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INVESTMENT POLICY REVIEW

ECUADOR

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Investment Policy Review

Ecuador

UNITED NATIONS
Geneva, June 2001

Note

UNCTAD serves as the focal point within the United Nations Secretariat for all matters related to foreign direct investment (FDI) and transnational corporations (TNCs). In the past, the Programme on Transnational Corporations was carried out by the United Nations Centre on Transnational Corporations (1975-1992) and the Transnational Corporations and Management Division of the United Nations Department of Economic and Social Development (1992-1993). In 1993, the Programme was transferred to the United Nations Conference on Trade and Development. UNCTAD seeks to further understanding of the nature of TNCs and their contribution to development and to create an enabling environment for international investment and enterprise development. UNCTAD's work is carried out through intergovernmental deliberations, technical assistance activities, seminars, workshops and conferences.

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The following symbols have been used in the tables:

Two dots (..) indicate that data are not available or are not separately reported. Rows in tables have been omitted in those cases where no data are available for any of the elements in the row;

A dash (-) indicates that the item is equal to zero or its value is negligible;

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A slash (/) between dates representing years (e.g.1998/99), indicates a financial year;

Use of a hyphen (-) between dates representing years (e.g. 1998-1999), signifies the full period involved, including the beginning and end of years.

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ABBREVIATIONS

ACP	African, Caribbean and Pacific countries
CAE	Corporación Aduanera Ecuatoriana (Customs Corporation of Ecuador)
CAF	Corporación Andina de Fomento (Andean Development Corporation)
CAAM	Comisión Asesora Ambiental (Environmental Advisory Commission)
CAN	Community of Andean Nations (Comunidad Andina de Naciones)
CEPE	Corporación Estatal Petrolera Ecuatoriana (Ecuadorian State Petroleum Corporation)
CORPEI	Corporación de Promoción de Exportaciones e Inversiones (Export and Investment Promotion Corporation)
CAST	Council for Agricultural Science and Technology (Consejo para le Ciencia Agrícola y la Tecnología)
CDC	Commonwealth Development Corporation
CENAIM	Centro de Acuicultura e Investigación Marina (National Aquaculture and Marine Research Centre)
CONAM	Consejo Nacional de Modernización (Council for Modernization of the State)
DAC	Dirección de Aviación Civil (Direction of Civil Aviation)
DEST	Department of the Evironment, Sport and Territories
ESPOL	Escuela Politécnica del Litoral (Superior Polytechnic School of the Litoral)
EU	European Union
FDI	Foreign direct investment
GDP	Gross domestic product
GFCF	Gross fixed capital formation
GW	Giga-watts
HACCP	Hazard Analysis and Critical Control Point
INBIO	Instituto Nacional de Biodiversidad (National Bio-diversity Institute)
INIAP	Instituto Nacional Autónomo de Investigaciones Agropescuarias (National Institute of Agricultural Research)
INEBAN	Instituto Ecuatoriano del Banano (Ecuadorian Institute of Banana)
ITC	International Trade Center
IMF	International Monetary Fund
LET	Ley de Transformación Económica (Economic Transformation Law)
MICIP	Ministerio de Comercio Exterior, Industrialización y Pesca (Ministry of Foreign Trade, Industrialization and Fishing)
NSI	National System of Innovation
NGO	Non-governmental organisation
OCP	Oleoducto de Crudo Pesado (Crude Oil Pipeline)
OPEC	Organization of the Petroleum Exporting Countries
PANE	Patrimonio de Areas Naturales del Estado (Area of Natural Heritage)
PHO	Panamerican Health Organization
PROMSA	Programa de Modernización del Sector Agropescuario (Modernisation of Agro-fishing Programme)
R & D	Research and development
SEBIOCA	Sociedad Ecuatoriana de Biotecnología (Ecuadorian Biotechnology Society)
SICA	Sistema de Información y Censo Agrícola (Agricultural Census and Information System)
TTI	Tiputini, Tambococha, Ishpingo
TNC	Transnational corporation
UNCTAD	United Nations Conference on Trade and Development
WHO	World Health Organization
WTO	World Trade Organisation
WEF	World Economic Forum
$	United States dollar

PREFACE

The UNCTAD Investment Policy Reviews are intended to help countries improve their investment policies and to familiarize Governments and the international private sector with these countries' investment environment. The reviews are considered at the UNCTAD Commission on Investment, Technology and Related Financial Issues.

The Investment Policy Review of Ecuador was initiated at the request of the Ministry of Foreign Affairs and the Trade and Investment Promotion Corporation (Corporación de Promoción de Exportaciones e Inversiones, CORPEI). In preparing the Review, UNCTAD received the full support and cooperation of CORPEI's Executive President and its staff, the Government of Ecuador and the Permanent Mission of Ecuador to the United Nations Organizations in Geneva.

The views of the international donor community in Ecuador, the international private sector and domestic business were canvassed at various stages of the project.

The report benefited from the contributions of experts within and outside Ecuador. The national experts include Pamela Cumba, Alonso Pérez Kakabadse, Monica Rojas and Edgar Terán. The international experts include Enrique Egloff, Andrés Lopez and Carlos Stark.

The report was prepared by Fiorina Mugione, Tagi Sagafi-nejad and Zbigniew Zimny under the direction of Khalil Hamdani. Rory Allan, Bijit Bora, Lucian Cernat, Giorgio Gabrowski, Rachel Holmes and Luis Toral also provided inputs. Comments were received from Reinaldo Figueredo, John Gara, Menelea Masin, Joseph Mathews, Reinder Kutsch-Lojenga and Paul Wessendorp. Chiraz Baly, Stefano Guicciardi, Dinh Lang and Airton Valente provided research assistance. Ursula Moëhrle, Virginie Noblat-Pianta and Chantal Rakotondrainibe provided production assistance.

The United Nations Development Programme, the Government of Switzerland and the United Nations through its Development Account provided funding for the project. UNIDO collaborated in the project implementation.

It is hoped that the analysis and recommendations of this review will contribute to an improvement of policies, promote awareness of investment opportunities and serve as a catalyst for increased investment into Ecuador.

Geneva, June 2001

ECUADOR

Key economic and social indicators

INDICATOR	1998	1999
Population (million)	12.2	12.4
GDP at market prices (billions of current dollars)	19.7	18.7
Annual GDP growth (percentage)	0.6	-7.5
Inflation (percentage)	42	58
GDP per capita (dollars)	1615	1508
GDP by sector (percentage)		
Agriculture, mining and petroleum	18	23
Manufacturing	22	21
Services	60	56
FDI inflows (millions of dollars)	831	636
Exports of goods and services (percentage of GDP)	25	..
Imports of goods and services (percentage of GDP)	32	..
Gross domestic investment (percentage of GDP)	25	15
National poverty line (percentage)[1]	35	..
Human development index [2]	0.722	..
Adult illiteracy rate (percentage of people aged 15 and above)	9.40	11

Sources: UNCTAD, Central Bank of Ecuador, *Quarterly Statistical Bulletin*, 2000, and World Bank, *World Development Indicators*, 2000.

[1] Percentage of population below poverty income line.
[2] For comparison, the index for Peru was 0.737, Colombia 0.720 and Chile 0.826.

INTRODUCTION

Ecuador, like many developing countries, aims at increasing the role of foreign direct investment (FDI) in its development not only through attracting more FDI but also through benefiting from it more in terms of technology, employment, exports, skills and, in general, competitiveness. To achieve this, Ecuador, in concert with other member countries of the Community of the Andean Nations (CAN), liberalized FDI policies in the early 1990s. In addition, it opened up its economy to international trade, reformed its tax and fiscal systems and tried to initiate a privatization programme.

As shown in chapter I, foreign investors responded to these changes. FDI inflows into Ecuador tripled between 1992 and 1994 and subsequently doubled between 1996 and 1998. In the second half of the 1990s they were, on average, 80 per cent higher than in the first half. However, by the end of the decade, Ecuador ran into the worst political, economic and social crisis in its history. Inflation peaked at 100 per cent in 1998 and GDP dropped by 7 per cent in 1999. Given the scale of the crisis, FDI inflows showed surprising resilience. Though they fell from a peak level of $830 million in 1998, they stayed at a relatively high level of $636 million in 1999 and $ 680 million in 2000.

Even before the crisis, both quantity and quality of FDI was much below Ecuador's needs. Financial and investment needs of Ecuador increased vastly because of the growing budget deficit, external debt crisis and the El Niño disaster. On the other hand, private sources of external financing such as bank loans dried up and FDI inflows fell. Also, the qualitative impact of FDI in terms of technology, exports or linkages is very limited because most of the investments went into one industry - petroleum - which, because of its nature and local conditions, does not have many linkages with, and spillovers into, the local economy.

Ecuador's FDI performance has also been below its potential. Inflows grew at a slower pace than those into Latin America and at a much slower pace than those into neighbouring Andean countries. This cannot be explained by the small size of the Ecuadorian economy. Bolivia, a country with a market of only half the size of Ecuador and a much lower per capita income, increased its average inflows in the 1990s more than two and a half times faster than Ecuador, and received by 1999 inflows almost a quarter higher than those achieved by Ecuador in its peak year (1998).

Chapter II analyses Ecuador's FDI potential. The country has indeed many attractions to foreign investors which, with appropriate policies, can be turned into opportunities. Firstly, it has abundant natural resources, including non-renewable resources such as oil and unexplored minerals and renewable resources such as bananas, flowers, fishing and the biological resources of its vast rain forest. Ecuador's climate makes many of these resources particularly attractive, permitting several crops per year as well as a high quality of many of its agricultural or fishing products. Secondly, its labour force has been competitive, with wage-productivity ratios comparing favourably with those of neighbouring countries. Thirdly, Ecuador has a free and sometimes preferential access to large regional and international markets including the Andean countries, Mercosur, the United States and European Union for many of its export products. Finally, based on this access and the country's comparative advantages, in the 1990s Ecuador has been able to develop a number of commodity-based export industries with FDI potential.

The greatest immediate potential, apart from the oil industry, however, exists in the services sector and especially in the infrastructure service industries such as telecommunications, power generation and distribution and air transportation. Foreign investors' participation in privatization programmes in these industries has periodically fuelled FDI inflows into a number of Latin American countries. Slow pace and limited scope of Ecuador's privatization programme has left FDI potential untapped. The impact of privatization programmes on FDI is not limited to the initial value of assets purchased by foreign investors. Typically, these investors undertake post-privatization sequential investment, the value of which often far exceeds that of the initial purchase. In addition, the improvement of infrastructure services resulting from specific foreign investment projects leads to the improvement of investment conditions in general, thus stimulating FDI in other sectors and industries. Also other areas of infrastructure such as roads, railways and water supplies have potential for the participation of foreign investors in the form of concessions. Other service industries with considerable FDI potential include tourism and the banking industry.

Chapter III deals with policies and actions needed to realise the country's considerable FDI potential. Successive Ecuadorian Governments have taken a number of steps in this direction. Government's efforts intensified recently in the face of the economic crisis. According to an FDI promotion programme prepared in 1999, inflows should reach $1 billion in 2003 and grow thereafter at an annual rate of 15 per cent. Achieving these objectives is possible if the path to reforms continues unimpeded. However, FDI will have to be much more diversified, flowing not only into the petroleum industry but also other sectors including manufacturing and services. Furthermore, qualitative contributions of FDI, particularly to export promotion, technology transfer and human resource development should improve. Priorities should be given to attracting investment in the export industries and to improving the infrastructure necessary to foster international trade. Furthermore, FDI should help a restructuring process aimed at modernizing the existing export driven production and improving its competitiveness as well as facilitating the integration of foreign investments into the local economy.

Success will depend on the effectiveness of the following policies and actions of the Government:

- ***Restoring stability and resuming growth.*** Ecuador has launched a number of reform programmes towards this end. The dollarization of the economy, introduced in January 2000, has been the boldest among various steps aimed at restoring macroeconomic stability and resuming economic growth. Growth indeed resumed in 2000 (partly owing also to rising oil prices) although a full recovery of output may take a few years. Inflation is expected to fall in 2001. The stability and transparency of economic laws and regulations including tax, labour, property and other laws are equally important. In addition, restoring political stability is one of the fundamental conditions for improving the business environment, which should also receive a boost with the completion of the modernization of the State programme.

- ***Achieving social consensus***. Building social consensus around reforms is another critical area. The economic crisis has brought hardships to various segments of the population, especially the poorest. Economic reforms and increased inflows of FDI, while improving the economic situation, may aggravate some hardships in the short run. Social consensus on reforms should be built through dialogue among all stakeholders. In building such consensus, the issues of burden-sharing of adjustment costs, protecting the poorest, and broadening the distribution of gains from reforms to benefit all groups (including indigenous people) should be dealt with. The provisions of the Constitution concerning the establishment of the Solidarity Fund, to channel a portion of revenues from privatization to social needs, provide a useful step towards building such consensus.

- ***Further improving the legal framework for investment***. With recent changes in the legal FDI framework, Ecuador compares favourably with other Latin American countries such as Peru or Chile and other APEC Member Countries with respect to FDI treatment and settlement of disputes. Although the Constitution has improved treatment and provided new guarantees to investors, enforcement remains problematic. The proliferation of secondary legislation introduced by the administration often leads to legal confusion. A case in point is the enforcement of property rights, creating uncertainty in areas such as mining, petroleum exploration and the exploitation of biological resources. Changes are still needed in basic laws such as the Penal Code, the Labour Code and the Commercial Code, which present problems for both foreign and domestic investors.

- ***Implementing a viable privatization programme.*** This is the key programme for the immediate realization of FDI potential in a still large State-owned sector, from manufacturing enterprises and the primary sector to the services sector and, in particular, infrastructure services and the banking industry. It is of course up to the Ecuadorian Government to decide to what extent, in which industries and in what forms this potential should be exploited. However, once these decisions are made, to be successful in terms of attracting foreign investors, the programme has to take the form typically used in international investments, taking into account investors' desire for control and other requirements. If this is not the case, new privatization programmes will share the fate of previous failed attempts, undermining the credibility of Ecuador's economic policy.

- ***Improving physical infrastructure***. The quality of infrastructure is a key FDI determinant. In Ecuador, where much of the potential is in export industries, the focus should be on infrastructure services that facilitate access to international markets and enhance the competitiveness of export industries. These include air, maritime, rail and road transportation (including the functioning of airports and ports), telecommunications and energy industry. The planned privatization programme also offers significant opportunities to increase FDI. However, some areas of infrastructure require investment from both private and public sources, including international development institutions. In addition, as the experience of many countries shows, participation of foreign investors in privatization programmes does not always lead to greater efficiency and improvements in the quality of services. Care should be taken to ensure that public monopolies are not simply replaced by private foreign ones.

- ***Designing policies aimed at increasing long-term benefits from FDI***. A number of policy areas are identified as important in this respect. In particular, four policy areas are crucial, namely human resource development, science and technology, competition, and policies aimed at establishing and strengthening linkages between foreign and local enterprises. Ecuador's labour force has the potential to become an even greater advantage once rigidities in the labour market are alleviated. Policies should also aim at improving the skills of the labour force and educating a cadre of qualified professional managers through stronger links between industry and educational institutions and by giving incentives to companies for management training. Appropriate science and technology policies should include pursuing the planned initiatives such as the establishment of a national innovation system, financial incentives for technology development, as well as the streamlining of the myriad institutions involved in science and technology. Linkages should be strengthened between industry and academia, and between foreign investors and the domestic industry. In the area of competition, the general principles are formulated in the Constitution. To implement them, further operational work on the competition law and establishing a competition agency are among the highest priorities.

- ***Implementing an investment promotion programme***. The formulation and launch of an investment promotion programme should be one of Government's priorities. This requires that COMEXI – the Foreign Trade and Investment Council – assume its statutory authority in the area of FDI, and CORPEI – the Export and Investment Promotion Corporation – be strengthened through the establishment of an investment promotion unit. Based on the best practices of other investment promotion agencies, CORPEI's promotional activities should focus on policy advocacy (e.g. championing improvements in the investment climate) and the dissemination of information about the reform programme and the recent changes in the investment framework aimed at attracting FDI. Investment generation activities should be directed to attracting investors to the privatization programme and to industries with FDI potential, such as petroleum, banking and tourism. Furthermore, these activities should target TNCs already established in the country by addressing their needs through investor services aimed at encouraging re-invested earnings and sequential investment.

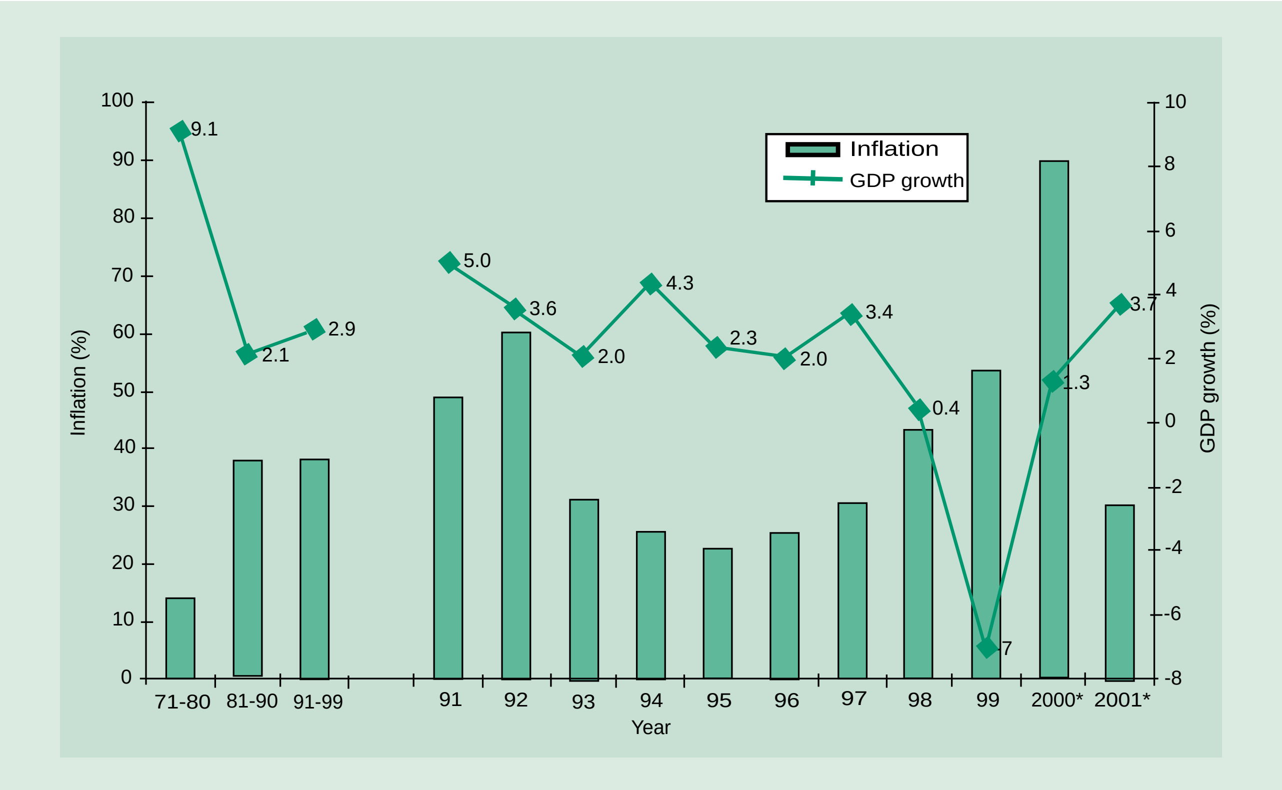
I. Foreign Direct Investment: Performance and Needs

A. Investment climate

The 1970s were characterized for Ecuador by fast growth and low inflation, fuelled largely by the vigorous expansion of the State-dominated oil sector (figure I.1). During the 1980s, however, the economy suffered from a series of setbacks, namely the 1982 debt crisis, the 1986 collapse of oil prices and the severe earthquake of 1987. Besides the tragic human cost, the earthquake destroyed oil pipelines and paralyzed oil exports for about eight months, depriving the Government of nearly half the anticipated annual oil revenue. Attempts to stabilize and restructure the economy failed, and all economic indicators, including real per capita income deteriorated.[1]

Figure I.1. GDP growth and inflation, 1971- 2001

(Percentage)



Source: Central Bank of Ecuador and ECLAC.

* Estimates and forecasts by Central Bank of Ecuador.

Following the trends in Latin America and elsewhere, Ecuador began the 1990s by opening up its economy to international trade, reforming its tax and fiscal systems and trying to rationalize the public sector through privatization. As part of reforms, together with other member countries of the Community of Andean Nations (CAN or Andean group) Ecuador liberalized FDI policies in 1991, assigning a greater role to foreign investment in its development. The country also joined the World Trade Organization (WTO) in 1996 as well as several regional economic integration schemes.

[1] World Bank (1991). *Ecuador: Public Sector Finances: Reforms for Growth in the Era of Declining Oil Output.* Report N° 8918-EC, Latin America and The Caribbean Region, Washington D.C.

Reforms and stabilization measures initially yielded some positive results. The most spectacular among them was export performance: between 1990 and 1998 the value of exports doubled. More importantly, exports of such products as bananas, shrimps, tuna and flowers made significant inroads in the world market. For a few of these products Ecuador ranks among the world's top five exporting countries. During the same period, share of non-traditional industrial products in total exports increased from 6 to 19 per cent and that of traditional non-oil exports from 43 to 52 per cent. By the early 1990s, economic growth also improved compared with the 1980s, although inflation was high.

Not all reforms, however, were successfully implemented. Except for some relatively minor divestments in oil, transport and cement industries, for example, privatization largely failed. Failure resulted from the lack of will of the State to sell majority stakes and to give up control of State-owned companies and from the reluctance of the private sector to assume responsibility for the restructuring of these companies. Consequently, Ecuador became the only country in Latin America with growing public but declining private investment.[2] Moreover, operational losses forced public enterprises to rely more and more on fiscal resources to finance their investments, resulting in a growing drain on the State budget. This is in addition to the spiralling external debt, which has increased to more than four times the value of the country's export.

Ecuador's economic performance, hence its investment climate, further deteriorated during the 1990s due to:

- External shocks such as a sharp drop in world oil prices, disruption of the economy due to the El Niño weather phenomenon and lack of adequate response aimed at cushioning the impact of these shocks;
- Instability in the political system and its institutions, as exemplified by the change of six presidents in four years;
- Instability created by the long-standing border conflict with Peru, which was resolved through a peace agreement in October 1998; and
- Lax banking supervision.

By the end of the 1990s, Ecuador was facing the worst political, economic and social crisis in its history, culminating in a popular uprising in January 2000. It became the first country ever to default on Brady bonds and on Eurobonds, which further damaged credibility and prompted capital flight and devaluation. Money supply grew over 160 per cent in January 2000 from the previous year.[3] All conditions were ripe for the explosion of hyperinflation. To shield the fragile banking system, the Government closed all banks for a week in March 1999 and froze most bank deposits for one year. After international auditors reviewed the banking system's viability, nearly 60 per cent of bank assets were absorbed by the State. Economic growth nearly halted in 1998 and GDP fell by 7.3 percent in 1999. Consequently, Ecuador was rated one of the highest investment risk levels in the world (table I.1).

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[2] This was due, among others, to a boost in the Government spending on the reconstruction of the El Niño damaged infrastructure and on State-owned enterprises. ECLAC (1999). *Economic Survey of Latin America and the Caribbean 1998-1999*, United Nations publications, Sales N° 99.II.G.2 . The State has stakes in some 190 companies in agriculture, mining, manufactoring, communications, energy, finance, storage, transport and tourism.

[3] Central Bank of Ecuador (2000). *Quaterly Statistical Bulletin*.

Table I.1. Investment risk rating in selected countries in Latin America

Country	Moody's rating (November 2000)	Euromoney ranking (March 2001)
Argentina	B1	66
Brazil	B2	64
Chile	Baa1	36
Colombia	Ba2	70
Ecuador	**Caa2**	**113**
Mexico	Baa3	42
Panama	Ba1	65
Peru	Ba3	73
Venezuela	B2	77

Sources: Moody's, www.Moody.com; Euromoney (March 2001).

In March 2000, the new Government enacted the Economic Transformation Law (Ley de Transformacion Economica - LET), a comprehensive programme of reforms aimed at regaining economic stability and resuming growth. The Law introduced the official dollarization of the economy and fiscal, financial and labour reforms. These measures, coupled with the successful re-negotiation of Ecuador's debt and a significant increase in the price of oil, stopped the decline of GDP. Within the year, it started growing again, with projections for further growth in 2001 (figure I.1). Full recovery of output however, may take a few years. Inflation rose to 90 per cent in 2000 but is projected to drop to 30 per cent a year later.

These trends, if continued, would improve the investment climate. They are important and necessary, but are not the only conditions for restoring foreign investor confidence and increasing Ecuador's attractiveness to FDI, especially in areas other than oil. Changing a high-risk investment designation is a long-term process that depends on many factors. Improvement of the political and economic stability is only the beginning [4]. Thus, the medium- and long-term prospects of Ecuador depend on structural and institutional reforms aimed at improving and stabilizing the business environment -- including successful privatization.

The second part of the Economic Transformation Law deals with many of these measures. These and other measures and their possible effects on FDI will be discussed in detail in chapter III.

[4] For example, when Brazil, one of the most attractive host developing countries, introduced reforms in 1993, it took three to four years for the reforms to successfully tame inflations and restore economic growth. In addition to these reforms, a major privatization programme had to be successfully implemented before FDI inflows picked up significantly. UNCTAD (2000). *FDI Determinants and TNCs Strategies: The Case of Brazil*, United Nations publications, Sales N° E.00.II.D.2.

B. FDI performance

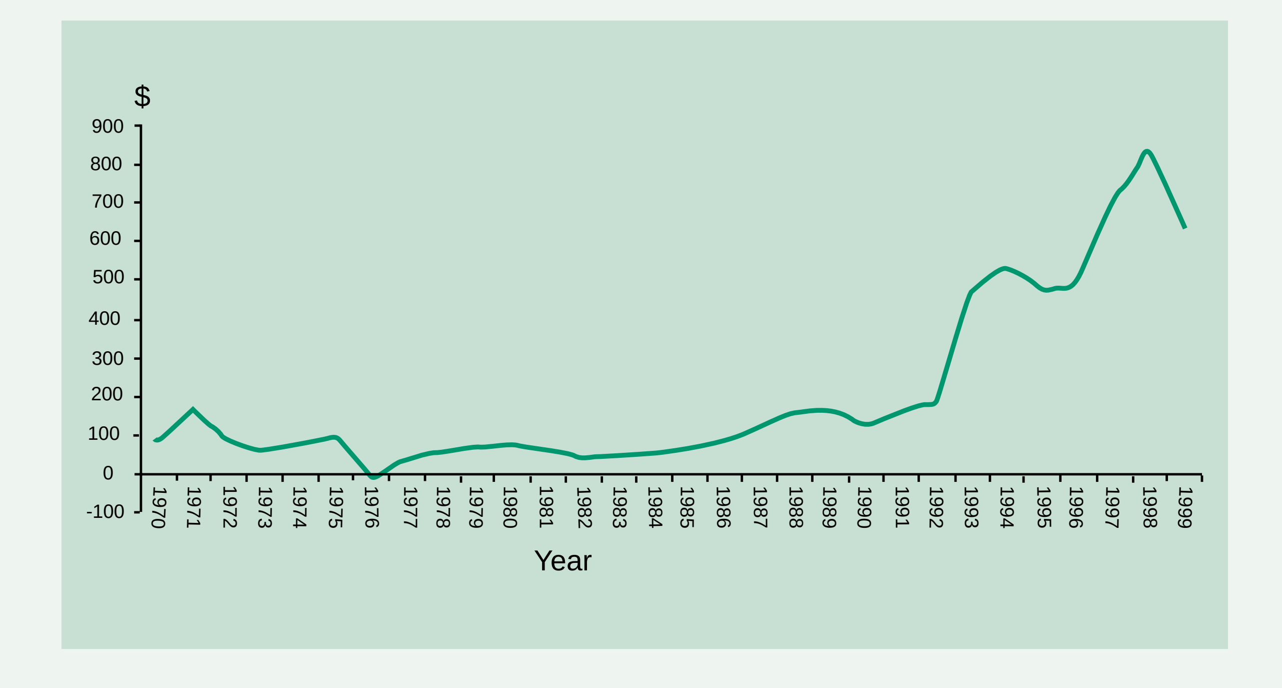
1. Growth and relative importance of FDI

In the 1990s, Latin America regained first position among host developing countries' regions, lost to Asia and the Pacific in 1986 (UNCTAD, 1999).[5] The surge of FDI was fuelled by privatization programmes in several countries of the region, and was sustained by a wave of cross-border acquisitions of private companies as well as greenfield FDI projects.

Given Ecuador's deteriorating investment climate and the fact that it did not implement any major privatization programmes, its FDI performance during the 1990s was better than might have been expected. FDI inflows tripled between 1992 and 1994, and subsequently doubled between 1996 and 1998, falling only in 1999 by a quarter, but still remaining at a high level of $640 million (figure I.2).

Figure I. 2. FDI inflows into Ecuador, 1970-1999

(Millions of dollars)



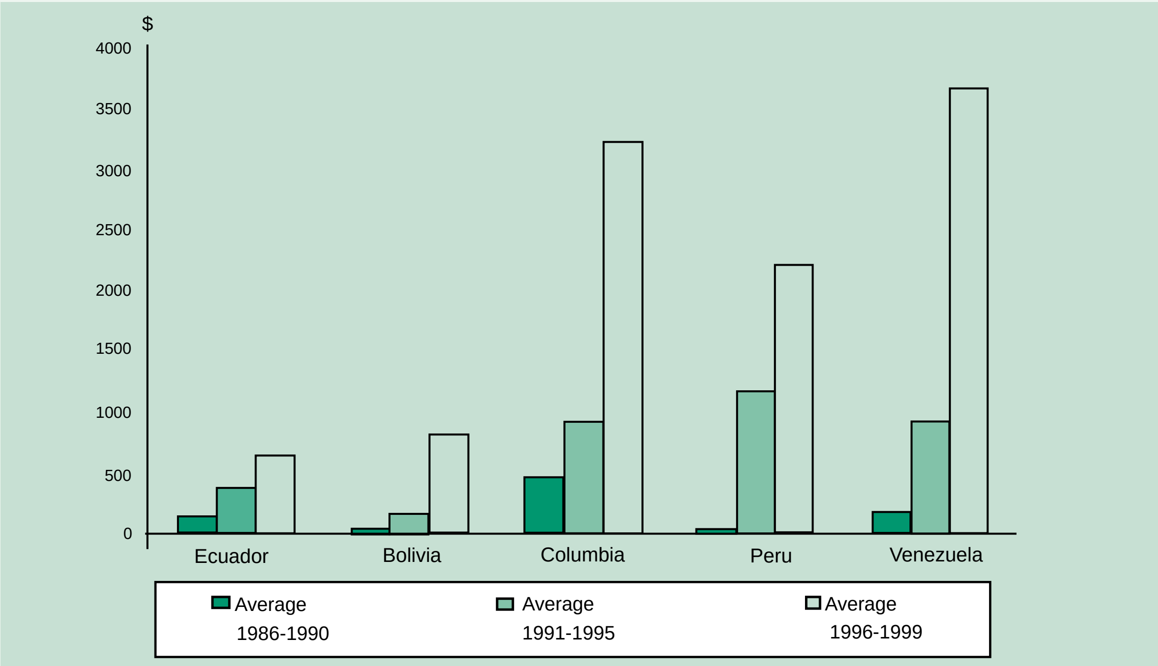
Source: UNCTAD, FDI/TNC database.

Annual average inflows in the second half of the 1990s were considerably higher than in the first half, which in turn considerably exceeded the inflows in the second half of the 1980s (figure I.3). During the 1990s, FDI inflows into Ecuador kept pace with inflows into all developing countries. Therefore, their share remained stable (0.4 per cent). They, however, increased at a slower rate than those into neighbouring CAN member countries (figure I.3), where inflows were fuelled by fast track privatization programmes, especially in Peru and Bolivia. As a result, Ecuador's share in Andean total inflows fell from 11 per cent in 1991-1995 to 7 per cent in 1996-1999.

[5] UNCTAD (1999). *World Investment Report. Foreign Direct Investment and the Challenge of Development* United Nations publication, sales N° E.99.II.D.3; and ECLAC (1999). *Foreign Investment in Latin America*, United Nations publication, Sales N° S.00.II.G.4.

Figure I.3. FDI inflows into Andean countries, 1986-1990, 1991-1995 and 1996-1999

(Millions of dollars, annual averages)



Source: UNCTAD, FDI/TNC database.

In absolute terms, Ecuador received much less foreign investment than other Andean countries. Bolivia, much smaller than Ecuador, attracted over $1 billion of inflows in 1999 while much larger countries like Colombia, Peru, and Venezuela received $1.4 billion, $2 billion, and $2.6 billion, respectively. But in relative terms (accounting for differences in size), the gap between Ecuador and the larger Andean countries is much smaller or even disappears on some measures (table I.2).

In terms of FDI inflows per capita, the recent performance of Ecuador is weak - with some $57 of average annual inflows for 1996-1998 compared to Colombia's $97 and Venezuela's $178. Recent FDI inflows per $1,000 of GDP were comparable to those of Peru but were much weaker than those of Bolivia. In terms of FDI stock compared with the size of the economy, Ecuador was second among Andean countries in 1998, after Bolivia. In terms of FDI stock per capita, Ecuador was third, after Venezuela and Bolivia (table I.2).

Table I.2. Ecuador's FDI performance compared to Andean countries during the 1990s

(Dollars and percentage)

	ABSOLUTE PERFORMANCE			RELATIVE PERFORMANCE						
	FDI inflows per year (Millions of dollars)		**FDI** stock (Millions of dollars)	**FDI inflows** per capita (Dollars)		**FDI inflows** per $1000 GDP (Dollars)		**FDI inflows** As % of GFCF	**FDI stock (dollars)** per capita	**FDI stock (dollars)** per $1000 GDP
Country/ region	1991-1995	1996-1999	1999	1991-1995	1996-1998	1991-1995	1996-1998	1996-1998	1998	1998
Ecuador	362	664	6,088	33	57	25	35	18	447	297
Bolivia	169	820	4,843	24	97	29	95	47	484	446
Colombia	912	3,264	19,133	25	97	15	43	20	444	176
Peru	1,177	2,232	8,573	52	94	27	36	16	323	128
Venezuela	943	3,690	21,736	45	178	15	48	27	825	201
Andean Community	3,562	10,668	60,372	36	109	19	44	...	501	190

Source: UNCTAD, FDI/TNC database.

2. Sectoral and industry distribution

During 1990-1999, the lion's share of FDI inflows (80 per cent) went into the oil industry (figure I.4). This explains Ecuador's noteworthy FDI performance despite the difficult economic situation and the slow pace of privatization. Oil is an attractive natural resource to transnational corporations (TNCs) engaged in mineral exploration. Since oil-related FDI in Ecuador is export-oriented, it is somewhat immune to domestic macroeconomic and political instability. Non-oil industries were, however, affected by the deteriorating investment climate; their share, which had ranged from some 20 to over 40 per cent of the inflows annually in the first half of the 1990s, fell to below 5 per cent by 1999.

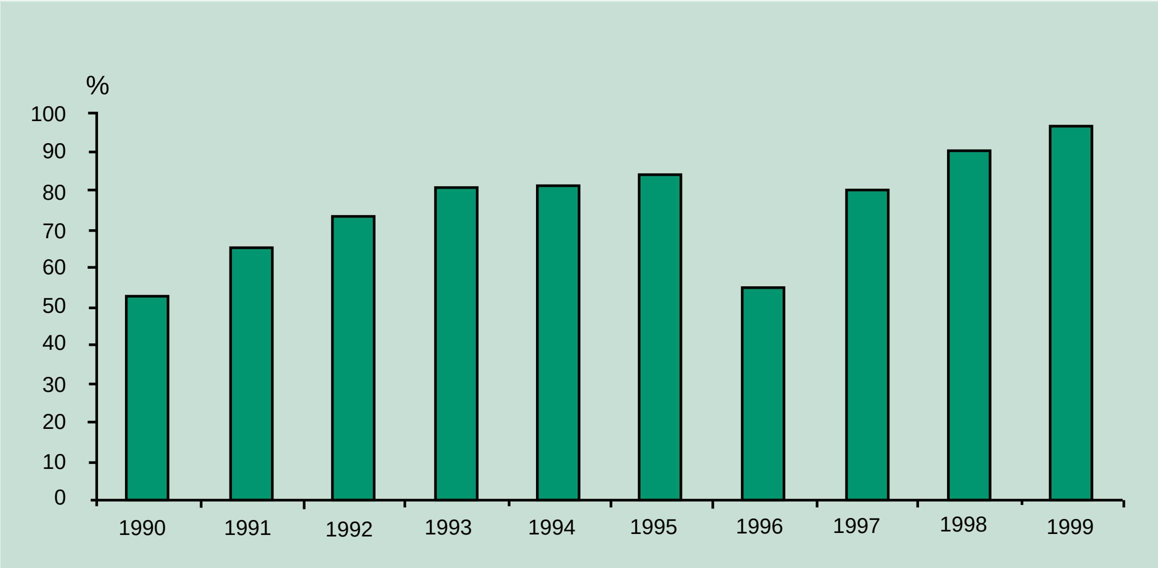
Within the manufacturing sector, food processing and chemical industries attracted the largest share of FDI. However, investment in the chemical industry was also related to oil: it was undertaken by foreign producers of oil lubricants and other oil products (CORPEI, 1999).[6] In the absence of major privatization schemes, FDI in the services sector remains insignificant. Trading, transportation and communication services attracted the largest share of FDI during 1996-1999, or 85 per cent (table I.3). The presence of foreign banks is limited, although there is some FDI in other financial services.[7]

[6] CORPEI (1999). "Política y estrategia de promoción de inversiones. Programa de trabajo y estructura de la gerencia de promoción de inversiones", mimeo.

[7] As tax haven countries (Panama, Bahamas, Virgin Islands, Bermuda and Cayman Islands) account for some 40 per cent of FDI in the financial services industry, it is quite likely that a substantial portion of this FDI constitutes domestic capital re-invested in the country.

