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Ecuador: First Review Under the Stand-By Arrangement and Requests for Modifications and Waiver of Nonobservance and Applicability of Performance Criteria—Staff Report; Staff Statement; Press Release on the Executive Board Discussion; and Statement by the Executive Director of Ecuador

In the context of the first review under the Stand-By Arrangement and request for modifications and waiver of nonobservance and applicability of performance criteria, the following documents have been released and are included in this package:

- the staff report for the first review under the Stand-By Arrangement and requests for modifications and waiver of nonobservance and applicability of Performance Criteria, prepared by a staff team of the IMF, following discussions that ended on **June 30, 2003,** with the officials of Ecuador on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on July 24, 2003**. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a staff statement of **July 31, 2003** updating information on recent developments.

- a Press Release summarizing the **views of the Executive Board as expressed during its August 1, 2003 discussion** of the staff report that completed the review.

- a statement by the Executive Director for Ecuador.

The documents listed below have been or will be separately released.

Letter of Intent sent to the IMF by the authorities of Ecuador*
Memorandum of Economic and Financial Policies by the authorities of Ecuador
Technical Memorandum of Understanding*

*May also be included in Staff Report

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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First Review Under the Stand-By Arrangement and Requests for Modifications and Waiver of Nonobservance and Applicability of Performance Criteria

Prepared by the Western Hemisphere Department
(In consultation with other departments)

Approved by Charles Collyns and Mark Allen

July 23, 2003

- **Stand-By Arrangement.** An arrangement in the amount of SDR 151 million (US$206 million, or 46 percent of quota on an annual basis) was approved by the Executive Board on March 21, 2003. In addition, the repurchase expectations during the period of the arrangement (SDR 14.1 million) were converted to an obligations basis. The first tranche of SDR 30.2 million (US$42 million) was disbursed upon approval. Completion of the first review allows a purchase of SDR 30.2 million.

- **Discussions.** Discussions were held in Quito and Guayaquil during May 5–18, and at headquarters during June 26–30 with Minister of Economy Pozo, Central Bank President Yépez, and other senior officials and private sector representatives. The staff team comprised Mr. Traa (Head), Ms. Zermeño, and Messrs. Hirschhofer, Vesperoni (all WHD), Kapteyn (PDR), and Ley (FAD), and was assisted by Mr. Yuravlivker, the Fund resident representative. Ms. Krueger and Messrs. Singh and Dawson joined the final two days of the May mission, and met with President Gutiérrez, the economic cabinet, and representatives of the indigenous, corporate, and banking communities.

- **Developments under the program.** Slippages in the fiscal and financing program caused several end-March quantitative performance criteria to be missed, and while final data are not yet available, it is estimated that some end-June performance criteria also have not been observed. There were also delays in completing structural reforms, requiring that several follow-up structural reform measures be retimed. Moreover, in June, the authorities granted new wage and pension increases for which compensating policies had to be identified. Nevertheless, steps have been taken to put the program back on track, the Paris Club has agreed on a rescheduling in line with program assumptions, and progress is being made with the structural reforms.

- **Waivers.** With incomplete data, but with expectations that some program objectives were not met, waivers are being requested for nonobservance of the end-June quantitative PCs on the NFPS overall balance, noninterest expenditure, deposits in the central government account, external payments arrears, domestic payments arrears, and the continuous performance criterion on the nonaccumulation of external payments arrears. The authorities are also requesting a waiver of applicability for the end-June PC on the stock of registered debt, which is expected to have been observed. For the structural reforms, waivers are being requested for the delay of four banking reforms; a study of the petroleum sector; the hiring of private sector management in the electricity and telephone sectors; not fully meeting the objectives of the custom reform law; and for the delayed submission to Congress of the civil service reform bill.

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EXECUTIVE SUMMARY

Performance under the program. Program implementation has so far been uneven. While there have been fiscal slippages, the authorities are making efforts to bring the program back on track and the fiscal targets for the year remain within reach. Notwithstanding some delays, the banking, customs, and civil service reforms are moving forward. The authorities are also intensifying their efforts in structural reforms, with special emphasis on improving operating efficiency in the state enterprises.

Policies to complete the first review:

- **Prior actions.** These include re-submitting the civil service reform law as urgent legislation to Congress; taking measures to offset recent wage increases; reducing intermediation margins for fuel retailers to retain additional revenue for the budget; clearing external payments arrears; and signing a framework agreement to start collecting on fuel deliveries from PetroEcuador to the electricity sector and providing assurances that these payments will be transferred from PetroEcuador to the Treasury.

- **Fiscal policy.** Following slippages in the first half of the year, several corrective measures are being taken in order to achieve the NFPS primary surplus target of 5¼ percent of GDP for 2003 as a whole. Besides the prior actions noted above, the authorities would make further cuts in expenditures on goods and services; limit expenditure in the social security system to offset a new pension increase that has gone into effect in July; and take additional measures as necessary to limit the 2003 wage bill to the program amounts.

- **Enterprise reforms.** State enterprise reforms are being given increased priority as the companies are becoming a drain on the budget and on the economy. The authorities will expedite reforms in the oil sector to bolster output and revenues. The electricity and telephone companies also need to become more efficient and less costly, and the authorities would press ahead with the installation of private sector management in these enterprises. The authorities would also adopt policies to reduce inter-enterprise arrears and normalize payments flows between the oil and the electricity sector.

The risks to the program remain high. The cushions envisaged in the original program for fiscal slippages have been used up. Moreover, the government needs to strengthen political support for the structural reform agenda. Support could be bolstered by the unwavering implementation of the envisaged fiscal and reform policies, continued combating of corruption, and by eliminating payment arrears.

I. Recent Developments

1. **The main macroeconomic developments since the approval of the arrangement are as follows:**

- **Output growth**. Output growth continued to slow in the first half of 2003 as the domestic demand boom cooled and the new oil pipeline (OCP) shifted from the construction to the testing phase. In general, consumers and businesses have become more cautious in their spending, awaiting clearer signals on the direction of economic policies and reforms.

- **Inflation.** 12-month CPI inflation was 7.6 percent in June, slightly above program assumptions. Fuels prices and transport fares were increased in mid-January, and nontradeables prices have continued to rise. On the cost side, private sector wages were increased by 8 percent in January, and Congress has mandated an increase in the 14th month wage bonus *(bono escolar)* from US$8 to US$121 effective in 2003.

- **The external current account balance.** The first quarter deficit was lower than projected, reflecting improved estimates of the balance on services and transfers. The trade deficit was also lower, reflecting higher oil export prices and weaker imports than in the program, despite significantly higher fuel imports.

2. **The end-March NFPS overall surplus was slightly below target (see Table 1 attached to Appendix IV—the LOI), mainly because of difficulties in state enterprises and failure to fully implement the fiscal program.**

- **Despite higher-than-budgeted oil export prices, revenues were less than programmed**. PetroEcuador incurred higher-than-expected fuel import costs, which were netted out of oil revenue transfers to the budget. Moreover, some oil export revenues were deposited in a provisioning account in the Central Bank, instead of being distributed to the budget. Also, because of its poor collection record, the state electricity sector did not pay PetroEcuador for its fuels purchases, depressing the latter's operating result.[1] In February, Andinatel purchased a wireless telecom license from the government, but did not pay the fees on time. Also, the authorities did not implement a measure to reduce intermediation margins for fuel retailers and distributors that would have increased net revenues from fuel sales to the budget.

- **Primary expenditures were less than originally programmed but slightly above the adjusted end-March program ceiling**. The limit was lowered by US$90 million, consistent with the shortfall in oil revenues transferred to the budget.[2] The authorities

[1] Not all state companies are included in the NFPS, due to a lack of data.

[2] The adjustor relates to net oil revenues being transferred to the budget. When they are above budget, the windfall needs to be saved. When they are below budget, expenditures

(continued)

did not implement the reversal of a one time subsidy to the National Development Corporation (CFN), nor did they suspend the net lending program from the Social Security Institute (IESS). At the same time, the government did not implement an agreed increase in the *bono solidario* (the social safety net) to compensate the poor for the fuel price hikes in January. Capital outlays and expenditures in local governments were lower than programmed through May.

3. **Preliminary indications suggest that the fiscal performance in the period April–June continued to fall short of the program.** Budgetary oil revenues continued to disappoint because of a rupture in the government-owned oil pipeline in May and a 10-day strike in PetroEcuador in June. In April and May, more cautious consumer spending contributed to a dip in tax revenues, and a corruption scandal in customs led to weaker import tax compliance. As a result, the end-June overall NFPS fiscal balance target is estimated to have been missed. Expenditure data are incomplete, but the authorities made efforts to dampen outlays, and spending in the social security institute (IESS) was below program. Nevertheless, with the disappointing oil revenues and the effect of the program adjustor, staff estimates still suggest a small deviation from the program expenditure target.

Summary of Program Performance for January-June 2003

(In millions of U.S. dollars)

	Program target	Preliminary staff estimate	Margin (+)
Overall NFPS balance (surplus +)	420	260	-160
Noninterest expenditure	2,616	2,641	-25
Deposits of the NFPS	1,226	1,483	257
Deposits of the Central Government	187	125	-62
Gross registered public sector debt	13,862	13,500	365
External arrears	0	5	-5
Domestic arrears	22	200	-178

Source: Staff estimates.

need to be cut. The bulk of the shortfall in oil revenues reflects the resources that had been placed in a provisioning account in the BCE, instead of being transferred to the budget.

4. **There were also some slippages in the financing plan, although corrective measures were taken in the second quarter.** Reflecting administrative delays in the first quarter, and the above-mentioned unexpected placement of oil revenues in a provisioning account, the authorities issued less debt and accumulated more deposits than programmed. This lowered the debt, but also created new liquidity pressures on the Treasury, resulting in domestic arrears. However, in the second quarter, the coordination with the Attorney General's office was improved to avoid delays in authorizing debt placements, and agreements were made with IESS to improve liquidity management. These efforts permitted substantial debt placements in April–May. Also, the oil export revenues that had accumulated in the BCE provisioning account were released to the budget by end-June, permitting some reduction in the stock of arrears.

5. **The Paris Club rescheduling was concluded in June (Box).** Some small arrears on noneligible amounts that were incurred during April, May, and June have been paid off. Amounts falling due in July would also need to be paid off as a prior action for this review. The authorities are negotiating with non-Paris Club members to obtain debt relief comparable to that provided by the Paris Club (burden sharing).

6. **There has been progress on the fiscal reforms.** The passage of the Customs Reform Law was an important step forward, providing more demanding requirements for valuation and documentation at the point of origin, better information systems, and tighter surveillance in the ports. However, it does not provide the Internal Revenue Service with sufficient authority over personnel management in the customs office, as had been sought. A civil service and wage unification reform bill was submitted to Congress, albeit with some delay. However, Congress indicated that, because of its length and complexity, the reform bill could not be treated on an emergency basis (see below).

7. **In the banking system, deposits continued to expand but credit to the private sector remained stagnant.** Reflecting continued uncertainty about the direction of economic policies, most deposits remained short term and banks continued to expand their liquidity reserves abroad. While the EMBI risk spread for Ecuador—along with the overall EMBI index—has dropped significantly since end-2002, the domestic deposit and lending rates remain at around 5 and 14 percent, respectively. Banks' profit margins are still healthy, but nonperforming loan ratios increased markedly to double digits in 9 out of 22 banks. The deterioration was related to the growth slow down as well as a tightening of the classification of consumer loans in effect since November 2002.[3]

8. **There was progress on resolving the issues with failed banks.** In Filanbanco, two independent firms have begun collecting on the loan portfolio; audits were started for nine closed banks in the AGD; and the AGD will complete the first auction of the restructured

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[3] Consumer loans account for nearly a quarter of total loans.

Box. Paris Club Rescheduling

On June 13, 2003, the Paris Club concluded an agreement with Ecuador to reschedule US$81 million in debt service falling due between March 1, 2003 and March 31, 2004. Assuming an additional US$22 million in comparable treatment from other creditors (excluding bonds of the 2000 debt exchange, and multilaterals), this agreement provides the exceptional financing from bilateral creditors envisaged for the program.

In the original LOI and MEP (February 10, 2003) for the SBA, it had been assumed that US$150 million in debt relief would be obtained from Paris Club and other creditors on outstanding arrears and maturities falling due in 2003 to resolve intrayear liquidity pressures. However, to expedite the negotiations, and reflecting resistance by some creditors again to reschedule arrears, the authorities agreed with Paris Club creditors first to clear arrears of US$86 million that were outstanding at end-February.[1]

The negotiations took place in Paris from June 11–13. The authorities obtained a rescheduling of US$69 million on Houston terms, and a deferral until March 2004 of an additional US$12 million. In addition, the Paris Club agreed to a goodwill clause to follow developments with Ecuador's external debt, and possible needs for additional debt relief, in the context of an updated debt sustainability analysis in the next Article IV consultation. The rescheduling will come into force when the first review under the current arrangement is approved by the Executive Board (entry-into-force clause).

1/ The arrears clearance was financed by a drawdown of central bank net foreign assets, and left US$84 million to be rescheduled. This figure was subsequently revised upward to US$103 million in the data reconciliation process.

loan portfolios as a prior action for the first review.[4] The AGD is also moving forward to collect on the loans through foreclosures. An international investment firm has been hired to bring Banco del Pacífico to the point of sale.

9. **In the April–June period, the authorities continued to face very strong political pressures from diverse fronts and agreed to new expenditure demands.** The corporate sector, indigenous movements, civil service unions, those in state enterprises, and pensioners and teachers, all continued to press for tax concessions or increased spending. In the face of these pressures, the authorities decided that they could not suspend a 27 percent pension increase, effective July (half-year cost of US$48 million in 2003), contrary to what had been expected under the program.[5] Also, in June, the authorities settled a lengthy teacher's strike by increasing their wages by US$25 million in 2003, and US$170 million from 2004

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[4] About US$35 million in loans of the closed banks are in the AGD and could be auctioned off.

[5] The increase had been granted initially by the outgoing administration in January 2003, to be implemented by the IESS, which is an autonomous agency and not directly under control of the central government authorities.

onward.[6] Earlier in the year, five ministries had gone on strike and obtained wage concessions effective in July, provided that offsetting measures are found to contain the ministerial wage bills within the originally targeted amounts.[7]

10. **These difficulties reflect the lack of consensus on disciplined financial policies and on structural reforms to strengthen the economy consistent with dollarization.** Protests and strike activity have continued, including in the oil sector and, most recently, by health care workers. Moreover, the political environment has been further complicated by accusations that the previous government mismanaged the bonded debt exchange in 2000, which are now being investigated by state prosecutors. If the Ecuadoran courts find that the debt exchange had been conducted in a faulty manner, the US$2.6 billion haircut that was obtained in the exchange may need to be reinstated, which would present serious new financing challenges.

II. Report on the Discussions

A. Macroeconomic Framework

11. **The macroeconomic framework has been modified to reflect recent information.** The projection for output growth was reduced from 3½ to some 3 percent, reflecting the likelihood that economic activity would remain subdued until the new oil pipeline comes on stream. CPI inflation is projected to be around 7 percent by year-end, up from 6½ percent expected earlier. The external current account deficit is projected to be 4.9 percent of GDP, from 5.3 percent in the original program.

B. Fiscal Policy

Program for the remainder of 2003

12. **Despite the recent expenditure increases, the revised 2003 program maintains the NFPS primary surplus target of 5¼ percent of GDP**. The revised fiscal projections incorporate higher oil prices than had been budgeted (the WEO price for Ecuador blend of US$24.70, compared with a budget assumption of US$18 per barrel).[8] The overall fiscal

[6] As the wage increase is being phased in, the impact in 2003 is small compared to 2004. The wage bill for 2004 is now projected to be double that of 1999 (in dollar terms).

