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Ecuador : Potential Policies for the Future

Abstract

In 1531 Spanish explorers embarked from Peru and landed in what is now modern day Ecuador. Peru was "the richest of the New World prizes won for the Spanish crown" (Ecuador, 1991), but the Spanish wanted to find more colonies to plunder. Drunk with tales of great riches in Ecuador, King Charles I of Spain decided to send an explorer by the name of Francisco Pizarro to investigate. Pizarro and his men killed thousands of Inca tribesmen; they also looted and pillaged everything that they could find. By the early 1540s, the whole of what is now Ecuador was under Spanish control.

Ecuador: Potential Policies for the Future

Jeremy Cunningham

The body of this paper will consist of the following three parts: an introduction, a progress report, and a set of policy recommendations. The introduction will introduce the history of Ecuador. The progress report will be devoted to painting an accurate picture of modern day Ecuador. Current policies will be addressed as well as current economic and social indicators. The third section of this report is concerned with policy suggestions for Ecuador to follow in order to develop at a stable pace.

I. INTRODUCTION

In 1531 Spanish explorers embarked from Peru and landed in what is now modern day Ecuador. Peru was "the richest of the New World prizes won for the Spanish crown" (*Ecuador*, 1991), but the Spanish wanted to find more colonies to plunder. Drunk with tales of great riches in Ecuador, King Charles I of Spain decided to send an explorer by the name of Francisco Pizzaro to investigate. Pizzaro and his men killed thousands of Inca tribesmen; they also looted and pillaged everything that they could find. By the early 1540s, the whole of what is now Ecuador was under Spanish control.

The Spanish government established a feudal system that placed the Spanish as the elite land owners and the natives as the working class. A system known as *mita* was established. Under this system, "all able-bodied free Indians were required to devote one year of their labor to some public or private Spanish concern" (*Ecuador*, 1991). These Indians were paid so poorly that they incurred large debts to their employers in order to survive. The Indians were not allowed to leave the *mita* until all the debts were paid, so

many Indians were forced to work for years to pay back their debts. Effectively, this was slavery. There were "real" slaves in Ecuador at this time, but to own them was far more expensive than using *mita* labor.

When Napoleon deposed King Ferdinand of Spain and placed Joseph Bonaparte on the throne, many Spanish colonies in South America protested. In 1809, the first rebellions started in Ecuador. These early rebellions were savagely put down by Bonaparte's forces. Over the next 13 years Ecuador struggled for independence. Little success was had by the poorly trained and equipped Ecuadorian rebels until the early 1820s. It was at that time that the two great armies of Bolivar and San Martin were systematically emancipating various Spanish colonies. Bolivar from Venezuela and San Martin from Argentina aided the Ecuadorians in their struggles for independence. On May 24, 1822, Ecuador had its sovereignty.

The history of free Ecuador has been anything but tranquil since that day in 1822. There have been 86 different governments in control since 1822, and there have been 17 different constitutions drawn up. There have been periods of extreme economic boom and times of great hardship. Border disputes and the occasional armed coup have added to the turmoil that has engulfed Ecuador over the last 174 years.

II. MODERN-DAY ECUADOR

A. Economics

The Ecuadorian economy faces three problems that seem ubiquitous in developing countries around the globe. These are chronic inflation, an often devalued currency, and monstrous international debt. It is difficult to

