



Update on the Ecuadorian Economy

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Executive Summary

Rafael Vicente Correa Delgado was elected President of Ecuador in November 2006 and took office the following January. He was re-elected in April 2009 under a new constitution.

Correa was originally elected on a platform opposed to neoliberal economic policies, with promises to improve growth and employment, reform the oil sector, and reduce poverty. During his campaign, Correa also questioned the legitimacy and legality of the country's foreign public debt, and in July 2007 he authorized the creation of an international Public Credit Audit Commission to analyze that debt.

This paper is a brief overview of some of the recent major macroeconomic and social indicators, and policy changes, in Ecuador, focusing mainly on the last two and a half years since the Correa administration took office in January 2007.

Among the highlights:

- GDP growth averaged 4.5 percent annually for the first 2 years, contributing to significant reductions in unemployment, poverty, and extreme poverty during this time. Growth would have been significantly higher if not for the decline in the private oil sector, where output fell by 8.93 percent per year during these years.
- The government doubled spending on health care, as compared to past levels, to 3.5 percent of GDP (about \$1.8 billion). Spending on free health care programs has been expanded especially for children and pregnant women.
- There was also a very large increase in social spending by the government, from 5.4 percent of GDP in 2006 to an estimated 8.3 percent of GDP in 2008. This included a doubling of the cash transfer payment to the poorest households. It also included a \$474.3 million increase in spending on housing programs, mainly for low-income families, as well as numerous new programs in areas such as education, training, and microfinance.
- The government maintained an expansionary fiscal policy even as inflation rose from 2.7 percent, year-over-year, when Correa took office, to 10 percent in the fall of 2008, before falling back to 6.4 percent over the past three months. This appears to have been a good policy, as the spike in inflation last year proved to be a mostly temporary increase caused by a rise in commodity prices.
- The government defaulted on \$3.2 billion of foreign public debt, and then completed a buyback of 91 percent of the defaulted bonds, at about 35 cents on the dollar. The default has apparently been very successful for the government's finances. In addition to clearing off a third of the country's foreign debt and much of its debt service at a huge discount, the debt reduction appears to have convinced foreign investors that Ecuador's ability to repay its non-defaulted debt has increased.

- In the last quarter of 2008 and the first quarter of this year, the economy was affected by the world recession, mostly in the form of lower oil prices and declining remittances. This led to reduced annual current account and trade surpluses in 2008. In January 2009, the government implemented import restrictions, which appear to have contributed to a reduction in its trade deficit.

Looking forward, Ecuador will probably be helped by the rebound in the price of oil, and the fall in the dollar (if it continues) from its recent peak in March. Perhaps more importantly, the government's use of fiscal and other policies (monetary policy being limited because of dollarization) will be important determinants of Ecuador's growth during the world recession.

Introduction

On September 28, 2008, Ecuadorians overwhelmingly voted in favor of approving a new constitution (with 63.93 of the vote in favor). The new constitution called for general elections, including for president, vice-president and a new National Assembly, which were held on April 26 of this year. In contrast to the 2006 presidential elections, following the April elections there was no need for a second round since President Correa obtained a simple majority (51.95 percent of all votes), enough to avoid a runoff. His closest competitor, Lucio Gutierrez, obtained 28.24 percent of the vote.¹

Correa was originally elected on a platform opposed to neoliberal economic policies, with promises to improve growth and employment, reform the oil sector, and reduce poverty. During his campaign, Correa also questioned the legitimacy and legality of the country's foreign public debt, and in July 2007 he authorized the creation of an international Public Credit Audit Commission to analyze that debt.

This paper is a brief overview of some of the major macroeconomic and social indicators, and policy changes, in Ecuador, focusing mainly on the last two and a half years since the Correa administration took office in January 2007.

Economic Growth and Development in Recent Years

Economic Growth

Real GDP growth for 2007 was 2.5 percent and preliminary figures for 2008 put growth for that year at 6.5 percent (an average of 4.5 per cent per year for the 2007-2008 period).

TABLE 1
Ecuador: Real Oil and Non-Oil GDP
(annual % change)

	2007	2008	2006-2008 annual average
Oil GDP	-10.05	-5.17	-7.64
Non-Oil GDP	3.98	7.95	5.94
Other components of GDP	5.85	7.80	6.82
Total GDP	2.49	6.52	4.48

Source: Banco Central del Ecuador

However, in the last two years, real oil GDP (Gross Value Added in oil production and the manufacturing of oil products) contracted at an annual rate of 7.6 percent, compared to a 4.7 percent growth rate for the 2000-2006 period (see **Table 1**).

The contraction in oil GDP was mainly due to a decline in oil production by the private companies operating in Ecuador. While Petroecuador, the national oil company, expanded

¹ Results are from Consejo Nacional Electoral, República del Ecuador. "Resultados preliminares elecciones 2009, primera vuelta." Accessed online on June 22, 2009 at <<http://app.cne.gov.ec/resultados2009/>>.

oil production at an average annual rate of 3.87 percent during the 2006-2008 period, production by the private companies declined at an average rate of 8.93 percent per year. As a result of the decline in oil production, the oil sector's share of total real GDP went from 12.3 percent in 2006 to 9.6 percent in 2008.

On the other hand, real non-oil GDP (Gross Value Added in production activities other than oil extraction and manufacturing of oil products) grew by 5.9 percent per year over the last two years, compared to an annual rate of 4.8 percent for the 2000-2006 period.

Growth in the non-oil sector can arguably have a higher and more direct impact on employment, labor income and poverty reduction in an oil-producing country like Ecuador, where the construction, manufacturing and trade and repair² sectors comprise around 37.9 percent of total employment and where 30.2 percent of the population work in agriculture (70.4 percent of the rural population work in this sector). In contrast, employment in the oil and mining sector represents only around 0.5 percent of total national employment.³

In the second and third quarters of 2008, the non-oil sector grew at record, year-over-year rates of 9.9 and 9.0 percent, respectively, the highest since at least 1990 (the first year available for quarterly data). Preliminary figures show, however, that growth slowed down to 5.4 percent year-over-year in the fourth quarter of 2008, as the impacts of the world financial and economic crisis began to spread.