Figure I.4. Ecuador: the share of the oil industry in FDI inflows, 1990-1999

(Percentage)



Source: Central Bank of Ecuador. 2000

FDI in the food processing industry is not strongly related to the agricultural sector. The latter, together with fishing, accounts for some 18 per cent of GDP and generated between 40 and 50 per cent of Ecuador's total export during the past decade. This included such export successes as bananas, shrimps, flowers, coffee, cacao, tuna fish and timber [8]. The involvement of foreign investors in these and other so-called non-traditional export products is limited. Although FDI inflows in this sector increased five times between 1990 and 1998, it remains modest at merely $15 million.

An exception, indicating an FDI potential in many of these products, is the flower industry, Ecuador's most recent export success story. The industry has expanded owing, among other things, to equity and non-equity links with foreign investors, in particular from Colombia. Ecuador is now the world's fifth largest flower exporter after the Netherlands, Colombia, Israel and Kenya and is the largest supplier to the United States. The flower export earnings grew ten times from $14 million in 1990, to $141 million in 1998. The industry employs 60,000 people, 60 per cent of whom are women, and offers wages consistently above minimum wages. In addition to Colombian FDI, it also attracted Dole, a large TNC, which invested not only in trading but also in the production of flowers (Paterson, 1999).[9]

[8] Ecuador supplies 80 per cent of world's balsa wood.
[9] Paterson, M. (1999). *La Gobalización de la Economía y la Exportación de Flores*, (Quito: SICA).

Table I.3. Ecuador: inflows of non-oil FDI by sector and industry, 1986-1999

(Millions of dollars, annual averages)

Sector/industry	1986-1990	1991-1995	1996-1999
Agriculture, fishing and forestry	**1.9**	**4.3**	**7.0**
Manufacturing	**24.2**	**49.6**	**26.7**
Services, of which:	**10.0**	**36.9**	**73.3**
Electricity, gas and water	0.2	0.4	0.0
Construction	1.3	0.3	4.0
Trade	6.1	23.3	35.1
Transport, distribution and communication	0.4	6.4	27.1
Other services	2.1	6.6	7.1
Total, non-oil	**36.1**	**90.9**	**107.0**

Source: Central Bank of Ecuador, 2000.

FDI in manufacturing is small, due among other reasons to small size and lack of sophistication of the local market. Approximately a third of Ecuadorians' income is spent on food items, which explains the large share of the food processing industry in FDI in this sector. In addition, over 40 per cent of the country's economy is informal, constraining demand conditions. Furthermore, many manufacturing industries are dominated by a few enterprises, which are slowly adjusting to an open economy. Lack of sophistication of the domestic market also hampers the development of competitive manufacturing products for export markets.

Demand is also concentrated in a limited number of locations, with Guayaquil, Quito and Cuenca accounting for approximately 70 per cent while approximately half of the population lives in rural areas. Guayaquil alone accounts for 42 per cent of the total demand. Demand for high-end goods and services (often foreign and mostly US-made products) comes from the small upper-class, which comprises approximately 2 per cent of all households. Ecuadorian products account for a small share in the market for such products (Chiri et al, 1998).[10]

3. Sources of FDI: countries and TNCs

Oil industry is the predominant recipient of foreign investments. These inflows originate in few countries whose oil TNCs invest in Ecuador. In 1996-1999, 70 per cent of inflows came from four developed countries: the United States (47 per cent), Canada (15 per cent), United Kingdom (5 per cent) and Italy (4 per cent). But noteworthy changes took place in the composition of inflows by countries of origin from the first half of the 1990s to the second. While average annual FDI inflows increased from all groups of countries, the increase from Latin America was particularly remarkable. Inflows grew nearly three times (from an annual average of $28 million to nearly $80 million), compared to a 10 per cent increase from the United States (still the largest FDI country to Ecuador, but whose share is declining) and 40 per cent increase from Western Europe (table I.4). This indicates that Latin American countries discovered Ecuador's investment potential in the second half of the 1990s. For example, annual investment from Argentina, Chile and Mexico, below $2 million in the first half of the 1990s, increased to $44 million in 1996-1999. Other countries that "discovered" Ecuador in the second half of the 1990s included Canada and Italy, increasing their combined investments from close to zero to $133 million on an annual basis (table I.4).

[10] Chiri, A. Peterson, J. Popik, S. and Torres, A. (1998). "Ecuador", in Porter, M. (1998). *Case Studies in Competition and Competitiveness*, (Boston: Harvard Business School).

Other large investor countries such as Japan, the Republic of Korea and Brazil are either absent or do not yet play an important role in Ecuador. In addition, there is a limited and stagnating or declining participation of some European countries, in particular that of Spain and the United Kingdom, the largest European investors in Latin America. All in all, the emergence of new home countries shows that FDI potential in Ecuador not only exists but is exploited by new investors, in spite of difficult economic situation. This augurs well for the future, provided the business climate in Ecuador improves.

Table I.4. Ecuador: FDI inflows by country of origin, 1986-1999

(Millions of dollars, annual averages)

Country/region	1986-1990	1991-1995	1996-1999
United States	73.3	254.7	290.7
Canada	5.8	1.1	117.0
Western Europe	**29.3**	**76.4**	**101.0**
of which:			
Italy	0.3	0.6	16.2
United Kingdom	9.7	28.2	39.2
Spain	0.6	11.0	5.1
Sweden	0.3	0.4	11.4
Latin America	**18.6**	**27.6**	**87.0**
of which:			
Argentina	0.2	0.2	13.5
Panama	10.0	8.9	7.9
Chile	0.2	0.5	7.3
Brazil	4.5	6.4	1.0
Colombia	0.3	2.8	5.7
Mexico	0.4	1.0	22.7
Venezuela	0.2	1.5	11.9
Others	**1.8**	**1.9**	**67.7**
Total	**128.8**	**361.7**	**663.4**

Source: Central Bank of Ecuador, 2000.

As regards companies, the largest foreign investors in Ecuador (table I.5) are petroleum companies engaged in exploration and extraction of oil in the Amazon basin, including Occidental Energy Corporation, ARCO and ORYX Energy (United States), YPF Ecuador (Spain) and Elf Aquitaine (France). Investors from the region, not listed in table I.5, include Braspetro (Brazil) and C.G.C (Argentina), as part of a consortium with the leading university and research centre, Escuela Superior Politécnica del Litoral (ESPOL) exploiting oilfields in the peninsula of Santa Elena.[11] There are also several distribution TNCs including AGIP (Italy), which markets liquefied gas, and Mobil, Texaco (United States) and Shell (United Kingdom), which have invested in retail gasoline distribution. Non-petroleum TNCs include Continental Grain (United States) which mills flour and is, along with several other United States firms, a major investor in shrimp farming. Standard Fruit/Dole (United States) is involved in banana marketing. Citibank (United States), Lloyd's Bank (United Kingdom) and ABN AMRO bank (Netherlands) have commercial banking operations in Ecuador. Bell South operates one of Ecuador's two mobile phone services (table I.5).

[11] It should be noted that 30 per cent of the net revenues of the consortium, after royalties and operation expenses, are invested in educational, social and developmental programmes in Santa Elena. However, some foreign companies have reduced or closed their operations due to the lack of commercial hydrocarbons discoveries or simply because their contracts expired. Examples include Esso-Hispanoil, Belco II, Texaco-Pecten, Tenneco, PetroCanada, Unocal and Santa Fe. Arteta Ponce, A. (1999). "Doing Business in the Oil and Gas Industries in Ecuador", September.

Table I.5. Major transnational corporations present in Ecuador, 1998

Transnational corporation	Industry	Home country
YPF Ecuador [12]	Oil	Spain
Occidental Energy Corporation	Oil	United States
ARCO	Oil	United States
ORYX Energy	Oil	United States
ELF Aquitaine	Oil	France
Mobil	Distribution of oil products	United States
Texaco	Distribution of oil products	United States
Agip	Distribution of oil products	Italy
Shell	Distribution of oil products	United Kingdom
Newmont Gold	Mining	United States
Gold Fields	Mining	South Africa
Morton Salt	Salt production	United States
Owen Illinois	Glass	United States
Phelps Dodge	Copper and aluminium conductors	United States
Philip Morris	Food	United States
Borden	Chemicals	United States
Eveready	Batteries	United States
Fuller	Chemicals and paints	United States
General Tire	Tires	United States/Germany
Holderbank	Cement	Switzerland
AKSO Nobel	Paints	Netherlands
Eternit	Construction materials	Switzerland
Colgate Palmolive	Hygiene / cleaning	United States
Dial	Hygiene / cleaning	United States
Johnson Wax	Hygiene / cleaning	United States
Grupo Santo Domingo	Beer	Colombia
Nestlé	Food	Switzerland
Nabisco	Food	United States
Continental Grain	Food	United States
Standard Fruit / Dole	Food	United States
Citibank	Financial services	United States
Lloyd's Bank	Financial services	United Kingdom
ABN AMRO Bank	Financial services	Netherlands

Source: CORPEI (1999).

[12] YPF, a TNC based in Argentina was acquired in 1999 by Repsol (Spain).

C. Overall assessment

Foreign direct investment into Ecuador accelerated during the 1990s. In the second half of the 1990s inflows were, on average, 80 per cent higher than in the first half. Such growth compares favorably with developing countries considered successful in attracting FDI during the decade. This is a noteworthy result given the slow pace of privatization and the difficult economic and political situation. However, FDI performance has not been considered satisfactory, for a number of reasons.

First, in terms of the dynamism of FDI inflows, Ecuador has performed much below Latin America as a whole and all its neighbouring Andean countries. This indicates that, while the region is considered an attractive FDI destination, Ecuador ranks low among Latin American countries and lowest among the Andean countries. This cannot be explained by the small size of the Ecuadorian economy alone. Bolivia, a country with a market of only half the size of the Ecuadorian market and a much lower level of income per capita, was able to increase its average FDI inflows between the two halves of the 1990s more than two and a half times faster than Ecuador and received by 1999 flows by almost a quarter higher than those achieved by Ecuador in its peak year ($830 million in 1998). Needless to say, Ecuador enjoys free access to the Andean market and other markets, as do all its neighbours. The next chapter presents evidence indicating that considerable untapped FDI potential exists in many industries.

Secondly, countries seek to attract FDI not only for its quantitative aspect, measured by the size of FDI inflows and their contribution to the inflow of external financial resources and domestic investment, but also, and perhaps even more importantly, for its qualitative contributions, including technology transfer, enhancement of local technological capabilities and skills, boosting export competitiveness, generating employment, restructuring firms and industries or protecting the environment. While in a number of Latin American countries FDI has indeed contributed in these areas -- in varying intensity and scope -- in Ecuador, FDI impact is limited and does not extend to the whole economy. The reason is that FDI is concentrated in the petroleum industry, which, by its nature and because of local conditions, does not have many linkages with, and spillovers into, the local economy. Therefore FDI contributions to export, employment or higher technological level are limited mainly to this industry.

Thirdly, FDI performance in terms of both quantity and quality is much below Ecuador's needs. The gap between performance and needs widened towards the end of the 1990s with the deteriorating economic situation. On the one hand, financial needs of Ecuador increased vastly because of the growing budget deficit and external debt crisis. On the other hand, private sources of external financing such as bank loans dried up and FDI inflows fell from a peak of $830 million in 1998 to $636 million in 1999 and to $680 million in 2000.[13]

Investment needs of Ecuador are vast, and have increased greatly after the last El Niño disaster. It is estimated that basic infrastructure services would require an investment of $35 billion during the next five years, an amount exceeding current domestic investment by a factor of eight.

Because of the crisis, competitiveness of the Ecuadorian economy deteriorated significantly. Global Competitiveness Report 1999, which analyzes and ranks countries by "the underlying economic conditions to achieve economic growth for a number of years", ranked Ecuador 53rd out of 59 countries (World Economic Forum, 1999).[14]

[13] Estimate by Corporación Andina de Fomento, 2000 (www.latinvestor.com).
[14] World Economic Forum (1999). *Global Competitiveness Report 1999*, (Geneva).

True, this is still slightly better than the position of its two neighbours, Colombia and Bolivia, ranked, respectively, 54th and 55th (but much below the position of Peru which ranked 36th) that also have problems with competitiveness. But apparently, low competitiveness of these two countries did not affect their FDI performance as much as that of Ecuador. In the year 2000, however, Ecuador fell to (the last) 59th position in terms of growth competitiveness ranking (WEF, 2000).[15]

To improve its competitiveness, it is not enough for Ecuador to have sufficient savings and investment. Many more assets and factors are needed such as technology, managerial and organizational skills, access to markets, diversification and upgrading of production and the restructuring of inefficient State-owned and private enterprises. FDI can contribute in all these areas. Finally, even if Ecuador had not been in the difficult economic situation, many of its successful industries, export-oriented industries in particular, are approaching the limits of their commodity- or low-cost-labour-based competitiveness. To sustain their success they need upgrading to move towards higher value-added activities thus accelerating overall economic development. As examples of some Asian or Latin American countries indicate FDI can provide assets and other ingredients missing in the country. As noted in the *World Investment Report 1995*, it can help restructure such industries by augmenting local resources.[16]

To meet these challenges, the Government of Ecuador began to introduce, in the second half of the 1990s, a series of measures aimed at enhancing Ecuador's FDI attractiveness and performance. It also formulated quantitative and qualitative objectives in this regard. According to a proposal,[17] inflows should reach $1 billion by 2003 and grow at an annual rate of 15 per cent thereafter. The share of employment generated through FDI in total employment should reach 20 per cent by that year.

To attain these ambitious objectives, FDI will have to be much more diversified than is presently the case, flowing not only into petroleum industry but also into other sectors, including manufacturing and services. Furthermore, qualitative contributions of FDI particularly to export promotion, technology transfer and skills development have to improve. Priorities should be given to attracting investment to the export industries and to building the infrastructure necessary to foster international trade. A restructuring process aimed at modernizing export production and improving its competitiveness as well as facilitating horizontal and vertical integration with the local economy should be launched. The next chapter will deal with the question whether Ecuador's expectations concerning a greater role of FDI in the economy are justified. In other words, what is Ecuador's unexploited FDI potential. Government measures and policies – both existing and new ones – aimed at realizing this potential will then be analyzed in chapter III.

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[15] World Economic Forum (2000). *Global Competitiveness Report 2000*, (New York, Oxford).

[16] UNCTAD (1995). *World Investment Report 1995. Transnational Corporations and Competitiveness*, United Nations publication, Sales No. E.95.II.A.9, pp. 227-264.

[17] Corporación de Promoción de Exportaciones e Inversiones, CORPEI (1999). "Política y Estrategia de Promoción de Inversiones".

II. Investment Potential

A. Overall potential

An analysis of past FDI performance as well as economic determinants of FDI in Ecuador indicates that the country has considerable unexploited potential for inward investment in all sectors of the economy.

The primary sector: Ecuador is endowed with rich natural resources and good climate conditions. These are potentially, the greatest, yet barely exploited, source of attraction to foreign investors. Ecuador has attained an international reputation for its bio-diversity resources. It has rich soil and ideal climate conditions for several crops; it is one of the few countries in the world with up to three tropical fruit harvests per year. Its FDI potential in natural resources extends to fishing and aquaculture and, significantly, petroleum and mining. This will be discussed in greater detail in section B.

The services sector: In the mid-1990s, share of FDI stock in this sector in total stock was much smaller than in most Latin American countries. In per capita terms, it was several times smaller than in most countries of the region except for Bolivia.[18] The greatest potential for FDI is in infrastructure services. Ecuador's investment needs in this area are huge; and successes of FDI-driven privatization programmes in other countries of the region, small and large, indicate that foreign investors are interested in this type of investment. Paradoxically, Ecuador's delays its privatization programme represent an untapped FDI potential for the future, provided that the programme is made attractive to foreign investors. This potential is also discussed in the next section.

Other industries with FDI potential in the services sector include tourism and financial services, especially banking, though for different reasons. As regards tourism, the country has many attractions and unique bio-diversity, including the Galapagos Islands beaches and the Amazon basin. FDI in this industry is rather limited with a few international hotels established in the main cities.

The banking industry is in a state of crisis. Many banks are State owned. The Government has tried to auction them off to private investors, including foreign investors. But FDI in banking in Ecuador is still insignificant. However, there has been a rapid increase of FDI in this industry in the second half of the 1990 in most Latin American countries through cross-border acquisitions of local banks, led by Spanish banks. As a result, the share of foreign banks in the banking industry in the region has increased from 8 per cent in 1994 to more than a quarter in December 1999.[19] Other Andean countries have already benefited from this process. Between 1994 and 1998, the role of foreign banks increased in Colombia (from 6 to 18 per cent), Peru (from 7 to 33 per cent) and Venezuela (from 0.3 to 44 per cent).

The manufacturing sector: FDI potential is in this sector related to Ecuador's access to international markets, its comparative advantages, trading skills and labour force.

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[18] UNCTAD (2000). *FDI Determinants and TNCs Strategies: The Case of Brazil*, United Nations publication, Sales No. E.00.II.D.2, pp. 26. Given Bolivia's large privatization programme in the second half of the 1990s, this has probably changed.
[19] See IMF (2000). *International Capital Markets*, pp.153.

Ecuador's domestic market is relatively small, but the country enjoys free long-term access to a number of international markets, offsetting the domestic market disadvantage for many products.[20] The most important is tariff - and quota - free access for all goods to other members of the Andean Community, representing altogether a market 15 times larger than that of Ecuador's in terms of GDP and almost 10 times larger in terms of the population (table II.1).Furthermore, as one of the least developed countries of the region, Ecuador has, together with Bolivia and Paraguay, preferential access to the markets of Argentina, Brazil, Chile, Mexico and Uruguay. It is also a beneficiary of the generalized systems of preferences of the United States and the European Union.

Table II. 1. Market size in an enlarged Latin American free trade zone

(Number and millions of dollars)

Country or grouping	Population (Millions)	GDP per capita (Dollars)	Total GDP	Exports	Imports
			(Billions of Dollars)		
	1998	1998	1998	1999	1999
Andean Community	**108,5**	**2639**	**288**	**43**	**37**
of which:					
Ecuador	11,9	1508	18	4	3
Bolivia	7,8	1079	9	1	2
Colombia	40,8	2522	103	12	11
Peru	24,8	2530	63	6	7
Venezuela	23,2	4088	95	20	15
MERCOSUR	**210,5**	**5252**	**1106**	**75**	**87**
of which:					
Brazil	165,9	4692	778	48	55
Latin American Free trade zone	**334,3**	**4403**	**1472**	**133**	**139**
Chile	14,8	5312	79	16	15

Source: UNCTAD, FDI/TNC database.

Ecuador has been able to capitalize on this market access, especially to other Andean countries, and on its comparative advantages. Ecuador has thus expanded its export significantly in the 1990s and diversified from oil towards other commodities such as banana, shrimp and non-traditional industrial goods[21] (figure II.1). Yet, according to an analysis by the International Trade Centre (ITC)[22], Ecuador's comparative advantages have not been fully exploited, and several products are underachieving in exports.The country's potential for increased exports is large, as shown by imports potential from Ecuador by a number of its main trading partners, exceeding in many cases actual imports (figure II.2). FDI potential exists in export-oriented production geared to serving additional international markets.

[20] This does not mean that there is no potential for market-seeking manufacturing investment at all in small markets. The optimal scale of production in a number of manufacturing industries such as food industry or branches of the chemical industry is not large, and small markets can easily accommodate such production. In a number of industries proximity to customers matters more than market size. The presence of many manufacturing TNCs in Ecuador (table I.5) seems to support this point. When the market starts growing, this may also lead to an increase in FDI oriented to the domestic market.

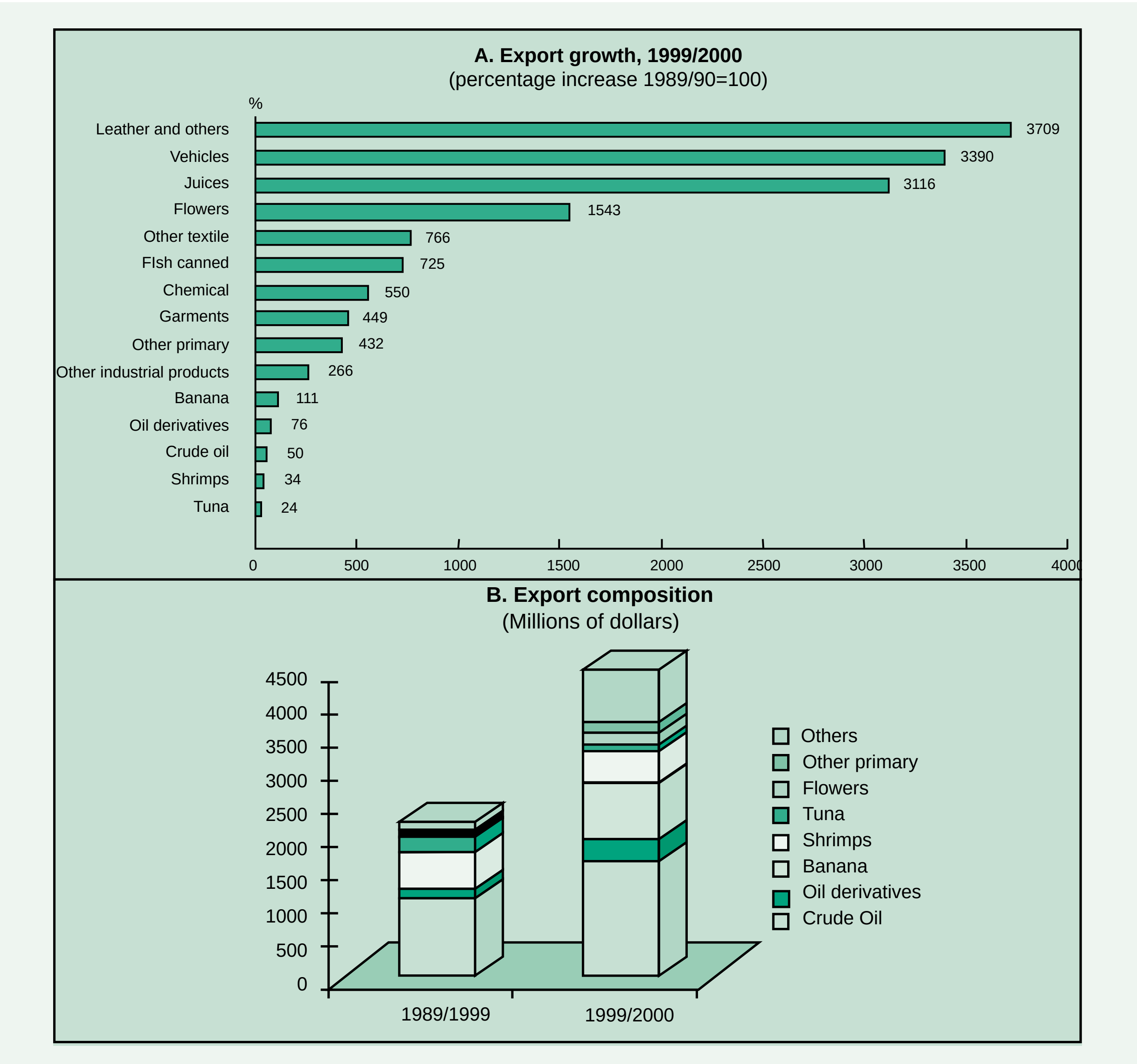
[21] Non-traditional industrial goods include flowers, juice, canned fish, chemicals and drugs, metal products, automobile, garments, leather manufactures and other industrial products.

[22] The International Trade Centre operated jointly by UNCTAD and WTO is the focal point in the United Nations system for technical cooperation with developing countries in trade promotion.

Except for a few products such as flowers where FDI played a role, Ecuador's export success during the 1990s has been built on domestic entrepreneurial skills and competitive labour force. The country has a relatively large human capital of professionals and technicians with sufficient business vision and knowledge of international markets to start and sustain international trade links. As regards labour force, Ecuador had by far the most competitive unskilled and semi-skilled labour among the Andean countries in 1999, as measured by wages adjusted for productivity for three categories of employees: office cleaners, drivers and mid-level secretaries.[23] According to an UNCTAD survey of foreign investors in Ecuador, other characteristics of the labour force have added to its competitiveness. One is a general positive attitude towards work. Most Ecuadorian workers were found to be motivated, with a capacity for adaptation. Given adequate training, the skills base of the workforce can be upgraded.

Figure II. 1 Ecuador's export success: growth and diversification, 1989-2000

(Percentage and millions of dollars)

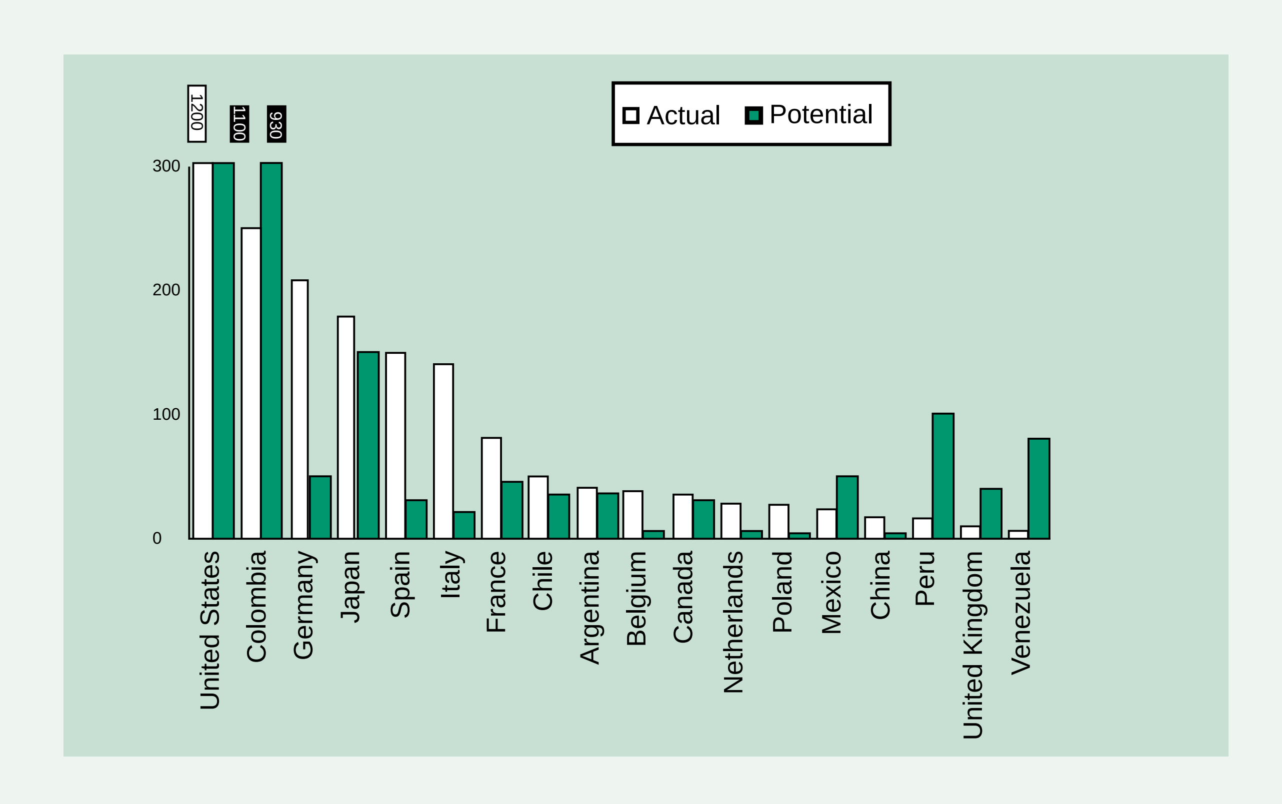


Source: Central Bank of Ecuador, 2000.

[23] World Economic Forum (1999). *The Global Competitiveness Report* 1999, (Geneva: WEF) pp. 66-80.

Figure II.2 Ecuador non-oil export potential, by country, 1998

(Millions of dollars)



Source: International Trade Center, 2000.

While the above components of comparative advantage, i.e., natural resources, climate, trading skills and competitive wages were sufficient for the initial export success, they may not be enough to sustain it, especially to develop a dynamic comparative advantage. In other words, as will be seen below, a number of Ecuadorian traditional and non traditional exports may be reaching the limits of their competitiveness. They cater mostly to low-end markets and focus on quantity rather than quality. They rarely tap, if at all, the high growth, new export and niche markets. To sustain its competitiveness in these area of exports where technology redefines traditional domestic comparative advantage, Ecuador will have to increase the quality and value added of its products, stimulate technological innovation and gain access to new markets and employ new distributors. This may not be possible without attracting FDI to existing export oriented production (see the discussion of shrimp and banana industries below) as well as to physical infrastructure, the improvement of which is another condition to sustain export competitiveness.

B. Potential in selected industries

1. Petroleum industry

Foreign direct investment potential in this industry is determined by Ecuador's known reserves as well as potentially unexplored deposits of oil and the continued attractiveness of oil to foreign investors, induced by growing international demand for oil and the recent price increases. In addition, this potential has been enhanced by the investment needs of the oil industry to improve its competitiveness.

Exploitation of hydrocarbons in Ecuador started in the 1920s at the Santa Elena peninsula. However, only in the 1970s did oil become the main economic activity of the country, accounting, together with natural gas, for 20 per cent of GDP. Foreign companies doing exploration work participated in the industry until 1972, when the State took control of the industry, creating the Ecuadorian State Petroleum Corporation (CEPE). CEPE was restructured and renamed Petroecuador in 1989.

Although the importance of petroleum industry decreased since the 1970s, the industry remains an important branch of the Ecuadorian economy. During the 1990s, it contributed, together with natural gas and electricity, close to 15 per cent of GDP. Most of the oil produced is exported – 60 per cent in 1999. Oil export is one of the largest sources of foreign exchange earning, accounting for almost a third of the country's total exports between 1994 and 1998.[24] The industry is also a large contributor to the Government budget, providing for about 35 per cent of its revenues in 1999 (Central Bank of Ecuador).[25]

In spite of the recent opening of Ecuador's petroleum industry to private firms and the rapid increase of FDI, 86 per cent of the total number of oil fields is still managed by Petroecuador and only 14 per cent by private firms (Ginatta, 1999).[26]The company accounts for three quarters of Ecuador's oil production. However, its lack-lustre performance has affected the performance of the entire industry and has often been severely criticized. The company does not meet international standards of productivity and profitability and does not pay dividends (Chiri et al, 1998). Its technological and engineering level is low and has been deteriorating over the years.[27] Maintenance tasks have almost been abandoned, which has resulted in a severe deterioration of the infrastructure and the equipment, and in potentially serious safety problems. In one study, Esmeraldas refinery was cited as an example of "technical nightmare" where environmental standards and efficiency were neglected (Ginatta, 1999). In fact, Petroecuador is in deep financial crisis: its debt is considered unsustainable. The company has not been able to comply with the debt-rescheduling agreements concluded with its subcontractors and suppliers. Its production has fallen steadily, contributing to a decreasing share of oil in Ecuador's export, from 52 per cent in 1990 to 30 per cent in 1994-1998.[28]

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[24] Until 1997, crude oil was the single largest export product, but lost its top position in 1998 to shrimps and bananas. With the increasing oil prices in 2000, oil can, however, regain its leading position.

[25] Central Bank of Ecuador (2000). "Informaciõn Estadistica Mensual" No. 1785, November.

[26] Ginatta, G. (1999). "Foreign Direct Investment and Sustainable Development: the Case of Ecuador", Fundación Biocon-Ministry of the Environment, November.

[27] This is in spite of the fact that the Hydrocarbon Law requires private firms performing services for Petroecuador to pay an annual fee of 1 per cent over the payments received for their services after deducting labour cost and the income tax. The fee should be used for technology development. Chiri, A. Peterson, J. Popik, S. and Torres, A. (1998). "Ecuador", in Porter, M. (1998). *Case Studies in Competition and Competitiveness*, (Boston: Harvard Business School).

[28] In 1998, the share of oil in total exports dropped to 22 per cent but recovered in the following years thanks to increasing oil prices.

Another critical area is that of oil reserves. Proven reserves are estimated at 6,3 billions of barrels, an amount sufficient, according to some analysts, to continue oil extraction for about 25 years. This has led to fears that if new reserves are not found and the production of oil is not increased, Ecuador will become a net importer of oil (Chiri et al, 1998).[29] Given Petroecuador's crisis and its very low level of investment in recent years, the company has not been able to undertake exploration to find new deposits.

As part of Government plans aimed at reactivating the industry, a plan called "Oil Opening 2000", was unveiled in November 1999 (see chapter III for a detailed discussion of policy measures of the plan). The industry's investment needs are put at $2.8 billion – an amount that exceeds the financial resources of Petroecuador and domestic private investors. Therefore, the implementation of the plan will not be possible without more foreign investment. In fact, the plan specifies areas with FDI potential (box II.1).

Box II. 1. Launching the "Oil Opening 2000" plan to lure foreign investors

The Oil Opening 2000 Plan comprises five projects with FDI potential, where participation of foreign investors will not only be allowed but is actively sought:

- A new pipeline for heavy crude oil -- the Oleoducto de Crudo Pesado (OCP) -- to become operational by the end of 2002. The project is expected to bring in about $500 million in FDI.
- Reactivation through joint ventures with private capital, local and foreign, of the five principal fields which account for 72 per cent of Petroecaudor's production.
- TTI projects: development of new fields in the areas of Tiputini, Tambococha and Ishpingo through concessions auctioned in public bidding open to international investors.
- Auctioning of exploration rights in the South-Eastern Amazon region owing to the peace treaty signed with Peru. Participating companies will have access to the Peruvian pipeline.
- Refurbishment of the existing refineries: participating companies will be offered operating rights in exchange for capital investment.

Source: Republic of Ecuador, 2000. *Strategy for the Petroleum Industry up to the year 2025*, Quito, Abyalyala.

More importantly, TNCs have technological and managerial assets needed to increase the efficient exploitation of oil wells, to develop new fields, including offshore fields, to build new pipelines and state-of-the art refineries, and, in general, to raise the competitiveness of the oil industry.

The current policy recognizes this, and places a strong emphasis on the need to attract foreign investors, and thus trying to unleash FDI potential and turn it into investment opportunities (see chapter III). These efforts may be facilitated by the fact that Ecuador has additional locational advantages which may make it more attractive over a number of competing locations. It is not an Organization of the Petroleum Exporting Countries (OPEC) member and therefore is free to increase its production capacity. In addition, most of its oil fields are easy to access and exploit and the time lag between investment and production is relatively short.

[29] Chiri, A. Peterson, J. Popik, S. and Torres, A. (1998). "Ecuador", in Porter, M. (1998). *Case Studies in Competition and Competitiveness*, (Boston: Harvard Business School).

The construction of new oil pipeline that has been approved in February 2001, is expected to get underway with no further delays, and it should thus be in operation by the end of 2003.[30] A private consortium – including seven international companies - will carry out the construction and operation of the pipeline.

2. Mining

Investment potential in mining is much less realized than that in petroleum and related fields such as natural gas. One of the reasons is that mining production is very small and mineral deposits remain unexplored. The extraction of minerals accounts for about 1.4 per cent of GDP, employing about 60,000 workers, or some 2 per cent of Ecuador's labour force. Export is also small: $ 26 million in 1998, out of which $18 million came from gold export.

Extraction of gold is the most important metal mining activity: in 1997, its production was estimated to be 15.5 metric tons. Efficiency of the gold industry is low as the industry is based on prospecting by individuals and informal miners which are responsible for about 85 per cent of gold production. As a result, Ecuador's share in the total gold production of Latin America declined from 4.1 per cent in 1987-1989 to 3.7 per cent in 1995-1997 and in the world production, from 0.5 per cent to 0.46 per cent, in the same period.

Although many important international mining firms have undertaken exploration activities in Ecuador, no significant metallic deposits with chances of profitable exploitation have been discovered.[31] The decrease in metal prices in 1997 slowed down exploration activity, especially by smaller companies. In 1998, only 1.7 per cent of the exploration expenses by mining firms in Latin America and the Caribbean were spent in Ecuador. Chile accounted for over 45 per cent of the regional total, Peru 17 per cent, Brazil 15 per cent and Argentina, which did not have any exploration at the beginning of the decade, for 9.5 per cent, (Sanchez Albavera et al, 1999).[32] In absolute numbers, in Peru alone, investment earmarked for exploration in mining amounts to $3.8 billion for the period 1999-2005 (UNCTAD, 2000).[33]

The non-metallic mining industry includes minerals such as limestone used in cement plants, kaolin and feldspar for the ceramic industry, siliceous sands for glass bottle factories, gypsum, marbles, bentonite and pumice stone that are abundant in many regions of the country. These represent an investment potential (Velasco, 1997), and are yet to be realized. The assertion that Ecuador has indeed considerable potential is based on the popular belief that the mineral reserves in Ecuador's Andes mountains should be no less than those found in Peruvian or Colombian Andes, where the mining industry is highly developed and has attracted significant FDI.[34] To unleash this potential and translate it into profitable and technically feasible investment projects, huge investment in exploration is needed. Since Ecuador lacks technological and financial resources needed to undertake such investment, foreign investors are the only economic agents able to take risks and foster mining development.[35] Peruvian firms which have reached an internationally competitive level in mining supplying industries and technical services can also be involved. There may also be scope for joint ventures between Ecuadorian and Peruvian firms which could help develop similar capabilities in Ecuador.[36]

[30] They include US corporations Occidental Petroleum and Kerr-McGee, Canada's Alberta Energy, Spain's Repsol-YPF, Agip of Italy and Perez Companc and Techint, both of Argentina.

[31] One of the obstacles for mining activities in Ecuador is the existence of a thick vegetal stratum covering many promising mineral zones.

[32] Sánchez Albavera, F. Ortiz, G. and Moussa, N. (1999). "Panorama minero de América Latina a fines de los años noventa", ECLAC, Serie Recursos Naturales e Infraestructura N° 1, Santiago de Chile, September.

[33] UNCTAD (2000). *Investment Policy Review of Peru*. United Nations publication, Sales No.00.II.D.7.

[34] Velasco, P. (1997). "The Mineral Industry of Ecuador", U.S. Geological Survey, Minerals Information.

[35] Needless to say foreign investors' interest in exploration and extraction activities is determined strongly by the level of international prices and their prospects.

[36] Following the peace agreement between Ecuador and Peru, a number of bilateral programmes have been set up, including in mining.

