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DIRECTORATE OF
INTELLIGENCE

# Intelligence Memorandum

## *Ecuador: Economic Impact of Petroleum Development*

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CENTRAL INTELLIGENCE AGENCY
Directorate of Intelligence
June 1972

INTELLIGENCE MEMORANDUM

# ECUADOR: ECONOMIC IMPACT OF PETROLEUM DEVELOPMENT

## Introduction

1. This chronically unstable and politically volatile country will soon become the second largest crude oil exporter in Latin America, although at levels far below Venezuela, the leading producer. Petroleum exports are scheduled to begin in July, after a Texaco-Gulf consortium completes a trans-Andean pipeline from the eastern jungle oilfields to the Pacific coast. The resulting spurt in foreign exchange earnings and budget revenues should substantially ease some of Ecuador's chronic economic problems. Important financial questions remain to be settled, however, between the consortium and the military government that took power in February 1972. This memorandum briefly examines Ecuador's economic problems and assesses the potential impact of petroleum development on them. It also discusses the unresolved issues that could impede further petroleum development and limit financial returns from the new industry.

## Discussion

### Background – Rodriguez's Economic Inheritance

2. When the military junta headed by Army General Guillermo Rodriguez Lara assumed power on 15 February 1972, it inherited the tenacious economic problems that were partly responsible for the Velasco government's overthrow. Budget deficits had increased steadily between 1969 and 1971 and, in the latter year, amounted to more than US $35 million – 18% of expenditures (see Figure 1). The Velasco government had attempted to dissipate the inflationary potential of its 1971 deficit by easing import restrictions. This move succeeded in holding the inflation rate to about 6%, but it also allowed imports to grow considerably more rapidly than exports (see Figure 2). Capital flight triggered by the turbulent

Note: This memorandum was prepared by the Office of Economic Research and coordinated within the Directorate of Intelligence.