Given its low share of total employment, the oil sector can best contribute positively to the development process by providing the resources needed for investments in human capital and infrastructure. For these purposes, what matters is the overall level of resources that the state receives in royalties and taxes rather than just the real growth rate of the oil sector. A negative growth rate in *real* oil GDP (as discussed above) indicates a contraction in output in this industry. However, while real oil GDP contracted by about 14.7 percent between 2006 and 2008 in Ecuador, the reference price for Ecuadorian oil increased by 59 percent,⁴ implying a significant increase in resources for the government through increased tax revenues from oil production.

² This refers to the wholesale and retail trade and repair of motor vehicles and motorcycles sector (Group G) of the International Standard Industrial Classification (ISIC), Revisions 3 and later.

³ Data are from the National Statistics and Census Institute (Instituto Nacional de Estadística y Censos – INEC) from the December 2006 Employment, Underemployment and Unemployment Survey (Encuesta Nacional de Empleo, Desempleo y Subempleo – ENEMDU), which contains information for both urban and rural sectors.

⁴ This refers to the spot price per barrel of Ecuador's Oriente oil, from the U.S. Energy Information Administration's database on World Crude Oil Prices available online at (http://tonto.eia.doe.gov/dnav/pet/pet_pri_wco_k_w.htm)

On the expenditure side, real GDP growth has been led mainly by increased real gross investment, as can be seen in **Table 2**. Total gross investment accounts for about one third of total real GDP and has grown at an average annual rate of 10.5 percent between 2006 and 2008. This compares to an average rate of 11.2 percent per year for 2000-2006.

TABLE 2
Ecuador: Real GDP, Expenditure-Based
(annual % change)

	2007	2008	2006-2008 annual average
Total GDP	2.49	6.52	4.48
Private Consumption	3.48	7.02	5.24
Public Consumption	6.11	11.55	8.80
Gross Investment	6.94	14.14	10.48
<i>of which: Gross Fixed Investment</i>	2.47	16.10	9.07
Exports	2.23	3.32	2.77
Imports	7.25	10.23	8.73

Source: Banco Central del Ecuador.

Consumption spending by the public sector increased at an average annual rate of 8.8 percent during the 2006-2008 period, compared to a slower rate of 2.6 percent per year for the 2000-2006 period. This may be due in part to higher social spending (discussed below), as the government has had to purchase more goods and services in the provision of health care and education. Public consumption accounts for 9.2 percent of GDP.

Public and Social Spending

The most important increase in the government's spending has been in the area of health. It more than doubled in 2008, compared to historical levels. Between 1990 and 2004, social spending on health averaged 1.1 percent of GDP and was 1.5 percent of GDP in 2007. In 2008, public spending on health was increased to 3.5 percent of GDP (around \$1.8 billion).⁵ Free health care coverage has been expanded especially for children and pregnant women, as well as the provision of vitamins and other nutrients to Ecuadorians in these groups.

Public spending on housing also increased significantly in 2008, compared to previous years. Between 1990 and 2004, public spending on housing averaged 0.2 percent of GDP. In 2008, this was increased to 0.94 percent of GDP, mainly geared towards providing subsidies for low-income families in both rural and urban areas to build new homes (up to \$5,000 per family) or for home improvements (up to \$1,500).⁶

Preliminary figures for 2008 show an increase in total revenues, from the previous year, of 53.3 percent for the Non-Financial Public Sector (NFPS), led by an increase of 163.2 percent in oil revenues (non-oil revenues increased by 20.3 percent). This is a much larger annual

⁵ Government of Ecuador. 2008. "Cifras comparativas en Salud." Accessed online on June 22, 2009. <http://www.presidencia.gov.ec/articulog.php?ar_codigo=221&ca_codigo=96&ca_padre=0>

⁶ Government of Ecuador. 2008. "Cifras comparativas en Vivienda." Accessed online on June 22, 2009. <http://www.presidencia.gov.ec/articulog.php?ar_codigo=269&ca_codigo=96&ca_padre=0>

increase in revenues than the one that occurred in 2007, when total revenues increased by 19.4 percent, oil revenues by 2.6 percent and non-oil revenues by 14.7 percent. The significant increase in oil revenues in 2008 has been a result of the global increase in oil prices, changes in the way oil revenues are administered by the government and changes in taxes for the oil sector.

In April 2008, all of Ecuador's separate oil revenue funds were eliminated and transferred to the central government's budget (\$1,991.6 million).⁷ Since then, oil revenues are recorded in the budget as capital revenue and no longer transferred to the oil funds. These oil revenues can only be spent on investment projects and not on current spending (such as wages or interest payments). This change in the way oil revenues are managed means that the central government has direct control over these revenues. Before, the existence of various oil funds resulted in the earmarking of oil revenues for specific purposes, such as repaying public debt and spending on education, health and public investment projects. Now the central government has more flexibility in assigning these revenues to its most important priorities at any given time.

Another important change introduced by the new government is a windfall tax on profits for oil companies.⁸ In the past, whenever the price of oil exceeded the one agreed upon in the contracts signed between oil companies and the Ecuadorian state, the government would get 50 percent of the resulting windfall profits. In October 2007, the Correa administration signed a new decree changing the government's share to 99 percent of excess profits. This windfall tax was later reduced to 70 percent in October 2008.

About 44 percent of the increased oil export revenues in 2008 can be attributed to the changes mentioned above, rather than an increase in the price of oil or increased oil export volume. These changes garnered an additional \$3.8 billion (7.2 percent of GDP) in revenue for the Ecuadorian government.⁹ The bulk of this additional money is due to the incorporation of the oil funds into the central government's budget.

