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2002: POLITICAL UNCERTAINTIES, SLOWDOWN

Economic growth slowed in 2002. According to the Central Bank of Ecuador, using newly revised national accounts in US dollars, GDP grew 3.3 per cent in 2002 down from 5.1 per cent in 2001. The slowdown was a result of an electoral race that was unpredictable until the last minute, and world growth. Despite this, the stability afforded by dollarisation contributed to brisk personal consumption growth (3.8 per cent). End-of-year inflation fell to 9.4 per cent, the first time a single digit rate has been achieved in over 20 years. The differential with international inflation led to a real exchange rate appreciation of 8.1 per cent, adding to the accumulated appreciation of previous years and placing the economy at a disadvantage on world markets. The financial system has begun to stabilise although interest rates remain high (14.9 per cent). Investment, fuelled by the on-schedule construction of the new Oleoducto de Crudos Pesados (OCP) pipeline, which will transport oil to the Pacific, was the highest contributor to GDP growth. The project also contributed most of the FDI flows into Ecuador in 2002, financing 85 per cent of the high US$1.4 billion current account deficit. The sound fiscal management in 2000–01 went off track in 2002 despite the surplus posted. The government increased current spending over budgeted levels, which played against an agreement that was being sought with International Monetary Fund. The inability to obtain financing forced the government to leave significant bills unpaid in 2003.

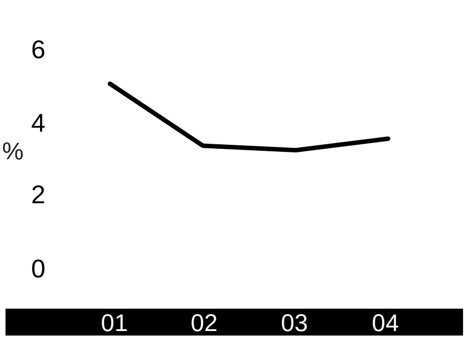
Gross fixed investment grew by 12.8 per cent, only partially reflecting the new oil pipeline. Business confidence remained high in the first semester of 2002, leading to important business investments. This pace of investment took the ratio of investment to GDP to 23.3 per cent, well above that which prevailed before the 1999 crisis.

Private consumption, which accounts for almost 70 per cent of GDP, grew 3.9 per cent and accounted for 75 per cent of the GDP growth. The appreciation of the real exchange rate continued to encourage imports, which grew 13.2 per cent in 2002. Imports were also influenced by the imports related to the construction of the oil pipeline. Meanwhile, real exports fell 0.8 per cent as a result of lower oil output, and were not offset by the prevailing high prices for most export commodities.

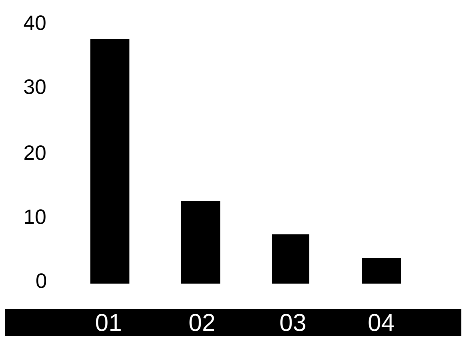
The trade balance posted a deficit of 4.4 per cent of GDP or US$1 billion. Unrequited transfers (mostly workers' remittances) fell slightly but remained above US$1.5 billion in 2002. Yet they were not enough to offset a US$1.8 billion deficit in the service balance. The current account deficit more than doubled in 2002 reaching US$1.4 billion or 5.9 per cent of GDP. The deficit was counterbalanced by net private capital inflows of US$534 million and US$1.2 billion or 5 per cent of GDP in direct investment.

In 2002, the government sought an IMF program that never materialised. Policy slippages and over-budget spending prevented an agreement.