[7] The authorities emphasized that it would be a violation of the budget law to increase the payrolls of the five ministries involved in this agreement, and no increase has yet taken place.

[8] The higher oil price does not trigger an adjustment of the primary surplus target because the (net) oil revenues in the budget would still be below the program amounts.

objective is achievable, provided that some delayed corrective measures are put in place, and that the new spending increases are compensated within the year:

- The authorities have issued a decree to reduce the intermediation margin for fuel distributors, yielding US$8 million through year-end (a prior action for the review).
- To begin collecting from the electricity companies for fuel deliveries from PetroEcuador, the government has negotiated an interagency agreement, as a prior action for this review, to collect at least US$70 million from these companies during the remainder of 2003. These payments would in turn be transferred from PetroEcuador to the Treasury.
- Goods and services spending would be curtailed by a further US$25 million.
- Earmarked expenditures from the new oil stabilization fund (FEIREP) would be allocated only in the 2004 budget, reducing 2003 outlays by US$13 million.
- The teacher's wage increase of US$25 million would be compensated within the program wage bill by cleaning the government payroll of absentee workers and by implementing hiring restrictions through year-end. Issuance of related decrees was a prior action for this review.
- The increased pension costs in 2003 would be absorbed in the budget of the Social Security Institute (IESS), which is experiencing higher contributions and lower health outlays than had been expected. IESS would now also restrict net lending.
- In July, the authorities implemented the first step increase in the cash assistance program to the poor for the fuels price increases of January. The authorities are working with the IDB on improving further the targeting of the social safety net to lay the basis for the elimination of the cooking gas subsidy by year-end.

13. **Improvements in the financing plan would support the arrears clearance program**. Besides the Paris Club rescheduling, understandings have now been reached with the multilateral institutions: US$200 million in program support was approved by the World Bank in May, and another US$200 million was approved by the IDB in June. Scheduled disbursements from these loans amount to US$200 million in 2003. The remaining US$180 million in external financing would be provided by the CAF and the Fund (of which US$42 million in this review). In addition, the authorities are planning to issue US$380 million of Treasury securities during the second half of 2003.

Fiscal reforms

14. **The civil service reform was resubmitted to Congress as emergency legislation** (prior action for this review). This reform contains all the elements discussed in the program to facilitate the restructuring of the public sector labor force, beginning in 2004, and also contains two corrective measures to complete the missing elements of the Customs Reform

Law (provisions to restructure customs personnel, and to prohibit them from sharing in the proceeds from the auctions of confiscated goods). The remaining aspects of the reform will be resubmitted to Congress as soon as possible as a separate wage unification bill, i.e., after the consideration of the tax reform bill, which is to be sent to Congress as urgent legislation by end-August.

15. **The mission reviewed the progress on submitting to Congress of a tax reform law including the elimination of earmarking** (an end-August PC). The authorities said that they were preparing this reform and aimed to have a first draft ready in late July.

16. **The strategy to deal with the challenges in the social security system is to obtain first an actuarial study of the social security system and a diagnostic review of the system's operating procedures, and then to develop remedial measures, as needed.** The authorities indicated that with the new increase in July, average pensions would be at their level in dollar terms of 1998 (just before the crisis), and no further exceptional increases in pensions were envisaged in the future. However, the mission noted that average benefits had risen faster than wages since dollarization, and the ratio of beneficiaries to contributors had increased, and the consistency of these developments with long-term solvency of the system needed to be assessed.[9] Therefore, the authorities would seek assistance from the World Bank immediately to update the actuarial balance of the system (and that of the police and military pension funds) before end-September, as a structural benchmark under the program, and to review the operating procedures of these autonomous agencies. Based on the findings of these studies, a calendar of corrective steps, including a possible recalibration of contribution rates, would be developed as required to strengthen the system.

Fiscal policies for 2004

17. **Increased spending commitments have made the further fiscal strengthening envisaged for 2004 harder to achieve.** On a full-year basis, the pension and wage increases are estimated to add nearly US$100 million and US$180 million, respectively, in expenditures from 2004 onward. The staff indicated that it was important to maintain the momentum toward restoring Ecuador's fiscal sustainability, and reiterated its particular concern about the competitiveness implications of the wage increases. Therefore, such pressures would need to be substantially compensated with permanent revenue increases or expenditure offsets. The authorities indicated that they shared the staff's view on the need to preserve competitiveness and they would pursue two new main initiatives:

- On the expenditure side, the increase in the wage bill increase would be cut to US$105 million. Using provisions in the civil service reform, the authorities would now seek to reduce employment by end-2004, thus cutting the wage bill by US$25 million (the full-year savings would be US$50 million from 2005 onward).

[9] A preliminary figure for the actuarial balance of the pension system contained in Table 4 suggests a deficit that is already one-third of GDP.

The other US$50 million would be the full-year carry-over effect from the measures to be taken in the remainder of 2003 to maintain the wage bill for this year within the program limits. The severance payments for the employment reductions in 2004 (estimated at 0.4 percent of GDP) would be included above-the-line in other current expenditures.

- On the revenue side, all invoice subsidies to the electricity sector will be eliminated (i.e., no more fuel deliveries without cash payment) starting in September 2003 (this would yield US$210 million in 2004). Through end-2003, the authorities would develop with the oil and electricity sectors a payments system, and seek to improve managerial efficiency in the enterprises in support of this objective, as described below. The staff would monitor these efforts in the upcoming reviews.

18. **Based on these compensatory measures, the primary surplus is projected to be 6.4 percent of GDP in 2004—an improvement of over 1 percentage point of GDP from 2003.** While the surplus in 2004 is less than projected at the time of program approval, the difference is accounted for by the outlays for severance payments as a one-time expenditure, which would be financed with higher program disbursements from the World Bank and IDB. The appropriate objective for the primary fiscal surplus in 2004 will be discussed further with the authorities in the context of the next review, with a view to getting as close as possible to the original adjustment path.

C. Banking Reforms

19. **The reforms in the banking system would continue in the second half of the year, aiming largely to complete the process of dealing with failed banks.** For Filanbanco, by end-September, an independent firm would be hired to start collecting on the real estate assets as well. The closed AGD banks that are currently receiving audits, are expected to enter liquidation by end-August. And the Banco del Pacífico is expected to be ready for sale by end-September.

20. **An FSAP mission is planned for September to assess Ecuador's financial system.** The FSAP would look at a broad set of issues related to the safety net and crisis management, including deposit insurance, procedures for efficient bank resolution, stress testing and early warning triggers, and the institutional role of the central bank. The authorities would also explore with the FSAP mission options for a new liquidity fund. The authorities said that while the legal protection for regulators and supervisors was relatively weak, there was little political support to strengthen it, and they would like to explore options on this issue with the FSAP mission as well.

D. Enterprise Reforms

21. **From the poor experience in the first half of 2003, it is clear that enterprise reforms are now overdue**. Operating efficiency in the state enterprises has deteriorated in recent years, reflecting weak management and poor labor relations. PetroEcuador is steadily losing output and the refineries and the state-owned oil pipeline (SOTE) have suffered from

inadequate maintenance and upgrading, and are now frequently breaking down. Also, the public enterprises' accounting is opaque and their cost structure unclear. To help remedy this situation, several efforts would be undertaken:

- **PetroEcuador.** The authorities' strategy to deal with the challenges in the oil sector is to focus policies on efficiency improvements in PetroEcuador and to expand participation by the private sector in some state-run oil fields, with the objective of increasing oil revenues to the budget. As part of this strategy, PetroEcuador will contract an international firm to conduct an independent external financial audit (an end-September structural PC). Moreover, the authorities already are working with foreign oil-industry experts to assist them with a diagnostic study of the production and distribution of petroleum products (however, due to delays it is now proposed to be retimed as an end-October structural PC), and to develop an action plan for policy adjustments. As a prior action for this review, the authorities issued a decree establishing a high-level advisory committee comprising the ministers of economy and energy, and the president of the BCE, to implement this action plan and any other reforms that may be needed in the oil sector.

- **Electricity companies.** The authorities' strategy in the electricity sector is to strengthen management of the distribution companies and to stem the losses from nonpayment of electricity bills, thus improving the payments stream from the distributors to the electricity generators, to PetroEcuador, and ultimately to the budget. In this regard, and as a prior action for the review, a written agreement has been signed between the electricity sector, PetroEcuador, and the central government to make at least US$70 million in cash payments to PetroEcuador in 2003, and to eliminate altogether the purchase of fuel deliveries from PetroEcuador to the electricity generators on credit starting in September 2003, as noted above. Public sector management in the distribution companies would be replaced by private sector management by end-August (a structural PC).

- **Telephone companies.** The operations of the telephone companies would also be improved by bringing in private sector management. Discussions are at an advanced stage for signing a contract with an international firm to manage Pacifictel, the telephone company in the coastal region, which experiences billing losses of up to 50 percent. The authorities will also bring private sector management to Andinatel, even though this company is somewhat better run.

E. Other Issues

22. **Debt management and debt reduction.** From late 2003 onward, the oil stabilization fund (FEIREP) will receive resources to begin reducing Ecuador's debt. The authorities are contacting international financial experts to manage these debt reductions in an appropriate way to avoid front-running and other pitfalls sometimes associated with such operations.

23. **Safeguards assessment**. A safeguards assessment mission visited Ecuador in March. The report was generally positive and made some recommendations for follow-up actions.

Most importantly, it called for a resolution to publish the annual financial statements of the Central Bank of Ecuador within its annual report, starting with the 2003 report (including disclosure notes and the audit opinion). The authorities issued this resolution on April 2.

F. Risks to the Program

24. **While progress has been made, the program is subject to considerable risks, as was foreshadowed in the Board paper (EBS/03/21).** The main risks relate to the steady erosion of competitiveness and growth prospects brought on by the continued pressures to increase spending, and to the state enterprises' production and financial difficulties. The banking system would also be at risk if these trends continue. In addition, there are political pressures, especially from vested interests, to dilute the government's reform agenda. Continued efforts to strengthen the social safety net and to reduce corruption should help to build support for the government's drive to sustain prudent macroeconomic policies.

25. **Risks also arise from limited managerial and administrative capacity.** Continued problems in the state enterprises could again lower revenues to the budget. The program contains corrective measures, but these may need some time to take effect.

26. **Finally, the central government will need to be vigilant in implementing its challenging financing program.** The placement of Treasury securities is very ambitious, but necessary in view of the need to clear arrears. If the government's assumptions on these placements can not be met, it will have to negotiate with entities within the public sector to mobilize more of their deposits to finance the Treasury, which are projected to be higher now than in the original program.

G. Prior Actions, Performance Criteria, and Request for Waivers

27. **To help limit the implementation risks, the program contains several prior actions for the completion of the first review** (Annex I of the attached SMEP). The quantitative performance criteria are presented in Tables 1 and 2 of the SMEP. These prior actions have now been met, except for the completion of a first auction of restructured loans under the AGD, and the requirement to clear external arrears on non-reschedulable Paris Club obligations. The floor on the overall fiscal surplus, the central government deposits, and the stock of domestic arrears are proposed to be revised slightly for end-September; and the ceiling on the stock of debt is proposed to be lowered for all quarters. Some structural performance criteria are proposed to be retimed, as in Annex II of the SMEP.

28. **The authorities are requesting several waivers (paragraphs 2 and 3 of the LOI).** While final data are not yet available for several quantitative PCs through end-June, preliminary staff estimates suggest that they were missed (paragraph 4 above), and the authorities are requesting a waiver for nonobservance. The staff can support the request based on corrective measures that are under way, and since, with these corrective steps, the program objectives for year-end are preserved. For the PC on the stock of gross debt, which staff estimates suggest was observed, the authorities are requesting a waiver of applicability, which the staff can also support. Regarding the structural PCs, the authorities have missed

several implementation deadlines. As indicated in the attached LOI and SMEP, several have now been completed. For others, the authorities are proposing some retiming, but most actions would be taken by the time of the next review. Since the authorities are making efforts to complete the structural reforms, the staff can also support this waiver request.

III. Staff Appraisal

29. **Taken overall, the authorities are making progress with program implementation.** The new administration took some courageous measures when it entered office in January; the end-March NFPS surplus was close to program; the stock of debt declined; and external arrears were largely eliminated. Also, substantial progress was made with the banking and customs reforms, and the preparation of the civil service reform.

30. **Nevertheless, there were important slippages in the fiscal and financing program.** Some of the measures were not implemented; oil revenues were not distributed to the budget as envisaged; and the financing program initially was handled poorly. This resulted in a large stock of domestic arrears, which affected the willingness of public employees, local governments, and suppliers to cooperate with the government's program. The authorities have also granted large new permanent expenditures in wages and pensions, but did not implement on time the increase in the *bono solidario* to compensate the poor for the fuels and transportation price hikes in January.

31. **The authorities are committed to implementing the measures needed to bring the fiscal program back on track.** Recent actions to contain wage costs and begin collection for fuel deliveries from electricity companies are encouraging steps forward, and together with the benefits of the favorable oil prices, means that the fiscal objectives for the year remain within reach. However, the earlier cushion from a conservative oil price assumption has been used up, and the authorities cannot afford any further slippages. The efforts being made to strengthen the financing program are commendable, and should allow the reduction of the domestic arrears under the program by year-end. Ecuador needs to put an end to the recurrence of any arrears.

32. **The structural reform program is under way.** Some initial delays were addressed, and the government has made up ground lately. The follow-up steps in the banking reforms are proposed to be retimed slightly, but virtually all of them would still be concluded by end-September. The customs reform represents a good advance, and the authorities have folded into the civil service reform bill two provisions to complete its remaining objectives. The draft civil service reform bill represents a major effort, and will be considered by Congress as emergency legislation. It will be important that the resulting law be consistent with the objective of limiting the increase in the public sector wage bill, which will require determined implementation through a substantial reduction in public sector employment.

33. **Enterprise reforms clearly have become very urgent.** The deterioration in PetroEcuador's financial situation, and the recurrent managerial and financial problems in the electricity and the telephone sectors are becoming major threats to the public finances and the productive infrastructure of the country. The staff welcomes the financial audit that will be

contracted by PetroEcuador, and Pacifictel should soon be placed under the management of a large international firm. The reforms in the electricity sector need to be implemented firmly and without delay.

34. **The staff can recommend completion of the review and approval of the necessary waivers and program modifications requested by the authorities.** This is based on the undertakings presented in the LOI and SMEP, and provided the prior actions for the review are fully implemented. To be sure, the risks from political pressures to increase spending and hold back reforms remain large. Improved performance under the program hinges on difficult measures to offset new wage costs, improve the cash payments from electricity companies, and bolster the performance of PetroEcuador. These measures will require greater public support for the program than has been forthcoming so far. This support may have been bolstered by the recent progress in strengthening the social safety net, but will also depend on continuing efforts to combat corruption through the reform program, and avoiding the build-up of domestic or external payments arrears.