Total expenditure increased by 70.9 percent in 2008 (preliminary figures) from the previous year. Capital expenditure increased at a faster rate than current expenditure (111.5 percent compared to 55.9 percent). Expenditure on gross fixed investment (a subset of capital expenditure) increased by 124.9 percent during the same period, reflecting a significant increase in public investment, particularly in housing and roads, which largely explains the

⁷ Informe de Transparencia y Rendición de Cuentas 2008, Capítulo 7.

⁸ See, for example, Monahan, Jane. "Ecuador Throws Down Oil Gauntlet." BBC News 12 December 2007. Accessed online on June 22, 2009 <<http://news.bbc.co.uk/2/hi/business/7132767.stm>>

⁹ In the absence of these changes, the government's revenue in 2008 would have increased to \$4.9 billion, compared to \$3.3 billion in 2007 (a 47 percent increase), due to a 2.3 percent increase in the volume of exports of oil and oil products and a 39 percent increase in the average export price for Ecuadorian crude oil and oil products. However, total oil export revenue in 2008 reached an estimated \$8.7 billion, implying that the difference between this amount and the \$4.9 billion the government would have received given its average share of total oil export revenue in the prior two years can be attributed to changes in tax policy introduced by the Correa administration. Note: government revenue data are for the non-financial public sector. Author's calculations based on oil export and government revenue data published in the Ecuadorian Central Bank's Monthly Statistical Bulletin, February 2009 (<http://www.bce.fin.ec/docs.php?path=/home1/estadisticas/bolmensual/IEMensual.jsp>) and oil price data from the Central Bank's website (<http://www.bce.fin.ec/frame.php?CNT=ARB0000984>).

significant revival of growth in the construction sector last year (13.8 percent annual growth rate in 2008, compared to 0.1 percent in 2007).

Social spending by the central government has increased from 5.4 percent of GDP in 2006 to an estimated 8.3 percent of GDP in 2008.¹⁰ The average for the 2000-2006 period was 4.8 percent of GDP. This represents a very significant increase in social spending. However, Ecuador still lags the rest of the region, which spent an average of 13 percent of GDP per year in social areas during the 2000-2006 period.

Overall, the NFPS had 1.61 percent of GDP deficit in 2008 compared to 2.12 percent of GDP in 2007 as expenditures increased more than revenues. Total revenues for 2008 were 39.2 percent of GDP in 2008, compared to 29.38 percent of GDP in 2007, while total expenditures increased from 27.42 percent of GDP in 2007 to 40.82 percent of GDP in 2008.

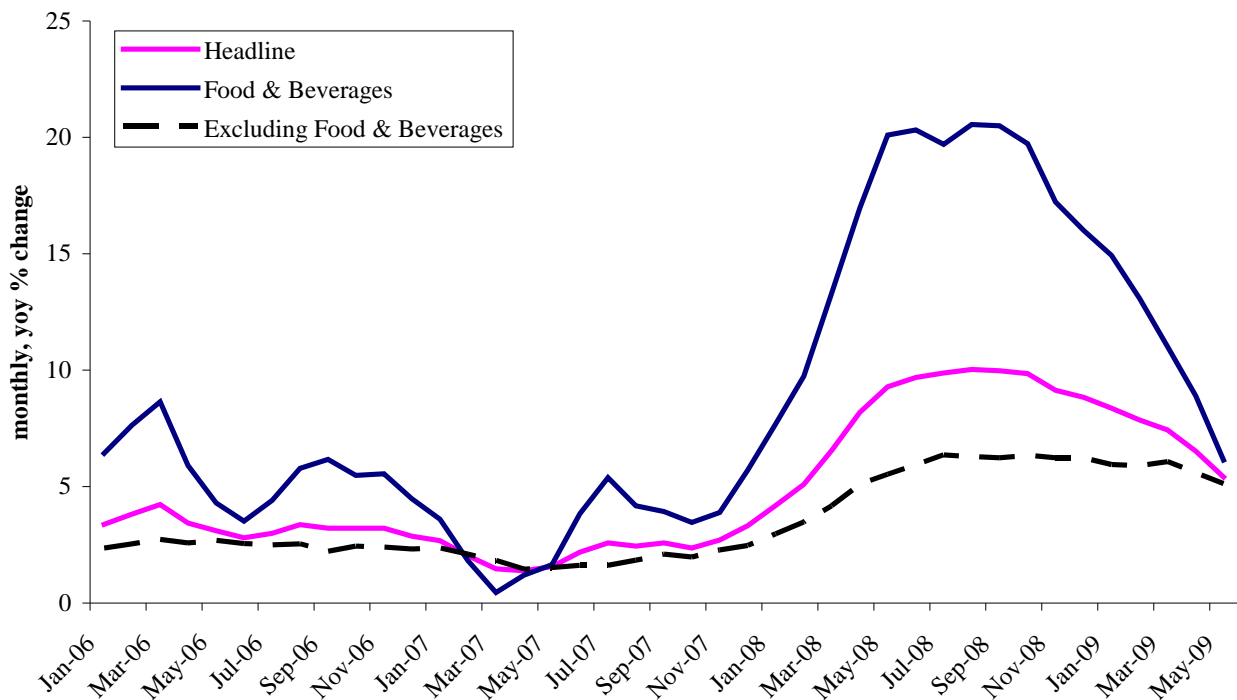
We can expect a deficit in the first quarter of 2009 as non-oil tax revenue collection diminishes in tandem with a slowdown in economic activity led by drops in consumption and exports, and as the government sustains public investment and current spending in order to stimulate the economy. Oil revenues might have started to recover since the first quarter of the year due to the increase in oil prices since January. However, if the first quarter oil receipts correspond to sales made in 2008, then there may be a lag between the recovery in prices and the one in oil revenues.

