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Extraordinary *comparative advantage* and long-run growth: *the case of Ecuador*

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The authors are Economic Affairs Officers of the ECLAC Economic Development Division, stationed in Santiago, Chile and the ECLAC Subregional Headquarters in Mexico, respectively.

The objective of this article is to describe how the transformation of the trade and industrialization regime is taking place in Ecuador and what are the systemic factors which condition the realization of this transformation. A long-run perspective of economic policy and growth in Ecuador (considering the whole of the twentieth century) reveals that growth has been relatively fast compared to other countries in the region, with exports as the driving force of that growth. The disturbing fact is that these exports have been dominated by a few booming export products at different points in time, and that growth has therefore shown a distinct stop-go nature. Corporate behaviour would seem to be characterized by rent-seeking, as natural economic rents have been present at several moments in history. This study develops the hypothesis that one of the above-mentioned systemic factors is the country's unstable growth, which can partly be attributed to the existence of extraordinary comparative advantages, and the effects of export booms and busts under different policy regimes are highlighted in this connection. The overall conclusion is that the import-substitution policy created a manufacturing industry that was hardly competitive, mainly because it replaced the economic rents from windfall profits with policy-induced economic rents. In the concluding section the outlines of a policy approach that could minimize the existence of such rents are discussed.

I

Introduction

Ecuador, like most Latin American countries, experienced one of the severest economic crises in the 1980s, with mounting inflation and negative per capita growth, and this crisis led to a major shift in economic policies. Likewise, in Ecuador, just as in most of the other countries of the region, there is a growing conviction that the import-substitution industrialization strategy must be dismantled and that there must be a reorientation toward a more outward-looking development strategy. This change of policy orientation is clear when one looks at the programmes of the two former administrations and the present government, but the programmes adopted, whether of a more orthodox or heterodox nature, have failed because of natural disasters or systemic political and economic factors. The objective of this article is to describe how this transformation of the trade and industrialization regime is taking place in Ecuador and what are the systemic factors which condition its realization. This study develops the hypothesis that one of these systemic factors is the country's unstable growth, which can partly be attributed to the existence of extraordinary comparative advantages, and the effects of export booms and busts under different policy regimes are shown.

Policy approaches in Ecuador aimed at diversifying the export base and hence improving the stability of economic growth have a long-standing tradition but show frustratingly few successes. Only, perhaps, during the heyday of the oil boom, in the mid-1970s, can any noteworthy upsurge in non-traditional exports be observed. This –perhaps surprisingly– makes the 1973–1978 period, together with the years of the Second World War, the only moments when the well-known “Dutch Disease” effects are least visible in the performance of other tradeables. But this development was also related to rent-seeking behaviour, as different policy instruments were developed to channel oil rents to the manufacturing industry. The collapse in the early 1980s proved this export drive based on oil rents to be unsustainable.

A long-run perspective of economic policy and growth in Ecuador (considering the whole of the twentieth century) reveals that growth has been relatively fast compared with other countries in the re-

gion, with exports as the driving force of that growth. The disturbing fact is that export performance has been dominated by a few booming export products at different points in time, so that growth has therefore shown a distinct stop-go nature. Corporate behaviour would seem to be characterized by rent-seeking, as natural economic rents have been present at several moments in history.

The various approaches seem to be closing a circle: the essentially “laissez-faire” regime of the beginning of the century was abandoned during the Great Depression of the thirties, and the subsequent interventionist import-substitution strategy began to be dismantled during the debt crisis of the eighties. The debate is now about whether the unrestricted working of market forces will lead the country to a better performance, or if a different policy approach should be designed and what this should entail.

It is not clear why the dismantling of interventionist policies would achieve by itself high and stable growth. The country continues to depend on exports based on significant natural advantages, which renders long-run growth unstable and leads to what has been called “ultra-biased” growth. There are strong reasons to support the dismantling of most import-substitution policies, as there are also strong reasons to suggest that a different type of intervention in the market mechanisms is called for. The lessons to be drawn from the Ecuadorian policy approaches may shed light on the contours of a new strategy, a main feature of which should be how to avoid rent-seeking behaviour among manufacturing enterprises.

This article develops the argument in a descriptive, chronological way. In section II the problem of unstable growth is shown through time-series permitting an international comparison covering most of the twentieth century. Section III puts forward the hypothesis that this problem can be attributed to the presence of extraordinary comparative advantages that lead to “Dutch Disease” effects.

Section IV refers to long-run time series on exports and real effective exchange rates to show the effects of export booms and busts under different policy regimes. Three observations are crucial for the

argument: one is that an export boom under a *laissez-faire* regime in effect hinders the development of other tradeables; the second is that an export bust leads to changes in the policy regime; and the third is that the import-substitution policy designed to alter the effects of the export boom succeeded in stimulating the upsurge of other tradeables, but failed to provide a sustainable base for the diversification of exports and the stabilization of growth.

Mainly in order to explain the third observation, section V analyses in some detail the policy ap-

proaches adopted, while section VI deals with the behaviour of firms in different stages of the boom-and-bust cycle. The overall conclusion is that the import-substitution policy created a manufacturing industry that was hardly competitive, mainly because it replaced the economic rents from windfall profits with policy-induced economic rents. In the concluding section (section VII) the outlines of a policy approach that minimizes the existence of such rents are discussed and the final conclusions of the study are presented.

II

The basic problem: Instability of long-run economic growth and productivity

The 1900-1989 period has been subdivided, as shown in tables 1 and 2, in order to permit international comparisons (Maddison, 1986 and 1991; Hofman, 1993a). In the case of a specific country these benchmarks obviously function as a straitjacket, and we will therefore give the appropriate phases for the Ecuadorian case, when appropriate. However, it should be noted that our phases do in fact fit in rather well with Ecuador's economic development (Benalcázar, 1989 and Hofman, 1994).

The first years of the twentieth century show fast growth in Ecuador, propelled mainly by cocoa exports (especially between 1908 and 1914) (Moncada, 1991 and Salgado, 1989). In the phase from 1914 until 1924 growth was relatively slow, due, among other things, to the First World War and the decrease in cocoa exports. In the second half of the 1920s growth rates improved following institutional reform (creation of the Central Bank) and policies aimed at development and export promotion (Drake, 1984; Rodríguez, 1987, and Marchán Romero (ed.), 1987).

The "Great Depression" finished off this promising phase and led Ecuador, together with Latin America and the rest of the world, into a period of recession. We have divided this period into two subperiods -1929-1938 and 1938-1950- as these two subperiods show quite different results on a world scale. The first subperiod, 1929-1938, showed worldwide deceleration of per capita growth. This panorama changed drastically during the 1938-1950

period, however, when the world experienced the disaster of the Second World War but Latin America remained relatively untouched, increased its exports and initiated an import-substitution industrialization process also induced by the unavailability of imports, thus increasing economic growth (Blomström and Meller, 1990; Abril-Ojeda, 1990).

