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Ecuador: 2003 Article IV Consultation, Request for a Stand-By Arrangement, and Approval of an Exchange Restriction—Staff Report; Public Information Notice and Press Release on the Executive Board Discussion; and Statement by the Executive Director for Ecuador

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of a combined discussion of the Article IV consultation with Ecuador, request for a Stand-By Arrangement, and approval of an exchange restriction, the following documents have been released and are included in this package:

- the staff report for the combined 2003 Article IV consultation, request for a Stand-By Arrangement, and approval of an exchange restriction, prepared by a staff team of the IMF, following discussions that ended on **March 7, 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 March 14, 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 Public Information Notice (PIN) and Press Release, **summarizing the views of the Executive Board as expressed during its March 21, 2003, discussion** of the staff report on issues related to the Article IV consultation and the IMF arrangement, respectively.

- a statement by the Executive Director of Ecuador.

The document(s) 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*
Selected Issues Paper and Statistical Appendix
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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Staff Report for the 2003 Article IV Consultation, Request for a Stand-By Arrangement, and Approval of an Exchange Restriction

Prepared by the Western Hemisphere and Policy Development and Review Departments

(In consultation with other Departments)

Approved by Charles Collyns and Mark Allen

March 14, 2003

- **On August 28, 2000, Directors concluded the last Article IV consultation with Ecuador.** They emphasized the need to keep the fiscal balance strong, create a robust financial system, and deepen structural reforms to sustain the gains of dollarization.

- **The last review under the 2001 SBA was concluded on December 10, 2001.** Since then, several rounds of Article IV discussions have been conducted jointly with negotiations for a new SBA, but these negotiations could not be concluded because of a faltering policy record and failure to meet prior actions.

- **Against Fund advice,** fiscal policies in 2002 included large wage increases and new revenue earmarking, and structural reforms were suspended in April 2002. An important achievement in 2002 was the passage of the *Fiscal Responsibility and Transparency Law*, which provides medium-term rules for fiscal consolidation and debt reduction, consistent with the demands of dollarization.

- **The new government that took office on January 15, 2003 has moved quickly.** It has put in place a package of corrective fiscal measures to alleviate cash flow needs and reduce arrears, and developed a comprehensive economic program in support of which it is requesting a new SBA in the amount of SDR 151 million (46 percent of quota on an annual basis) (Appendix VII).

- **The 2003 Article IV consultation discussions** took place in Quito and Guayaquil in December 2002 and January 2003. The missions met with the president, his chief of staff, and the ministers of economy and labor, management of the Central Bank of Ecuador and the Banking Superintendency, other senior public officials, and representatives of the private sector.

- **Missions.** The missions comprised Mr. Traa (Head), Ms. Zermeño, and Messrs. Hirschhofer, Vesperoni (WHD), and Abrego (PDR). Messrs. Collyns (WHD) and Cayazzo (MAE) also joined the January mission. Mr. Yuravlivker, the resident representative in Quito, assisted the missions.

- **Fund Relations.** Outstanding Fund credit is SDR 227 million (75 percent of quota). Ecuador has accepted the obligations of Article VIII, Sections 2, 3, and 4, and 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 held in closed banks managed by the Deposit Guarantee Agency. The authorities are requesting approval of the exchange restriction until end-December 2003.

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Executive Summary

Since President Gutierrez took office on January 15, his government has made an impressive start at implementing a comprehensive economic program. Measures have been taken to address the public sector's severe short-term liquidity pressures, and structural reforms have resumed aimed at bolstering growth in the dollarized economy. In support of their program, the authorities have requested a new SBA equivalent to 46 percent of quota (SDR 151 million).

The proposed policies include:

- A package of fiscal measures aimed at strengthening the primary surplus from 4½ percent of GDP in 2002 to at least 5¼ percent in 2003, and 6¾ percent in 2004.
- A strengthening of the social safety net through additional allocations for cash income transfers to the poor.
- Customs reform legislation (approval by congress by end-April).
- Civil service reform legislation (approval by congress by end-August).
- Tax reform legislation (approval by congress by year's end).
- Reform of the electricity, petroleum, and telephone public enterprises.
- Completing the liquidation of closed banks and returning blocked deposits.

Prior actions for the program include:

- Passage of the 2003 budget containing a wage freeze and a cautious oil price assumption of US$18 per barrel.
- Issuing satisfactory regulations for the Fiscal Responsibility and Tourism laws.
- Ending the freeze on electricity and telephone tariff adjustments.
- Clearance of all external payments arrears.

The risks to the program: The implementation record in past years has been poor and there is no room for slippages, especially on the fiscal front. Also, congress needs to agree to the important customs, civil service, and broad-based tax reform (including to reduce revenue earmarking). These important tasks will require patience and perseverance, and careful coalition building, given that Ecuadoran society is very divided along income, ethnic, and regional lines, and forging consensus for sustained strong economic policies has been problematic.

I. Recent Economic Developments

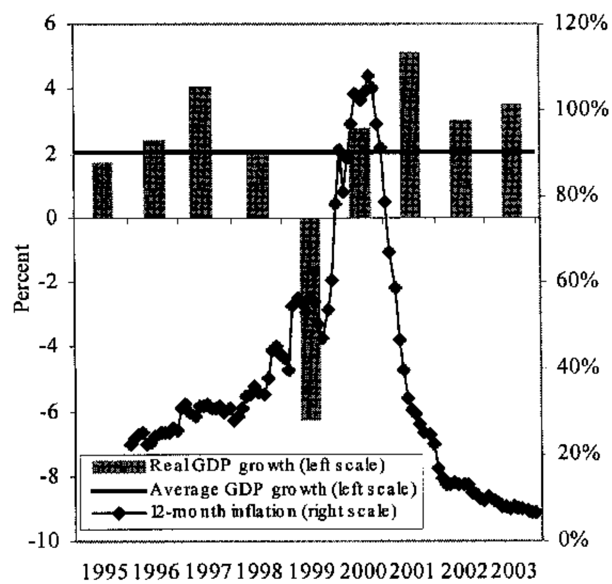
1. **Ecuador went through a difficult period in the 1990s, and per capita income stagnated.** The 1998 oil price slump, damage from the *El Niño* weather phenomenon, and disease in the shrimp industry further complicated the situation. As a result, Ecuador experienced severe economic stress, culminating in accelerating inflation and a currency crisis. Ecuador defaulted on its public debt in 1999, and obtained a 40 percent haircut on eligible instruments, including Brady bonds, in the subsequent restructuring in 2000. Meanwhile, the currency crisis spilled over into a banking crisis, which led to a deposit freeze and the closure of some 18 banks, affecting about half of total deposits.

2. **The adoption of the U.S. dollar in January 2000 stabilized expectations, and economic activity began to turn around.** Oil prices recovered, while imports surged due to a boom in domestic demand associated with the exchange rate-based stabilization. In 2001, demand was given further impetus by the start of the construction of a new (private) oil pipeline (*Oleoducto de Crudos Pesados*, OCP) and higher public sector spending (Table 1).

3. **However, economic growth slowed again in 2002 due to policy slippages and faltering confidence.** Fiscal discipline weakened with large increases in the wage bill and in social security benefits, the granting of new revenue earmarking, and discretionary tax cuts. Moreover, oil output dropped because of inefficiencies in PetroEcuador; the structural reform agenda was suspended in April; and there was a high-level corruption scandal in June.