¹⁰ These figures correspond to the budgeted amounts, which are not always fully utilized. Preliminary figures from the Finance and Economy Ministry put the amount actually spent closer to 7.52 percent of GDP for 2008, compared to 4.7 percent of GDP in 2006.

Inflation

Since Ecuador adopted the dollar as its official currency in 2000, inflation has reached its lowest levels since at least 1970. While inflation was generally high prior to dollarization, the country never experienced the type of hyperinflation experienced in countries like Argentina and Brazil in the late 1980s and 1990s, where inflation rates reached above 1,000 percent in some years. In fact, since 1970, the 1990-2000 decade was the period when inflation reached its highest levels, with an average annual inflation rate of 43.8 percent. That includes the most recent crisis, which prompted the move to dollarize the economy, in 1999 when inflation reached 96.1 percent.

Figure 1
Ecuador CPI Inflation (monthly, yoy % change), January 2006-May 2009



Source: Instituto Nacional de Estadística y Censos (INEC) and author's calculations.

After the 1999 crisis, inflation began to drop and by 2004 it reached an annual rate of 2.4 percent and remained below 4 percent until 2007. During 2008, Ecuador began to feel the impact of the steep increase in world food prices. As can be seen in **Figure 1**, food and beverage prices went up to a high of 20.5 percent year-over-year inflation rate by August 2008. However, in the first quarter of 2009, food price inflation has started to decelerate significantly as the global recession dampens demand and recorded an 8.5 percent year-over-year rate in April. This in turn, brought the headline inflation rate down to 5.4 percent in May, compared to a peak of 10 percent in August 2008.

This downward trend in inflation can be expected to continue during the rest of the year as the effects of the external price shock disappear. In fact, the latest International Monetary

Fund (IMF) projections for Ecuador suggest that inflation will come down to 2 percent by December of this year.¹¹

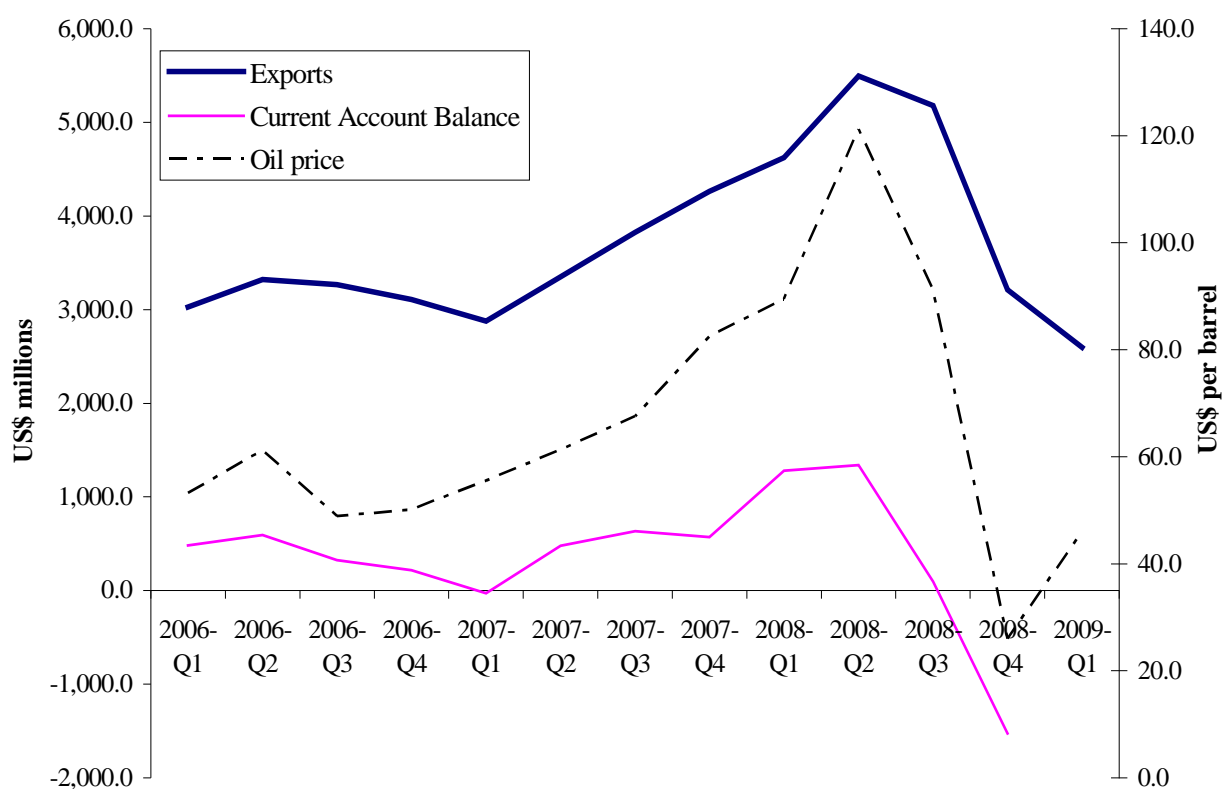
Given these trends, it turns out to be positive that the government of Ecuador did not respond – as many other governments did – to the commodity-driven rise in the headline inflation rate by slowing economic growth in order to bring down inflation.

Current Account and Trade Balance

The current account surplus shrank to 2.27 percent of GDP (or \$1.2 billion) in 2008 from 3.6 percent of GDP (or \$1.7 billion) in 2007. During the first half of 2008, the nominal current account surplus (i.e., in current US\$) actually increased by 485 percent when compared to the first half of 2007. However, it shrank by 219 percent year-over-year (yoy) during the second half, led by a deceleration in export growth (from 61.3 percent yoy in the first half to 3.6 percent yoy in the second half).