The 1950-1989 per capita growth rates (table 1) indicate that growth accelerated in Ecuador and Latin America during the 1950-1980 period but suffered an extreme slowdown, even with negative per capita growth, in the 1980s. The picture is different for the Asian and advanced countries, which show much higher growth acceleration in 1950-1973, after which, however, the Asian countries increased growth a little further in 1973-1980 and again in 1980-1989, whereas growth in the advanced countries slackened abruptly in 1973-1980, speeding up again slightly in the 1980s.

Table 2 presents a comparison of the levels of per capita GDP with those of the United States for the 1900-1989 period.

It is thus clear that, comparatively speaking, Ecuador's growth record looks quite satisfactory. A closer scrutiny, however, reveals some important drawbacks. Figure 1 gives the annual per capita GDP growth data in constant dollars from 1940 to 1990. It can immediately be seen that the growth record is rather unstable. The average growth for the whole 50-year period amounts to 2.5% per year, but the standard deviation is 4.7%. In the 1940s, 1970s and

TABLE 1

Per capita gross domestic product, 1900-1989
(Annual average growth rates)

Country or region	1900-1913	1913-1929	1929-1950	1950-1973	1973-1980	1980-1989	1900-1989
Ecuador	2.5	1.6	2.0	2.9	3.3	-0.7	2.2
Latin America	1.9	1.6	1.7	2.5	2.3	-0.6	1.7
Asian countries	0.5	1.0	-0.6	4.8	5.4	5.9	2.3
Spain and Portugal	1.1	0.7	0.4	5.3	1.4	1.9	2.1
Industrialized countries	1.2	1.5	0.5	4.7	1.8	2.1	2.1
United States	2.0	1.7	1.5	2.2	1.0	2.2	1.8

Source: A. A. Hofman, 1993b.

TABLE 2

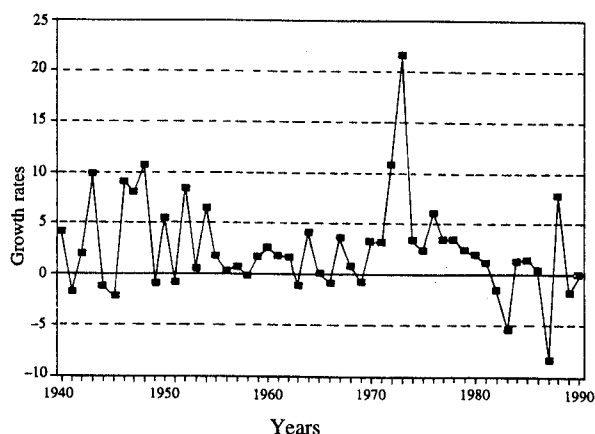
Per capita gross domestic product, 1900-1989
(United States = 100)

Country or region	1900	1913	1929	1950	1973	1980	1989
Ecuador	12	13	13	16	19	22	17
Latin America (average)	29	29	28	28	29	32	24
Asian countries	18	15	14	9	16	22	26
Spain and Portugal	34	31	28	21	41	42	40
Industrialized countries	60	54	51	43	68	71	70
United States	100	100	100	100	100	100	100

Source: A. A. Hofman, 1993b.

FIGURE 1

Ecuador: Per capita GDP growth rates, 1940-1990



1980s growth rates are either between 8% and 10% a year, or else are negative.

This unstable growth can be related to the country's export performance, as we will argue at a more theoretical level below. Total per capita exports in constant dollars over the same 50-year period show an average growth rate of over 7% a year, but with a standard deviation of 26%. In other words, growth rates per year were as high as 80% or even more, but they also fell to -20% or less.

Other flaws in Ecuador's rather favourable long-run growth performance relate to productivity growth, and specifically to the capital-intensity of that growth and the quality of labour. In a paper by Hofman (1993b), in which figures on labour productivity in Ecuador and other Latin American countries are presented, it is shown that Ecuador systematically registered significantly higher growth rates (except in 1929-1938) than the other countries of the region. In capital productivity the overall picture is somewhat different, as Ecuador had lower capital productivity growth over the 1950-1989 period than the average for Latin American countries. With respect to total factor productivity, Ecuador turned in a good performance, having the highest growth, together with Colombia. As regards labour inputs, however, the figures show that the growth rate of labour quality is far below the standards of other developing economies.

In sum, Ecuador's growth record in this century has been favourable in comparative terms, but shows problems of high instability. This seems to be due to the very unstable, but nevertheless dynamic, overall export performance. Other problems with Ecuador's growth performance are the capital-intensity of growth and the slow improvement in the quality of labour.

III

The hypothesis: "Dutch Disease" leads to unstable growth

Since *The Economist* coined the term "Dutch Disease", referring to the problems which arose in the Dutch economy as a consequence of the natural gas price hike following the first oil shock, it has mostly been associated with the situation in oil-exporting countries. Conceptually, though, it can be (and has been) applied to all kinds of major windfall profits accruing to an economy. In Bianchi and Nohara (1988), the concept of extraordinary comparative advantage is used as a substitute for the Dutch Disease and is applied to the historical development experience of Latin America, which it fits quite well. We will here follow their line of reasoning in order to identify the effects we will trace throughout the Ecuadorian development experience.

The main hypothesis is that the unbridled exploitation of economic rents creates distortions that favour both those sectors with extraordinary competitive advantages and the non-tradeable sectors, while precluding the production of other tradeables. This hypothesis is based on a static and a dynamic argument. The static argument is that an export boom brings about a change in relative prices in favour of a booming tradeable, with an impact similar to an across-the-board tax on other tradeables. This works as follows: the massive inflow of foreign exchange leads to a sharp increase in internal demand, which exerts inflationary pressure on non-tradeables, assuming that output growth in non-tradeable sectors will not be able to match the growth in demand. Strong public investment in non-tradeables (infrastructure, public services) exacerbates these inflationary pressures in the short run, as a significant time lag is involved before output increases. The prices of tradeables are held in check through increasing imports. Exchange rates will increase less than the domestic rate of inflation, and the real effective exchange rate appreciates. A loss of competitiveness results, precluding the growth of other tradeables and eroding the comparative advantage of the booming tradeable. The movement of the real effective ex-

change rate is thus pivotal in these mechanisms, and although they do not tell the whole story, the index of the real effective exchange rate will be used in the next chapter to show the incidence of the Dutch Disease effects.