4. **Inflation has dropped but remains too high for a dollarized economy.** Consumer price inflation came down from 91 percent at end-2000 to just under 10 percent by end-2002. Strong domestic demand (fiscal expansion), weak domestic supply (the absence of structural reforms), and wage-driven cost increases have prevented inflation from dropping to international levels. In an attempt to reduce inflation, fuel prices were kept constant in 2002, electricity and telephone tariffs were frozen in April 2002, and medications were also subject to price controls. Wages have more than doubled since dollarization in early 2000 (led by the public sector), thereby reversing their previous decline and exceeding inflation over this period. The unemployment rate has dropped by half since 2000, to 8½ percent at end-2002.

Figure 1
After the 1999 crisis, and dollarizing in 2000, growth rebounded and inflation fell...



5. **The external current account deficit widened to 5 percent of GDP in 2002.** While merchandise exports benefited from higher oil prices and continued growth of non-oil exports, imports grew rapidly on strong domestic

demand, and an appreciating real effective exchange rate. In the capital account, FDI in the oil sector declined to about 4 percent of GDP as the construction of the OCP pipeline approached completion, while private sector capital showed some reflows for the first time since the crisis.

6. **After a strong improvement in 2000, the fiscal position weakened in 2001 and 2002.** The nonfinancial public sector (NFPS) primary surplus fell from 7¾ percent of GDP in 2000 to around 4½ percent of GDP in both 2001 and 2002 (Tables 2 and 3). Revenues fell from 27½ percent of GDP in 2000 to 26 percent in 2002. Oil revenue declined with a drop in oil prices and inefficiencies in PetroEcuador that are causing a gradual but persistent shortfall in oil output. These losses outweighed the gains from improvements in the central government tax administration, revenues from the sharp jump in domestic demand, some one-time effects,[1] and strong social security receipts following the large wage increases and a broadening of the base for social security contributions in the private sector. At the same time, primary expenditures surged from 20 percent of GDP in 2000 to 21¾ percent in 2002. The main drivers were an increase in the wage bill from US$910 million in 2000 to almost US$2 billion in 2002; increases in purchases of goods and services and capital spending; and a boost in social security benefits with the aim of restoring real pre-crisis (1998) benefit levels.

Figure 2
...but the external balance turned sharply negative.

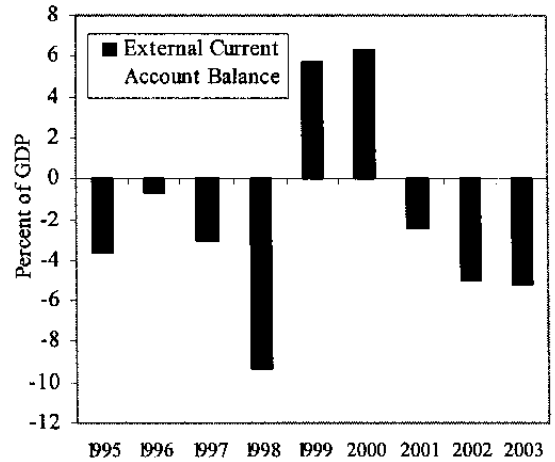
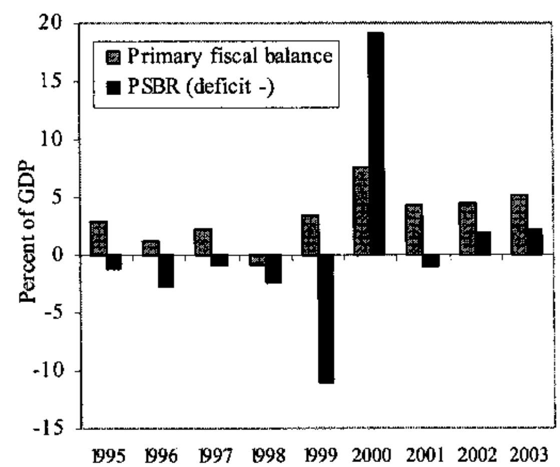


Figure 3
The overall and primary surpluses have declined after dollarization.



[1] As part of the 2001 program supported with a Fund SBA, the VAT rate was increased in July 2001, but this increase was reversed by a decision of the constitutional court. Also, VAT refunds to private oil companies were suspended at end-2001, and remain in dispute.

7. **Despite an overall NFPS surplus, the central government's own cash position has remained very difficult (Box 1).** Revenue gains automatically result in higher expenditures through extensive earmarking.[2] Together with the sharp increase in the wage bill, and because the central government is responsible for virtually all debt service, the treasury ended 2002 with over US$600 million in domestic and external payments arrears.

8. **The public debt-to-GDP ratio (including arrears) declined from 102 percent in 1999 to 60 percent in 2002 (Table 4).** This result mainly reflects the haircut received after the 1999 default and the sharp appreciation of the real effective exchange rate. Excluding the one-time effect of the haircut, the stock of debt including arrears has increased in dollar terms, in part because there were large bailouts of banks managed by the public sector.

9. **Monetary aggregates expanded rapidly during 2001–02, as improved stability led to reintermediation.** Private bank deposits and credit to the private sector both increased by well over 30 percent over 2001–02, while net credit to the NFPS declined as some entities accumulated deposits. Overnight interest rates have moved close to the federal funds rate, dropping below 2 percent in recent months. However, average deposit rates have remained around 5 percent, and average lending rates were close to 14 percent at end-2002. The high interest spread reflects bank's efforts to restore adequate revenue margins, and the continued high EMBI spread on sovereign bonds, which places a floor on lending rates (Table 5).

Figure 4
Deposits and credit continue to expand.

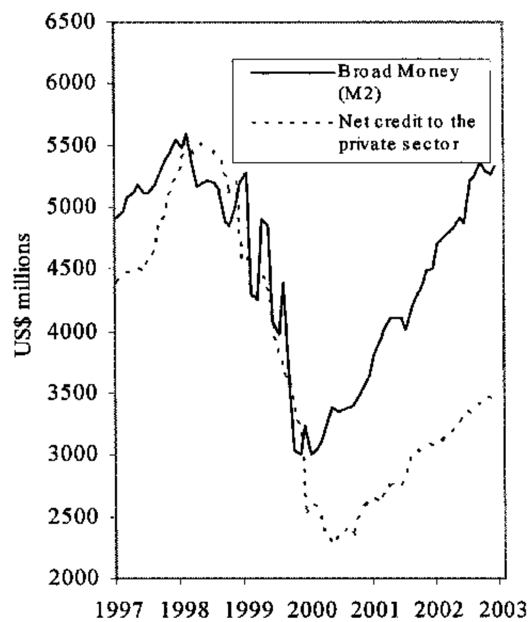
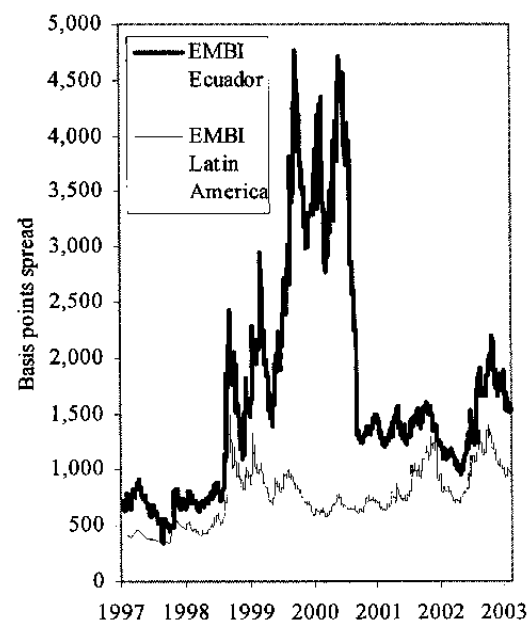


Figure 5
The risk premium remains too high.



