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Report RS21687

*Ecuador: Political and Economic Situation and U.S.  
Relations*

Clare Ribando Seelke, Foreign Affairs, Defense, and Trade Division

November 21, 2008

**Abstract.** President Correa has fulfilled his campaign pledge to call a Constituent Assembly to reform the country's constitution. The Assembly, which had a majority of delegates elected from Correa's party, drafted a new constitution that was approved by 64% of voters in a referendum held in late September 2008. New presidential, legislative, and municipal elections are scheduled for April 26, 2009. Some observers are concerned that the new constitution concentrates too much power in the Ecuadorian presidency. U.S. officials have expressed concerns about President Correa's populist tendencies, ties with Hugo Chavez of Venezuela, and trade and energy policies. Despite those concerns, Congress enacted legislation in October 2008 to extend U.S. trade preferences for Ecuador through June 2009.

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# Ecuador: Political and Economic Situation and U.S. Relations

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## Summary

Ecuador, a small, oil-producing country in the Andean region of South America, has experienced ten years of political and economic instability. On January 15, 2007, Rafael Correa, a left-leaning, U.S.-trained economist, was inaugurated to a four-year presidential term, becoming the country's eighth president in ten years. President Correa has fulfilled his campaign pledge to call a Constituent Assembly to reform the country's constitution. The Assembly, which had a majority of delegates elected from Correa's party, drafted a new constitution that was approved by 64% of voters in a referendum held in late September 2008. New presidential, legislative, and municipal elections are scheduled for April 26, 2009. Some observers are concerned that the new constitution concentrates too much power in the Ecuadorian presidency. U.S. officials have expressed concerns about President Correa's populist tendencies, ties with Hugo Chávez of Venezuela, and trade and energy policies. Despite those concerns, Congress enacted legislation in October 2008 to extend U.S. trade preferences for Ecuador through June 2009. For more information, see CRS Report RS22548, *ATPA Renewal: Background and Issues*, by M. Angeles Villarreal.

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## Background

Slightly smaller than Nevada, Ecuador has a population of 13.8 million people. Since independence from Spain in 1830, Ecuador has lost 61% of its total land area as a result of border conflicts with Brazil, Colombia, and Peru. Despite its small size, Ecuador's location on the Pacific Coast between two major drug-producing countries (Colombia and Peru) increases its strategic importance to the United States. Ecuador is both geographically and ethnically diverse, and has a relatively long, albeit unstable, experience with democratic rule. Some 40% of Ecuadorians live in poverty and another 13% live in extreme poverty.<sup>1</sup>

## Political and Economic Situation

In the past decade, Ecuador has weathered a number of political and economic crises. The three popularly elected presidents preceding Rafael Correa did not complete their terms. In 1997, Abdala Bucaram was removed from office after being declared mentally unfit by the legislature and allegedly misappropriating \$90 million in public funds. In 2000, Jamil Mahuad was ousted by a coup after a prolonged economic crisis led by a junta that included then-army Colonel Lucio Gutierrez. In April 2005, Lucio Gutierrez was removed from office by Ecuador's congress after weeks of popular protests. Ecuadorians rejected Gutierrez's attempt to replace judges on the country's three highest courts with his political allies, a move that was also sharply criticized by the international community.<sup>2</sup> He was replaced by his vice president, Alfredo Palacio. There are historical antecedents for the instability that has recently plagued Ecuadorian democracy. Since 1830, regionalism and personalism have defined Ecuadorian political culture. Quito, the colonial capital, and Guayaquil, the industrial port, have battled for urban dominance. Superimposed against this regional divide are the ethnic and class divisions that have encouraged political parties to develop as electoral machines for competing segments of the elite. Following the return to democracy in 1979, party splits, bureaucratic ineptitude, and corruption proliferated. As the economic situation has deteriorated since the 1980s, voters have reacted by blaming incumbents for their troubles and by periodically backing populist, anti-party candidates (similar to Correa). This trend has led to the inability of presidents to complete their terms, as well as inconsistent economic policies from one administration to the next.

Ecuador has a weak and poorly regulated economy that is overly dependent on a few export commodities (oil, bananas, and shrimp) with volatile prices. In 1998, El Niño rains caused an estimated \$2.6 billion worth of crop damage, white spot disease hit the shrimp industry, and oil prices plunged. As a result, Ecuador suffered a disastrous economic crisis in 1999-2000, the country's worst in more than seventy years. In late 1999, then-president Jamil Mahuad abandoned the country's domestic currency in favor of the U.S. dollar as a last-ditch effort to stop hyperinflation. Dollarization has helped curb inflation in Ecuador and restored some macroeconomic stability to the country, but limited the government's ability to conduct an independent monetary policy.<sup>3</sup>

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<sup>1</sup> United Nations Economic Commission for Latin America and the Caribbean, *Social Panorama of Latin America*, 2007.