The dynamic argument is that the exploitation of these rents leads to permanent distortions in product, capital and labour markets, in the nature of rent-seeking. Both arguments combined lead to the phenomenon of ultra-biased growth, characterized by virtually complete specialization in tradeables with extraordinary competitive advantage and in non-tradeables.

If export booms were permanent and the economy had no distortions, this specialization would scarcely matter for long-run growth. As it turns out, however, export booms are by nature transitory phenomena (although there can be a number of successive export booms), and their exploitation creates a number of distortions, for example on the capital market, where the private rate of discount will contain a rent-element. Since rent-seeking does not increase value-added (output), growth of production will show a downward trend over time, as capital formation is precluded. If we assume imperfections in the labour and land markets, then the process of the erosion of the export boom will be further accelerated, as a search for supra-competitive wages comes about, as well as a search for rents through the concentration of ownership rights. If we furthermore introduce into the argument the existence of international competition, which makes the exporting economy a price-taker on international markets, it becomes clear that economic rents dissipate and export-booms are, by their very nature, transitory phenomena. In theory, an optimal rate of domestic savings and asset accumulation would suffice to keep long-run growth up to potential, but in view of the above-mentioned imperfections it can be argued that capital accumulation will be restricted to the booming activity and will, in general terms, fall short of the rate required for optimal long-run growth. Thus, the resulting ultra-biased

growth is lower than long-run potential growth, and furthermore it is of a "stop-go" nature.

To be sure, policy intervention can alter the effect of temporary booms, but the question is whether there are arguments to make the case that policy interventions would lead to welfare improvement. It is theoretically possible, if we assume that economies

of scale, technological learning effects and the like externalities are greater in other tradeables than in the booming tradeables, that a policy-induced distortion of relative prices in favour of other tradeables can lead to higher long-run growth and welfare gains. It depends, however, on the type of instruments used and the way of implementing them.

IV

Export booms and busts

Long-run series in constant 1980 dollars have been constructed for exports, the real effective exchange rate¹, and GDP (Buitelaar and Hofman, 1993).² In the following paragraphs we will analyse three cycles of booms and busts. The first is the cocoa cycle, with a boom at the beginning of the twentieth century, followed by its collapse and diversification of exports during the 1920s. The Great Depression and the years of the Second World War cannot be seen as part of a particular Ecuadorian boom and bust cycle, and are therefore discussed in the cocoa section up to the end of the depression (1937), and in the next cycle from that year onward. This second cycle really started with the banana boom in the early 1950s and lasted until the beginning of the oil boom in the 1970s. The third (oil and debt) cycle continues until the present. In each of these subperiods we will analyse the results with respect to the product enjoying a boom and other exports which do not enjoy extraordinary comparative advantages.

1. The cocoa cycle

At the beginning of the twentieth century Ecuador experienced a period of rapid economic growth in which exports of cocoa were the dominant element. The boom before the First World War was further

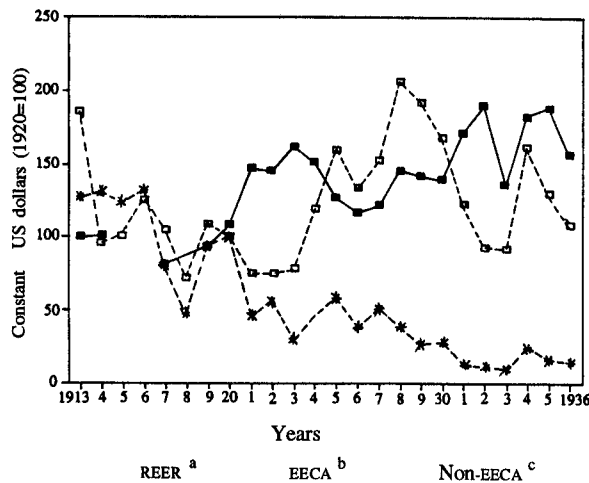
stimulated by the opening of the Panama Canal in 1914. At this time, Ecuador was the main exporter of cocoa in the world, with 20% of the market. The boom reached its historical peak between 1908 and 1914, with exports amounting to some US\$77 million (in constant 1980 dollars) in the years 1914 and 1916. A downturn occurred in 1918, but exports recovered to some US\$60 million in 1919-1920. The movement of the real effective exchange rate was as expected, with the national currency appreciating up to 1914 and depreciating strongly after 1918. This would suggest a Dutch Disease problem in the second decade (see figure 2). Non-cocoa exports, consisting mainly of coffee, tagua, rubber and wood, fell steadily from almost US\$37 million in 1912 to an all-time low of less than US\$11 million in 1921-1922. The Dutch Disease hypothesis is thus confirmed, showing a sharp fall in other exports during the cocoa boom. The economic policy regime in these years is usually characterized as being a "laissez-faire" regime. Nevertheless, it is interesting to note that even so the policymakers reacted to the economic circumstances. A fundamentally self-sufficient agricultural economy was in these years transformed in an agro-export economy, and the major source of tax receipts changed from the taxes levied on landowners in the Sierra to import taxes, and later an export tax on cocoa. This economic evolution brought about a political rupture in 1895, when the so-called Liberal Revolution transferred power from the pre-capitalist Sierra landowners to the emerging capitalist agro-exporters: i.e., the rising financial and commercial class of the coastal areas.

There were also other typical signs of the Dutch Disease, such as heavy public spending, basically on infrastructure. The single most important public works

¹ The real effective exchange rate was calculated only with the nominal exchange rate and the consumer price indexes of the United States and Ecuador. A more sophisticated approach would need to consider the impact of industrial and commercial policy instruments (see, for example, the work of Schydrowski, S. Levy, R. Parot, M. Rodríguez, S. Hunt and I. Mezzera at the Center for Latin American Development Studies of the University of Boston).

² These series can be obtained upon request from the authors.

FIGURE 2

Ecuador: Exports and exchange rates, 1913-1936^a Real effective exchange rate^b Exports with extraordinary comparative advantages^c Exports without extraordinary comparative advantages

project carried out in these years was the railroad between Quito and Guayaquil, for which the Government obtained a foreign loan. This railroad, which was opened in 1908, significantly increased contacts between the two main cities. It was constructed under the second government of General Eloy Alfaro: a period which was also marked by important sanitation works and public lighting projects carried out in Quito and Guayaquil through foreign enterprises, as well as important institutional changes (education law, separation of Church and State, etc) (ECLAC, 1953).

In the latter years of this cycle (1926-1930) the export structure diversified with the inclusion of coffee (a rather spontaneous phenomenon, brought about by favourable prices) and rice exports, bringing the share of cocoa exports to less than 50% of overall exports. Non-cocoa exports rose in the 1920's following the depreciation of the currency, with a time lag of several years. Total non-cocoa exports combined climbed from US\$18 million in 1922 to US\$49 million in 1928, reducing the share of cocoa exports in the total to less than a third. It could therefore clearly be concluded that the collapse in cocoa exports impelled policy reforms which, together with currency depreciation and the private-sector efforts to increase other exports, seem to have had the desired effects.