3. Shrimp industry

Since the 1970's, shrimp farming oriented mainly towards export has developed rapidly. In 1979, Ecuador's shrimp exports were 4,000 metric tons, worth $31 million. By 1998, they had increased to 115,000 metric tons, worth $875 million. Shrimp became the second largest export item, with more than 20 per cent of the country's total export. Ecuador became the second world producer of farmed shrimp, after Thailand, accounting for more than 20 per cent of the world's production.[37] In 1998, almost 60 per cent of the shrimp export went to the United States and more than 27 per cent to Europe. The industry contributes nearly 4 per cent of Ecuador's GDP and is the second largest source of employment in the coastal area, with 220,000 direct jobs. The shrimp farming is undertaken by more than 2,000 farms and 284 hatcheries for larvae production. There are 79 firms exporting shrimp.

FDI potential in this industry is determined by the locational advantages of Ecuador in the shrimp production including the dynamic development of the industry, natural conditions, the quality of the product, significant local expertise and skills developed by local training and research institutions. The potential is accentuated by the need to upgrade the industry, moving it to the production of higher value added products for which international demand is increasing. Meeting this demand would require improvements in processing, packaging and marketing of products. Without these improvements the industry's success may not be sustainable.

About 60 per cent of the inputs used by the shrimp industry comes from locally based suppliers. The shrimp feed is fish flour produced in Ecuador. There is also a substantial local capacity for packaging. However, some key inputs, including micronutrients, fertilizers and machinery are imported.

Responding to the demands of foreign markets, some local producers have been able to make progress towards higher value-added products such as breaded or pre-cooked shrimp as well in the area of food safety, a condition for export to developed countries. By 1998, 19 shrimp exporters had been certified under the Hazard Analysis and Critical Control Point (HACCP) programme. This certification is required for export of seafood to the United States. Similar programmes are also used in many European countries (Larach, 1999). Moreover, some firms which produce "organic shrimp" expect to receive environmental certifications helping their exports to developed countries.

Ecuador's topography and climate, including the confluence of cold and temperate ocean currents along its coastline, are very favorable to shrimp farming, allowing three crops a year. Furthermore, the quality of Ecuadorian shrimp is attractive to foreign consumers due, among other things, to its "sweet" flavour and its processing being relatively "chemical-free". These conditions as well as significant local expertise and know-how developed by local firms and institutions have laid ground for the dynamic development of the industry.

Local expertise has helped overcome many threats to the industry posed by viral and bacterial diseases (such as the "Taura syndrome"), the climatic phenomenon known as "El Niño" and the destruction of mangrove. Post-harvest handling techniques are considered excellent by foreign wholesale buyers, contributing to the high quality of the product. Local know-how includes pond construction, hatchery and farming techniques which is also exported to other countries such as Honduras.

[37] Farmed shrimp represents around 90 per cent of Ecuador's total shrimp production. Larach, M.A. (1999). "Las barreras medioambientales a las exportaciones latinoamericanas de camarones", ECLAC, Serie Comercio International No. 1, (Santiago de Chile).

The industry has managed to guarantee 50 per cent of the larvae stock required for all year-round production owing among others to its research and development (R & D) laboratories - an exception in Ecuador where private firms rarely, if at all, undertake R&D or technological learning activities. As a result, Ecuadorian hatcheries have technical expertise to breed high yield specimens that is on a par with the expertise of most developed countries (Chiri et al, 1998).

An institution which has contributed to the development of the shrimp industry is the National Chamber of Aquaculture, a professional association of producers in the aquaculture, including the shrimp industry established in 1993. The Chamber deals with international promotion and lobbying on behalf of the industry and provides technical, financial and market information to its members. An important area of the Chamber's activities has been the promotion of sustainable aquaculture practices which are critical for the long term survival of the shrimp farming which causes mangrove deforestation.[38] The Chamber has signed an agreement with the prestigious NGO "Fundación Natura" (related to the World Wide Fund for Nature) to "self-monitor" mangrove destruction. As a result, there were few reports of new mangrove destruction in the last years.

The most important research institution supporting the industry is the National Aquaculture and Marine Research Centre (CENAIM), established in 1990, at the Superior Polytechnic School of the Litoral (ESPOL). The Centre has also developed an Aquacultural Engineering Programme. Both CENAIM and the Aquaculture Programme benefited from the support of the Ecuadorian and Japanese governments. CENAIM performs research on water quality control for shrimp farming, shrimp pathology, immunology and genetics, among others.

Although the shrimp industry is one of the most successful industries of Ecuador, it is not without weaknesses. Its labour productivity is high by national standards, but lags behind the productivity of its Asian competitors. The level of qualifications of the labour force in farming and processing activities is low, making improvements in productivity difficult (Badillo et al, 1998).[39] The situation in this regard is further aggravated by the fact that the rapid growth of shrimp farming has led to an excessive accumulation of shrimp waste products and uneaten feed, lowering the quality of water and creating conditions that give rise to pathogens, reducing industry productivity. To stay competitive internationally, the industry needs to improve further the quality of its products, develop niche products and even a national brand. There is also a need to improve processing, packaging and commercialization practices.

Although the development of the local expertise has increased the resistance of shrimps to diseases, it did not go far enough to protect the farms from the attack, in 1999, of the virus known as "mancha blanca" (white spot) which caused major damage to the industry.[40] Currently available methods for detecting white spot virus, based on "prevention by exclusion" are not sufficient and new practices both at hatcheries and pond management have to be adopted by Ecuadorian farmers to avoid such disruptions in the future. In addition, further research is needed to find ways to avoid mangrove destruction.

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[38] Shrimp farming has caused the destruction of around 12 per cent of existing mangroves since 1969. Larach, M.A. (1999). "Las barreras medioambientales a las exportaciones latinoamericanas de camarones", ECLAC, Serie Comercio International No. 1, (Santiago de Chile).

[39] Badillo, D. Borja, D. and Sánchez, P. (1998). "El estado actual de la competitividad de la industria en el Ecuador", Federación Nacional de Cámaras de Industrias del Ecuador, October (Quito)

[40] Attacked by the virus, infected shrimps are lethargic, stop feeding, swim slowly on the pond surface, and eventually sink into the bottom and die. It has been reported that about 70 per cent of the shrimp ponds have been temporarily abandoned because of the white spot. This forced Ecuador to import shrimp tails to re-export the product, in order not to lose foreign markets. In 2000 production has been recovering. Chiri, A. Peterson, J. Popik, S. and Torres, A. (1998). "Ecuador", in Porter, M. (1998). *Case Studies in Competition and Competitiveness*, (Boston: Harvard Business School).

The solution to these problems is not facilitated by the fact that the industry has been largely organized so far, in spite of the efforts of the National Chamber of Aquaculture, as a conglomeration of separate activities rather than an integrated industry, the components of which interacting with one another enhance its competitiveness. The industry does not use information systems properly and linkages between suppliers, labour and production organization, management and quality control systems are weak (Badillo et al, 1998). Local producers typically do not share information about technical aspects of their work, not to say about their wholesale clients.

In turn, as exports are handled by trading firms, producers lack information about international markets including changing consumers' requirements and demand trends. Joint-ventures among producers and distributors needed to facilitate the introduction of value-added products have also been difficult, if at all possible.

The need for change had not been felt very strongly because, as some observers have noted, the profitability of the business had been so good, that many producers and exporters have not been interested in improvements (Chiri et al, p. 13). A change of the business culture and the improvement of management skills by local entrepreneurs required to stimulate integration and networking is now recognized as a pre-requisite for enhancing competitiveness.

The industry has developed mainly on the basis of the domestic effort. Domestic effort has to continue to upgrade the industry in areas such as research, improvement of supply capacity and quality of products and the transformation of the industry into a cluster of integrated activities or skills. The former area has become critical, as an increasing demand for specialized skills in the areas of management, R&D, water monitoring and growth control in farms and hatcheries has led to a deficit of skilled labour. But domestic effort may not be enough to upgrade the industry. Although domestic expertise has progressed a lot, it does not have all necessary capabilities, especially in the areas of research and disease prevention, environmental and other technologies and marketing. This is one of the reasons, why restrictions were lifted on FDI in farming, processing and commerce in 1997. Authorization is, however, still needed for foreign investment in research and larvae laboratories.

Given Ecuador's locational advantages related to its natural conditions in shrimp farming, the dynamism of the industry as well as its investment needs, there is indeed considerable FDI potential in this industry in areas such as R&D and biotechnology (provided that the remaining restrictions on FDI will be lifted), industrial processing, environmental services and technologies, infrastructure, logistics and marketing. FDI can take many forms, including green-field projects, cross-border acquisitions and joint ventures. As regards the latter, they may be facilitated by the fact that domestic entrepreneurs, or at least a part of them, are aware of their technological, commercial and financial limitations, seem to be open to associations and joint ventures with foreign firms (UNCTAD survey).

4. Banana industry

Bananas are even greater export success than shrimps: between 1989 and 1998 their export increased by 225 per cent while that of shrimp by 166 per cent. In 1998 banana exports surpassed $1 billion, and became the country's largest export, second only to oil export s of $0.8 billion. Ecuador is the world's leader in banana export and the third largest world producer, after India and Brazil. The industry accounts for 3 per cent of GDP.

One third of Ecuador's banana export goes to the United States. In 1998, Ecuador was the largest supplier of fresh bananas to the United States (followed by Costa Rica), accounting for over 30 per cent of the United States import of banana. Other significant destinations are Germany, Italy and the Russian Federation (each accounting for between 8 and 15 per cent of Ecuador's banana export in 1998) and Argentina, Belgium and Japan (5-7 per cent each).

Competitive advantages of Ecuador in this industry, and thus, locational advantages for FDI, include favourable climate, enabling the growing of bananas all year-round and thus putting Ecuador in an exceptional position among banana exporting countries. Ecuador can guarantee the uninterrupted supply of bananas, including during the seasons when other producing countries are unable to supply the product. World markets also appreciate the flavour, quality and resistance to diseases of Ecuador's bananas. In addition, the industry has developed packaging capacity and its shipping system meets the demands of external markets. Low labour costs are another competitive and locational advantage.

Quite different from banana exporting countries in Central America, where the banana industry is vertically integrated and TNCs play a major role, bananas in Ecuador are grown in local small and medium-size independent plantations[41] and exported by trading companies. At present, 4,000 out of 5,000 plantations have the size between one and 30 hectares, and only 139 plantations exceed 100 hectares, according to Agricultural Census and Information System (SICA). Large local corporations with plantations between 4,500 and 7,500 hectares are very few. In contrast with the great number of banana producers, export is highly concentrated. In 1998, four largest companies accounted for 80 per cent and ten largest accounted for 94 per cent of the total banana export. Among the top five exporters, three are TNCs, Dole, Chiquita and Del Monte (from the United States), the other two being local companies exporting under their own brands.[42]

Export companies usually give financial and technical assistance to their suppliers and sell them inputs. There is, however, a trend towards vertical integration in the industry. Some large companies exhibit a high degree of integration (box II.2). Recently, this trend has intensified. Exporters, both TNCs and local, have begun to invest in agricultural property (Ginatta, 1999), prompted by the system of official minimum prices for bananas bought by exporters from the producers. Competitive pressures, and especially fear that emerging markets such as Russian Federation or the People's Republic of China would be lost, push exporters to avoiding official prices via backward integration. This trend will be most likely reinforced as a result of a new law introducing severe sanctions for not paying official minimum prices.

[41] This is due to restrictions on land ownership dating back to the 1950's when Ecuador emerged as the world's largest exporter of bananas. They prevented the development of corporate plantations.

[42] This is a key competitive asset in an industry in which most bananas sold in international markets are branded. See Read, R.A. (1993). "The banana industry: oligopoly and barriers to entry", in Mc Kern, B. (ed) *Transnational Corporations and the Exploitation of Natural Resources*, United Nations Library on TNCs, Vol. 10, (London: Routledge).

Box II. 2. Favorita Fruit Holding Company

The second largest Ecuadorian exporter of bananas, accounting for 20 per cent of total banana export in 1998, is the Favorita Fruit Holding Company, a joint venture between the Wong Group of Companies and the Commonwealth Development Corporation (CDC) of the United Kingdom. CDC owns 10 per cent of the capital of the company and Wong – a local group -- 90 per cent.

Favorita has a high degree of backward integration: it grows, harvests, packs and exports bananas. It owns 5,600 hectares of banana plantations, which supplies bananas for 26 per cent of its total banana export. The balance is supplied by independent local growers. The company has also factories producing cardboard and plastic packaging boxes and labels and an aviation unit for aerial fumigation of banana plantations. The degree of Favorita's integration deepened in 1994, after it acquired Fertisa, a State-owned enterprise. Fertisa's operations include import and distribution of fertilizers, as well as port and shipping services. Fertisa controls the first private maritime port in Ecuador.

Favorita has also made significant progress in the environmental area. Reybancorp, the banana-producing subsidiary of the holding corporation, has been the first company in Latin America to obtain the environmental certification ECO-OK from the Rainforest Alliance. Its activities in this area are helped by the fact that one of its owners, the Wong Group, is deeply involved in environmental work. In fact part of its mission is to raise ecological awareness of the communities.

Source: UNCTAD survey.

Increasing productivity and advancement in technology is also a factor contributing to Ecuador's export success. Banana output per hectare increased from 26 metric tons (MT) in 1992 to 37 MT in 1997. While only 41 per cent of the total planting area were characterized as "technology-intensive" in 1991, this figure rose to 68 per cent by 1998 (SICA, 1999). Furthermore, Ecuador enjoys preferential access to many markets, except for the European Union market. A long-standing dispute was finally successfully resolved in 2001 (box II.3). Also support from national and international institutions matters increasingly (box II.4). In addition, local exporters increasingly embark on programmes for improving their environmental management systems to obtain, among others, an environmental certificate ECO-OK.[43] This certificate facilitates exporting bananas to more eco-conscious markets. An example includes Favorita Fruit company which has recently obtained such a certificate (see box II.2). Currently, there are 6,500 hectares of banana plantations in Ecuador with the ECO-OK certification. Other firms are trying to obtain the more prestigious and costly ISO 14000 certifications.[44] A local firm, Corporación Noboa, owner of the brand "Bonita", has established a multitask Environmental Committee for this purpose. Under the "Bonita" label the company also exports to more demanding markets such as Japan (Ginatta, 1999).

Ecuador's banana industry has been built on its natural resource base and has not gone far beyond the exploitation of this base. This industry (as well as the shrimp industry) remains a natural resource-based industry which exports an agricultural commodity – bananas. As such, it faces many drawbacks and challenges which, if not faced and solved, will undermine its long-term competitiveness. These challenges are as follows:

[43] This certification has also been adopted in the cacao, coffee and horticultural industries in Ecuador.

[44] Recently, it has been estimated that the costs involved in obtaining the ISO 14000 certification for the whole of Ecuador's banana export amounted to $90 million FUNDAGRO (1999).

Box II. 3. Challenging the European Union for market access

Although some of Ecuador's export are granted preferential access to the European Union (EU) market under so called "Andean Tariff Preferences Act", bananas are not. As such, they are at a disadvantage vis à vis bananas exported from African, Caribbean and Pacific (ACP) countries that are parties of the Lomé Convention, which accords privileged treatment in the EU market. Ecuador, together with the United States and a number of Latin American producers, filed a complaint with WTO against the EU banana import regime. A WTO panel concluded in 1997 that the EU regime was, indeed, inconsistent with the GATT 1994, the General Agreement on Trade in Services and the Import Licensing Agreement.

Moreover, a WTO arbitrator ruled on 18 May 2000 that Ecuador could suspend concessions and impose sanctions to the EU to the equivalent of $201.6 million per year for the EU's failure to comply with the WTO ruling against its banana import regime. The suspension of concessions could be applied on a cross-sectoral basis against EU goods, intellectual property rights, services as well as the access rights for EU wholesale distributors. Ecuador did not suspend these concessions.

In July of 2000, the European Union proposed a new import regime. According to it, tariff quotas will be applied in granting banana import licenses on a "first come, first served" basis during a transition period that would last until 2006. After the transition period, quotas would be abolished and only a tariff would be used. Accordingly, beginning in 1 January 2001, import licenses would be grouped into two quotas with different tariffs: one for 2.2 million tonnes with an import tariff of 75 euros per tonne, and another one for 850,000 tonnes, with a tariff of 300 euros per tonne.

Ecuador expressed its willingness to accept this mechanism on the condition that it would be applied indeed only during the transition period and stressed its preference for a single tariff. A new banana export regime was agreed upon between Ecuador and the EU in April of 2001, fully compatible with the one reached between the United States and the EU earlier. The new licensing system will become effective in July 2001, and will remain in force until the tariff-only system becomes effective in January 2006. This new regime will provide increased opportunities for Ecuador and will increase its banana exports by some 100,000 tonnes.

Source: World Trade Organization, WT/DS27/RW/ECU and Corft, Adrien "Ecuador turns on U.S. in banana dispute", Reuters News, 6 October 2000.

- Some 50 per cent of Ecuador's banana export is sold in low-price markets where volumes are low and cyclical fluctuations high. In 1997, the United States accounted for only 32 per cent of Ecuador's bananas exports, while Colombia and Costa Rica exported over 50 per cent of their bananas to the Unites States (SICA, 1999).
- In spite of some progress, the industry has not made significant advances in developing higher value-added products for which there is a growing world demand such as dried, roasted and mashed bananas and banana pulp and flour. In 1997, processed bananas represented only 1.7 per cent of total exports of bananas.
- Ecuador has not made significant progress as a producer of organic bananas, another market with good prospects for growth, especially in the European Union, where other Latin American countries such as Dominican Republic, Mexico, Colombia, Honduras and Costa Rica have already established themselves as significant suppliers.
- Ecuador's productivity, although growing, still lags behind that in other Latin American countries. Between 1996 and 1998 Ecuador's yield reached, on average, 36 MT per hectare. This compares with 47 MT per hectare in Colombia, 42 in Costa Rica, 40 in Honduras and 39 in Panama (see SICA 1999; and FUNDA-GRO, 1999).

Box II. 4. Supporting institutions

The National Institute of Agricultural Research (Instituto Nacional Autónomo de Investigaciones Agropecuarias – INIAP) conducts research for the banana industry. But its research has not yet resulted in significant technical assistance activities, which are still provided mainly by the exporting firms. Two other relevant institutions are INEBAN (Instituto Ecuatoriano del Banano) and PROMSA (Programa De Modernización del Sector Agropecuario). The latter is financed by the World Bank.

More recently, the Superior Polytechnic School of the Litoral (ESPOL), in association with some local corporations, established the Ecuadorian Biotechnology Society (SEBIOCA). 80 per cent of SEBIOCA's capital comes from private sources including, local companies such as Isaias, Noboa and Hernandez. SEBIOCA's principal task is to do research on sugarcane and banana produce, including in vitro sprouting, genetic markers, conservation and micro-propagation. SEBIOCA's objective is exploit its research commercially, marketing new technologies to the private sector.

Another institution is the Technical Assistance Project of the Agricultural Census and Information System (SICA), within the Ministry of Agriculture and Livestock, financed by loan from the World Bank. SICA's objective is to provide information and assistance aimed at improving public sector policy making as well as private sector decisions. The banana industry is included in its services.

Source: UNCTAD survey.

- Key technological inputs for the industry, such as machinery, fertilizers and herbicides, are imported. Ecuador also depends on foreign germ-plasm banks, a situation which has obvious negative consequences. The fact that the growth of natural species is highly dependent on specific natural conditions and that a significant part of the genetic knowledge is highly location-specific calls for domestic development in this area.
- Another challenge is the environmental performance in an industry where potential environmental damage can be extensive, including mangrove forest destruction or negative effects of pesticide applications or extensive plastic waste.

The way to deal with these problems, is to move forward and transform a resource-based, commodity-exporting industry into an advanced industry exporting more value-added products, being able to respond to changing demand in international markets, increasingly relying on its own R&D activity, as well as establishing a cluster of firms supplying services and other inputs.

According to a local study, in order to win high-income export markets and to adapt products to new consumer requirements, banana producers should use technological inputs that warrant higher output productivity and quality levels including: i) standardization; ii) facilities for packing, drainage and irrigation; iii) production systems with state-of-the-art technology for harvest and packing purposes, cultivation and phytosanitary control; iv) fertilizers and herbicides with low contamination risk levels; and, v) new management style focused on human resources development (SICA, 1999).

As in the case of the shrimp industry, the upgrading of the banana industry requires an effort by all parties concerned including the private sector, related institutions (such as research institutions) as well as the Government which should have an overall strategy for the industry (helping build a local germ-plasm bank could be one of the immediate objectives). As is clear from this section, many initiatives in this direction have already been taken by both the private sector and the Government. Most of them are only in the beginning stage and should be intensified. In addition, as in the case of shrimps, TNCs could also play a key role in the upgrading of the banana industry by contributing their technological, managerial and marketing assets. In fact, some TNCs, such as Dole, are already making useful contributions, pushing their local suppliers towards improving runoff of plants, recycling plastics, using organic fertilizer and applying stringent health protection standards (UNCTAD survey). Potential for FDI exists in areas such as biotechnology, environmental technologies, irrigation, export and industrial processing. Turning this potential into FDI opportunity depends also on Government policies. At the moment, two TNCs present in Ecuador do not seem to be interested in increasing their investment, uncertain about economic stability and property rights

5. Biological resources

Biological resources – also referred to as biological diversity or bio-diversity – include the variety of life forms such as plants, animals and microorganisms, the genes they contain and the ecosystems they form. The interest in preserving worldwide biodiversity, an essential part of human environment, has significantly increased during the last decades, especially in developed countries (DEST, 1993).[45] But these resources represent also an economic value, giving rise to many rapidly growing economic activities (box II.5).

Ecuador has such immense biological resources that it is one of the few countries on earth labeled "megadiverse". According to the World Resources Institute, it has 340 mammal species, 18 250 plant species, 1 600 bird species, 380 reptile species, 412 amphibian species and 765 freshwater fish species. In some of these areas, relative to the size of its territory, Ecuador occupies the first place not only in Latin America but also in the world. In fact, there are several animals and plants which exist only in Ecuador. Recently, the World Wildlife Fund identified 200 of the most important ecological areas in the world, and ranked Ecuador on the 11th place. Conservation International has included Ecuador in the list of 25 "hotspots" defined as places harboring greatest concentration of species.

A number of studies indicate the economic value of these resources, thus suggesting a potential for investment. For example, it has been found that a fruit named camu-camu (Myrciaria dubia) contains 10 times more C vitamin than any other citrus fruit, and that it might be profitably exploited in the Ecuadorian Amazon region (Vallejo E., 1998).[46] Some known but recently "rediscovered" crops, such as quinua and amaranth, are increasingly appreciated due to their nutritional properties. Studies also point to plants with potential to become the basis for pharmaceutical drugs. Exotic fruits like uvillas, guayabas, guanabanas, naranjillas, babaco, obos, taxo and granadilla and palms are among many Ecuadorian resources considered to be of direct economic value.

[45] Commonwealth Department of the Environment, Sport and Territories- DEST (1993). "Biodiversity and its value", Biodiversity Series, Paper No. 1, (Canberra).

[46] Vallejo, E. A. (1998). "Conservación de la Biodiversidad: ¿Gasto o Inversión?", Revista Ecológica. Sociedad para la Investigación y Monitoreo de la Biodiversidad Ecuatoriana, Vol. 1 (1).

A development known as "Tagua Initiative" provides an example of how biological resources can be usefully exploited.The initiative has been promoted by Conservation International to help protect the Cotacachi-Cayapas Ecological Reserve, one of the world's most diverse rain forests. Tagua is a white hard endosperm seed that comes from a native palm that grows in the humid forests of coastal regions. Its composition and appearance are remarkably similar to that of animal ivory. If its use can be developed as an alternative to the ivory, indiscriminate killing of endangered animals can be preserved. The Tagua initiative has encouraged international businesses to form partnerships with local groups who harvest rain forest products in a sustainable fashion. These partnerships have provided incentives to local people to save forests. In less than nine years, the Initiative has sold more than 2,500 tons of raw materials and millions of finished buttons, creating over 1,800 part-time jobs in the community, including high-quality artisan jobs in manufacturing hand-carved buttons for export.

Box II. 5. Economic significance of bio-diversity

Natural ecosystems can be, and increasingly are, considered economic assets. Like other forms of assets, if properly nurtured, they may be used to produce valuable goods and services. For example, recent research on plant species demonstrates that agriculture and forestry can benefit greatly from increased use of biodiversity in terms of productivity, stability, and sustainability. Genetically diverse breeding materials are essential for increasing crop yields. Modern biotechnology has increased the value of biodiversity because it has greatly enlarged the pool of potential sources of useful genes for crop breeding (CAST, 1999).[47]

Other uses include healthcare. Consumers in the United States spend already more than $6 billion annually on medicines derived from tropical plants. And, according to Conservation International, of the estimated 250,000 known plant species in the world today, perhaps only 5,000 have been screened for their medicinal potential. A huge and potentially lucrative market provides an incentive for pharmaceutical companies to scour the rain forests for the virtually limitless supply of potential medicinal compounds.

Besides these examples, biological resources are, or can be, the basis for products in areas such as food ingredients, fibres, ornamental plants, cosmetics, agro-chemicals, enzymes, bio-polymers, etc. International tourism is also increasingly attracted to bio-diversity intensive regions (the so-called "eco-tourism").

Needless to say, apart from or perhaps even before its economic utility, bio-diversity has an important social and cultural significance; in other words, bio-diversity has a value per se. Once it is lost, it can never be recreated. It needs to be exploited in a sustainable manner. This need itself gives rise also to activities aimed at finding ways of preserving bio-diversity.

Source: CAST, 1999; UNCTAD Biotrade Initiative (www.biotrade.com).

But such activities are still exceptions. Whatever other examples of the exploitation of biological resources exist (not too many), they indicate that Ecuador has failed to manage these resources in a sustainable manner. A case in point is forest products, the export of which grew rapidly in the 1990s: Ecuador is a principal world supplier of some of these products. For example, it satisfies 80 per cent of the world demand for balsa wood.[48]

[47] Council for Agricultural Science and Technology- CAST (1999). "Benefits of Biodiversity", Task Force Report, 133, Ames, Iowa, February.

[48] It should be noted that the industry has a competitiveness problem, due to the lack of capital and skilled human resources, deficient infrastructure and logistics as well as insufficient information about foreign markets. Its problems extend to the furniture industry SICA (1999). "Estudio de competitividad del sector maderero del Ecuador", (Quito: SICA).

But the industry uses techniques aggravating the problem of deforestation, already serious because of expanding petroleum production increased use of forest by landless poor for agriculture. As a result, Ecuador suffers the highest rate of deforestation among the Amazonian countries (1.2 per cent)[49]. In addition, Ecuador suffers from land degradation, soil erosion and desertification, all of which are also threats to biodiversity. Population growth, insufficient information and inadequate institutional and legal systems are among the causes of these harmful trends.

During the 1990s, a number of official programmes have been launched to preserve and effectively manage Ecuador's biodiversity. In 1993, the Environmental Advisory Commission (CAAM) prepared a national strategy for biodiversity. In 1994, the Ecuadorian Forestry Institute of Natural Areas and Wild Life, INEFAN, prepared a master plan for biodiversity protection jointly with the United Nations Development Program and the Global Environment Facility. In another initiative, protected areas were designated National Patrimony of Natural Areas (Patrimonio de areas naturales del estado – PANE) where development activities are not allowed, including, in particular, commercial exploitation of certain wood species. In another case, an old policy regime, thought to have contributed to deforestation, has been revoked.[50] These initiatives, however, have failed to reverse negative trends described above. In most cases there were problems with implementation and enforcement.

Such problems, combined with economic and political instability, and a lack of financial and human resources, have prevented the sustainable development of Ecuador's biological resources. But the bio-diversity investment potential exists. Furthermore, the Ministry of Environment is preparing the National Biodiversity Policy to establish a national strategy.

It also represents potential for FDI, which, in addition to exploiting these resources, could help overcome some of the above-mentioned obstacles, benefiting Ecuador. TNCs certainly have financial, managerial, human, marketing and technological resources needed to exploit Ecuadorian's biological resources not only in a profitable but also in a sustainable manner. Analysts have suggested concrete examples of such potential. Prominent among them is eco-tourism (Ginatta, 1999).[51] If efforts are made to improve the technological infrastructure and the human resources base of Ecuador, biodiversity could also attract FDI in "high-tech" activities such as biotechnology and molecular biology. Ecuador's bio-diversity should also be attractive to large food and chemical TNCs in search of new tropical food ingredients (Alvarado, 1999).

In many cases, before FDI can take place, it should be preceded by exploration activities. This exploration differs, however, from exploration activities in the oil or mining industries, because most of the resources are known. Only their potential applications are unknown. A practice called "bio-prospecting" can offer a viable solution. Bio-prospecting undertaken by Conservation International, among others, involves TNCs, local communities, government agencies, and NGOs resulted in the discovery and development of genetic resources from plants and animals. Conservation International as well as other NGOs help in the design of effective and equitable bio-prospecting programmes, focusing on the pharmaceutical industry. Under these programs, developing countries negotiate access fees. and royalties with TNCs interested in making research and eventually exploit their genetic and biochemical resources (box II.6).

[49] The forest area amounts to 12 million of hectares, or nearly 45 per cent of the national territory. Most forests are natural. 2.6 million hectares could be added through appropriate forestation techniques.

[50] It was the Agrarian Reform and Land Settlement Law which had provided tenure rights to those who cleared original vegetation, transforming the lands into cultivation and livestock lands. Pareja, L. (1999). "Timber", SICA, (Quito: SICA).

[51] Ginatta, G. (1999). "Foreign Direct Investment and Sustainable Development: the Case of Ecuador", Fundación Biocon-Ministry of the Environment, November

Box II. 6. Bio-prospecting agreements

Programme Bolsa Amazonia was launched in November 1998 and is designed to promote community development and ecological conservation through commercial partnership in the Amazonian region that process locally available materials and resources. For example POEMA and Daimler Chrysler/Mercedes Benz of Brazil established a partnership in 1994. It resulted in the generation and transfer of technologies to small-holder producers of Amazonia, and the creation of a production plant for automobile parts to manufacture truck head rests from coconut fiber (previously burned as waste) and latex. This project involves approximately 8 municipalities that produce coconut, the State, federal and municipal governments, and private companies. It has strengthened community-based enterprises to compete in local and international markets through the commercialization of good quality bio-resources products.

Partly based on the positive experience generated by the above mentioned partnership, private sector actors such as Daimler Benz, Henkel, Company Vale do Rio Doce, and the Amazon Bank have decided to participate in, and contribute financially to, the Programme Bolsa Amazonia.

Furthermore, this programme has expanded to other Amazonian countries such as Bolivia, Colombia, Ecuador, Peru, and Venezuela. In Ecuador, Bolsa Amazonia started in November 2000 under the coordination of the Ecuadorian NGO "Ambiente y Sociedad".

Source: POEMA and BIOTRADE Initiative (see also www. Bolsaamazonia.com.br).

6. Infrastructure

Infrastructure, including power generation and distribution, telecommunications, roads, ports and airports, water and sanitation treatment represents a large part of economic activity in all countries. Infrastructure is one of the key factors determining productivity and competitiveness of countries (box II.7). According to the World Bank's estimates, a 1 per cent increase in infrastructure capital is associated with a 1 per cent growth of GDP [52]. Needless to say, infrastructure determines also the quality of life through the quality of water distribution, transportation and communication services.

Infrastructure also represents a significant FDI potential as the experience of many developing and transition countries shows. In a number of Latin American countries privatization of State-owned assets, mainly in infrastructure, fuelled FDI inflows in the early 1990s. Between 1990 and 1993, about 50 per cent of FDI inflows into Argentina came from the sale of such assets (ECLAC, 1995, p.82). In Bolivia the same happened between 1995 and 1998 (ECLAC, 2000, p. 19).

The sale of Peru's largest telecommunication company accounted for 30 per cent of the country's total FDI inflows in 1997 (ECLAC, 1998, p. 126). Moreover, the impact of privatization on FDI is not limited to the sale of assets and does not stop with the completion of the privatization programme. The Latin American experience indicates that the sale of State-owned enterprises to foreign investors is frequently just the first stage of a process involving substantial post-privatization FDI, sometimes several times larger than the original investment. Sequential FDI for rationalizing and modernizing privatized enterprises has been especially prevalent in telecommunications and energy.

[52] World Bank (1994). World Development Report 1994: Infrastructure and Development, (Washington, D.C).

Box II. 7. Infrastructure and the competitiveness of flower export

In the case of Ecuador, the importance of infrastructure for competitiveness can be best illustrated with the example of the impact of air transportation services on the competitiveness of flower exports. According to EXPOFLORES, the flower exporters and producers association, inefficient airport and air transportation services result in significant over-head for the air cargo cost of flower export leaving the Quito airport. As a result, the cost of transporting a kilogram of flowers from Ecuador to Miami is $1,25 while the corresponding cost from Colombia $0.65 and from Chile $0.90. Tariffs to Europe are as follows: from Ecuador $3, from Colombia $1,60 and from Chile $1.00. One of the reasons why tariffs are so high is that air transport enterprises fix their tariffs considering factors such as airport infrastructure, availability and price of aircraft fuel, length of airstrip, airport security and volume of traffic, all of which are not favourable at the Quito Airport.[53]

According to EXPOFLORES, better management of airport premises, the reduction of taxes on aviation and "an open sky" policy (leading to a larger air traffic and the reduction of operational costs) are required to help increased competitiveness. These improvements, however, do not eliminate an urgent need for a new airport.

This is but one example of how infrastructure can affect export competitiveness. If there are similar cost disadvantages in case of other services used by exporters, ranging from telecommunication services to power generation, rail transportation to banking and insurance services, they all adversely affect export competitiveness of the country.

Source: UNCTAD survey.

In addition, privatization can impact FDI in less obvious ways. It signals the sustainability of the reforms process, removes subsides to enterprises, eases the fiscal burden, and contributes to restoring macroeconomic stability. All these factors improve the prospects for attracting FDI on a regular basis. Restricting foreign participation in privatization programmes may also compromise the chances to attract regular FDI.

Almost the entire components of infrastructure in Ecuador remains in the public domain. The results of the State ownership and management of infrastructure have been very poor. The deterioration of most services is evident, especially during the past three years. According to Quito Chamber of Commerce[54], investment needs in basic infrastructure (electricity, roads, ports, airports, water and sanitation, telecommunications, irrigation and oil) during the five years beginning in 1999 were about $35 billions, or more than two times the GDP in 1999.

In spite of its poor condition and also because of it, infrastructure represents considerable FDI potential for Ecuador. As the experience of other countries shows, despite the fact that privatization often involves local companies with obsolete technologies that incur losses and have to be restructured, TNCs are, in general, interested in acquiring such enterprises, especially in service industries, including telecommunications, transportation, energy production and distribution and financial services. It is so because, enterprises in these industries frequently enjoy monopoly or near monopoly positions and, by acquiring them, TNCs also acquire their markets and good prospects for profitability after their restructuring" (UNCTAD, 2000). That is why great care has to be taken, to ensure that public monopolies are not replaced by private foreign monopolies.

[53] All this is in addition to the airport's high altitude – 3,500 meters – which causes additional technical problems.
[54] Quito Chamber of Commerce (1998). "La modernización del Estado, un imperativo nacional". Second Edition, (Quito).

As regards Ecuador, FDI could be involved potentially in almost all areas of infrastructure (as well as other services industries with State ownership such as banking) in forms decided by the Government and/or commonly used in these areas (see table II.2). A review of infrastructure services and their investment needs follows (table II.3). In some areas of infrastructure such as roads, water supply or airport and customs operation, the involvement of foreign investors typically takes the form of non-equity arrangements such as performance or management contracts or service concession contracts. Foreign investors rarely, if at all, own assets in Latin American countries, which frequently remain with the State. In industries such as telecommunications or power generation and distribution, both equity investment and non-equity arrangements are possible, at least theoretically. Foreign investors, however, seem to prefer full control of assets (unless they undertake portfolio investment). Policies aimed at turning investment potential into FDI opportunities have to take these preferences into account, because otherwise they will not be effective, as discussed in the next chapter.

Table II. 2. FDI potential in Ecuador's infrastructure

Area of infrastructure	Type of ownership	Foreign investor's involvement
Electricity	S	Performance contract
	F	Purchase of shares or assets
Telecommunications	S	Performance contract
	F	Purchase of shares or assets
Roads	S	Performance contract, service concession, contracting out, management contracts, multiple concessions
Ports	S	Performance contract, service concession, contracting out, management contracts, multiple concessions, BOT, lease.
Airports	S	Performance contract, service concession, sub-contracting, management contract, multiple concession, BOT, lease.
Water	S	Performance contract, service concession, contracting out, management contracts, multiple concessions, BOT, lease.

Source: UNCTAD Survey

S = State ownership; F = foreign ownership.

Table II. 3. Investment requirements in Ecuador's infrastructure

(Millions of dollars)

Area of infrastructure	Project	Investment requirements
Electricity	Hydroelectric	14 600
	Transmission and distribution	761
	Thermoelectric	1 284
Subtotal		***16 645***
Telecommunications	New lines	2 000
Roads	Road plan for 5 years	3 591
	Road concessions	523
	External financing	379
	Roads restoration (coast)	500
Subtotal		***4 993***
Ports and airports	Ports modernization	34
	Quito airport	300
	Guayaquil airport	360
Subtotal		***694***
Water and drainage	Modernization plan	4 600
Total infrastructure		***28 932***

Source: CONAM, INECEL, Quito Chamber of Commerce, Airports Commission.

a. Power generation and distribution

During the 1990s, the supply of energy lagged behind an increasing demand, leading to energy deficit of about 500 giga-watts[55] (GW) and causing production losses to the Ecuadorian economy estimated at $500 million per year. Faced with such power shortages, the private sector resorted to the installation of small thermic plants for emergency supply. The economic recession has prevented a major crisis in the Ecuadorian power industry, but power rationing has been a feature of life.

Energy was supplied by a State-owned monopoly, INECEL, which was re-organized in 1998 into 6 stock companies dealing with power generation and one dealing with the transmission of energy. The energy deficit increased because of the lack of public resources for investment. Even hydroelectric generation projects, for which partial multilateral financing was available, could not be undertaken due to the lack of the local public counterpart. Deficit occurs in both generation and distribution of power. In addition, companies dealing with distribution are financially indebted with generation companies.