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Figure 1

## ECUADOR: Government Revenues and Expenditures

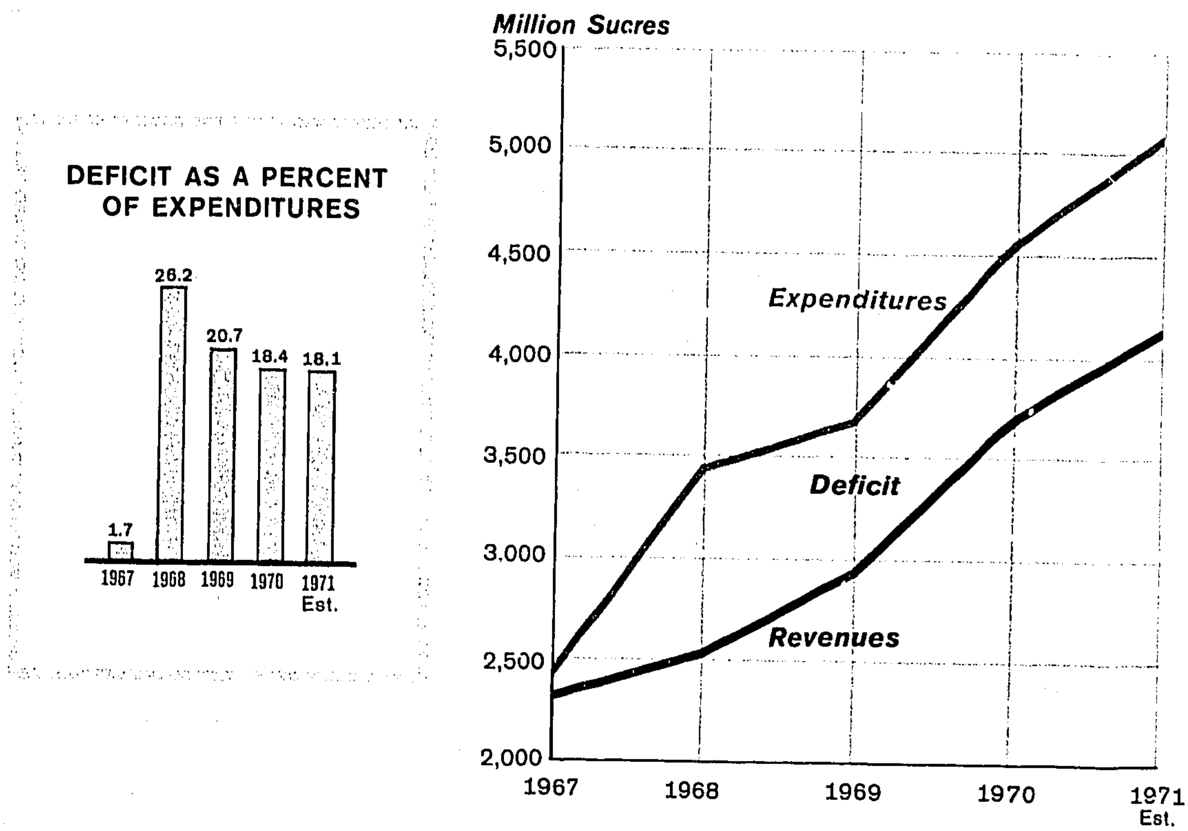
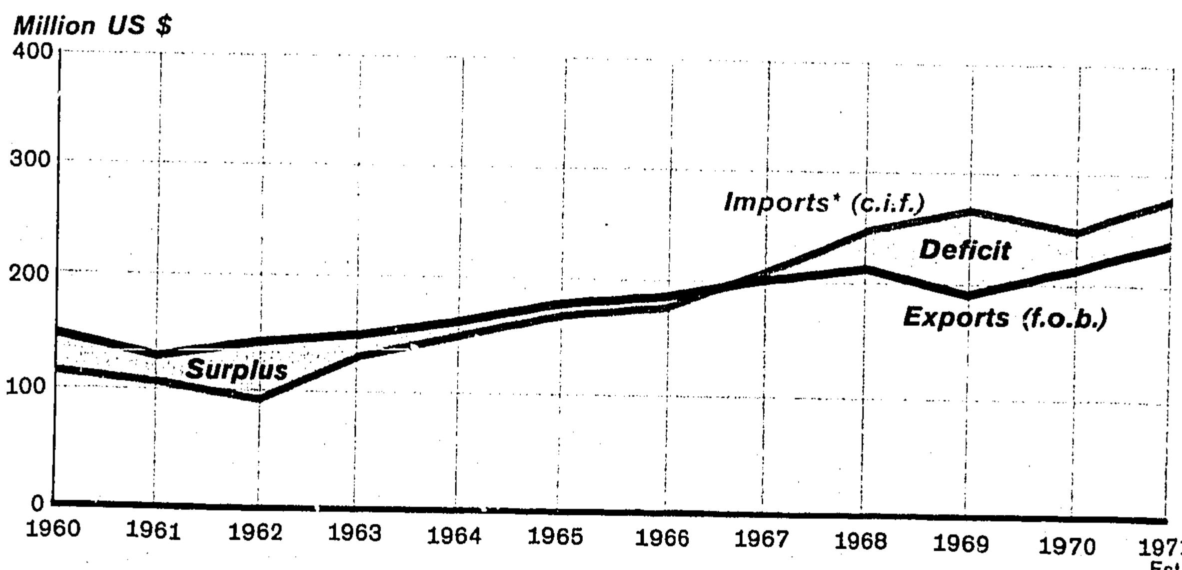



Figure 2

## ECUADOR: Trade Trends




*Excludes imports related to petroleum development, which generate additional trade deficits that are automatically financed by the foreign companies making the direct investment.

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pre-coup political situation further aggravated the foreign exchange drain. As a result, net foreign reserves fell during the year by more than one-half, to only $25 million – equal to about one month's imports and the lowest year-end reserve position since 1949.

3. The new government was able to stave off a financial crisis by negotiating a $40 million loan package with a US bank. The basic problems nevertheless remain and might be exacerbated by new social and economic programs if a major new revenue source were not on the horizon. While these programs are now little more than vague promises, some armed forces factions are pressing hard for a Peruvian-type "revolution." Other elements, including new Finance Minister Nestor Vega Moreno, are pushing for fiscal responsibility – at least during the first year. The sketchy 1972 budget approved by the previous administration projected a $40 million to $50 million deficit, but Vega claims that the deficit could reach $90 million unless substantial changes are made. Consequently, he is preparing a new 1972 budget that will focus on limiting expenditure growth and improving tax collection. Nevertheless, given the regime's need to establish a popular base, an eventual large expenditure increase will probably be politically necessary. The government increasingly is looking toward petroleum to save the day.