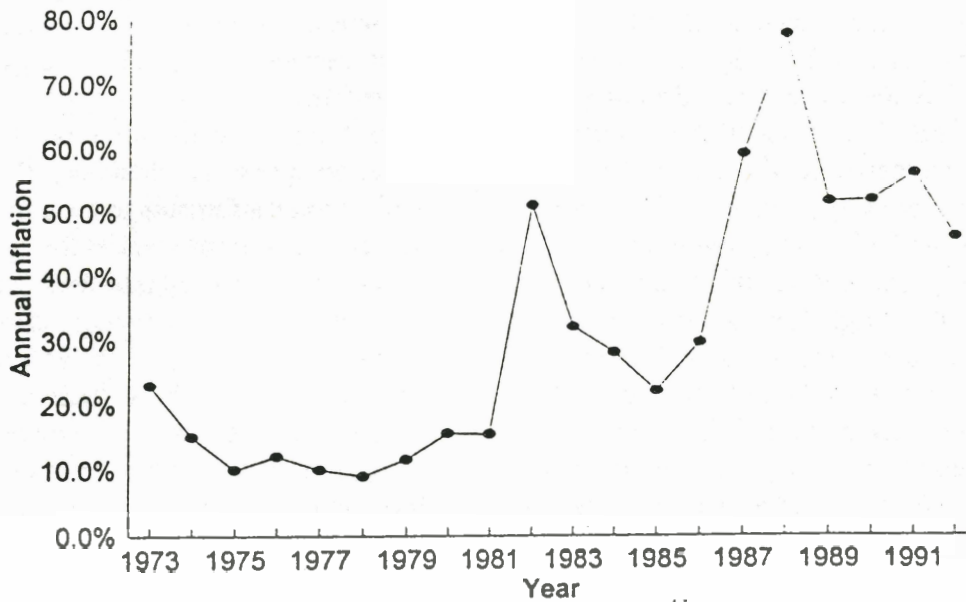


Figure 1: Annual Inflation

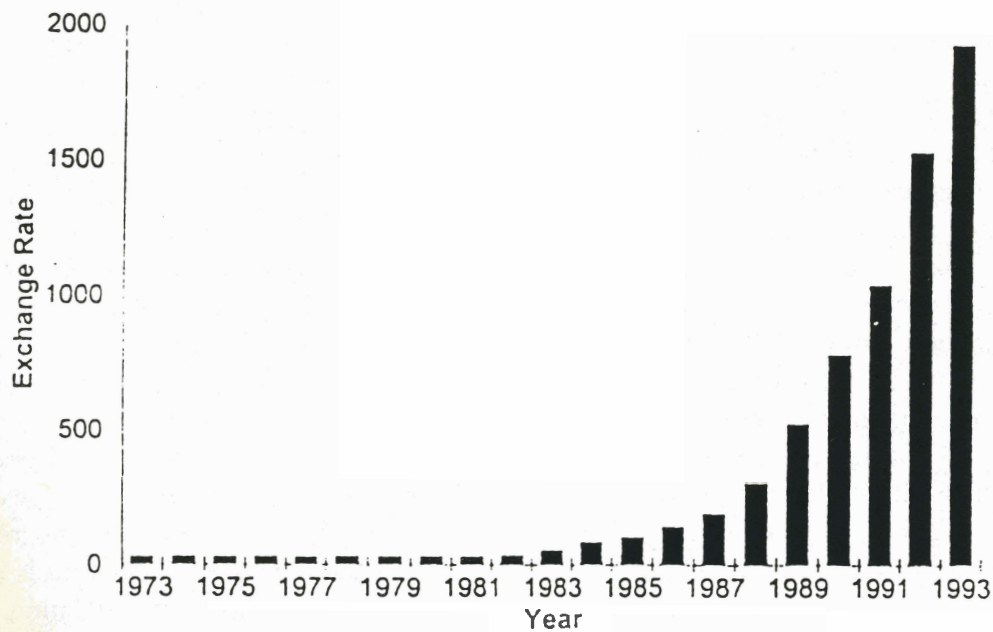


Figure 2: Annual Sucre / Dollar Exchange Rate

say which causes the other, but they are definitely related. Inflation averaged 47.5% between 1984 and 1994 (*World Development Report*, 1996). To make matters worse, the rise in inflation has not been marked by steady gains, but by violent shifts. Figure 1 shows the wild ride that the Ecuadorian economy has endured. Figure 2 shows how the Ecuadorian sucre has compared to the US dollar since 1973. The sucre was pegged at 25 per dollar for most of the 1970s. The government could afford to peg and defend the sucre because Ecuador had enough foreign currency from profitable oil sales on the world market to fight off any speculation. When the price of oil fell in the 1980s, Ecuador found itself no longer able to defend its currency and was forced to devalue it. What followed was a series of devaluations. For a period in the 1980s, the Ecuadorian government abandoned having a fixed exchange rate all together. This caused the value of the sucre to drop even further and helped inflation reach nearly 80 percent (see Figure 1). While all of this was happening, Ecuador was doing its part to add to the debt crisis of the 1980s. In the 1970s and early 1980s, Ecuador had borrowed heavily from around the world. Ecuador, like several developing countries, was using some of its money for capital investment and some for current spending. Though the lenders were unhappy about this, it was hard for the Ecuadorian government to justify building and buying capital and infrastructure while its population was hungry. Before the aforementioned drop in oil prices hit in 1986, 14% of Ecuador's entire GNP was from oil sales (*Ecuador*, 1991). Oil accounted for over 60% of all of Ecuador's exports (*Ecuador*, 1991). In 1987, after the price drop and despite an increase in production, oil was only 8% of GNP. This loss in export revenue, coupled with skyrocketing world inflation that forced the interest rates to rise on Ecuador's international loans, caused the net present value of their external debt to be 50% of the