[55] The deficit was aggravated by the drought around the Paute hydroelectric plant.

Ecuador's investment needs in this industry are huge: for the period 1997-2005 they are estimated at $16 billion, 87 per cent of which is allocated in the generation of hydro-electricity and the rest in thermoelectricity and power distribution. The Electric Sector's Regime Law promulgated in 1996 was the first step towards turning these needs into FDI potential. It opened up activities in the industry to private investors. In the 1990s, FDI in this industry was one of fastest growing among service industries worldwide.

For example, the United States outward stock of FDI in this industry increased more than 10 times between 1990 and 1997 (Mallampally, 2000, p.35)[56] Much of FDI takes the form of cross-border acquisitions of existing companies, in developing and transition economies, within privatization programmes.

Such a programme has also been initiated in Ecuador, and in 2000 the industry was opened to foreign investors. To attract FDI, the programme should not only meet Ecuador's concerns and objectives but its conditions should also prove to be satisfactory to foreign investors. The programme as well as the new regulatory framework addresses foreign investors' concerns, which has not always been the case in Ecuador not only in this industry, but also in other industries included in the privatization programme (see next chapter).

b. Telecommunications

The story in telecommunication is largely similar to that of the power generation and distribution industry: two State-owned companies, Andinatel and Pacifictel, were not able to catch up with the rapidly growing demand, which resulted in the inadequacy of telephone lines and not being able to cope with the explosive growth of the cellular telephony.

The unsatisfied demand in 1996 amounted to 765,000 lines, approximately half of the total demand. Teledensity rate is among the lowest in the region: 7-8 lines per 1,000 of inhabitants compared to the average of 13 in Latin America. The quality of the international service is poor in spite of the fact that the rates are high.[57] Investment needs are estimated at $2 billion to install 2,000,000 new lines (urban, rural and public phones) until the end of 2002, or which not be met with public resources.

As in the power industry, the response, proposed by CONAM, has been to open the industry to private investment and competition. But, to turn this potential into FDI opportunity will require a viable privatization programme. Worldwide, FDI plays an important role in this industry. But, in developing countries and economies in transition it takes place mainly through cross-border acquisitions. Needless to say, modernization of the telecommunication industry is fundamental for productivity and the competitiveness improvement. Without modern and cheap telecommunication services, electronic business cannot develop and serve the needs of the country's exports.

[56] Mallampally, P. and Z. Zimny, (2000). "Foreign direct investment in services. Trends and patterns", in Aharoni, Y. and Nachum, L. (eds). *Globalization of Services. Some implications for theory and practice* (London and New York: Routledge).
[57] They are used to subsidize domestic telephone rates.

c. Roads

The national road network consists of 43,249 kilometres of roads, some one fifth of which are paved roads, constituting the core of the network. Half of the network has deteriorated recently because of the phenomenon of "El Niño" in the coastal region and lack of maintenance.[58]

To deal with the situation, an investment of $5 billion was needed in road construction in 1998 alone. On the contrary, the government budget earmarked only $30 million in the year 2000 for road maintenance. A five year plan, the Master Plan for Roads prepared in 1998, specifies investment needs in the areas of new road network and rehabilitation of existing roads as follows:

- Construction, improvement and maintenance of 6,905 kilometres of roads - $3,6 billion.
- Rehabilitation and integration of roads (with multilateral financing from the International Development Bank (IDB) and the Corporaciõn Andina de Fomento (CAF)) $379 million.
- Construction of 1,677 kilometres of highways within the construction programme of concessions promoted by the CONAM - $523 million.
- Rehabilitation of the coastal network devastated by "El Niño" - $500 million.

Again, there is no possibility to meet these investment needs from public resources. Participation of private investors is needed. In distinction from the two previous industries, there is hardly any FDI in the road construction and maintenance internationally. Private sector participation takes place mainly the form of concessions. The legal framework for concessions has been in place in Ecuador for six years and is considered to be adequate. There are also examples of involvement of foreign firms: the Provincial Councils of Guayas and Pichincha issued regional concessions for maintenance, improvement, extension, operation and administration of highways to Tribasa Group, a Mexican TNC (box II.8). Large construction companies based in Latin America such as Andrade Gutierrez (Brazil) and Techint (Argentina) are involved in other projects.

d. Ports and airports

The participation of foreign firms in providing maritime port services has been possible since 1998 with the establishment of four State commercial ports. Within a new framework, the State port authorities outsource the provision of various port services to private firms on the basis of concessions. Thus the authorities, while owning and regulating the port infrastructure, have become organizations supervising the provision of services and carrying out the strategic control. To do this effectively, management control and cost information systems are being developed for all ports.

[58] See Chamber of Commerce (1998). (Quito).

Box II. 8. Tribasa Colisa's experience with road concessions

Tribasa Colisa is a Mexican company involved in infrastructure development, including road infrastructure. The 1994 financial crisis in Mexico prompted it to expand abroad in Costa Rica, Chile and Ecuador. Ecuador had a lot of road projects underway (both in the Andes and coastal areas) which the company perceived as an investment opportunity in spite of competition from other foreign companies. The investment in the construction of a highway (Autopista Rumiñahui) was undertaken under a concession scheme administered by the local government, a form of private investors' involvement is typical in road construction.

In Tribasa's view, the initial phase of its first (and so far the only) concession went well. The scheme was well designed by the local government, the Consejo Provincial de Pichincha, and Tribasa received a satisfactory support from local institutions. The procedure of getting the concession, involving many different authorities, was long but clear and transparent, meeting international standards. Problems occurred in the operational phase, when the authorities imposed limitations on the company, thus not respecting the terms of the contract. In the company's opinion, the legal framework for concessions is adequate, but enforcement is sometimes problematic because of inconsistencies in the authorities' policies. For example, the contract allows the company to have advertisements on the side of the road, while the municipality where the contract is implemented forbids all types of advertisements.

Because of bureaucratic delays Tribasa Colisa has only one concession in operation, although it has sought a number of additional concessions, including for highway management and operation. The process of issuing and managing concessions involves, apart from a local government and municipalities, other institutions at the central level, such as the Ministry of Public Works, the Ecuadorian Normalization Institute and the Modernization Council. In Tribasa's view, a clear country-wide strategy on infrastructure development would help better co-ordinate the responsibilities of these institutions.

The company believes that there are many profitable and significant investment opportunities in Ecuadorian infrastructure, including in power, telecommunications, roads and highways. Tapping additional resources from international organizations such as the World Bank, Interamerican Development Bank, Andean Corporation (CAF) would help realise these opportunities. Unfortunately, except for its first concession which was issued smoothly, Tribasa's experience with additional concessions has not been encouraging. As a result, it is looking for projects in other markets, and it may loose interest in making future investment commitments in Ecuador.

Source: UNCTAD survey.

The first pilot concession for the private operation of a port was issued for the Port of Guayaquil in 1999. The management of two terminals - Granelero and the multi-purpose terminals - was subcontracted by the Port Authority of Guayaquil to a private group, Andipuerto S.A.[59] The new operator improved harbour services and invested in new infrastructure facilities. Other ports, including Manta, Esmeralds and Port Bolivar will soon follow similar operational and managerial approach. The process of ports' modernization represents investment potential and all conditions seem to be ripe to attract FDI.

[59] Andipuerto is an affiliate of Andinave S.A operating in the maritime industry since 1974 as owners of bulk and general vessels and providers of port management services, based in Guayaquil. Other members of the group are Pacific Link (cargo consolidation), Andigrain (private terminal operator) and Anditrade (private provider of customs services), all affiliates of Andinave. Andipuerto and Andigrain have concessions for 20 years to handle grain/bulk cargoes in the Port of Guayaquil.

As regards the airports, investment potential is related to the need to operate more efficiently the existing airports as well as to build new ones. Recent reforms have paved the way for a concession system open to private investors. As in the case of the ports, a State agency, Direction of Civil Aviation (DAC), will regulate air transportation, including the infrastructure and monitor and supervise the system of concessions while concessions will be issued by local governments. Airport services in Quito, Guyaquil and Manta have already been contracted out to a private company EMSA, a foreign affiliate of the German group Globe Ground. The construction of new international airports in Guyaquil and Quito will require, respectively, $300 million and $360 million of investment. Auctioning of concessions for the construction and operation of the new airports in Guyaquil and Quito should take place in the first half of 2001. The construction and operation of the new airports is expected to attract foreign investors if tender and contract conditions will meet their requirements.

e. Water

According to World Health Organization (WHO) and Panamerican Health Organization (PHO), Ecuador is one of the countries with poorest potable water and sewage systems in Latin America.[60] About 43 per cent of the population lack potable water and 60 per cent do not have access to the sewage system. In order to upgrade a sewage system in Guayaquil, $1 billion in new investment is required. In Emeralds, the sewage system covers only 30 per cent of the 120,000 inhabitants of the urban zones. The lack of quality control and the contamination of water have caused high rates of bacterial and parasitic diseases and of infant mortality. In the countryside the situation is much worse than in urban areas. All organizations that have analyzed the problem – the World Bank, WHO and PHO – described the situation as disastrous.[61]

Low tariffs and poor tax collection do not cover operational costs of water and sewage companies which are State-owned. The tariffs also do not cover the additional costs of water distributed in tankers to the poorest segments of the population. To deal with the situation, according to the PHO estimates, an investment of $4,6 billion is required until the year 2005 (or $300 per capita for potable water and $400 per capita for the sewage system).[62]

Actions needed to turn these huge needs into potential for private investment – local or foreign – include the introduction of a stable regulatory framework, including the setting of tariffs and a system of concessions which does not yet exist in this area. Internationally, companies specializing in the development and administration of water and sewage systems do exist, but it might be difficult to turn the need into private investment potential and opportunity. It is the area where multilateral and Government funding may be required in addition to private financing, if the latter cannot be mobilized.

[60] Panamerican Health Organization (2000). *Basic Indicators of the Health Situation in the Americas* (1999).

[61] There are, however exceptions: potable water companies of Quito and River basin provide such services and the quality of water is at an acceptable level.

[62] See, Quito Chamber of Commerce (1998). Panamerican Health Organization (2000). *Basic Indicators of the Health Situation in the Americas* (1999).

7. Tourism

Tourism is one of the world's largest and fastest-growing industries. In 1999, according to the World Tourism Organization, revenues reached $455 billion. If spin-offs (furniture supplied to hotels, food catering and the like) are added, the total output associated with the tourism industry is placed as high as $3.6 trillion (estimate of the World Travel and Tourism Council). Worldwide tourist arrivals grew at an annual rate of 4.3 per cent between 1989 and 1998 and are expected to more than double between 2000 and 2020.[63] The long-term trend is toward the diversification in tourism destinations: while in 1950 the world's top five tourist destinations accounted for three-quarters of tourist visits, by 1999 this share was just one-third.

Tourism into Ecuador (which represents less than 1 per cent of tourist arrivals in Latin America) grew by about 6.5 per cent annually between 1992 and 1998. This is a rate higher than the world's average rate but lower that the rate of tourism growth in Latin America, where tourism has expanded at about 10 per cent annually (excluding Brazil), and in neighboring countries. In Bolivia, for example, tourist arrivals grew by 24 per cent between 1992 and 1998 and in Peru by 15 per cent. They represent less than 1 per cent of tourist arrivals in Latin America. Nevertheless, tourism is currently the fourth-largest foreign-exchange earner for Ecuador, behind oil, bananas and shrimps. In 1999, receipts from tourism reached $343 million despite the bad publicity generated by the political turmoil and the reactivation of the Pichincha volcano (table II.4).

Table II.4. Tourism receipts and arrivals in Ecuador, 1996-1999

(Million of dollars, number and percentage)

Year	**Tourism receipts** ($ million)	**Tourist arrivals** (number)	**Arrivals from United States** (percentage)	**Arrivals from Colombia** (percentage)
1996	281	493,727	25	39
1997	290	529,492	29	37
1998	291	510,600	22	32
1999	343	n.a.	n.a.	n.a.

Source: Central Bank of Ecuador, 2000.

Ecuador's main competitive advantage lies in cultural, eco-tourism and nature tourism. The country has a wide range of tourism attractions, including the Galapagos Islands, pristine beaches, the Amazon Basin and a unique biodiversity. They all offer untapped tourism potential, including FDI potential. The Galapagos Islands, the only destination in Ecuador with international market recognition and a global following among nature lovers, still have considerable potential for expansion, particularly in increased numbers of visitors (currently stands at around 65,000 - significantly less than the maximum number of 120,000 visitors per year permitted by law for environmental reasons). If the number of visitors to the islands continue to grow at the same rate as in the 1990s (6.7 per cent per year), then the quota will only be met by 2010.

[63] World Tourism Organization (2000). *Annual Report.*

Box II. 9. Kapawi project

Kapawi is an innovative ecotourism project, which proves that private investment can succeed while at the same time taking into consideration local community objectives and limiting negative environmental and community impacts. Run by a private Ecuadorian tour operator, the Kapawi is located in the remote South-eastern corner of Ecuador, inhabited by indigenous Achaur people. The tour operator is one of the principal operators in Ecuador and has linkages with main international travel agents and tour operators.

The objective of the project is to invest $2 million in a sustainable tourism project in an indigenous territory, leasing the land from the Achaurs, while passing on the know-how and eventually the ownership and management of the facility to the local people, at the end of a 15 year period in 2011. In the interim, Kapawi will seek to recover the money it has invested and make a profit. As part of the arrangement, Kapawi has contributed to a non-profit organization that provides access to technical expertise and funding for a variety of Achuar projects, furthering the community's goal of building longer-term autonomous structures.

Although the project is quite small scale, this is the costliest ecotourism project in the Ecuadorian Amazon Basin. The Kapawi compound incorporated twenty thatched huts, accommodates a maximum of 70 guests and employees, and utilizes low-impact technologies, such as solar energy. The land is rented for $2,000 per month, increasing each year by 7 per cent. By the end of the 15-year period, the total rent paid will exceed $600,000. Each visitor is charged a community tax of $10 - with over 1,000 visitors each year, a total of $150,000 will be accumulated through 2011.

The Achuar communities involved in the project receive over 45 per cent of their income from Kapawi direct employment as well as from supplying building materials and other products to the ecotourism project. In addition, about 21 per cent of an average family's income comes from the manufacture and sale of handicrafts. The Achuar also enlighten Kapawi guests with their culture and knowledge of the forest making for a truly unique holiday experience.

Source: Rodriguez, A. (1999) "Cultural survival magazine", (Summer) and UNCTAD survey.

Due to its divergent ecosystems and species, Ecuador is one of the few countries on earth labeled "megadiverse", making it potentially attractive to a growing number of tourists, particularly in the developed world, interested in biodiversity and the natural world. Investment potential in these areas is illustrated by small-scale projects undertaken by Ecuadorian firms, particularly in the field of eco-tourism (see box II.9). The recent peace treaty with Peru has also opened-up new opportunities for industrial expansion. With new direct flight routes now operating between the two countries, tour operators can now include Ecuador in packages not only with Peru but also with other countries in the region.

There is also strong potential in business tourism, as exemplified by the recent initiative supported by private sector to establish the Quito Convention Centre and Visitors Bureau, to promote the organization of regional and international events such as fairs, conventions and exhibitions. Main international hotel chains are participating in the initiative, which may also lead to improving occupancy rates in the capital.

Ecuador has an adequate supply of labour at relatively advantageous wages, particularly in the tourism sector. Skills are less frequent: demand for education and training in the field of tourism services is very high. Major weaknesses of the tourism industry include underdeveloped infrastructure (airports, ports, roads) as well as the quality and quantity of accommodation - all these areas represent potential for investment including foreign investment. Although international hotel chains have been established through FDI or non-equity arrangements in the country's main cities, development potential still exists in the high and middle market segments - historical and natural tourist sites. The travel agency business remains mainly local and is very fragmented, with 440 registered and many informal agencies. It is under increasing competitive pressure resulting from new technologies (notably the use of Internet for marketing of services) and efforts of big tour operators aimed at vertical consolidation of the industry.

In spite of the policy to diminish the country's dependency on oil exports, tourism has not truly been promoted by the Government which continues to focus on exports of goods such as shrimps. The stark fact remains, little has been done to promote Ecuador as a tourist destination. This has to change, if FDI is to play a greater role in the development of the industry. Investment potential in the industry is so significant that there is, of course, plenty of room also for local investors in partnerships and other forms of cooperation with foreign companies. For instance, an Ecuadorian real estate development company has sought help from United States firms in the form of feasibility studies for planned "Puerto Real" development on the Santa Elena peninsula, worth an estimated $400 million. This development is set to include about ten top quality hotels as well as residential and leisure facilities. If the outcome of the feasibility studies is positive, the company plans to attract foreign funds into the project.

A booming tourism industry can help boost other industries, such as construction. But the size and scope of local benefits will depend on the ability of local industries to supply tourism. To the extent to which this is not possible, new tourism investments will imply large initial imports. Moreover, rapid tourist development is not without controversy. Many - both inside and outside Ecuador - worry about the detrimental impact on the environment and local cultures from an influx of tourists. Therefore, environmentally-friendly schemes, community involvement and the protection of cultural heritage should be highlighted as selling points in the promotion of tourism (box II.9).

C. Overall assessment

Ecuador has many attractions for foreign investors. It has abundant natural resources, including non-renewable resources - oil and unexplored minerals, as well as renewable resources - bananas, flowers, fishing and biological resources of its vast rain forest. Based on main components of its comparative advantage – natural resources, climate, trading skills and competitive wages - Ecuador has, apart from oil, developed a number of commodity-based export industries. Some of them may be reaching the limits of their competitiveness. To sustain export competitiveness, when technology redefines traditional comparative advantage and international competition intensifies, Ecuador will have to increase the quality and value added of its products, stimulate technological innovation and gain access to new markets and distribution channels employing modern marketing techniques. The upgrading of export capacity requires efforts by all parties concerned including the private sector, related institutions (such as research institutions) as well as the Government. Although many initiatives have already been taken by both the private sector and the Government, most are only at the initial stage of realization and should be vigorously pursued. The upgrading will be a difficult task which FDI may alleviate. Although domestic expertise has progressed a great deal, contributing to export success, it does not have all necessary capabilities, especially in the areas of research and product development, environmental and other technologies and marketing, to upgrade production, target new markets and to sustain export success. The Government should have an overall strategy for attracting FDI into targeted export-oriented industries.

The greatest immediate FDI potential is in the oil industry. In addition to the $1.1 billion, which will be directly invested in the construction of the new pipeline, foreign oil companies have pledged to invest also in exploration and production to make full use of the additional transportation capacity resulting from the new pipeline. The pipeline project is not only expected to increase FDI but to also raise export revenues and create over 50,000 new jobs, directly and indirectly.

Apart from the oil industry, FDI potential exists in the services sector, particularly in the infrastructure service industries such as telecommunications, power generation and distribution and air transportation. FDI can be potentially involved in almost all areas of infrastructure (as well as other service industries with State ownership such as banking and tourism) in forms decided by the Government and/or commonly used in these areas. In some areas of infrastructure such as roads, water supply or airport and customs operation, the involvement of foreign investors typically takes the form of non-equity arrangements such as performance or management contracts or service concession contracts. Strengthening the concession process by making the procedures clear and transparent will facilitate the involvement of foreign contractors. In other industries such as telecommunications or power generation and distribution, both equity investment and non-equity arrangements are possible. However, foreign investors seem to prefer full control of assets. Turning investment potential into FDI opportunities, policies will have to take these preferences into account to be effective.

The backlog of privatization and investment needs create many investment opportunities for both domestic and foreign private capital. As the country builds a track record in privatization – demonstrating the political will and ability to manage the process, additional investment opportunities will become available. Improved infrastructure will help attract additional FDI, since a strong and cost-competitive infrastructure is a pre-requisite for investment by firms that rely on, for instance, efficient port services, good road links and efficient telecommunications. Privatization programmes, however, must be carried in such a manner as to ensure cost-efficient and high-quality services and not merely to replace public monopolies by private foreign ones.

III. Policies to Realize FDI Potential

Ecuador has formulated programmes and taken steps to realise its considerable FDI potential. Government's efforts have intensified in the face of the economic crisis of 1998-2000. Dollarization has been the boldest among various steps aimed at restoring macroeconomic stability and resuming economic growth, which indeed resumed in 2000 (thanks in part to rising oil prices) and inflation is expected to fall in 2001. Still, a full recovery may take a few years.

Ecuador's legal FDI framework with respect to treatment and settlement of disputes compares favourably with that of other Latin American countries such as Peru or Chile and other APEC countries. Furthermore, it is solidly grounded in the Constitution, which reinforces such principles as national treatment of foreign investors and the supremacy of international treaties over the national legislation. However, enforcement of laws remains sometimes problematic. The proliferation of secondary legislation introduced by the administration often leads to legal confusion.

A viable privatization programme is essential for the immediate realization of FDI potential in a still large State-owned sector, from manufacturing enterprises and the primary sector to the services sector and, in particular, infrastructural services. The programme is essential for the upgrading of infrastructure. Economic and political crises and natural disasters have resulted in the deterioration of infrastructural services. Their improvement is a precondition to reviving local investment and attracting FDI.

A number of policy areas are important in increasing the long-term benefits of FDI. In particular, four areas are crucial, namely human resource development, science and technology, competition, and policies aimed at establishing and strengthening linkages between foreign and local enterprises. Ecuador's labour force has the potential to become an even greater advantage once rigidities in the labour market are alleviated and the skills of the labour force including managerial skills are enhanced.

Appropriate science and technology policies include the planned initiatives such as the establishment of a national innovation system, financial incentives for technology development, as well as the streamlining of the myriad institutions involved in science and technology. Linkages should be strengthened between industry and academia, and between foreign investors and domestic industry. In the area of competition, the general principles are formulated in the Constitution. To implement them, further operational work on the competition law and the establishment of a competition agency are essential.

After exploring these policies in some details, the chapter concludes by elaborating on the need for formulation and launch of an investment promotion programme. This requires that COMEXI – the Foreign Trade and Investment Council – assume its statutory role in the area of FDI, and CORPEI – the Export and Investment Promotion Corporation – be strengthened and an investment promotion unit be set up.

A. Restoring stability, resuming growth and achieving social consensus

To realize its full FDI potential, Ecuador must stabilize its political situation and the economy, strengthen institutions and resume growth. In addition, it should build social and political consensus for reforms.

As mentioned in chapter I, the Law of Economic Transformation (LET, also known in Ecuador as the “ley trolebús”), approved by Congress on 1 March 2000, initiated a comprehensive programme of reforms aimed at regaining economic stability and resuming growth.

In addition to giving official status to the dollarization of the economy, one of the principal measures aimed at restoring economic stability, LET reforms put in place improved banking supervision and set more attractive rules for encouraging privatization and foreign direct investment (see section C of this chapter). With no independent monetary and exchange rate policy under dollarization, fiscal policy is expected to protect the economy from external shocks (box III.1). Furthermore, in addition to the dollarization regime LET has introduced three measures aimed at helping the economy to absorb external shocks. They include an oil stabilization fund, a liquidity stabilization fund and greater labour flexibility.

The purpose of the oil stabilization fund is to protect the economy from fluctuations in the oil price. When the price of oil is high, 45 per cent of the above-budgeted oil revenues must be contributed to the fund and used only when oil prices are low. Of the remaining surplus revenues, 35 per cent is to be allocated to infrastructure development for the Amazon region, 10 per cent to national police and another 10 per cent to development projects in five provinces. The liquidity stabilization fund serves the banking system as a lender of last resort. As regards flexibility of the labour rules, LET allows enterprises to hire new workers on a per-hour basis with fewer legal constraints.

This should provide a cushion against the social impact of negative external shocks and reduce the need for drastic reductions in employment while integrating the informal labour market into the formal economy. Another LET reform targeted the reduction in the non-financial public sector deficit from 6 percent of GDP in 1999 to 3.2 percent of GDP in 2000.

The Government also laid the legal and operational framework for bank restructuring by calling for specific measures to strengthen the solvency of banks based on international best practices; facilitating the effective restructuring of private sector debt, gradually unfreezing deposits and developing supporting measures to strengthen banks' liquidity management; establishing specific measures for liquidating closed banks; and proposing measures to strengthen prudential regulation, supervision, and transparency.

Box III. 1. Dollarization

After years of currency volatility and exchange rate fluctuations, Ecuadorian authorities decided on full-scale dollarization, to tame inflation and bring about currency stability. This meant full replacement of the sucre - the former national currency - by United States dollars, with the exception of coins, which would remain in circulation in denominations of less than one United States dollar. This policy, aimed at economic stability became effective on 8 January 2000. Inflation and exchange rate volatility are considered as one of the most serious economic factors holding back foreign investment.

The debate over exchange rate stability has raged within Ecuador since the 1970s, when problems with currency stability began. The country has benefited from substantial oil exports and rents, but this has created a recurrent Dutch disease problem. The exchange rate tracked oil prices very closely. Excessive dependence on oil revenues made the sucre volatile and vulnerable, thus serving as a brake on FDI inflows and creating other economic woes.

When oil exports grew, the real appreciation threatened other export-oriented or capital-intensive industries. In addition, inflationary pressures continued. In 1999, consumers inflation reached 60 per cent (and producers inflation 186 per cent) and there was an almost 200 per cent devaluation, plus an additional devaluation of 25 per cent in the first week of January 2000. Inflation remained high in 2000, with slow pace of wage adjustment, resulting in deteriorating real wages, depressed aggregate demand, low consumption and slow investment recovery. The Central Bank of Ecuador estimates inflation at 90 per cent in 2000 and forecasts 30 per cent inflation in 2001.

The dollarization in Ecuador was a response to a complete loss of confidence in past economic policies, which were unable to stem pressures on the sucre. The exchange crisis was aggravated by lack of banking supervision and economic recession. In 1994, the Law on Financial Institutions restricted the power of the Banking "Superintendency" to exercise control. The result was a strong expansion of loans. The 1998-99 recession made it difficult to roll over credits, hence the financial crisis. Speculative attacks on the currency were then aggravated by a lack of confidence in the sucre that resulted from the over expansion of the money supply.

Ecuador's expectation is that dollarization should keep inflation below the international average (e.g. to less than five percent) thus helping currency stability, lowering the risk of financial contagion and speculative attacks on the currency and lowering the cost of international borrowings. All this should instill greater confidence by international investors and financial community, leading eventually to more FDI. By being very difficult to reverse, dollarization ensures a degree of economic stability.

There are also negative aspects of dollarization. For instance, it leads to a perceived loss of economic sovereignity; loss of revenues from seignoriage income, namely the difference between the cost of producing and distributing the paper money and its (greater) purchasing power. In addition, dollarization may adversely affect export competitiveness to non-dollar markets. Nevertheless, greater currency stability, lower inflation and reduced uncertainty on the part of foreign investors and international banks is expected to put Ecuador on the path to stability and economic growth.

Source: UNCTAD Survey.

The economic stabilization and recovery programme has received considerable international support. In May 2000, Ecuador secured a $304 million 12-month standby facility with the IMF (and access to $2 billion of multilateral funding in the next three years). The IMF's first loan review praised Ecuador's dollarization effort. The IMF agreement has allowed Ecuador to accelerate its debt restructuring, by providing the policy credibility necessary for the Government to start and conclude negotiations with (in October 2000) both the Paris Club and commercial creditors.

Furthermore, the second package of reforms included in the Law to Promote Investment and Citizen Participation, known as Trolebús II, was passed on 18 August 2000. The package includes measures to increase investment in, and to speed up the restructuring and privatization of, oil, mining and electricity industries. It also includes further measures to strengthen the banking industry, considered one of the weakest in the region. However, in December 2000 Ecuador's Constitutional Tribunal declared 44 articles of the Trolebús II fully or partially unconstitutional, including some measures facilitating private investment and labour reforms. The constitutional court's ruling came in response to a legal challenge to the form and content of the legislation brought by CONAIE, an organisation representing indigenous groups. The form of the legislation was finally declared constitutional and key reforms to modernise the economy can move ahead.

An important aspect of the reforms which may promote legal and political stability is to improve the functioning of the Government and to strengthen State institutions. This attempt is within the programme of the Modernization of the State, which began in the mid-1990s. The programme, managed by the Consejo Nacional de Modernización (CONAM), established in 1994, aims to revamp and redesign the role of the State and in particular to promote the separation of the political responsibilities of the Government from its economic ones (box III.2). The Council has made progress in reforming the State, rationalising ministries through the restructuring of functions as well as the shedding of employment redundancies. It has introduced modern management criteria, including strategies and priorities for public administration, adequate service-oriented systems and mechanisms for accounting, supervision and coordination. In the area of infrastructure, it has successfully reformed customs (box III.3) and ports management. In the area of State reforms, it has examined a proposal for decentralisation and other structural reforms.

The economic crisis has brought hardships to various segments of the population, especially the poorest. In the long run, the programme of economic reforms - dollarization, privatization and changes in labour laws – should lead to the improvement of the economic situation and help attract more FDI. In the short term, reforms may aggravate a number of hardships. Labour, for example, may face layoffs as a result of restructuring inefficient State-owned enterprises. The programme will also change the traditional configuration of interests in Ecuadorian society. Therefore, it is necessary to generate the requisite political and social consensus to implement it.

While seeking greater economic efficiency or improvements in the functioning of the legal system, government policies should not ignore re-distributive issues, hardships of the poorest or the legitimate grievances of indigenous people.

Box III. 2. The Council for Modernization of the State (CONAM)

The CONAM is an administrative body attached to the Office of the President of the Republic, established in 1994 under the Modernization Law enacted in 1993, for the purpose of directing, coordinating and supervising the modernization process of the Ecuadorian State. It is the government agency responsible for defining the strategies, rules and procedures to implement the modernization and privatization programmes in Ecuador. It is in charge of disposing of State holdings and investments, as required. The Council is governed by a board. The President of the board and the Executive Director are appointed by the President of the Republic.

Mission. To modernize the State and society, with efficiency and transparency, in order to improve the quality of life and well-being of Ecuadorians.

Vision. An efficient and decentralized Ecuadorian State, with a simplified regulatory framework, that can prevent corruption and stimulate productive investment, provide a broad coverage of quality basic services, in an environment of equal opportunities and solidarity with the deprived population.

Objectives. To improve the quality and coverage of basic services for the population. To release and channel State resources for social investment. To optimize public investment by prioritizing subsidies to the most deprived social groups.

Structure of CONAM. Current structure is based on "management by objective" techniques and incorporates private sector best practices. The organization of CONAM is composed of three "operating or business units" as follows:

- Reform of State institutions;
- Privatization of public enterprises;
- Infrastructure concessions.

The Reform of State Institutions Units is restructuring the Ecuadorian public sector through the reorganization and consolidation of functions, institutional strengthening to improve efficiency, transparency and accountability, and is implementing a National Plan for decentralizing State functions to local and regional governments.

The Privatization of State-owned Enterprises Unit is implementing major reforms in the telecommunications, electrical, hydrocarbons and other sectors including creation of new regulatory entities that will encourage more private investment in these areas. This Unit is also charged with the sale of shares of industrial enterprises that are owned and operated by the Government of Ecuador.

The Infrastructure Unit is carrying out an ambitious program for improving Ecuador's national transport services through private concessions of roads, seaports, airports, railroads and custom services to encourage greater efficiency and private investment. It is developing new regulatory entities and services to encourage private operation and investment of Ecuador's transport infrastructure.

To carry out all its functions and speed up the process, CONAM created in 2000 the **Decentralization Unit** to deal with decentralization, with a regional office in Guayaquil. This office has been designed to coordinate modernization programmes in Ecuador's largest city and coastal region and to further improve the decentralization of governmental functions.

Source: CONAM, II Semester Report, 2000.

Key elements of the Government's social programme, addressing the needs of the poorest segments of the population include:

- Improved targeting of the bono solidario, including those living in remote regions, with additional cash transfers for families whose children have good school attendance records;
- The provision of nutritional and medical support for young children and pregnant women;
- Development of a fund to accelerate the social and economic development of indigenous communities, with financial assistance from the Inter-American Development Bank (IDB).[64]

Some of the other central issues that Ecuador must address to achieve social consensus around reforms are the following:

- Burden-sharing of adjustment costs equitably among Government, enterprises and labour. Workers cannot be the only ones to bear the burden of reforms and adjustment;
- Compensating the informal sector (including unemployed) with improved social policies (through an emergency employment plan in areas such as infrastructure repair and maintenance);
- Implementation of privatization and concessions schemes, which will not only revive private investment but also provide financing for the Solidarity Fund established to deal with some social consequences of reforms;
- In the fiscal area, simplifying the tax regime and improving the tax collection to give Government greater freedom to deal with social issues.

In the past, reforms had suffered from a lack of popular support as well as obstruction from various interest groups. The above measures are only examples of actions which should help achieve social and political consensus around reforms.

[64] Ministerio del Bienestar Social (2000). "El Ecuador frente a los compromisos de la Cumbre Mundial sobre Desarrollo Social", (June).

Box III. 3. Managing private provision of customs services: Customs Corporation of Ecuador (CAE)

The customs service constitutes an important part of logistics for the operations of foreign trade. As such, it also affects foreign investors. Its efficient operation is also a factor in competitiveness and productivity. The new Statutory Law of Customs of 1998 established a new framework for the private provision of customs services. The Ecuadorian Customs Corporation (CAE) was created to regulate and control services such as storage, verification, valuation, gauging, settlement and tax collection, operated by the private sector. The only exception to the private provision is the service of customs monitoring and fiscal surveillance. The customs service has improved since the creation of CAE.

The CAE is a public law corporation with private sector participation. Its Board consists of three directors appointed by the public sector (Ministry of Finance, MICIP and President) and three appointed by the private sector (Federation of Commerce, Production Chambers and Agricultural Chamber). Instead of providing customs services itself, CAE supervises the provision of these services by private firms operating on the basis of concessions.

The CAE was established to promote Ecuador's competitiveness by supporting international commerce and foreign investment through the use of effective, efficient integration and balancing of the taxation process regarding import and export, generating reliable statistics and contributing to better control of the traffic of goods. This change is based on the principles of good faith, openness, honesty, as well as internationally accepted practices. The emphasis is on customer service and the safeguarding of the country's interests.

The activities of CAE are organized around the Management Control System that was developed after the analysis which evaluated potential impacts of the customs reform and underlying management needs. Improvement efforts focus on areas of trade facilitation, traffic control of goods and substances, taxation, and collection of reliable data. With this in mind, The Management Control Department of the CAE is obliged to monitor on a regular basis performance indicators that allow an evaluation of the quality of services.

Source: CAE.

B. Improving the regulatory framework for investment

1. General framework

a. Framework's legal foundations

Current national legislation dealing with FDI issues was preceded by the Decision 291 of the Cartagena Agreement of 1991. This decision which, like all Andean decisions, has the status of law upon official announcement, initiated the process of the opening the five countries of the Andean Group to FDI. This decision is later on carried further through national legislation in each country.

FDI in Ecuador is governed by the Law on Promotion and Guarantee of Investments enacted in 1997, which is consistent with the above-mentioned Decision 291. This law, referred to as the investment law, recognises potential economic benefits of FDI, such as employment generation, increase and diversification of exports, development of appropriate technologies and the integration of the national economy with the global economy. The law establishes a National Investment Promotion System – a system of rules and institutions, both public and private, dealing with policies and issues related to the participation of foreign firms in the Ecuadorian economy. It assigns the overall coordination of the system to the Ministry of Foreign Trade, Industrialisation and Fishing (MICIP), while giving the responsibility for the formulation of national investment policies to a special Council, the Foreign Trade and Investment Council (COMEXI). Institutions participating in the system include The Ministry of Foreign Affairs, the National Financial Corporation, the newly-established Export and Investment Promotion Corporation (CORPEI), and other public and private entities including producer and professional associations.

The new Constitution, which entered into force in 1998, includes a number of provisions applying directly or indirectly to FDI. It encourages private investment in the economy, ensures the freedom of enterprise and obliges the State to encourage free competition and competitive markets. It has provisions aimed at protecting private property and guaranteeing the stability of contracts. While the State maintains the responsibility for roads and ports and the provision of potable water, electricity and telecommunications, it can do so through delegating the provision of services in these areas to the private sector through concessions or privatization of State-owned enterprises. These provisions apply to all private investors, local and foreign. This contrasts with the previous Constitution which reserved the supply of these services exclusively for the Government. Provisions of the 1998 Constitution applying to foreign investors include national treatment, guarantees against expropriation and the superiority of international agreements over national law. The latter is important to foreign investors in case of disputes with local entities. Provisions also include the principle of direct application of constitutional rights, with the implication that those rights cannot be modified by laws and provisions issued by any authority.

b. Entry and establishment

Entry and establishment of foreign investors is free without prior authorization in most industries, with few exceptions. One exception applies to fishing, where prior approval is required from the National Fishing Institute, responsible for the control and protection of fishing resources. The Constitution also states that non-renewable natural resources (e.g., oil) are unalienable properties of the State. But they can be explored and exploited by private, mixed or public enterprises. The State also maintains exclusive rights for issuing concessions for radio and television frequencies, media, sovereign rights to bio-diversity, natural reserves and protected areas such as national parks. Since August 2000, reporting from the Joint Chiefs of the Armed Forces and express authorization by the President of Ecuador requisite for foreign companies to participate in projects located 50 km from national border areas have been eliminated.