## The New Oil Discoveries

4. After almost three decades of unsuccessful exploration, commercial quantities of petroleum were discovered in March 1967. Since then, the Texaco-Gulf consortium that made the original discovery has had spectacular success. By the end of 1971, it had drilled 74 successful wells and only four dry holes in the northeastern jungles near the Colombian border (see photographs and map). The oil is of good quality, having a sulphur content of less than 1%. Proved reserves, already an estimated 5 billion to 6 billion barrels, could increase substantially as drilling by other consortia proceeds. Although Ecuador's proved reserves already exceed Colombia's 1.7 billion barrels and Bolivia's 200 million barrels, they still stand a distant second to Venezuela's 14 billion barrels.

5. Texaco-Gulf moved quickly to exploit its new discoveries. Following difficult negotiations in 1969, the consortium received government permission to construct a 318-mile, 20-26 inch diameter pipeline to the Pacific port of Esmeraldas. Construction has been rapid despite difficult mountain and jungle terrain, and the $154-million project is expected to be completed in June 1972, about six months ahead of schedule. By then the consortium's total investment in developing its 2.6 million acre concession will have reached an estimated $300 million, or about 60% to 70% of the book value of total US direct investment in Ecuador. The pipeline's capacity will be 250,000 barrels per day (b/d),



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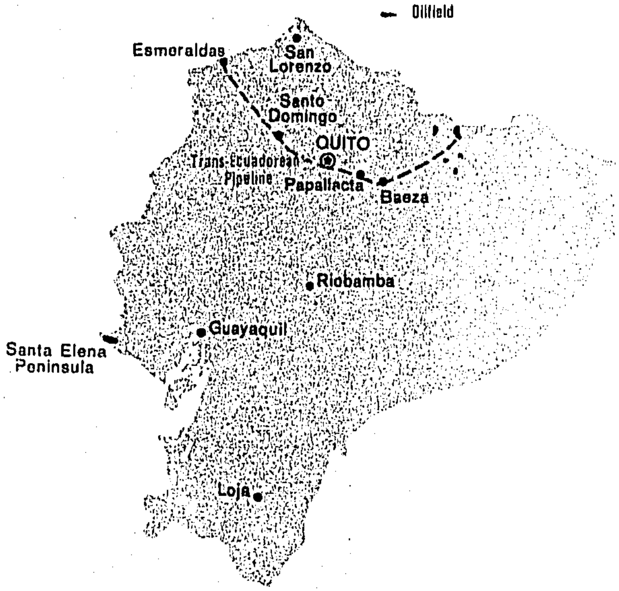
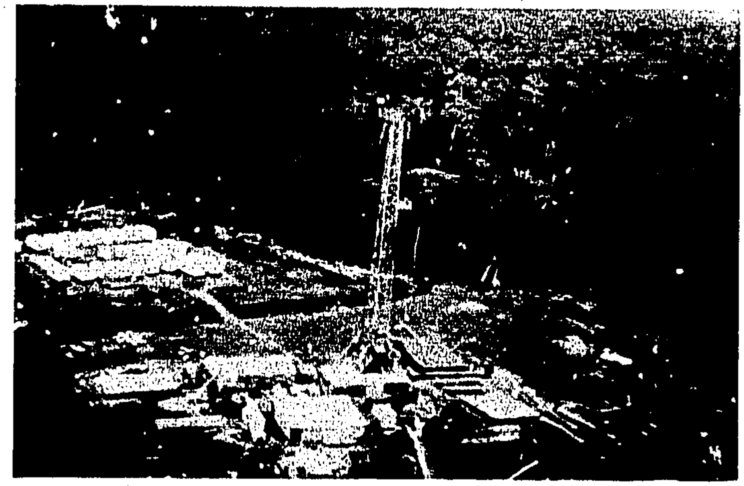
**ECUADOR: Petroleum Development**



Texaco-Gulf Drilling Rig in the Oriente

Crude Oil Storage Tanks at Esmeraldas

Coating and Laying Pipe near Santo Domingo

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which can be increased to 400,000 b/d by adding additional pumping stations. When operations begin, the pipeline's initial flow will be 150,000 to 200,000 b/d; full capacity should be reached in 1973. Ecuador's crude oil exports would then rank second in Latin America, after Venezuela's (which amounted to 2.2 million b/d in 1971).