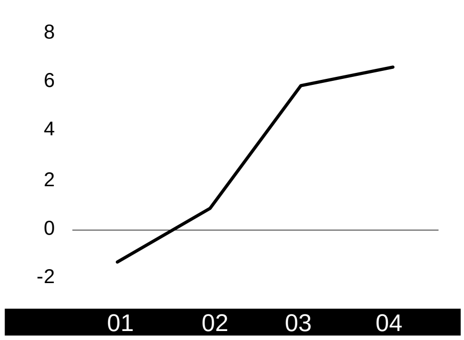
GDP growth



CPI inflation



Export growth



Nonetheless, the government passed a fiscal responsibility law that establishes spending growth rules and a host of norms to stabilise fiscal accounts in the medium term. It also installed an oil fund that will use the revenue windfalls from the new oil pipeline to establish a debt repayment and stabilisation fund.

2003–04: GROWTH RECOVERY

The slow pace of economic activity should continue in 2003, with more upside than downside risks. The forecast period 2004–05 in contrast presents better prospects for strong growth. The economy will be pushed by high world oil prices. Low international interest rates will alleviate balance of payments and fiscal pressures. Meanwhile, the new oil pipeline will afford higher export revenues as output expands.

GDP is projected to grow 3.3 per cent in 2003. Although the new administration got off to a fast start by reaching an agreement with IMF within a month of taking office, it must carry out politically tough reforms. The new government is a coalition of inexperienced former military officials and indigenous groups that do not share a clear policy line, despite the very leftist campaign. Additionally, the government coalition only holds 12 seats in the 100-member legislature.

The operation of the dollarisation regime will continue to provide a stable business environment. End-of-year consumer inflation is projected to fall to about 6.7 per cent in 2003. Adding this decline to an expected weaker dollar should keep the rate of appreciation of the real exchange rate under 3 per cent. One issue though is the relatively rapid rise in prices of non-traded goods.

Consumption growth will fuel most of the economic expansion in 2003. Although investment should still be an important contributor, the conclusion of the construction of the oil pipeline will slow the high investment of 2002.

A large fiscal surplus will be required in 2003. As part of a new adjustment program under the IMF's umbrella, the non-financial public sector needs a surplus of 1.9 per cent of GDP. The new government is trying to pay off bills inherited from the previous administration equivalent to about 1.2 per cent of GDP while also meeting bulky financing requirements. It is an open question whether the government will be able to achieve such a large surplus in the face of public demands for higher social spending, many of which stem from President Gutierrez's campaign promises. The government, however, will benefit from the expected continued solid performance of the Internal Revenue Service (SRI), which set new landmarks in tax collection in 2000–02. Tax revenue reached 19.2 per cent of GDP in 2002, up from 16.5 per cent in 2001 and an average 14.8 per cent during the 1990s. The government will also benefit from the expected high oil prices.

General confidence problems in the financial sector will continue to keep interest rates high in 2003. Average lending rates will probably only fall to about 13.4 per cent from 14.9 per cent in 2002. Banks are utilising the spread (of *about* 1000 basis points) to recapitalise according to the stricter Basel standards being phased in and to set aside reserves because they fear the absence of a lender of last resort.

The rate of import growth should decline significantly in 2003 (to single digit growth) with the end of imports related to the construction of the oil pipeline. FDI related to the pipeline will also tail-off. High oil prices and the beginning of operations of the new pipeline, as well as continued growth of non-traditional exports, should strengthen export revenue. Overall, the current account deficit should decline slightly from 5.9 per cent of GDP in 2002 to about 4.4 per cent in 2003.

RISKS

The most worrisome short-term economic risk continues to be high indebtedness. A 52 per cent ratio of public debt to GDP looms over this dollarised economy, even though the interest bill does not present a high risk because of low international interest rates. Additionally, non-oil economic activity is straining to cope with the accumulated appreciation. The lost competitiveness of domestic industry is compounded by many of the recessionary IMF-sponsored economic policies. These industries may be at risk of attrition and could compromise stability in the medium term.

Finally, the unclear positions of indigenous leaders within the government coalition, many of whom have expressed their opposition to dollarisation, pose a threat to the current monetary system. Any regime change would cause a severe deterioration of the projected growth rate.

Tradable good prices and inflation

The overall inflation rate has been driven by falling tradeable goods prices. Inflation of non-traded goods prices has not fallen.