The Great Depression of the early 1930s brought this modest recuperation to an abrupt end, and overall export revenue sank to an all-time low of less than US\$30 million in 1933. Once again, devaluations,

foreign exchange controls and tariff hikes were necessary in order to adjust to an extraordinarily low level of import capacity. Even so, the gold and foreign exchange reserves were depleted, making it necessary to maintain a very high real exchange rate until 1940.

2. The banana cycle (with a prelude covering the Second World War years)

All exports recovered from 1937 onward. Up to 1948, they were quite diversified, as may be seen from the remarkable upsurge in exports of Panama hats, which were the main export product in 1945, accounting for just over 25% of the total (26 out of 103 million constant 1958 dollars). The bulk of the exports in the Second World War years consisted of rice and coffee, the latter being usually considered as the fourth export product of Ecuador. There is, however, no reason to distinguish a separate coffee boom with possible Dutch Disease effects, as coffee exports were never the main foreign-exchange earner and thus cannot be supposed to have altered significantly the internal price structure.

The restrictions on imports because of lack of supply provided an opportunity for "spontaneous" import substitution, despite the strong appreciation of the currency. Important industries that were established during the 1930s include the oil refinery and a cement plant, as well as other industries basically funded by foreign investors. A typical example of this phenomenon is the pharmaceutical industry, created by an Italian immigrant in 1940. This plant reportedly grew to employ as many as 700 persons in the 1940s, and exported to most countries in South America.

Exactly how "spontaneous" this import substitution was might be a matter of debate, since import tariffs were quite high: ECLAC reports tariffs for raw materials between 25% and 30%, for intermediate inputs between 30% and 90%, and up to 265% for finished products. The term "spontaneous" refers not so much to the absence of trade policy as to the absence of a rationale in terms of economic theory (a rationale that was later formulated by ECLAC, around 1950). In any case, the war years provided a stimulus for industrial growth, and the industrial production index went up from 50 in 1939 to 100 in 1948. The recovery observed during the war years must be viewed, however, in the perspective of the extremely poor country Ecuador still was.

A second moment of windfall profits for the Ecuadorian economy occurred in the early 1950s, with the banana boom. The main reason for the rise in the country's banana exports did not lie in a strong price increase, but in the fact that the Central American countries, until then the major producers, suffered from a pest (the Panama disease) that destroyed a large part of their crops. Thus, Ecuadorian banana exports rose from US\$10 million in 1948 to US\$113 million in 1955.

There was never a significant collapse in the banana cycle, as occurred with the other two important product booms. Exports did fall to US\$96 million in 1958, but recovered gradually to US\$184 million in 1964. In the mid-1960s a structural change occurred in the Ecuadorian market position, as a disease-resistant new variety was introduced in Central America. Ecuadorian planters reacted immediately by changing varieties, but the country lost its leading position on world markets to the countries in Central America. Political turmoil in the latter region from the end of the 1970s onward, however, restored Ecuador's market position, and favourable prices on world markets towards the end of the 1980s led to an all-time high in banana export receipts of US\$433 million (in constant 1980 dollars) in 1990. This second banana boom came to an end in 1992.

If we define banana and cocoa exports as being based on extraordinary comparative advantages and analyse the performance of all other exports, we see an unstable and rather sluggish period in which the total value of the latter exports fluctuated between US\$120 million (1952, 1957) and US\$87 million (1959, 1961). In these years, coffee exports accounted for the bulk of such other exports.

The Dutch Disease effect of the banana boom can thus be expressed by the downturn in the 6-year average of all other exports: from slightly above US\$115 million in the 1952-1957 period to slightly more than US\$100 million in the 1958-1963 period. If this is a Dutch Disease effect at all, it is definitely milder than the reaction following the cocoa bust. In 1965 a significant increase in other exports was registered, bringing the figure close to US\$150 million, around which level it remained until 1971.

Growth slackened from 1955 onward, investments hardly increased and construction stagnated. An atmosphere of national crisis was felt in 1959, when some revolts took place, inflation accelerated, and a devaluation was necessary in 1961. Neverthe-

less, it is difficult to speak of a collapse of banana exports, as in 1971 such exports surpassed historical records. It was the period of institution-building necessary to implement the by then widely accepted import-substitution strategy. The National Economic Planning and Coordination Board was set up in 1954, and the first Industrial Development Act was adopted in 1957. It provided for total exemption from import duties on capital goods and substantial reductions in other import duties, and it also allowed tax exemptions on reinvested profits. The National Finance Corporation was created in 1963, and the Industrial Development Centre, which provides technical assistance, was established in 1962.

Towards 1970 the legal and institutional framework of the import substitution industrialization strategy was completed: the changes in the import tariff structure of 1971 consolidated high and dispersed effective rates of protection, mainly for consumer goods; the interest rate was legally fixed in 1970 at 12%, which meant negative rates in real terms, and a complex system of tax benefits and tariff exemptions for industries, as well as import prohibitions and licenses, had been consolidated through the periodic revisions of the Industrial Development Act. The limited scale of the domestic market was a known problem, and the solution adopted consisted of ambitious regional cooperation projects in the context of the Andean Pact market. The only missing elements in this strategy were resources to invest and import.

From 1955 to 1972 domestic-market industries (in a broad definition) became the most dynamic element in the economy. These comprised the non-tradeable public utilities (water, electricity and sanitation, which grew at 15% annually in the 1950s) and the services sector, which grew faster than the rest of the economy. Manufacturing industry in factories grew by 10% or more annually in these years, spurred by Government incentives and cheap credit, but overall manufacturing growth was less (5% per year) because of the stagnation of small enterprises and handicrafts.

Within the manufacturing sector, the traditional food and textile sectors continued to be those which contributed most to growth, together with the chemical sector, which received a strong impulse from banana production because of the latter sector's intensive use of pesticides and of plastics as protection for the fruit. Most other industries, including

metal products and other advanced industries, also have their (modest) origin in this period, however. A special case is sugar production, which more than trebled after Ecuador was granted a quota for the US market in 1960.

