has fallen from 41 to 20 thousand hectares and production from 30 to less than 14 thousand tonnes since the 1990s. As a consequence, Ecuador has become strongly dependent on imports, as domestic wheat production satisfies only 5% of consumption.

Table 8: Agricultural production (selected products), 1971-2005
(average annual growth rates based on metric tons)

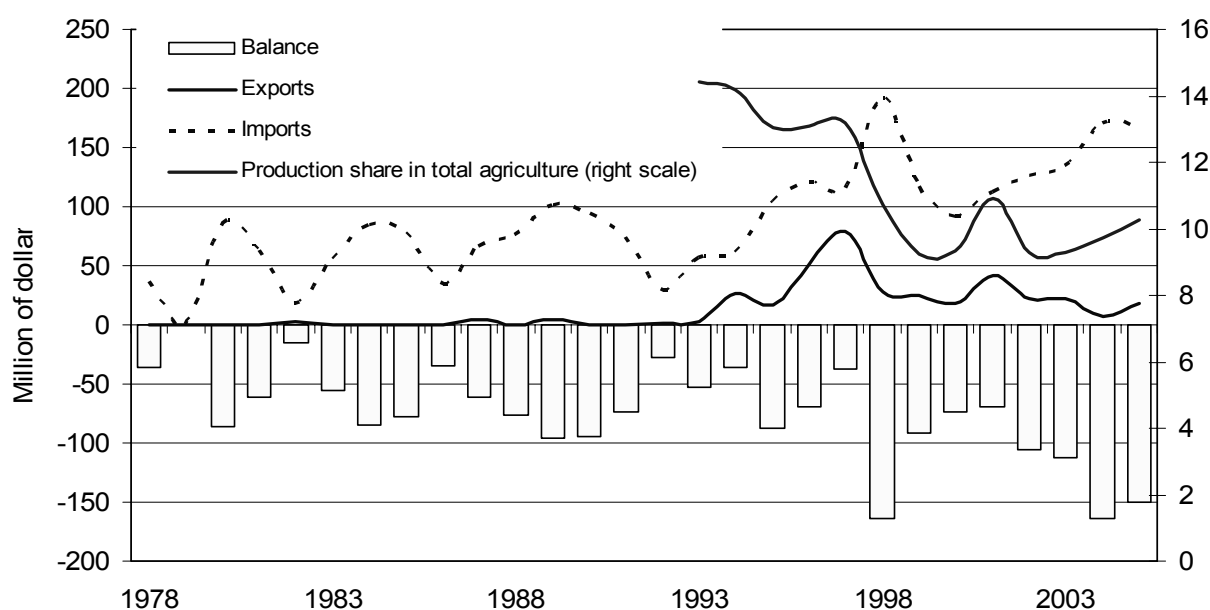
Products	1971-1980	1981-1990	1990-1996	1997-2005	1970-2005
Wheat	-7.6	-3.2	-1.3	-4.0	-4.8
Cotton	14.0	-1.3	-11.5	-16.5	-2.2
Sugarcane	1.0	-0.9	2.7	1.6	-0.4
Maize	-0.3	5.2	4.3	1.1	3.1
Rice	6.8	6.8	7.1	3.2	5.2
Banana	-0.5	4.0	8.2	-2.4	2.1
Coffee	1.1	4.6	5.9	2.1	1.0

Source: Authors' based on ECLAC data.

71. Another cause of the reduction of cereal cultivation was the major cuts in public support over the 1980s and particularly between 1992 and 1994, which had the form of price guarantees for barley, corn and wheat and subsidised loans (microcredit). The only price guarantee that survived was for bananas as part of the National Banana Programme. Price support (mostly corn and rice) by a public company in charge of price and output stabilisation was also eliminated in the mid-1990s.

72. Farmers have had varying degrees of success in shifting to other products. Farmers in mountain areas have had more success as they have partially shifted from cereals to other crops, like fruits and vegetables stimulated by a rising (urban) demand for more diversified products, as well as non-traditional exports such as flowers, broccoli, and asparagus, amongst others. Farmers in the coastal areas have focused their production on corn and rice, which are the cereals that best survived the multiple reforms. Their production is concentrated in a few months per year with abundant rainfall (March to June).

