

Development Challenges in Ecuador

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Abstract

This policy brief presents a summary of the development challenges facing the country.

Keywords: Regional Integration, Economic Growth, Productivity and Growth, Economic Integration, Investment, and Global Trade

JEL Codes: H30, F15, F31, F32, F34, Q32

Medium-Term Economic and Social Trends

After the financial crisis of 1999 and 2000, the Ecuadorean economy entered a period of prolonged expansion and stability with few historical precedents. Between 2001 and 2015 real GDP growth rates averaged 4.3%, compared to 2.5% during the 1980s and 1990s. In contrast with the intense price pressures that characterized previous decades, inflation has remained at single-digit levels since 2002. The three factors that can be argued to have contributed the most to this positive performance are the following: i) the restrictions imposed by official dollarization on monetary and exchange rate policies successfully put an end to decades of monetary instability; ii) high global commodity prices between 2004 and 2014 constituted a positive terms of trade shock; and iii) the oil price windfall resulted in a large increase in the government's investment in social and physical infrastructure.

This positive macroeconomic performance favored a reduction in poverty and inequality. Between 2005 and 2015 the poverty rate (measured by income) fell from 42.2% to 23.3%, while the Gini index fell from 0.54 to 0.47. The pronounced increase in the government's social investment (from 4.2% of GDP in 2006 to 9.2% of GDP in 2014) contributed to this improvement in Ecuador's social indicators. However, the reduction in poverty and inequality was primarily explained by the evolution of labor incomes, which was influenced by the policy of raising minimum wages, a successful effort to combat informality, and the fact that Ecuador's growth model made intensive use of low-skilled labor.

The Ecuadorean economy has undergone an external shock resulting from a sharp decline in oil prices. Oil prices (Ecuadorean mix) fell from US\$96 per barrel in 2013 to US\$84/BBL in 2014, US\$42/BBL in 2015 and US\$35/BBL in 2016, leading to a substantial reduction in public revenues and oil export proceeds. In 2015, the government was forced to adopt a drastic fiscal adjustment, reducing primary spending by close to 5% of GDP. Because of its dollarized economy, Ecuador could not use the nominal exchange rate as a shock absorber as other commodity exporters did. Instead, in 2015 it was confronted with the sharp depreciations of the Colombian peso and the Peruvian sol, to which the authorities responded with the adoption of tariff surcharges (balance of payment safeguards). The shock and the government's



policy response resulted in a rapid economic slowdown: between 2015Q3 and 2016Q3 five consecutive quarters of negative GDP growth were registered (see Figure 1).

An economic recovery is underway, although its foundations could be weak. Real GDP growth rates have been positive since 2016Q4, peaking at 3.8% year-on-year in 2017Q3. The IMF estimates that 2017 could have closed with a 2.7% expansion, slightly above the government's projections. This recovery is primarily the result of an increase in oil prices which, together with an improvement of external financing conditions, allowed for an interruption of the fiscal adjustment effort in the months leading to the 2017 presidential elections. As a result, the public deficit has not been contained, and the consolidated debt burden has increased by more than 16% of GDP since the shock (see Figure 2). This has been made possible by private investors' appetite for Ecuadorian debt and several successful bond issuances in international financial markets. As will be discussed later in more detail, whether the fiscal consolidation process can be postponed for much longer is unclear, which could lead to a new economic slowdown.

Medium-Term Economic and Social Outlook

Medium-term growth projections are modest. According to the IMF, between 2018 and 2021 the Ecuadorean economy will grow annually by 1.7% on average, barely enough to compensate for the population increase that is anticipated for this period (1.5% a year). These growth projections are based on the assumption that Ecuadorean authorities will eventually be forced to resume their fiscal consolidation effort, thus weakening aggregate demand.

Sustaining a continuation of the poverty reduction process could be difficult in a slow growth environment. In fact, the poverty rate and the Gini index have stopped falling since the oil shock, suggesting that social progress may prove elusive in a context of weak economic activity. The reason why the improvement in social indicators registered until 2014 has come to a halt is to be found primarily in performance of the labor market. Although the unemployment rate does not exhibit a clear upwards trend, underemployment has increased from 12.9% in December 2013 to 19.8% in December 2017. Only 42.3% of the working force currently earns at least the minimum wage, against 49.3% in December 2014. Unless economic growth picks up and new job opportunities are created in the medium term, it will be challenging to sustain the decline in poverty to which Ecuadorean society grew accustomed during the last decade.

Risk Factors

The most prominent risk factor facing the Ecuadorean economy is the possibility of a sudden stop in the government's access to external finance. Under such a scenario, the authorities could be forced to abruptly adjust capital spending, and possibly to accumulate arrears with the domestic private sector, as occurred in 2015. As a result, the economy could slip back into recession, leading to a further deterioration of labor market conditions. The financial system would not be immune to such a sudden stop in external financing, which could trigger a reduction in deposits and credit to the private sector, as well as a deterioration of banks' balance sheets. This is particularly relevant in the case of Ecuador because, in the context of official dollarization, the public sector lacks a lender of last resort with deep pockets, reducing the government's ability to contain a liquidity banking crisis.