Table 1. Ecuador: Selected Economic and Financial Indicators

	1999	2000	2001	2002	2003 Program Original	2003 Program Revised	2004 Projection Original	2004 Projection Revised
(Annual percentage changes; unless otherwise indicated)								
National income and prices								
Real GDP	-6.3	2.8	5.1	3.4	3.5	3.1	6.0	5.0
Domestic demand (contribution to growth)	-19.7	7.5	10.9	9.1	3.6	4.6	4.6	3.3
Consumption	-6.8	3.9	4.8	4.6	3.5	3.9	2.8	3.8
Gross fixed investment	-27.7	12.1	12.1	17.6	2.8	5.0	9.9	2.0
Foreign balance (contribution to growth)	13.4	-4.7	-5.8	-5.7	-0.2	-1.5	1.4	1.6
Exports of goods and nonfactor services	7.8	-1.0	-1.3	0.9	1.7	2.6	11.1	4.6
Imports of goods and nonfactor services	-29.5	15.8	17.2	17.2	1.9	6.1	6.2	-0.2
Real GDP per capita	-8.2	0.9	3.2	1.5	1.6	1.2	4.1	3.1
Consumer price index period average	-29.2	-7.7	37.7	12.6	7.9	8.2	4.4	4.4
Consumer price index end-of-period	-25.2	-10.1	22.4	9.4	6.5	7.0	4.0	4.0
Unemployment	14.4	14.1	10.4	8.7	...	...	...	...
Banking system								
Liabilities to the private sector	19.2	8.5	24.2	18.4	11.2	11.2	10.0	10.0
Net domestic assets	23.6	-12.1	26.3	22.5	18.2	8.0	7.1	2.9
Credit to the private sector	...	-5.1	16.9	13.6	10.7	7.1	10.9	9.6
Average overnight rate (in percent)	7.8	6.1	3.4	1.5	...	...	...	...
Average lending rate (in percent)	16.5	16.3	15.1	14.4	...	...	...	...
EMBI Ecuador (percentage points spread)	2,650	2,866	1,233	1,801	...	...	...	...
EMBI Latin America (percentage points spread)	853	669	833	1,007	...	...	...	...
External sector								
Exports	5.9	10.7	-5.0	7.5	0.1	5.1	13.6	5.3
Oil	60.3	65.1	-22.2	8.5	-7.2	10.0	27.0	5.5
Non-oil	-9.4	-16.4	11.8	6.9	5.1	1.6	5.3	5.1
Imports	-46.4	24.5	43.6	20.6	3.7	8.4	8.1	0.8
Terms of trade, national accounts data (deterioration -)	9.1	10.7	-15.6	4.3	-2.2	1.3	-0.4	-0.4
Real effective exchange rate (depreciation -)	-30.8	-6.6	39.4	10.1	...	...	...	...
(In percent of GDP)								
Public finances								
Revenue	22.5	27.6	24.7	26.0	27.0	26.2	27.8	28.0
Noninterest expenditure	19.1	19.9	19.6	21.7	21.9	21.1	21.2	21.6
Discrepancy (unrecorded expenditure -)	0.0	0.0	-0.8	0.2	0.0	0.0	0.0	0.0
Primary balance (deficit -)	3.4	7.7	4.3	4.5	5.2	5.2	6.7	6.4
Interest bill	8.1	6.6	4.7	3.5	3.3	3.1	3.1	3.1
Overall balance (deficit -)	-4.6	1.0	-0.5	1.0	1.9	2.0	3.6	3.3
Total public debt	101.2	91.4	70.2	58.2	51.7	51.0	44.1	44.7
Domestic	18.7	19.4	15.7	11.3	9.4	8.9	7.4	8.3
External	82.5	72.0	54.5	46.9	42.2	42.1	36.7	36.4
Saving investment balance								
National saving	20.5	26.4	23.2	23.6	20.2	22.6	22.2	23.2
Gross investment	14.7	20.1	25.7	27.7	25.5	27.4	26.2	26.9
Foreign saving = external current account deficit (+)	-5.7	-6.3	2.4	4.2	5.3	4.9	4.1	3.7
Memorandum items:								
Public sector external debt service (percent of exports of goods and nonfactor services)	27.7	28.7	26.5	22.0	22.5	21.5	20.8	21.4
Interest	21.5	22.9	13.6	10.4	10.6	10.0	9.5	9.5
Principal	6.2	5.8	12.8	11.5	11.9	11.5	11.3	11.9
Use of Fund resources (percent of quota)	0.0	37.5	75.0	75.0	100.2	100.2	85.1	85.1
Net foreign assets (in millions of US$)	872	1,180	1,074	1,008	919	1,219	1,154	1,665
Public sector deposits (in millions of US$)	570	1,228	1,261	1,327	1,306	1,519	1,589	1,941
Central government deposits (in millions of US$)	78	396	86	118	118	118	218	218

Sources: Central Bank of Ecuador; Ministry of Finance; and Fund staff estimates and projections.

Table 2. Ecuador: Operations of the Nonfinancial Public Sector

	1999	2000	2001	2002	2003 Program Original	2003 Program Revised	2004 Projection Original	2004 Projection Revised
	(In millions of U.S. dollars)							
Revenue	**3,751**	**4,391**	**5,184**	**6,318**	**7,244**	**7,048**	**8,197**	**8,217**
Oil revenue 1/	1,039	1,461	1,351	1,393	1,686	1,678	1,925	2,128
Non-oil revenue	2,581	2,793	3,728	4,709	5,314	5,169	6,035	5,866
Taxes	1,517	1,870	2,590	3,047	3,419	3,228	3,849	3,616
Social security contributions	228	215	455	766	895	951	1,097	1,171
Other	836	708	683	896	1,000	990	1,089	1,079
Operating surplus of public enterprises	131	137	105	216	244	201	237	224
Primary expenditure	**3,177**	**3,169**	**4,127**	**5,273**	**5,858**	**5,663**	**6,228**	**6,338**
Current	2,181	2,287	2,719	3,719	4,327	4,200	4,604	4,735
Wages and salaries	1,181	910	1,446	1,991	2,239	2,240	2,213	2,345
Purchases of goods and services	511	521	670	870	912	883	996	940
Social Security Benefits	...	...	151	346	636	561	700	727
Other 2/	489	856	452	512	536	515	674	707
Social spending in FEIREP	0	0	0	0	4	0	21	16
Capital	995	882	1,408	1,554	1,531	1,464	1,624	1,603
Fixed capital spending	...	...	...	1,396	1,571	1,470	1,624	1,603
Net-lending	...	...	...	158	-40	-6	0	0
Discrepancy (unrecorded operations)	0	0	-163	42	0	0		0
Primary balance	**575**	**1,222**	**894**	**1,087**	**1,386**	**1,385**	**1,969**	**1,879**
Interest	1,348	1,057	990	842	877	842	906	909
Overall balance nonfinancial public sector	**-773**	**165**	**-96**	**245**	**509**	**543**	**1,063**	**970**
	(In percent of GDP)							
Revenue	**22.5**	**27.6**	**24.7**	**26.0**	**27.0**	**26.2**	**27.8**	**28.0**
Oil revenue 1/	6.2	9.2	6.4	5.7	6.3	6.2	6.5	7.3
Nonpetroleum revenue	15.5	17.5	17.7	19.4	19.8	19.2	20.5	20.0
Taxes	9.1	11.7	12.3	12.5	12.8	12.0	13.1	12.3
Social security contributions	1.4	1.3	2.2	3.2	3.3	3.5	3.7	4.0
Other	5.0	4.4	3.2	3.7	3.7	3.7	3.7	3.7
Operating surplus of public enterprises	0.8	0.9	0.5	0.9	0.9	0.7	0.8	0.8
Primary expenditure	**19.1**	**19.9**	**19.6**	**21.7**	**21.9**	**21.1**	**21.2**	**21.6**
Current	13.1	14.4	12.9	15.3	16.1	15.6	15.6	16.1
Wages and salaries	7.1	5.7	6.9	8.2	8.4	8.3	7.5	8.0
Purchases of goods and services	3.1	3.3	3.2	3.6	3.4	3.3	3.4	3.2
Social security benefits	...	...	...	1.4	2.4	2.1	2.4	2.5
Other	2.9	5.4	2.1	2.1	2.0	1.9	2.3	2.4
Capital	6.0	5.5	6.7	6.4	5.7	5.4	5.5	5.5
Fixed capital spending	...	...	...	5.7	5.9	5.5	5.5	5.5
Net-lending	...	...	...	0.6	-0.1	0.0	0.0	0.0
Discrepancy (unrecorded operations)	0.0	0.0	-0.8	0.2	0.0	0.0	0.0	0.0
Primary balance	**3.4**	**7.7**	**4.3**	**4.5**	**5.2**	**5.2**	**6.7**	**6.4**
Interest	8.1	6.6	4.7	3.5	3.3	3.1	3.1	3.1
Overall balance nonfinancial public sector	**-4.6**	**1.0**	**-0.5**	**1.0**	**1.9**	**2.0**	**3.6**	**3.3**
Memorandum items:								
Real growth in primary expenditure (percent)	-10.4	7.3	3.7	13.7	3.5	0.1	2.0	6.9
Fiscal balance excluding oil export revenue (percent of GDP)	...	...	-5.0	-3.0	-1.4	-1.7	0.4	0.1
Implicit average interest rate on the debt (percent)	8.8	7.2	7.1	6.1	6.3	6.2	7.3	7.3
GDP (in millions of US$)	16,674	15,934	21,024	24,311	26,808	26,872	29,432	29,338

Sources: Ministry of Finance; Central Bank of Ecuador; and Fund staff estimates and projections.

1/ From 2003 onward, includes revenues accruing to the oil stabilization fund (FEIREP).

2/ Data in the 2003 are not strictly comparable to previous years, because the subsidy on cooking gas is now presented as an expenditue, rather than netting it out of oil revenue.

Table 3. Ecuador: Nonfinancial Public Sector Financing

(In millions of U.S. dollars)

					2003 Program		2004 Projection	
	1999	2000	2001	2002	Original	Revised	Original	Revised
Gross financing needs	**1,614**	**2,606**	**1,981**	**2,233**	**1,976**	**2,983**	**1,550**	**2,067**
Nonfinancial public sector deficit	773	0	96	0	0	0	0	0
Deposit build-up (+)	-251	670	33	20	24	192	283	422
Amortization	556	905	1,117	1,113	1,150	1,058	1,174	1,276
External	556	606	731	710	726	749	776	816
Domestic	0	299	386	403	424	310	398	460
Additional debt reduction	0	0	0	0	29	173	15	306
Accounts payable carried in	0	0	79	68	78	78	67	63
Gross arrears clearance	0	865	304	832	626	1,482	12	0
External	0	772	116	446	185	341	0	0
Domestic	0	93	188	386	441	1,141	12	0
Other financing requirements 1/	535	166	352	200	69	0	0	0
Gross identified financing	**1,522**	**1,652**	**1,648**	**1,983**	**1,402**	**2,374**	**1,470**	**1,824**
Nonfinancial public sector surplus	0	165	0	246	509	543	1,064	970
Bond issues	262	266	333	138	376	460	0	440
External	0	0	3	0	0	0	0	0
Domestic	262	266	330	138	376	460	0	440
Loan disbursements	380	796	584	412	339	315	338	348
External - Project loans	380	796	584	328	308	295	280	290
Domestic	0	0	0	84	31	20	58	58
Accounts payable carried out	0	0	68	78	66	65	69	66
Gross arrears accumulation	880	425	663	798	25	888	0	0
External	330	0	98	436	25	189	0	0
Domestic	550	425	565	362	0	699	0	0
Other	0	0	0	312	88	104	0	0
Gap = exceptional financing	**92**	**954**	**333**	**250**	**574**	**608**	**80**	**243**
Rescheduling/debt relief	92	815	28	74	84	100	0	4
IDB	0	139	61	0	100	100	40	100
WB	0	0	71	0	130	130	0	100
CAF	0	0	173	81	100	119	0	0
IMF	0	0	0	96	160	160	40	40
Unidentified	0	0	0	0	0	0	0	0

Sources: Ministry of Finance; Central Bank of Ecuador; and Fund staff estimates and projections.

1/ Includes financial assistance to public banks.

Table 4. Ecuador: Public Sector Balance Sheet (Preliminary)

(In millions of U.S. dollars)

	1999	2000	2001	2002	2003 Program		2004 Projection	
					Original	Revised	Original	Revised
Assets	**91,134**	**140,395**	**114,308**	**116,341**	**104,117**	**134,427**	**106,423**	**106,641**
Deposits	570	1,228	1,261	1,327	1,306	1,519	1,589	1,941
Net worth BCE	1,032	1,343	1,037	1,037	1,141	1,146	1,253	1,251
Equity participation in enterprises and funds	5,484	4,424	4,620	5,205	5,977	5,800	6,605	6,371
Fixed capital stock, adjusted for depreciation 1/	11,271	11,204	11,701	12,819	13,623	13,623	14,778	14,778
Proven petroleum reserves 2/	60,381	104,440	75,002	82,817	66,325	96,555	65,740	65,761
Proven natural gas reserves 3/	8,103	13,653	15,276	6,877	8,834	8,834	8,831	8,831
FEIREP stabilization fund	0	0	0	0	8	31	50	156
NPV of biodiversity and carbon-dioxide capture 4/	4,293	4,102	5,412	6,259	6,902	6,918	7,577	7,552
Liabilities	**21,080**	**18,575**	**20,067**	**20,288**	**20,610**	**20,489**	**20,412**	**20,500**
NPV of shortfall in deposit insurance reserves 5/	2,131	2,036	2,686	3,106	3,426	3,434	3,761	3,748
NPV of shortfall in El Niño Contingent Insurance Fund 5/	2,073	1,981	2,614	3,023	3,333	3,341	3,659	3,647
Registered debt	16,496	13,227	13,979	13,371	13,782	13,544	12,932	12,931
Domestic	3,124	2,757	2,696	2,119	2,463	2,227	2,123	2,265
External	13,372	10,470	11,284	11,252	11,319	11,317	10,809	10,666
Net arrears and net accounts payable	380	1,331	788	788	69	171	60	174
Net worth	**70,054**	**121,820**	**94,241**	**96,052**	**83,507**	**113,937**	**86,011**	**86,140**
Net worth excluding oil and gas reserves	1,570	3,727	3,963	6,358	8,348	8,548	11,440	11,548
Net worth at constant oil and gas prices of 2001	96,540	96,369	94,241	94,361	95,506	95,729	97,320	97,450
Index: 1970 = 100	69	69	68	68	69	69	70	70
Memorandum items:								
Registered debt and arrears, in percent of GDP	101.2	91.4	70.2	58.2	51.7	51.0	44.1	44.7
Domestic	18.7	19.4	15.7	11.3	9.4	8.9	7.4	8.3
External	82.5	72.0	54.5	46.9	42.2	42.1	36.7	36.4
Contingent liability refund VAT to oil companies 6/	0	0	41	137	233	233	...	...
Actuarial shortfall in pension system 7/	6,279	6,000	7,531	8,422	9,007	9,031	9,329	9,391

Sources: Ecuadoran authorities; Arteta and Samaniego (World Bank, April 2001); Energy Information Agency of the U.S. Department of Energy (various issues); and Fund staff calculations.

1/ Vintage adjusted capital stock adjusted for depreciation (straight line, perpetual inventory method).

2/ Millions of barrels of proven reserves at average spot price pbbl, minus US$3.20 pbbl for transportation and extraction costs.

3/ Estimated natural gas reserves at average spot price at wellhead, per thousand cubic feet.

4/ Biodiversity: net present value of a notional annual income stream on 10 million hectares of national parks. Value per hectare (US$22.50) obtained from biodiversity valuation in Costa Rica (see Arteta & Samaniego). CO2 capture of Ecuador's forests: NPV of polution rights as discussed in the Kyoto Treaty (see Arteta & Samaniego).

5/ Estimate of reserve needs for explicitly or implicitly insured events in the banking system (deposit insurance), recurring (i.e., predictable) weather-related damage (El Niño), or recurring earthquake/volcanic damage (see Arteta & Samaniego).

6/ Private oil companies claim the tax authorities owe them VAT refunds; this dispute may require a court decision.

7/ There is no official published estimate of the actuarial position of the social security system. These values are preliminary Fund staff estimates based on data provided by Ecuadoran analysts.