<sup>2</sup> International Crisis Group (ICG), "Ecuador: Overcoming Instability?" August 7, 2007.

<sup>3</sup> Paul Beckerman and Andrés Solimano, *Crisis and Dollarization in Ecuador*, Washington, D.C.: World Bank, 2002; (continued...)

Ecuador's dollarization has not been accompanied by much-needed structural reforms to diversify the economy, restrict public spending, and increase productivity and investment. In 2003, the Gutierrez government attempted to restrict spending, increase taxes, remove subsidies, and promote private investment in the oil sector. These efforts spawned sustained popular protests. Although the economy grew some 6.3% in 2004 as a result of high oil prices, remittance flows, and a weak U.S. dollar, a lack of fiscal discipline postponed the renewal of a new IMF stand-by agreement. For the last several years, investors have been concerned by the Ecuadorian government's lack of fiscal discipline during a time of strong oil revenue growth. The Ecuadorian economy could face serious budget shortfalls in the short to medium term should global oil prices continue to fall.

## The Correa Presidency

On January 15, 2007, Rafael Correa, a left-leaning, U.S.-trained economist, began a four-year term as President of Ecuador. Correa, an economics professor whose only prior government experience was a four-month stint as Alfredo Palacio's finance minister, surprised many analysts by finishing second in the first round of presidential voting held in October 2006. Contrary to many analysts' predictions, Correa won the November 2006 run-off election with 57% of the vote against Alvaro Noboa, a well-known banana magnate, who earned 43% of the vote. Voters appeared to embrace Correa's pledge to enact dramatic political reform.<sup>4</sup>

Nearly halfway through his term, President Correa continues to enjoy high approval ratings. Those ratings have been boosted by his efforts to reform the country's political system, increase social spending, and reassert government control over Ecuador's economy and territory. Many Ecuadorians approved Correa's condemnation of Colombia's unauthorized March 2008 raid of a guerrilla camp in Ecuador. They also supported his decision not to renew the U.S. lease on the air force base at Manta when it expires in 2009, a decision which has strained U.S.-Ecuadorian relations. Correa's economic policies, though popular among Ecuadorians, have concerned foreign investors. Foreign direct investment in Ecuador fell from some \$271 million in 2006 to roughly \$179 million in 2007. President Correa has recently suggested that, given declining oil revenues, his government may default on part of its roughly \$10 billion foreign debt.<sup>5</sup>

## Constituent Assembly

President Correa has carried out his campaign pledge to enact constitutional reform. On April 15, 2007, 82% of Ecuadorians approved a referendum to convene a Constituent Assembly with the power to rewrite the country's constitution and dismiss its current elected officials. Some have questioned the legality of the events leading up to the referendum, which culminated in Ecuador's Electoral Court expelling (with Correa's backing) 57 legislators who had opposed giving the Constituent Assembly power to dissolve the Congress.<sup>6</sup>

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(...continued)

ICG, 2007.

<sup>4</sup> Catherine Conaghan, "Ecuador's Gamble: Can Correa Govern?" *Current History*, February 2007.

<sup>5</sup> Alonso Soto, "Ecuador Foreign Investment Tumbles, Outlook Murky," *Reuters*, April 24, 2008; J. Valdivieso, "Ecuador Audit Advises Default on 40% of Foreign Debt," *AP*, November 20, 2008.

<sup>6</sup> Mary Anastasia O'Grady, "Sharp Left Turn in Ecuador," *Wall Street Journal*, April 9, 2007.

Elections for the new Constituent Assembly were held in September 2007. With the traditional parties in disarray, Correa's newly-formed "Alianza Pais" (Country Alliance) party captured 80 of 130 seats in the Constituent Assembly. Convened on November 29, 2007, the Assembly immediately closed the Ecuadorian Congress and assumed its legislative functions. On January 8, 2008, Ecuador's Constitutional Court ruled that the Assembly's decisions may not be challenged. By the end of July 2008, the Assembly drafted a constitution that increases the power of the president by, among other things, giving him the power to dissolve Congress and allowing him to run for two consecutive terms. On September 28, 2008, some 64% of Ecuadorian voters approved the new constitution, expressing hope that it may help end the corruption and institutional frailty that have long plagued Ecuadorian democracy. Government critics have expressed concerns about the strong presidential system created by the new constitution. They have also challenged the legitimacy of the transitional assembly that is charged with legislating until the April 2009 elections occur, as well as the process by which judges are currently being selected for the country's highest courts.<sup>7</sup>