[2] An FAD technical assistance report from November 1999 estimated that 60 percent of total revenues are earmarked. Since then, further earmarking has occurred.

Box 1. Fiscal Rigidities in the Central Government Budget

The usefulness of the central government budget as a tool for macroeconomic adjustment is limited due to extensive revenue earmarking, the high share of essentially nondiscretionary spending (including the wage bill and the large debt service burden), as well as the need to reduce debt and build a record of fiscal prudence. Revenue gains lead to automatic increases in transfers to other levels of government, especially in the VAT, income tax, and most excises, which are promptly spent. Almost by default, expenditure cuts often fall on the capital budget and other necessary programs.

Recent developments show a steady deterioration in the flexibility of the central government budget—leading to deficits and arrears. The table below shows that the level of partially discretionary spending has decreased from 5.6 percent of GDP in 2001 to about 4 percent of GDP in 2003. Without reforming the earmarking laws, the 3.5 percent cap on real primary expenditure growth of the *Fiscal Responsibility and Transparency Law* will worsen these tendencies, because with increased revenues the mandated revenue sharing will further squeeze out discretionary spending. To avoid this effect and to make fiscal policy compatible with dollarization over the medium term, it is essential to reduce the wage bill and to eliminate earmarking not mandated by the constitution. The program proposed by the government envisions these steps.

Ecuador: Spending Composition of Central Government Budget

(In percent of GDP)

	2001	2002	2003 proj.	2004 proj.
Primary spending	**14.7**	**15.9**	**15.8**	**15.3**
Wages	5.2	6.9	7.0	6.4
Transfers	4.0	4.0	4.7	5.2
Municipalities	2.7	2.6	2.8	2.7
Social security system	0.5	0.8	1.0	1.1
Universities	0.1	0.0	0.1	0.4
Social safety net (Bono Solidario)	0.7	0.6	0.8	0.9
Other (partly discretionary)	5.6	5.0	4.0	3.8
Memorandum items:				
Real growth in CG primary spending	...	...	3.4	3.5
Nominal GDP in US$ million	21,024	24,347	26,806	29,450

10. **The private banking system has largely restored its financial health (Table 6).** By adopting the U.S. dollar, the large exchange rate valuation losses in the dollarized balance sheets were brought to a halt, while renewed output growth contributed to improved profitability and the weakest banks were intervened. On average, the private banks raised average return on equity to 17½ percent in 2002, while their nonperforming loan ratio was cut from over 14 percent in 1999 to 6 percent in 2002, and the ratio of provisioning-to-overdue credits was strengthened to 129 percent by end-2002. Moreover, in the absence of a

lender-of-last-resort, private banks have built a large liquidity cushion abroad, with total liquidity now at over 30 percent of deposits.

11. **Public banks have fared less well.** Filanbanco, owned by the treasury, received a capital injection of US$300 million in May 2001 but, nevertheless, had to be closed in July 2001. Its liquidation is still not complete and some deposits remain blocked. Banco del Pacífico, owned by the central bank (BCE), and the only public commercial bank that remains open, received capital injections of US$129 million in 2001 and US$121 million in early 2002. The bank was placed under a recovery plan with private management in late 2001, and its financial position has stabilized as the new managers cut costs and benefited from expanded powers to collect collateral (*coactiva*). The nonperforming loan ratio has been reduced from 53 percent in 2001 to 32 percent in 2002.

12. **Public sector development banks have also performed poorly.** The National Finance Corporation (CFN) was forced to accept as payment on its loans, at face value, Certificates of Restructured Deposits (CDRs) that had been issued against blocked deposits by bankrupt banks taken over by the Deposit Guarantee Agency (AGD). The CDRs were trading at a deep discount, which implied a large loss for the CFN, and in 2002 the treasury took over from the CFN some US$270 million in external debt to strengthen its balance sheet. The Banco Nacional de Fomento (BNF), operating mainly in the rural areas, also regularly receives treasury funds (some US$22 million in the 2003 budget), and Banco del Estado (BEDE), which channels project financing to local governments, is financed with government-guaranteed multilateral loans.

13. **Some eighteen private banks that were taken over by the AGD during the banking crisis remain unresolved.** Little progress has been made toward collecting on US$1.6 billion in defaulted loans, and these banks also still have blocked deposits. In 2002, an independent private sector debt negotiator restructured viable loans in the portfolio, but few agreements have been signed, and the value of the credits is deteriorating since they are not managed well in the public sector.

14. **The pace of structural reform slowed in 2002.** Achievements in 2001 included a social security reform,[3] the unification of private sector wages, and increased private sector participation in the water and telecommunications sectors. However, in 2002, the privatization of important public enterprises was cancelled, after tariffs were frozen. The main achievement in 2002 was the approval in congress of the *Fiscal Responsibility and Transparency Law,* which governs medium-term fiscal policies and is key to medium-term debt reduction (Box 2).

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[3] The reform strengthened the pension system by raising contributions and pensionable age, and opened up the possibility for private capitalized pension funds alongside the public pay-as-you-go system. However, regulations to implement this reform have not yet been issued, and there have been legal challenges to establishing private pension plans.

Box 2. The Fiscal Responsibility and Transparency Law

The law regulates the allocation of public sector revenues from the new oil pipeline (OCP). The law:

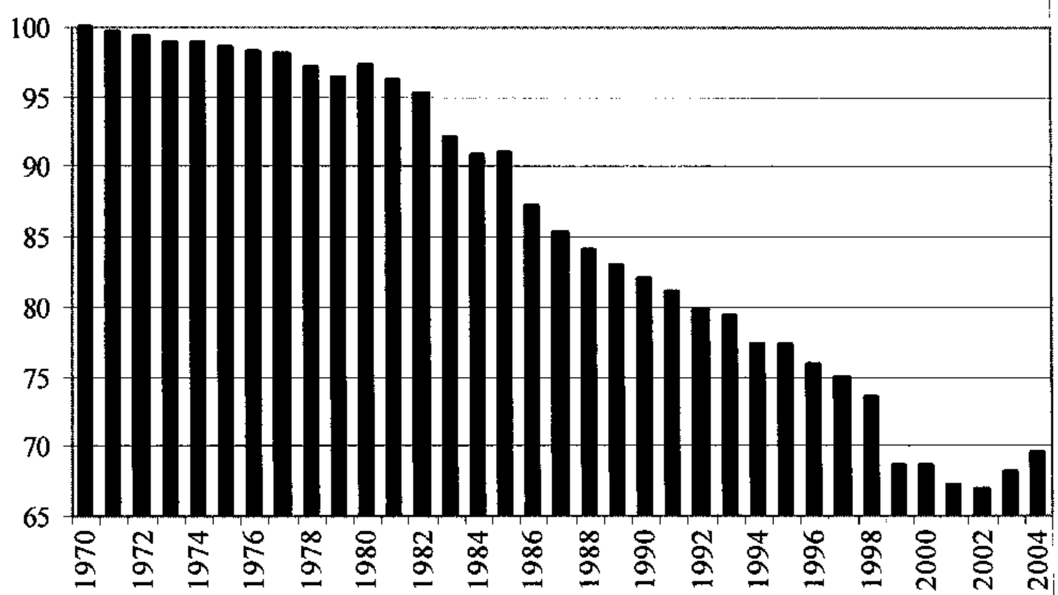
- Restricts the growth in real primary expenditures of the central government budget to a maximum of 3.5 percent a year (benchmarked on the estimated potential output growth of the economy);
- Requires a reduction in the non-oil fiscal deficit (excluding oil exports) by at least 0.2 percentage points of GDP a year; and
- Channels 10 percent of the revenues from the new oil pipeline to social spending (included under the 3.5 percent spending limit above); 20 percent to a petroleum stabilization fund (FEIREP; for use in case of an economic emergency; a natural disaster; or a collapse in oil prices); and 70 percent to domestic or external debt reduction, in addition to the regularly scheduled amortization.
- Requires a reduction in the public debt until it reaches a level of at most 40 percent of GDP.