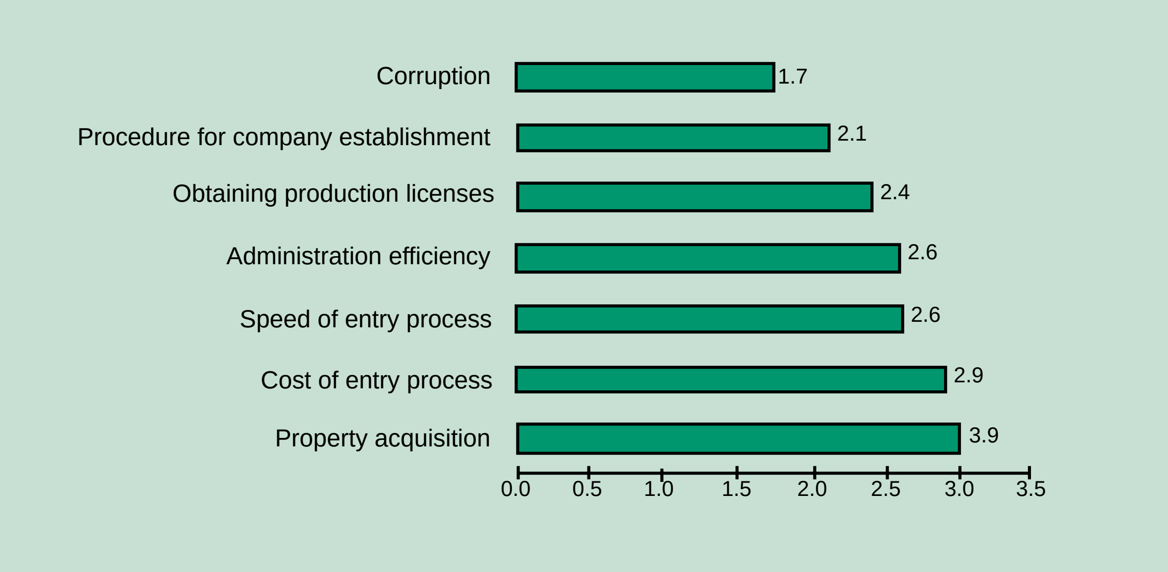
There are no ownership restrictions; any investment may be 100 per cent foreign owned and there is no requirement to invest through joint ventures with national investors. An exception to this is the oil industry where it is applied on a non-discriminatory basis; all private investors, foreign and local, must enter into development and production agreements with the State oil company (see below). Other exceptions are certain public utilities such as water supply and roads where the involvement of private investors can take the form of concessions. FDI can be financial, in-kind, or technological in form. If it takes a technological form or know-how contract, it must be registered with MICIP.

Legal forms of establishment are determined by the Company Law and apply to both domestic and foreign investors. They include corporations, limited liability companies, branches, general partnerships, limited partnerships, mixed-private-public-ownership companies, holdings or shareholders companies.

As mentioned above, prior authorization is not required for foreign companies establishing in Ecuador. The only formality is to register the investment for statistical purposes with the Central Bank, which communicates it to the Superintendencia des Compañias, an institution charged with ensuring compliance with existing regulations. The registration can be made by the foreign investor, its representative or a representative of a local investment partner. The required documentation includes a copy of a duly registered public deed, if applicable, receipt of currency exchange (if the currency is exchanged in the country), the import licence declaring the method of payment for investment or documents proving the transfer of shares or interests. Licenses, trademarks, patents and technology transfer contracts are registered with the Ministry of Industries, Commerce, Integration and Fisheries (MICIP) which also deal with the decisions of the ANDEAN Community related to investment.

According to investors, the company establishment process is fairly smooth and well supported by local legal firms. The UNCTAD survey of the foreign affiliates indicates which areas or issues related to the entry and establishment process worked relatively better than others. The weakest points of the process, as perceived by foreign investors already established in Ecuador, included corruption and bureaucratic procedures. The strongest points included property acquisition and the speed and cost of entry (figure III.1 and Annex A).

Figure III.1. FDI entry and establishment



Note: Ranking: 1 = negative; 5 = very positive.
Source: UNCTAD survey.

c. Treatment

The Constitution and the investment law grant important rights to foreign investors including:

- National treatment: including equal access to local finance and to incentive or assistance programmes available to national investors;
- The right to repatriate profits and proceeds of disinvestment in convertible currency. The convertibility assurance is formulated as a right of "free access to foreign currency markets" which is not a legal guarantee of availability of foreign currency for these purposes;
- The right to take any disputed matter covered by the foreign investment law to international arbitration under the terms of international treaties signed by Ecuador;
- The right to acquire and own land and buildings with the exception of natural preserved areas.

There are no performance requirements as a condition of undertaking a foreign investment project.

d. Protection

Both the Constitution and the law provide various forms of protection to foreign investors. The Constitution prohibits the confiscation of property. Expropriation may only be for a purpose clearly determined by law and upon payment of fair compensation. The investment law, supported by constitutional provisions, provides assurances of rights to private property and private commercial dealings.

Given Ecuador's history of frequent changes in laws, rules and regulations and resulting instability, special contracts have been introduced between investors (both foreign and local) and the State. These contracts allay fears and provide for the stability of investors' rights, as well as incentives and taxes. Such arrangements also exist in neighbouring countries such as Peru and Chile. An investor may enter into a contract with the State to stabilize his rights based on the provisions of the investment law.

The contract gives the investor a legal guarantee that it will not suffer from any change in subsequent legislation. In the case of non-adherence by the Government, the matter can be referred to international arbitration. The expectation was that this confidence-building measure would be especially important for foreign investors from home countries without protection treaties with Ecuador. However, to date not a single contract has been signed by a foreign investor and improvements are necessary to make such agreements more attractive to foreign investors (box III.4).

Foreign investors do not perceive the device in its current form as a useful instrument and tend to prefer guarantees offered by bilateral investment treaties as well as regional and multilateral arrangements.

Ecuador has entered into 23 bilateral investment treaties and 8 double taxation treaties. Bilateral investment agreements include clauses on national and most-favoured nations treatment, profits repatriation and provisions protecting against expropriation and referring disputes to international arbitration.

Double taxation treaties typically include clauses on income tax, capital gains, taxes on interest and dividends, royalties and loans (table III.1).

The Government of Ecuador has an open attitude to international arbitration. The new Constitution recognizes international arbitration and allows foreign investors to take any disputed matter to international arbitration under the terms of international treaties of which Ecuador is a party. In addition, Ecuador is signatory to the Convention on the Settlement of Investment Disputes between States and Nationals of other States (ICSID, adopted in Washington in 1965). And needless to say, foreign investors have equal access to local courts for dispute settlement.

According to the UNCTAD survey, respect for due process and fairness and competence of the judiciary in commercial disputes involving foreign investors has improved (see Annex A). However, there is still a high element of risk given the extent of discretionary powers the public administration retains. In investors' perceptions, public officials simply do not have a habit of respecting or applying the law.

Box III. 4. Improving stability agreements

Tax stability agreements differ from "investment contracts" in that the latter apply to the investor and the former to the investor's enterprise. An investment equivalent of at least $500,000 entitles the investor to enter into an agreement with the State to stabilise the rate of income tax for the following periods:

- 10 years in the existing enterprises where no expansion in production or capacity is planned;
- 20 years for new investment or expansion of the existing capacity.

According to investors, however, an agreement that stabilises only one type of tax (income tax) and then only the rate and not the base is rather weak.

The stability agreements could be improved in several ways to make them more attractive to investors:

- Incentives offered by stability agreements could be granted automatically;
- The income tax levels could be included among protections offered with an option of returning to the general fiscal regime if the tax falls below the guaranteed level;
- The system could be extended to other taxes such as VAT. In addition, the tax base could be stabilized, not merely the tax rate;
- Guarantees should extend to the freedom to export and the right to retain exports proceeds abroad;
- The assignment provision could be liberalised, i.e., lenders should be able to assume rights automatically under stability agreements when foreclosing and then to re-assign these rights with safeguards upon disposal of the secured assets;
- Legal stability agreements could be offered on an industry-by-industry basis, focussing on priority industries such as mining and tourism and on investments in export processing zones;
- The duration of legal stability agreements in the case of concession contracts could be extended to match the duration of concessions.

A change in the law is required to make these agreements more attractive to foreign investors. According to the current law, COMEXI has, for example, the authority to modify the periods of stability, but not to extend the scope of the application of the agreement.

Source: UNCTAD survey.

Table III.1. Ecuador: double taxation treaties and bilateral investment treaties, as of 1 October 2000.

Country	Date of conclusion
A. Double taxation treaties	
Belgium	December 1996
Brazil	May 1983
Chile	August 1999
France	March 1989
Germany	December 1982
Italy	May 1984
Mexico	July 1992
Romania	April 1992
Spain	May 1991
Switzerland	November 1994
B. Bilateral investment treaties	
Argentina	February 1994
Bolivia	May 1995
Canada	April 1996
Chile	October 1993
China; People's Republic	March 1994
Cuba	May 1997
Dominican Republic	June 1998
El Salvador	May 1994
France	September 1994
Germany	March 1996
Honduras	June 2000
Netherlands	June 1999
Nicaragua	June 2000
Paraguay	January 1994
Peru	April 1999
Romania	March 1996
Russian Federation	April 1996
Spain	June 1996
Switzerland	May 1968
United Kingdom	May 1994
United States	August 1993
Uruguay	July 1985
Venezuela	November 1993

Source: Ministerio de Relaciones Exteriores, Dirección General de Negociaciones Económicas, 2000.

2. Industry-specific frameworks

a. Petroleum

Successive Governments have been improving the general regulatory framework and policies related to the petroleum industry to exploit FDI potential in order to raise efficiency.

The Hydrocarbons Law of 1978 constitutes the basic regulatory framework for the industry. Although the Constitution holds that oil resources belong to the State, their extraction and development can be undertaken by public and private enterprises, domestic or foreign. The Law itself allowed FDI in the form of joint ventures with the State. Several amendments to the Law increased the range of options available to private domestic and foreign investors to a number of delegation contracts (box III.5).

The State monopoly has been abolished, allowing delegation contracts in practically all activities including transportation of hydrocarbons through oil pipelines, secondary pipelines and gas lines, refining, industrialization, storage and commercialization. A new form of a mixed-economy company has been introduced under the new modality. Furthermore, companies established in Ecuador can import or export hydrocarbons subject to technical requirements and standards of quality. Hydrocarbon prices are being deregulated, establishing that the reference price for hydrocarbons shall be the weighted average price for the last month of export sales made by Petroecuador for an equivalent quality.[65]

In addition, the Government has tried to stimulate the oil and gas industries by providing a number of incentives to private investors. Companies engaged in the exploration and exploitation of hydrocarbons may import equipment and machinery, tools and materials duty-free - provided they are not produced in the country - during the entire exploration stage and for ten years during the exploitation stage. Similar duty-free status is offered to investors in petrochemical and related industries during the construction period and up to five years after starting operations.

To deal with the deteriorating performance of Petroecuador and to sustain and improve the generation of fiscal and export revenues from the industry, the Government prepared a strategic plan in 1999, which led the following year to modifications of the Hydrocarbons Law within LET of 2000.

This opened the way to reforms of the industry aimed at increasing known reserves and oil production as well as oil refining and transportation capacity. One of the most important provisions concerned the construction of a new pipeline, a necessary condition to increase production, since the old Trans-Ecuadorian Oil Pipeline System (SOTE) has long operated at full capacity. The pipeline will be built by a private consortium, including foreign investors.

Ecuador's Constitutional Tribunal declared, however, unconstitutional an article concerning the participation by joint ventures in the largest oil fields in the State sector. The legal framework for joint ventures needs thus to be clarified before foreign investors would commit their funds.

[65] Arteta Ponce, A. (1999). "Doing Business in the Oil and Gas Industries in Ecuador", (September)

Box III. 5. Petroleum contracts

With the last amendments to the Hydrocarbons Law, private companies, foreign and local, are allowed to enter into the petroleum industry under a wide range of contractual arrangements:

Participation contracts: These are contracts performed by the State through Petroecuador whereby the contractor is delegated the right to explore and exploit hydrocarbons. The contractor takes on and is responsible for all risks, investments, costs and expenses. These contracts are levied a 25 per cent income tax rate.

Association contracts: In these contracts Petroecuador contributes with rights over areas, oil fields or other rights, and the associated company undertakes the obligation to make the investment agreed between the contracting parties. In the event of full abandonment or return of the areas due to non-productivity, Petroecuador will not be held liable for costs.

Service contracts: Under this modality a company undertakes to perform, with its own financial resources, exploration and exploitation services in the areas marked for these purposes. Only when the service company has found commercially exploitable hydrocarbons will it be entitled to reimbursement over the investments, costs expenses and payment for services. These reimbursements shall be made by Petroecuador in cash from the gross income produced by the oil fields found in the area of the contract.

Marginal fields contracts: The contractor is delegated the right to additional exploration and exploitation in marginal production fields presently being exploited by Petroecuador, making all the required investments for additional exploration and exploitation.

Work or service contracts: The contractor undertakes to perform specific works or services for Petroecuador, contributing with its technology, capital, equipment or machinery, in exchange for a price or remuneration in cash in an amount and form of payment agreed between the contracting parties.

Operation contracts: Under this modality, Petroecuador may contract with national or foreign companies the construction and operation of main oil pipelines, secondary pipelines, gas lines, terminals and hydrocarbons processing plants.

Delegation contracts: Petroecuador may delegate to foreign or local companies the activities of transportation of hydrocarbons, their refining, industrialization, storage and commercialization by entering into association contracts or any other contractual means currently in force under Ecuadorian law.

Source: Republic of Ecuador (1999). *Strategy for the Petroleum Industry up to the year 2005*.

Government plans, to further develop the petroleum industry and improve its performance have encountered opposition from various groups concerned with adverse short- and long-term effects of those plans. Concerns come from labour unions in State-owned enterprises (concerned about job cuts) to indigenous groups and NGOs concerned about the impact of oil development on the social and physical environment. Environmental and social issues are frequently related. For example, in the region of Oriente where oil development activities in the 1990s led to protests by both Ecuadorian and international environmental organizations and indigenous groups (Ginatta, 1999).[66]

[66] Ginatta, G. (1999). *Foreign Direct Investment and Sustainable Development: the Case of Ecuador*, Fundaciòn Biocon-Ministry of the Environment, Novembre

The former claimed that oil development caused deforestation and the loss of bio-diversity. The latter, inhabitants of the rainforest region, where almost all the Ecuadorian oil is produced, complained that only 3 per cent of the petroleum budget is invested in the region, where poverty indicators are among the highest in the nation. Besides, they argue that oil has deteriorated their life quality.

According to a recent study, there are examples of both positive and negative environmental practices in the Ecuadorian petroleum sector. Although, in general, TNCs have better capacity to deal with environmental ramifications than domestic companies in developing countries (UNCTAD, 1999), in Ecuador this is not always the case.[67] According to a recent study, both Petroecuador and TNCs have failed to set an example of good environmental behaviour. For example, although several NGOs have protested against air and waste pollution by Petroecuador's Esmeraldas refinery, little has been improved. Among foreign firms, Texaco has a bad reputation, especially among indigenous people.[68] Other foreign companies which have entered more recently, such as Oxy, enjoy better reputations (Ginatta, 1999).

While opening the oil industry to private investors, domestic and foreign, Ecuador also introduced regulations aimed at protecting the environment. According to these regulations, organic waste must be processed using environmentally friendly methods and inorganic waste must be recycled or buried in waterproof wells. In order to control erosion, companies must remove any obstruction to the natural flow of rivers when such obstruction has been produced in activities associated with exploration. They must also replant affected areas where vegetation and top soil has been removed.

Furthermore, regulations aim at preserving local species and protecting native communities. The latter are entitled to receive financial compensation in case of damage. Regulations are enforced by The National Environmental Bureau (DINAMA), a technical and administrative department that controls and monitors compliance with environmental laws affecting activities susceptible of producing negative social impact to the environment (Arteta Ponce, 1999). All companies including Petroecuador, its affiliated and associated companies, service contractors, mixed economy companies and others related to hydrocarbons activities, must submit their annual programmes annual reports on environmental activities to the Under Secretary for the Environment.

Given the environmental behaviour of both domestic and foreign firms, as evidenced by the cited study and by the continued protests of environmental groups and indigenous people, there are significant problems with the implementation of this legislation. To increase the chances of the Government's plan to revitalize the petroleum industry with the increased participation of foreign investors, provisions of the plan must not only prove to be attractive to these investors but the plan must also include mechanisms for addressing legitimate social and environmental concerns.

While pre-occupied with current problems, Government should not neglect the need to encourage value added activities by foreign investors and to foster foreign affiliate linkages with the local economy so as to increase benefits from FDI. To date, Ecuador has failed to make significant inroads into the production of petrochemicals, fertilizers or lubricants, predominately exporting crude oil. Linkages of the oil industry to the local economy have been very weak or non-existent.

[67] UNCTAD (1999). *World Investment Report 1999: Foreign Direct Investment and the Challenge of Development* United Nations publication, Sales N° E.99.II.D.3, pp.289-312.

[68] Recently a lawsuit involving Amazonian Indians and Texaco was taken before to a New York instead of an Ecuadorian court, where Texaco wanted. The plaintiffs argue that, during its thirty year history in Ecuador, Texaco caused direct damage to 400,000 hectares, and indirectly to one million hectares, with frequent oil spills that could add up to 17 million gallons of hydrocarbon wastes placed in the rainforest soil (Ginatta, 1999)

As regards backward linkages, advanced services such as surveying, computing, communication via satellites, engineering, equipment design, mapping and construction are mostly imported or, if supplied by established foreign firms, provided through personnel brought from abroad (Chiri et al, 1998).[69] Ecuador could also encourage foreign participation in energy-intensive industries. Diversifying into petrochemicals and petroleum derivatives are a natural next step as Ecuador continues to industrialize and attract FDI.

Needless to say, most of the capital goods used in this industry are also imported. Improvements in these areas are not easy and do not happen rapidly, especially in countries at such a low level of development. However, in the absence of appropriate policies, they do not take place at all. Government policies aimed at encouraging local linkages include supplier development and training, development of energy-related local skills and energy technology and improvement of infrastructure. Foreign affiliates can contribute to some of these areas with appropriate Government policies, including incentives. The latter can also be aimed at encouraging more value-added activities by foreign affiliates, geared to both domestic and foreign markets, as the size of the domestic market alone might be an obstacle in capital-intensive activities.

b. Mining

As mentioned in chapter II, FDI potential in mining is yet to be fully explored. Therefore, if Ecuador wishes to attract FDI into mining, apart from improving the general enabling framework for FDI, it should improve the framework related to mining. As investment in mining is risky and has long-term maturation periods. Therefore, political and economic stability and ensuring the stability of contracts and property rights is essential for this investment. Furthermore, a mining regime should provide the freedom to export mineral products at world market prices and access to foreign exchange at market rates. Investors also look for a stable and equitable tax regime. Countries which have high royalties, import duties or output- or cost-related taxes are at a competitive disadvantage in attracting mining investments compared with countries that emphasise income taxes and allow early recovery of exploration and capital investments (UNCTAD 2000; World Bank, 1996).[70]

The legal regime for mining activity in Ecuador is provided by the Ecuadorian Mining Law (no. 126/91). Over the years, Ecuador has been improving the regime, bringing it closer to the above requirements. The latest improvements took place in 2000. As a result, it is becoming more and more "investment-friendly", although its full impact will also depend on its enforcement, which has often posed problems in the past.

According to the regime, both local and foreign individuals or companies can undertake mining activities including prospecting, exploration, smelting, refining and commercialization. There are no restrictions or requirements concerning ownership or form of FDI. Foreign investors are not required to have nationals as partners and investment can take the form of cash, machinery or services. There are no restrictions on the repatriation of profits. Mining concessions are issued for fields ranging in size from one mining hectare to 5,000 mining hectares per concession. Their duration has been extended to 30 years.

There are no export restrictions of mining products nor export taxes or duties, except for the 0.5 per cent tax on F.O.B. export value. Minerals sold to the Central Bank of Ecuador are considered as exports. There is no Value Added Tax (VAT) on local and export sales of minerals. Customs duties on imports of inputs such as spare parts and machinery cannot surpass 5 per cent ad valorem. Machinery imports can also be exempted from VAT provided that no local production of the same machinery exists.

[69] Chiri, A. Peterson, J. Popick, S. and Torres, A. (1998). Ecuador, in Porter, M. (ed.), *Case Studies in Competition and Competitiveness, Harvard Business School.*

[70] UNCTAD (2000). *Investment Policy Review of Peru* United Nations publication, Sales N° 00.II.D.7. World Bank (1996). *A mining Strategy for Latin America and the Caribbean, World Bank Technical Paper 345.*

As regards other fees and taxes, royalty payments have been replaced by annual concession fees. In addition, mining investment is exempted from real estate and municipal taxes in the areas of concession. Even if the Mining Law does not include provisions on tax stability, foreign investors can enter into an agreement with the State to stabilize the income tax rate for 20 years for new investments amounting to at least $500,000 (box III.4).

The greatest mining problem area remains property rights, which has always been difficult to enforce because of the so called "invaders" (invasores), informal miners that occupy promising mining zones and devastate them through the use of unsustainable operation techniques. A study by the World Bank called for the strengthening of Governments regulatory function in mining as well as for more effective supervision of small scale mining (World Bank, 1995).[71] Many foreign investors have complained about the uncertainty surrounding property rights. While recent changes in the mining law have further improved the situation in this regard, it remains to be seen how they will be implemented. Another important area requiring improvement is the reform of the mining rights, since a large part of the concessioned land is in the hands of speculators.

There has also been significant progress regarding the availability of geological information. The responsibility for undertaking geological research, preparing geological maps and minerals inventory lies with The Corporation for Research and Development in Geology, Mining and Metallurgy (CODIGEM). Its recent geological and geochemical survey in western Ecuadorian Andean Cordillera has been supported by funding from the World Bank and staff from the British Geological Survey. As regards environmental issues they are governed by the same Law as in petroleum (no. 126), discussed above, mandating environmental impact studies and plans of environmental management to avoid or minimize negative environmental and social impacts of mining operations.[72]

Government policy in the mining sector, if successful, should lead to increased revenues and employment[73], though not very significant, considering that mining is a very capital-intensive activity. Given the lack of local capabilities, it would be unrealistic to expect FDI to generate any immediate significant linkages and spillovers for Ecuador's economy. As regards backward linkages, local supply of inputs and equipment for the mining industry is negligible, necessitating investors to rely on imports. Forward linkages would also be limited, since local consumption of processed metals, one of the important products of mining, is low. Lateral linkages would also be weak, although some "learning by interaction" with technological centers and consultants might arise.[74] Finally, there is a lack of skilled human resources, especially in the area of mineral deposits evaluation (see, Consultora CIMACYT, 1996).[75]

Policies should encourage the cluster development around the country's minerals base by improving the effectiveness of the supplier network and the adequacy of the supporting physical infrastructure and building capabilities in skilled labour, including managerial, and supporting technical, design, consulting and engineering services.

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[71] World Bank (1995). *Characteristics of Successful Mining Legal and Investment Regimes in Latin America and the Carribean Region*, Industry and Mining Division, September.

[72] Enforcement of this Law is even more difficult in the mining sector than in petroleum industry, because, as mentioned, mining is dominated by informal operators using rudimentary technology, based on the widespread use of mercury. On the other hand, there are examples of positive environmental impact by TNCs, including the National Cement Co., a foreign affiliate of the Swiss TNC Holderbank, following global environmental and corporate social responsibility standards determined by the headquarters (Ginatta, 1999).

[73] Mining companies are required to employ at least 80 per cent Ecuadorian personnel, although recent changes in labour laws have eased the recruitment of foreign personnel.

[74] In Chile, for instance, a country with a long mining tradition, 150 researchers undertake R&D projects in mining, with an annual budget of over $4 million. Over the years, Chilean enterprises have acquired experience in large scale mining, permitting them to enter partnerships with leading international companies investing in Latin America. See UNCTAD (2000). *Investment Policy Review of Peru*. United Nations publication, Sales No.E.00.II.D.7.

[75] Consultora CIMACYT (1996). "Estudio del sector minero en el Ecuador", (Quito: Corporación Financiera Nacional).

3. Investment incentives

Ecuador offers several investment incentives to all investors, foreign and local. The schemes are similar to those in neighbouring countries, although the coverage of exemptions differ quite substantially.

a. Industry incentives

As part of the reform of public finance, many exemptions granted to specific industries were eliminated in 1994.[76] Certain tax benefits remain in the mining, petroleum and tourism industries.

Incentives in tourism are based on the 1997 special law on Tourism Development. The law gives equal access to national and foreign investors on incentives. Incentives are offered for 10 years and include:

- Exemption from taxes and payments levied on the incorporation of a company and other financial transactions;
- Exemption from taxes on the transfer of ownership and property tax;
- Deduction of capital investment in tourism from taxable income;
- Preferential access to credit from all financial institutions, both public and private, that offer credit to tourism companies;
- Exemptions from tax levied on interest.

The law offers additional incentives to categories of projects pre-approved by the Ministry. The first category includes projects located in depressed, rural and border areas with tourism potential. Benefits are given for 10 years and include:

- Total exoneration of income tax;
- Refund of import duties (with the exception of VAT) on boats, automobiles, construction material and machinery imports aimed at providing tourist services;
- Urban and rural property tax exemptions.

The second category involves projects included in the Government Tourism Development Plan. Projects enjoy the same incentives but only for five years. These incentives are administered by CETUR, an organisation with private sector participation.

Within the framework of governmental changes, in 1999 the Ministry of Tourism was formally abolished and the incentives suspended as of 30 April 1999. The Ministry was then reinstated in August 2000. The Ministry is preparing a Tourism Master Plan, with the support of international organizations and the involvement of business representatives, local administrations and communities. It includes a new law offering special guarantees and incentives to tourism companies.

As shown in the preceding section, the Hydrocarbons Law of 1978 and its amendments, as well as the Mining Law of 1991 and its amendments offer a number of incentives to private investors. Industry-specific incentives are also offered in agriculture, in the form of tax-free imports of materials, modified seeds, animals, machinery and technology for agriculture research.

These incentives are offered on a non-discriminatory basis, and are of potential interest to foreign investors.

[76] Article 20 of the Reform to the Public Finance No. 9924 of 30 April 1994.

b. Free trade zones

General, i.e., non-industry-specific incentives are offered in free trade zones (FTZs), and various provinces offer tax incentives to lure investors.[77] The first FTZ was established in 1985 in the port of Esmeralda by Executive decree. In 1991, the General Law of the Free Zones was promulgated.[78] The objectives of the FTZs are to promote exports, foreign direct investment and employment. FTZs provide a wide range of commercial and industrial activities and services to support the development of the zone such as telecommunications, transportation and banking services. In 1994, these activities were extended to include tourism, educational and hospital services.[79]

Companies established in FTZs pay rent to the administration of the zone, which is responsible for maintaining the infrastructure. Foreign entrants are exempted from the requirement to register investment projects with the Central Bank and technology agreements with MICIP. Enterprises establishing in FTZs register with CONAZOFRA, the National Council for Free Trade Zones, paying a fee equivalent of up to 2 per cent value of their investment.

The following incentives are granted under the FTZs legislation to both foreign and local investors:

- Tax holiday for 20 years;
- 100 per cent exemption from import duties on raw materials, equipment, parts and other capital goods such as vehicles necessary for production and operation;
- 100 per cent exemption from taxes on remittances abroad;
- 100 per cent exemption from export taxes;
- 100 per cent exemption from sales tax on local purchases of good and services;
- No restrictions on capital repatriation;
- No restrictions on sales to local exporters;
- More flexible employment contracts.

Merchandise produced in the FTZs can be sold in the domestic market. However, in this case it is treated as imports. To date six FTZs have been established: Zona Franca de Esmeralsdas (ZOFREE), Zona Franca Centro Ecuatoriano (ZOFRACENE) en Riobamba, Zona Franca del Pacífico (ZOFRAPACIFIC) in Quinindé, Zona Franca Manabí (ZOFRAMA) in Montecristi, and Zona Franca in Cuenca. However, only three are fully operational: ZOFRAMA, ZOFREE and ZOFRAC. Two additional FTZs are to be set up in areas bordering Peru, within the framework of the bilateral programme following the Peace Agreement.

[77] Examples include a tourism development plan in Manabí and an industrial park in Cuenca.
[78] Law No. 1, OR No. 625 19 February 1991. The regulations of the law were introduced with executive decree 2710 of 1991.
[79] Reform of the Free Zone Law No.7 of June 1994.

ZOFRAMA is the FTZ that attracted the largest number of foreign investors. This zone has been established by local investors with a 25 per cent participation by Chilean investors, who support the zone's infrastructure development.

By 2000, 33 foreign companies were planning to establish in the zone, including investors from Chile, Colombia, Republic of Korea, the Netherlands and Taiwan Province of China. Only 12 have started activities, most of which import industrial equipment for fishing and agro-industry.

A Maquila Law has been in effect since 1990 (Law No. 90, OR No. 493, 3 August 1990) but only a few companies, most of them local, in the textile and fish processing industry take advantage of it. The law offers generous incentives, including:

- Exemption from payment of import tariffs on inputs to be processed for export;

- No restrictions on remittance for foreign investors;

- More flexible employment contracts;

- Rapid processing of the application for maquila rights (10 days).

The existing free zones have so far failed to attract FDI in manufacturing activities. One of the reasons is poor infrastructure of the areas. Customs warehouses are small and it is not uncommon for cargo to be stored in open-air patios. Security is generally a concern (box III.6).

Box III. 6. Increasing attractiveness of free zones to FDI

Making the zones more attractive would require not only a more sophisticated infrastructure and improvements in security but also the establishment of logistic and other business support services. Free zones should:

- Be privately operated;
- Offer tailor-made logistic centres (packaging, loading, unloading, transporting, storing, and keeping track of handling, inventory, warehousing and transit costs);
- Host specialised investment promotion units;
- Be actively marketed (information material, including directory of foreign firms investing in the free zones, type of investment existing and desired focus);
- Constitute an integrated network (e.g. providing dedicated transportation links among zones, communication etc.).

Source: UNCTAD survey.

C. Implementing a viable privatization programme

A viable privatization programme is critical to the realization of the significant FDI potential that exists in still largely State-owned sectors extending from manufacturing enterprises to primary sectors, the services sector and, in particular, infrastructural services and banking industry. From 1970 to 1995 the number of public enterprises in Ecuador increased from 65 to 167. Adding banks rescued in the past two years by the State, this figure increases further. The privatization programme is particularly important for infrastructure development. Successive economic and political crises as well as natural disasters have resulted in the deterioration of infrastructure and public services. Their improvement is a precondition to reviving investment, both domestic and foreign, in other areas.

The Modernization Law of 1993 was the first attempt to launch a privatization programme establishing the Consejo Nacional de Modernización (CONAM) to execute the programme and the Social Solidarity Fund to manage a social expenditure part of the proceeds from privatization. The schemes adopted in particular industries did not meet investor expectations and requirements including the transparency and fairness of the process and the desire for control of acquired assets or protection against risks. The programme was not successful in terms of the sale of State-owned enterprises. Attempts to involve private investors in some activities through the programme of concessions were more successful, although, as discussed in the previous chapter, this programme also needs improvements. Ecuador should learn from its own past and also draw on the positive experiences of other Latin American countries in the area of privatization in the design and implementation of its privatization programme.

The role of the Government in a privatization programme is not limited to, and does not end with, the sale of State-owned assets, especially in the area of infrastructural services, even if the sale is successful and the price received is satisfactory. The objective of the Government should be to maximize fiscal gains and perhaps more importantly, to achieve the expected improvement in the quality of services at lower prices. The Government should also ensure a fair distribution of the long-term gains from privatization among the government, investors, consumers and other stakeholders.

This requires additional Government actions and policies. Given the monopolistic nature and externalities of many infrastructural services, regulatory functions are very important to ensure that public monopolies are not replaced by private foreign monopolies free from incentives and pressures to invest and to improve services. For example, Government's role should include economic regulation of user charges, technical supervision and strategic planning of infrastructural services. When ownership is retained by the State, and management contracts or operational concessions are used to involve private investors to provide these services, then, Government's role is to ensure the effective functioning of the concession system. Even with the greater role of the private sectors in infrastructure projects, Government must remain responsible for financing and investing in projects with important social aspects which may be considered unattractive or too risky by private investors. Moreover, the co-ordinating role of the central Government is essential to ensure consistency in infrastructure development programmes, which involve many agencies and authorities.

While the Constitution of 1998 paved the way for the role of the private sector in infrastructural services, the Law of Economic Transformation (LET), approved on 1 March 2000, introduced a series of measures permitting the Government to go ahead with a new privatization programme that included provisions intended to meet many of the above mentioned requirements. The programme is implemented by CONAM, established in 1994.

In the oil industry, the LET allowed private companies to build and operate pipelines, thus facilitating the construction of a new and long overdue oil pipeline. The State-owned oil company, Petroecuador, excluded from being privatized, can enter into joint ventures with the private sector. However, the legal framework for such joint ventures as defined by new rules contained in the second part of the modernisation bill (Trolebús II) have been declared unconstitutional. In the electricity industry, the law cleared the way to the privatization of six electricity generation companies and 18 electricity distribution companies. The law permits private majority ownership in the telecommunications industry, and will thus facilitate the privatization of the two State-owned companies in this industry.

The LET also modified the Civil Aviation Law, allowing the central and local governments to initiate the construction and operation of new airports. This facilitates private sector participation, including foreign investors. A civil aviation regulatory agency was established. These modifications opened the way to the privatization of airport services and a German company has acquired a majority stake. CONAM also began to co-operate with the relevant ministries to promote concession programmes for postal services (Empresa Nacional de Correos, ENC), electricity distribution, roads, airports and railways.

The second part of the LET, Trolebús II, also proposed modifications to the Solidarity Fund, established to administer the proceeds from privatization. However, those modifications were removed by the law by the Constitutional Tribunal's decision. The original law establishing the Fund permitted investment of the capital (but only in safe investments) and the use of the investment income (e.g. interest) for social purposes such as education, housing, health, environment and dealing with social effects of natural disasters. The Fund cannot, as originally proposed, operate capitalization schemes and introduce other mechanisms to allocate the Fund's income.

According to CONAM, the largest privatizations will be in the telecommunication and electricity industries where, for the first time, the LET allows the sale of majority stakes of State-owned companies in these industries. Two earlier attempts to privatize the State telecommunications companies – Andinatel and Pacifictel – failed due to a lack of bidders' interest in acquiring minority stakes. Andinatel was restructured into a corporation in 1997 but has remained owned and operated by the Government. Private sector managers have been appointed and business management criteria applied, leading to improvements in services.

Meanwhile, the preparation of electricity companies for privatization has began. The State-owned electricity company, INECEL, was re-organized in 1998 into 6 stock companies dealing with power generation, one dealing with transmission, and 18 distribution companies. The LET provides for private investors to acquire stakes of 51 per cent, 10 per cent offered to the company's employees and the State retaining the balance. Later, the State will have the option to sell its shares through the stock market. The International Finance Corporation (IFC), an arm of the World Bank, has been appointed to advise CONAM on electricity company sales and to provide initial valuations. On 20 May 2000, a consortium led by the United States investment bank Salomon Smith Barney was contracted to promote the sale; it has also been asked to provide a second valuation. Furthermore, the regulatory framework and tariff structure have been prepared. By the end of 2000, the following steps remained to be undertaken to conclude the privatization process:

- Setting a minimum price for the companies;
- Setting up holding companies for distribution;
- Designing the sale model and promoting the sale;
- Pre-qualification of bidders;
- Sale of the companies.

D. Increasing long-term benefits from FDI

To attract and retain FDI and increase its long-term benefits, Ecuador must deal with a number of policy issues. They can be grouped into human resources, science and technology policies, and other issues and policies including the capital market, taxation and the tax system, competition, environmental protection, and international trade. This section deals with these policy issues, with a view towards increasing their impact on FDI.

1. Human resources: issues and policies

Success in attracting FDI requires, among other things, the availability of a pool of human resources adequate in quality and quantity for deployment by foreign investors. This, in turn, requires a well-developed human resource development base in the host country. Skilled or trainable employees are among the key determinants of entry by foreign firms. Therefore, in the long run, attention to human resource development is a pre-requisite for both attracting and taking full advantage of foreign investment.

In Ecuador, as well as many less developed countries, most of the labour force is unskilled. One third are employed in the agricultural sector. An inadequate educational and training system at the vocational level, combined with a public university system that produces a relatively large pool of professionals but does not respond to the requirements of the labour market, exacerbate the human resource problem. Additional rigidities in the labour market include socio-cultural if not legal restrictions on female participation; women account for only a quarter of the labour force. Labour markets are heavily regulated and the legislation imposes restrictions to hiring and firing workers. (Chiri et al, 1998). Perhaps as a consequence, Ecuador ranks 57 in the World Economic Forum's 2000 ranking with respect to management/worker relations.[80]

These labour related issues are potential obstacles to FDI. Fortunately, improvements are under way. For instance, changes to labour legislation were introduced by the LET, 2000. These changes inject needed flexibility in labour contracts, including contracts for hourly part-time workers, and simplified the cumbersome minimum wage structure to a single uniform one.

In addition, Ecuador has other labour related advantages. Employers interviewed by UNCTAD indicated that creativity, adaptability, motivation, a positive attitude, and the ability to learn quickly characterized most Ecuadorian workers (see Annex A). In addition, many young Ecuadorians, who left the country because of the difficult economic situation, have been able to obtain better education abroad. These skilled professionals constitute an interesting potential if opportunities for attracting them back materialize.

At the managerial level, too, Ecuador has unrealized potentials, including the development of a cadre of professional managers as the economy moves from family-based management to a more professional managerial class. Moreover, vocational and university educational establishments are gaining sufficient rigor to satisfy the more rigorous requirements of foreign investors. Ecuadorian firms employ relatively few professional managers because of the scarcity of well-trained professional managers in the country.

[80] See World Economic Forum (2000). *The Global Competitiveness Report 2000* (New York and Oxford: Oxford University Press), pp. 272

In addition, a relatively small number of business groups in Guayaquil and Quito control large segments of the economy. This trend has accelerated over the past years as credit crisis and difficult economic conditions have impeded the growth of new businesses. This leads to a great concentration of business activity, leading to fewer opportunities for the development of a professional managerial cadre.[81]

Against this backdrop, positive signs in human resource development include institutions of higher education. At present, there are 44 universities and five polytechnic schools in Ecuador, with nearly 220,000 students. In addition, a number of technical institutions also contribute to professional training (Badillo et al, 1998). These include ESPOL, CENAIM, and SEBIOCA (box III.7). The remaining challenge is to enhance the quality of these educational systems.

Box III. 7. ESPOL: A model for human resource development?

One of the most important and dynamic institutions is the Superior Polytechnic School of the Litoral (ESPOL) in Guayaquil. Since its early years, ESPOL's objective has been to involve itself in those areas in which the Ecuadorian development process generated demands of skilled and technologically competent workers. In the 1960s, for instance, ESPOL created the first academic programme in the region linked to areas such as petroleum, mining, marine and mechanical and electrical engineering.

ESPOL has since been involved in several initiatives to upgrade Ecuador's technological capabilities, such as the establishment of the National Aquaculture and Marine Research Center (CENAIM) in 1990, the creation of Ecuadorian Biotechnology Society (SEBIOCA), and the setting up of Aquacultural and Computer Science Engineering Programs.