Table 5. Ecuador: Summary Accounts of the Banking System

	1999 1/	2000	2001	2002	2003 Program Original	2003 Program Revised	2004 Projection Original	2004 Projection Revised
	(In millions of U.S. dollars, unless otherwise specified)							
	I. Central Bank							
Net foreign assets 2/	**872**	**1,180**	**1,074**	**1,008**	**919**	**1,219**	**1,226**	**1,665**
Net domestic assets	**254**	**-919**	**-785**	**-704**	**-624**	**-923**	**-907**	**-1,346**
Net credit to the nonfinancial public sector 3/	979	346	277	77	35	-226	-313	-713
Net credit to the banking system	412	170	282	356	338	322	338	322
Other assets net	-1,138	-1,435	-1,345	-1,137	-997	-1,019	-932	-954
Central bank fully backed liabilities	**1,126**	**261**	**289**	**304**	**296**	**296**	**319**	**320**
	II. Banking System							
Net foreign assets	**-224**	**137**	**506**	**728**	**721**	**843**	**791**	**913**
Net domestic assets	**3,497**	**3,770**	**4,363**	**5,029**	**5,657**	**5,555**	**6,225**	**6,125**
Net assets held in the central bank	149	225	124	190	114	132	133	150
Net credit to nonfinancial public sector	312	214	268	177	131	305	131	346
Net credit to the private sector	2,765	2,623	3,066	3,483	3,863	3,731	4,284	4,090
Other domestic assets	271	708	904	1,180	1,549	1,387	1,677	1,539
Liabilities to the private sector	**3,273**	**3,907**	**4,869**	**5,757**	**6,378**	**6,399**	**7,016**	**7,038**
Deposits	2,878	3,608	4,475	5,304	5,880	5,900	6,468	6,490
Other	395	299	393	453	498	499	547	549
	III. Consolidated Banking System							
Net foreign assets	**648**	**1,316**	**1,580**	**1,736**	**1,640**	**2,062**	**2,017**	**2,578**
Net domestic assets	**2,986**	**2,626**	**3,316**	**4,061**	**4,786**	**4,385**	**5,051**	**4,512**
Net credit to the nonfinancial public sector	1,291	560	545	253	166	79	-182	-367
Net credit to the private sector	2,765	2,623	3,066	3,483	3,863	3,731	4,284	4,090
Other net domestic assets	-1,071	-558	-295	325	758	574	949	789
Liabilities to the private sector	**3,634**	**3,942**	**4,896**	**5,797**	**6,426**	**6,447**	**7,068**	**7,090**
	(Flows, in millions of U.S. dollars)							
Consolidated banking system								
Net foreign assets	...	668	264	156	-89	326	377	516
Net domestic assets	...	-360	690	745	737	324	265	127
Net credit to the nonfinancial public sector	...	-731	-15	-292	-82	-174	-348	-448
Net credit to the private sector	...	-142	443	417	374	249	422	359
Other assets	...	513	262	620	445	249	191	217
Liabilities to the private sector	...	308	954	901	648	650	642	644
Memorandum items:								
M2 (percentage change)	19.2	12.4	23.6	18.7	11.3	11.3	10.0	10.0
M1 (percentage change)	88.6	5.4	41.1	31.1	13.9	13.8	10.0	10.0
Net credit to private sector (percentage change)	...	-5.1	16.9	13.6	10.7	7.1	10.9	9.6
Public sector deposits at central bank	500	1,079	1,001	1,027	1,009	1,270	1,333	1,733
Central government deposits "cuenta única"		396	86	118	118	118	218	218

Sources: Central Bank of Ecuador, and Fund staff estimates and projections.

1/ End-1999 figures valued at end-of-period exchange rates.

2/ Including IMF liabilities.

3/ The original program was redefined to make it consistent with the current treatment of IMF liabilities by the BCE.

Table 6. Ecuador: Banking Soundness Indicators 1/ 2/

	December			2003				
	2000	2001	2002	January	February	March	April	May
I. Profitability Ratios								
(In percent of total assets and contingencies)								
Operating revenue	22.1	9.9	11.4	1.0	1.9	2.8	3.8	4.8
Private banks	22.5	9.7	11.0	1.0	1.9	2.6	3.5	4.5
Public banks	21.4	11.4	15.0	1.0	1.9	4.3	6.0	7.3
Operating expenses	21.0	9.0	10.7	0.9	1.7	2.6	3.5	4.4
Private banks	20.5	8.2	9.7	0.8	1.7	2.5	3.4	4.3
Public banks	21.9	16.3	20.5	1.2	2.3	3.4	4.7	5.8
Net operating margin	1.1	0.9	0.7	0.1	0.2	0.2	0.3	0.4
Private banks	2.0	1.5	1.4	0.1	0.2	0.3	0.4	0.5
Public banks	-0.5	-4.8	-5.4	-0.2	-0.5	-0.7	-1.0	-1.1
Profits	-2.2	-0.4	1.2	0.1	0.3	0.4	0.5	0.6
Private banks	0.7	1.1	1.3	0.1	0.3	0.4	0.5	0.7
Public banks	-7.6	-14.6	0.3	0.1	0.1	0.2	0.3	0.4
Profits (percent of equity)	-25.2	-5.2	15.4	1.5	2.9	4.5	5.8	7.4
Private banks	10.4	15.5	18.1	1.7	3.2	4.9	6.5	8.2
Public banks	-63.9	-68.1	2.1	0.5	1.1	1.9	2.3	2.9
II. Asset Quality Ratios								
Nonperforming loans/total loans (percent)	34.7	13.4	8.4	9.2	9.6	10.0	9.6	10.1
Private banks	12.2	7.4	6.0	6.7	7.2	7.7	7.5	8.1
Public banks	60.6	53.3	32.3	33.7	33.3	33.6	31.9	31.7
Loan provisions/total loans (percent)	28.9	15.5	11.0	11.0	11.1	10.8	10.6	10.6
Private banks	14.4	9.5	7.7	7.8	7.9	7.9	7.7	7.5
Public banks	45.5	55.5	43.9	42.9	43.7	41.8	43.0	43.9
Uncovered nonperforming loans/total loans (percent)	5.9	-2.1	-2.6	-1.8	-1.6	-0.9	-1.0	-0.5
Private banks	-2.2	-2.1	-1.7	-1.1	-0.7	-0.2	-0.1	0.6
Public banks	15.1	-2.2	-11.6	-9.2	-10.4	-8.3	-11.1	-12.2
Loan provisions/past-due loans (percent)	83.1	115.5	131.4	120.0	116.2	108.8	110.8	105.1
Private banks	118.0	127.9	129.0	116.3	109.1	102.3	101.5	92.9
Public banks	75.0	104.1	136.0	127.4	131.3	124.6	134.7	138.5
III. Liquidity Ratios								
Total loans/total deposits (percent)	94.4	76.1	70.7	71.2	70.4	67.6	67.6	67.3
Private banks	75.2	71.3	69.7	70.2	69.3	66.8	67.2	66.6
Public banks	133.4	139.1	82.2	83.7	82.4	76.7	72.1	76.8
Total liquid assets/total deposits (percent)	42.2	35.3	34.7	34.9	34.5	36.5	36.0	36.7
Private banks	45.4	33.8	31.0	31.0	30.9	33.2	32.1	33.5
Public banks	35.8	54.9	77.6	80.0	77.2	76.8	81.2	76.9
IV. Capital Adequacy Ratios 3/								
Capital/(assets plus contingencies) (percent)	6.5	8.1	8.9	9.1	9.1	9.0	9.0	9.0
Private banks	7.8	8.2	8.4	8.6	8.6	8.5	8.5	8.5
Public banks	4.3	6.9	13.2	13.4	13.4	13.3	13.3	13.3
Capital/risk-adjusted asssets (percent)	13.1	13.5	14.4	14.7	14.8	14.9	14.9	14.9
Private banks	16.1	13.7	13.2	13.6	13.6	13.7	13.7	13.7
Public banks	8.1	11.8	28.2	28.7	28.9	29.4	29.4	29.4
Deposits/capital = leverage (percent)	767.2	722.4	677.7	659.2	663.1	679.1	679.4	694.2
Memorandum items:								
Private banks' share of total assets (percent)	64.7	90.2	89.9	90.0	89.9	90.1	90.1	90.1
Public banks share of total assets (percent)	35.3	9.8	10.1	10.0	10.1	9.9	9.9	9.9

Sources: Superintendency of Banks; and Central Bank of Ecuador.

1/ For open banks.

2/ The data are cummulative to the end of the year, or to the corresponding month.

3/ Capital in balance sheet at the end of the period net of profits. Last data available are for March 2003.

Table 7. Ecuador: Balance of Payments

	1999	2000	2001	2002	2003 Program Orig. 1/	2003 Program Rev. 2/	2004 Projection Original	2004 Projection Revised
(In millions of U.S. dollars)								
Current account	**955**	**1,004**	**-509**	**-1,014**	**-1,429**	**-1,310**	**-1,196**	**-1,085**
Trade account	1,665	1,458	-302	-976	-1,191	-1,223	-1,017	-991
Exports, f.o.b.	4,451	4,927	4,678	5,030	4,957	5,285	5,628	5,565
Of which: petroleum products	1,480	2,443	1,900	2,061	1,887	2,268	2,396	2,393
Imports (f.o.b.)	-2,786	-3,469	-4,981	-6,005	-6,147	-6,508	-6,645	-6,557
Of which: oil sector investment 3/	-492	-544	-896	-845	-753	-753	-524	-520
Services (net)	-1,811	-1,814	-1,867	-1,716	-1,876	-1,781	-1,911	-1,822
Of which: interest payments	-1,134	-1,205	-999	-1,032	-1,050	-979	-941	-931
Transfers (net)	1,101	1,360	1,660	1,678	1,639	1,695	1,731	1,729
Capital account	**-1,801**	**65**	**349**	**779**	**798**	**945**	**1,441**	**1,337**
Net public sector capital	210	540	-23	-308	-475	-474	-575	-588
Direct investment	636	720	1,330	1,275	1,246	1,301	1,355	1,039
Of which: oil sector	615	680	1,120	1,057	1,076	1,076	805	799
Other net private sector capital 4/	-2,647	-1,195	-958	-187	27	118	661	887
Banks	224	-361	-370	-383	0	-115	-70	-70
Other private sector	-2,871	-834	-588	196	27	233	731	957
Purchase of U.S. dollars for dollarization	...	-865	...	...	...	...	...	...
Overall balance	**-846**	**204**	**-160**	**-235**	**-630**	**-365**	**244**	**252**
Financing	**846**	**-204**	**160**	**235**	**57**	**-244**	**-324**	**-496**
NFA at the BCE (increase -) 5/	423	-165	152	177	219	-82	-324	-496
Net exceptional financing	423	-39	86	57	-163	-133	0	0
Public sector arrears (decrease -) 6/	331	-854	-9	-16	-163	-162	0	0
Debt relief obtained 7/	92	815	95	73	0	29	0	0
Public debt reduction	0	0	0	0	0	-139	-15	-306
Cash outlay from debt reduction	0	0	0	0	0	110	15	306
Others 8/	0	0	-78	0	0	0	0	0
Financing gap	**0**	**0**	**0**	**0**	**574**	**608**	**80**	**244**
Possible program loans	...	...	...	...	490	509	80	240
Possible debt relief 9/	...	...	...	...	84	100	0	4
Residual financing gap	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**
(In percent of GDP, unless otherwise specified)								
Current account	**5.7**	**6.3**	**-2.4**	**-4.2**	**-5.3**	**-4.9**	**-4.1**	**-3.7**
Trade balance	10.0	9.2	-1.4	-4.0	-4.4	-4.6	-3.5	-3.4
Exports	26.7	30.9	22.3	20.7	18.6	19.7	19.5	19.0
Imports	-16.7	-21.8	-23.7	-24.7	-23.0	-24.2	-23.1	-22.4
Public sector external debt	**82.5**	**72.0**	**54.5**	**47.0**	**42.2**	**42.1**	**36.7**	**36.4**
Total external debt service ratio								
(As percentage of exports of goods and nonfactor services)	**33.8**	**33.9**	**33.6**	**30.0**	**29.6**	**26.9**	**26.2**	**26.4**
Of which: public sector debt	27.7	28.7	26.9	23.8	24.6	22.7	24.3	22.8
Financing gap	**0.0**	**0.0**	0.0	**0.0**	0.0	**0.0**	0.0	**0.0**
(In percentage change)								
Exports, f.o.b.	5.9	10.7	-5.0	7.5	0.1	5.1	2.9	5.3
Petroleum	60.3	65.1	-22.2	8.5	-7.2	10.0	0.0	5.5
Non-oil	-9.4	-16.4	11.8	6.8	5.1	1.6	5.3	5.1
Import, f.o.b.	-46.4	24.5	43.6	20.6	3.7	8.4	4.9	0.7
Memorandum items:								
Current Account Balance excluding oil exports (In percent of GDP)	-3.2	-9.0	-11.4	-12.6	-12.4	-13.3	-12.3	-11.9
Net foreign assets at the BCE								
(In months of imports of goods and nonfactor services)	2.9	3.0	1.7	1.1	0.7	1.2	1.2	1.8
(In millions of US$)	872	1,037	884	707	488	789	813	1,285
Public sector external debt (end-of-period) 10/	**13,752**	**11,470**	**11,462**	**11,415**	**11,319**	**11,317**	**10,809**	**10,666**
GDP (In millions of U.S. dollars)	16,674	15,934	21,024	24,311	26,808	26,872	29,432	29,338
Crude oil export prices								
(In U.S. dollars per barrel)	15.1	24.6	19.1	21.4	18.0	24.7	18.2	18.8
LIBOR interest rate (percent)	5.50	6.94	3.78	1.87	1.63	1.31	3.93	2.77

Sources: Central Bank of Ecuador; and Fund staff estimates and projections.

1/ Price included in the program and in the budget: US$18 per barrel.
2/ Price according to WEO projections: US$24.7 per barrel.
3/ Imports of goods related to new foreign investments in the oil sector.
4/ Includes errors and omissions.
5/ Freely disposable net international reserves minus IMF liabilities. It includes deposits of the oil fund.
6/ Includes arrears clearance on external credit lines of closed AGD banks.
7/ Includes recapitalization of PDI bonds interest payments and capital gains on buybacks of Brady bonds in 1999.
8/ In 2001, it includes a discount on global bonds.
9/ Expected debt relief from Paris Club on reschedulable arrears and current maturities. Includes comparable treatment by non-Paris Club creditors.
10/ Including external arrears.

Table 8. Ecuador: External Financing Requirements and Sources

(In millions of U.S. dollars)

	1999	2000	2001	2002	2003 Program Orig. 1/	2003 Program Rev. 2/	2004 Projection Original	2004 Projection Revised
Total requirements	**3,224**	**2,832**	**2,385**	**1,829**	**2,212**	**2,189**	**2,054**	**2,269**
Current account deficit	**0**	**0**	**509**	**1,014**	**1,429**	**1,310**	**1,196**	**1,085**
Capital outflows	**3,224**	**2,832**	**1,876**	**815**	**783**	**879**	**870**	**1,184**
Scheduled public sector amortization	578	772	918	815	783	769	855	878
Nonfinancial public sector	556	606	731	710	726	748	776	816
Financial public sector	22	166	186	105	57	21	79	62
Public debt reduction	0	0	0	0	0	110	15	306
Private sector net outflows	2,647	1,195	958	0	0	0	0	0
Foreign exchange cost of dollarization	**0**	**865**	**0**	**0**	**0**	**0**	**0**	**0**
Total sources	**3,224**	**2,832**	**2,386**	**1,828**	**2,212**	**2,189**	**2,067**	**2,268**
Current account surplus	**955**	**1,004**	**0**	**0**	**0**	**0**	**0**	**0**
Capital inflows	**1,424**	**1,721**	**1,920**	**1,604**	**1,581**	**1,597**	**2,297**	**1,329**
Foreign direct investment	636	720	1,330	1,275	1,246	1,301	1,356	1,039
Disbursements to public sector 3/	788	1,001	590	330	308	296	280	290
Nonfinancial public sector	380	796	587	329	308	296	280	290
Financial public sector	408	205	3	0	0	0	0	0
Release of collateral from Brady bonds	0	171	0	0	0	0	0	0
Private sector net inflows	0	0	0	-187	27	118	661	887
Exceptional financing	**92**	**954**	**401**	**250**	**574**	**608**	**80**	**244**
World Bank	...	...	61	0	130	130	0	100
Inter-American Development Bank	...	139	71	0	100	100	40	100
Andean Investment Corporation (CAF)	...	...	173	81	100	119	0	0
IMF	0	0	0	96	160	160	40	40
Debt relief 4/	92	815	96	73	84	100	0	4
Change in arrears, net (- decrease) 5/	330	-854	-9	-16	-163	-162	0	0
Change in net foreign assets at the BCE (- increase)	423	-165	152	177	219	-82	-324	-496
Cash outlay from debt reduction	0	0	0	0	0	110	15	306
Other 6/	0	0	-78	0	0	0	0	0
Residual financing gap	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**

Sources: Central Bank of Ecuador; and Fund staff estimates.