Box 3. The Public Sector Balance Sheet and Net Worth

Constructing a (preliminary) public sector balance sheet illustrates how, since 1970, the net worth of the public sector has been systematically depleted.

- The balance sheet (Table 4) is a useful gauge for the sustainability of macroeconomic and especially fiscal policies over a longer time period.[4] Since 1970, Ecuador has drawn down its oil assets mainly to finance consumption, to the detriment of accumulating income-generating financial assets or building fixed capital stock to support development. This policy has eroded the net worth of the public sector (see chart below).
- Prudent use of the country's oil wealth is gaining further importance with the new oil pipeline, which can double the pace of extraction of the oil reserves and erode net worth even faster. Current projections suggest that oil reserves may be used up between 2020 and 2030, depending on the discovery of new reserves.
- The staff's policy recommendation is to treat oil revenue incrementally as a financing item in the fiscal accounts (below the line, similar to privatizations). Full adherence in the medium term to the *Fiscal Responsibility and Transparency Law* would lead gradually to restructuring the public sector balance sheet by using the proceeds from oil to eliminate the debt and to lower significantly Ecuador's very high risk interest spreads, thereby crowding in the non-oil economy.

Public Sector Net Worth with constant oil prices of 2001
(Index 1970=100)



[4] See Chapters IV and V of the accompanying Selected Issues paper.

II. Institutional and Political Context

15. **Ecuador is rich in natural resources and opportunities, but institutions are weak and the economy has functioned below potential.** Half the population is poor.

- So far, oil revenues have been largely consumed. Ecuador has defaulted twice on the debt in 20 years, and frequently incurs arrears. As a result, it has lost access to borrowing on commercial terms.

- The public sector remains heavily involved in the petroleum, electricity, and telecommunications sectors. Government spending is inefficient.

- The judicial system is highly politicized, and the rule of law is unreliable. The citizens have unequal access to the law, and even policy makers face judicial insecurity, which weakens policy commitment. Transparency International rates Ecuador among the most corrupt countries in Latin America.

16. **Ecuador has recently suffered a series of weak governments.** Notwithstanding its early success in stabilizing the economy, the previous administration did not receive much support from congress and was unable to sustain sound policies. In the course of 2002, its credibility was damaged further by a corruption scandal and a series of populist measures.

17. **In this environment, the public set aside the traditional parties and elected Mr. Lucio Gutierrez,** a political outsider, in the November 2002 elections. Mr. Gutierrez is a former army colonel supported by the indigenous movement, left-of-center groups, and some economists and bankers. He ran on an anticorruption platform and committed to pay more attention to the poor. The new president was inaugurated on January 15 for a four-year term. However, the congress remains under control of the traditional parties, which have claimed virtually all committee and leadership posts. The government will need to build bridges with these parties to get support for its legislative agenda.

III. Policy Discussions and Program Design

18. **Policy makers in Ecuador face two challenges:** the immediate challenge of stabilizing the economy consistent with dollarization, and the medium term challenge of generating sustainable high-quality growth while preventing the rapidly growing oil sector from causing Dutch disease problems. The staff and the authorities broadly agreed on the approach to be taken to dealing with these challenges, and the policy discussions focused on details of implementation and sequencing of this strategy. The staff strongly supported the authorities' resolve to take large up-front measures to boost the fiscal balance and to help eliminate arrears. The mission also endorsed the government's ambitious structural reforms to reduce rigidities in fiscal policy (i.e., cut wage pressures and revenue earmarking), strengthen the banking system, and modernize the state enterprises. The discussions were set in a medium-term context, emphasizing the need to use the new oil revenues for debt

reduction, thus helping to achieve a sustainable fiscal position, bring down the country risk spread, and facilitate investment in the non-oil economy.[5]

A. Macroeconomic Framework in 2003–04

19. **Real GDP growth is projected at 3.5 percent in 2003.** Output growth may remain subdued in the first half of 2003 but, provided policies stay on track, confidence will strengthen and risk premia should ease. This will boost financial intermediation and investment during the course of the year. Moreover, the new pipeline is scheduled to come on stream in the second half of the year, boosting exports. Consumer price inflation is programmed to decline further to an end-of-period rate of 6–7 percent, but will be affected initially by the unfreezing of utility, fuels, and other prices.

Selected Macroeconomic Indicators

(In percent)

					Proj.	
	1999	2000	2001	2002	2003	2004
Real GDP	-6.3	2.8	5.1	3.0	3.5	6.0
Domestic demand (contribution to growth)	-19.7	7.5	10.9	7.6	3.6	4.6
Foreign balance (contribution to growth)	13.4	-4.7	-5.8	-4.5	-0.2	1.4
Consumer price inflation, eop (U.S. dollar basis) 1/	-25.2	-10.1	22.4	9.4	6.5	4.0
External current account balance (percent of GDP)	5.7	6.3	-2.4	-5.0	-5.3	-4.1

1/ Inflation measured in dollars was negative in 1999–2000 because of the sharp depreciation of the Sucre before dollarization was implemented.

20. **Assuming a cautious oil price of US$18.00 per barrel, the external current account deficit is projected at just over 5 percent of GDP in 2003 (Table 7).** Non-oil exports are projected to expand by 5 percent. Import growth is projected to decelerate to 3¾ percent as imports for the pipeline decline (the deficit includes about one percentage point of GDP in one-time imports for the pipeline). Income remittances into Ecuador are expected to remain high at about 6 percent of GDP. The capital account (before exceptional financing) would remain strong in 2003 reflecting continued FDI inflows, dominated by the oil industry, which needs to invest in wells to fill the new pipeline. The public sector is projected to experience a net outflow (scheduled amortization, before exceptional financing).

[5] The letter of intent in support of the authorities' program was signed on February 10, 2003; a supplementary letter of intent is attached as Appendix IX.

21. **While 2003 is to some extent a transition year with strong short-term liquidity pressures and a need for exceptional financing, the dividends of sustained good policies should start to show in 2004 and beyond.** With progress toward improving productivity, declining risk premia, and rising oil production, real GDP could expand by 5–6 percent next year. Consumer price inflation in 2004 is projected to decline to 4 percent. The external current account deficit is projected to decline in 2004, when the new oil comes on stream.

