Highlights of Ecuador 2013

A. Introduction

According to data from the Latin American and Caribbean Economic Commission (CEPAL for its acronym in Spanish), Ecuador's expected growth for 2013 is 3.8%; a growth lower than that reached in 2012 (5.14%).

In February 2013, President Rafael Correa was re-elected for a further 4-year term (he was initially elected in 2007). Accordingly, continuity is expected in the country's current economic policies.

During 2013, the growth of the Ecuadorian economy was primarily boosted by public spending, and supported by oil prices, increased tax pressure and internal demand. As of December, the non-oil sect0r's balance of trade was negative. Similarly, during the third quarter of 2013, the net balance of Direct Foreign Investment (DFI) was greater than the balance registered in the previous year during the same period, thus evidencing a minor improvement.

During the period between January and October 2013, tax reforms put in place represented an increase of 13.3% of the Government's net tax collection (in comparison with the same period the previous year) amounting to approximately USD 11,523 million and representing close to 12.5% of the GDP.

During the period January to October 2013, an important increase in the collection of the most relevant taxes was recorded. One of the direct taxes that had the most significant impact in the Government's tax collection activities was the Income tax, which as of October 2013 reached up to USD 3,342 million and represented an increase of 15.9% in comparison to the same period in 2012.

It is worth noting that as of 2010 an annual one percentage point reduction to the corporate income tax rate was established thus decreasing from 25% to 22% for 2013. The 22% rate applies for 2014.

On June 25th, 2013 the Organic Communication's Law was published with the purpose of developing, protecting, and regulating the exercise of constitutional communication rights.

On July 16th, 2013 a law reforming the Mining Law, the Reforming Law for Tax Equality in Ecuador and the Organic Internal Tax Regime Law was approved. This Law reforms to various issues including: the strengthening of the Mining Control and Regulation Agency (ARCOM for its acronym in Spanish), the payment of royalties, taxes to non-ordinary income, licensing and environmental defense (among others).

Subsequently, on August 1st, 2013 the Social Control and Transparency Organic Law was issued with the purpose of promoting and boosting control over public institutions and entities, as well as control over private individuals or entities that render services (or develop activities) of public interest. Furthermore, this law seeks to encourage citizen participation in the aforementioned control, promote the exercise of individual rights and accomplish the prevention of corrupt practices in public administration activities.

On August 12th, 2013 the Tax Bonus Law and Organic Internal Tax Regime Law were reformed by way of the Organic Law for Incentives in the Productive Sector. Through these reforms, previously established norms which contained benefits on exports were reformed in order to align them to the new legal framework. The reforms issued mainly relate to modifications to the Tax Bonus Law with regards to tax bonus certificates which will be granted over the value of each export to exporters whose access level to a specific market has been affected either due to changes in custom duty levels or the levying of unilateral sanctions. With regards to the Organic Internal Tax Regime Law, the reforms pertained to modifications to the Special Consumptions Tax (ICE for its acronym in Spanish)taxable base.

Additionally, in October 2013 and through a ruling by the Superintendence of Companies, it is resolved that companies within economic groups previously identified by the Ecuadorian Internal Revenue Service (SRI for its acronym in Spanish) are required to present consolidated financial statements. This requirement is in addition to that of companies which were already required to do so under International Financial Accounting Standards.