entire GNP in 1986 (*World Tables*, 1995). This problem has only gotten worse over time because Ecuador continues to be basically a monocrop economy with half of its export revenue coming from oil (*Ecuador*, 1991). As debt service grew, oil prices fell, and the government continued to devalue the currency. This further fed the inflation monster. As inflation grew in Ecuador, foreign goods looked more affordable to the common citizen. When Ecuadorians wanted foreign goods, the Ecuadorian government had to buy these foreign goods with foreign currency. The increase in demand for foreign currency and decrease in demand for the Ecuadorian sucre caused the "real" price (the market price that would prevail if the sucre were not pegged) of the sucre to decrease. Since the sucre was pegged, it could not fall right away, but the foreign currency reserves of Ecuador were decreased in order to defend its currency. Eventually, Ecuador had to devalue its currency because it could not fight the market forever. This caused increased inflation, higher international debt, and the vicious circle continued.

By the early 1990s, Ecuador's government decided to try to stop this downward spiral and control inflation by once again pegging the sucre to the dollar. They adopted what is called a crawling peg. This means that the devaluations are planned and in small increments. The Ecuadorian government understood that they could not defend the sucre for a very long period of time, otherwise the entire crisis of the 1980s would reoccur. While the current devaluations are still painful, they are not nearly as lethal as the devaluations of the 1980s. The government is not spending huge sums of foreign reserves on defending the sucre; the central government simply devalues soon after it is apparent that a devaluation is needed. This causes inflation, but it is planned and stable inflation. With a more stable economy, the Ecuadorian government has started to tighten money

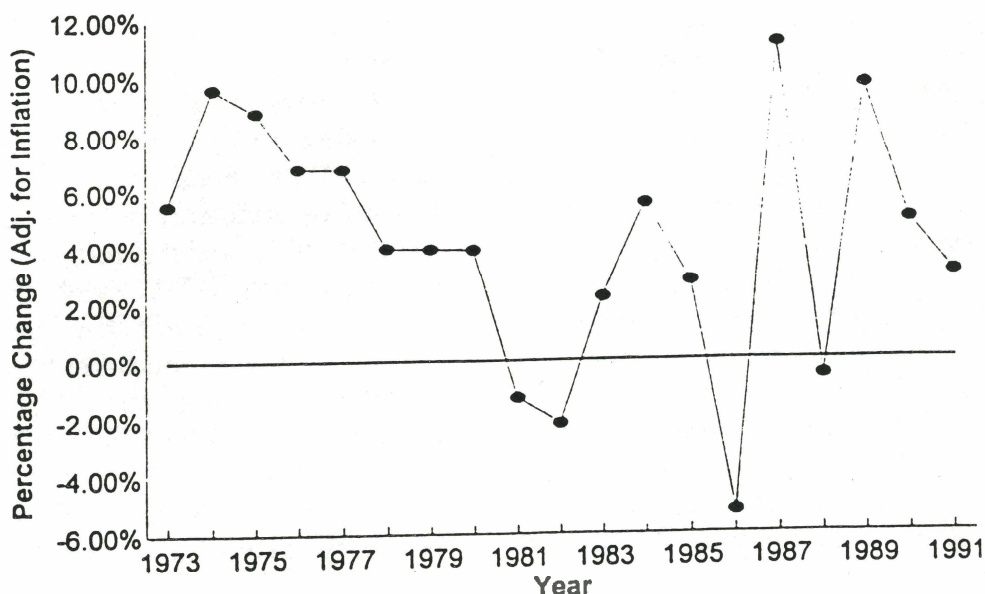


Figure 3: Annual Percent Change in GNP

supply and reign in inflation (see the last 3 years on Figure 1). The hope is that with more controllable inflation, the “real” value of the sucre will stabilize and the international debt will diminish. Ecuador has also restructured its loans so that debt servicing is not such a burden on the economy. Debt servicing fell from 35% of exports in 1980 to 22% in 1994 (*World Development Report*, 1996). It is far too early to tell if these policies will work, but they appear to be successful in the short run.