Figure 17: Cereals: Production and trade



Source: FAOSTAT, Comtrade.

d) ... as well as textiles

73. Before trade opening, the textile sector was a major industry, representing 16% and 8% of manufacturing employment and production, respectively. Textiles is one of the oldest manufacturing sectors, which started in the first half of last century with wool spinning, and shifted in the second half to cotton. The textile sector was highly protected, a heritage of the import substitution industrialisation era, and produced mostly for the domestic market. Within this protected environment, little investment in modernisation, such as new machinery and equipment, took place. Combined with low-skilled, low-productivity and relatively well-paid employees²³ and high input costs (e.g. electricity and water), the sector lacked competitiveness when the domestic market was opened for imports in the 1990s.

74. Market opening boosted imports and led to a huge loss of home market share for domestic textile producers (Figures 18, 19). Another setback was falling demand from the domestic apparel sector which itself also suffered from trade opening. The textile sector had great difficulty to improve the quality and design of its products to compete with imports at home and in foreign markets. The share in total manufacturing value added fell from 11 to 2% and the share in employment from 16 to 6% between 1984 and 2004. The import surge was led first by Andean partners, while later on these were joined by the United States, China and other Asian countries. Correspondingly, the trade balance in textiles worsened steadily in this period, particularly in the 1990s. Both textiles and wearing apparel industries also have suffered from contraband and under-pricing of imported textiles. Mostly large firms disappeared, including *Textiles Nacionales* in 2004. Another difficulty was the dramatic fall in domestic cotton production due to natural disasters (el Niño and la Niña) and shifts to other crops by farmers (planted area fell from 30,000 to

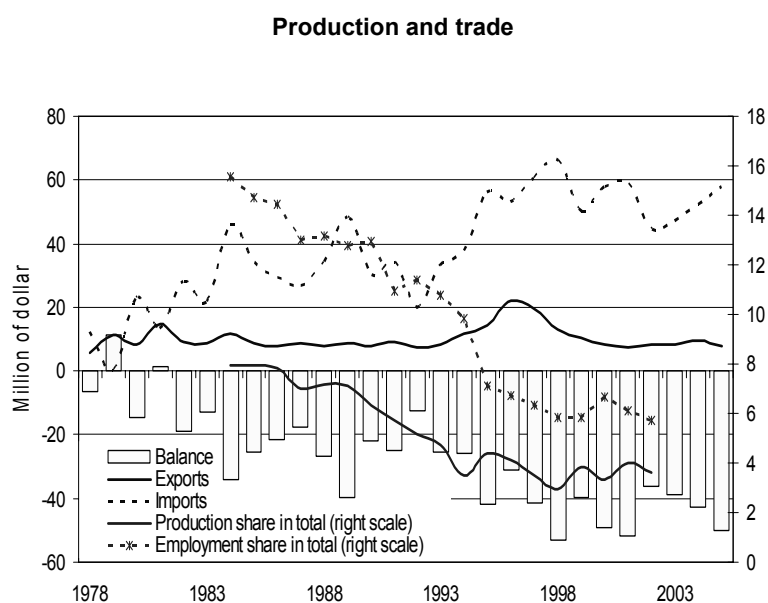
²³ An average textile worker earns around USD 350 in Ecuador, compared to USD 200 in Colombia and USD 25-30 in China and India (CORPEI).

1,500 hectares), which was replaced by imports of cotton and synthetic fibres (more than 90% of domestic consumption).

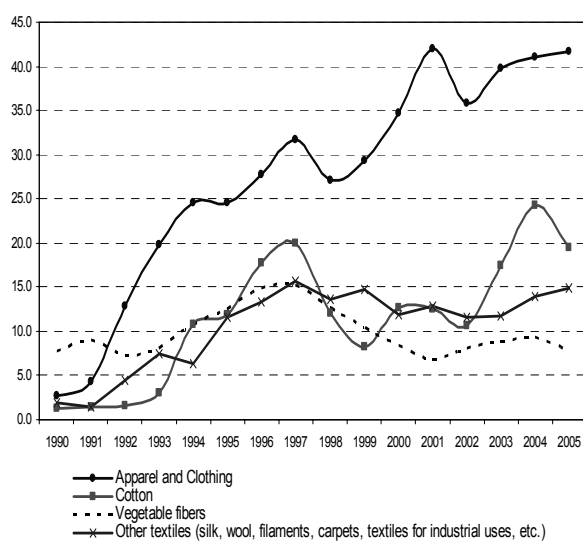
75. Other factors that hindered the adjustment of this sector have been the lack of foreign direct investment (due to a poor functioning maquila regime, uncertain property rights, and substantial contraband imports) and insufficient economies of scale in production. In recent years additional complicating factors have been dollarisation, which increasingly affects cost competitiveness, and lack of credit. Another handicap is the lack of vertical integration of the textile and apparel industry.

