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WTO Trade Policy Review:

Ecuador*

Note: This text provides brief description of the conditions foreign business will encounter in trade with Ecuador. It is based on a WTO Trade Policy Review for Ecuador, mid November 2011. Readers wishing for deeper analysis should turn to the original Trade Policy Review available on the WTO website. (www.wto.org/english/tratop_e/tpr_e/tp354_e.htm)

Trade Policy Reviews are an exercise, mandated in the WTO agreements, in which member countries' trade and related policies are examined and evaluated at regular intervals.

• ECONOMIC ENVIRONMENT

Ecuador is a small, fairly open, "dollarized" economy, very much dependent on oil revenue (for 14% 20% of GDP, more than half of export earnings and 20% 30% of government revenues). Thus, the economy remains vulnerable to external shocks, including the recent global economic downturn that began in 2008 and resulted in a slowdown in growth due in large part to the sharp reduction in oil export prices and volumes, which was compounded by a sharp drop in expatriates' remittances, the second most important source of foreign currency. However, Ecuador weathered the crisis well, and growth rebounded to 3.6% in 2010; it is predicted to be 5.1% in 2011, mainly due to higher prices for oil exports and a strong rebound in domestic demand, especially public investment in infrastructure projects. As a result of "dollarization", inflation has remained relatively low. During the period under review, urban unemployment fell from 9.3% to 6.1%. Human development improved and there has been a slight fall in income inequality. On the other hand, Ecuador's productivity is such that it is ranked among the world's least competitive economies.

With Ecuador's "dollarized" monetary regime constraining macroeconomic policy options in responding to external shocks, the burden has fallen mainly on fiscal policy. Ac-

ordingly, Ecuador's fiscal deficit rose sharply to 5.1% of GDP in 2009, largely due to the drop in revenues from oil exports, increased energy subsidies, and high public investment in strategic infrastructure projects, health, education, and social welfare, to correct long overdue investment in these areas and pave the way to sustainable growth. As a result of the increased fiscal deficit, national saving was insufficient to finance gross domestic investment. The consequent saving investment gap was reflected in Ecuador's current account, which shifted from a surplus to a small deficit in 2009 and a larger deficit, of 3.3% GDP, in 2010. The Government responded by restricting certain imports through safeguard measures from 22 January 2009 to 23 July 2010.

The EU remains Ecuador's main non oil export market, and the United States its main supplier. From 2009, FDI inflows dropped considerably, mainly as a result of the increasingly uncertain investment climate owing to major policy and constitutional changes. A wide ranging Organic Code of Production, Trade and Investment, passed in 2010, streamlined the legal framework governing, inter alia, foreign direct investment, which now provides for national treatment to foreign investors under certain conditions and additional guarantees involving investment contracts. The FDI regime remains, in principle non discriminatory, except for investment in "strategic" sectors and certain other areas (e.g. fisheries, media, extractive activities, and maritime transport) representing about 50% of GDP, where the Government retains certain exclusive rights.

• TRADE POLICY FRAMEWORK

Ecuador is in the process of thoroughly redesigning its economic and social development strategy, with a view to, inter alia, diversifying the economy and making it more inclusive. During the period under review, it undertook major constitutional amendments and related institutional changes, with potentially far reaching implications for the roles of trade and FDI in this strategy. These constitutional amendments provide for, inter alia, greater state involvement in, and/or control of, "strategic" sectors of the economy and envisage an increasingly inward looking trade regime, with greater emphasis, for example, on certain pre defined priority sectors and some selective import substitution activities. The 2008 Constitution has frequently been the source of litigation, controversy and investor concern in numerous areas, both at home and abroad, possibly to the detriment of FDI. Ways to enhance total factor productiv-

* Extracted from WTO Secretariat Report on Trade Policy Review Ecuador

ity, and thereby improve Ecuador's international competitiveness, as well as product and market diversification have also become important features of economic policy.

Despite new constitutional provisions focused on regionalism, Ecuador, a beneficiary of WTO trade related technical assistance, recognizes that multilateral trade rules provide a certain degree of security and predictability, and used WTO Dispute Settlement procedures to defend its trade interests during the period under review. Its regional integration objectives have increasingly been based more on political or social criteria rather than conventional economic priorities. Following a recent pragmatic policy shift, Ecuador envisages concluding its trade negotiations with the EU without further delay, and negotiating more comprehensive agreements for development covering several policy areas rather than just trade. Such agreements are now being negotiated (for example with Turkey) or explored (for example, China, Korea (Rep. of), Gulf Cooperation Council countries, and EFTA).