Figure 2

Ecuador: Quarterly Exports, Current Account and Oil Prices, 2006-2009



Source: Banco Central del Ecuador.

¹¹ International Monetary Fund. 2009. World Economic Outlook Database, April 2009. Washington, DC: International Monetary Fund. Accessed online on June 22, 2009
<<http://www.imf.org/external/pubs/ft/weo/2009/01/weodata/index.aspx>>

The behavior in the current account balance during 2008 was largely influenced by what happened to the total value of exports and oil prices during that time. Oil exports, which account for 61 percent of total exports, were strongly affected by the continued increase in the price of Ecuador's exported oil from previous years until it peaked in July 2008, followed by a sharp drop during the rest of the year.¹² As can be seen in **Figure 2**, total exports and the current account balance followed a pattern similar to that of oil prices.

Despite the decline in the value of exports in the second half of 2008, overall export growth for the year was positive and greater than in 2007 (exports grew by 28.8 percent in 2008, compared to 12.9 percent in 2007), fuelled by a 40 percent increase in total oil exports. Traditional exports grew by 18.2 percent, led by a 25 percent increase in banana exports, while non-traditional exports grew by 11.3 percent.

In the first quarter of 2009, however, oil exports dropped by 66 percent compared to the first quarter of 2008. Non-oil exports also declined in the first quarter of 2009, by 4.5 percent, but there was great variation in performance among the various product categories. Banana exports, for example, went up by almost 13 percent while canned tuna exports dropped by 22.7 percent, compared to the first quarter of 2008.

On the other hand, imports have been increasing at a faster rate than exports during the past two years. In 2007 the total value of imported goods increased by 14.4 percent and in 2008 by 36.3 percent. This increase in imports has been broad-based across all import categories from durable and non-durable goods to inputs and capital goods. Imports continued to grow throughout 2008, with only a decrease in import growth from a peak of 55.7 percent year-over-year growth in the third quarter to 24 percent in the fourth (as opposed to an actual contraction in export growth in the fourth quarter). Nonetheless, import growth was negative for the first quarter of this year, with a small drop of 2.7 percent (compared to the first quarter of 2008). Imported non-durable consumption goods dropped by 4.7 percent, compared to a 35.3 percent growth rate in the first quarter of 2008, which may be an indication that incomes are being hit by a significant drop in remittances during this period, as discussed below. The year over year growth in imports of durable goods did not turn negative in the first quarter, but it did drop almost in half, from 15 percent in the first quarter of 2008 to 7.6 percent in the first quarter of 2009. Non-durable imports represent 14 percent and durables 9 percent of all imported goods in Ecuador.

All other imports, except for capital goods and construction materials, experienced negative growth rates in the first quarter of 2009. Capital good imports increased by 15.3 percent, compared to 13.3 percent in 2008Q1, while imported construction materials actually went from a negative growth rate of 5 percent in the first quarter of 2008 to a positive increase of 11.4 percent in the first quarter of 2009. This is most likely a result of the significant increase in public investment by the government in infrastructure and housing projects, as discussed below.

In addition, the current account balance has also been negatively affected by a deceleration in the growth of remittances during the last two years. Remittances grew by 5.5 percent in

¹² The rapid increase in oil prices started in early 2007. From January 2007 to July 2008, the weekly spot price for Ecuadorian oil increased by 163 percent, from \$44 to \$126 per barrel. From the July peak until December 2008, oil prices then dropped by 79 percent, down to \$26 per barrel.

2007, compared to 19.3 percent in 2006, and actually suffered an 8.6 percent drop in 2008. The situation worsened during the first quarter of 2009, when the total value of remittances sent by Ecuadorians abroad declined by 27 percent, compared to the first quarter of 2008. Remittances are an important source of demand in Ecuador's economy, accounting for 5.4 percent of GDP in 2008.

Thus, lower export growth during the second half of 2008, combined with sustained import growth and a drop in remittances for the whole year, caused the current account surplus to shrink in 2008. There is no detailed current account data available yet for this year, but the trends in the trade balance and remittances during the first quarter of 2009 suggest a current account deficit for that quarter (compared to a \$1.3 billion surplus in the first quarter of 2008).

In January 2009, Ecuador implemented import restrictions to curb its growing trade deficit, which aim for a \$2.69 billion cut in imports in 2009. The measures cover 8.7 percent of all tariff lines, representing around 23 percent in volume of Ecuador's total imports in 2008¹³. On June 4, the World Trade Organization (WTO) approved Ecuador's use of import restrictions to deal with its balance of payments problems after reaching an agreement with the Ecuadorian authorities on a timeline to lift these restrictions. By September 1, 2009, Ecuador agreed to replace most of the quantitative restrictions it imposed with tariffs and to slowly remove all import restrictions as the situation improves, but no later than January 22, 2010.

The measures seem to be working, as evidenced by a narrowing of the trade deficit from \$1.5 billion in the fourth quarter of 2008 to \$820 million in the first quarter of this year.

However, as oil prices are now recovering the current account deficit is likely to improve by the end of this year. Since January, the export price for Ecuadorian oil has increased by 81 percent and is currently at \$53 per barrel. On the other hand, the recession in countries like Spain and the United States, where there is a large concentration of Ecuadorian immigrants, will probably result in slower growth or even an overall drop in remittances this year, compared to 2008. Lower levels of remittances will put downward pressure on the current account balance but could also indirectly improve the current account by causing slower import growth. As remittances drop, the demand for imported consumption goods in Ecuador will decline as incomes shrink.