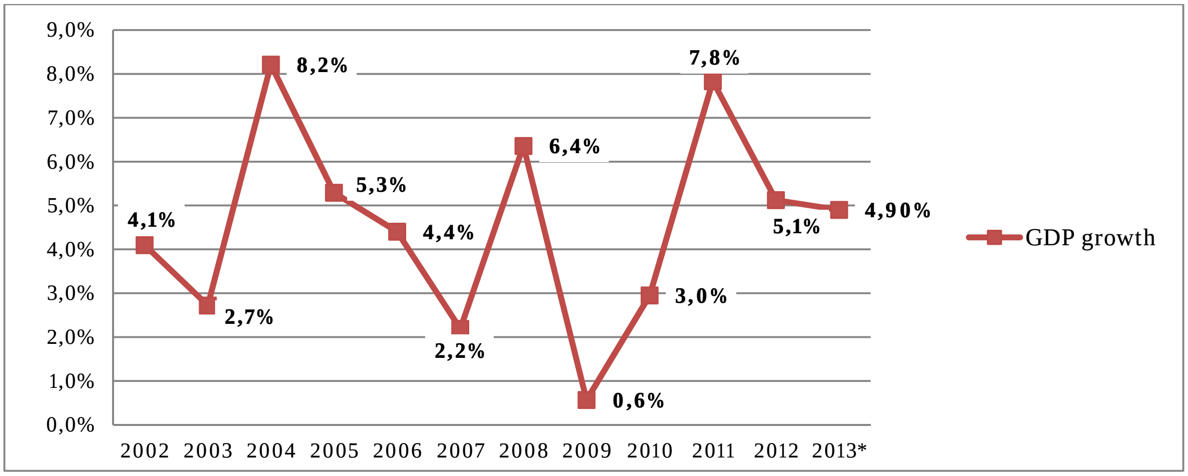
B. GDP

The Ecuador Central Bank (BCE for its acronym in Spanish), through its publication of the Quarterly National Accounts, revealed that the third quarter's GDP for 2013 increased by 4.9% in relation to the third quarter of 2012. This growth was boosted primarily by contributions from the non-oil sector which recorded an increase of 4.9% (in comparison with contribution from the oil sector which only increased by 3.8%). Among the GDP components that mainly contributed to the inter-annual economic growth forthis third quarter were the following: final consumption expenditures from homes (2.58%) and exports of goods and services (1.74%). With regards to economic activities that recorded major contributions to the inter-annual GDP we can identify the following: construction (0.62%), oil and mining (0.56%) and professional activities (0.54%).

According to BCE projections currently available, the GDP for 2013 is estimated to reach approximately USD 93.6 billion, a value greater than that of 2012 (USD 73.23 billion).

As previously mentioned, CEPAL projections determined an economic growth for Ecuador of 3.8%. In turn, the International Monetary Fund (IMF) projected a growth of 4.1% for 2013.

GRAPH N° 1
ECUADOR – GROSS DOMESTIC PRODUCT GROWTH



* *Variation corresponding to the third quarter of 2013*

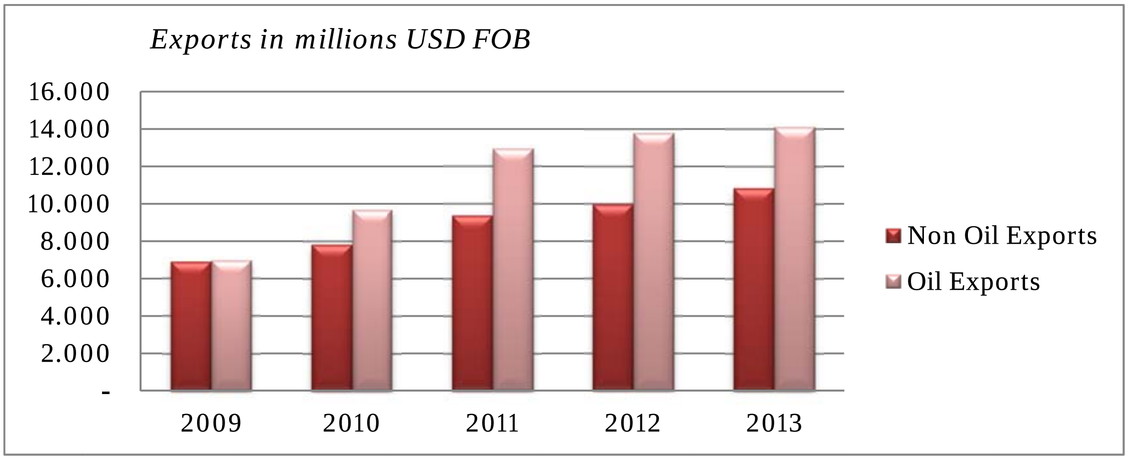
Source: Ecuador Central Bank.