76. Nevertheless, some firms managed to modernise, adapt and prosper. Not only did these firms succeed in recovering their market share at home, they also boosted exports. Although exports have been relatively dynamic, their level remains low compared to Colombia and Peru which together account for 80% of Andean textile exports. Today's main export markets are Colombia and Peru (50-60%) and the United States (20%). Textile exports have become more diversified, as product variety increased from 11 to 62 tariff lines (SITC, 2nd revision) between 1990 and 2002. However, most textile exports are of low quality compared to imports, as illustrated by their unit values, and the low share of exports to advanced countries which require better quality and more variety (MICIP/ONUDI, 2004).

Figure 18: Textiles: Production and trade dynamics



Export dynamics (million US\$)



Source: FAOSTAT, Comtrade.

5. Lessons learnt

77. The structural adjustment experience of Ecuador over the past two decades provides several important lessons to be learnt for other developing countries, in terms of the conditions that need to be in place to make sure that reforms translate into sustained growth and poverty reduction.

78. The first is the importance of macroeconomic stability, which conditions (foreign) investment and the emergence of non-traditional exports. In Ecuador, instability prevailed until 1999. The stability imposed by dollarisation in 2000 helped to destroy the fiscal illusion, resolve financial imbalances, put an end to financial imbalances linked to hyperinflation and exchange rate depreciation, and establish new rules for competitiveness (Fretes-Cibils *et al.*, 2003). In this relatively stable macro environment, non-traditional exports have grown at high rates, increasing their share in total exports from 20 to 24% between 1995 and 2004.

79. Second, sustained structural reforms are a necessity for sustained growth and poverty reduction. In Ecuador, there has been little continuity in economic reforms, being concentrated in the early 1990s and early 2000s, with some subsequent setbacks. The relatively successful recent economic performance is strongly linked to the very favourable external environment of high oil prices and liquidity and is not a result of fundamental strengthening of the Ecuadorian economy in general. Dollarisation has made the need for reforms even more urgent as it decreases the policy options available in times of crises. Without sufficient reforms, the country's external competitiveness could be hurt, and even worse, dollarisation could collapse. The most urgent reforms are further fiscal adjustment (*e.g.* less earmarking, broader tax base less dependent on oil), promotion of private (foreign) investment and private participation in infrastructure, deeper trade reform and a more flexible labour market.

80. Third, the way trade is liberalised is important, as well as the support from other policies, like the exchange rate regime, to create new trade and export opportunities. The Ecuadorian experience was a mixed success:

- Trade liberalisation aims to reduce the anti-export bias and correct the distortion of price signals and resource allocation. In Ecuador, trade reforms have only partially achieved this, as despite substantial overall reductions, tariff escalation has been maintained and several non-tariff barriers (*e.g.* tariff quotas) continue to exist, which continue to distort price signals and leading to misallocation of resources. This is in stark contrast to some other Latin American countries such as Chile where quantitative restrictions were eliminated early on and a uniform tariff put in place.
- A competitive exchange rate is fundamental to seize new export opportunities created by trade liberalisation. In Ecuador, the major tariff reduction between 1989 and 1993 was accompanied by a currency RER appreciation, which held back the emergence of new types of exports.
- The initial tariff cut from 60 to 20% in the mid-1980s was large and conducted in a short period of time. The lack of export response subsequently led to a reversal which seems to underline the importance of accompanying reforms and complementary policies to smoothen structural adjustment. In Ecuador, again the story is mixed: (incomplete) financial sector, FDI and capital account liberalisation as well as the elimination of price controls and subsidies facilitated structural change, whereas the absence of reforms in other areas like the stringent labour market and inefficient state enterprises hindered the adjustment process.