B. Fiscal Policy

22. **The 2003 fiscal program proposes a strengthening in the primary surplus from 4½ percent of GDP in 2002 to 5¼ percent in 2003, and 6¾ percent in 2004.**[6] These targets are consistent with an overall surplus of 2 percent of GDP in 2003 and 3½ percent in 2004, and the clearance of the external and domestic payment arrears left by the previous government. To achieve these objectives, the government implemented significant revenue and expenditure measures within days of taking office, and sent a budget to congress that is consistent with the program.

Nonfinancial Public Sector Operations

(In percent of GDP)

					Proj.	
	1999	2000	2001	2002	2003	2004
Revenue	22.5	27.6	24.7	26.1	27.0	27.8
Expenditure	19.1	19.9	20.4	21.7	21.9	21.2
Primary balance	3.4	7.7	4.3	4.5	5.2	6.7
Interest bill	8.1	6.6	4.7	3.5	3.3	3.1
Overall balance	-4.6	1.0	-0.5	1.0	1.9	3.6
Public sector debt (including arrears and accounts payable)	101.6	91.4	70.2	59.6	51.7	44.1

[6] From 2003 onward, the consolidated NFPS finances include public sector revenues from the new oil pipeline (OCP). Consistent with the Fiscal Responsibility Law, these revenues, however, do not enter the spending stream. The accompanying Selected Issues paper indicates that the planned fiscal policies in 2003–04 impart broadly neutral impulses to aggregate demand.

23. **NFPS revenues are programmed to increase by almost one percentage point of GDP in 2003 to 27 percent of GDP.**

- On January 19, prices for gasoline and other fuels were increased by an average of 25 percent. Together with improved cost control in PetroEcuador and at the retail level, this is projected to yield nearly US$400 million (1.5 percent of GDP).

- The cooking gas subsidy will be eliminated before end-June, for a gross yield in 2003 of US$75 million (0.3 percent of GDP).

- Some discretionary and distortionary import tariff concessions that were granted in late 2002 have been reversed, yielding US$30 million (0.1 percent of GDP).

- The planned wage unification in the public sector will widen the base for payroll taxes and yield about US$20 million (0.1 percent of GDP) in 2003.

24. **NFPS primary expenditures are programmed to increase slightly to 21.9 percent of GDP in 2003, before declining in relation to GDP in 2004.** This reflects a substantial effort, especially in the central government, because the budget must absorb a US$410 million carryover from the wage and pension boom in 2002, deal with continued revenue earmarking, and provide for increased social spending to compensate the poor for some of the revenue measures noted above.

- On January 22, the authorities issued an austerity decree that included a freeze in central government wages for regular employees[7] and cut spending on goods and services (MEP, paragraph 8).

- Pensions were increased by 27 percent in early January 2003. The authorities have committed to delaying a second increase, also of 27 percent, that was previously planned for July. In addition, they have suspended lending from the social security system. The average monthly pension is now US$110, nearly as much as the minimum wage (MEP, paragraph 8).

- To compensate the poor for some of the above revenue measures, the government raised the cash assistance program (*bono solidario*) and pledged to increase it further when the cooking gas subsidy is eliminated (MEP, paragraphs 8 and 10). The authorities are working with the IDB to improve the targeting mechanism of the social safety net, including the *bono solidario*.

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[7] Wages outside the central government (18 percent of the total NFPS wage bill) could increase but this is not expected after an election year and with strong central government leadership to reduce wage costs.

25. **The authorities are moving ahead with several structural fiscal reforms:**[8]

- On January 31, the authorities issued the regulations for the *Fiscal Responsibility and Transparency Law*, making effective the fiscal rules described in Box 2.

- Regulations also were issued for a *Tourism Law* passed last year, clarifying and containing the tax revenue concessions that could have resulted from this law.

- The authorities have placed in congress, on a fast track basis, a *Customs Reform Law* to overhaul the customs administration and to bring it under the umbrella of the tax administration office (SRI). Most personnel in the customs office would be replaced. This is an important effort against corruption, and it could boost revenue buoyancy, even though the fiscal projections do not count on such a boost.

- After passage of the customs law, the government will seek approval for a public sector *Wage Unification and Civil Service Reform Law*, which aims at achieving a lower nominal wage bill in 2004 through shrinking the size of government and reducing personnel. The wage unification aims at phasing in a broadening of the base for social security contributions and income taxes, akin to the reform in the private sector.

- Finally, the authorities will seek the passage of a *Tax Reform Law* to eliminate revenue earmarking not mandated in the constitution (the amounts now transferred will be grandfathered and gradually reduced, in parallel with efforts to strengthen local tax bases), and most tax exemptions (including special rules in the income tax system). The law would also cut some low-yielding taxes; increase fees for vehicles; and reduce the (high) standard deduction for income taxes (MEP, paragraph 13).

- Regarding *pension benefits*, the government intends to reassess, with outside technical assistance, the operations of the social security system and the actuarial position of the general social security system (IESS) and the pension funds for the military and the police (ISSFA and ISSPOL).

26. **The program envisages US$574 million in exceptional financing.** The Andean Development Corporation (CAF, nonconcessional lending) and IDB would contribute US$100 million each, the World Bank US$130 million, and the Fund US$160 million. The remaining amounts would be obtained in a rescheduling of liabilities falling due with the Paris Club and official creditors. Project loan disbursements and domestic debt placements[9]

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[8] The World Bank and IDB will assist the authorities with some of these reforms.

[9] Domestic placements include US$160 million in arrears clearance with government paper. Domestic placements on commercial terms reflect less than 100 percent rollover.

are projected to provide US$715 million, and the fiscal surplus would contribute US$509 million. This financing would permit US$1.2 billion in debt amortization, and the elimination of all domestic and external payments arrears.

27. **The fiscal program contains some features to address potential risks:**

- **The government has framed its budget with an average 2003 oil price for Ecuador mix of US$18 per barrel.** The program contains an adjuster, so that a shortfall in oil revenues would need to be compensated through expenditure cuts. Windfall gains would need to be saved and reflected in a stronger primary target in 2003. Under current law, slightly more than half of the gains would be earmarked for spending in 2004, but the remainder would be used for debt reduction.[10]

- **Cash needs for contingent claims would be contained.** Such claims that are moving through the courts or are in arbitration (as with private oil companies) could eventually result in additional financing needs. The authorities (and some claimants) said that, in such an event, they would be willing to negotiate a payment schedule to settle at least the retroactive amounts with government paper.

- **The legislative agenda is sequenced to build support.** The early submission of the customs bill to congress is a signal of the government's commitment to fight corruption. The civil service law focuses on cost-cutting, the tax reform on revenue enhancements, thereby offering a balanced adjustment. Moreover, the tax reform law comes later in the year to allow setting a track record of timely revenue transfers to local governments and building confidence that the elimination of earmarking is not intended to place local governments at a disadvantage.[11]

28. **The authorities and the mission discussed the preliminary fiscal program for 2004.** The outlook depends on observing the fiscal rules and implementing all fiscal measures envisioned for 2003 as scheduled. Using the WEO oil price forecast for next year and taking account of some US$200 million in additional receipts for the full-year effect of the new oil pipeline, the NFPS primary surplus could strengthen further to almost 7 percent of GDP. In this scenario, the public sector would not need new exceptional financing besides the residual program amounts that would be disbursed in 2004.