¹³ See: World Trade Organization. Committee on Balance of Payments Restrictions. "Members Conclude Consultations with Ecuador on Balance-of-Payments." Press release, 2 and 4 June 2009. Accessed online on June 22, 2009 <http://www.wto.org/english/news_e/news09_e/bop_04jun09_e.htm>

Employment

Labor force indicators in Ecuador are available for major urban areas on a quarterly basis from the National Statistics and Census Institute since September 2003. However, there is a break in the series after June 2007 due to methodological changes to the survey¹⁴. Table 3 below shows three basic indicators for the Ecuadorian urban labor market for the month of March of every year since 2004. The trends in these indicators have shown a slow, but steady improvement in recent years until 2008. In early 2009, we see a slight reversal of this trend. The worsening conditions in the first quarter of this year reflect the impact of the global financial and economic crisis on the Ecuadorian labor market.

The unemployment rate first declined from 11.1 percent in March 2004 to 9.9 percent in March 2006. After the break in the data series, it continued to decline from 8.8 percent in March 2007 to 6.9 percent in March 2008. In March 2009, unemployment rose to 8.6 percent, but still remained under the March 2007 levels. The Employment-to-Population Ratio – which is an indicator of net job creation, taking into account the growth of the working age population – also fell over the last year, to below its 2007 level. But the underemployment rate – which measures what percentage of the workforce is employed, but working fewer hours than desired – dropped considerably from 2007 to 2008, and showed slight improvement of the last year. The apparent worsening of labor market conditions in March 2009 may be a sign of an economic slowdown in the first quarter of the year, but the full extent of the impact of a world recession on Ecuador remains to be seen and it will depend on the effect of any countercyclical measures the government undertakes to sustain employment or to prevent a serious deterioration in the labor market.

TABLE 3
Ecuador: Selected Urban Labor Force Indicators* (in %)

	March-04	March-05	March-06	Break in Series	March-07	March-08	March-09
Unemployment Rate /1	11.1	9.8	9.9			8.8	6.9
Employment-to-Population Ratio /2	52.4	52.0	53.5		56.5	56.6	55.0
Underemployment Rate /3	52.7	51.0	56.4		58.5	52.3	51.9

Source: INEC, Encuesta Nacional de Empleo, Desempleo y Subempleo.

Notes:

* Figures after June 2007 are not strictly comparable to prior figures due to methodological changes.

1/ Ratio of total unemployment to the Economically-Active Population (Workforce).

2/ Ratio of total employment over the population of age 10 and over.

3/ Ratio of underemployment to the EAP (Workforce).

¹⁴ The Ecuadorian Central Bank, in conjunction with the Latin American Faculty of Social Sciences (Facultad Latinoamericana de Ciencias Sociales – FLACSO), used to compile labor force indicators separately. After June 2007, INEC's new methodology represents the unification and improvement of all labor force surveys.

Poverty

Table 4 shows the latest income-based poverty and extreme poverty data available for Ecuador at the urban, rural and national levels. As can be seen, poverty is much higher in rural areas than in urban centers, with rural poverty at 59.7 percent by December 2008 compared to 22.6 percent in urban areas. Poverty in Ecuador is also disproportionately higher for the indigenous and Afro-Ecuadorian populations. In 2006, consumption-based poverty rates for these groups were 70 and 48.7 percent, respectively, while the national poverty rate was 38.3 percent.¹⁵

TABLE 4
Ecuador: Income-Based Poverty Rates (in %)

Urban Areas		
	Poverty	Extreme Poverty
Dec-06	25.9	8.8
Mar-07	24.3	8.0
Jun-07	22.4	7.7
Sep-07	22.0	7.0
Dec-07	24.3	7.9
Mar-08	25.2	8.2
Jun-08	23.3	7.6
Sep-08	22.0	7.4
Dec-08	22.6	7.6
Rural Areas		
	Poverty	Extreme Poverty
Dec-06	60.6	32.8
Dec-07	61.3	33.3
Jun-08	58.0	31.0
Dec-08	59.7	31.7
National (Urban and Rural)		
	Poverty	Extreme Poverty
Dec-06	37.6	16.9
Dec-07	36.7	16.5
Jun-08	35.0	15.5
Dec-08	35.1	15.7

Source: INEC.

Urban poverty rates have dropped significantly in recent years. From December 2006 to December 2008, the income-based poverty rate fell by 12.7 percent while extreme poverty fell by 13.9 percent. However, the decline in poverty rates for the rural areas was much less pronounced, with poverty falling by 1.4 percent and extreme poverty by 3.3 percent over the same period. Overall, poverty fell by 6.7 percent and extreme poverty by 7.1 percent at the national level.

¹⁵ Inter-American Development Bank. 2008. "Country Strategy with Ecuador (2008-2011)." Washington, DC: Inter-American Development Bank Accessed online on June 23, 2009
<<http://idbdocs.iadb.org/wsdocs/getdocument.aspx?docnum=1726069>>.p 6.

Social Programs

Bono de Desarrollo Humano (Human Development Cash Transfer Program)

This program was first established in 1998 under the name *Bono Solidario*, as an unconditioned cash transfer program that did not specifically target the poorest segments of the population. Since its inception, the program has targeted mothers, senior citizens and individuals with disabilities. In 2003, the program's name was changed to *Bono de Desarrollo Humano* and was modified to target to the population in the lowest two income quintiles (the poorest 40 percent) with a higher monthly payout of \$15 per beneficiary household. In 2007, the program was modified again to include a better monitoring of the conditions attached and a significant increase to a monthly payment of \$30 per beneficiary household (not individuals).

Since 2007, the BDH program requires that children between ages 5 and 15 in beneficiary households be enrolled in school with an attendance rate of at least 75 percent for each term. For children age 1-5, the program requires a health exam at least once every six months and for children under the age of 1, the health exam must be done at least once every two months.

By the end of 2008, there were an estimated 1.3 million beneficiary households for a total cost of \$485.2 million (or 0.9 percent of GDP). For comparison, the program covered 1.1 million households with a \$190 million budget (or 0.6 percent of GDP) in 2004.¹⁶

The BDH program also has a microfinance component. Beneficiaries of the program can apply for a low-interest loan of up to \$600 for a one-year period in order to start or boost self-employment activities or a small business. In 2007, \$2.1 million were disbursed through this program.