6. Texaco-Gulf's success has attracted other foreign oil companies, and six other consortia embracing some 20 companies now are actively exploring or drilling in neighboring areas. Thus far, three consortia have announced oil finds, but their commercial potential has not yet been determined. Another US consortium has found gas in the Gulf of Guayaquil. If further drilling reveals that deposits are large enough for commercial production, liquefied gas exports seem likely.

## Petroleum and the Budget

7. Despite the government's new financial resources, budget strains will continue in 1972. If petroleum exports start at mid-year as anticipated, government oil revenues will reach an estimated $30 million this year – equal to 18% of its total revenues in 1971. Even so, if deficits are held to a reasonably noninflationary level, unpopular restraints on expenditures will still be necessary.

8. The government's revenue position should improve markedly in 1973. Expected oil revenues of about $100 million – some 60% of total 1971 revenues – would permit a balanced budget even with substantially increased public investments in social and economic infrastructure. The lack of such investment in recent years has been a major cause of unemployment and sluggish economic growth. Total gross domestic investment (excluding petroleum) was only about 11% of gross domestic product (GDP) in 1970, one of the lowest shares in South America, and public investment was a very small 4% of GDP and declining. Petroleum investment, financed almost entirely by foreign companies, reached some 3% of GDP in 1970.

9. The ousted Velasco government had laid the groundwork for channeling some petroleum revenues into public investment. For 1973, about $10 million were earmarked for electric power development, and $4.5 million were to be used to expand educational facilities. Velasco yielded to military pressure, however, and planned to use $10 million of oil revenues to purchase military equipment. The new government is not expected to make any immediate changes in these measures, but if it limits the rise in current expenditures, oil revenues will be available to finance other major investments. Priority areas for public investment include agricultural irrigation systems, road construction, and health facilities, in addition to education and electric power development.



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## Petroleum and Exports

10. Without oil, Ecuador's export prospects would not be promising. Three commodities – bananas, coffee, and cocoa – now account for 75% to 85% of total earnings (see the table). Banana exports, by far the most important, stagnated during the 1960s and then spurted in 1970-71 as Ecuador took advantage of storm damage in other producing countries. Because world production now is outrunning demand, however, Ecuador's banana sales probably will do no better than level off during the next few years. Moreover, growing world supplies are expected to restrict coffee and cocoa sales as well. Despite probably rapid expansion in minor exports, chiefly fish products, sugar, and lumber, the expected poor performance of Ecuador's chief foreign exchange earners could limit the growth of non-petroleum exports as a whole to 3% or 4% annually during the next few years.

Ecuador: Commodity Composition of Exports[a]

Million US $

| Commodity | 1960 | 1965 | 1969 | 1970 | 1971 Estimated |
|---|---|---|---|---|---|
| Bananas | 90 | 96 | 96 | 111 | 118 |
| Coffee | 22 | 38 | 27 | 50 | 36 |
| Cocoa | 21 | 19 | 25 | 22 | 25 |
| Fish products | 2 | 6 | 9 | 7 | 15 |
| Sugar | 1 | 7 | 11 | 9 | 14 |
| Other | 13 | 14 | 20 | 19 | 27 |
| **Total** | **149** | **180** | **188** | **218** | **235** |

a. Exports are f.o.b.

11. Petroleum exports should substantially improve this picture in 1973, when crude oil exports of 250,000 b/d should yield some $180 million in foreign exchange, equal to more than three-fourths of total export earnings in 1971. At this level, oil exports would represent 40% to 45% of total exports. If import growth can be held to a reasonable 8% annually,



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Ecuador could achieve a trade surplus approaching $100 million in 1973 and add substantially to its foreign reserves.

Unresolved Issues

12. How much or how little Ecuador eventually gains from its oil bonanza largely depends on the policies established relative to the foreign oil companies. Too generous a policy could entail needless loss of budget revenue and foreign exchange, while too strict a policy could discourage further oil expansion and generally dampen the investment climate. Several important financial issues carried over from the Velasco administration are still to be resolved by the government and Texaco-Gulf. These issues have been at least temporarily overshadowed by a totally unexpected decree of 6 June which would retroactively apply the very restrictive Hydrocarbons Law of October 1971 to all existing oil company contracts. The terms involved in the final resolution of all of these issues will be indicative of the degree of economic realism in the Rodriguez government's oil policy.