3. The oil and debt cycle

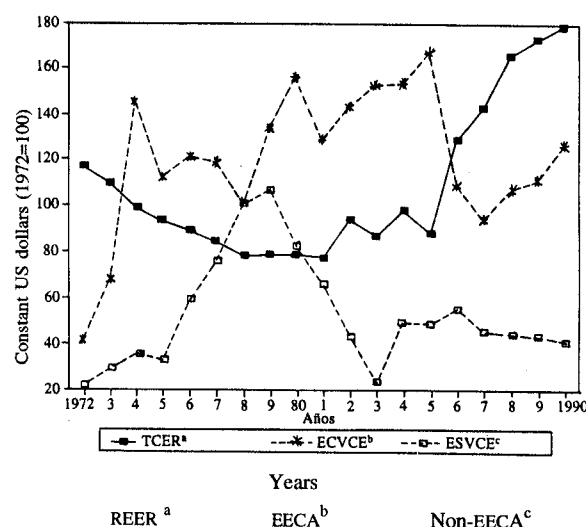
a) *Export performance and economic policy*

Investment in oil exploration led to the discovery of oil in the Amazon region in 1967 and to a considerable increase in production capacity in the early 1970s. The international oil price hike in 1973 provided the country with an affluence of foreign exchange that helped to overcome two of the basic problems that were structural in the years before: the low levels of domestic savings and demand, and the low capacity to import. Oil revenue rose from virtually nothing in 1971 to US\$1160 million in 1974, accounting for almost two-thirds of total export earnings that year. A new high was reached in 1980, and an all-time peak of US\$1400 million (in constant 1980 dollars) was registered in 1985. Public investment grew rapidly in the 1970s, channelled for example through the National Development Fund (FONADE), which effectively limited the danger of overexpanding Government consumption expenditure. Inflation was held in check by deliberately keeping the wages of civil servants low. Most sectoral policies were consumer-oriented, in the sense that the basic goal was to provide wage goods at low prices.

Exports of products other than those with extraordinary comparative advantages (i.e., total exports minus exports of cocoa, bananas and oil: non-EECA exports, for short) multiplied by a factor of almost seven between 1969 and 1979, reaching an all-time high of US\$950 million at the end of the first oil boom. This result is certainly not in line with the Dutch Disease argument, and calls for an explanation both in terms of economic policy and in terms of linkage effects. Two-thirds of these non-EECA exports came from two sources related to EECA exports: oil derivatives and cocoa derivatives. The exports of chocolate were not due solely to linkage effects, but were forcefully stimulated by the military government of the time, which obliged cocoa producers to build up chocolate production capacity. A significant number of other products also registered steep increases.

FIGURE 3

Ecuador: Exports and exchange rates, 1972-1990



^a Real effective exchange rate

^b Exports with extraordinary comparative advantages

^c Exports without extraordinary comparative advantages

The boom in domestic demand and the possibility of importing capital goods provided fertile ground for a rapid increase in manufacturing output, together with the tax benefits provided by the Industrial Development Act, from which half of all the firms benefitted (a total of 800 enterprises claimed benefits under this Act).

Further benefits were the extremely low energy and gas prices. Schematically, we can speak of a channelling of oil rents to manufacturing industry through a series of mechanisms:

- low energy and gas prices
- subsidized interest rates, negative in real terms
- tax exemptions for capital goods imports
- tax benefits for new industries
- wage repression made viable through the policy of price controls on basic consumer goods
- a slowly appreciating domestic currency, making capital goods imports cheaper
- strong protection of domestic industry through high tariffs (basically on finished products), import licenses, prior deposit requirements, etc.

The outcome in the 1970s was a rapid increase in manufacturing output (almost 10% a year during that period), through the establishment of a host of small firms in a great number of activities. The resulting manufacturing sector was allegedly over-

dimensioned and intensive in the use of energy and capital, but not in the use of labour, as rigid labour laws dissuaded entrepreneurs from granting long-term contracts to employees. Furthermore, the industrial sector ran heavy balance-of-trade deficits and performed poorly in terms of developing linkages both within the sector and with the rest of the economy. Agriculture benefitted least of all from these mechanisms channelling oil rents to the economy, and the growth of agricultural output was the lowest of all the productive sectors (Vos, 1984).

While public expenditure increased, public income slackened as it relied excessively on petroleum revenue. Oil exports remained more or less stable during the 1975-1982 period, and this, combined with a fixed exchange rate and a marked anti-export bias, led to fiscal deficits and balance-of-payments problems in the latter years of the 1970s. It was possible to put off the necessary adjustments, as international banks were more than willing to increase lending and the international debt soared. The long-postponed adjustments finally became unavoidable, however, as international interest rates went up and capital transfers stopped after the Mexican debt-servicing failure of September 1982 (Acosta, 1990).

The expected Dutch Disease effect of declining exports on other products can be seen in the subsequent period, between 1979 and 1983. By this time, a new product with extraordinary comparative advantages had developed: shrimps. Exports of this product rose from US\$30 million to US\$300 million constant dollars between 1978 and 1990. Consequently, we have also subtracted shrimp exports from the total. All other exports plummeted back to US\$207 million in 1983, recovering to US\$490 million in 1986 but suffering a steady decline afterwards.

In the early 1980s the oil boom, rapid economic growth and significant social improvements came to an end. In 1980 oil production fell, and in 1981 economic growth per capita was very low. The boom of the 1970s had left Ecuador quite unprepared for the 1980s. The competitiveness of its agricultural sector was weakened, while the subsidized manufacturing sector had grown a great deal without becoming internationally competitive. The public sector had grown rapidly, accounting for 23% of GDP in 1973 but over 30% in 1982. However, this public sector expansion was financed almost exclusively with oil revenues and foreign debt.

The debt crisis broke out in 1982 and brought a reversal in capital transfers and consequent balance-of-payments problems. However, exports of oil did not decline further (after the 1980-1981 drop) until the collapse in oil prices in 1986 and the earthquake that destroyed the oil pipeline in 1987. Cocoa exports had a low point in 1983, bananas in 1984, shrimps in 1985 and oil in 1987. Overall, we see periods of declining exports between 1980 and 1983, a slight recovery in 1984-85, a collapse in 1986-87 and a very modest recovery afterwards. The debt crisis ended the possibilities for debt-led growth and the government of President Hurtado was forced, for the first time since 1970, to devalue the sucre and introduce a package of stabilization policies. The package included reduction of the fiscal deficit from 7% of GDP in 1982 to a small surplus in 1984, and import restrictions were introduced to improve the trade balance. However, the reduction of the deficit was financed in great part by money creation, causing an increase in inflation and a fall in per capita GDP in 1982 and 1983.

It was the newly-elected administration of President Febres Cordero which initiated in 1984 a major stabilization programme also aiming at modernizing the economy through a series of measures contained in a neo-liberal (or neo-conservative) programme. The direct role of the State in the economy was to be reduced, along with the web of regulations. The programme also included the elimination of price controls and subsidies (e.g. on energy) and the freeing of trade and the exchange rate, and it involved a shift from import substitution to the promotion of manufactured exports. Foreign direct investment was promoted through this programme, and full debt servicing was designed to improve Ecuador's image. This programme had similarities with the programmes initiated earlier in Chile, Argentina and Uruguay, but with great differences in the economic and political context (Ramos, 1986).