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[10] With the latest WEO forecast of an average price of US$23 per barrel, oil revenues would be higher by ¾ percent of GDP in 2003.

[11] The extensive earmarking is largely the political response to the treasury's frequent failure to transfer payments on a timely basis and in the agreed amounts.

C. Liquidity and Banking Issues

29. **The mission discussed with the authorities their plans to develop more comprehensive policies to maintain a sound financial system.** These include the reinforcement of banking supervision, reforming the liquidity support system, and improving mechanisms for the recovery of nonperforming loans. Under the program, the authorities are taking the following actions:

- **Filanbanco:** The liquidation of Filanbanco will be completed by appointing independent managers to the bank's liquidation trust funds and proceeding with the sale of fixed assets and the resolution of the loan portfolios (MEP, paragraph 16, and supplementary LOI, paragraphs 6 and 7).

- **Closed banks in the AGD:** at least eight banks in the AGD will be audited, and then entered into formal liquidation. The restructured private sector loans from the AGD banks will be auctioned off to the private sector; and all blocked deposits will be returned to depositors before year's end (MEP, paragraphs 17 and 18, and supplementary LOI, paragraphs 6 and 7).[12]

- **Banco del Pacífico** will hire an internationally recognized investment firm to prepare its sale (MEP, paragraph 19). Moreover, the staff recommends that the bank sell part or all of the capitalization bonds that it received in 2001–02, write off nonperforming loans, and recognize contingent liabilities.

30. **The private banks and the authorities have been discussing a strategy to replace the existing Liquidity Fund.**[13] Current thinking involves pooling the reserve requirements, short-term foreign assets abroad, and the contributions to the existing liquidity fund, in a single new Liquidity Fund. This new fund could cover 35–45 percent of total deposits. It is contemplated that the new Liquidity Fund would be administered by an independent private manager, who would keep most of the liquidity abroad. Progress with the new Liquidity Fund will be discussed further by the mission to conduct the first review of the program.

31. **Under dollarization, the measure of public sector liquidity has shifted from net international reserves to government deposits.** Since the BCE has no currency to defend, and under its charter it cannot act as lender-of-last-resort, the government's deposits have become the standard of liquidity for working balances, debt service payments, and prudential cushions. The program includes a performance criterion on these deposits. In 2003,

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[12] Filanbanco has US$150 million in private sector blocked deposits, the AGD banks have US$125 million.

[13] Chapter VII of the Selected Issues paper discusses the proposed Liquidity Fund in more detail.

remonetization is expected to continue, with an expansion of liabilities and credit to the private sector of around 11 percent each. Net foreign assets in the banking system would remain unchanged, partly reflecting the commercial banks' adequate liquid position abroad.

32. **The superintendency and the central bank are to be commended for the improvements in monitoring the financial system.** However, the mission expressed concern that they appear hesitant to move beyond the minimum regulatory rules, when necessary. Banking supervision has improved through better loan classifications and provisioning and income recognition rules. However, the staff believes that the hesitancy to seek performance beyond the minimum regulations reflects legal insecurity and political interference that regulatory (and other) officials face in the execution of their duties. Proposals to deal with these issues will be discussed further in the first review. Also, the authorities have requested a Financial Sector Assessment Program (FSAP) from the Fund and the World Bank.

D. External Financing and Policies

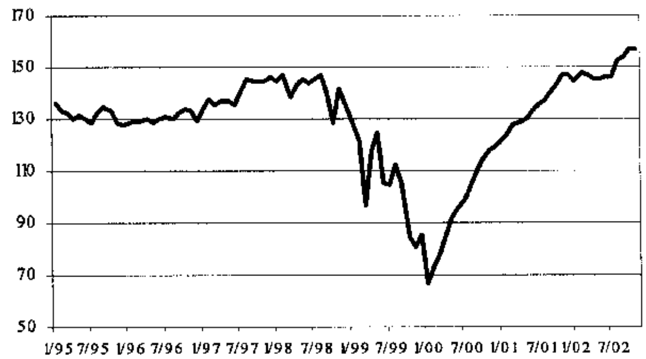
33. **The program envisages an external financing gap of US$574 million in 2003.** This is the counterpart of the exceptional financing provided to the fiscal program as described in paragraph 26. Additional disbursements of US$40 million each are expected from the Fund and the IDB in 2004 (Table 8).

34. **The debt rescheduling would be on a nonconcessional basis and involve all bilateral creditors.** It is assumed that Paris Club creditors would provide about US$60 million, all on pre-cutoff date debt, excluding that consolidated under the 2000 agreement. This comprises maturities falling due in 2003. Other external creditors, excluding multilaterals and bondholders, would provide the remaining US$24 million through comparable treatment. The rescheduling excludes bondholders which granted the haircut in the 2000 bond restructuring. Arrears by end-2002 on post-cutoff date debt (about US$30 million) and debt consolidated under the 2000 agreement (about US$20 million) were paid in cash in February 2003. On March 11, 2003, Paris Club creditors agreed to defer the cash payment of almost US$90 million in additional arrears by a few weeks. The government requests that the repurchase expectations to the Fund arising during the arrangement period be moved to an obligations basis, equivalent to SDR 14 million (4.7 percent of quota).

35. **Exceptional financing needs could be reduced, ex post, if the oil price were to stay above the level assumed in the program.** WEO projections suggested that the average oil price could be as high as US$23 per barrel for Ecuador mix, and the program includes an adjustor requiring that oil revenues in excess of the baseline be saved to build up assets or lower public debt. If the WEO projection materializes, the external current account would be stronger and the program would be overfinanced (Tables 7 and 8, second 2003 column). However, these resources would materialize gradually in the course of the year, and upfront debt relief would still be needed to help the government meet the severe cash flow constraint in the first semester. Ecuador has no market access and all available domestic financing options (including bridge lending) already have been used. If oil prices were to be higher,

Ecuador could use the extra revenue to amortize later in the program period some of the amounts rescheduled, or deferred, by the Paris Club.

Figure 6
The real exchange rate is now above its pre-crisis level.



36. **The mission expressed concern that, to support growth in the non-oil economy, Ecuador needs to strengthen competitiveness.** With domestic inflation still much higher than in trading partners (in part because of recent wage pressures), the real effective exchange rate continues to appreciate. With high debt, and the economy subject to volatile oil markets, Ecuador is vulnerable to shocks. With the expected growth in the oil sector, the effects of real exchange rate appreciation and Dutch disease on the non-oil economy could be substantial. The non-oil economy has been incurring fiscal deficits of 5–10 percent of GDP a year, and the non-oil current account deficits averaged over 16 percent of GDP a year (Table 9).[14] The authorities agreed that it was important to implement policies to align better wage developments with productivity growth to narrow these gaps, including wage restraint in the public sector as well as reforms to enhance productivity growth.