Source: UNCTAD Survey.

Employment and residence rights of non-citizens fall under human resource issues and are of concern to foreign investors. Employment in Ecuador is regulated by the Labour Code and by the Compulsory Social Security Law. The Labour Code was inspired by the Mexican Code and enacted in 1937. At that time, the Code was highly protective towards workers. Recent reforms have somewhat moderated this stance. In any case there is more of a permissive attitude towards workers and a restrictive attitude toward employers in the application of the Labour Code than in its provisions.

Employers can, nevertheless, terminate a contract with appropriate compensation. Dismissal without indemnity is allowed only during the probationary period. Collective contracts usually provide for higher indemnification. The power of unions may also make it difficult to terminate employment, but the cost of dismissal is already a deterrent for firms. Workers are entitled to participate in profit sharing arrangements. This is seen as an additional fiscal burden to enterprises. The LET has set minimum wages at $0.5 per hour. It also introduced for the first time flexibility in contracts, hourly contracts, and simplified compensation schemes. Minimum wages are set on an industry basis, and adjusted every six months.

[81] According to a recent survey, family members, holding the majority of ownership, manage most Ecuadorian firms. See Consultora Edison Ortiz-Merchantbansa (1999). *Estudio sobre la Structura de Capital de las Empresas Privadas del Ecuador*, (Quito: Corporación Financiera Nacional)..

Certain reforms aimed at increasing flexibility in the labour market contained in the Trolebús II were declared unconstitutional. They included the right for workers to perform more than one job within the same company, the limit set on the total amount that workers can directly receive from participating in profit sharing, and the dismissal procedures.

The Social Security regime is outdated and poorly managed. The wage compensation system is complicated by an array of mandatory bonuses and fringe benefits that exceed salaries by up to 24 per cent. Therefore, only a proportion of the wage is subject to contributions to Ecuadorian social security.

The State Ecuadorian Social Security Institute is the sole provider of social security. The Institute started to experience difficulties in 1987 following the creation of a single fund into which all social security contributions were paid. In practice, the Institute cannot meet demands for health insurance, work risk insurance, rural pension and State pensions. The pension fund is depleted and cannot finance the pension for people reaching retirement age. As a general rule, contributions should exceed payments by a ratio of 6:1 but in Ecuador this ratio is 1.5:1. Medical services are also deficient.

Efforts to modernise or privatise the social security are underway, emerging from the provision of the Constitution which calls for the establishment of a special commission to design a new system. The establishment of a more open system, allowing privately operated funds, was proposed but encountered political opposition.

Foreigners can obtain work visas in Ecuador. However, the law establishes that 80 per cent of a company's local personnel must be Ecuadorian. Overall, it is easy, to obtain a work visas in Ecuador both for foreign investors (the minimum investment requirement is $5,000) and for employees of an Ecuadorian company. A recent reform introduced by Trolebús II further eased the release of visa and residence permits for businessmen, investors and their relatives.

To conclude, human resource policies and condition reflect the evolving situation, with the Government trying to strike a balance between contending forces. Once again, foreign investors look to stability, fairness and transparency in dealing with the human resource issues in Ecuador.

2. Science, technology and intellectual property

To attract FDI and to extract significant benefit from it, host economies must also have the ability to absorb imported technology and know-how. This technological absorptive capacity is enhanced through appropriate government policies, including those in the areas of science and technology, innovation and intellectual property.

a. Science and technology: policies and institutions

Ecuador has made several strides in developing policies and institutions that could promote science and technology and encourage research and development. One example is the National System of Innovation (NSI), governed by the National Secretary of Science and Technology (SENACYT). Another example is the Foundation for Science and Technology (FUNDACYT). The First National Plan of Scientific and Technological Research was launched in 1996 (box III.8). The Plan defined 15 programmes for strengthening and expanding S&T, the demand for R&D, the innovation of the private sector, its linkages with Science and Technology Institution and the strengthening of institutions in the public system.

One of the most interesting features of the program is the introduction of a credit line for R&D in the private sector. There are also fiscal incentives offered to S&T programmes (see chapter II). However, the main focus of the program is still on basic science and it contributes little to foster linkages between the productive and the academic sectors.

Currently, the most relevant initiative in the S&T area is the Science and Technology Program (which took eight years to negotiate and design). The programme is managed by FUNDACYT and is financed by the Interamerican Development Bank (IDB) and by the Ecuadorian government for a total amount of $30 million.

In spite of these and other efforts, (not unlike many other Latin American countries) there is little co-ordination among the different institutions and actors that are part of the Ecuador's National System of Innovation (NSI). Linkages among universities, research centres and the private sector are, consequently, very weak and innovations are rare (Badillo et al, 1998).[82]

The analysis of the available indicators regarding Ecuador's NSI clearly shows a poor performance, even in comparison with other Latin American countries. This has prevented Ecuador from reaping benefits from TNCs presence. Data on R&D expenditures and S&T activities (including traditionally under the heading of "R&D", but also those related to teaching and training in S&T fields and S&T activities) shows that Ecuador spends less in comparison with other Latin American countries. The number of researchers is very small, and the expenditure level per researcher is also low. Overall, the Ecuadorian NSI has not made a significant contribution to the country's economic development. Several studies (Badillo et al, 1998; Vega, 1998) have called for a thorough reform of the Ecuadorian NSI as a priority in Ecuador's agenda of public development policies.[83]

[82] Badillo, D. Borja, D. and Sánchez, P. (1998). "El estado actual de la competitividad de la industria en el Ecuador", Federación Nacional de Cámaras de Industrias del Ecuador, October (Quito).

[83] Vega, E. ed. (1999). "Propuesta de una Política Industrial para el Ecuador", MICYP/UNIDO, (Ecuador).

Box III. 8. SENACYT, FUNDACYT and credit line

A. SENACYT: The National Secretariat of Science and Technology (SENACYT) was created in 1994. It operates within the Vice-Presidency and has the following tasks:

- Formulates policies on Science and Technology;
- Elaborates the national programme on S&T;
- Coordinates strategic actions of the national systems of Science and Technology;
- Provides financing to the system, negotiating financial and technical cooperation;
- Promotes the establishment and improvement of legal instruments to develop S&T;
- Presides over FUNDACYT.

B. FUNDACYT: Its mission includes to plan, execute and monitor medium and long term policies and strategies on S&T as approved by SENACYT; set criteria to assign resources to national programmes; provide financing to R&D projects, S&T services and infrastructure; develop human resources and training; and introduce diffusion mechanisms of technology innovation in the private sector.

C. Credit line: The credit line offered to private firms is aimed at strengthening linkages between the private sector and the universities and encouraging applied research activities or experimental development as well as the adoption of systems for technological modernization.

The following projects may receive financial support:

i) Technological innovation: pre-competitive applied research and experimental development activities aimed at developing new products and processes and/or obtaining significant increases in productivity or in product quality;

ii) Technological modernization: e.g. activities of selection and assimilation of technology performed by specialized consultants and incorporation of technology management systems to increase productivity and efficiency in the enterprises.

The program finances up to 80 per cent of the project, for a maximum of $250,000. The main incentive for private firms to submit project proposals is that 20 per cent of the granted credits is non-reimbursable (the non-reimbursable portion of the credit may increase up to 35 per cent if the project is performed in cooperation with an academic research unit).

The submitted projects are subject to technical and economic evaluation and if they meet the eligibility criteria, they are approved by FUNDACYT. The holder of an approved project may chose any financial institution to obtain the respective credit. In turn, the financial institution performs a financial evaluation of the project and sets the conditions of the loan.

In 1998, the Executive Committee of the Science and Technology Program of FUNDACYT approved eight projects which represented a total investment of $1,145,000. At the end of that year there were five additional projects for a total amount of $377,000 being evaluated by the Executive Committee. In 1999, 22 projects had been presented, for a total amount of $5.5 million, and involving credits for $3 million. Many of the presented projects are related to aqua-culture, but there are also projects in software, information technology, metalworking, agro-industry, etc.

Source: UNCTAD Survey.

In its 2000 survey, the World Economic Forum ranks Ecuador quite low in the quality of infrastructure (58 among the 59 reporting countries), but a closer look reveals a more optimistic picture, especially with respect to some indicators relevant to science and technology. Ecuador ranks 4th on the companies' use of E-Commerce, 14th in their Internet use for supplier relations, 24th on their use for general information, and 38th on E-mail use. Ecuador also ranks 14th on the degree of demand satisfaction with telephone lines. These components of competitiveness indeed bode well for the country. These constitute relative strengths, to be accented in investment promotion efforts. Its overall ranking is pulled down, however, by some other factors that have been touched upon elsewhere in this report. Finally, the country ranks 43 out of the 59 on brain drain. [84]

The extent to which a developing country has demonstrated technological sophistication (which includes the absorption of imported technology) can also be demonstrated through a number of outputs, including domestic patents granted to domestic firms and individuals, innovations, and scientific publications. Ecuador has a weak record in scientific publications. The number of patents granted in the United States to Ecuadorians is low, both in absolute terms and per capita, compared to patents granted to Argentines, Brazilians, Chileans and Costa Ricans. Of the 397 patents granted in Ecuador in 1997, only two were to Ecuadorians.

At the private sector level, Ecuadorian private firms, especially small and medium enterprises, lack an innovative culture, have poor information access and limited financial resources. Firms rarely undertake formal R&D activities. Informal in-house learning and innovative processes are weak. The use of tools such as market research and consumer surveys is rare. However, there are a few success stories, including the INIAP, in the public sector, and the experience of shrimp farming, in the private sector. Shrimp farming has resulted on a significant development of local expertise on issues such as pond and facility construction, hatchery and farming techniques.

One of the most ambitious initiatives currently under analysis is the building of a Technology Park of 200 hectares in the ESPOL campus at Prosperina, near Guayaquil. The project seeks to foster linkages between the academic resources of ESPOL and the private sector, especially in the areas of technology transfer. ESPOL is currently looking to convince some TNCs to act as "anchor firms" in the Park.

According to Alvarado (1999), this park is part of a project to create a development pole in the coastal area of the Guayas province. This pole would lead to the creation of a Special Economic Zone - like that established in China during the last two decades. Besides the proposed the development of "maquila" operations, plans have been made for knowledge-intensive activities. In particular, opportunities are perceived in the area of financial software - where some Ecuadorian firms have made significant inroads recently [85] - and R&D geared to obtaining tropical food ingredients.

R&D in agriculture has built a solid base in some areas. The main research institute in the agricultural sector is the INIAP, created in 1959, with a mandate to generate and transfer the technologies necessary for increasing agricultural production and productivity and improving the living conditions of growers (box III.9).

[84] World Economic Forum (2000). *Global Competitiveness Report 2000* (Geneva: Oxford University Press for World Economic Forum).
[85] There are more than ten Ecuadorian firms selling financial software in Latin America and Europe. See Alvarado Lozada, J. (1999). Más que una Banana Republic: Una Nueva Estrategia Competitiva para el Ecuador, (Guayaquil: ESPOL/ESPAE).

Box III. 9. INIAP: an example of successful applied research

Established in 1959 to generate and transfer technology in the agricultural sector, INIAP has currently seven experimental stations and eight experimental farms.

INIAP has contributed to the development of new and improved biological and agronomic technologies for at least 60 commodities. It has made important biological advances, including the development or adaptation of 124 improved varieties of 25 different crops. INIAP has transmitted crop-management recommendations to growers, including packages comprising fertilizer recommendations, pest and disease control practices, cultural practices, and harvesting and storage methods.

INIAP performs research and tests related to new seeds, soil and environment, and their adaptation to local condition, and with the use of pesticides and fertilizers. INIAP has also an information service and gives technical assistance to those producers who wish to incorporate new technologies. In 1991, INIAP accounted for almost 70 per cent of the country's total investment in agricultural research and 90 per cent of the scientists in the system. Reflecting its focus on applied and adaptive research, INIAP concentrates on agronomic technologies (39 per cent), such as pest management, and biological technologies (60 per cent), including genetic improvement. Research to develop new or improved post-harvest and mechanical technologies accounts for the remaining 1 per cent (Falconi, 1993).[86]

The main factors that contribute to INIAP's success are:

- A focus on applied and adaptive research, which increases the possibility of technology transfers to the private sector;
- A deep involvement in genetic improvement, which is increasingly a key technology for the agricultural sector;
- A wide range of interactions with several international research organizations;
- A significant experience of research contracts with both commercial and non-commercial private organizations;
- Experienced and infrastructure availability for conducting R&D in many key agricultural commodities;
- The key association with FUNDAGRO, which has helped INIAP work more effectively with the private sector.

Source: Falconi (1993).

[86] Falconi, C. (1993). "Ecuador: Agricultural Research in the Public and Private Sectors", ISNAR, briefing paper 2, (Ecuador).

INIAP's success has been attained in spite of the fact that science and technology policies for the agricultural sector have remained rather vague. Traditionally, INIAP had paid attention mainly to the most relevant products in terms of cultivated land - coffee, cacao, wheat, corn, potatoes. In the late 1980s it began to include non-traditional products such as fruits and vegetables. In parallel, while INIAP has been mainly oriented to generate technologies and services attuned to the needs of small and medium Ecuadorian agricultural producers, in recent years has moved toward a greater emphasis on issues such as competitiveness, exports, etc. However, research is not carried out on important products as sugarcane, shrimp and flowers, where innovation is left exclusively to the private sector. One of the main problems faced by INIAP is the gradual exodus of many of its most qualified personnel, due to low salaries. Remuneration in the private sector is two to five times higher.

Another organization charged with providing a link between the public and private sectors in the Ecuadorian agricultural technology system and working in tandem with INIAP, is FUNDAGRO. Its mandate is to play a catalytic role in revitalizing Ecuador's agricultural research, extension, and education system. It provides financial support for research in both the public and private sectors. It also conducts and supports technology transfer, aiming to fill gaps left by the public-sector extension service. Through its extension activities, FUNDAGRO serves medium and small growers. FUNDAGRO transfers mainly technology produced and validated by INIAP.

There are also some private organizations conducting or supporting agricultural research in Ecuador[87]. These entities work mainly on export commodities, such as bananas, coffee, quinoa, tropical fruits, tropical vegetables, flowers, shrimp, extracts, colorants, etc. Their activities focus on applied and adaptive research.

Research products are disseminated mainly to growers under contract. Growers' associations transfer technology mainly to members, but also to nonmembers through sales. Increased yields, lower production costs, improved quality and management of crops, and fewer field and post harvest losses are some of the farm-level impacts of private-sector research in Ecuador. However, most of these private-sector technologies are available only to contract growers.

Another important institution within the Ecuadorian S&T system is the Ecuadorian Standardization Institute (INEN), which is in charge of defining Ecuador's national technical standards and the norms for granting quality certifications. It is composed of four laboratories, which offer different kind of testing services (packaging, food control, microbiology, etc.). It is also involved in metrology and consumers protection.

According to a recent survey, Ecuador lags considerably behind other Latin American countries in adopting the new management techniques such as ISO 9000 certifications[88] and environmental management systems. To catch up, a strong joint effort by the Government and the private sector is needed.

[87] These include, among others, the Oilpalm Growers' Association (ANCUPA), the Ranchers' Association (AGSO), and some local -San Carlos, Ecuavegetal, Laboplant, etc.-, as well as foreign companies –Agripac, Pronaca, etc. Nestlé had a laboratory doing research on cocoa –Latinreco-, but it was recently closed.

[88] Consultora Edison Ortiz-merchantbansa (1999). "Estudio sobre la Estructura de Capital de las Empresas Privadas del Ecuador", (Quito: Corporación Financiera Nacional).

Box III. 10. Decision 291: the Andean approach to technology transfer

Decision 291 of the Commission of the Cartagena Agreement, Common Code for the Treatment of Foreign Capital and on Trademarks, Patents, Licences and Royalties (1991) has the following significant features:

1. It provides that foreign investors shall have the same rights and obligations as national investors, except as otherwise provided in the legislation of each member country, and eliminates previous requirement to subject foreign investment to an authorisation procedure.

2. It removes previous restrictions on the transfer of funds by obligating member countries to permit foreign investors and sub-regional investors to remit abroad in convertible currency the verified net profits derived from foreign direct investment and the proceeds from the sale or liquidation of such investment.

3. It removes restrictions on access of products produced by foreign enterprises to the benefits from the trade liberalisation under the Cartagena Agreement. Prior to the adoption of this Decision, such products could benefit from this trade liberalisation only if the foreign enterprise undertook to convert into a joint or national enterprise.

Aside from these provisions on rights and obligations of foreign investors, the Decision contains rules requiring the registration of contracts for imports of technology and prohibiting the inclusion of certain kinds of restrictive clauses in such contracts.

In the area of technology, Decision 291 has eliminated the following restrictions:

- The authorisation requirement for contracts between related companies in specific cases has been abolished;
- Only registration of the contracts is still mandatory;
- Ceilings on royalty payments have been abolished;
- The number of clauses that may not be used in contracts has been reduced to those listed in Decision 291, namely:

a) Clauses whereby the furnishing of the technology or the use of a mark entails the obligation that the recipient country or company acquire capital goods, intermediate products, raw materials or other technologies from a specific source, or permanently use personnel specified by the company furnishing the technology;
b) Clauses whereby the company selling technology or granting the use of a mark reserves the right to set the sale or resale prices of the products manufactured on the basis of the respective technology;
c) Clauses containing restrictions regarding production volume and structure;
d) Clauses prohibiting the use of competing technologies;
e) Clauses granting the supplier of the technology a total or partial purchase option;
f) Clauses whereby the buyer of technology is under the obligation to transfer to the supplier the inventions or improvements resulting from the use of said technology;
g) Clauses whereby royalties must be paid to the holder of the patents or marks, for unused or expired patents or marks;
h) Other clauses having a similar effect.

Source: www.comunidadandina.org.

Technology introduced by an investor will be considered a foreign investment if registered with the MICIP and is accorded rights and protections under the Foreign Investment Law. Contracts for technology transfer are governed by Decision 291 of the Cartagena Agreement (1991). This Decision is far more liberal than the Decision 24 of the 1970s, which was held out for many years as an example of highly restrictive and hostile host country policies towards technology transfer. The new regime contains specific prohibitions against restrictive policies that tend to hamper the inflow of technology. It also gives some uniformity to the Community of Andean Nations (box III.10).

While providing an overall framework for technology transfer to the Andean Countries, Decision 291gives members the right to regulate technology transfer via their own national legislation, within limits. In Ecuador, all contracts dealing with technology transfer must be registered. There are a number of restrictive clauses in the relevant regulation (No.1525 of June 1998) including compensation provision and limits on the licensee's sales. The registration has a regulatory as well as protective function (Art. 32 of No. 1525).

Ecuador has been considering the establishment of a National System of Innovation (NSI) to promote innovation and, by extension, the ability of the country to absorb and diffuse technologies that accompany foreign investment (box III.11). It is unrealistic to expect rapid change in the attitude of the Ecuadorian private sector regarding technological dynamism and innovations. Experience has shown that the involvement of the private sector as a participant as well as provider of financing for innovation activities is the result of long and gradual learning processes. In the case of Ecuador, a more gradual and cooperative approach would be preferable. At present, Sectoral Technological Innovation Centers (CENITs), envisaged in the NSI, would probably not have a great demand for services since Ecuadorian producers have to develop an understanding of innovation and few of the technological needs may translate into specific requirements to the S&T institutions.

b. Linkages

Inter and intra-industry linkages are relatively low thus hampering the long term effects of imported technology. Different sectors of the economy do not undertake complementary activities; and typically exports have low levels of value-added. Most of Ecuador's exports - oil, bananas and shrimps - are exported as primary products with little or no internal processing. In addition, these commodities are typically traded with long distribution channels and buyer and supplier linkages are weak. In addition, sophisticated services that complement each activity are unavailable in Ecuador and are performed abroad. For example, the oil industry, that attracts most FDI, failed to create such linkages. Foreign contractors, employing personnel from abroad, perform most advanced services, such as equipment design and mapping.

Local research and development is minimal in most industries, due to lack of resources and inter-institutional coordination. This, in turn, reduces the linkage effects. The exception is the shrimp industry, where Ecuador has managed to develop important knowledge and technology. Ecuadorian hatcheries breed high yield specimens and technical expertise is on par with most developed countries.[89]

[89] Chiri et al, (1998). "Ecuador", in Porter, M. ed. Case Studies in Competition and Competitiveness, Harvard Business School.

Box III. 11. Establishing a National System of Innovation (NSI)

A 1999 study led by UNIDO recommended that an "Ecuadorian System of Innovation" be established. The proposed system would consist of the following components:

(i) The National Council of Innovation: it would mainly play a political role and would be coordinated by the MICYP jointly with the Industrial Chambers of Ecuador.

(ii) Sectoral Systems of Innovation (SSI): to be established at the national as well as at the regional level. They would operate in the most dynamic productive sectors, coordinated by the respective sectoral chambers, offering services such as technological forecasts analysis; and diffusion of technological information; improvement of links with universities and technical education and training. SSIs will also coordinate the activities of Sectoral Technological Innovation Centers;

(iii) Sectoral Technological Innovation Centers (CENITs): CENITs would operate as private institutions, and their management would be in charge of representatives named by the sectoral/regional chambers and by firms. They would be involved in R&D, technical assistance, training, technology transfer, intellectual property legislation, etc. The proposal does not specify how these Centers would be financed.

It also proposed the establishment of a Fund for Technological Innovation, to provide subsidized credits for the following:

i) Technological innovation projects;

ii) R&D, testing and quality control labs;

iii) Adoption of modern quality and environmental management systems;

iv) Education and training activities in order to equip the workforce with the skills needed to employ the so-called "new technologies";

v) Adoption and assimilation of foreign technologies, etc. (It is not clear whether this Fund would replace or complement the existing Science and Technology programme run by FUNDACYT);

vi) A system of fiscal incentives, based on those currently employed in developed countries. This system would include income tax deductions as well as accelerated depreciation schemes for R&D expenditures.

At present, Sectoral Technological Innovation Centers (CENITs), envisaged in the NSI, would probably not have a great demand for services since Ecuadorian producers have to develop an understanding of innovation and few of the technological needs may translate into specific requirements to the S&T institutions. A national system of innovation (NSI) cannot be "created", since it is the result of specific historic trajectories, partly influenced by public policies, but also shaped by different participants. A learning process is needed, involving both public and private institutions and organizations. The building of a strong human resources base should be a key objective for any policy geared to improve the NSI, since at present there seems to be a lack of qualified personnel required for performing high-quality innovation activities in Ecuador.

Source: UNCTAD survey and Vega, E. ed. (1999). *Propuesta de una Política Industrial para el Ecuador*, MICYP/UNIDO, Ecuador.

The resources-intensive commodities that Ecuador exports are internationally competitive. But an industrial structure can be built around these resources to produce higher value-added goods domestically. There is also a need to develop critical supply services locally to support the establishment of processing industries. Foreign investors can contribute to generate such linkages. For example, Nestlé solved a supply (quantity and quality) problem by developing a network of local suppliers and offering them agricultural know-how and financial resources. Nestlé invested in order to technically upgrade its suppliers and in return it secured the supply of a key resource and gained political support in the region.

c. Protection of intellectual property

Sound technology policy, aimed at attracting foreign investment and technology transfer, requires a well-developed and properly enforced and implemented intellectual property protection system. In Ecuador, intellectual property rights are governed by Decision 486 (which replaced Decision 344 of 1993) of the Community of Andean Nations introduced in September 2000 establishing a common intellectual property regime, and by the Law of Intellectual Property of 1998.

The law recognises patents, registered trademarks, copyrights, industrial designs and models. Trademarks registered outside of the country but not in Ecuador are also recognised by the law under a subjective standard of how well known the trademark is. The law also protects innovation in cybernetics, biotechnology, and implements international commitments. It created the Instituto Equatoriano de Propiedad Intelectual, an entity charged with the responsibility of defending intellectual property.

Trademarks and copyrights are well protected by the new law. Recent court cases have shown that the judicial system has the ability to enforce and protect trademarks and copyrights. This is reflected in Ecuador's' relatively high ranking in the World Economic Forum's survey. When asked whether intellectual property is well protected, respondents ranked Ecuador at 42. This is higher than the country's overall ranking, reflecting the reasonably good protection perceived by the international business community.

Several cases involving foreign investors have been resolved in their favour. The law, according to dispute settlement procedures in force, admits arbitration. The law also protects patents but in practice their protection is more difficult. Piracy is a concern. It is expected that enforcement of the law would improve since civil courts, believed to the more effective than criminal courts in treating such offences, are entitled to process the cases. Although the judicial process is still lengthy, and corruption remains widespread, improvement will come.

The new measures introduced at CAN have created awareness among member countries about the importance of having strong intellectual property protection as a fundamental part of the investment environment. The new regime sets minimum standards of protection for patents, copyrights, trademarks, trade secrets, geographical indicators and other forms of intellectual property and provides for the effective enforcement of these rights. Main changes to the patent regime concerned bringing it into conformity with the World Trade Organization (WTO) agreement on Trade Related Aspects of Intellectual Property (TRIPs).

3. Other issues and policies

a. Tax policies

Ecuador's taxation system is in turmoil. Until May of 1999, the general fiscal regime established that companies operating in Ecuador should pay income taxes on profits at a rate ranging from 15 to 25 per cent. This range was levied after subtracting 15 per cent from net income, which by law is to be distributed amongst employees. Dividends and interests on loans registered with the Central Bank are exempt from tax. It also stipulated additional provisions, including the following:

- Companies should withhold 33 per cent on total payments, remittance or transfer abroad. This same rate was applied in the following special cases involving calculation of the taxable base:
  - Eighty per cent on professional services provided abroad or provided in Ecuador by non-residents;
  - Ninety-six per cent of commissions paid abroad for exports;
  - Three per cent of insurance premiums or reinsurance with companies not permanently established in Ecuador;
  - Monies withheld were to be declared and handed over to authorised financial institutions in the month following payment;
- Payments abroad, except for dividends and a wide variety of business expenses, were subject to 33 per cent tax, to be withheld by the sender and paid to the Ministry of Finance. These deductible expenses included mainly technical services;
- Depreciation was allowed at 10 per cent a year on most machinery and equipment. Buildings could be depreciated at 5 per cent. Losses could be carried forward up to 5 years, provided that losses do not exceed 25 per cent of profits in each period.
- A value-added tax (IGV) applied at the rate of 12 per cent to a comprehensive range of transactions.

In 1999, the Government took a number of fiscal emergency corrective measures. The purpose of these measures was to redress shortfalls in the budget approved by Congress. Due to the emergency nature of the situation, the fiscal regime changed three times in 1999.

First, income tax was suspended at the beginning of the year in favour of a one per cent tax on all financial transactions, levied also on transfer of payments abroad. In May 1999, following the freezing of banking deposits, a series of new fiscal measures were approved, including the reinstatement of income tax at 15 per cent of net income, after subtracting 15 per cent from this net income which by law is to be distributed amongst employees. Financial institutions are taxed at an income tax rate of 25 per cent.

The one per cent tax on financial transactions was reduced to 0.8 per cent but retained until January 2001, when it was to be abolished altogether. Other important measures included the elimination of all value-added tax and import duty exemptions and the establishment of taxes on corporate assets and luxury vehicles. In December 1999, income tax was again raised at 25 per cent for all companies.

In Ecuador, the fiscal regime is ruled by the Fiscal Code that governs the rights and obligation of the administration and of taxpayers. Tax disputes can be resolved in first instance at the administration level, which includes the Income Tax Department, the Ecuadorian Customs Corporation and the National Bureau of Land Appraisal and Record. The tax system operates on the basis of self-assessment with subsequent inspection. The tax-collection capacity has improved but there is a lack of personnel and adequate training. The Income Tax Department has functions similar to that of corresponding department in Peru, which was the model that Ecuador followed. At times, it operates with an excessive dose of independence because it applies the fiscal principles without an appropriate legal interpretation, often ignoring the general framework of the law and of the Constitution. Tax disputes can be appealed to Supreme Court of Justice.

Customs operations have recently been reformed with the establishment of an independent corporation governed by a management board, comprised of public and private sector representatives. The administration of all customs activities, including the resolution of disputes, has been entrusted to this corporation. This is an interesting model for other parts of the bureaucracy.

Double taxation treaties provided for special treatment of withholding tax rates, shown in table III.2. Rates vary based on the terms of each treaty.

Table III. 2. Withholding tax rates under Ecuador's tax treaties

(Percentage)

Country	Dividends	Interest	Royalties
Brazil	15	15	15
Chile	5-15	15	10 [a]
France	15	10[b]	15
Germany	15 [c]	10	15
Italy	15	10	5
Romania	15 [a]	10	10
Spain	15	10	10 [a]
Switzerland	..	10	10

Source: Official Register, Ecuador, 1999.

[a] Maximum amount

[b] 10 per cent on loans for industrial, commercial or scientific equipment.

[c] Rate is 10 per cent on certain items.

Overall, the corporate tax burden is high relative to other countries in the region. But, more importantly, the fiscal regime is not stable and predictable. The frequent changes of the tax system produce confusion even among tax professionals. For example, regulations on issuing receipts were changed four times in one year, and thereafter modified six times. The tax on financial transactions proved highly unpopular among foreign investors.

To provide stability and reduce tax uncertainty, Ecuador introduced the concept of "investment contracts" and "tax stability agreements" in 1997 (section III.B.1.d). According to these initiatives, an investment equivalent to at least $500,000 entitles an investor to enter into an agreement with the State to stabilise the rate of income tax. Such an agreement can be reached for ten years in existing enterprises where no expansion in production or capacity is contemplated and for 20 years for new investment or expansion. According to the law, COMEXI has powers only to modify the periods of stability, but not to extend the scope of the application of the agreement.

These agreements are fairly typical of incentives offered by neighbouring countries such as Peru and Chile. The “investment contracts” apply to the investor and “tax stability agreements” apply to the enterprise into which investment is made. These are somewhat similar to arrangements in neighbouring countries.

Ecuador could consider reforming the tax stability agreements. For instance, these agreements could be applied on an industry by industry basis. They could focus on the new priority sectors to set up particularly competitive arrangements in new areas where it wants to boost investment, namely mining, tourism, services and non-traditional agriculture.

Investor confusion, caused by frequent and mercurial changes in the tax system and related fiscal policies, suggests that Ecuador could also do more to promote its tax incentive scheme. It should stay the course on eliminating the "financial transactions tax" (ICC), in place since 1999. The current rate of 0.8 per cent, though lower than before, has not been popular with foreign investors. In addition, tax administration and collection need further improvement. Foreign investors welcome not only low taxes but an open system and a level playing field with domestic businesses. The Government was considering a thorough reform of the fiscal system in 2001, and felt the need to raise more tax revenues. However, the emphasis is likely to be on improving collection rather than increasing the tax burden.

Fiscal reforms are also underway but the government has yet to achieve its tax reform objectives. It intends to introduce a comprehensive tax reform bill and to further improve the efficiency of the tax collection system. Such measures, if pursued systematically, consistently, transparently and over a sustained period of time, are bound to increase foreign investor confidence in Ecuador.

b. Capital markets

Ecuador's capital market started in 1993, after the approval of the Capital Market Law. The law envisaged the development of an efficient, organised, integrated market that strongly emphasised full and fair disclosure and the safeguarding of investor interests. The authorities transformed both the Bolsa de Valores de Guayaquil (BVG) and Quito exchanges into non-profit organizations subject to the authorization and control of the office of the Superintendent of Companies in 1993.

Trading value increased by 170 per cent in dollars terms that same year. The following year's trading value increases by an even more dramatic 305 per cent. And Ecuadorian banks became the major participants in the country's stock market. As table III.3 shows, in 1999 public titles dominated, because of the Central Bank's interventions (by issuing monetary stabilisation bonds) to control money and foreign exchange markets.

Private activity decreased between 1997 and 1999, not only in percentage but in value as well. Uncertainty about the future increased the costs of financing investments with equities, given the predominance of closely held local companies, strongly dependent on public financing. Like other Latin American countries, the family-based company structure is the most common in Ecuador.

Table III. 3. Operations of the Guayaquil and Quito stock exchanges

(Percentage)

Sector/Title	1997 (Jan.-Dec.)	1998 (Jan.-Dec.)	1999 (Jan.-Oct.)
Public sector, of which:	**40**	**34**	**78**
- Government	14	21	12
- Central Bank	26	3	66
Private sector, of which:	**60**	**66**	**22**
- Equities	4	3	2
- Fixed-Income	56	63	20

Source: Central Bank of Ecuador, 2000.

In addition, the crisis in the social security held back the infusion of long-term funds to energise the capital market. It may not be necessary to privatise pension funds, as has been done in Chile and is being considered in a number of other countries. Nevertheless, it is imperative to introduce efficient and effective management systems that could generate savings needed to invest in equities or other long-term assets.

c. Competition policy

The principle of free competition is granted by the Constitution. Article 244 defines the role of the State as that of "promoting the development of activities for competitive markets and sanctioning, in accordance with the law, monopolistic practices". Article 3 of the Company Law prohibits commercial practices that lead to monopoly behaviours. Mergers are treated in Article 387 which requires that one or both companies must approve and vote for the mergers in an extraordinary general meeting of shareholders.

However, Ecuador does not have a competition law. The Government, with the assistance of UNCTAD, is in the process of enacting a competition law. The draft law would establish a competition agency responsible for the enforcement of the provisions of the law.

The adoption of the competition law and the establishment of the competition enforcement agency are expected to play an important role in promoting a more competitive and freer environment for both domestic and foreign enterprises operating in Ecuador. In fact, there are some key sectors where enterprises' anti-competitive practices make the entry of new domestic and foreign firms very difficult. In this connection, the competition agency could exercise a multi-fold role, including the removal of anti-competitive practices, advising the Government on policy issues, and monitoring enterprise behaviour in specific sectors.

Article 92 of the Constitution further states that the laws should establish quality control, consumer protection, mechanism for indemnification for deficiencies and poor quality of goods and services as well as for interruption of public services that are not caused by force majeure. Ecuador adopted (July 2000) a law on consumer protection. In general, there are no price controls, except on banana, coffee, cocoa, pharmaceuticals and fuels.

d. Environmental protection

The Environmental Management Law No. 245 of 1999 defines the role for the public and the private sector in environmental management and it establishes the national system for sustainable development, including monitoring mechanisms and sanctions for environmental damage. The law requires that all proposed exploitation of non-renewable resources in protected areas must have prior environmental impact and feasibility evaluations. The law was inspired by the 1992 Rio de Janeiro Declaration on Sustainable Development. Ecuador is also a signatory to other major international environmental laws such as the Biodiversity Convention, the Climate Change Convention and the International Convention for Trade of Endangered Species.

Environmental protection as well as the development of natural resources is part of the broad strategy adopted by the Ministry of Environment. The plan adopted by the Ministry includes nine programmes:

1. Sustainable use of biological resources, including the creation of a centre for conservation and bio-diversity use and a centre for environmental services;
2. Forestry programme;
3. Integrated management of hydroresources;
4. Energy efficiency and alternative energy programme;
5. Management and conservation of Galapagos;

6. Pollution prevention and control;
7. Consolidation of the national system of protected areas and reserves;
8. Institutional and organizational development programme;
9. Environmental legislation and national information system and land use management system.

With regards to environment, the Investment Law recognises that all investors must preserve the environment or repair environmental damage. Other laws such the Hydrocarbons Law, the Mining Law and all laws related to infrastructure development have a close relationship with environmental protection. The Ministry of Environment cooperates with the different ministries to propose adequate changes in legislation in order to reflect environmental protection. The Ministry is also developing investment proposals for bio-diversity use, providing useful research for new product development.

e. International trade

Ecuador has been very active in seeking to liberalize and promote international trade. It has long been involved with the Community of Andean Nations (CAN) trade initiatives, beginning with the Cartagena Agreement of 1969 and the schemes for establishing a common external tariff. With a population of 106 million, CAN amounts to a large potential market for Ecuadorian firms, most of which are currently domestic in orientation. Other sub-regional initiatives include economic and trade agreements with several other Latin American countries. Ecuador is now negotiating the formation of a free trade zone with the Common Market of the Southern Cone (Mercosur). Formation of a single trade area, uniting CAN with Mercosur, means firms based in Ecuador could have, in the medium-term, access to a market with of some 230 million consumers, with a combined GDP of over $1.2 trillion.

Ecuador is also member of the Latin America Integration Association (LAIA) established in 1980.[90] Within this framework, Ecuador enjoys preferential access granted to less developed countries in the region, including Bolivia and Paraguay. Partial scope agreements signed by Ecuador include bilateral agreements with Argentina, Brazil, Chile, Cuba, Mexico and Uruguay.

Ecuador is a party to discussions of a Free Trade Area for the Americas (FTAA) and should consider playing a more active role in the negotiations. It was admitted as a full member of the Economic Council of the Pacific Trade Zone in 1999, which may facilitate its admission to the Asian-Pacific Forum of Economic Cooperation.

Ecuador and more than 140 independent countries and territories, have improved access to the United States and a number of developed countries via the General System of Preferences (GSP). Ecuador benefits from preferential trade arrangements with the European Union under the Andean Trade Preference Act. However, some key traditional exports – notably bananas – receive far less preferential access than that afforded to former European colonies under the Lomé Convention. This treatment has directly affected foreign investors in Ecuador's banana growing industry and caused trade frictions with the EU. As a satisfactory resolution has been found, Ecuador stands to benefit significantly from greater access to the EU's banana markets, which in turn could make Ecuador a more attractive location for firms wishing to invest in agribusiness (see box II.3).

[90] Members of LAIA are Argentina, Bolivia, Brazil, Chile, Colombia, Cuba, Ecuador, Mexico, Paraguay, Peru, Venezuela, Uruguay.

Ecuador is also a beneficiary of the Andean Trade Preferences Act (ATPA) with Bolivia, Colombia and Peru. This act covers most products, with the exception of textiles, certain types of footwear, canned tuna and sugar products. Other countries offering Ecuador unilateral preferential market access akin to GSP include Canada, Czech Republic, Japan, Norway, New Zealand, Poland and the Russian Federation.