## **Energy Policy**

Oil is extremely important to Ecuador's economy, accounting for more than 50% of exports. High oil prices fueled an economic growth rate of 4.2% in 2006, but declining production levels resulted in growth of only about 1.5% in 2007. Production by Petroecuador, the state-owned oil company, has fallen by 50% in the last ten years, and a lack of capital has forced the company into a deep financial crisis. In recent years, Petroecuador has lost some \$200 million annually in production due to protests and other community-related problems.<sup>8</sup>

President Correa is seeking to increase state control over the energy sector. In October 2007, he issued a decree that increased the Ecuadorian state's share of windfall oil revenues from 50% to 99%, unless companies were willing to switch from production sharing agreements to new service contracts controlled by Petroecuador. Five foreign oil companies entered into negotiations with the government and were about to agree to switch to service contracts within a two-year period when President Correa shortened the proposed transition period to just six months. As of November 2008, three of those companies had signed interim agreements with the Correa government. Private companies have long experienced problems investing in the Ecuadorian oil industry, stemming from the country's chronic instability and tendency for conflicts with private producers. President Correa supports the prior government's 2006 termination of its contract with the U.S. firm Occidental Petroleum (Oxy) over an alleged breach of contract, a controversial move that is currently in dispute settlement.

## **Ecuador-Colombia-Venezuela Border Crisis**

On March 1, 2008, the Colombian military bombed a Revolutionary Armed Forces of Colombia (FARC) camp in Ecuador, killing at least 25 people, among them, Raúl Reyes, the terrorist group's second highest commander. In a subsequent raid on the camp, Colombian forces captured

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<sup>7</sup> "Ecuador: Correa's Big Win," Economist Intelligence Unit (EIU) Business Latin America, Oct 6, 2008; "Ecuador's 'Transition' Raises Doubts," Latinnews Andean Group Report, November 2008.

<sup>8</sup> "Oil Sector Protests Become Norm in Ecuador," Platts Oilgram Price Report, March 26, 2007; "Ecuador Says State Oil Company in Crisis," EFE, November 29, 2007.

laptop computers, which Interpol has verified as belonging to Reyes.<sup>9</sup> Files in those laptops allege that the government of Hugo Chávez of Venezuela was planning to provide millions of dollars in assistance to the FARC for weapons purchases and that President Correa received campaign donations from the FARC in 2006. Both Chávez and Correa have vigorously rejected those claims.<sup>10</sup>

Colombia's unauthorized incursion caused a major diplomatic crisis between Colombia, Ecuador and Venezuela. President Correa responded to the raid by breaking diplomatic ties with Colombia and sending additional troops to the Ecuador-Colombia border. In a show of solidarity with Ecuador, President Chávez broke ties with Colombia and sent troops to Venezuela's border with Colombia. Some feared that the Ecuador-Colombia-Venezuela crisis might escalate into a military conflict, but those concerns were allayed after a Rio Group summit held in the Dominican Republic on March 7, 2008.

At the summit, President Uribe publicly apologized for the incursion and vowed that it would never happen again. President Chávez appeared to accept the apology and called for an end to the crisis, but President Correa remained angered by the incident. The Rio Group issued a resolution that rejected Colombia's incursion of Ecuadorian territory, but acknowledged Uribe's apology.<sup>11</sup> On March 18, 2008, after extended debate, the Organization of American States adopted a resolution rejecting, but not condemning, the bombing raid and called for the restoration of diplomatic ties between Ecuador and Colombia.<sup>12</sup> Ecuador has yet to restore diplomatic relations with Colombia. The border crisis may have served to reinforce the pre-existing ties between the Correa government in Ecuador and the Chávez government in Venezuela.

## U.S. Relations

Ecuador's relations with the United States have traditionally been close, although recent events have strained bilateral relations. While the United States has concluded free trade agreements (FTAs) with Peru and Colombia, negotiations for a bilateral free trade agreement with Ecuador have been suspended indefinitely in the wake of the dispute with the U.S. firm Occidental Petroleum. U.S. officials have expressed concerns about Correa's populist tendencies, his ties with Hugo Chávez of Venezuela, and his state-centered economic policies. Some analysts have urged the U.S. government to use pragmatic means to urge President Correa to maintain open-market and democratic policies, such as maintaining U.S. trade preferences for Ecuador. Others are more skeptical, questioning why the United States should extend trade benefits for a country that has taken hostile actions against U.S. companies and refused to negotiate an FTA.

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<sup>9</sup> Simon Romero, "Files Released by Colombia Point to Venezuelan Bid to Arm Rebels," *New York Times*, March 30, 2008.