37. **As regards trade and payments policies,** Ecuador maintains an exchange restriction subject to Fund approval under Article VIII, Section 2 (a) of the Fund's Articles of Agreement in the form of a freeze on deposits in closed banks taken over by the AGD. The authorities are requesting the Fund approval of the exchange restriction and the measures proposed in the program envisage a phasing out of the restrictions by end-December 2003. There are no other restrictions in current or capital account, and foreign investors face the same regulations as their domestic counterparts. In the *trade* area, Ecuador needs to open up more decisively.[15] Two difficulties are that it is a member of the Andean Trade Community, so that special permission is required to lower some of the high common external tariffs, and there are also strong protectionist pressures from local producers because

[14] The staff's non-oil simulations remove export and domestic oil revenues, but also take into account that without oil, Ecuador would need to *import* its current energy needs. (Ecuador consumes 55 million barrels a year of its own oil production.) In this sense, it is appropriate to call it a "no-oil" simulation.

[15] Ecuador has seven import tariff rates between 0–35 percent. The average tariff is 11.3 percent, and there is wide dispersion of tariff rates (some agricultural products and items in the automobile sector have effective protection rates in excess of 100 percent). This contrasts with a negative effective protection for exports, and goods with a zero import tariff (see Chapter VIII of the Selected Issues paper).

of the appreciated real exchange rate. Local producers are against eliminating nontrade barriers (price bands) on a range of agricultural goods, import prohibitions on used goods, and import preauthorizations (even though most were to be removed for accession to the WTO). There are also temporary import safeguards for some goods from the Andean Community, which are expected to be lifted during 2003 after a 6-month duration. The authorities recognized that import restrictions are, in the end, a tax on exports, but they have not yet developed a calendar for their removal. They said that they would, however, resist pressures to *increase* trade distortions.

E. Medium-Term Outlook

38. **The medium-term baseline scenario assumes that the authorities are successful in implementing structural reforms that make fiscal policy compatible with dollarization.** These reforms include a more transparent budget process, a civil service reform, the elimination of earmarking that is not mandated in the constitution, and public prices that reflect economic costs. Inflation would fall to international levels by 2005 and GDP growth could remain strong amid continuing investment in the economy. Adherence to the *Fiscal Responsibility and Transparency Law* would guide the fiscal surplus higher, and the debt and the interest bill would drop substantially. External current account deficits would also decline in the medium term, with the boost in oil exports from the new pipeline (Table 10).[16]

39. **Revenues from the new oil pipeline need to be used prudently to provide the basis for a sustained acceleration of growth.** The mission noted that the increase in oil exports in the next few years could crowd out the non-oil economy. It was therefore critical to implement the *Fiscal Responsibility and Transparency Law* to channel the oil boom into higher savings (with the bulk of new revenues being used for debt reduction), and improve the public sector net worth. The authorities agreed that Ecuador would benefit by improving its creditworthiness, permitting a crowding in of private sector non-oil economic activity. If these policies are combined with a steadier legal framework, investments and growth could be strong in the medium term.

40. **Appendix VI presents the public sector debt-sustainability scenarios.** These suggest that the government's intent to run fiscal surpluses over the medium term, combined with the debt reductions that are possible with the revenues from the new oil pipeline, could produce a decline in the public debt ratio from 60 percent in 2002 to between 20–30 percent by 2008. Standard sensitivity tests, such as much higher interest rates on the debt, or a temporary small primary deficit (instead of the substantial surpluses in the baseline scenario), would still produce a sustainable medium-term debt profile. Even an average price of Ecuadoran oil between US$10–15 dollars per barrel in the period 2004–08 could produce a sustainable debt profile and drop the debt ratio to below 30 percent of GDP by 2008,

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[16] The scenario assumes that full capacity use of the new pipeline is phased in through 2006.

provided that the fiscal rules in the Fiscal Responsibility and Transparency Law are adhered to. This occurs because the weight of oil in the budget has been reduced in recent years, and the expenditure rule would contain outlays. With much lower oil prices, the debt reduction would slow, but not end.

41. **The main risks to the medium term arise from the pressures to spend the new oil revenues.** If these revenues are not sterilized, import demand could increase substantially further, the real effective exchange rate would continue to appreciate, and the public sector net worth would decline. The economy would become highly vulnerable to the oil cycle.

F. Structural Issues

42. **The mission and the authorities agreed that Ecuador has ample opportunities for reform, the potential gains could be large, and they could emerge relatively quickly.**

- **The electricity distribution and telephone companies (Pacifictel and Andinatel) need to be more efficient.** For this purpose, the companies will be placed under the management of reputable international firms, and the subsidies to these enterprises will be gradually eliminated. The tariff freeze has been lifted, and tariffs for households will be increased in equal monthly steps for 36 months until these reach economic cost recovery (MEP, paragraph 20).

- **Improvement in the petroleum sector could produce substantial savings for the economy.** With assistance from international experts, the authorities will conduct an analysis, and prepare an action plan and time table, to improve the efficiency of the petroleum sector, which will also be opened up further to foreign investment.

- **The government will improve the disclosure and transparency in the public sector, to provide citizens with better information.** The monthly fiscal spreadsheet used to frame the program and follow its implementation will be published. State enterprises also are to publish on the web their annual reports approved by their Board of Directors. The authorities agreed to publish the Report on the Observance of Standards and Codes (ROSC) for statistical dissemination, prepared by STA.

G. Statistical Issues

43. **Statistical information provided to the Fund is generally adequate.** Ecuador subscribes to the SDDS. However, the timeliness of the fiscal data and the accuracy of revenue and expenditure data, especially outside of the central government, need to be improved to enhance the monitoring of economic developments.

H. Conditionality, Access Under the New SBA, and Capacity to Repay the Fund

44. The program contains quarterly **quantitative performance criteria** on the NFPS overall balance; the NFPS noninterest expenditures, the stock of registered public sector

gross debt; the stock of public sector deposits, and central government deposits in the BCE (*cuenta única*). The program also includes **structural conditionality** on customs reform, civil service reform, tax reform, on liquidating closed banks and auctioning off their remaining portfolios and other assets, and on improving the operations of the public enterprises. Access to Fund resources is about average for SBAs without exceptional circumstances. Table 11 presents the disbursement schedule and the schedule for the quarterly reviews. Ecuador's use of Fund credit is moderate. Moreover, with the *Fiscal Responsibility and Transparency Law* in place and the measures and reforms to be implemented under the program, Ecuador's fiscal position and repayment capacity is expected to improve in the coming years. Ecuador should therefore be able to meet fully its obligations to the Fund.

Indicators of Financial Obligations to the Fund

(In millions of SDR)

	Over-due	2003	2004	2005	2006	2007	2008
Obligations from existing and prospective drawings							
Principal (repurchases) 1/	0.0	24.8	66.1	79.1	69.9	69.8	37.8
Charges and interest	0.0	7.8	8.1	6.3	4.5	2.7	1.2
Total debt service to the Fund	0.0	32.6	74.2	85.4	74.4	72.5	39.0
In percent of quota	0.0	10.8	24.5	28.3	24.6	24.0	12.9
In percent of exports of goods and nonfactor services	0.0	0.7	1.4	1.5	1.2	1.1	0.5
Total Fund credit, including prospective drawings	0.0	322.7	256.6	177.5	107.6	37.8	0.0
In percent of quota	0.0	106.8	84.9	58.7	35.6	12.5	0.0
In percent of GDP	0.0	1.6	1.2	0.8	0.4	0.1	0.0

Sources: Treasurer's Department; and staff estimates and projections.
1/ Assumes obligations schedule.