13. The most important issues still pending when the Velasco regime was ousted center on activating a 15% tax on oil exports, handling foreign exchange earnings from oil exports, establishing the price basis on which company income taxes will be calculated, and determining the pipeline amortization period. When the Velasco government imposed a 15% tax on exports other than oil after the August 1970 devaluation, it gave private assurances that the tax would not be extended to oil exports. This promise, however, has not been enacted into law despite consortium pressures to do so. The consortium also is pressing the government to modify its requirement that all oil companies' foreign exchange earnings be turned over to the Central Bank before exchange is made available for profit remittances and capital depreciation. It also is seeking a ruling on whether income taxes will be assessed on the basis of realized export prices or tax reference prices. The government began negotiations with Texaco-Gulf in April but, at the time of its surprise announcement in early June, had not resolved a single one of these issues. The company attributed this delay to the government's fear that its ignorance on petroleum matters would result in a faulty decision.

14. Although all of the oil companies operating in Ecuador have been highly critical of the Hydrocarbons Law, they had been repeatedly assured that the law would not be applied retroactively to their existing contracts. The Velasco government had indicated, however, that it would try to renegotiate several contracts, including Texaco-Gulf's, to make them conform more closely to the new law's "association" principle, which allows the government to share directly in profits. The oil companies are dismayed by the new government's more sweeping action and claim that, if the decree is strictly enforced, it would make petroleum operations in Ecuador



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unprofitable. Rodriguez's motives in issuing the decree are unclear. He could be making an empty gesture to nationalist forces while intending in practice to apply the decree only in the broadest and most lenient terms. It is also possible, however, that because of inexperience in petroleum matters the government misjudged the adverse impact of its precipitous action.

15. The tentative financial arrangements now in force between the government and Texaco-Gulf would give Ecuador 60% to 65% of gross profits, well below the average 80% that major oil-producing countries now receive. The government is well aware of this discrepancy and, faced with nationalist pressures, could be expected to try to exploit it. Texaco-Gulf, with its extensive investments serving as hostage, probably will be forced to give in to government demands even if they severely reduce the profitability of its operations. The other consortia, however, are not yet heavily committed. In the event of an unrealistic stance by Ecuador, they probably would deem it prudent to cut their losses by pulling out.

## Nationalism, Petroleum, and the Future

16. Since taking power, the new government has not had to contend with any organized political opposition, and for the moment Ecuador's political scene is relatively quiet. Given the country's past history, however, such a situation is unlikely to continue. Should the government's political position weaken, Rodriguez would be even more tempted to strike a nationalistic posture to consolidate public support. There is already an element within the military around which this course of action could coalesce. This element hopes that Rodriguez can be forced to emulate the military regime in Peru and press ahead rapidly with far-reaching social and economic reforms. Whether or not Rodriguez eventually follows such a course -- and there are few indications that he is personally inclined to do so -- will depend on internal political pressures.

17. The only obvious target of a nationalist course is the oil industry. Relations between the foreign oil companies and the Velasco government were always uneasy and threaten to continue unstable under Rodriguez. There are also strong indications that the new government is interested in participating in other aspects of the industry apart from crude oil production. It is moving ahead with plans initiated under Velasco to construct a refinery, strengthen the administration of the state-owned enterprise to monitor all phases of the petroleum industry, and establish a joint government-private tanker fleet to transport the one-half of oil exports reserved for Ecuadorean vessels.

18. If a modicum of reason prevails, however, there is little likelihood that Ecuador would want to nationalize the petroleum industry in the next few years. Unlike some other Latin American countries, Ecuador simply


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does not have the human resources to exploit its petroleum deposits. The state-owned Ecuadorean Government Petroleum Corporation was established only in January 1971. It is still in the process of being organized and has had no experience in the industry's day-to-day operations. Although the government is sending some military officers abroad for petroleum industry training, it will be years before they have much technical competence. Only when the oil companies themselves, through years of operation in the country, have trained a large corps of Ecuadorean workers, technicians, and administrators, will the government be in a position to operate the industry effectively. While an economically self-defeating act cannot be ruled out, it appears far more likely that Ecuadorean nationalism will take the form of increased regulation and demands for higher profit shares.



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