Of course there are other economic problems facing Ecuador. Ecuador needs to diversify in order to grow. As stated earlier, Ecuador is basically a monocrop economy. Oil fueled the growth up to this point, but this sole dependence on oil has created several problems and has taken Ecuador as far as one crop can take a country. The economic mix of the GNP in Ecuador has changed little since the boom days of the early 1980s. In Ecuador, agriculture accounted for 12% of GNP in both 1980 and 1994. Industry, with the

manufacturing subset in parentheses, was 38% (18%) in 1980 and, similarly, 38% (21%) in 1994 (*World Development Report*, 1996). More industry must be developed and less dependence on oil must transpire for stable growth to occur. Not that GNP has declined. Overall the GNP is higher now than it was 20 years ago. The problem is that the last 20 years have been marred by violent swings in the GNP, as shown in Figure 3. With this much volatility, it was impossible for anyone in the Ecuadorian government to accurately plan for the future.

To end this section on an upbeat note, the government of Ecuador by 1994 has managed to balance its budget. It has increased the amount of non-tax revenue from .6 billion dollars in 1980 to 2.0 billion dollars in 1994 (*World Development Report*, 1996). The government of Ecuador has also increased capital expenditures by over 50% from 1980 to 1994 (*World Development Report*, 1996). This will help the country industrialize more and reduce Ecuador’s dependence on oil.

B. Social Issues

The social problems that Ecuador faces stem mainly from the current economic instability and the past political turmoil. Some of the problems that face Ecuador are health care, sanitation, education, and distribution of wealth discrepancies.

Until very recently health care was mostly limited to people in the cities. People in the country had to travel long distances to receive treatment for even the most minor problems. This was such a problem because as recently as 1980 52% of Ecuador's population lived in rural areas (*World Development Report*, 1996). Only in the last 15 years has Ecuador been able to establish clinics in its rural regions. The government has established a four tier health care system. The lowest levels are in the countryside and are only equipped for minor emergencies, immunizations, and other family practice type procedures. The higher the tier, the larger the facility and the more complicated the procedures that occur there. The benefits of improved health care are already visible in certain areas. The infant mortality rate has dropped 45% from 67 deaths per 1000 in 1980 to 37 deaths per 1000 in 1994 (*World Development Report*, 1996). Concerning other social measures, Ecuador understands that old adage "an ounce of prevention is worth a pound of cure." The Ecuadorian government knows that if its population has access to clean water and good sanitation then people will not be as sick and will not have to visit the government-sponsored clinics as much. Access to sanitation rose from 43% of the population in 1980 to 54% in 1994 (*World Development Report*, 1996).

One area where the government is grossly lacking is the area of population control. Between 1990 and 1994 Ecuador experienced an annual population growth rate of 2.2% (*World Development Report*, 1996). This means that the population will double in just 32 years. This is one of the highest growth

rates in all of Latin America. While researching several sources, not a single mention of public policy concerning population control was found. Ecuador must get this problem under control soon.

Another societal success in Ecuador is the fact that the Ecuadorian government has established mandatory primary education for all of its citizens and that roughly half of all of the population of Ecuador goes on to secondary school (*World Development Report*, 1996). This solid education has resulted in only 9% of the males and 12% of the females being illiterate as of 1995 (*World Development Report*, 1996).

Though distribution of wealth might technically be an economic issue, it reflects on the development of society. In Ecuador, 5.4% of the income went to the lowest fifth, 8.9 going to the next fifth, 13.2 goes to the middle fifth, 19.9 to the fourth 20%, while 52.6 of the income goes to the rest. This gives a Gini coefficient of 46.6. With over half the wealth going to only 20% of the population and no clear middle class defined, it is obvious that Ecuador has not yet reached the apex of Kuznet's inverted U. More needs to be done to share the wealth of Ecuador.

III. POLICY RECOMMENDATIONS

The most obvious recommendation that could be made to Ecuador would be to diversify. Ecuador is a monocrop economy, which makes the entire country a slave to the international price of oil. Industrialization and the development of linkages to primary products are the keys for improving the economic situation of Ecuador. This would ease the pain during periods of low oil prices in the world. Oil income would be considered more transitory and would not be depended on so heavily. This extra, hopefully more stable income from industry would help ease all three of the major economic problems facing Ecuador that were mentioned earlier: inflation,

weak currency, and international debt.