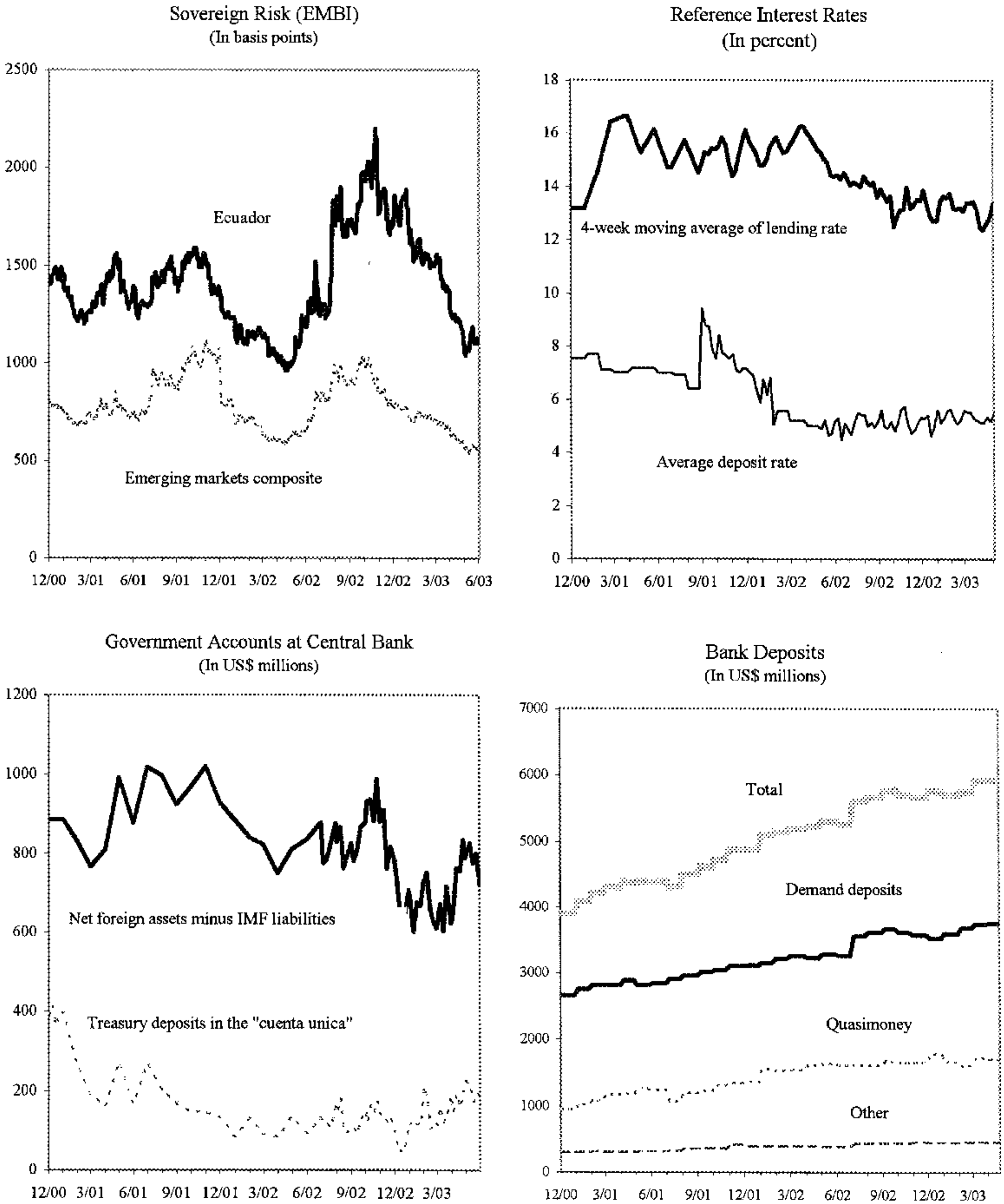
1/ Price included in the budget: US$18 per barrel.
2/ Price according to WEO projections: US$24.7 per barrel.
3/ Project loan disbursments; in 1999-2000 also includes disbursements of program loans. It also includes US$150 million oil facility in 2000.
4/ For 2003, expected debt relief from Paris Club on reschedulable arrears and current maturities. Includes comparable treatment by non-Paris Club creditors.
5/ Includes arrears clearance on external credit lines of closed AGD banks.
6/ Includes a discount on global bonds (2001).

Table 9. Ecuador: The Non-oil Economy

	1999	2000	2001	2002	2003 Program Original	2003 Program Revised	2004 Projection Original	2004 Projection Revised
Total economy (including oil)								
Nominal GDP (in millions of US$)	16,674	15,934	21,024	24,311	26,808	26,872	29,432	29,338
(percentage change)	-28.3	-4.4	31.9	15.6	10.1	10.5	9.8	9.2
Real GDP, percentage change								
CPI inflation period average, percentage change (dollar based)	-29.2	-7.7	37.7	12.6	7.9	8.2	4.4	4.4
GDP deflator period average, percentage change (dollar based)	-23.5	-7.0	25.5	11.8	6.4	7.2	3.6	4.0
REER, percentage change	-30.8	-6.6	39.4	10.1	4.5	4.7	2.9	2.9
Primary balance, percent of GDP	3.4	7.7	4.3	4.5	5.2	5.2	6.7	6.3
Overall balance, percent of GDP	-4.6	1.0	-0.5	1.0	1.9	2.0	3.6	3.2
External current account balance, percent of GDP	5.7	6.3	-2.4	-4.2	-5.3	-4.9	-4.1	-3.7
Public sector debt, percent of GDP	101.2	91.4	70.2	58.2	51.7	51.0	44.1	44.8
Non-oil economy								
Nominal GDP (in millions of US$)	14,703	12,050	18,553	21,580	24,278	23,610	26,116	26,021
(percentage change)	-31.9	-18.0	54.0	16.3	12.2	9.4	7.6	10.2
Primary balance, percent of non-oil GDP	-3.2	-2.0	-2.5	-1.4	-1.2	-1.2	0.2	-1.0
Overall balance, percent of non-oil GDP	-12.3	-10.8	-7.8	-5.3	-4.8	-4.8	-3.3	-4.5
External current account balance, percent of non-oil GDP	-6.9	-23.9	-16.1	-17.4	-16.3	-19.4	-17.3	-16.9
Public sector debt, percent of non-oil GDP	114.8	120.8	79.6	65.6	57.1	58.1	49.7	50.5

Sources: Central Bank of Ecuador; Ministry of Finance; and Fund staff estimates and projections.

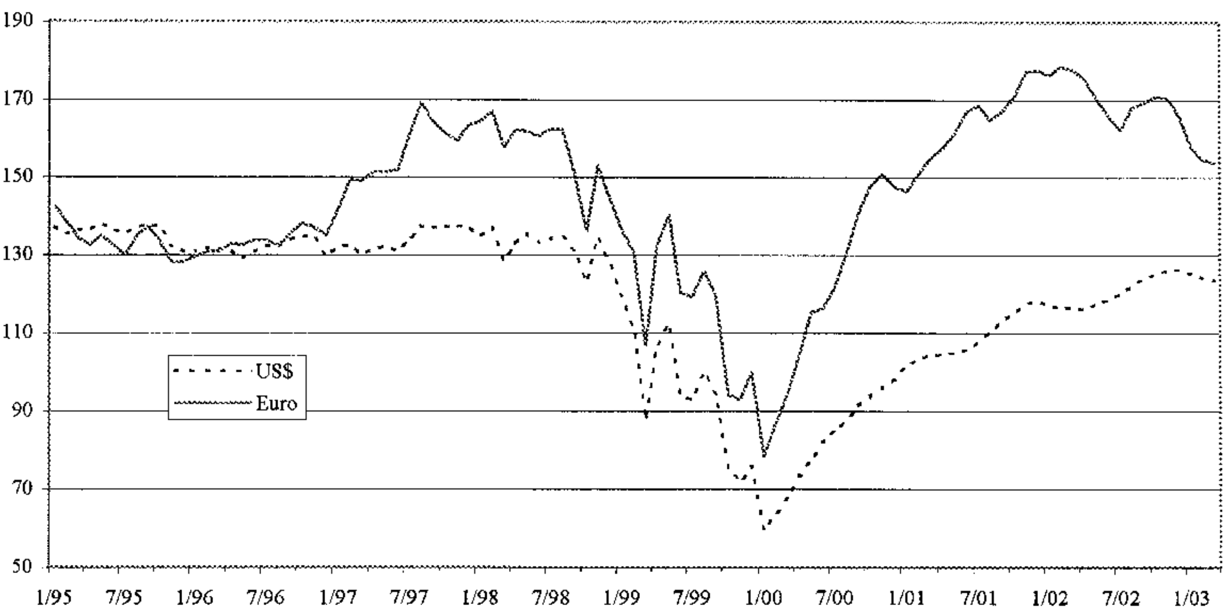
Figure 1. Ecuador: Financial Vulnerability Indicators



Source: Ecuadoran authorities; JPMorgan.

Figure 2. Ecuador: Real Effective Exchange Rate

Bilateral Real Exchange Rates



Source: Information Notice System.

ECUADOR: FUND RELATIONS
(As of April 30, 2003)

I. Membership Status:

Joined: 12/28/45 Status: Article VIII

II. General Resources Account:	**SDR Million**	**In percent of Quota**
Quota	302.30	100.00
Fund holdings of currency	542.08	179.32
Reserve position in Fund	17.15	5.67

III. SDR Department:	**SDR Million**	**In percent of Allocation**
Net cumulative allocation	32.93	100.00
Holdings	1.83	5.57

IV. Outstanding Purchases and Loans:	**SDR Million**	**In percent of Quota**
Stand-By Arrangements	256.93	84.99

V. Safeguards Assessments:

Under the Fund's safeguards assessment policy, the Central Bank of Ecuador (BCE) is subject to an assessment with respect to the arrangement, which was approved on March 21, 2003 and is scheduled to expire on April 20, 2004. An on-site safeguards assessment was conducted in March 2003 and the report is currently being finalized.

VI. Latest Financial Arrangements:

Type	**Approval Date**	**Expiration Date**	**Amount Approved (SDR Million)**	**Amount Drawn (SDR Million)**
Stand-By	03/21/2003	04/20/2004	151.00	30.20
Stand-By	04/19/2000	12/31/2001	226.73	226.73
Stand-By	05/11/1994	12/11/1995	173.90	98.90

VII. Projected Obligations to the Fund (Obligations Basis):

(SDR million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2003	**2004**	**2005**	**2006**	**2007**
Principal	24.79	66.12	79.12	58.57	24.55
Charges/Interest	4.73	5.45	3.64	2.02	0.94
Total	**29.52**	**71.57**	**82.77**	**60.59**	**25.49**

Repurchase expectations apply to purchases after November 28, 2000 in the credit tranches, including the Compensatory Financing Facility, and under the Extended Fund Facility. Repurchases in the credit tranches and the Extended Fund Facility are expected to be completed 2¼–4 years and 4½–7 years, respectively. The Fund has the option of extending the repurchase expectations upon request by members.

VIII. Exchange Rate Arrangement:

On February 12, 1999 the central bank abandoned the exchange rate band and floated the *sucre*. On March 9, 2000 the economy was dollarized at 25,000 *sucres* per U.S. dollar.

Ecuador has accepted the obligations of Article VIII, Sections 2, 3, and 4. However, Ecuador maintains an **exchange restriction** subject to Fund approval under Article VIII, Section 2(a) in the form of a freeze on demand and savings deposits in closed banks. This exchange restriction was approved by the Executive Board on March 21, 2003 until December 31, 2003.

IX. Last Article IV Consultation and Recent Contacts:

On March 21, 2003, the Executive Board concluded the 2003 Article IV Consultation. Consultation with Ecuador is on the 12-month cycle. The mission to negotiate the new SBA visited Quito in January 2003, and for the first review in May 2003.

X. Technical Assistance:

MAE	Assist in the design of a strategy for dealing with banks' systemic problems.	January 2000
STA	Assist in the preparation of the central bank accounts under dollarization.	January 2000
MAE	Role of central bank under dollarization.	February 2001
STA	ROSC	April 2002

XI. Resident Representative:

Mr. David Yuravlivker, stationed in Quito since September 2002.

ECUADOR: RELATIONS WITH THE WORLD BANK

The Bank approved a new Country Assistance Strategy (CAS) for Ecuador on May 27, 2003. The objectives of the CAS are to help the government achieve its twin strategic priorities of promoting growth and fighting poverty, and to address reforms required under dollarization. The proposed CAS lending program calls for $200 million in FY04 and $250 million in FY05, of which $100 million a year will be for programmatic loans. Such loans would depend on the achievement of a set of targets (triggers) related to the implementation of key actions agreed in a multiyear reform program.

Two series of multiyear loans are under implementation: one on fiscal consolidation and competitiveness, and the other on human development reform (both approved in May 27, 2003). The first loan addresses the consolidation of Ecuador's fiscal position, to ensure that the country can compete effectively under dollarization in the context of the forthcoming American Free Trade Area. The programmatic social loan series aim at ensuring that the essential structural reforms are socially sustainable, by supporting improvements in the effectiveness and coverage of key social programs.

To complement these policy-based loans, the investment lending portfolio will focus on competitiveness and poverty reduction through projects on rural roads, urban poverty reduction, institutional reform and competitiveness.

The Bank's nonlending services to the Gutiérrez administration started with a set of Policy Notes completed in January 2003. These Notes provide the basis for the Bank's dialogue with the country and feeds into the two series of programmatic loans. Future studies will focus on: (i) sectoral reviews (education, rural development, environment and financial services), (ii) specific constraints to growth (labor market, health insurance), (iii) financial sector development; (iv) institutional reforms in the public sector including debt management and fiscal decentralization; (v) human development (health sector) and (vi) rural poverty reduction.

Pipeline

The Bank's main current operations in Ecuador focus on rural development, health service modernization, and rural water supply and sanitation. Other operations include a rural power and communications project, public sector financial management project, and a financial sector technical assistance loan.

For the upcoming fiscal year, the Bank plans on approving loans on rural roads, institutional reform, and Prodepine II. On the nonlending side, the Bank plans to conduct a poverty assessment, a joint-IDB Public Expenditure Review (PER) and a joint-IMF Financial Sector Assessment Review (FSAP).