C. Balance of Trade and Balance of Payments

Between January and November 2013, the balance of trade recorded a negative balance. Notwithstanding, by December 2013 it was recording a positive balance of USD 260.7 million. According to statistics based on BCE figures, Ecuador ended the year with a trade deficit of approximately USD 1,084 million; this balance for the same period in 2012 was negative by USD 440.6 million. The oil balance of trade as at December 2013 reached a positive balance of USD 8,027 million. On the other hand, the non-oil balance of trade recorded a negative balance of USD 9,111 million.

In turn, the total oil and non-oil exports for 2013 reached USD 14,108 million and USD 10,850 million (respectively). Thus, the total FOB exports amounted to USD 24,958 million -- this is to say 5% more than the total exports recorded in 2012 (USD 23,765 million).

GRAPH N° 2
ECUADOR – TOTAL EXPORTS IN 2013

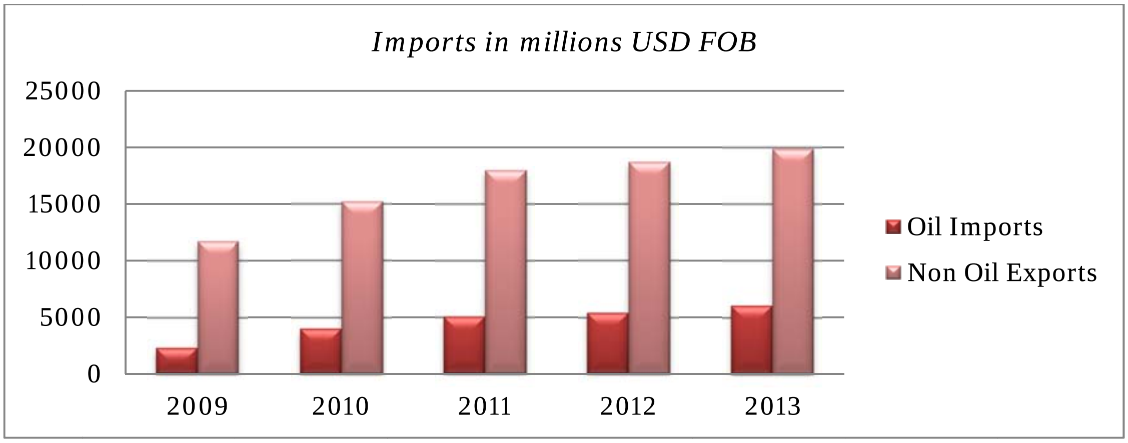


Source: Ecuador Central Bank

With regards to imports, the total FOB value recorded as at December 2013 was USD 25,979.50. This represented an increase of 7.4% in comparison to the imports undertaken during 2012 (USD 24,181.60 million).

Between 2012 and 2013, imports increased in the majority of product groups as was the case for fuels and lubricants (11.7%), raw materials (7.4%), capital goods (5.6%) and consumer goods (4.8%) among others.

GRAPH N° 3
ECUADOR – TOTAL IMPORTS IN 2013



Source: Ecuador Central Bank

Mid 2013 the Government decided to terminate its participation in the Andean Trade Promotion and Drug Eradication Act (ATPDEA) signed with the United States of America and in force since 1991. The ATPDEA allowed Ecuadorian products to enter de US market exempt of custom duties which represented savings for Ecuador of approximately USD 23 million.

The proposal of the Incentives Law regime sought to compensate exporters through the delivery of the Tax Bonus. This law represented a tax incentive that would allow the refund of custom duties paid in the US market.

Through a ruling in November 2013, the Foreign Trade Committee issued as a pre-import requirement the presentation of an acknowledgement certificate (or quality standards) for 293 items within the import tariffs listing.

D. Foreign Debt

As of December 2013 the public foreign debt balance amounted to USD 12,920.2 million – representing 14.3% of the GDP. In the case of private foreign debt, the balance was USD 5,624.6 million which represented 6.2% of the GDP.

E. Foreign Investment

According to data from the BCE, Direct Foreign Investment (DFI) between 2006 and 2012 behaved irregularly. The highest flow of DFI was recorded in 2008 (USD 1,057.5 million) channeled primarily towards the exploitation of mines and quarries. The DFI recorded as at the third quarter of 2013 amounted to USD 495.29 million – 31.4% more than what was reported during the same period in 2012.