New legislation was passed in several trade and trade-related areas (e.g. production, trade, investment, government procurement, SPS, hydrocarbons, mining), but no comprehensive regulatory reform has been undertaken to streamline or simplify the existing legal framework consisting of different types of national legal instruments, and several Andean Community regulations (e.g. on customs valuation, reference prices, rules of origin, contingency measures, standards, SPS, competition policy, intellectual property rights). As comprehensive legislation implementing constitutional and institutional changes is in the process of being passed or implemented, no evaluation of their impact is available at present. Streamlining business creation, investment, and customs clearance procedures has been a priority.

Action has been taken to improve and institutionalize transparency, and consequently fight corruption, a concern and a challenge in Ecuador. Despite some improvement since its last TPR, Ecuador's WTO notification record has been characterized by irregular submissions or long periods without submission in several areas; improved notifications are envisaged with the technical support of the WTO Secretariat.

• TRADE POLICY DEVELOPMENTS

The tariff remains one of Ecuador's main trade policy

instruments and an important source of tax revenue (13.3% of total tax revenue). As a result of customs tariff reforms (including the adoption of the HS 2007 tariff nomenclature) and changes in the type, level, and distribution of duty rates, the average applied MFN tariff rate dropped from 11.4% in 2005 to 9.3% in 2011. Whereas the average applied MFN tariff for industrial imports dropped from 10.6% to 7.6%, that for agricultural products rose from 16.7% to 19.6%. Some 53.5% of applied MFN tariff rates are currently in the range of zero to 5%, up from 38.7% in 2005. Peak ad valorem rates (affecting meat offal, rice, and milk and milk cream) remained unchanged. The structure of tariff rates has become more complex and dispersed with the increase in the number of ad valorem rates, and the adoption of compound duties; the tariff now involves 17 ad valorem, and 10 compound rates. Some 95% of tariff rates are ad valorem, which contributes to the transparency of the tariff. On the other hand, ad valorem equivalents of non ad valorem rates, which in general tend to conceal relatively high tariff rates, were not available. The fact that all tariff lines are bound imparts a high degree of predictability to the tariff. However, the simple average of bound MFN rates (21%) is considerably higher than the average applied MFN rate (9.3%), providing the authorities with substantial scope for increasing applied MFN tariff rates within bindings, as was the case during the review period. Furthermore, 19 ten digit lines exceed the bound rates by 5 to 15 percentage points, a problem to be corrected upon completion of the HS 2002 transposition of binding commitments, hopefully this year. The use of compound rates on items bound on an ad valorem basis, and the non submission of their ad valorem equivalents (AVEs) casts doubt on whether these rates are within their binding levels.

Computerized customs clearance and other modernization efforts were undertaken to facilitate trade by, inter alia, reducing physical inspections, and instead focusing on import risk assessment; the pre shipment inspection regime was eliminated as of 2008. Imports have been subject to a so called "redeemable quota" (until end 2010), a contribution to the Children's Development Fund, and a tax on foreign exchange flight, all levied on ad valorem basis.

Import prohibitions and restrictions affect numerous items but slightly less than in 2005; they apply mainly for human, animal or plant life or health, the environment, safety, or security reasons. In addition to institutional changes in the area of standards, new mandatory conformity assessment requirements, consisting of test reports and certificates of conformity for industrial products

were introduced in 2007. The share of national standards that are identical to international standards stands at 3.6%. No new mutual recognition agreements (MRAs), a trade facilitation measure, were signed during the review period; some of the few existing MRAs expired and were not renewed. New legislation was passed to ensure more flexible and user friendly management of the entire Codex Alimentarius legislation, and to regulate biotechnology.

A safeguard measure against imports of windshields other than those from developing countries except for Colombia (September 2010), and safeguard measures for balance of payments purposes were taken during the review period, in the form of quantitative restrictions and tariff surcharges.

Major legislative, procedural and institutional changes were implemented in 2008 with a view to improving the transparency and efficiency of Ecuador's public procurement regime; as from 2009, all government controlled companies have been subject to the new rules. New online procurement procedures were introduced, but special procedures continue to be used most often; open calls for tendering are the second most frequently used procurement method. Emphasis was placed on using government procurement as an instrument of industrial policy, and a series of preferences for local suppliers, depending on local content and company size, were adopted.

To ensure domestic supplies and encourage domestic processing, temporary export prohibitions (on rice) and quantitative restrictions (on exports of waste and scrap of certain ferrous and non ferrous metals) are being used; temporary export surveillance also affects leather and furs. Exports of bananas and coffee remain subject to industry levies; exports (and production) of banana and plantains, cocoa, coffee, shrimp, and fish products continue to be subject to minimum reference or support prices paid to producers by buyers. Ecuador has maintained drawbacks, maquila (until 2010), free zones (until 2010), and a special economic development zone (as from 2010) that offer various tax concessions, including exemptions from income tax.