ECUADOR: RELATIONS WITH THE WORLD BANK

(In millions of U.S. dollars)

	Commitments	Disbursements	Undisbursed	Repaid	Outstanding
I. IBRD/IDA Operations (as of March 31, 2003) 1/					
Total loans	2,364.9	2,227.0	137.8	1,325.5	851.8[2]
Active loans	239.7	102.6	137.1	n.a.	n.a.
Closed loans	2,125.2	2,124.5	0.7	n.a.	n.a.
Active loans (by loan purpose)					
Total	**239.7**	**102.6**	**137.1**		
Rural development	69.8	35.1	34.7		
Health	45.0	14.9	30.1		
Water	32.0	4.4	27.6		
Technical assistance	67.9	23.6	44.3		
Other	25.0	24.6	0.4		

II. IFC Operations (as of December 31, 2002)

	Loans	**Equity**	**Participation**
Commitments			
Net total held by IFC	39.0	10.6	15.0
Total undisbursed	8.6	1.0	11.2

III. IBRD Loan Transactions (calendar year)
(Includes IDA repayments)

	1998	**1999**	**2000**	**2001**	**2002**
Disbursements	84.5	90.3	68.8	123.6	25.2
Repayments	84.4	83.1	90.6	76.5	86.4
Net lending	0.1	7.2	-21.8	47.1	-61.2

IV. World Bank—Policy-Based Lending

The Bank approved a US$152 million Structural Adjustment Loan (SAL) on June 22, 2000, declared it effective on June 7, 2001 and closed it on March 31, 2003. The first tranche (US$70 million) was disbursed on June 12, 2001, and the second tranche (US$30 million) on March 27, 2003 under the new administration. At the previous government's request, the US$30 million Tax Reform tranche was cancelled in June 2002 and the US$20 million Public Sector Reform tranche in January 2003. Under the new administration, two policy-based multiyear loans have been approved: one on fiscal consolidation and competitive growth (US$50 million), and another on human development reform (US$50 million).

Source: World Bank.

[1] Net of cancellations.
[2] Includes exchange rate adjustments and loans sold to and repaid by third parties.

ECUADOR: RELATIONS WITH THE INTER-AMERICAN DEVELOPMENT BANK

(As of July 2, 2003)

I. IDB OPERATIONS

(In million of U.S. dollars)

	Approved	Disbursed	Undisbursed
Total (approved and not fully disbursed)	**444.7**	**243.4**	**2013**
Total (historical)	**3,819.6***	**3,612.7**	**201.3**

* The total amount approved to date is US$4,351.9 million. The difference represents cancellations. The outstanding debt to the Bank is US$1,966.3 million.

II. IDB LOAN TRANSACTIONS

(In millions of U.S. dollars)

	1998	1999	2000	2001	2002
Disbursements	186.6	141.5	237.7	165.0	90.3
Repayments	102.8	106.8	124.2	113.6	140.9
Net lending	83.8	34.7	113.5	51.4	-50.6

Source: IDB.

The Bank is in the process of preparing a new strategy for the period 2003–06. The lending program for this period, for US$600 million, will be designed to support the government's efforts to improve governance, reduce poverty, and increase productivity in Ecuador. The government and the Bank have already agreed on the 2003 lending program, for US$261.5 million, that includes a fast disbursing loan for US$200 million (approved in June 25, 2003), and four small loans to improve rural financial services, expand coverage of the Seguro Social Campesino, protect the coastal environment, and improve rural transportation. To date, about one-third of Bank approvals have supported projects in agriculture and fishery, whereas the balance is divided among projects in industry, energy, transportation, health, public sector reform, and education. The Bank approved three loans in 2002 to support the government's efforts to improve sanitation in Quito, develop the Amazon region, and support low-income housing.

Quito, Ecuador
July 23, 2003

Mr. Horst Köhler
Managing Director
International Monetary Fund
Washington, D.C. 20431

Dear Mr. Köhler:

1. The attached Supplement to the Memorandum of Economic Policies (SMEP) describes recent developments and policy implementation, and the government's plans for the coming months, including additional steps to be taken to meet the objectives of the 2003–04 economic program supported by the Stand-By Arrangement (SBA) from the Fund. Except as modified in this letter and the SMEP, the objectives and commitments of the economic program remain as described in the original letter of intent (LOI) and Memorandum of Economic Policies (MEP) dated February 10, 2003, and the supplementary LOI dated March 13, 2003.

2. Regarding performance under the program through end-June, the quantitative performance criteria on deposits of the NFPS was observed. Moreover, the government believes that the end-June limit on the stock of registered gross debt also was observed although the precise data will not be available until after the Board meeting, and therefore the government requests a waiver of applicability for this performance criterion. The end-June quantitative performance criteria on the NFPS overall fiscal balance, noninterest expenditure, deposits in the central government BCE account (cuenta única), and domestic and external payments arrears are likely to have been missed. Final data will not be available until after the Board meeting. As indicated in the SMEP, corrective actions are being taken to bring the program back on track and the government requests waivers for the nonobservance of these performance criteria. Finally, there were some small external payments arrears in April, May, and June, contrary to the continuous performance criterion on the nonaccumulation of arrears under the SBA. The government will pay off these arrears as a prior action for the Board consideration of this review, and it requests a waiver for the nonobservance of this continuous performance criterion. Prior to the Board consideration of the review, the government will provide to the Fund the latest available data on the observance of the quantitative performance criteria described above.

3. Regarding the structural reforms, four performance criteria related to resolving issues in the closed banks could not be implemented by the intended date. Two have now been observed (to conduct audits in the AGD banks, and to hire firms to manage Filanbanco liquidation trust funds), and two are proposed to be rescheduled for a later date (to enter AGD banks into liquidation, and to hire a firm to manage the Filanbanco real estate liquidation trust fund). Moreover, an economic and environmental study of the petroleum sector has begun but was not finished by end-June, and efforts are underway to hire private

sector management for the state electricity and telephone companies but these have not yet been concluded. The government also proposes new completion dates for these reforms. Progress has been made with the passage in Congress of a Customs Reform Law, but the legislation fell short of transferring full control of the customs administration to the SRI. Two corrective measures were included in the Civil Service Reform Law to remedy these shortcomings. The civil service reform and wage unification bill was submitted to Congress, as emergency legislation, in mid-June. However, because the bill was large and complex, Congress could not consider it on an emergency basis. Therefore, as a prior action for the first review, the government re-submitted to Congress only the civil service reform part, as emergency legislation. The portion pertaining to wage unification will be re-submitted to Congress as soon as possible, i.e., after the consideration of the tax reform bill, which is to be sent to Congress as urgent legislation by end-August. Based on corrective steps having been taken in each of these cases, the government requests waivers for the nonobservance of the above-referenced structural performance criteria.

4. Reflecting the latest estimates and projections under the program, the end-September targets on the NFPS overall balance, the deposit accumulation by the central government, and the stock of domestic arrears need to be revised slightly, although the end-December targets would remain unchanged. Therefore, the government requests a small modification for these end-September performance criteria by reducing slightly the target for the NFPS overall balance, and the stock of central government deposits, and increasing slightly the stock of domestic arrears, as specified in the attached Tables 1 and 2 of the SMEP. Finally, the government requests a reduction in the ceiling on the level of registered public sector gross debt during the remaining of the year, reflecting a revision in the end-2002 stock of debt, as shown in the attached Table 1 of the SMEP.

5. Prior actions for the first review are as proposed in Annex I, and most of them have already been observed. These comprise a decree to reduce fuel intermediation margins; decrees to eliminate absentee workers and to implement hiring restrictions; signing a framework agreement for the electricity sector to improve payments flows to PetroEcuador and reciprocal letters between PetroEcuador and the Ministry of Economy and Finance agreeing to transfer these payments to the Treasury; clearance of nonreschedulable external arrears; submission to Congress of the civil service reform bill as urgent legislation; completing the first auction of restructured loans in the AGD banks; and establishing a high-level committee to expedite reforms in the oil sector. In addition to these actions, the government will take any additional measures necessary to stay within the 2003 programmed wage bill. In view of the delays in the structural reforms mentioned above, several follow-up actions are now expected to be completed somewhat later in the year than envisaged in the original program. The new set of proposed structural performance criteria and benchmarks are set out in Annex II. The government regards these structural reforms as integral parts of the economic program, and essential steps to improve the functioning of the Ecuadoran economy, and remains committed to their full implementation.

6. During the remaining period of the Arrangement, the government will continue to maintain a continuous dialogue with the Fund on the adoption of any measures that may be appropriate to achieve the objectives of the program. Further reviews are expected to be completed by end-September 2003, end-December 2003, and end-March 2004. These reviews will continue to be associated with the assessment of overall performance under the program, and observance of the performance criteria for end-June, end-September, and end-December 2003, respectively.

Sincerely,

/s/
Mauricio Yepez Najas
President
Central Bank of Ecuador

/s/
Mauricio Pozo Crespo
Minister of Economy
and Finance

Attachments

SUPPLEMENT TO THE MEMORANDUM OF ECONOMIC POLICIES

I. Introduction

1. This supplement to the memorandum of economic policies (SMEP) describes recent developments under the program supported by a Stand-By Arrangement from the Fund, and elaborates policies for the remainder of the program period, including several initiatives to respond to problems that have emerged in recent months.

II. The Macroeconomic Framework

2. **The outlook for real GDP growth for 2003 has been moderately lowered from 3.5 to 3.1 percent**. The downward revision mainly reflects lower output in the petroleum sector in the first half of 2003. Inflation has been slightly higher than expected, and consumer prices are now projected to increase by 7 percent through year-end, from 6.5 percent expected previously. The external current account balance will likely be stronger than earlier projected, with a deficit below 5 percent, from above 5 percent in the original program.

III. Fiscal Policy

3. **In the first quarter, the fiscal surplus and noninterest expenditure targets were missed by small margins.** The NFPS overall surplus was 0.3 percentage points of GDP below program on an annual basis. Notwithstanding favorable oil export prices, oil revenue transfers by PetroEcuador to the central government were lower than programmed because of a decline in oil production and a shortfall in the output of the refineries, which had to be compensated with costly fuel imports. Also, fuel intermediation margins were not lowered, as had been programmed, leading to some revenue loss to the budget. The social security system and the local governments performed better-than-programmed. The small deviation from the noninterest expenditure target includes the effect of an adjustor under the program, which calls for offsets in expenditures when there are shortfalls in net oil revenues to the budget. While the budget expenditures were below program, the difference was not enough to fully compensate for the lower oil revenues to the budget.

4. **While corrective actions are being taken, the end-June fiscal targets are also likely to have been missed.** Preliminary data suggest that oil revenues in the second quarter were lower than programmed, in part because of a breakdown in the SOTE oil pipeline in May and a 10-day strike in the oil sector in June. Tax revenues were lower than expected in April and May owing to slowing consumption and disappointing import tax collections, although collections recovered in June. The government continued to exercise expenditure restraint, but the end-June noninterest expenditure target is also expected to have been missed by a small margin.

5. **The government experienced some difficulties with the financing program in the first half of the year, and it was not able to reduce the payments arrears as expected.** There were some delays in domestic debt placements, and part of the oil revenues to the budget were temporarily held up in a BCE escrow account. As a result, while external arrears have almost been eliminated, paying off domestic arrears remains to be completed.

Nevertheless, in the second quarter of the year improvements have been made in the financing plan by reversing the buildup of deposits in the provisioning escrow account for oil revenues in the BCE; and in April and May the government regularized the domestic debt placements and sold over US$300 million in gross debt. It anticipates net domestic placements of bonds and bills in the amount of US$379 million in the second half of 2003.

6. **In recent weeks, the government has had to accommodate some important spending pressures.** To resolve a two-month old teachers' strike, the government agreed to wage increases that will raise wage costs by US$25 million in 2003 and US$170 million from 2004 onward. Also, the Social Security Institute (IESS) needed to honor a commitment to increase pensions by 27 percent in July 2003, which was included in a resolution adopted by the outgoing administration in January of this year. The pension increase is estimated to cost US$48 million in 2003 and double this amount in 2004.

7. **Notwithstanding these pressures on the budget, corrective measures are being taken and the annual primary surplus objective of the program in 2003 of 5¼ percent of GDP is maintained.** This objective will also facilitate aiming for the primary surplus of 6.7 percent in 2004, as envisaged in the medium-term projections for the original program.

- First, as a prior action for the first review, the government issued a decree to lower the intermediation margin in fuels distribution and retailing—thus making available US$8 million in additional derivatives sales revenues to the budget.

- Second, the government is committed to offsetting the additional wage costs arising from the settlement with the teachers within the wage bill itself, thus maintaining the ceiling on the NFPS wage bill for 2003 as in the program. To this end, and as a prior action for the first review, the government issued decrees that include hiring restrictions through year-end, and remove absentee workers from the payroll.

- Third, the government has taken measures to lower purchases of goods and services and other current spending by US$25 million in the rest of the year.

- Fourth, the government, through PetroEcuador, is committed to collect in cash at least US$70 million from the electricity companies for fuel sales in the second half of 2003. To do this, a framework agreement between the Fondo de Solidaridad, the electricity companies, the Minister of Economy and Finance, PetroEcuador, and the Central Bank of Ecuador to ensure cash payments to PetroEcuador for future fuel sales was signed as a prior action for the first review. In addition, the Ministry of Economy and Finance and PetroEcuador signed reciprocal letters to transfer the US$70 million in cash proceeds to the Treasury. Also, the government will develop a mechanism to start clearing the arrears from electricity companies on past fuel deliveries.

- Fifth, in the social security area, the IESS has identified offsets to maintain the overall surplus of the social security system, notwithstanding higher pension outlays in the rest of the year. These offsets reflect a combination of higher-than-expected payroll contributions that are being received by the Social Security Institute (IESS) and lower-than-expected demand for health care services. Also, lending to the private sector from the IESS (*préstamos quirografários*) will be limited to contain the stock to US$142 million by end-2003.

- Finally, the original program was framed with a deliberately cautious oil price assumption of US$18 per barrel. The latest WEO oil price projections show oil prices in excess of this benchmark, even after taking account of the recent decline in world oil prices following the conclusion of the Iraq war. This favorable oil price development is compensating for most of the lower volume of crude oil output now expected, even through the share of total oil revenues available to the central government is expected to be lower than what was budgeted.

8. **The government has concluded the Paris Club negotiations**. In June, the government reached agreement with Paris Club creditors to reschedule eligible maturities that are projected to fall due during the program period, and to seek comparable treatment in the rescheduling of maturities falling due during the same period to non-Paris Club creditors. Small amounts of external arrears were incurred in April, May, and June. As a prior action for the first review, the government will clear these remaining arrears that could not be rescheduled consistent with the Paris Club agreement.

9. **The government has made progress in key fiscal structural reforms**:

- **Customs reform**. Legislation approved in April marked a substantial step forward to improving customs administration, including with new requirements for valuation and documentation of shipments at the point of origin, improvements in the information systems, and stronger surveillance in the ports. However, the law lacked two important provisions that relate to human resource management of the customs office without which the reform would be incomplete. Therefore, the government included in the civil service reform that was resubmitted to Congress as an urgent law (see below), provisions to remove the customs office personnel from the civil service labor code, and to eliminate the sharing by the customs office personnel in the proceeds from the auctions of confiscated goods.

- **Civil service reform**. A bill divided in two parts dealing with civil service reform (including two corrective provisions for the customs reform law noted above) and wage unification was submitted to Congress as emergency legislation in mid-June. However because of the complexity of the bill, Congress indicated that it could not be considered in full as emergency legislation. As a prior action for the completion of the first review, the government resubmitted to Congress, as emergency legislation, the civil service reform part of the bill. We request that the related structural performance criterion on the passage of the legislation be modified to require only the passage of the civil service reform, and the provisions to remove the customs office personnel from the civil service reform, and to eliminate their sharing in the proceeds of auctions referred to above. The government will resubmit the portion of the bill on wage unification after the consideration of the tax reform bill, which is to be sent to Congress as urgent legislation by end-August.