During the third quarter of 2013, the activity sectors that have recorded the most foreign investment were: exploitation of mines and quarries, manufacturing, and commerce. According to amounts provided by the BCE, Holland was the country with the highest level of DFI during the third quarter of 2013, investing US 32.8 million in the exploitation of mines and quarries sector. Holland is followed by Spain and the USA as second and third with investments of USD 21.7 and USD 20.6 million respectively. Similarly, Uruguay destined most of its DFI in Ecuador into the construction sector; Mexico to transportation, warehousing and communications; Italy and Panama to corporate services; China, Spain, Venezuela and Chile to exploitation of mines and quarries.

Among the highest foreign investment projects, we can highlight the hydroelectric projects currently under construction by Chines and Brazilian companies as well as the new Quito Airport which became fully operational in February of 2013 after it opening was delayed from October 2012.

The Ministry for the Coordination of Production, Employment and Competitivity (MCPEC for its acronym in Spanish) signed the greatest foreign investment contract in 2013 with Ecuacorriente for an amount of USD 2,014 million relating to the extraction, exploitation, transport and commercialization of minerals. The signing of this contract would give rise to multiple benefits in Ecuador, such as the generation of new direct and indirect jobs, the strengthening of local and national production chains, the promotion of human talent, and the contribution of new income for the Government.

Similarly, in April 2013, four investment contracts were signed with Holcim, Surpapelcorp, Promopesca and Mastercubox. These investments will be applied in the construction, paper manufacturing, fishing and the agricultural food segments.

Additionally, early in the year, an investment contract was signed with overseas company Tenaris S.A. for the construction and operation of a completion plant for the manufacturing of tubing used in the oil industry.

F. Country Risk

At the end of 2013, Ecuador's country risk as measured by the Emerging Markets Bond Index (EMBI) was close to 530 points. Among the highest and lowest indexes obtained in 2013, we can highlight the 826 points reached at the beginning of January and the 499 points reached at the end of October. It is worth mentioning that the country risk's downwards tendency was maintained throughout the year with an exception of the 674 points reached at the end of September.

G. Employment, unemployment and poverty

On the other hand, as at December 2013 unemployment in Ecuador recorded 4.9% rate of the total Economically Active Population (PEA for its acronym in Spanish). Notwithstanding, at the close of 2013 sub-employment (lack of full time employment or adequate employment amount by the PEA) reached 43.3% of the total PEA.

According to information published by the BCE, as of December 2013, the rate for incidence of poverty in the national urban population was placed at 17.6%. In comparison, this rate for the same period in 2012 was 16.1%.

In Ecuador, for the year 2013, the minimum wage reached USD 318; representing an increase of 8.9% in comparison to the previous year (USD 292). In 2014, the minimum wage was increased by USD 22 and established at USD 340.

H. Inflation

According to the National Institute of Statistics and Census (INEC for its acronym in Spanish), the inflation as at December 2013 reached 2.7%. Evidencing a decrease of approximately 1.5 percentage points in comparison to the inflation rate of 4.16% recorded in December 2012.

In November 2013, and out of a group of 17 Latin American countries analyzed, Ecuador was positioned as one of the lowest inflation economies, below the median and average.

The segments with the highest Consumer Price Index increases during December were: alcoholic beverages (7.9%), restaurants and hotels (6.35%), education (6.05%), recreation and cultures (4.64%), and health (4.07%).

I. Interest Rates and the Financial System

The Organic Law for the Redistribution of Income for Social Expenditure published in December 2012, attempted to fund the increase of the Human Development Bonus (BDH for its acronym in Spanish) through tax reforms. Since then, tax reforms have been implemented for the country's financial institutions which included, among others, the following: changes to the income tax pre-payments, the application of Value Added Tax (VAT) to financial services, bank secrecy by the SRI, and the capping of salaries for administrators of the Banking Board.