Development Challenges

Ecuador's main development challenges are to strengthen its fiscal position and to increase productivity and stimulate private investment. Returning to healthy rates of GDP growth is crucial to continue eradicating poverty and improving Ecuadoreans' quality of life. This requires coping with the macroeconomic vulnerabilities stemming from the government's weak fiscal position. A credible medium-term consolidation plan should be articulated to reduce the pace of accumulation of public debt while trying to minimize the negative effects of the adjustment on aggregate demand. In parallel, Ecuador needs to transition towards a private sector-led growth model, overcoming the distortions that have constrained investment in recent years. Social interventions should continue being a central element of Ecuador's development strategy, with the aim of minimizing the potential effects of a complex macroeconomic environment on vulnerable groups.

The fiscal framework could be reinforced to gradually reduce the deficit and to start playing a macroeconomic stabilization role. Ecuador has plenty of room to increase tax revenues, which in terms of GDP are still far below the Latin American average (14.1% vs. 21.7% of GDP in 2015). This is partly due to the foregone revenues that result from the multiple exemptions and incentives in place (close to 4.7% of GDP in 2016), still-pervasive tax evasion, and comparatively low tax rates (for instance, the VAT rate is 12%, compared to a regional average of 14.8%). There is room to increase efficiencies and reduce certain categories of public spending, most notably energy subsidies, which are among the most generous in the region. Finally, Ecuador could strengthen its fiscal responsibility framework, which in the past has failed to contain deficits in good times in order to create space to cope with adverse shocks. As a result, Ecuador's fiscal policy has been procyclical in spite of its being one of the few instruments for macroeconomic stabilization available for a dollarized economy.

Ecuador ranks low in international competitiveness rankings, and productivity has been a marginal contributor to economic growth. Although the fiscal consolidation process could be beneficial for long-term growth, it could also weaken aggregate demand in the short and medium term. To offset this effect, Ecuador should tap new sources of economic growth. More specifically, there is room to stimulate private investment, which has tended to fall in recent years, and which is substantially lower than that of its neighbors (11.5% of GDP in 2015 compared to 15.5% in Colombia and 14% in Peru).¹ This reflects a number of weaknesses in the business climate, as captured in Ecuador's low ranking in the *Global Competitiveness Report* (World Economic Forum, 2016) (91 of 138 countries) and in the *Doing Business* report (World Bank, 2017) (114 of 190 countries). In addition, total factor productivity has barely increased during the last decade, suggesting the presence of distortions that may be interfering with the optimal allocation of factors of production in the economy. The design and implementation of a structural reform agenda could remove some of these frictions and gradually increase the contribution of private investment and productivity to economic growth.

¹ Source: IMF, Investment and Capital Stock Dataset.



Conclusion

Ecuador has some important strengths to help it confront these development challenges. The public investment effort of the last decade upgraded the country's infrastructure, expanding the road network, transforming the energy generation matrix, and reducing the vulnerability of the electric sector. The government's social policies have also had a positive impact on human capital, which is particularly apparent in the education sector, as evidenced by Ecuador's improvement in the UNESCO-SERCE ranking. Ecuador's development process is thus not as constrained by an under-endowment in physical and human capital as that of other countries, implying that maintaining or increasing public investment may be less relevant than in those cases. Instead, to reinvigorate growth the country should concentrate on structural reform, an approach that would require a less intensive use of public financial resources and therefore may be particularly appropriate at the current juncture, given the need to resume the fiscal consolidation process.

Figure 1. GDP Growth and Poverty

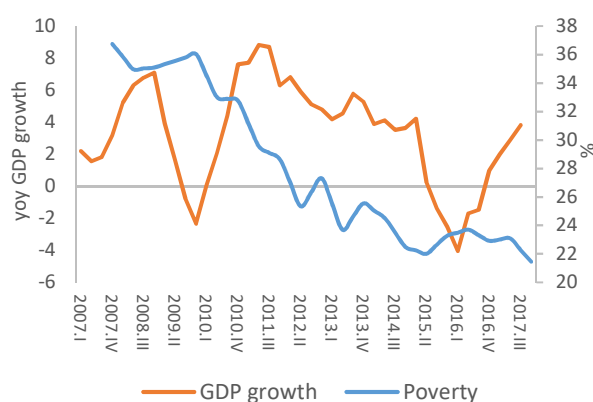
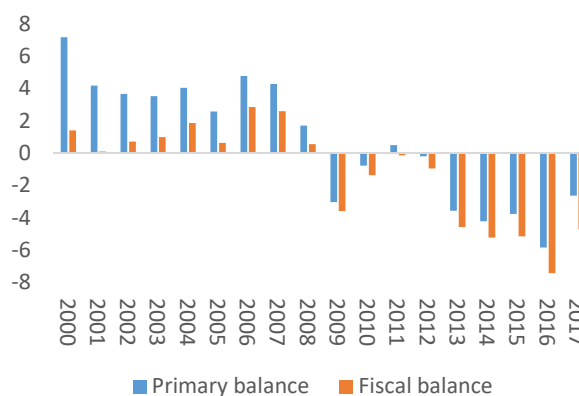


Figure 2. Fiscal Balance (NFPS, % of GDP)



Source: Banco Central del Ecuador, and Instituto Nacional de Estadísticas y Censos (INEC).

Note: The 2017 fiscal balance has not yet been disclosed. Figure 2 projects the 2017 balance based on available information until the month of November.



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