The initial results of the programme were relatively positive, as GDP grew over 4% in 1984 and 1985, helped in particular by the recovery of the agricultural sector after the floods of 1983. However, social unrest mounted in the country as the social costs of the restrictive monetary and fiscal policy affected a great part of the population through the removal of price controls, devaluation, falling employment, declining government subsidies and sinking real wages. The loss of political support,

worsened by the fall in oil prices in 1986, led to the relaxation of fiscal austerity and the initiation of a public works programme, with resulting budget deficits and a rise in the rate of inflation in 1986 and 1987. The 1987 earthquake which destroyed the pipeline transporting oil from the Amazon region to the coast, and the additional fall in oil prices in 1988, caused disastrous economic results at the end of the Febres Cordero administration.

The expected upsurge in other exports after the oil collapse in 1986 is not yet clearly visible, but perhaps we should bear in mind that historically non-EECA exports have lagged several years in reacting to the existence of a high real effective exchange rate. Total exports other than oil, cocoa, shrimps and bananas declined from US\$490 million at constant 1980 prices to US\$322 million in 1990. This tendency was

heavily influenced, however, by coffee, oil derivatives and chocolate. Some minor exports seem to be picking up, without reaching a scale that affects the overall picture.

The Borja administration took office in 1988 and managed to restore the international reserves but did not advance very much in the modernization of the Ecuadorian economy. On a per capita basis the performance was rather meagre, with zero per capita growth over the whole 1988-1992 period, although GDP growth did pick up somewhat at the end of the Borja administration. Inflation was persistently high, around 50%, during the whole period. One of the causes of this persistent inflation was that the administration was not able to combine monetary and fiscal policy efficiently, for while monetary policy was rather restrictive, this was not the case on the fiscal side.

V

Economic policy

Poor manufacturing export performance and production inefficiency characterize the Ecuadorian industrial sector³, and this situation was made worse by the economic policies applied. Special attention will be given in this section to trade policy, exchange rate policy, and policy regarding foreign direct investment.

1. Trade policy

Ecuador has a long tradition of the application of export regulations which has further increased the bias against exports, including export permits, export prohibitions and regulations on foreign exchange proceeds. Domestic protection, with its effect of decreasing the relative prices of exportables compared to import substitutes and non-tradeables, consisted of a very complicated system including four separate tariff lists which, until 1985, each had different exchange rates, a system of tax exemptions which were largely firm-specific, prior authorization for selected imports, import prohibitions and foreign exchange

authorizations. During the 1980s protection through tariffs and surcharges was raised and lowered on several occasions. In 1983 new surcharges were added which increased the rate of protection. In 1986 a new tariff structure was introduced that lowered rates and reduced their dispersion, but in 1989 new import taxes were introduced. At the end of 1992 Ecuador dropped its previous objections to the Andean Pact Free Trade Area, and imports from Colombia and Bolivia have entered duty free since September 1992, and those from Venezuela since February 1993. In November 1992 Ecuador further reduced tariff rates by adopting a 5% to 20% tariff schedule for imports other than from the Andean Pact countries. Advances have also been made in the simplification of import and export procedures.

2. Exchange rate management

Up to March 1983 the country had a fixed exchange rate system which was relatively stable. Between 1950 and 1983 the exchange rate was only changed four times, rising from 15 sucres per dollar in 1950 to 33 sucres per dollar in 1983. Until the mid-1980s exchange rate policies discriminated against tradeable goods. The main instrument for exchange rate

³ For a more general description of economic policy and the political process, see Hurtado (1988), De Janvry, Sadoulet and Fareix (1991), and Thoumi (1990).

management has been direct intervention in the supply of foreign exchange, fostered by oil exports and foreign indebtedness. These policies encouraged capital-intensive production and thus imports of capital goods. In 1983, after a macrodevaluation, a crawling peg system was introduced which lasted almost two years, after which the government introduced a dual exchange system. In 1986 a free market exchange rate system was introduced, with only official imports and oil exports remaining in the official market, but macroeconomic instability caused the free market to collapse in 1988. After a short experiment with a fixed exchange rate, a new crawling peg system was introduced which remained in place until September 1992. Since then the government has moved towards a free market exchange system, with Central Bank intervention to stabilize the exchange rate (a dirty float).

3. Foreign direct investment

Recent years have seen a liberalization of the foreign investment regime. In 1991 new regulations included equal treatment for national and foreign firms in

terms of taxes, tariffs and other fiscal incentives, eliminated limits on the repatriation of net profits (doing away with the previous ceiling equivalent to 40% of the company's capital base), and allowed foreign investment in sectors which had previously been classified as strategic, such as utilities, the mass media, advertising and domestic transportation. At the beginning of 1993 the recently installed new government further liberalized foreign investment regulations, eliminating the remaining restrictions on foreign investment in commercial banking and extending to foreign firms the promotional mechanisms available to Ecuadorian firms. The new rules allow foreign investors and firms to become local investors without registering or meeting specific qualifications and eliminates prior authorization for the transfer of equity shares. Regulations on technology transfer have also been eased.

A new investment code was adopted in mid-1991 which gives equal treatment for national and foreign corporations in terms of fiscal incentives, does away with restrictions on the repatriation of profits and permits foreign investment in several previously restricted sectors.

VI

Business behaviour

Typically, industries catering for domestic demand in Ecuador can be classified in four subgroups which have different characteristics as regards the type of firms involved (ownership, size), and as regards the type of government intervention applied. It may also therefore be assumed that they are different as regards the strategies of the firms in response to changes in the policy environment:

- Basic-needs-oriented companies, with price controls and oligopolistic market structures.
- Enterprises producing traditional consumer goods, sometimes with a distinct indigenous background and usually operating in rather competitive markets, despite the frequently high tariff protection.
- Companies producing durable consumer goods, with private quasi-monopolies in strongly regulated markets.

- Enterprises producing industrial and agricultural inputs, usually linked to firms dominating the field of traditional export products.

The policy-induced distortions are greatest in the first and third groups of industries, and thus the changes in company behaviour in response to changes in the policy environment are likely to be stronger in these groups.

