Summary

INVESTMENT POLICY REVIEW

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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), liberalised 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 chapter I of the Report shows, 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. By 1999 it received 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, railroads 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 modernising 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 March 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 modernisation 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. It should deal with the issues of burden-sharing of adjustment costs and protecting the poorest, and broaden the distribution of gains from reforms and increased FDI to benefit all groups, including indigenous people. 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 realisation 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 important. 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 academia 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 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, including through the setting up of an investment promotion unit (IPU). Based on the best practices of other investment promotion agencies, CORPEI promotional activities should focus on policy advocacy (e.g. championing improvements in the investment climate), disseminating information about the reform programme and recent changes in the investment framework aimed at attracting FDI. Investment generation activities should focus on 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.