Other programs

The significant increases in social spending over the last two years in Ecuador, mentioned earlier, have gone to numerous new programs in areas such as health, education, labor training and microfinance. It is still too early to assess the impact of these programs on basic social indicators such as mortality, school attendance and literacy, particularly due to a lack of data.

There are currently several microfinance projects targeting specific economic activities and segments of the population, including repair shop owners, textile and agricultural workers, milk producers and cattle owners. In 2008, \$23.45 million were disbursed in microcredits with an average loan of \$525.

A training program for workers who want to improve or learn new skills was created, which offers courses that range from milk processing to graphic design.

¹⁶ See Ponce, Juan and Arjun S. Bedi. 2008. "The Impact of a Cash Transfer Program on Cognitive Achievement: The Bono de Desarrollo Humano of Ecuador." IZA Discussion Papers, No. 3658. Bonn, Germany: Forschungsinstitut zur Zukunft der Arbeit / Institute for the Study of Labor.

In education, the recently approved constitution guarantees universal education through college in Ecuador. On this front, the government has started to provide free uniforms and books in some schools in primary education as well as expanding an existing school meal program that currently reaches over 1.3 million students at a cost of \$37.7 million (in 2008).¹⁷

Foreign Debt: Default and Debt Buyback

On July 9, 2007, President Correa signed a decree authorizing the creation of an international Public Credit Audit Commission to analyze Ecuador's public debt, with "the aim of determining its legitimacy, legality, transparency, quality, efficacy and efficiency."¹⁸

On November 20, 2008, the Commission issued its report, finding a number of irregularities and illegalities in the contracting of various portions of the country's public debt. On the basis of the commission's findings,¹⁹ the Correa administration stopped payment on \$510 million of its Global 2012 bonds in December 2008, and then on \$2.7 billion of Global 2030 bonds in February 2009, for a total default of \$3.2 billion.

This month, Ecuador completed a buyback of 91 percent of the defaulted bonds, at about 35 cents on the dollar. The government thus retired about a third of its foreign debt, at a huge discount, in the process reducing its foreign public debt to 17 percent of GDP.

The default has apparently been very successful for the government's finances. In addition to clearing off a third of the country's foreign debt and much of its debt service, the debt reduction appears to have convinced foreign investors that Ecuador's ability to repay its non-defaulted debt has increased. On June 15, after the buyback was complete, Standard & Poor's raised the country's rating to CCC+, a very low level but the same as it was four years ago, before Correa ran for office on a program that questioned the legality and legitimacy of the country's foreign debt. The price of Ecuador's 2015 bonds, which were not held to be illegitimate, rallied to 70.25 cents, from a price of 44.75 cents before the buyback. Although there have been press reports that the default might lead to reduced credit to the private sector, there is no obvious economic reason that investors considering lending to the private sector should take the government's default as an indication of reduced creditworthiness of private borrowers. Thus, the government appears to have emerged from the debt default with a significant net gain for the country.

¹⁷ Government of Ecuador. Ministerio de coordinación de desarrollo social. 2008. "Informe de seguimiento de los avances de la agenda social 2008." Accessed online on June 22, 2009 <<http://www.mcds.gov.ec/images/stories/avances.pdf>>

¹⁸ The original decree, Executive Decree No. 472, is available in Spanish at: http://www.auditoriadeuda.org.ec/index.php?option=com_content&view=article&catid=35&id=51&Itemid=55.

¹⁹ For a summary (in English) of the Commission's full report, see: Government of Ecuador. Internal Auditing Commission for the Public Credit of Ecuador, Ministry of Economy and Finances. 2008. "Final Report of the Integral Auditing of the Ecuadorian Debt." Quito, Ecuador: Government of Ecuador. Accessed online on June 22, 2009 <http://www.auditoriadeuda.org.ec/images/stories/documentos/Libro_CAIC_English.pdf.zip>

Other Policy Changes: Financial and Foreign Trade Policies

The government has also implemented some financial and foreign trade policies since the last quarter of 2008. Among them are:²⁰

- Companies that reinvest their profits in the country on capital investments (i.e., machinery and equipment) can receive a reduction of 10 percentage points on their income tax rates. Lending institutions that provide loans for capital investments can also obtain this benefit. Additionally, shareholders of lending institutions that contribute new capital funds can receive a tax credit equivalent to 12.5 percent of the total amount of new funds lent out for capital investments.

- Creation of a monthly tax on the liquid funds and investments of private entities in the banking, insurance and financial investment sectors (i.e., under the supervision of the oversight authorities, the Superintendencia de Bancos y Seguros – for banks and insurance companies – and the Intendencia de Mercado de Valores de la Superintendencia de Compañías – SEC equivalent) that are held abroad.

-Opening of ‘second-tier’ credit lines by the National Development Bank (Banco Nacional de Fomento, a state-owned development bank) for financial institutions that rely heavily on remittances for their operations.

-The Ecuadorian Social Security Institute announced on March 1, 2009 the decision to buy \$400 million in mortgage portfolios over the course of the year from the private banking sector. The banks, on their part, made a commitment to lend those funds again to the [real estate] sector and to keep the same terms used for housing loans in 2008.

-A moratorium on advance payments on income taxes until December 2009 for exporters in the sectors most affected by the crisis; reduction of income tax retentions on interest paid abroad to 0% for the banking sector and to 5% for private enterprises until December 2009 (except in the case of capital coming from fiscal havens).

-Taxes on the private banking sector will be temporarily lowered and banks will be asked to capitalize their earnings. Furthermore, the banking sector will be allowed to access fiscal stimulus funds in exchange for increased lending in productive activities.