1. Industries catering for basic needs⁴

Industries which may be classified in this group include those producing sugar, rice, oils and fats, pharmaceuticals, and cement. Policies regarding this type

⁴ The descriptions of specific industries are partly based on Spurrier Baquerizo (ed.), various issues.

of industries generally obeyed the basic objective of keeping the consumer prices low, in order to diminish social unrest stemming from low wages. This poses the problem of how to guarantee an acceptable profit rate and usually requires the establishment of price controls throughout the production chain. Exports have to be prohibited, because otherwise foreign consumers would benefit from the subsidized consumer prices. As the profit rate thus depends on Government decisions regarding price levels, incentives to invest in expanding production capacity or in modernization efforts designed to improve efficiency are very low. Production will eventually fall short of domestic (subsidized) consumption, and imports become necessary. These imports have to be subsidized, making this another form of rent channeling to producers. Some examples may clarify these points.

In the *sugar industry*, cane is processed in three main mills or "ingenios", one of which is State-owned (by the CFN). The quota granted to Ecuador on the United States market makes sugar exports a highly profitable operation. The quota is distributed among the ingenios by the State retailing company, the National Commodity Storage and Marketing Company (ENAC), but in exchange the ingenios are obliged to sell all sugar for domestic consumption to ENAC. Price controls operate at all points in the chain: from the price between cane producers and ingenios, to the price for sugar in the shops. Since sugar production usually falls short of domestic demand, permits are given for the importation of sugar both to complement supply on the home market and for re-export to the United States. It may naturally be assumed that the effect on company behaviour is that there is no incentive to invest in more production capacity or to improve productivity, neither on the farms nor in the plants.

A similar situation is found in the *rice sector*. This is still an important product, as a significant number of small farmers engage in rice production. Price controls are used, but cannot be enforced as easily as in the case of sugar. The grain mills are obliged to sell their output to ENAC. When prices are raised, production readily increases and has to be exported, which causes deficits for ENAC, as home producer prices are higher than the (allegedly heavily subsidized) world market prices. Such market saturation leads the Government to lower prices, leading to less rice cultivation and the need to import rice. In

this case, too, ENAC still suffers losses, as consumer prices need to be subsidized. The endless political struggle about rice prices is an explosive issue which has occasioned the dismissal of several Ministers of Agriculture.

Four plants dominate *cement production*, one of which is State-owned. Price control was practiced until very recently, by fixing the profit rate in the industry. Output used to be at maximum potential, yet a shortage of cement in the market was the rule. Black market prices were alarmingly high, and cement smuggling to Colombia was reported. However, the price controls hindered investments to expand production capacity. The Borja Government raised cement prices and abolished import controls, and the black market disappeared as demand dropped. The Andean Development Corporation proposed a major investment project for increasing production capacity.

The *pharmaceutical industry* also has an important share in the consumption basket of the population. It is perhaps surprising that this sector had a good performance from as early as the 1940s, and frequently exported its products, although these were based on imported active principles, which account for around half the production costs. Most of the transnational pharmaceutical enterprises set up shop in Ecuador, and by 1987 more than 100 laboratories were registered, of which the largest 26 accounted for 80% of production. Only two of these 26 are of Ecuadorian capital. Stiff price policies were meant to keep consumer prices low, and this was perfectly possible during the 1970s because imports were cheap in sucre terms. The devaluations from 1982 onward brought profit levels down, however, and enterprises reported losses, in response to which the Government decided to grant a subsidy based on the amount of imports. The laboratories always protested against these subsidies, which implied a fiscal sacrifice of close to US\$50 million in 1990, arguing that the best solution was the abolition of price controls. Obviously, exports had to be prohibited and massive smuggling was reported (up to 30% of total production). Finally, in September 1991 the Government announced the elimination of the subsidy and its replacement by a direct subsidy to low income groups. To the dissatisfaction of the laboratories, however, price controls were not eliminated. The entrepreneurs stress the competitiveness of the sector in the Andean market, and they are confident that the transnational companies might prefer Ecuador as a

production base for the regional market. This will depend on the elimination of the export prohibition and the incidence of other trade and foreign investment policies.

These examples clearly illustrate the negative side-effects of price controls designed to keep consumer prices low.

2. Durable consumer goods

Perhaps the best-known example of the effects of Ecuadorian industrial policies is the establishment of industries producing durable consumer goods. The policy approach was to guarantee a high rate of return for new establishments by subsidizing investments and guaranteeing a market. Investment subsidies took the form of credits at negative interest rates and tariff exemptions on imports of capital goods. The markets were secured through high tariff protection and regional agreements within the Andean Pact integration scheme. The result was that the price-quality relation did not really matter as far as making profits was concerned. Most industries did not develop a genuine capacity to compete in open markets, and they virtually disappeared after the change in economic policy. One exception is the automobile industry, where policy changes were slow to be implemented, and the competitiveness of the industry in open markets is therefore yet to be tested.

The history of the automobile industry in Ecuador is strongly linked to the common industrialization efforts of the Andean Pact countries. Before the Andean Pact there was only one assembly firm, linked to General Motors, and few suppliers of auto parts. The automobile policy of the Andean countries did not have all the desired effects, but nevertheless two more firms entered the market. In 1983 a more protectionist policy was installed, and Volkswagen set up shop in Ecuador. The main policy instrument was the authorization to import Completely Knocked Down (CKD) kits, with complete prohibition of other automobile imports. This complete prohibition was relaxed for a short time between 1985 and 1987, but extremely high import tariffs were maintained. The CKD import authorizations were distributed among firms by a coordinating agency, CORDINAUTO. In the latter half of the 1980s these authorizations were used to implement a programme known as the Economic Automobile. Under this programme, 40% of all

CKD imports should be of inexpensive automobiles, and it caused local assembly operations to flourish. In 1991 the programme was stopped, and imports of CKD kits were freed from restrictions. The Andean Pact automobile production scheme was eliminated, and free imports from member countries were stimulated. The Ecuadorian automobile industry does not seem to fear the competition from Colombia, Peru or Venezuela. Most firms are owned by mother companies which also own firms in other Andean Pact countries. Consequently, a specialization strategy among daughter firms in the countries is taking shape, with Ecuadorian firms exporting cheap cars to Peru and Colombia, while importing the more luxurious models from those countries, and especially from Venezuela. The prospects of the industry in a scenario of liberalization towards third countries (a prospect that might become a reality after 1993) are not so clear, however.

Among the other industries which benefitted to some extent from the impulse of the Andean Pact industrialization policies was the refrigerator industry: a branch that registered at the end of the 1970s exports to member countries as high as US\$80 million, but the end of the Andean Pact industrialization strategy brought this export drive to a complete stop. The same is true of the woodworking industries. All four enterprises in this branch collapsed after the breakdown of the common policy. Likewise, of the 15 enterprises that entered the metalworking industry under the Andean Pact policies, all but four have stopped producing. The remaining four, producing electrical systems, sewing machines, vacuum cleaners and hydraulic systems, exported together US\$8 million in 1989. In the chemical sector at least two enterprises (both of them in the pharmaceutical industry) survived the closing down of the Andean Pact industrialization policies. The country's experience with the industrialization scheme in the context of Andean integration has not given Ecuador any important lasting capacity in any branch, with some firm-specific exceptions. Most firms simply could not survive without protection.