Ecuador's tariff rate structure is consistent with the CAN Common External Tariff. Rates range between zero and 20 per cent. As an exception, a higher tariff (35 per cent) is applied to automobile production to protect the local assembly industry. Ecuador joined the WTO in 1996 and stands to benefit significantly from further multilateral trade liberalization. Under the provisions of the WTO, Ecuador has agreed to eliminate price bands on imports for 149 farm products. As of 1997, Ecuador temporarily increased import duties to finance the fiscal deficit. The measure would likely be extended until the end of 2000. Exceptions apply to imports of capital goods and industrial inputs as part of the incentives offered to domestic and foreign investors in key industries.

Ecuador has liberalized imports and dismantled previous import restrictions by establishing a single import document. Within the framework of recent reforms introduced by Trolebús II, the health code was also modified to facilitate the process for obtaining sanitary licenses for the commercialization of food. Licences can now be obtained through the recognition of permits issued in other countries or through the implementation of good manufacturing practices. Such measures should facilitate investment in industrial activities, such as food and chemicals.

These trade-related issues and policies will present new challenges, as well as opportunities, although investors interviewed by UNCTAD view regional integration as a positive development. For instance, regional investment by South American-based TNCs could increase as regional ties develop, as they seek to make the most of the competitive advantages of each country and the enlarged market. As noted in Chapter I, regional investment is an untapped potential from Ecuador’s perspective.

E. Implementing an investment promotion programme

To promote and diversify FDI into Ecuador is a tough challenge for the Government. Hence, the formulation and launching of an investment promotion programme should be one of the Government’s priorities. Among institutions dealing with the participation of foreign firms in the Ecuadorian economy, CORPEI, has been assigned the lead role in the proposed investment promotion programme under the direction of COMEXI, the Foreign Trade and Investment Council (box III.12).

To put the promotion programme in place requires that COMEXI assume its statutory authority in the area of foreign direct investment and make the system of institutions dealing with FDI issues coherent and operational. The responsibilities of these institutions should be reviewed and clarified as a matter of priority, as some of them overlap. In addition, they should be updated in light of the new legislation enacted in 2000.

COMEXI should organize and lead the effort to define the strategic plan concerning the role of FDI in overcoming the economic and financial crisis and playing a greater role in Ecuador's development. A starting point could be a national consensus-building workshop with the participation of all institutions involved in FDI issues as well as the private sector, including foreign investors. The national FDI strategy to emerge from such a consensus-building exercise should be well understood and embraced by key players and segments of the society. These include not only Ecuador's President and Ministers but also Congressional Deputies and entrepreneurs.

Box III. 12. Ecuador: institutions dealing with FDI

According to the Foreign Trade and Investment Law of 1997, "Lexi", the most important institutions dealing with FDI issues and involved in formulating and implementing national FDI strategy and their functions are the following:

- **COMEXI**. The Foreign Trade and Investment Council responsible for the formulation of national strategies and policies in the area of foreign trade and investment. COMEXI's duties include, among others, proposing strategies and guidelines for international negotiations, formulating policies for free trade zones and developing guidelines for investment promotion. The President of the Republic presides over it. COMEXI consists of representatives from relevant ministries and the private sector.
- **MICIP**. The Ministry of Foreign Trade, Industrialisation and Fishing is in charge of planning, directing and controlling trade and investment policies. It implements COMEXI's decisions. It is also responsible for preparing proposals for consideration by COMEXI, for analysing investment and trade policies and disseminating information on trade and investment. It also carries out together with the Ministry of Foreign Affairs bilateral and multilateral negotiations on trade and investment.
- **CORPEI**. The Export and Investment Promotion Corporation, a quasi-private non-profit organization is in charge of exports and investment promotion. CORPEI funding comes from Government and redeemable contributions equivalent to 1.5 per thousand dollars FOB value of private sector exports, the 0.5 per thousand dollars of oil and oil products exports and 0.25 per thousand dollars of all imports. CORPEI also received support from bilateral and international technical assistance programmes.* CORPEI has offices abroad in six locations (Brussels, Bejing, Bogotà, Lima, Miami and Santiago) and has set up an external network in cooperation with the Ministry of Foreign Affairs.
- **Ministry of Foreign Affairs**. The Ministry is in charge of negotiating bilateral investment and tax treaties and participation of the country in regional and international trade and investment agreements. As a member of COMEXI, it participates in designing the country's investment policies. In addition, embassies cooperate with CORPEI in the area of trade promotion. Eleven embassies are integral part of the country's external promotion network. Once the investment promotion system is in place, embassies will be involved in investment promotion as well.

Source: National legislation.

* Trade Development Ireland, the World Bank and the International Trade Centre assisted CORPEI in developing export promotion programmes.

Investment promotion programme should be part of the national FDI strategy and should be implemented by an investment promotion unit (IPU) within CORPEI, the only institution with private sector representation. Thus the role of CORPEI among other institutions dealing with FDI needs to be strengthened and CORPEI should take responsibility, as an operational arm of COMEXI, for coordinating all investment promotion activities and functions. Emulating best practices of other investment promotion agencies, CORPEI's activities should focus on the following areas:

- **Policy advocacy.** This function involves building consensus behind reforms in general and an increased role for FDI, in particular and championing improvements in the investment climate. Dealing directly with investors will give the IPU detailed knowledge about the problems investors face, enabling CORPEI to become an effective champion of reforms. In building the consensus, CORPEI should work with business associations, non-governmental organizations and other stakeholders.

- **Image building.** Given that Ecuador's stabilising reforms are only beginning to bear fruit, it would be premature to launch generalised image-changing campaigns, which can be very expensive. Disseminating information about the ambitious programme of reforms, including recent changes in the investment framework aimed at attracting FDI is, however, an important task. It may be appropriate to conduct business forums and set-up an Internet website to cost-effectively promote changes. Once reforms are firmly in place, economic stability is restored and the economy resumes growth, at this stage, there will be a need to start a more rigorous image-building campaign considering that changing a high-risk investment perception is a difficult and long-term task.

- **Investment generation**. Priorities should include helping CONAM identify and attract investors to the privatization programme, both through the acquisition of State-owned enterprises and through the concession programme which should be improved. Another area of priority is the export-oriented industries, which may require targeting techniques to attract investors. Here, investment and export promotion efforts should be combined at home and abroad, through extending the already existing trade promotion co-operation between CORPEI and the Ministry of Foreign Affairs, to investment promotion. Furthermore, the petroleum industry should be included in the priority list for investment generation activities, especially after the LET opened new possibilities to FDI in this industry. This effort should be aimed to both new and current investors. As evidenced by relatively high FDI inflows into Ecuador in the years of crisis (over $600 million in both 1999 and 2000), most flowing into oil, FDI potential in this industry is significant. In the long-term, when economic conditions improve, investment generating activities should aim at the diversification of FDI into manufacturing industries and business services. They should increasingly target small- and medium-sized TNCs as well as new potential home countries, including especially Latin American countries such as Brazil, Argentina, Chile, Mexico and member countries of CAN. Firms from these countries have expanded abroad in recent years, including through majority-owned affiliates, joint ventures and strategic alliances. Ecuador has largely failed to attract investment by such TNCs, with some exceptions in the petroleum industry. These TNCs tend to be quite familiar with the region and several have pursued regional integration strategies. They are a promising potential source of FDI for Ecuador.

- **Investor services**. These services include information, problem-solving at the pre-investment and implementation stages, and after care-services. After-care services are important for two reasons. First, investment by already established investors in host countries is typically a significant source of FDI, through re-invested earnings. Secondly, a satisfied foreign investor, expanding investment, is the best evidence of good investment climate. Many large TNCs are already established in Ecuador, not only in petroleum industries, but also in manufacturing industries (see chapter I, table I.5). Investor services activities should entice the oil industry companies to expand their projects, and benefit from the Oil Opening Plan 2000. As regards manufacturing TNCs, whose investment is small, investor services should find out why this is the case, and aim at encouraging them to increase their investment:This would augur well for attracting new investors into manufacturing. The third group should be firms participating in the privatization programme in infrastructure. These firms are a source of a significant sequential investment, typically exceeding the value of initial privatization transactions.

Experience shows that to give an investment promotion unit a chance to be successful, it should not only be properly situated among various government institutions but adequately funded, well managed and properly staffed. Typically, up to 80 per cent (and sometimes 100 per cent) of the initial budget should be provided by the Government, with the balance coming from fees charged to the users of the investment promotion services or sponsorships. Management should have private sector experience, including background in marketing and sales. Staff qualifications are critical to success. If the unit is well established, and the country improves its investment climate substantially, promotional offices abroad can be opened in promising locations. Until then Ecuador's diplomatic representatives should start assuming promotional functions. This may require prior training, which UNCTAD could organize.

F. Overall assessment

The Government of Ecuador has taken important steps to restore macroeconomic stability and resume economic growth. It introduced a bold stabilization programme and two omnibus laws, setting a new legal, economic and social framework, which lays the ground to creating an environment conducive for FDI. The modernization of the State has commenced and the implementation of a viable privatization programme should allow for immediate realization of FDI potential in the still large State-owned sector. However, the Government still faces a difficult task in implementing many of its reform commitments.

Ecuador's openness to foreign investment compares favourably with international standards of countries such as Peru, Chile and other member States of APEC (table III.4). The legal framework for foreign direct investment is grounded solidly in the Constitution, which reinforces such principles as national treatment of foreign investors and the supremacy of international treaties over national legislation. Apart from World Trade Organization agreements, international treaties that protect investors include bilateral investment treaties and double taxation treaties. Finally, national legislation recognizes international arbitration, in particular the dispute settlement mechanism set by the World Bank's International Convention on the Settlement of Investment Disputes between States and Nationals of Other States.

However, foreign as well as domestic investors continue to face a number of difficulties, associated with obsolete basic laws including the Penal Code, Labour Code, Commercial Code and the general tax regime are not in conformity with the new Constitution.

Table III.4. Ecuador's foreign investors' treatment* compared with selected countries

Standard or measure	Country and score			
	Ecuador	**Peru**	**Chile**	**Other APEC****
National treatment	5	5	4	2.5
Non-discrimination	4	5	3	3.6
Repatriation and convertibility	4	5	4	4.4
Expropriation and compensation	5	5	5	3.6
Settlement of disputes	4	4	5	4.1

Source: APEC Investment Guide (1998) and UNCTAD assessment.
* see Box III. 13 for methodology
** "Other APEC" score is the unweighted average score of APEC member countries except Chile and Peru.

The package of reforms proposed by the Government within LET of 2000 includes proposals for reforming these codes (e.g. the Labour Code and the tax system). The stability and transparency of economic laws and regulations including tax, labour, and property are essential for improving the business environment, which should receive a boost with the completion of the modernization of the State programme and the enforcement of reforms. Furthermore, there is a proliferation of secondary legislation and legally binding norms introduced by the administration. These norms not only create legal confusion but also invite corruption.They allow the bureaucracies discretionary powers to take decisions which otherwise should be performed only by constitutionally mandated legal authorities. A case in point is the enforcement of property rights which create uncertainty in areas such as mining and petroleum.

Another area in need of review and improvement is investment incentives which, judging from the results, rarely work. In contrast to the standards of treatment, Ecuadorian schemes do not appear to match those offered by neighbouring countries. Without creating a competitive incentive scheme it will be difficult to promote investment into the areas of priority, especially mining, tourism and other service industries and non-traditional exports. As the existing free zones, for example, have failed to deliver expected results, they thus warrant reforms.

In an attempt to better protect foreign investors, Ecuador has concluded many bilateral investment treaties and a small number of double taxation treaties. Concluding more double taxation treaties with potential home countries should certainly be a priority for Ecuador. Although Ecuador has entered into many bilateral treaties, it has a dearth of such with Western Europe, Asia and the Latin America region. The broadening of bilateral investment treaty partners should be another task of immediate priority. In this regard UNCTAD's expertise and special scheme could facilitate the conclusion of such treaties.

In addition to improving its investment framework, in part, dealing specifically with foreign investors as well as, in part, dealing with all investors, but affecting also FDI, Ecuador has undertaken some actions and should consider undertaking many others aimed at attracting FDI and benefiting more from it. In the trade area, Ecuador has improved trade services, particularly customs. It has opened up its market, is actively pursuing regional integration and has succeeded in considerably increasing exports of non-traditional products (although these exports consist mainly of primary products with little or no processing).

Policies aimed at attracting FDI into export-oriented industries to increase competitiveness and develop linkages between foreign and local firms are being designed. A learning process is needed, involving both public and private institutions and organizations. The building of a strong human resources base should also be a key objective for any policy geared to improve local supply capabilities and benefit more from FDI: at present the lack of qualified personnel and many divergent skills reduces the expansion prospect of many industries.

Ecuador requires a well-developed and properly enforced intellectual property protection system. In the area of competition, the general principles are formulated in the Constitution, but the enactment of the competition law and the establishment of a regulatory agency to implement them are among the highest priorities. Equally important is the formulation and launch of an investment promotion programme, based on the best practices of other investment promotion agencies. Promotional activities should focus on policy advocacy, image-building, dissemination of information, investment generation and investor services.

Box III.13. Methodology for comparing APEC investment standards

The scoring system in compiling table III.4 sets the bar for "best practice" as follows:

National treatment – the highest standard is set by an explicit legal provision (or long established practice) which guarantees national treatment with sole exclusion on national security grounds (including border-related provisions and defence industries) and no screening procedures for admitting FDI. Thus, lower scores result from the adoption of screening mechanisms, sectoral restrictions on FDI participation including outright bans of FDI in certain sectors and/or foreign ownership limits, and from operating restrictions which apply only to foreign investors (such as restrictions on access to local finance).

Non-discrimination – the highest standard is no discrimination among investors on the basis of home country except in the context of regional economic agreements or bilateral tax treaties.

Convertibility – the highest standard is the absence of exchange controls on current and capital accounts. Also, in the case of countries whose currencies are not commonly traded "hard currencies", contractual arrangements guaranteeing access to foreign currency for repatriation of profits and capital and the ability to hold export proceeds offshore.

Expropriation – the highest standard is legal provision which states that expropriation will only be for a public purpose, will be performed in accordance with the due process of law and will result in internationally acceptable arrangements for compensation.

Dispute settlements – the highest standard is legal provision in favour of equal access to the host country legal system and the ability of investors from a wide range of home countries to have recourse to international arbitration to settle an investment dispute with the Government of the host country.

Source: UNCTAD.

IV. Conclusions and Recommendations

Ecuador has considerable potential for attracting FDI, which can be turned into investment opportunities with appropriate policies and programmes. Ecuador's bold stabilization programme comprises the dollarization of the economy, rigorous fiscal discipline, flexible labour market rules and a comprehensive privatization programme coupled with attractive rules to encourage FDI. The omnibus law approved by Congress in March 2000 set a new legal, economic and social framework for reforms aimed at restoring stability, resuming growth and achieving social consensus. New measures, including the restructuring of the financial system, an improved banking supervision, a successful re-negotiation of Ecuador's external debt and a significant improvement in the price of oil have contributed to a more optimistic investment climate. Economic recovery is under way and inflation has slowed down.

These are indications that the country is emerging from its political, economic and social crisis of 1999-2000, but still has a long way to go. To improve its image and to regain investor confidence, it must provide consistent policies and a stable and transparent political and economic environment. The modernization of the State and institutional capacity-building should also play an important role in reactivating the economy and creating an environment more conducive to business. In formulating and implementing these new policies, Ecuador should recognize that the stabilization programme has social costs, requiring, for example, poverty reduction measures. Moreover, the long-term goal is to integrate these social concerns into an overall development strategy through a national participatory process.

Ecuador seeks to extract greater benefits from FDI in its quest to overcome the crisis and lay the foundations for sustainable development. FDI can help as a source of external financing, foreign exchange and investment. It can also bring with it technology, managerial and organizational skills, access to markets, diversification and upgrading of production and the restructuring of inefficient State-owned and private enterprises. Although investment into Ecuador grew significantly during the 1990s, its role has been, by and large, limited to the oil industry. Overall, both quantity and quality of FDI has been much below needs and potential. To illustrate the scale of needs in just one area - basic infrastructure services - it is estimated that the sector would require an investment of $35 billion during the next five years, an amount exceeding current total domestic investment by a factor of eight.

Ecuador's FDI potential extends from non-renewable resources such as oil and minerals and renewable resources such as bananas, flowers, fishing and biological resources of the rain forest to infrastructure services industries such as telecommunications, power generation and distribution and air transportation. Other areas of infrastructure such as roads or railroads have potential for the participation of foreign investors in the form of concessions. Other service industries with considerable FDI potential include tourism and the banking industry. Potential also exists in the manufacturing sector, especially in the export-oriented commodity based industries, many of which enjoy free or preferential access to large regional and international markets.

Ecuador has formulated programmes and taken steps to realize its potential as an FDI location. In the face of the economic crisis the Government has recently intensified efforts. A number of these efforts have began to bear fruit, while still others require improvement and continuity. Priority objectives that relate directly to FDI are presented below in four broad areas including investment framework, privatization and infrastructure, investment promotion and international cooperation.

Objective 1: Further improving the investment framework and related policies

The new legal framework for FDI in Ecuador offers national treatment to foreign investors and greatly facilitates their entry and establishment. Foreign investors assess the entry and establishment process, including the issuance of permits, licences and other necessary authorizations to be fairly smooth and well supported by local private services. Constitutional norms provide additional support to investment protection including dispute settlement mechanisms granted by the 1997 Law on Promotion and Guarantees of Investment. The law itself is explicitly promotional and, together with the Constitution, provides for a sound investment framework.

Priority areas for the improvement of the framework and related policies include the following:

a. Investment framework

- While the law is sound, lack of enforcement hinders its full application;
- The legal system affecting enterprise operations, including reforms of the judicial system and commercial law, needs improvement;
- One of the main protections offered to investors by the law - the possibility to sign an investment contract with the State, protecting investors against adverse or a discriminatory treatment - is not used by investors and should be improved;
- Ecuador's present incentive structure is complex, costly to administer and not very attractive to foreign investors. It should be reviewed, simplified and coordinated and/or implemented by one institution, most probably COMEXI, which seems to be best suited;
- Free zones have failed to attract significant FDI. They are ripe for major overhaul.

b. Related policies

- A competition law should be enacted, and the implementation of intellectual property protection and environmental regulations strengthened;
- Efforts to improve tax administration efficiency and collection as well as efforts to stabilize the tax regime should continue;
- The planned national system of innovation, designed to focus on cluster development, quality control and ISO certification, should be established;
- To increase long-term benefits from FDI, technology and education policies should strive to better link these two areas to the needs of the economy. These policies should encourage interactions among public R&D institutions, technology centres, enterprises, universities and funding institutions. Specific measures could include introducing and monitoring standards of education, helping to launch specialized research and technical training (in areas such as petrochemicals, engineering or e-commerce) and increasing the number and the quality of vocational training institutes.

Objective 2: Implementing viable privatization and infrastructure development programmes

A viable privatization programme is essential to the realization of the significant FDI potential existing in the State-owned sector, which remains unduly large and extends from manufacturing enterprises and the primary sector to the services sector and in particular infrastructural services and the banking industry.

The privatization programme is equally important for the development of infrastructure. Economic and political crises and natural disasters have resulted in the deterioration of infrastructure and public services. Their improvement is a precondition to reviving overall investment, both local and foreign.

The following considerations are important in the implementation of the programmes:

- To attract foreign investors, the programme has to conform to typical international investment practices and investors' legitimate expectations concerning control and other requirements;
- The role of the Government in a privatization programme is not limited to, and does not end with, the sale of State-owned assets, especially in the area of infrastructural services, even if the sale is successful and the price received is satisfactory;
- The objective of the Government should be to not only maximize fiscal gains but also to achieve the improvement of the quality of services at lower prices, ensuring a fair distribution of the long-term gains from privatization among the Government, investors, consumers and other stakeholders;
- Given the monopolistic nature and externalities of many infrastructural services, regulatory functions are very important in ensuring that public monopolies are not replaced by private foreign monopolies, without the incentives and pressures to invest and to improve services;
- Where ownership is retained by the State and management contracts or operational concessions are used to involve private investors in the provision of services, the Government's role is to ensure effective functioning of the concession system;
- The coordinating role of the central Government is very important in ensuring the consistency of the infrastructure development programme in which many agencies and authorities at various levels are involved;
- Government must ultimately remain responsible for financing or co-financing of and investing in infrastructure projects deemed necessary from a social or economic point of view but considered unattractive or too risky by private investors.

Objective 3: Implementing an investment promotion programme

The formulation and launching of an investment promotion programme should be one of the Government's priorities. To achieve this objective:

- COMEXI should assume its statutory authority in the area of foreign direct investment and make the system of institutions dealing with FDI issues coherent and operational;
- The responsibilities of these institutions should be reviewed and clarified as a matter of priority, as some of them overlap;
- COMEXI should lead the effort to define the strategic plan concerning the role of FDI in overcoming the economic and financial crisis and playing a greater role in Ecuador's development. A starting point could be a national consensus-building workshop with the participation of all institutions involved in FDI issues as well as the local private sector and foreign investors;
- An investment promotion unit should be established within CORPEI (which needs to be strengthened) and should take responsibility, as an operational arm of COMEXI, for co-ordinating all investment promotion activities and functions;
- Emulating best practices of other investment promotion agencies, CORPEI activities should focus initially on (a) policy advocacy; (b) disseminating information about the programme and progress of reforms; (c) investment generation (e.g. helping CONAM identify and attract investors to the privatization programme); and (d) investor services (see section III.E for a detailed discussion).

In the long run, CORPEI should coordinate private-sector-led initiatives to create linkages and synergies between local firms and foreign affiliates. CORPEI should identify opportunities for and help eliminate impediments to such links, focussing on assisting local firms in overcoming gaps in skills or supply capacity.

Objective 4: Enhancing business confidence through international actions

Ecuador should participate more actively in international arrangements which help promote investment. These arrangements improve the country's locational attractiveness in two ways. Firstly, participation in arrangements establishing international standards in trade and investment (as well as other areas, such as finance or banking) signifies adherence to widely accepted rules, promotes stability of these rules and enhances business confidence. Secondly, these arrangements expand market access. Given the small size of Ecuador's domestic market, this is especially important.

Priorities include:

- Ecuador should support initiatives aimed at strengthening regional agreements especially the CAN. Merging CAN with Mercosur would expand and consolidate Ecuador's access to regional markets. Membership of other regional groupings such as a possible future Free Trade Area for Americas (currently being negotiated with Ecuador's participation) would serve a similar purpose. Ecuador should also consider joining APEC;
- The on-going programme of CAN to improve production in member countries through the development of economic complementarities, supporting strategic alliances among firms from member countries, and the strengthening of human resources and technological capacity can help Ecuador attract FDI and benefit more from it;
- Bilateral investment treaties and double taxation treaties should be concluded with all important actual and potential home countries for FDI in Ecuador;
- Ecuador should organize training programmes for negotiators of international investment agreements as well as personnel responsible for investment promotion in the country and abroad, including staff of the Ministry of Foreign Affairs and other private and public institutions.

ANNEXES

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Annex A. Business climate in Ecuador: results of a national survey of foreign affiliates

1. Methodology and respondents' profile

In the third quarter of 2000, CORPEI and UNCTAD conducted a survey among foreign affiliates in Ecuador to identify key investment determinants and obstacles as perceived by TNCs operating in Ecuador. The survey was based on a mailed questionnaire followed by interviews with selected foreign affiliates. When answering each question, respondents were asked to evaluate their responses on a scale from 1 to 5. Overall results concerning each question are averages of all responses.

Fifty-one firms from the following industries participated in the survey: agroindustry (21), oil and mining (3), pharmacuetical industry (3), trading (5), construction (5), telecommunications (3), and other services (11). They originated from the following home countries: Colombia (3), France (3), Germany (4), Japan (2), Netherlands (3), Spain (5), Sweden (3), Switzerland (3), United Kingdom (5), the United States (12), and Argentina, Bermuda, Chile, Brazil, Mexico, Norway, Peru and Venezuela (one each).

About 20 per cent of the respondents have annual sales of less than $5 million, with another 20 per cent registering sales between $5 million and $10 million. About 15 per cent of firms have annual sales in excess of $20 million. Among the largest companies are oil and pharmaceutical firms, while the smallest are in the agribusiness sector. About 10 per cent have sales between $15 and $20 million and 5 per cent between $10 and 15 million. The remainder did not answer the question.

The sample consists almost entirely of exporting companies with about 40 per cent of firms exporting their entire production. The main destination for exports of surveyed affiliates are South America, Europe and North America. Colombia and Peru are the largest export destinations within South America, while within Europe most exports go to Spain and the United Kingdom.

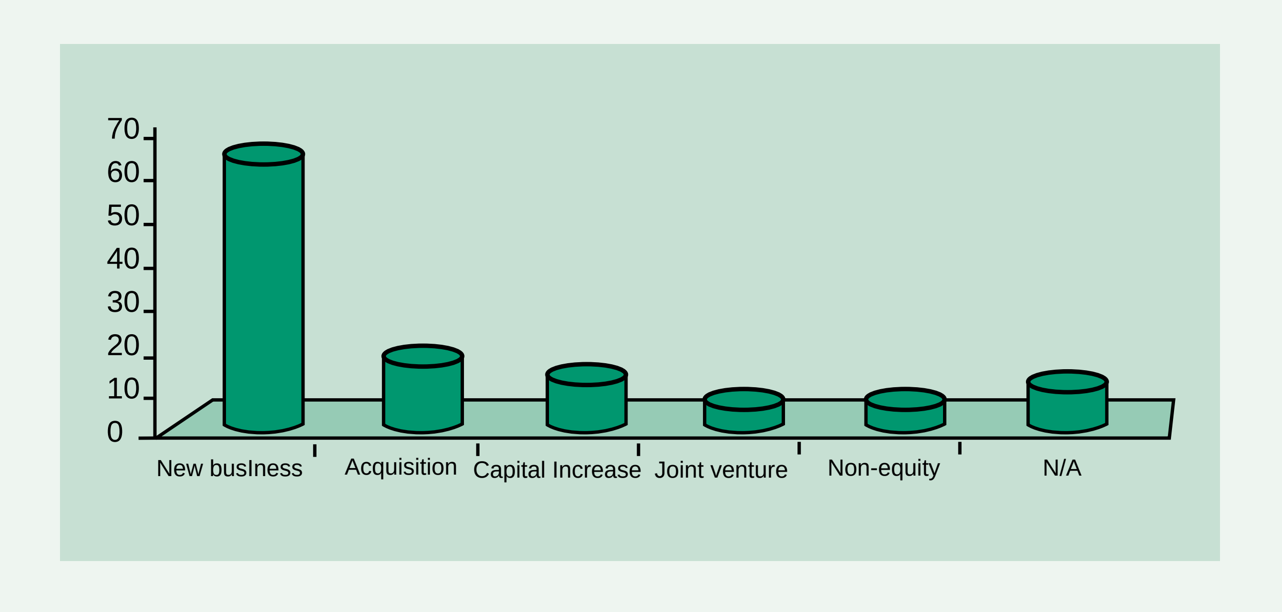
Most of the surveyed foreign affiliates were majority owned. In the case of over half of the respondents, their parent companies held 50 to 75 per cent stake in their capital. 20 per cent were 100 per cent foreign owned.

2. Entry and establishment

Almost 60 per cent of the affiliates were established through greenfield investment and more than 10 per cent through cross-border acquisitions (figure A.1).

Figure A.1. Mode of entry into Ecuador

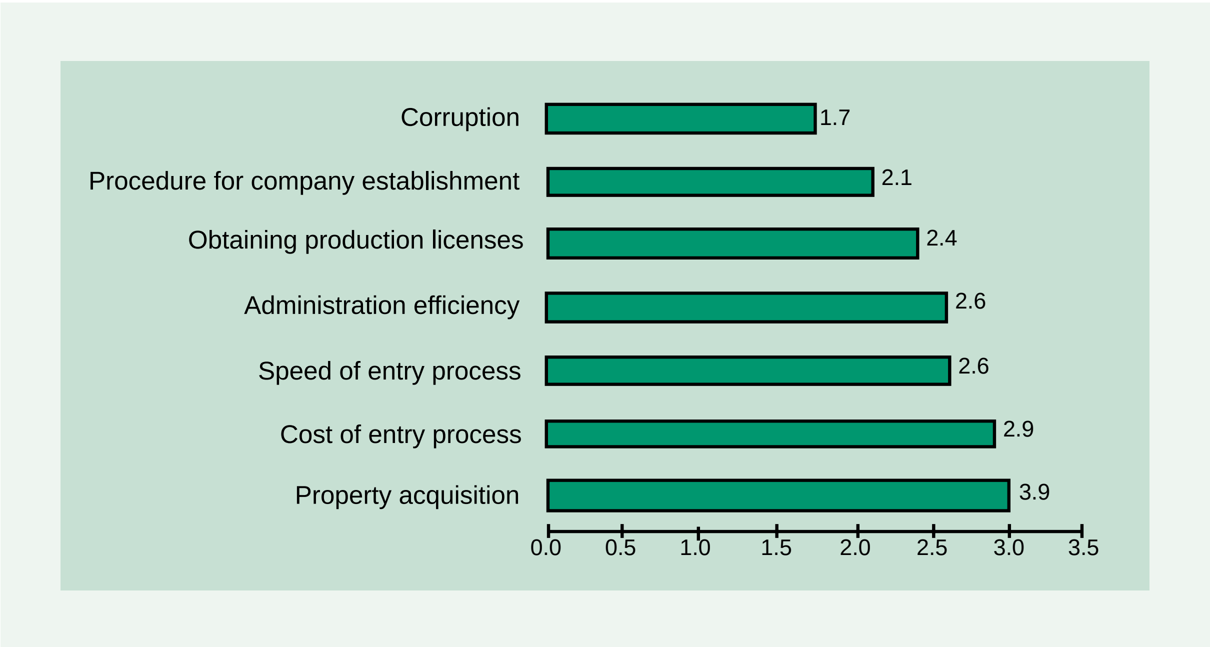
(Percentage of respondents



Source: UNCTAD survey.

Investors surveyed were critical of many obstacles to establishing investment in Ecuador, particularly corruption and the discretionary authority exercised by the administration (figure A.2).

Figure A.2. The entry process

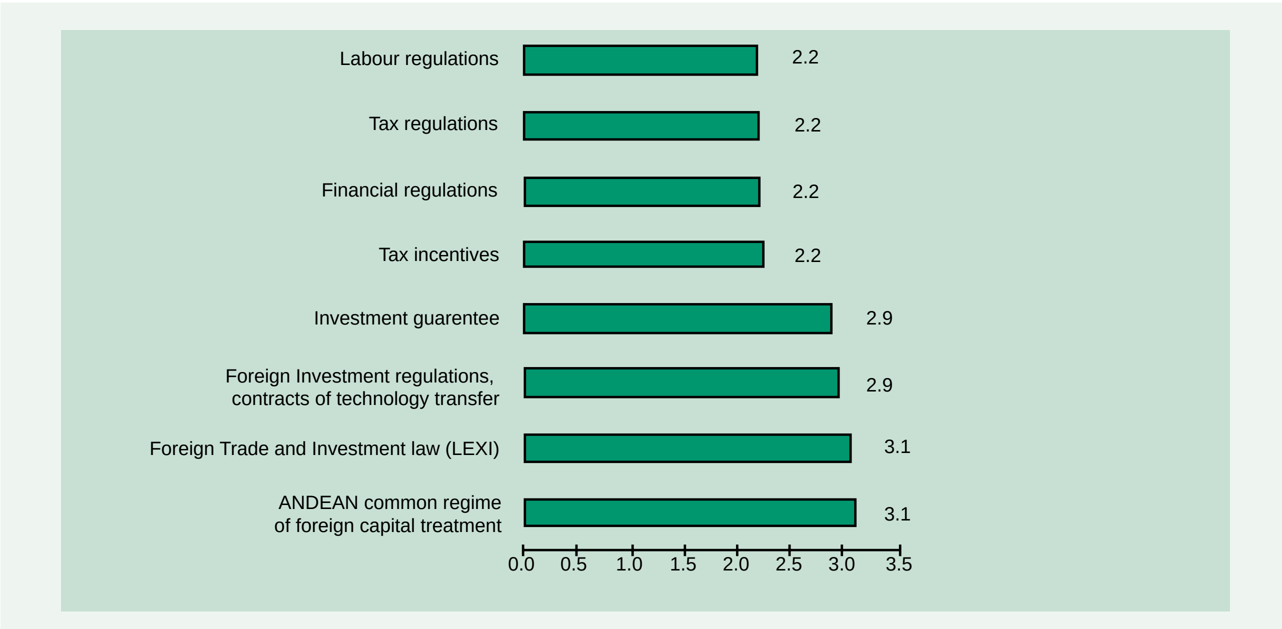


Note: Ranking: 1 = negative; 5 = very positive.
Source: UNCTAD survey.

3. Legal framework

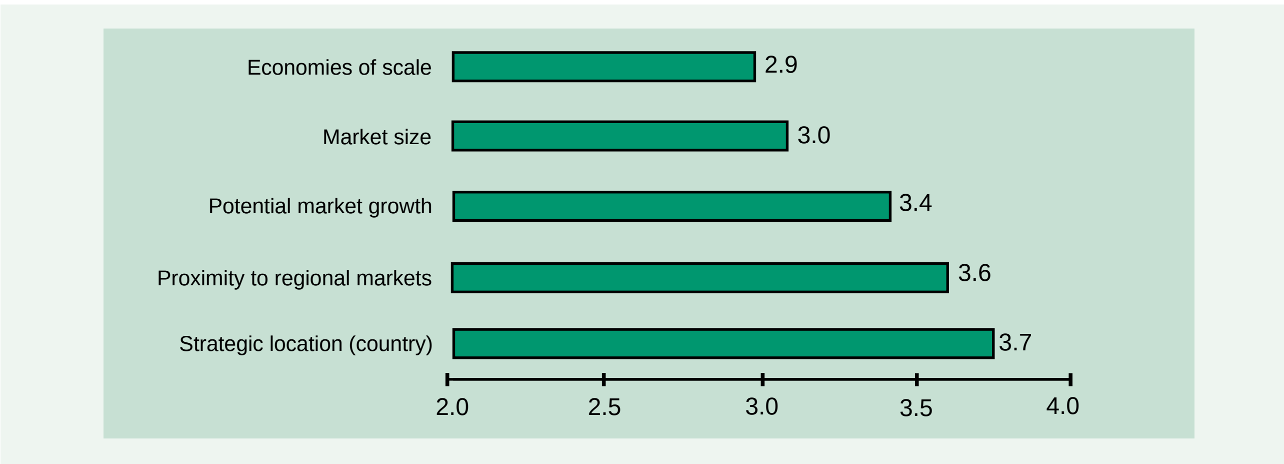
Firms also evaluated how existing legal regulations affected their entry and operations. Here, labour, tax and financial regulations were all viewed fairly negatively. On the positive side, the companies interviewed considered the Andean common regime of foreign capital treatment and the foreign trade and investment law adequate guarantees and protection to FDI. Foreign affiliates also noted that the legal framework lacks stability, hampering the long-term planning vital for the operations of foreign investors (figure A.3).

Figure A. 3. Legal framework



Source: UNCTAD survey.
Note: Ranking: 1 = negative; 5 = very positive.

Figure A. 4. Market factors

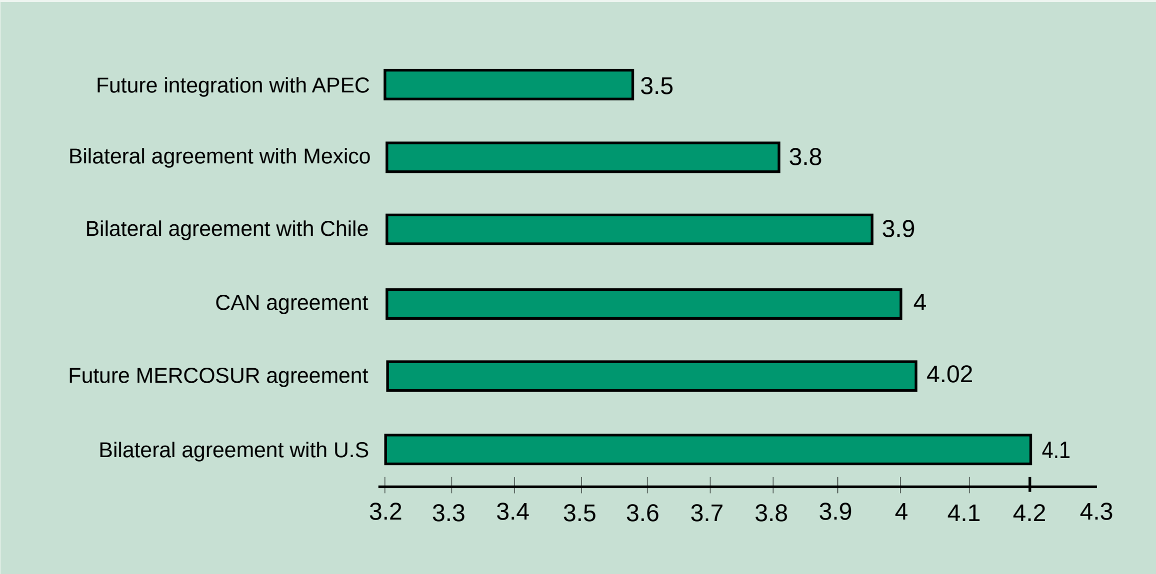


Source: UNCTAD survey.
Note Ranking:1 = not important; 5 = very important.

4. Key economic determinants of FDI in Ecuador

The most important economic factors attracting FDI are strategic location and proximity to regional markets (figure A.4). Other important considerations include the size and potential for growth in the local market. When considering investing in Ecuador, firms ranked regional and bilateral agreements as the most important factors, as well as possible future integration with other regional groupings, including MERCOSUR and APEC.

Figure A. 5. Access to international markets



Source: UNCTAD survey.
Note: Ranking: 1 = not important; 5 = very important.

In terms of local resources, investors consider as the most positive low cost of labour and land and the quality of raw materials, all receiving rating above 3.5 (figure A.6). About one-third of respondents were satisfied with the skills and qualifications of the local labour force, but another third were not. The minority of firms have established formal training programmes for their employees.

The majority of firms (60 per cent) had problems finding qualified labour. Among firms experiencing difficulties in employing specialized labour, it is more difficult to find agricultural engineers, machine and equipment operators, skilled technicians in the food industry and graduates with knowledge of foreign languages. To obtain access to skilled professionals, one third of the foreign affiliates have established relations with a local training institute. Many foreign affiliates noted that they would consider participating in local training if given appropriate incentives such as internship programs, development projects and schemes to share costs for training company workers.