- **Controlling wage costs.** The government recognizes the importance of containing the public sector wage bill and avoiding further pressures on wage costs. To address these pressures, the government has already issued budget directives for 2004 that include no general wage rate increase for next year. Moreover, with the instruments provided by the civil service reform bill, the government will seek a reduction of employment in the NFPS next year. Together with the offset of the wage costs already committed in the rest of 2003, the government is confident that it can limit the increase in the NFPS wage bill in 2004 to US$105 million.

- **Strengthening the social safety net.** With IDB assistance, and in the context of the government's intention to remove the generalized cooking gas subsidy later this year, the government has been developing systems to improve the targeting of the social safety net. The *bono solidario* (now restructured and renamed the *bono de desarrollo humano)* was increased as of July 1, 2003. Experience with this first step increase in the *bono* will be used to fine-tune the new data base for assessing eligibility to assistance and to improve the delivery system. Once experience shows that the new safety net is working well, and is appropriately targeted, the government will eliminate the generalized cooking gas subsidy. This second step of the program will be implement no later than end-2003.

- **Actuarial assessment of the social security system.** With the new pension increase in July, average pensions have regained their value in 1998 dollar terms. To assess the sustainability of the system after the recent increase, the government, together with the IESS and external experts, will undertake an actuarial assessment of the general pension system and the police and military pension funds. This assessment is a structural benchmark under the program for end-September 2003. The assessment will also be used to implement steps to improve the coordination of pension policies between the IESS and the government, to synchronize better their efforts in managing the macroeconomy.

IV. Financial System Policies

10. **Solid progress has been made with the financial system reforms included in the program, although legal obstacles and administrative difficulties have led to some implementation delays**. As a result, it is proposed that the calendar for the follow up steps for these reforms be adjusted as stated below. We remain committed to return all blocked private sector deposits by year-end, which is the central objective of these reforms.

- **Filanbanco**. On May 5, contracts were signed with two international firms to collect the proceeds from the loan portfolios in the liquidation trust fund, and they have started their work. Moreover, the firm(s) to collect on the real estate assets in a second trust fund will be hired by end-September.

- **AGD banks.** Contracts for the financial and performance audits for nine closed banks were signed on May 7. The audits have now started and will be concluded by end-August. We now expect these banks to be liquidated by end-August, rather than by end-June as envisaged originally. The independent firms to manage the liquidation of these banks are expected to sign contracts by end-September.

- **Loan portfolio**. An independent foreign firm assessed the value of the restructured loan portfolios from the AGD banks and prepared the auction process. The first auction will be completed in late July 2003 and is a prior action for Board consideration of the completion of the first review. It is expected that the whole portfolio will be sold by end-August.

- **Banco del Pacífico**. An international investment bank has been hired to prepare Banco del Pacífico for sale. The firm is expected to conclude its work and bring the bank to the point of sale by end-September 2003.

V. Public Enterprise Reform and Other Issues

11. **The government is fully committed to a fundamental restructuring of the petroleum sector.** To this end, the government issued a decree establishing a high level committee, to develop the strategy and oversee its implementation. A key element of the approach will be to increase oil production in PetroEcuador facilitated by efficiency improvements in the company and increased private sector participation in the state run oil fields. The government already is making progress with an economic and environmental study of the petroleum sector, which is being conducted with foreign oil industry experts and with assistance of the multilateral institutions (CAF, World Bank, IDB, and the Fund). The government aims to finish the study by end-October 2003, and it will contain a calendar of concrete policy steps to improve the results in this important sector. Moreover, to improve disclosure and strengthen accounting, PetroEcuador will contract an independent external financial audit from one of the large international auditing firms by end-September 2003. This audit will become a regular annual feature of the company, and be published.

12. **Reforms in the electricity sector have acquired new prominence.** To help strengthen the public finances, the cash flow for fuel purchases by electricity companies from PetroEcuador needs to improve. While the tariff structure has been raised in recent years, the collection experience in the electricity distributors and the payment record of electricity generators to PetroEcuador is still very poor. To address this problem and improve corporate efficiency, the program already includes the commitment to introduce private sector management into the electricity sector. (The bids for these management contracts are now being issued.) Moreover, a further step is being undertaken by seeking agreement with the companies (as a prior action for the first review) to move to a cash payments system only (and clear payments arrears) to normalize fully the cash flow between the electricity sector and PetroEcuador from 2004 onward.

13. **The process of hiring private sector management to run the state telephone companies is also underway.** It is expected that contracts will be signed with foreign firms to begin managing Pacifictel and Andinatel by end-August 2003.

14. As recommended by Fund staff in the Safeguards Assessment exercise, on April 2, 2003 the Central Bank Board adopted a resolution to publish the full set of financial statements of the BCE within six months of the financial year-end, including disclosure notes and the audit opinion, starting with the 2003 financial statements. The notes will include the quantified impact of deviations from IAS.

Table 1. Ecuador: Quantitative Performance Criteria under the 2003 Stand-By Arrangement Program 1/

(In millions of U.S. dollars)

	December 31, 2002		January-March 2003			January-June 2003			Program Targets	
	Program	Actual	Program	Actual	Margin (+)	Program	Actual	Margin (+)	Jan.-Sep.	Jan.-Dec.
1. NFPS overall balance (floor)	...	...	186	173	-13	420	...	...	465	508
2. NFPS noninterest expenditure (ceiling)	...	...	1,161	1,182	-21	2,734	...	...	4,245	5,860
3. Stock of public sector deposits in the BCE and commercial banks (floor) 3/	1,282	1,282	1,150	1,285	135	1,226	1,483	257	1,275	1,416
4. Stock of central government deposits in the "cuenta unica" at the central bank (floor) 3/	118	118	89	115	26	187	125	-62	114	192
5. Stock of registered public sector gross debt (ceiling)	13,730	13,458	13,770	13,292	478	13,862	...	...	13,650	13,650
6. Stock of external arrears, e.o.p. (ceiling)	163	163	0	3	-3	0	5	-5	0	0
7. Stock of domestic arrears, e.o.p. (ceiling)	452	480	211	541	-330	22	...	...	61	0

1/ As defined in the attached Technical Memorandum of Understanding (TMU).
2/ Includes a US$90 million adjustor on the NFPS noninterest expenditure (ceiling) as described in the TMU.
3/ Reflecting the quarterly averages of end-of-month stocks.

Table 2. Ecuador: Arrears Clearance Program for 2003

	Program		Actual					Program Targets						
	Dec. 02	Mar. 03	Dec. 02	Mar. 03	Apr.	May	Jun.	Jun.	Jul.	Aug.	Sep.	Oct.	Nov.	Dec.
Stock, end-of-period	**615**	**211**	**615**	**517**	**378**	**402**	**...**	**22**	**64**	**64**	**61**	**60**	**60**	**0**
External	**163**	**0**	**163**	**3**	**1**	**2**	**5**	**0**	**0**	**0**	**0**	**0**	**0**	**0**
Paris Club, governments	111	0	111	2	0	0	4	0	0	0	0	0	0	0
WB, IDB, CAF	18	0	18	0	0	0	0	0	0	0	0	0	0	0
Banks	33	0	33	1	1	2	1	0	0	0	0	0	0	0
Other	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Identified domestic, central government	**452**	**211**	**452**	**514**	**377**	**400**	**...**	**22**	**64**	**64**	**61**	**60**	**60**	**0**
Wages	117	0	143	156	158	168	...	...	...	...	...	...	...	...
ISSFA, ISSPOL	115	115	93	93	0	0	...	...	...	...	...	...	...	...
Transfers to local governments	41	20	41	101	77	76	...	...	...	...	...	...	...	...
Preasignaciones	30	0	73	70	47	40	...	...	...	...	...	...	...	...
IESS	26	26	26	26	0	0	...	...	...	...	...	...	...	...
Bienes y servicios (current and capital)	114	41	76	68	96	117	...	...	...	...	...	...	...	...
Other	9	9	0	0	0	0	...	...	...	...	...	...	...	...

Sources: Central Bank of Ecuador; Ministry of Economy and Finance.

Ecuador—Prior Actions for the Completion of the First Review

Objective	Timing
1. Issue a decree to reduce the intermediation margin in fuels distribution and retailing (Paragraph 7).	Observed.
2. Issue decrees to eliminate absentee workers from the payroll, and to implement hiring restrictions (Paragraph 7).	Observed.
3. Sign a written framework agreement between the Fondo Solidaridad, the electricity companies, the Minister of Economy and Finance, PetroEcuador, and the Central Bank of Ecuador to ensure cash payments to PetroEcuador for future fuel sales. Also, the Minister of Economy and Finance and PetroEcuador will sign reciprocal letters agreeing to transfer these cash payments to the Treasury. (Paragraph 7).	Observed.
4. Clearance of all external arrears that could not be rescheduled consistent with the Paris Club agreement (Paragraph 8).	At least five business days prior to the Board meeting for the first review.
5 Submission to Congress of legislation, on an emergency basis, for civil service reform (including amendments to the *Ley de Servicio Civil y Carrera Administrativa*), to reduce employment in the public sector and to contain the increase in the nominal wage bill in the central government 2004 budget. (Paragraph 13 of the MEP of February 10, 2003). This draft law must also include provisions to remove customs office personnel from the civil service labor code, and to eliminate the sharing by the customs office personnel in the proceeds from the auctions of confiscated goods (Paragraph 9).	Observed.
6. Complete the first auction of the restructured private sector debt portfolios of closed banks held in the AGD (Paragraph 10).	At least five business days prior to the Board meeting for the first review.
7. Issue a decree establishing a high level advisory committee, for the implementation of reforms in the oil sector. (Paragraph 11).	Observed.

Ecuador—Revised Structural Performance Criteria (PC) and Benchmarks (SB)

A. Structural Measures Envisaged for the First Review

Objective	Original date	PC/SB	Status/Comment
1. Auction off all restructured private sector debt portfolios of closed banks held in the AGD (Paragraph 10).	By March 31, 2003.	SB	Missed. First auction as a prior action for the completion of the first review.
2. Sign contract with an international investment bank to prepare Banco del Pacífico for sale (Paragraph 10).	By March 31, 2003.	SB	Missed. Implemented on May 7, 2003.
3. Sign contracts to conduct independent audits of at least eight closed banks in the AGD (Paragraph 10). .	By April 5, 2003.	PC	Missed. Implemented on May 7, 2003. Waiver requested.
4. Sign contract with independent international firm(s) to manage the Filanbanco liquidation trust fund containing the loan portfolio (Paragraph 10).	By April 5, 2003.	PC	Missed. Implemented on May 5, 2003. Waiver requested.
5. Passage of legislation to transfer control of the customs administration to the SRI (Paragraph 9).	By April 30, 2003.	PC	Missed. Two corrective measures to be included in Civil Service Reform bill. Waiver requested.
6. Submission to Congress of legislation for public sector wage unification and civil service reform (including amendments to the *Ley de Servicio Civil y Carrera Administrativa*), to reduce employment in the public sector and to achieve a lower nominal wage bill in the central government 2004 budget compared with the 2003 budget (Paragraph 9).	By April 30, 2003.	PC	Missed. Submission to Congress of the civil service reform part, as emergency legislation, is proposed to be converted into a prior action for completing the first review. Waiver requested.

B. Structural Measures Envisaged for the Second Review

Objective	Original date	PC/SB	Status/Comment
1. Auction off all restructured private sector debt portfolios of closed banks held in the AGD (Paragraph 10).	By March 31, 2003.	SB	Auctions to be completed by August 31, 2003.
2. Enter at least 8 closed AGD banks into liquidation (Paragraph 10).	By June 30, 2003.	PC	Missed. Proposed to be rescheduled to August 31, 2003. Waiver requested.
3. Sign contract to concession the management of the electricity distribution companies and Andinatel and Pacifictel to reputable international firms (Paragraphs 12 and 13).	By June 30, 2003.	PC	Missed. Proposed to be rescheduled to August 31, 2003. Waiver requested.
4. Submission to Congress of the tax reform law including the elimination of revenue earmarking not mandated in the Constitution, and tax exemptions.	By August 31, 2003.	PC	Unchanged.
5. Passage of the law for civil service reform, including two provisions to remove customs office personnel from the civil service labor code, and to eliminate the sharing by the customs office personnel in the proceeds from the auctions of confiscated goods. (Paragraph 9) .	By August 31, 2003.	PC	Date is unchanged. Proposed to be modified as specified in paragraph 9 of the SMEP.

C. Structural Measures Envisaged for the Third Review

Objective	Original date	PC/SB	Status/Comment
1. With technical assistance from international institutions, conduct an assessment of the operating procedures and actuarial balances of the IESS, ISFA, and ISPOL (Paragraph 9).	By September 30, 2003	SB	Unchanged
2. Sign contract with independent firm(s) to manage the Filanbanco liquidation trust fund containing the real estate assets (Paragraph 10).	By June 30, 2003.	PC	Missed. Proposed to be rescheduled to September 30, 2003. Waiver requested
3. Sign contract with large international auditing firm to conduct an independent external financial audit of PetroEcuador (Paragraph 11).	None.	PC	By September 30, 2003.
4. Sign contracts with independent firm(s) to manage the liquidation trust funds of the AGD banks (Paragraph 10).	By June 30, 2003.	SB	Missed. Proposed to be rescheduled to September 30, 2003.
5. Bring Banco del Pacífico to the point of sale (Paragraph 10).	By July 31, 2003.	SB	Proposed to be rescheduled to September 30, 2003.
6. Conduct and publish an economic and environmental analysis, and prepare an action plan with time table for the cost effective production, distribution, and sale of fuels and other petroleum products in Ecuador (Paragraph 11).	By June 30, 2003.	PC	Missed. Proposed to be rescheduled to October 31, 2003. Waiver requested.
7. Passage of the tax reform law, including the elimination of revenue earmarking not mandated in the constitution, and tax exemptions.	By November 30, 2003.	PC	Unchanged.
8. Conclude returning all blocked deposits in Filanbanco and the AGD banks in liquidation to depositors.	By December 31, 2003.	PC	Unchanged.

ECUADOR—TECHNICAL MEMORANDUM OF UNDERSTANDING

1. This Technical Memorandum of Understanding (TMU) defines the quantitative performance criteria under the program presented in Tables 1 and 2 attached to the Letter of Intent (LOI) and the Supplementary Memorandum of Economic Policies (SMEP) of July 23, 2003.

2. **Floor on the NFPS overall balance.** The NFPS comprises the central government, the municipal and provincial governments, the public sector enterprises, the social security institute (IESS), the Development Bank of Ecuador (BEDE), port authorities, universities, and NFPS autonomous agencies and funds. The NFPS overall balance is measured as the change in the NFPS gross debt (an increase in the debt indicating a deficit), minus the change in public sector deposits in the Central Bank of Ecuador (BCE), and in the commercial banks (as defined in point 4; an increase in deposits indicating a surplus). NFPS gross debt comprises total registered NFPS gross debt (defined in point 6), and arrears in interest payments on external debt, as well as all domestic arrears (principal and interest) and accounts payable. For purposes of measuring the NFPS overall balance, the debt outstanding at end-December of the previous year is valued during the present year at the constant U.S. dollar-third currency exchange rate of end-December of the previous year. New debt flows incurred during the program period are valued at the exchange rate of the day the debt is issued. Privatization receipts and other forms of below-the-line debt reduction are excluded for purposes of measuring compliance with the NFPS overall balance. For purposes of measuring the NFPS overall balance under the program, the amount of any forward sale of oil will be added to the registered debt; this debt will be considered amortized at the moment the oil is delivered (i.e., any nonspot oil sales are treated as asset-backed debt financing).

