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Policy Brief

Negotiating a Trade Agreement with the EU: Estimated Poverty Impacts in Ecuador

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A trade agreement with the EU may result in significant poverty reduction in Ecuador. However, the outcome depends on the degree of initial tariff reduction and whether or not Ecuadorian bananas are granted better access to the EU market. If the banana sector is granted better access, then investment in other sectors must be encouraged if the agreement is to reduce poverty.

Negotiating a Trade Agreement with the EU: Estimated Poverty Impacts in Ecuador

By Sara Wong

As part of its policy to increase market access for Ecuadorian products, the government of Ecuador is negotiating a trade agreement with the European Union (EU). The EU is one of Ecuador's most important trading partners, accounting for an annual average of 14 percent of Ecuador's total exports between 2003 and 2007 and 10 percent of imports in the same period. Ecuador has complementary trade with the EU. That is, Ecuador exports mostly agricultural products to the EU, while the majority of its imports from the EU are manufactured goods. The EU is also the main market for Ecuador's biggest agricultural export: bananas. Banana exports represent 42 percent of Ecuador's total non-oil and non-manufacturing exports, and the EU accounts for about half of Ecuador's banana exports (49% in 2007).

Under the Generalized System of Preferences Plus (GSP+), most Ecuadorian products enter the EU free of tariffs. There are a few important exceptions, including bananas, which are subject to a tariff of 176 Euros per metric ton. Through a trade agreement with the EU, Ecuador seeks to eliminate tariffs on key Ecuadorian products and to make permanent the trade preferences it already receives under the GSP+. However, the ultimate purpose of the trade agreement is to reduce poverty. Poverty is widespread in Ecuador, particularly in rural areas, where 49.6 percent of the population lives in poverty and 22.7 percent lives in extreme poverty (see Table 1).

Given the high rates of poverty in Ecuador and the role of agriculture and trade in the economy, it is important to identify the likely economic impacts of changes in Ecuador's agricultural trade policies that would result from a trade agreement with the EU. However, there has been little research on this issue. To help fill this gap, a study was conducted to examine the impacts of a trade agreement with the EU on rural and urban poverty in Ecuador (see Wong and Kulmer 2009). The study analyzed the economic impacts of changes in trade policies through their effects on prices, wages, employment, and macroeconomic performance. A computable general equilibrium (CGE) model and a micro-simulations model were used to assess three policy scenarios (with separate simulations for full employment and unemployment among unskilled urban and rural wage workers):

- Free trade for all products (i.e., zero tariffs on EU products)
- Partial trade liberalization (i.e., 50% tariff reduction on all EU products)
- Free trade for all EU products plus relatively better access to the EU market for Ecuadorian bananas (i.e., a 15% increase in export prices)

These scenarios assume that Ecuadorian products (other than bananas) enter the EU market under the current GSP+ tariff rates. The results of the analysis suggest that a trade agreement with the EU may result in a significant reduction in poverty in Ecuador (see Table 1). However, the nature and extent of the poverty impacts will vary depending on the degree of initial tariff reduction and whether or not Ecuadorian bananas are granted better access to the EU market.

As shown in Table 1, under all three scenarios there is a decline in extreme poverty in rural regions. However, depending on the scenario, extreme poverty in urban regions may



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Footnote 1: This tariff may be
 reduced to 114 Euros per metric
 ton (over a seven-year period)
 under an agreement reached
 between the EU and the Latin
 American countries at the end of
 2009. If and when the agreement
 is ratified, it would end a sixteen-
 year WTO dispute.

increase. The greatest overall poverty reduction occurs under the first (free-trade) scenario, when unemployment among unskilled workers is assumed (a reasonable assumption for the Ecuadorian labor market). In this case, there is an estimated 9.22 percent reduction in poverty and a 4.30 percent reduction in extreme poverty. Poverty is reduced among both rural and urban households, although the greatest reduction occurs in urban areas. The reduction in poverty is a result of the increase in employment among rural unskilled workers, the increase in real wages and earnings for urban and rural workers and the self-employed, and the fall in consumer prices that occur under this scenario.

Under the 50% tariff reduction scenario (assuming unemployment among unskilled workers), the reduction in poverty would be less than under the zero tariff scenario, mainly because the reduction in consumer prices would likely be smaller than in the zero tariff case.

Under the third scenario, free trade that includes better access to the EU market for Ecuadorian bananas, there is an overall increase in poverty rates when unemployment among unskilled workers is assumed (although there is a slight decrease in extreme rural poverty). This result is due to developments in the banana sector and their impacts on other sectors. When one important sector, such as bananas, gains better access to the EU market relative to other sectors, the production of bananas will increase. However, under the current settings of the model, which do not allow additional investments (i.e., the model is static rather than dynamic), the increase in banana production and exports can only be achieved by shifting resources (particularly labor) away from other sectors. This causes a decline in production and a rise in consumer prices in these other sectors, which in turn works against poverty reduction. This result highlights the importance of implementing economic policies that encourage investment as the economy is opened up to increased trade.

Table 1. Percentage changes in poverty under different policy scenarios

| | Extreme Poverty | Poverty | Extreme Poverty | Poverty |
|--|------------------------|-------------------------|------------------------|-------------------------|
| | Below one dollar a day | Below two dollars a day | Below one dollar a day | Below two dollars a day |
| Current Poverty Rates (2005) | | | | |
| Total Households | 14.87 | 35.28 | 14.87 | 35.28 |
| Rural Households | 22.72 | 49.55 | 22.72 | 49.55 |
| Urban Households | 10.78 | 27.82 | 10.78 | 27.82 |
| Scenario: Free Trade | | | | |
| | Full employment | | Unemployment | |
| Total Households | 0.06 | 0.01 | -4.30 | -9.22 |
| Rural Households | -0.11 | 0.18 | -3.39 | -6.17 |
| Urban Households | 0.14 | -0.08 | -4.79 | -10.81 |
| Scenario: Partial Trade Liberalization | | | | |
| | Full employment | | Unemployment | |
| Total Households | 0.08 | 0.09 | 0.08 | 0.11 |
| Rural Households | -0.07 | 0.23 | -0.06 | 0.26 |
| Urban Households | 0.15 | 0.03 | 0.15 | 0.03 |
| Scenario: Free Trade with Better Access for Bananas | | | | |
| | Full employment | | Unemployment | |
| Total Households | -0.16 | -0.07 | 0.08 | 0.32 |
| Rural Households | -0.87 | -0.37 | -0.43 | 0.13 |
| Urban Households | 0.20 | 0.09 | 0.33 | 0.42 |

Note: For each policy scenario, separate simulations were conducted for full employment and unemployment among unskilled urban and rural wage workers. Poverty is measured using aggregate income.

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