To prove this last point, Ecuador's share in the imports of the OECD countries has been calculated for the years 1963, 1971, 1980 and 1990, at the three-digit SITC level. Only the items with a market share of at least 0.01% of OECD imports have been taken into account. The oil boom was the period of strongest export performance, also in items other than the

traditional products. A decline in competitiveness was observed in the 1979-1983 period, in line with the Dutch Disease argument, while there was a very

modest recovery of competitive positions in the 1983-1989 period, basically in EECA exports other than oil.

VII

Summary and conclusions

Ecuador is on the road to a new development strategy which, as in many other Latin American countries, includes a reorientation towards a more outward-looking strategy. The transformation of the trade and industrialization regime should take into consideration one of the basic features of Ecuadorian growth, namely its instability as a result of the existence of extraordinary comparative advantages.

Ecuador has grown quite fast during the twentieth century: the overall 1900-1989 annual per capita GDP growth rate was 2.2%, compared to 1.7% for Latin America as a whole and 2.3% for the Asian developing countries. Since 1950 Ecuador's per capita GDP growth has been significantly faster than the Latin American average, although the Asian countries have grown more than twice as fast as Ecuador.

In this article we have analysed the different booms and busts that have occurred in Ecuador in the twentieth century: the cocoa boom at the beginning of the century, followed by its bust in the 1920s and the Great Depression of the 1930s, the banana boom of the 1950s and its decline in the 1960s, and finally the oil boom during the 1970s and the debt crisis in the "Lost Decade" of the 1980s. Ecuador experienced a clear-cut Dutch Disease problem during the cocoa boom at the beginning of the century. Growth in non-tradeables—such as the very necessary public services—, inflation and weakened competitiveness of other exports were the signs of this. It was already clear in 1921 that export diversification was called for, and a number of policy instruments were created to achieve that: import tariffs, foreign exchange controls, credit allocation and tax benefits for other industries. Some results were achieved in the latter half of the 1920s, but then the Great Depression brought the exports to a halt. The recovery after 1937, spontaneous import substitution and diversification of exports were an abnormal phenomenon due to the disarray of the developed countries. Banana exports in the 1950s, while not constituting a boom of the

magnitude of the cocoa and oil periods, allowed the strengthening of the Administration and financial institutions, and public investment rose quickly. An institutional system oriented towards an import-substitution strategy was built at this time. A hint of Dutch Disease problems can be seen in the sluggish performance of non-EECA exports between 1955 and 1965, but domestic manufacturing industries were born and grew at a considerable pace.

Oil revenues provided the financial resources needed to complement the institutional set-up for the import substitution industrialization strategy. Rents were channelled to manufacturing industry through a large number of direct and indirect mechanisms, enough to offset the Dutch Disease effects. All exports grew, and the export structure diversified up to 1978. The inflow of foreign exchange through the accumulation of debt exacerbated the Dutch Disease problems, however, and the export data clearly show the weakening of competitiveness in the 1978-1982/3 period. A gradual adjustment strategy was followed from 1982 to 1984, and a change in development strategy was essayed after 1984, with the abolition in practice of special credits and fiscal benefits. The change in development strategy was consolidated after 1988 as tariff reductions and deregulation proceeded, and a deepening of the liberalization strategy can be expected in the near future. The deliberate import-substitution strategy, which lasted roughly 30 years, from 1955 to 1985, altered the Dutch Disease effects significantly and allowed the build-up of some manufacturing capacity and the diversification of exports, basically through the oil-rent-based subsidization of producers. However, it did not create a competitive manufacturing sector that can compete without subsidies, with perhaps some firm-specific exceptions.

But the return to a development strategy based exclusively on the mechanisms of free trade is not likely to produce stable export-led growth, as the Ecuadorian economy is still characterized by the

presence of extraordinary natural competitive advantages, and distortions on the internal markets abound. It is not unimaginable that Ecuador will experience a second oil boom, just as it experienced a second banana boom between 1987 and 1991. Or perhaps a new product will significantly alter the export structure, just as the surprising boom in the shrimp industry did in the 1980s. Will tropical hardwood be the next product that brings significant rents to Ecuador, transforming the rain-forest just as cocoa and bananas transformed the coastal area?

The question remains how to make best use of these windfall profits in order to create competitive advantages in other areas and diversify (and hence stabilize) exports and, as a final goal, growth. Undistorted free trade will not do the trick unless one assumes an economy without distortions. In the past, the free trade regime did not achieve sustainable growth, and the distribution of rents to entrepreneurs while maintaining real wages low, as in the import substitution industrialization period, has severe drawbacks as shown by the reduced responsiveness and increased vulnerability of the production apparatus, not to mention the macroeconomic flaws of excess public spending and inflation.

A free trade regime and the presence of extraordinary competitive advantages distorts price signals and market mechanisms in the domestic economy, through rent-seeking behaviour. A conscious intervention strategy should be followed so as to stabilize, but not immobilize, the relative price structure over time. This could involve measures to protect or stimulate other tradeables during a boom. But the specific measures taken in the 1955-1985 period were misdirected, if we evaluate them with the crite-

tion of long-term growth. In a period of export booms, instead of subsidizing producers, measures should be taken to subsidize consumers, especially of the lower-income strata, through direct support, e.g. in the guise of scholarships for basic education and training. To slow down spending and stimulate saving, however, a high real interest rate would be necessary, instead of the negative interest rates that prevailed during ISI. Social insurance mechanisms are of the utmost importance for capturing savings and providing long-term resources to the financial system. At the same time, booming internal demand would be a great stimulus for local industries, and they should therefore not be (permanently) protected from international competition, but should instead be made familiar with international standards and practices. Apart from the drawback that protection from international competition hinders technological learning, imports are necessary to contain inflationary pressures and moderate oligopolistic behaviour.

In sum, Ecuadorian development will require public intervention in the market forces in order to attain optimum long-run growth. Such intervention will require other mechanisms, other institutions and better implementation than the type of intervention used in the past, however. To some extent, it will be a form of intervention to create and improve the functioning of the market forces in the domestic economy, instead of suppressing them. The task of changing the economic policy regime started with the debt crisis, but the shape of the new model is not yet entirely clear. It will probably take well into the next century to achieve a reasonably articulated and integrated set of institutions and mechanisms.

(Original: English)

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