To promote investment in domestic production activities for various purposes, in December 2010 three classes of tax incentives (general, sectoral, for depressed areas), including income tax holidays, were introduced for new investment in priority and selected import substitution

sectors, as well as for small and medium sized enterprises; non tax incentives, involving concessional loans and grants, are also available. Domestically produced milk and canned tuna, scad, sardine, and trout remain subject to a zero rate of value added tax (IVA), which is largely collected on imports; corrective action is envisaged when revising other tax related matters.

Several articles of the 2008 Constitution restrict competition by favouring state control or intervention in strategic activities, thereby reversing past limited privatization efforts. As a result, state involvement in the production and trade of certain goods and services remains significant and in certain areas (e.g. mining, pharmaceuticals) is being strengthened. Public enterprises benefit from the same tax free status available to public sector bodies, which includes income tax exemption and zero rating for IVA (i.e. reimbursement of taxes levied on the purchase of local or imported inputs of goods and services). As from 2007, Ecuador intensified price controls for several sensitive consumer items, fuels, and public utilities; implementing this policy required the use of subsidies. Action was also taken to improve consumer protection.

Legislation on protection of intellectual property rights was reinforced under the 2008 Constitution, particularly relating to ancestral knowledge and biodiversity, and is undergoing substantial reform. Registration procedures and enforcement action were also improved. Despite intentions to issue compulsory licences for numerous pharmaceuticals and agrichemicals, only one such licence has been issued (April 2010) so far.

• **SECTORAL POLICY DEVELOPMENTS**

Despite its relatively modest contribution to GDP (6.6%), agriculture (including fisheries) accounts for about a third of employment, so that labour productivity in the sector is roughly one sixth of the level in the rest of the economy. At the same time, compared to other sectors, agriculture is a major recipient of budgetary assistance in the form of preferential loans for training, technology transfer, crop diversification, and infrastructure projects. The average applied MFN tariff rate for the sector has increased, while such protection in manufacturing has been reduced. Certain agricultural products remain subject to peak tariff rates and variable import levies under the Andean Community's price band system applied to agricultural items originating in non Andean Community coun-

tries. Tariff rate quotas tied to domestic absorption requirements for 17 agricultural items have not been used because of lower applied MFN rates and increases in the world prices of the items concerned. No special safeguard measures were used during the period under review. Ecuador remains the world's largest banana exporter and a leading producer; the signing of the Geneva Agreement on Trade in Bananas (May 2010) improved its export prospects to the EU market.

New mining and hydrocarbons laws changed the nature of contracts with private sector companies (from shareholders to services providers), thereby requiring the renegotiation or termination of these contracts. Hydrocarbons, one of several "strategic" sectors, remains a key activity, accounting for more than half of merchandise exports despite the sharp decline of its contribution to GDP; two state firms remain the dominant players in all hydrocarbons operations. Despite being an important oil exporter, Ecuador's import dependency on refined products has increased, but action is being taken to expand its refining capacity. Refined oil prices are subsidized at a considerable budgetary cost. State control and involvement in mining, another "strategic" sector, was increased by, inter alia, creating a national mining company; the required quota on the number of Ecuadorian workers was reduced. Reforms were undertaken to improve the efficiency of state firms' operations in the electricity market, which is dominated by a government controlled enterprise and remains import dependent in periods of drought. Electricity tariffs are cross subsidized.

The manufacturing sector plays a relatively modest role in the economy and in merchandise exports. While the average MFN tariff rate applied to the sector has declined, the redistribution of rates has resulted in more pronounced tariff escalation. Budgetary assistance for manufacturing remains low. A programme under the Automotive Policy of the Andean Community remained in place during the period under review; a support programme for replacing aging public transport vehicles was also implemented, and tariff protection for passenger motor vehicles was reinforced.

The services sector is by far the largest contributor to GDP accounting for 56.5% in 2010. Ecuador's limited GATS commitments remain unchanged. Some access limitations on foreign investment and other restrictions apply to basic telecommunications, radio services, maritime transport, and airports. The State maintains a dominant position in fixed line telecoms, another "strategic"

sector; price caps for telecom services are in place. Cabotage and transportation of hydrocarbons are reserved to vessels flying the Ecuadorian flag, and transportation of hydrocarbons to a state owned firm; preferential kerosene prices are reserved for aircraft registered in Ecuador. Tax incentives for new tourism projects were suspended in 2010.

• OUTLOOK

Ecuador's economic growth is expected to remain relatively strong, albeit vulnerable to external economic shocks. Nonetheless, its long term prosperity depends on its success in improving the total factor productivity of its enterprises and thus their international competitiveness, and thereby diversify its economy. It remains to be seen whether Ecuador's unorthodox policies, such as state intervention and selective import substitution, together with regional trade liberalization are the most effective means to accomplish its economic and social objectives. A stable, predictable, and transparent trade and trade-related legal and institutional framework could be the key to success.