<sup>10</sup> "Interpol Confirms Link Between FARC, Chávez," *Miami Herald*, May 15, 2008.

<sup>11</sup> "How Diplomacy Silenced the Drums of War in Less Than a Week," *Latin American Security and Strategic Review*, March 2008; Francis Robles, "Ecuador Rages, Colombia and Venezuela Make Up," *Latinnews Daily*, March 14, 2008; "Leaders Defuse South American Crisis," *Miami Herald*, March 8, 2008.

<sup>12</sup> Resolution of the Twenty-Fifth Meeting of Consultation of Ministers of Foreign Affairs, Washington D.C., March 17, 2008.

## Counternarcotics

Ecuador, a major transport country for cocaine and heroin, has worked closely with the United States on counter-narcotics efforts in years past, but positions taken by the Correa government may not bode well for the future of U.S.-Ecuadorian counternarcotics cooperation. In November 1999, the United States signed a 10-year agreement with Ecuador for the creation of a forward operating location (FOL) for U.S. aerial counter-drug detection and monitoring operations at Manta, an air force base along the Pacific Coast. The United States reportedly spent some \$60 million to build those FOL facilities. President Correa has repeatedly confirmed that his government will not renew the lease on the U.S. air base at Manta when it expires in 2009.<sup>13</sup> He has opposed involvement in Plan Colombia, the Colombian army's incursions into Ecuadorian territory, particularly the March 2008 raid of a FARC camp in Ecuador, and Colombia's aerial fumigation of coca crops along the Ecuador-Colombia border.

## U.S. Aid

The United States is the largest bilateral donor in Ecuador. Principal goals for U.S. assistance to Ecuador are bolstering democracy, reducing poverty, protecting the environment, and securing the northern border with Colombia. Ecuador received roughly \$32 million in U.S. aid in FY2008, including \$9.1 million in counternarcotics assistance. The FY2009 request for Ecuador was for \$32.5 million, with \$13.4 million in counternarcotics assistance. An enacted continuing resolution (P.L. 110-329) will provide funding for U.S. aid programs at FY2008 levels through March 6, 2009.

## Trade

The United States is Ecuador's main trading partner, with some 45% of Ecuadorian exports going to the United States. Machinery and plastics are the leading U.S. exports to Ecuador, while oil, bananas, and shrimp account for the bulk of U.S. imports from Ecuador. Since joining the World Trade Organization (WTO) in 1996, Ecuador has lowered its average tariff rate from 30% to 13%, but a number of nontariff trade barriers impede U.S. access to the Ecuadorian market.

Since 1992, Ecuador, along with Peru, Colombia, and Bolivia, has been a beneficiary of the Andean Trade Preference Act (ATPA), which provides trade preferences for Andean countries in exchange for counternarcotics cooperation. Although oil continues to dominate Ecuador's export market, other goods, such as seafood and cut flowers, have benefitted from the program. The ATPA was reauthorized and expanded by the Andean Trade Promotion and Drug Eradication Act (ATPDEA), Title XXXI of the Trade Act of 2002, (P.L. 107-210). ATPDEA extended the preferential trade program until December 31, 2006, and expanded benefits to include certain textiles, petroleum, and pouched tuna. Since that time, Congress has favored short-term extensions of ATPA. Ecuadorian officials estimate that some \$5.6 billion in U.S. trade and 350,000 jobs could be lost without ATPA.<sup>14</sup>

<sup>13</sup> Simon Romero, "Ecuador's Leader Purges Military and Moves to Expel American Base," New York Times, April 21, 2008.

<sup>14</sup> See CRS Report RS22548, *ATPA Renewal: Background and Issues*, by M. Angeles Villarreal.

While Colombia and Peru have concluded FTAs with the United States, the Ecuadorian government opposes completing negotiations for an FTA with the United States and is not willing to restart negotiations as a condition to continue receiving U.S. trade preferences. Some Members of Congress favor continuing ATPA benefits regardless of a country's position on FTAs, while others oppose extending benefits for Bolivia and Ecuador. On October 16, 2008, the 110<sup>th</sup> Congress enacted legislation to extend ATPA trade preferences until December 31, 2009 for Colombia and Peru, and until June 30, 2009 for Bolivia and Ecuador (P.L. 110-436). Under certain conditions, trade preferences for Bolivia and Ecuador may be extended for an additional six-month period. For Bolivia, ATPA trade preferences will be extended only if the President determines that Bolivia has met program eligibility criteria. In the case of Ecuador, ATPA trade preferences will be automatically extended unless the President finds that the country is in violation of the eligibility criteria.

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