Some firms also noted that generally the business culture, including moral and ethical values, trustworthiness, responsibility and honesty need improvement.

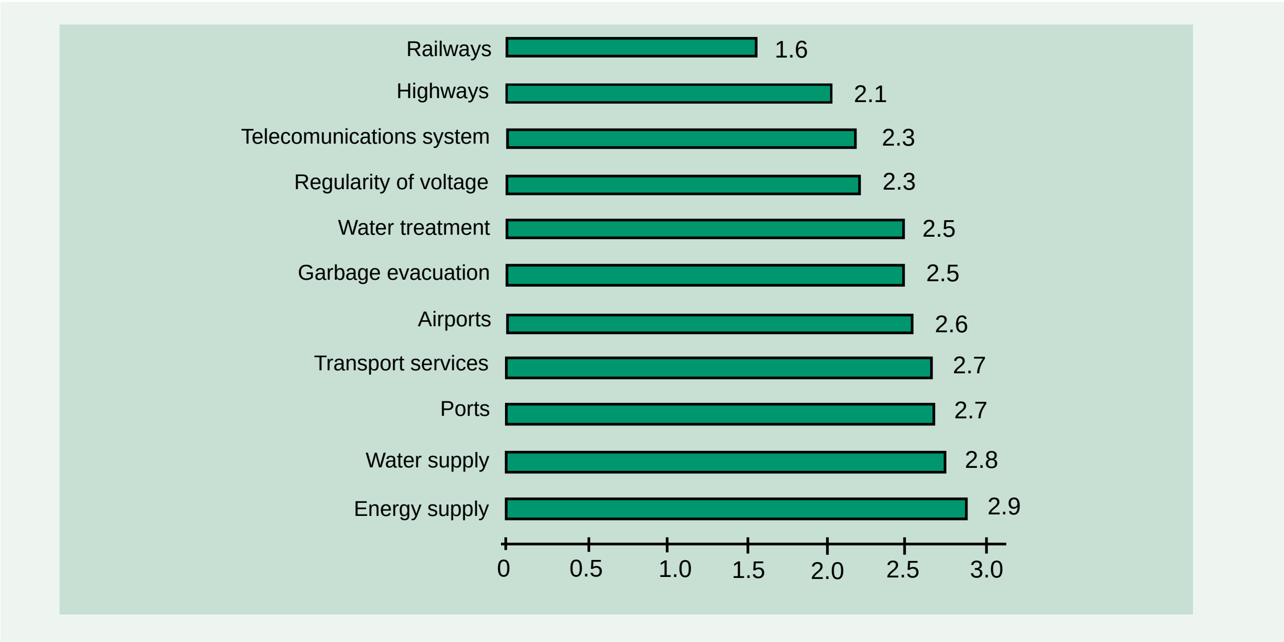
Figure A. 6. Cost and availability of local resources

Source: UNCTAD survey.
Note: Ranking: 1 = not important; 5 = very important.

5. Infrastructure

Infrastructure in Ecuador is generally considered poor. Transportation – notably railways and highways – score particularly poorly (figure A.7). Ecuador lacks a national railway system, and the existing coverage is minimal and unreliable. Many other basic infrastructure services, including telecom power and water supply services are considered inadequate.

Figure A. 7. Perceived quality of infrastructure



Source: UNCTAD survey.
Note: Ranking: 1 = poor; 5 = very good.

Most of the country's infrastructure (including railways, airports, ports, highways, telecoms and electricity) are still in the process of being concessioned or privatized. Many interviewed firms believed that the quality of these services will improve significantly when operated by the private sector.

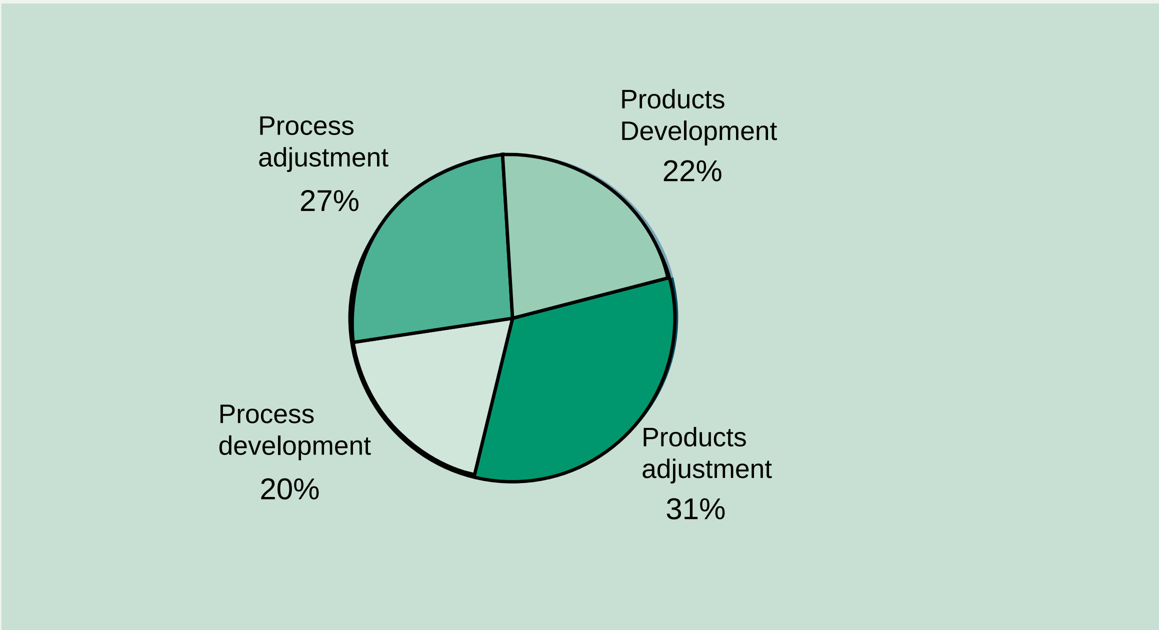
6. Local linkages and R&D

Linkages with the local economy are weak and foreign firms are dependent on imports. Almost one-third of respondent firms import up to 100 per cent of the inputs they use in their production processes. When asked if local companies capable of supplying required inputs (both in quantity and quality) exist, only about one-third responded positively. The majority are not satisfied with local suppliers. About 60 per cent of the interviewed companies indicated that they have developed some type of improvement programme, quality control for their suppliers. The majority of firms have not established formal training programmes for workers.

Almost one-half of the surveyed companies indicated that they have some type of R&D operation in Ecuador, although resources devoted to this item are scarce. Firms are constantly engaged in improving their production process and investigating mechanisms to increase productivity, bringing new products to the market. However, the type of R&D firms undertake in Ecuador mostly concern product and process adjustments (figure A.8).

Figure A. 8. Type of R&D undertaken by foreign affiliates

(Percentage)



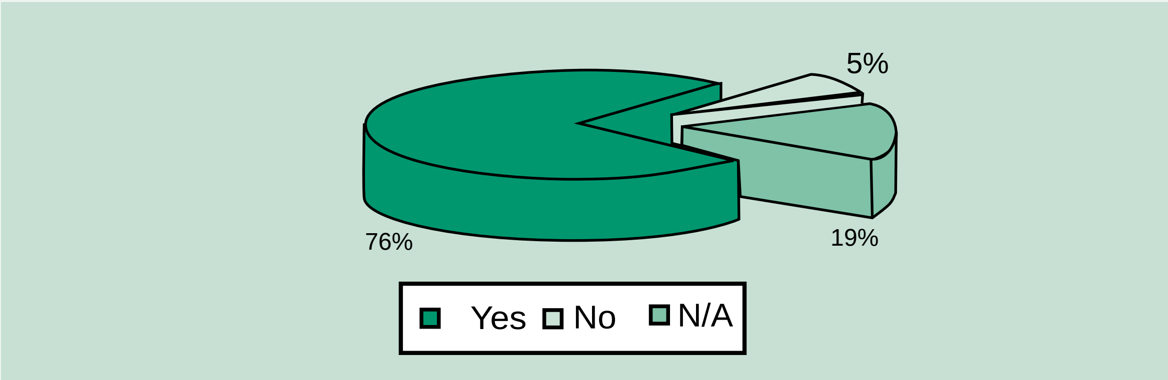
Source: UNCTAD survey.

When asked which would be the most significant incentives to increase R&D activities, firms indicated tariff and taxation incentives and programmes to improve education.

7. Future prospects

In the second half of 2000, 37 per cent of the respondents had plans to expand their investment in either the coastal regions (Guayaquil, Manabí and Salinas) or the Andean regions (Pichincha and Cuenca). As regards Ecuador's dollarization program, a very large majority of the firms interviewed (76 per cent) believed that the dollarization process will contribute to the recovery of investment in Ecuador (figure A.9). Investors believe that dollarization will bring monetary stability, reduce inflation and avoid the threat of hyperinflation. It will also eliminate exchange rate risk, eliminate shadow prices, improve Ecuador's competitiveness and allow for medium- and long-term planning in business.

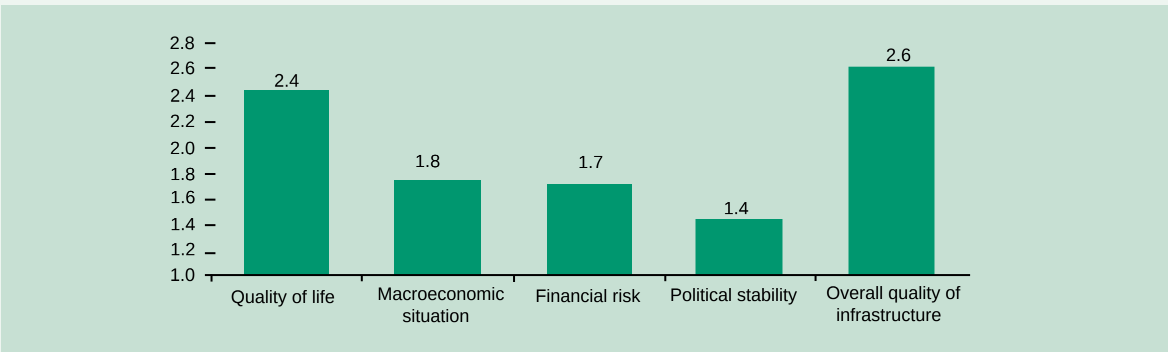
Figure A. 9. Will dollarization support investment recovery?



Source: UNCTAD survey.

When asked to rank the main factors that will affect their investment decisions, foreign affiliates considered that the broader business environment did not meet expectations. The macroeconomic situation, financial risks and political stability were considered to be negative or very negative (figure A.10).

Figure A. 10. Key determinants of FDI in 2000



Source: UNCTAD survey.
Note: Ranking: 1 = negative; 5 = very positive.

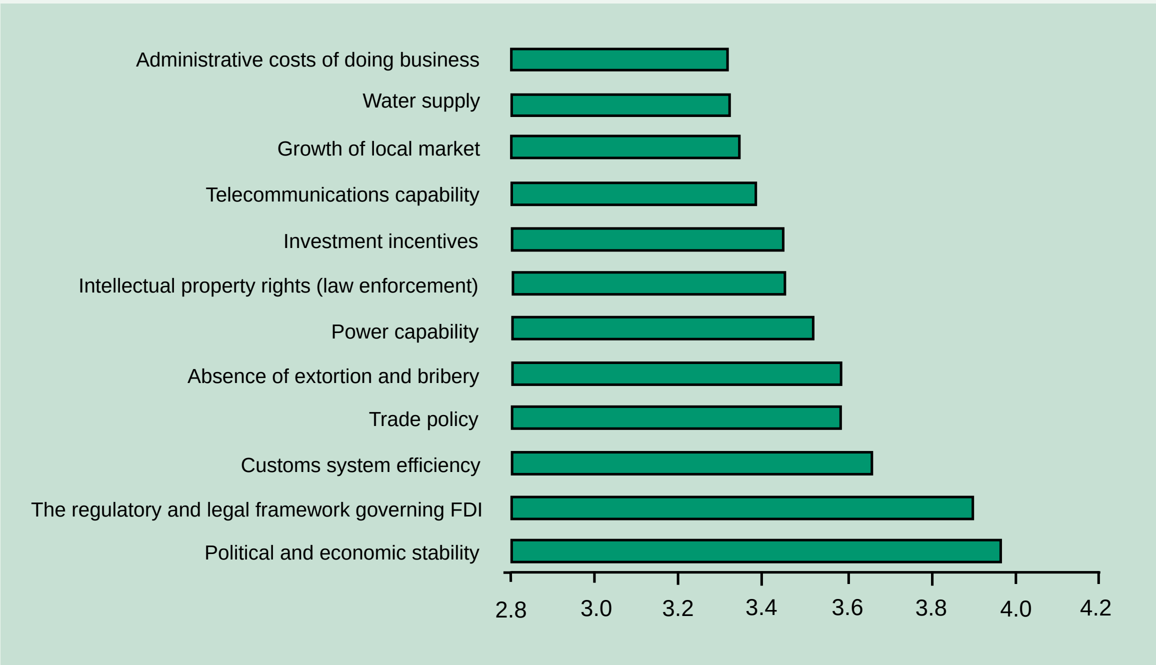
The survey was conducted during the second and third quater of 2000, wich is after the major political and economic crisis is generally thought to have abated. Nevertheless, political, economic and financial risks were still perceived to be very significant.

Annex B. Assessing Ecuador as an investment location: survey of potential foreign investors

In order to assist Ecuador in promoting FDI, UNCTAD conducted also a survey of potential foreign investors, that is firms which do not operate in Ecuador. The survey was conducted in 2000. 50 firms participated. The methodology was similar to that of the survey of foreign affiliates, although questions were not identical.

The first set of questions concerned factors potential foreign investors considered as important if they were to invest in Latin America. Potential investors held that, the primary considerations dealt with political and economic stability. The second most important consideration dealt with the regulatory and legal framework governing FDI. Results also show that firms consider many factors important to making an FDI decision, including policy matters (trade, intellectual property and incentives) as well as administrative efficiency (customs, corruption) and infrastructural issues.

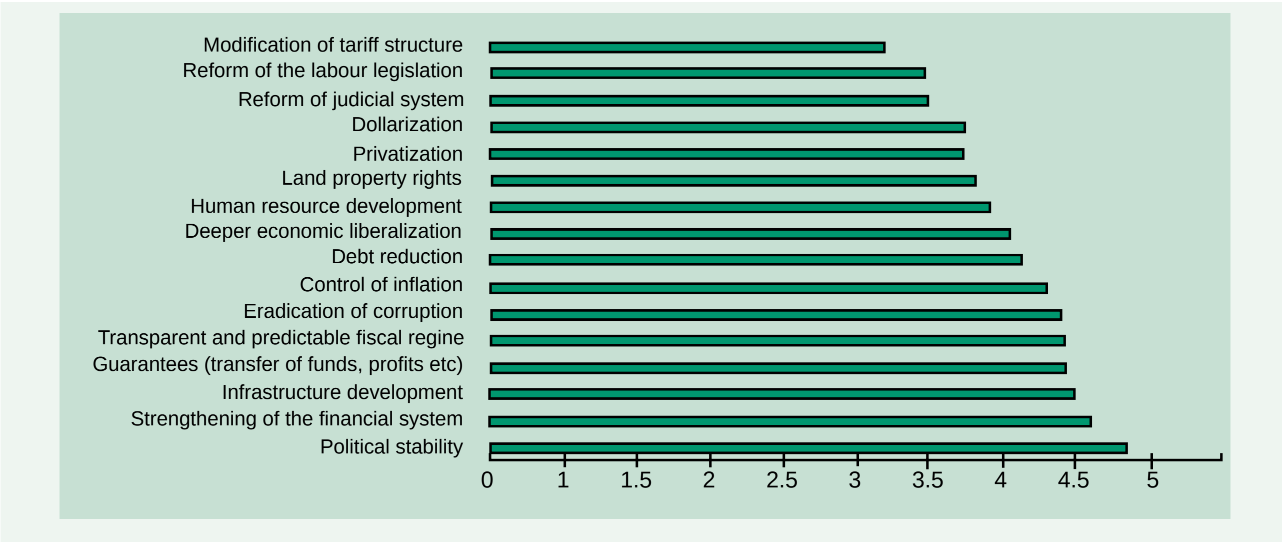
Figure B. 1. Latin America: the importance of factors influencing investment decisions



Source: UNCTAD survey.
Note: Ranking: 1 = not important; 5 = very important.

The importance business people attach to political stability was demonstrated again when the survey asked what factors would contribute most to the recovery of investment levels in Ecuador (figure B.2).

Figure B.2. Ecuador: factors contributing to the recovery in investment

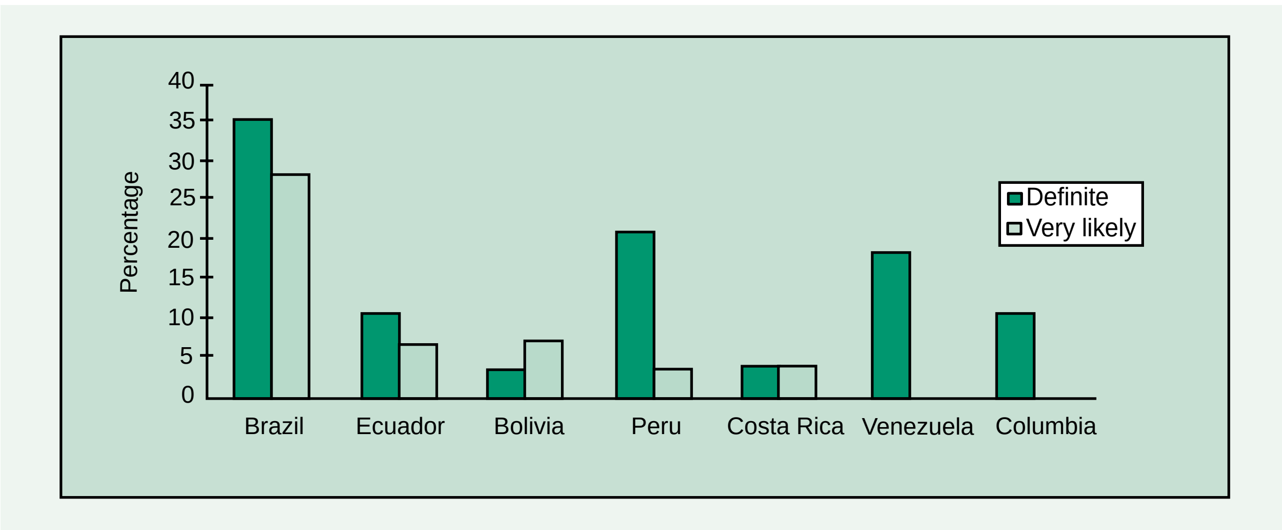


Source: UNCTAD survey
Note: Ranking: 1 = not important; 5 = very important.

When respondents were asked to assess investment opportunities open to them in selected Latin American countries, Brazil - the largest Latin American market - which in 1999 attracted over $30 billion in FDI, was the outright winner. Interestingly, Ecuador scored quite highly compared with many of its regional counterparts, particularly as regards definite investment opportunities (figure B.3). In part, this may reflect the fact that the privatization programme in Ecuador was about to be launched in 2000, while its neighbours have already implemented or advanced such programmes. It also indicates that business people are seeing investment opportunities in Ecuador, for example, in the petroleum industry.

Figure B.3. Assessment of investment opportunities in selected Latin American countries

(Percentage)*



Source: UNCTAD survey.

* Percentage of respondents indicating a selected country as a very likely or definite location for investment opportunity. Definite means that the company planned an investment project at the time of the survey.

Figure B.4 shows the types of support that foreign investors are likely to expect from Ecuadorian authorities, should they consider investing there. The results affirm the importance of developing the country's infrastructure, as they do the importance of having an agency whose responsibility it is to provide potential investors with general country information. Fiscal incentives are also high on the list of things that the authorities should provide.

Figure B. 4. Type of support expected from Ecuador by foreign investors

Percentage)*

Source: UNCTAD survey.

* Percentage of respondents indicating the type of support as very or extremely important on a scale of 1 to 5 where 5 = extremely important and 4 = very important. Respondents were not restricted in their choices.

Annex C. Ecuador's strengths and weaknesses in attracting FDI according to local firms

In November 1999, UNCTAD held two workshops in Ecuador: one with members of the Quito Chambers of Commerce where 8 business persons took part; the other with members of the Guayaquil Chambers of Commerce with 9 participants. There were three main objectives of these workshops:

1. To ascertain the participants' perceptions of Ecuador's strengths and opportunities in terms of its attractiveness to foreign investors.
2. To examine weaknesses and threats the country faces in its efforts to attract more FDI.
3. To identify the changes that should be made to Ecuador's present policies.

It is important to note that the results of the two surveys are not directly comparable because the exercise used SWOT analysis (strengths, weaknesses, opportunities and threats), which gives participants the freedom to suggest responses to questions like: "what are Ecuador's advantages?", "what obstacles does the country face?" and "what could be improved?".

Once a list of responses had been prepared, the participants were asked to rank them in order of importance for attracting FDI on a scale of 1 to 5, where the ratings meant:

1 = not at all important

2 = somewhat important

3 = of medium importance

4 = important

5 = very important

Ecuador's top ten strengths and opportunities as perceived by participants in Quito and Guayaquil workshops are shown in table C.1. Overlap between factors that the Quito and Guayaquil Chambers of Commerce identified as representing strengths or opportunities for Ecuador's efforts to attract FDI include a significant natural resource base, a climate favourable for agriculture and agribusiness and great potential for tourism development. The two groups also concurred that problems in the financial services industry including banking represent an FDI opportunity (figure C.1).

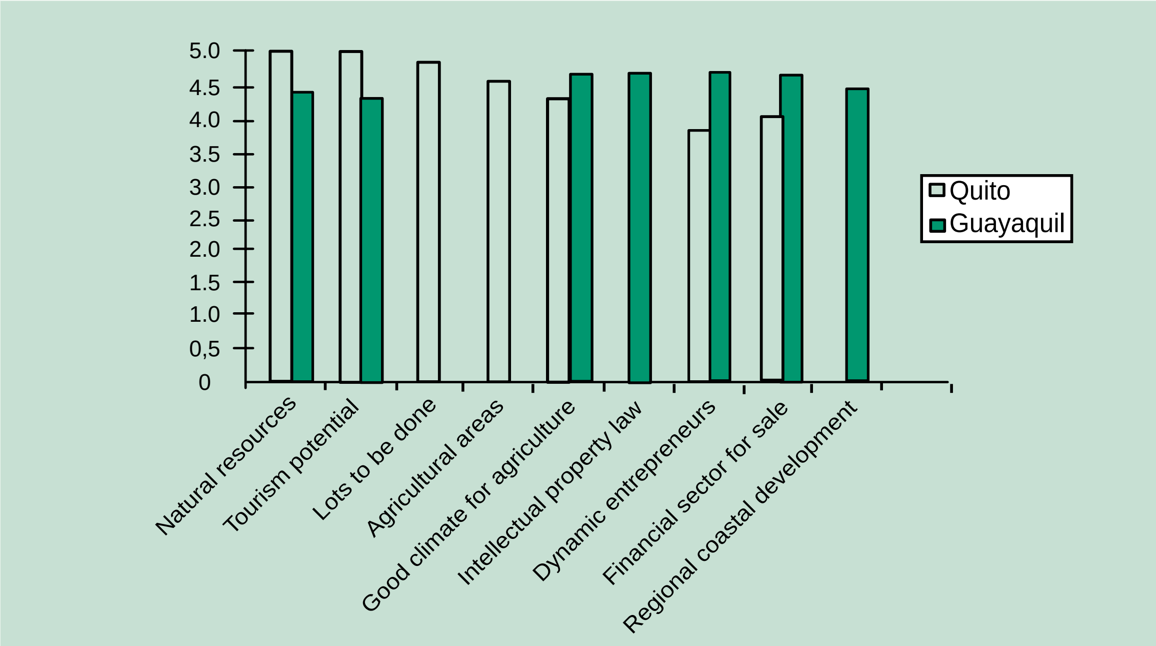
Table C.1. Ecuador's top ten strengths and opportunities in attracting FDI

Responses	Rank
A. Quito Chamber of Commerce	
Low level of natural resource development	5.0
High potential for tourism	5.0
Almost everything has to be done	4.8
Agricultural areas are ready to be developed	4.5
The climate is propitious for agribusiness	4.3
Public resources for investment are scarce	4.3
Human resources are inexpensive and responsive to training	4.0
Ecuador occupies a strategic position, close to regional markets	4.0
The legal framework is favourable to foreign investors	4.0
The banking system needs to be restructured	4.0
B. Guayaquil Chamber of Commerce	
Intellectual property law gives more confidence to FDI	4.6
The entrepreneurial sector is dynamic	4.6
The financial sector is for sale	4.6
The climate is favourable for all agricultural crops	4.6
Regional coastal developments, such as Santa Elena peninsula	4.4
The country's natural resources imply great potential	4.4
The potential for ecotourism	4.4
Relations between the business sector and the labour force are good	4.2
There is potential for tourism development	4.2
There is huge potential for maquila in all sectors	4.2

Source: UNCTAD survey.

There are some striking differences between the factors that the two workshops cited as being important. For instance, the Quito Chamber of Commerce did not mention the intellectual property law that its Guayaquil counterpart ranked as being a very important factor in attracting FDI. This is important for pharmaceutical and software firms, and demonstrates the need for FDI policy makers to listen to the views of businesses also outside of the capital. On the other hand, Quito respondents mentioned the country's workforce as a factor likely to attract FDI while those from Guayaquil emphasized the dynamism of the entrepreneurial sector. The former see also considerable opportunity in the fact that "almost everything has to be done".

Figure C.1. Ecuador's key strengths and opportunities *



Source: UNCTAD survey.
* Rank 1 to 5.

As regards the main weaknesses and threats, both Quito and Guayaquil business participants tend to accent them more heavily than they do the country's strengths and opportunities by giving the former much higher ratings (table C.2). In addition, differences are much greater than in the case of strengths. There are several factors that the Quito workshop saw as deterring foreign investors, but the Guayaquil workshop did not even consider, and vice-versa. There was a greater emphasis on political shortcomings in the Quito workshop and a greater concern about social issues and obstacles to business in the Guayaquil workshop reflecting perhaps differences between the two cities' main functions.

Quito is the highland administrative capital, while Guayaquil is the coastal main port and commercial centre where most economic activities are located. Traditionally, Ecuadorean policies have been strongly affected by regionalist pressures.

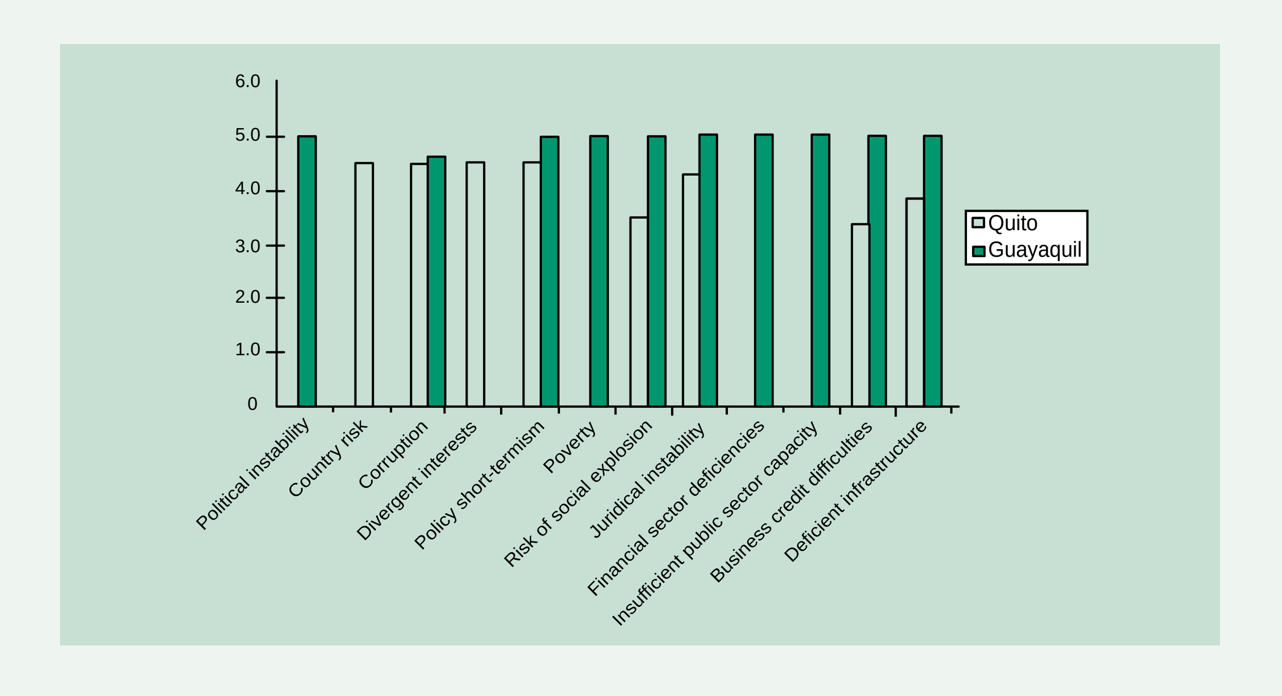
Negative factors that were mentioned in both workshops ranged from the risk of social explosion through juridical instability to "short –termism" in policy, deficient infrastructure and corruption (figure C.2).

Table C.2. Ecuador's top ten weaknesses and threats in attracting FDI

Responses	Rank
A. Quito Chamber of Commerce	
Political instability	5.0
Country risk	4.5
Corruption	4.5
The divergence of interests between the political class and civil society	4.5
Short-term orientation in making and implementing decisions	4.5
Poor external country image	4.5
No continuity in policies	4.3
The risk of hyperinflation	4.3
The slowness of the privatization process	4.3
Juridical instability	4.3
B. Guayaquil Chamber of Commerce	
Poverty	5.0
Risk of social explosion	5.0
Juridical instability	5.0
Short-term perspective in macroeconomic policy	5.0
Deficient financial sector	5.0
Insufficient public sector capacity	5.0
Difficult for business to obtain credit	5.0
Deficient infrastructure	5.0
Fragmented production chain	4.8
Anti-democratic culture in several sectors	4.8

Source: UNCTAD survey.

Figure C.2. Ecuador's key weaknesses and threats*



Source: UNCTAD survey.
* Rank 1 to 5.

Many of the workshop results corroborate the findings of the foreign investors' surveys conducted by UNCTAD for this study. This appears particularly true concerning the conditions that foreign investors and local businesses perceive to be important for doing business in Ecuador. Political instability, the poor state of the country's infrastructure and general country risk (particularly related to the financial health of the country's banks and businesses, as well as macroeconomic difficulties) figure prominently in both domestic and foreign business perceptions. However, one major difference seems to be that foreign investors are more concerned with market size and market access than the local businesses who participated in the workshops. Ecuador's potential as a strategic location for regional markets was mentioned only once in the workshops as a factor likely to attract investment; in the survey of international business, however, nearly all respondents offered comments on Ecuador's relatively limited market size and/or its potential as a regional base for serving other markets.

The proposals that the two workshops put forward for future actions to attract FDI into Ecuador give a strong sense that efforts hinge on creating more opportunities for private business – whether local or foreign. Suggestions like accelerating the privatisation program, strengthening private participation in infrastructure development or simply letting the private sector initiate change, speak strongly to this end (table C.3). The participants in both workshops also felt that what needs to be done to attract foreign investment is for the authorities to create the right conditions for business in general. This entails, for instance, creating a stable environment in which businesses can make their own decisions without fear that the conditions around them will change dramatically or unpredictably.

On the other hand, despite the fact that both workshops identified threats including a divergence of interests between the country's political class and civil society or the risk of social explosion, proposals for action overlooked the need to incorporate the views of those Ecuadorians who do not necessarily welcome greater private enterprise and foreign investment.

Table C. 3. Proposals for future actions

Responses	Rank
A. Quito Chamber of Commerce	
Design a national agenda with at least a minimum consensus	5.0
Implement a stable macroeconomic policy consistent with long-term targets	5.0
Implement a 10-year strategic economic development plan	4.8
Let the private sector initiate changes	4.5
Agree on a national investment promotion strategy	4.5
Accelerate the privatization process	4.5
Implement a campaign to improve the country's image abroad	4.5
Reform the social security system to eliminate state monopoly	4.3
Strengthen the productive sector	4.3
Define and implement a national training program	4.0
B. Guayaquil Chamber of Commerce	
Strengthen the productive sector	5.0
Conduct a study of foreign investors' expectations in Ecuador	5.0
Select 4-5 sectors likely to boost the domestic economy and promote them	5.0
Strengthen private participation in infrastructure development	5.0
Implement a campaign to improve the country's image abroad	5.0
Directly approach potential foreign investors	5.0
Develop projects in the tourism sector	4.8
Prepare an analysis of the country's attractiveness to FDI	4.8
Develop training programs	4.6
Define a new macroeconomic model	4.6

Source: UNCTAD survey.

It is also noteworthy that proposals by local businesses indicate the need for FDI promotion activities (the need for strategy, targeting investors and image building) and the analysis of foreign investors' expectations in Ecuador or the country's attractiveness to FDI.

Selected UNCTAD publications on transnational corporations and foreign direct investment

A. Individual studies

World Investment Report 2000: Cross-border Mergers and Acquisitions and Development. 368 p. Sales No. E.99.II.D.20. $45.

World Investment Report 2000: Cross-border Mergers and Acquisitions and Development. An Overview. 75 p. Free-of-charge.

International Investment Instruments: A Compendium, vol. IV, 319 p. Sales No. E.00.II.D.13. $55, vol.V, 505 p. Sales No. E.00.II.D.14. $55.

FDI Determinants and TNCs Strategies: The Case of Brazil. 195 p. Sales No. E.00.II.D.2, $35.

World Investment Report 1999: Foreign Direct Investment and the Challenge of Development. 536 p. Sales No. E.99.II.D.3. $45.

World Investment Report 1999: Foreign Direct Investment and Challenge of Development. An Overview. 75 p. Free-of-charge.

Investment Policy Review of Peru. 101 p. Sales No. 00.11.D.7

Investment Policy Review of Uganda. 75 p. Sales No. E.99.II.D.24. $15.

Investment Policy Review of Egypt. 113 p. Sales No. E.99.II.D.20. $19.

Science, Technology and Innovation Policy Review of Colombia. 175 p. Sales No. E.99.II.D.13. $23.

Foreign Direct Invesment in Africa: Performance and Potential. 89 p. UNCTAD/ITE/IIT/Misc. 15.

Investment Policy Review of Uzbekistan. 64 p. UNCTAD/ITE/IIP/Misc. 13. Free-of-charge.

The Financial Crisis in Asia and Foreign Direct Investment: An Assessment. 101 p. Sales No. GV.E.98.0.29. $20.

Science, Technology and Innovation Policy Review of Jamaica. 172 p. Sales No. E.98.II.D.7. $42.

World Investment Report 1998: Trends and Determinants. 430 p. Sales No. E.98.II.D.5. $45.

World Investment Report 1998: Trends and Determinants. An Overview. 67 p. Free-of-charge.

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Handbook on Foreign Direct Investment by Small and Medium-sized Enterprises: Lessons from Asia. 200 p. Sales No. E.98.II.D.4. $48.

Handbook on Foreign Direct Investment by Small and Medium-sized Enterprises: Lessons from Asia. Executive Summary and Report on the Kunming Conference. 74 p. Free-of-charge.

International Investment Towards the Year 2002. 166 p. Sales No. GV.E.98.0.15. $29. (Joint publication with Invest in France Mission and Arthur Andersen, in collaboration with DATAR.) 200 p. Sales No. E.98.II.D.4. $48

Handbook on Foreign Direct Investment by Small and Medium-sized Enterprises: Lessons from Asia. Executive Summary and Report on the Kunming Conference. 74 p. Free-of-charge.

International Investment Towards the Year 2002. 166 p. Sales No. GV.E.98.0.15. $29. (Joint publication with Invest in France Mission and Arthur Andersen, in collaboration with DATAR.)
World Investment Report 1997: Transnational Corporations, Market Structure and Competition Policy. 420 p. Sales No. E.97.II.D.10. $45.

World Investment Report 1997: Transnational Corporations, Market Structure and Competition Policy. An Overview. 70 p. Free-of-charge.

International Investment Towards the Year 2001. 81 p. Sales No. GV.E.97.0.5. $35. (Joint publication with Invest in France Mission and Arthur Andersen, in collaboration with DATAR.)

World Investment Directory. Vol. VI: West Asia 1996. 192 p. Sales No. E.97.II.A.2. $35.

World Investment Directory. Vol. V: Africa 1996. 508 p. Sales No. E.97.II.A.1. $75.

Sharing Asia's Dynamism: Asian Direct Investment in the European Union. 192 p. Sales No. E.97.II.D.1. $26.

Transnational Corporations and World Development. 656 p. ISBN 0-415-08560-8 (hardback), 0-415-08561-6 (paperback). £65 (hardback), £20.00 (paperback). (Published by International Thomson Business Press on behalf of UNCTAD.)

Companies without Borders: Transnational Corporations in the 1990s. 224 p. ISBN 0-415-12526-X. £47.50. (Published by International Thomson Business Press on behalf of UNCTAD.)

The New Globalism and Developing Countries. 336 p. ISBN 92-808-0944-X. $25. (Published by United Nations University Press.)

Investing in Asia's Dynamism: European Union Direct Investment in Asia. 124 p. ISBN 92-827-7675-1. ECU 14. (Joint publication with the European Commission.)

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World Investment Report 1995: Transnational Corporations and Competitiveness. 491 p. Sales No. E.95.II.A.9. $45.

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Small and Medium-sized Transnational Corporations: Role, Impact and Policy Implications. 242 p. Sales No. E.93.II.A.15. $35.

World Investment Report 1993: Transnational Corporations and Integrated International Production. 290 p. Sales No. E.93.II.A.14. $45.

World Investment Report 1993: Transnational Corporations and Integrated International Production. An Executive Summary. 31 p. ST/CTC/159. Free-of-charge.

Foreign Investment and Trade Linkages in Developing Countries. 108 p. Sales No. E.93.II.A.12. $18.

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