If industries were established that had a comparative advantage to other countries in the world then the Ecuadorian products would be sought on the global markets. Along with the increase in demand for Ecuadorian products would be the increase in demand for the sucre. This higher demand would make it much easier for the country to defend its currency. In time, Ecuador might even be able let the market establish the exchange rate. The government would not have to constantly sell foreign currency to artificially inflate the value of the sucre; its (the sucre's) value would naturally rise. For foreign companies to buy sucres, they must pay in hard currencies such as the US dollar, the German mark, British pound, etc. This helps the debt because Ecuador would now have the foreign currency needed to whittle away at that huge international debt. With a smaller debt comes smaller debt service; this means that more money can go back into capital expenditures or can be spent on social programs. Programs such as better sanitation, more accessible drinking water, better-funded health care, and more education would be natural consequences of the added revenue. Hopefully the problem of unequal income distribution would lessen due to the overall increase in GNP. The Fei-Ranis two-sector growth model theorizes that in the early stage of a country's industrial development there is a pool of labor surplus this is attracted from rural areas to cities by marginally higher wages. The only people really profiting from this are the elite classes that own the factories. As the surplus labor pool empties and industry expands, the demand for labor increases and the price paid for labor increases. As more and more people move away from agriculture and mineral production to work in the cities, the demand for rural and mineral labor increases and so does the wage paid to the rural and mineral labor. If labor is making more, the elite classes would be making less.

Therefore, income distribution becomes more equal, and the Gini coefficient improves.

This information looks great on paper, but how is Ecuador supposed to achieve this in the real world? By following the example of the Japanese, Ecuador may achieve its goals. The Japanese used a government-controlled, export-led growth. This means that Ecuador must find an industry that it can establish a comparative advantage in. An industry that utilizes the strengths of the country and compliments the existing economy. At this time, the Ecuadorian government would subsidize these industries so as to make them more competitive on the world market. These subsidies should not come easily to the budding Ecuadorian industry. These industries must prove that they are achieving their goal of becoming competitive on the world market. The government must have the self discipline to pull the subsidies if the industry is not performing up to standard. Basically, the company must either succeed or die. Another problem is the following: how is Ecuador going to pay for the huge initial start up fees associated with industry? Japan had the luxury of a high national savings rate. Ecuador does not have a very high savings rate, therefore this is not a viable option. Ecuador could borrow, but it does not want to go any further in international debt. Ecuador could try to attract Foreign Direct Investment (FDI), but given Ecuador's record of political and economic instability it is unlikely that many companies would flock to Ecuador in the near future. The Ecuadorian government could try to receive foreign aid that is earmarked for industrialization. This would be great, but Ecuador would be naïve to depend too heavily on "free" money. Unfortunately, an international loan is probably the only way to receive enough foreign currency to buy the needed capital.

A potential industry for Ecuador to explore would be plastics. Most plastics are made from petroleum. Everything from

frisbees to artificial hearts is created from various plastics. Ecuador would already have the petroleum and could import the capital it needed to convert oil into plastic. Ecuador might want to start on the low end of the market (e.g. frisbees) and gradually try to break into the high end (e.g. artificial hearts). This would have several advantages for Ecuador. Ecuador could buy used equipment from other countries. This would be less expensive, thus not as much would have to be borrowed. Also, the older the equipment is, the more labor-intensive it probably is. This benefits Ecuador because the demand for labor would rise, causing wages to rise.

While the industry is young and not very efficient, tariffs could be placed on whatever plastic products Ecuadorian industry produces. This would protect the new industry from foreign competition because the prices of the foreign plastic products would be artificially raised above the price of the domestic plastic products. The country would also benefit from the added revenue from the tariffs. Low or non-existent tariffs would be placed on whatever inputs are needed for the plastic industry, so as not to hamper the efforts of the new industry. The revenue that could have been made by having tariffs on the inputs would hopefully be offset by quicker industrialization of the country. Despite the tariffs this is definitely an export-led growth strategy, not an import-substitution strategy. The tariffs are only there to raise a little revenue and give the industries a break in the domestic market. These tariffs would only be temporary, with a definite ending time. The

exact ending date is crucial because industries in developing countries come to rely too heavily on the protection given by tariffs. The new domestic companies never become efficient enough to compete on the world markets, yet are profitable at home because of tariffs. If the Ecuadorian never became competitive in the world, then the goal of export-led development would be thwarted.

Despite all of the pitfalls that come with trying to industrialize, Ecuador can and must continue to strive forward. With good management and a little good fortune, Ecuador can emerge from its economic quagmire.

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Jeremy Cunningham ('97) graduated in December with a major in Business and is interested in international business. He wrote this paper for Dr. Lowry's class, The Economics of Developing Countries.