81. Fourth, the following conditions or actions should accompany the reforms. In Ecuador, the financial sector was liberalised when it was not in good shape without introducing effective surveillance mechanisms. Several lessons stand out from the Ecuadorian financial 1998-99 crisis (Jacome, 2004):

- Financial liberalisation must be accompanied by a sufficient regulatory framework and institutions to provide regulatory oversight. Financial liberalisation with little oversight increases the risk of imprudent banking behaviour such as maturity mismatches (lending long in USD at home and borrowing short in USD) and increases the risk of a financial crisis. This happened in Ecuador, where the borrowed funds were used for consumption and investment in the nontradable sector. When oil prices fell and international liquidity conditions worsened, banks entered into liquidity problems.
- The creation of a well-functioning legal framework is essential to increasing resilience of the economy to different types of shocks and to prevent a financial crisis. Strong institutions can control a crisis at an early stage.
- The possibility to adjust fiscal spending in periods of distress is essential in order to contain crises at a later stage. In the case of Ecuador, the inability of the government to respond in a timely manner exacerbated the macroeconomic imbalances which led to a deterioration of market sentiments. This in turn led to a negative cycle of higher interest rates on public debt, deterioration of the exchange rate which in turn negatively affected bank liabilities.
- Monetary assistance (money printing) to confront a banking crisis is only effective in the short run. High interest rates to stem excess liquidity damage the rest of the economy and, in a context of high financial dollarisation leads to a currency crash.
- Financial dollarisation may cause problems if banks and economic fundamentals are weak. In periods of stress, the central bank needs sufficient reserves to prevent a depreciation of the currency. If that cannot be prevented, the banks' assets erode which may trigger deposit runs. Also, insufficient reserves may question the credibility of financial safety net.

82. Finally, several lessons can be drawn from the sectoral studies.

- The private sector has been the main driver in the development of both the cut flower and tuna case studies. In both cases, FDI has played a role in technology transfer, Colombian and Dutch FDI in the case of cut-flowers, Colombia, Spain, Japan and Venezuela in the case of tuna. The development of a cluster with various forward and backward linkages is important, and the involvement of international technological leaders can be key. Examples in the flower industry included introduction of metal greenhouses and plastic roofs, innovation linked to the development of new plant varieties (partly with Dutch investment), computer driven drip irrigation systems (by Israelis), a pesticide industry for flowers (with US participation), and management (by Colombians).
- The public sector and international institutions can play a very important facilitating role. In the flower sector, credit in the form of subsidised loans, in part from the IADB and World Bank, played an important role as did foreign investment by Colombia and the Netherlands. Technical assistance through development aid (partly from the United States) and credit lines of the IADB were used in part to upgrade phytosanitary standards. In the tuna sector, there was government involvement at various periods in the development of the sector, including provision of favourable tax and tariff treatment for the modernisation of the fishing fleet, and development of the National Institute of Fisheries (INP) founded with the support of FAO. The latter has been especially important for quality control.
- The cereal and textiles cases showed how the most adaptive in a sector have adapted to changes in the environment. For example in the agriculture sector, there has been a shift from cereals to

other crops such as fruits and vegetables, while in the textile sector some companies have survived by increasing exports. However, some have been faced with extreme difficulties in coping with change.

83. To develop more non-traditional exports, the anti-export bias has to be further reduced. In Ecuador, this takes various forms, including the discriminatory support for certain sectors through tariff and non-tariff barriers, which shelters them from foreign competition and provides a disincentive to modernise. Other forms are the discriminatory application of non-tariff barriers, such as import licenses (distributed in a non-transparent way), custom procedures, technical norms, etc. (Fretes-Cibils et al., 2003).

84. An important challenge for the future of Ecuadorian exports is maintaining and expanding access to its main export markets. The future of the Andean Community has become uncertain with the exit of Venezuela in 2006. The ATPDEA programme with the United States, providing preferential access to its main export market, has been extended only up to the end of February 2008, and renewal beyond this date is uncertain as the government has decided it will not negotiate a free trade agreement. This may hurt significantly exports, as neighbouring countries Colombia and Peru, competing partly in similar types of exports, did have signed FTAs with the United States. Nevertheless, Ecuador has expressed its interest, together with other members of the Andean Community to liberalise its trade with the European Union.

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