-In order to create incentives towards domestic savings, a tax will be imposed on the foreign stock of capital of banks and the tax on capital outflows will be increased from 0.5% to 1%.

-Loans will be granted to public employees (up to three times of an employee’s monthly wage) to foster domestic demand.

²⁰ See the United Nations Economic Commission for Latin America and the Caribbean (ECLAC). 2009. “La reacción de los gobiernos de las Américas frente a la crisis internacional: una presentación sintética de las medidas de política anunciadas hasta el 31 de marzo de 2009.” Fifth Summit of the Americas, Port of Spain, April 17-19, 2009. Accessed online on June 22, 2009
<<http://www.cepal.org/publicaciones/xml/8/35768/2009-192-LaReacciondelosgobiernosdelasAmericas-pos31marzo2009.pdf>>

-Negotiating a \$500 million loan with the Inter-American Development Bank (IDB) to finance fiscal policy, with emphasis on road construction and repair.

-The government reduced the State-financed budget of Petroecuador to \$3 billion in 2009 (that budget was \$4.884 billion in 2008). This will be implemented through cuts in personnel, among other measures.

-The government is in negotiations to obtain financing for major infrastructure projects, such as a refinery (Refinería del Pacífico) and the hydroelectric project, Coca Codo Sinclair, and others.

-A reduction in the days (from 30 to 5) and the number of administrative procedures for tax returns (“drawbacks”), which means the return of those taxes paid in advance by exporters.

-Export sectors affected by the crisis will be exempt from advance payments on income taxes for 2009.

-Tariffs on imported inputs and capital goods that are not produced in the country will be eliminated.

-A \$100 million line of credit will be opened by the National Financial Corporation (Corporación Financiera Nacional) for foreign trade operations.

-Safeguard measures for imports were introduced for a (initial) period of one year, to partially alleviate the estimated balance of payments deficit for 2009, discussed above. This included an increase in tariffs and quantitative restrictions on a range of imports. The measures cover 8.7 percent of all tariff lines, representing around 23 percent in volume of Ecuador's total imports in 2008.

Outlook in 2009-2010 and Policy Options

The impact of the global financial and economic crisis has started to be felt in Ecuador since the last quarter of 2008 and probably worsened in the first quarter of this year. The main channels through which Ecuador's economy will be affected by this crisis are remittances and oil prices. As noted above, remittances dropped by 8.6 percent in 2008 and 27 percent, year-over-year, during the first quarter of 2009. The drop in remittances not only leads to less demand for goods and services in the country, but also affects the financial system as people have less money to deposit in bank accounts. Hence, credit growth also slows down as a result of the decline in remittances. In addition to curtailing domestic demand, the drop in remittances also put downward pressure on Ecuador's current account balance, which went into a deficit of \$1.4 billion in the last quarter of 2008 after posting record surpluses earlier in the year.

On the trade side, exports first contracted in value by 24.6 percent, year-over-year, in the last quarter of 2008 and by 43.8 percent in the first quarter of this year, as the export price for Ecuadorian oil dropped from a peak of \$126 per barrel by the end of July to \$26 per barrel by the end of December 2008. Total revenues for the NFPS also dropped by 21.8 percent in the last quarter of 2008 from the previous quarter, after having grown at an average quarterly rate of 14.2 percent for the 6 previous quarters (i.e., between the first quarter of 2007 and the third quarter of 2008, when oil prices experienced a large increase of 127 percent).

As oil prices dropped, oil exports and revenues fell with a lag, most likely due to the delivery of oil months after the original contracts were signed. Thus, the drop in oil prices since July 2008 did not impact oil exports and revenues during the third quarter of that year (July and August), but only in the last quarter of 2008 and the first quarter of this year. As oil prices have started to recover since the beginning of 2009, increasing by 81 percent between January and mid-May, we can expect oil exports and public revenues to show signs of recovery as early as the second quarter of this year. As with remittances, decreasing exports not only have a negative impact on domestic economic activity, but also on the current account balance.

Some recent forecasts predict significantly lower real GDP growth rates for Ecuador in the near future, with some observers predicting as much as a 10 percent negative growth rate for 2009, while the government is expecting a growth rate of 2 percent or more.²¹ The IMF, for example, expects Ecuador's economy to contract by 2 percent in 2009 and start growing again in 2010, by 1 percent, according to the April 2009 World Economic Outlook. In its previous projections (October 2008), the IMF was predicting a 3.1 percent annual growth rate in real GDP for 2009 and 4.0 percent in 2010. This is a significant change in the growth projections for Ecuador. However, the IMF has made numerous errors in the past when it

²¹ For example, a May 11, 2009 Bloomberg article cites two analysts in the investment banking industry predicting growth rates of -2.5 and -10 percent for 2009. See, Jaramillo, Andrea and Lester Pimentel, "Ecuador Bank Lending Falls as Default Sparks Outflows (Update2)." Bloomberg May 13, 2009. Accessed online on June 22, 2009 < <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=afpXFcrz2Zck> >

comes to forecasting growth in some countries that are implementing economic policies that go against the Fund's traditional policy recommendations.²²

In the end, Ecuador's economic growth in the coming years will depend partly on the pace of recovery of the world economy and oil prices, but more importantly, on the government's reaction to the crisis within the constraints of a dollarized economy. Dollarization caused the government to lose control over exchange rate policy, as well as the most important monetary policy options. However, the government still has the ability to affect economic growth through fiscal policy and some limited monetary policy tools, and policies affecting trade and investment.

²² For the case of Argentina and Venezuela in recent years, see Rosnick, David and Mark Weisbrot. 2007. "Political Forecasting? The IMF's Flawed Growth Projections For Argentina and Venezuela." Washington, D.C.: Center for Economic and Policy Research. Accessed online on June 22, 2009 <http://www.cepr.net/documents/publications/imf_forecasting_2007_04.pdf>