The volume of total loans granted by the private financial system during 2013 amounted to USD 22,773.13 million and registered an annual variation rate of 30.78% between December 2012 and 2013. The segment that recorded the highest annual growth in credit volume for December 2013 was the corporate segment. Notwithstanding, it is worth noting that in the third quarter of 2013 financial institutions reported a volume decrease in loans within the housing segment. In comparison, financial institutions were more restrictive with regards to loans for the consumer, production and microcredit segments even though the demand for these types of loans increased. In September 2013, the BCE issued Regulation 047-2013 in order to regulate interest rates on credit defaults within the Ecuadorian financial system. This regulation involves a scale system of percentages ranging from 3% to 10% which would be payable over the capital owed and only from the default date until the outstanding payment date. Through this, the government seeks to incentivize loan payments on the basis that the sooner a client pays its loans, the lower the late interest rate will be.

In 2013 corporate loans and rate deposits maintained an average interest of 8.17% and 4.76% respectively. On the other hand, the average active referential interest rate in consumer loans was 15.91% during 2013.

J. Tax Legislation

Relating to tax, on January 24th 2013, the Ecuadorian Internal Revenue Service (SRI for its acronym in Spanish) proceeded to reform a Ruling issued in 2008 which established the scope for the presentation of the Transfer Pricing annex and report. Through this new reform, changes were established to the minimum amounts required for the compulsory presentation of the transfer pricing annex and report and revised the scope to include local transactions (among other issues).

Subsequently, in December 2013 the SRI determined that the economic analysis of the Transfer Pricing report must include, among others, a detailed summary of the search undertaken in the corresponding databases to obtain the comparables used. The summary requires screen shots of the searches performed, corresponding to each of the sequential steps undertaken.

Similarly in January, regulations were issued which determined the information and documentation that companies subject to the control and oversight of the Superintendence of Companies are required to present to it. By issuing these regulations, the Superintendence of Companies proceeds to detail the information that companies must present before this authority. It is worth noting that the level of information required may vary depending on the nature of each company (e.g. local companies vs. foreign branches, etc.).

Additionally, early this year and through the issuing of the corresponding SRI rulings, the tax return forms which need to be completed for purposes of filing the Remittance Tax (ISD for its acronym in Spanish) and Foreign Assets Tax were approved. Through the rulings issued, the tax authority proceeds to compliment the corresponding tax legislation by defining the applicable deadlines, processes and obligations.

On the other hand, in November 2013, the Double Taxation Agreement between Ecuador and South Korea was signed.

K. Perspectives for 2014

The country's economy will maintain its upwards growth tendency but at a lower rate in 2014 with respect to 2013. In fact, projections show a process of deacceleration for the Ecuadorian economy through the upcoming year. According to IMF projections published in October 2013, the country's growth will be 4.04%. For its part, the BCE projects a growth rate of 4.o5%. In turn, CEPAL's estimate is the most optimistic with a growth rate calculation of 4.5%. Additionally, and in accordance with the United States Energy Information Administration (EIA), the value per barrell of WTI oil is expected to reach US 95. Under this scenario, there would be continuity with regards to the oil revenues which represent a contribution of more than 30% of total fiscal revenues. Within the 2014 general budget, the oil price per barrell is established at USD 86. Accordingly, investment in the public sector will originate from external financing, and therefore, any reduction in oil prices would affect the country's economy.

Concerning inflation, 2013 recorded the lowest rate since 2008. Inflation did not vary significantly due to the fact that the dynamic of the country's economic activity remained constant throughout the year. A similar tendency is expected for 2014. It is worth noting that the price control policy on food products influenced this indicator's variation. For 2014, the IMF projects an inflation rate of 2.4%, whilst the official rate applied in the budget is 3.2%.

Moreover, Ecuador is a country that maintains a high degree of dependency on the evolution of the international economy. In 2013, countries from the Euro zone continued to be affected by the Global Financial Crisis (GFC) whilst the US economy showed signs of recovery. For its part, the Chinese economy deaccelerated, which affected global demand of certain products. For 2014, a minor deacceleration is expected in the Chinese economy, better perspectives for the European economies are envisioned and an optimistic outlook for the US economy currently exists. This will, in turn, impact the global demand for products, the volume of exports for each country and the prices of these goods, specially if they relate to commodities.

Finally, the completion and/or continuation of hydroelectric projects currently being executed is expected as is the construction of the Metro system for Quito.