The NFPS overall balance will be adjusted upward by the amount of petroleum revenues accrued to the budget that are in excess of those assumed in the program (shortfalls of petroleum revenues must be compensated by expenditure cuts). The cumulative amount of petroleum revenues accruing to the budget, as assumed in the program, is US$429 million for the period January–March 2003; US$803 million for the period January–June; US$1,209 million for the period January–September; and US$1,595 million for the period January–December 2003.

3. **Ceiling on the NFPS noninterest expenditure.** NFPS noninterest expenditure comprises all current spending (including, among other items, wages and salaries, purchases of goods and services, social security benefits, and social spending in FEIREP), and capital spending (including net lending) of the public sector.

4. **Floor on the stock of public sector deposits** in the BCE and in the commercial banks. Public sector deposits are defined as all deposits held by the NFPS in the BCE and the commercial banks. The floor applies to the average of end-of-month deposits during the relevant calendar quarter.

5. **Floor on the central government deposits** in the *cuenta única* in the BCE. This stock of deposits is defined as those deposits owned by the central government and held in the *cuenta única* in the BCE, excluding amounts held in the oil stabilization (FEP) provisioning account. The floor applies to the average of end-of-month deposits during the relevant calendar quarter, as reported in line 231105 (*cuenta corriente única*) of the central bank Fund reporting Table 10-R.

6. **Ceiling on the stock of registered public sector gross debt,** recorded on a disbursement basis. The public sector comprises the NFPS (as defined in point 2) and the financial public sector (comprising the Central Bank of Ecuador (BCE), the National Development Corporation (CFN), The National Development Bank (BNF), and The Housing Bank of Ecuador (BEV)). The stock of registered public sector gross debt is defined as all external debt (including principal in arrears, and as defined by the residency of the holder), domestic debt (as defined by the residency of the holder) issued by the NFPS held outside the NFPS, and government guaranteed debt, as reflected in the below-the-line fiscal accounts. For purposes of measuring the stock of public sector debt at the end of each period, the debt outstanding at end-December of the previous year is valued at the constant U.S. dollar-third currency exchange rate of end-December of the previous year. New debt flows incurred during the program period are valued at the exchange rate of the day the debt is issued. The term debt will be understood to mean a current, i.e., not contingent, liability, created under a contractual arrangement through the provision of value in the form of assets (including currency) or services, and which requires the obligor to make one or more payments in the form of assets (including currency) or services, at some future point(s) in time; these payments will discharge the principal and/or interest liabilities incurred under the contract. Debts can take a number of forms, the primary ones being as follows:

(i) loans, i.e., advances of money to the obligator by the lender made on the basis of an undertaking that the obligor will repay the funds in the future (including deposits, bonds, debentures, commercial loans, and buyers' credits) and temporary exchanges of assets that are equivalent to fully-collateralized loans under which the obligor is required to repay the funds, and usually pay interest, by repurchasing the collateral from the buyer in the future (such as repurchase agreements and official swap arrangements);

(ii) suppliers' credits, i.e., contracts where the supplier permits the obligor to defer payments until some time after the date on which the goods are delivered or services are provided; and

(iii) leases, i.e., arrangements under which property is provided which the lessee has the right to use for one or more specified period(s) of time that are usually shorter than the total expected service life of the property, while the lesser retains the title to the property. For the purpose of the guideline, the debt is the present value (at the inception of the lease) of all lease payments expected to be made during the period of the agreement excluding those payments that cover the operation, repair or maintenance of the property.

7. Under the definition of debt set out above, arrears, penalties, and judicially awarded damages arising from the failure to make repayment under a contractual obligation that constitutes debt are debt. Failure to make payment on an obligation that is not considered debt under this definition (e.g., payment on delivery) will not give rise to debt. For purposes of this ceiling, the debt includes any amount of oil sold forward; this debt will be considered amortized at the moment the oil is delivered (i.e., any nonspot oil sales are treated as asset-backed debt financing).

8. **External and Domestic Arrears and Arrears Clearance.** Table 2 of the SMEP on the arrears clearance program for 2003 presents the stocks, at end-of-period, of external and identified domestic arrears, and a schedule of the reduction in these arrears. Domestic arrears are those identified by the treasury of the central government only. The public sector (as defined in point 6) will not accumulate at any time during the arrangement period any new external arrears, or increase the stock of domestic arrears.

Statement by the IMF Staff Representative
August 1, 2003

1. The following information has become available on compliance with prior actions since the staff report was issued to the Board on July 24. This information does not alter the thrust of the staff appraisal.

2. When we distributed the staff report to the Board, the observance of two prior actions (numbers 4 and 6 in Annex I of the Letter of Intent and Supplement to the Memorandum of Economic Policies attached as Appendix IV to the staff report) was not yet known. We can now report that both these prior actions have been observed in the time allowed under the program.

3. Prior action 4 called for the "clearance of all external arrears that could not be rescheduled consistent with the Paris Club agreement." Based on the information received from the authorities, Ecuador had cleared all the relevant external arrears five days prior to the Board meeting for the first review. Remaining obligations are subject to the conditions set forth in the agreed minute of the Paris Club agreement.

4. Prior action 6 was to "complete the first auction of the restructured private sector debt portfolios of closed banks held in the AGD". The authorities have notified the staff that they accepted bids, made in the auction of Thursday July 24, 2003, on two loans held by the closed banks in the AGD. Therefore, this prior action also has been observed.

Press Release No. 03/134
FOR IMMEDIATE RELEASE
August 1, 2003

International Monetary Fund
Washington, D.C. 20431 USA

IMF Completes First Review of Ecuador's Stand-By Arrangement, Approves US$42 Million Disbursement and Grants Waivers

The Executive Board of the International Monetary Fund (IMF) completed today the first review of Ecuador's performance under a 13-month SDR 151 million (about US$211 million) Stand-By Arrangement, approved in March 2003 (see Press Release No. 03/39). This decision entitles Ecuador to the release of a further SDR 30.2 million (about US$42 million), which would bring the total amount disbursed under the program to SDR 60.4 million (about US$85 million).

In completing the review, the Executive Board also approved Ecuador's request for waivers of nonobservance of performance criteria and waivers of applicability, until September 15, 2003 of certain end-June, 2003 performance criterion.

Following the Executive Board's discussion on Ecuador, Anne Krueger, First Deputy Managing Director and Acting Chair, said:

"The government of Ecuador has embarked on an ambitious fiscal and structural reform program to foster economic growth and reduce poverty. However, the authorities have faced significant political and institutional challenges, and performance under the program in the first half of 2003 was uneven. Nevertheless, the authorities remain fully committed to the originally envisaged macroeconomic objectives, and have taken corrective steps to ensure that these can be met. Moreover, despite some delays, good progress is being made in advancing the structural reform agenda.

"In the fiscal area, the government has taken measures to contain the wage bill, reduce goods and services outlays, and start collecting in cash PetroEcuador's fuel deliveries to the electricity companies. As a result, notwithstanding recent wage and pension increases, the program's objective of an overall public sector primary surplus of 5¼ percent of GDP in 2003 can still be achieved. Moreover, a new law to overhaul customs administration has already been passed, and progress is being made to pass legislation for civil service and tax reforms. These reforms should further strengthen the fiscal position in 2004 and lay the foundations to bring down Ecuador's high public debt, as revenues from the new oil pipeline begin to come on stream, consistent with the Fiscal Responsibility and Transparency Law.

"The authorities are also committed to improving the management and financial condition of the state enterprises in the oil, electricity and telephone sectors. Strong public enterprise reforms will have a positive effect on the public finances and on the country's productive infrastructure. Finally, welcome progress is being made to auction off restructured loans of closed banks, and to prepare the way for these banks to be liquidated.

"These reforms, together with actions to improve governance and the investment climate and increased focus on progress in strengthening the social security net, will expand Ecuador's growth potential while broadening the public support for the government's program," Ms. Krueger stated.

Statement by Roberto Steiner, Alternate Executive Director for Ecuador, and Carlos Ernesto Cobos, Advisor to Executive Director
August 1, 2003

On behalf of our authorities, we would like to thank staff, management, and the Executive Board for the support given to Ecuador. While progress has been achieved in a number of areas, program implementation has been slower than originally anticipated and there are risks and challenges ahead. Our Ecuadorian authorities are fully committed to taking the appropriate actions to secure medium-term fiscal and external sustainability.

Growth and inflation

After Ecuador dollarized in early 2000, the main economic indicators stabilized and expectations improved. Both in 2001 and 2002 Ecuador exhibited the highest rate of growth in the region. As a result, unemployment has been reduced from 14.4 percent in 1999 to 10 percent in May 2003. Even though growth forecasts have been revised downward, we still anticipate growth of 3.1 percent in 2003 and 5 percent in 2004.

While inflation, at 7.6 percent in June 2003, remains high for a dollarized economy, it is certainly moving in the right direction. In the last quarter, annualized inflation was 3.8 percent. Tradable and non-tradable inflation rates are now converging, and the real effective exchange rate has depreciated by 2.5 percent since January.

Fiscal policy

One of the primary objectives of the last four years has been to reduce the dependency of the general government on oil exports. While during 1996-99 the non-oil fiscal deficit was 6.6 percent of GDP, for 2000-03 it is projected to decline to 3.8 percent and to 1.7 percent in 2003. Since the advent of dollarization, non-oil proceeds have increased from 14.8 percent of GDP in 1999 to 20.1 percent in 2003.

Fiscal discipline weakened somewhat in 2002. While the NFPS registered a 1 percent of GDP surplus, the central government's own cash position in the third and fourth quarters became very tight. Extensive constitutional earmarking, together with the sharp increase in the wage bill and in expenditures on goods and services, forced the Treasury to end 2002 with over $700 million in domestic and external arrears.

The Government's program aims at reducing the total debt of the NFPS by around 14 percent of GDP between 2002 and 2004. Key to this result are the estimated surpluses of the social security system and the new oil stabilization fund (FEIREP). For the first half of 2003, the NFPS overall surplus is estimated to have been somewhat below target. Despite higher prices, oil sector revenues have been lower than expected, due to lack of investment and unforeseeable externalities such as the breakdown of the SOTE pipeline and a 10-day strike. Tax collection reached $1.5 billion in the first semester, slightly below expectations. Estimated tax revenue has been revised down to $3.2 billion. We are confident that a thorough execution of the program will diminish the impact of this slowdown. In any event, June tax collections were up 10.7 percent year-on-year.

In order to comply with the program, our authorities have taken several measures, including establishing a limit on central government primary expenditure consistent with the fiscal responsibility law, and eliminating invoice subsidies to the electricity companies starting in September 2003. In the last two years, current expenditures have grown significantly, reaching an unsustainable pace. On July 11, the President issued a decree to freeze public sector wages for 2003, eliminate vacancies, and implement hiring restrictions. As a prior action for this review, the government submitted to Congress, with a status of urgency, the civil service reform, which sets a framework to better manage the wage bill of the NFPS and gives the government tools to rationalize public sector employment. The government's purpose is to remove 10,000 public sector employees by the end of 2004. The authorities have agreed to pass by the end of August a civil service reform law, including provisions to remove customs office personnel from the civil service labor code, and to eliminate the sharing by customs office personnel in the proceeds from the auctions of confiscated goods.

Our authorities believe that additional efforts should be undertaken in several areas. First, by incorporating into the budget all expenditure that is undertaken outside its framework, including subsidies to the electricity sector via Petroecuador. Second, the government will submit to Congress a comprehensive tax reform bill that aims at a gradual elimination of revenue earmarking, elimination of tax exemptions, removal of taxes with low yields, an increase in vehicle taxes, and a decrease in the standard deduction for personal income taxes.

Ecuador has faced difficulties in executing the financing program, which includes aggressive debt placements within the public sector. The inability to overcome administrative procedures resulted in higher deposits in the NFPS and a higher level of domestic arrears. In the second quarter, however, coordination within the different public entities improved, allowing for some reduction in domestic arrears. As a prior action for this review, all external payment arrears not eligible for restructuring have been cleared.

The external sector

The trade deficit as of May 2003 is considerably lower than in 2002, reflecting weaker imports, higher oil prices and a recent positive evolution of non-oil exports. The decline in imports reflects lower foreign purchases for the construction of the new oil pipeline and lower private consumption. The real exchange rate has weakened recently, particularly with respect to Colombia, Spain, and Germany, and this should enhance the prospects for Ecuadorian exports. The non-oil trade balance continues to improve and oil price futures remain high.

While the current account deficit is expected to reach 4.9 percent of GDP in 2003, it should decline to around 3.7 percent in 2004, with increases in both oil and non-oil exports and a flattening out of imports. This reduced current account deficit should be financed with direct foreign investment. Regarding the observed increase in private external debt, our authorities believe this reflects a repatriation of capital by Ecuadorians, a most welcome development.

Financial sector

The Ecuadorian financial sector has substantially recovered from the currency and banking crisis. The private banking system presents sound levels of liquidity, as deposits continue to expand. Reflecting uncertainty, most deposits remain short term and banks have continued to expand their liquidity reserves abroad. Deposit and lending rates remain at around 5 and 14 percent, respectively.

There has been progress on resolving the issues with failed banks. In Filanbanco, two independent firms have begun collecting on the loan portfolio. In addition, audits began for nine closed banks in the Deposit Guarantee Agency (AGD) and an international investment firm has been hired to bring Banco del Pacífico to the point of sale. As a prior action for this review, the AGD is completing the first auction of restructured loan portfolios and is moving forward to collect loans through foreclosures. The authorities have agreed to auction by the end of August all restructured private sector debt portfolios of closed banks held in the AGD.

Structural reforms

The structural reform agenda is ambitious and aims to build institutions consistent with dollarization. While before dollarization inefficiencies were generally accommodated through high prices and user fees and/or through generous subsidies, in the context of dollarization the enhancement of productivity is the only sustainable policy option. The removal of subsidies is a politically sensitive issue, one that requires persistent efforts and for which the Government is requesting international support, particularly from the IMF. The government has proposed a structural reform program that focuses on three strategic sectors: the electricity, telephone, and oil sectors.

Reforms in the electricity sector seek to rearrange the management of revenues. The plan aims to decrease losses and collection inefficiencies. Currently, generators collect only around 60 percent of their total bill. The agreement signed by the Fondo Solidaridad, the electricity companies, the Minister of Economy, PetroEcuador, and the Central Bank will guarantee payment to generators for services provided. This framework should clear the way for new investments to the vital low-cost energy generating sector. If companies would marginally improve their billing and collection processes, tariffs could decline significantly. In addition, the authorities have agreed to concession by the end of August to reputable international firms the management of the electricity distribution companies as well as the telephone companies Andinatel and Pacifictel.

As a prior action for the completion of this review, the government has issued a decree that reduces the intermediation margins in fuels distribution and retailing. Additionally, the government is working on a comprehensive plan to better allocate petroleum assets, currently assigned to Petroecuador. This plan allows for a wider participation of the private sector. The goal is to more than double Ecuador's oil production by 2011, and to improve the cost structure of derivatives production by adding private capital, technology, and management to the existing infrastructure. Additionally, the authorities have agreed to conduct and publish by the end of October an economic and environmental analysis, and prepare an action plan for the cost-effective production, distribution, and sale of fuels and other petroleum products.

* * *

In conclusion, following a severe contraction and a currency and banking crisis, Ecuador dollarized in early 2000. While key macroeconomic indicators have stabilized in the last three years, structural rigidities have prevented Ecuador from fully benefiting from its new monetary framework. The administration that was inaugurated this past January is making significant efforts at overhauling key sectors, including the civil service, the banking and energy sectors, and the oil industry. Needless to say, these reforms directly affect powerful vested interests and, on occasion, the speed of implementation falls short of expectations. Completion of this review will provide the markets and other key actors with an important signal that the bold efforts of the government are supported by the international community. To that effect, our authorities request a waiver for the performance criteria that were not met.