IV. Staff Appraisal

45. **The Ecuadoran economy has generally rebounded following dollarization.** Output growth has been relatively strong while inflation has declined. Private banks have recovered well, and confidence is gradually returning as evidenced by growing deposits and credit. The new oil pipeline (the OCP) can be a catalyst for growth in the medium term, because of its potential to double oil exports.

46. **Nevertheless, in 2002, the recovery weakened and vulnerabilities have increased because of uncertainties related to fiscal policy and structural reforms.** The liquidity

position of the central government became very tight at the end of the year and there were large arrears. With poor supply policies, output growth has slowed. Confidence weakened again, and the country risk premium rose some 500 basis points during the year.

47. **To address these problems, within days of taking office on January 15, 2003, the new authorities started implementing a comprehensive economic program.** The government's program has four building blocks: a package of immediate fiscal measures; fiscal structural reforms; liquidating the closed banks and resolving other outstanding issues from the banking crisis; and reforms in the state enterprises.

48. **The main objectives of the fiscal program are to address immediate liquidity constraints and to bring expenditure growth under control, consistent with the demands of dollarization.** The government has moved very quickly to implement a package of politically difficult revenue measures. Spending growth has been limited by a budgetary freeze on wage rates and other expenditure controls, while the social safety net has been strengthened to compensate the poor for the effects of some of the revenue measures. The staff strongly welcomes this decisive approach and the efforts being made to build political support for the program. However, the wage bill continues to increase because of carryover effects (while capital spending drops marginally), and every effort should therefore be made to contain further wage pressures in the economy. The elimination of the cooking gas subsidy is envisaged before end-June. This is a politically difficult step but, with a better targeting system in place to assist the poor, it should be implemented without burdening the indigent.

49. **The authorities are planning three strong fiscal reforms.** These aim at limiting the growth in public sector spending and maintaining revenue buoyancy, thus laying a strong foundation for sustainable fiscal policies in the medium term. They comprise a customs, civil service, and tax reform, including the elimination of revenue earmarking not mandated by the constitution. The agenda is ambitious, and there are risks of political setbacks.

50. **While the private banking system has recovered well, there are still unresolved issues from the banking crisis that need to be addressed.** Filanbanco is finally to proceed to liquidation, and Banco del Pacífico will be prepared for sale. The staff has concerns about the functioning of the public sector development banks and urges the authorities to limit new funding for these banks. The issues surrounding the inability of the Deposit guarantee Agency (AGD) to collect on loans held by the bankrupt banks are very troubling and the staff strongly supports the authorities' commitments to conduct audits in these banks and then to liquidate them. This will free up resources to pay back the remaining blocked deposits still in the closed banks. Finally, the staff believes that legal insecurity and political interference that regulatory officials face in the execution of their duties need to be addressed, and will return to this issue in the first review of the program.

51. **The boom in public sector spending in recent years, and especially the unsustainable increases in wages, have contributed to an appreciation of the real effective exchange rate.** Inflation is still too high for a dollarized economy, and the staff is concerned about eroding competitiveness and its effects on investment and employment. The

coming on stream of the new oil pipeline in mid-2003 will alleviate the pressures on the external current account but, to avoid a further real exchange rate appreciation and a crowding out of the non-oil economy, it will be essential to adhere strictly to the Fiscal Responsibility law and cut the debt rapidly.

52. **The staff strongly welcomes the authorities' plans to reform the state enterprises.** The state companies are badly run, and the authorities will hire private sector management to improve their operations. The adjustments in electricity and telephone tariffs have resumed. The staff also looks forward to the study of the state oil sector, and urges the authorities to act quickly and decisively to lower costs and increase efficiency in PetroEcuador. These reforms need to be extended to the trade regime, where Ecuador needs to reduce import tariff dispersions, and effectively remove trade restrictions already agreed with the WTO.

53. **Ecuador's medium-term outlook holds some promise.** The authorities have issued the enabling regulations for the *Fiscal Responsibility and Transparency Law*, which was approved by congress in September 2002. The staff believes that full adherence to this law (combined with reduced earmarking to avoid automatic spending increases) will prove to be enormously beneficial for the economy, as it would help generate strong overall surpluses, achieve a decisive reduction in the public debt, and restore the public sector net worth. By strengthening savings and lowering the debt burden, the law will lower the risk profile of Ecuador and, thus, boost investment and employment in the non-oil economy.

54. **While recognizing the risks involved, the staff supports Ecuador's request for a new Stand-By Arrangement in support of the government's economic program.** The new authorities' fiscal objectives under the program are suitably ambitious; the public debt ratio would decline steadily; and the program contains a strong agenda for structural reform. Immediate corrective fiscal actions have already been taken with upfront revenue and expenditure measures. Some additional steps that are still needed for 2003 should be implemented rigorously as there is no room for slippages. The main challenge going forward is likely to be that of getting the ambitious legislative agenda approved in congress. The customs, civil service, and tax reforms are essential elements of the program to put Ecuador on a sustainable medium term path, and the authorities must be skilful to build coalitions to support them.

55. The staff recommends approval of the authorities' request for (1) the exchange restriction in the form of blocked deposits in the closed banks, until end-December 2003, and (2) the extension of repurchase expectations to an obligations basis arising during the period of the Stand-By Arrangement.

56. It is expected that the next Article IV consultation with Ecuador will be held on the 24-month cycle, subject to the provisions of the decision on consultation cycles approved on July 15, 2002.

Table 1. Ecuador: Selected Economic and Financial Indicators

	1999	2000	2001	Prel. 2002	Prog. 2003	Prog. 2004
(Annual percentage changes; unless otherwise indicated)						
National income and prices						
Real GDP	-6.3	2.8	5.1	3.0	3.5	6.0
Domestic demand (contribution to growth)	-19.7	7.5	10.9	7.6	3.6	4.6
Consumption	-6.8	3.9	4.8	6.9	3.5	2.8
Gross fixed investment	-27.7	12.1	12.1	11.1	2.8	9.9
Foreign balance (contribution to growth)	13.4	-4.7	-5.8	-4.5	-0.2	1.4
Exports of goods and nonfactor services	7.8	-1.0	-1.3	2.7	1.7	11.1
Imports of goods and nonfactor services	-29.5	15.8	17.2	15.8	1.9	6.2
Real GDP per capita	-8.2	0.9	3.2	1.1	1.6	4.1
Consumer price index period average	-29.2	-7.7	37.7	12.6	7.9	4.4
Consumer price index end-of-period	-25.2	-10.1	22.4	9.4	6.5	4.0
Unemployment	14.4	14.1	10.4	8.7	...	...
Banking system						
Liabilities to the private sector	19.2	8.5	24.2	18.0	11.2	10.0
Net domestic assets	23.6	-12.1	26.3	22.1	18.2	7.1
Credit to the private sector	...	-5.1	16.9	13.8	10.7	10.9
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	5.9	0.1	13.6
Oil	60.3	65.1	-22.2	7.0	-7.2	27.0
Non-oil	-9.4	-16.4	11.8	5.1	5.1	5.3
Imports	-46.4	24.5	43.6	19.0	3.7	8.1
Terms of trade, national accounts data (deterioration -)	9.1	10.7	-15.6	4.9	-2.2	-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	25.9	27.0	27.8
Noninterest expenditure	19.1	19.9	19.6	21.7	21.9	21.2
Discrepancy (unrecorded expenditure -)	0.0	0.0	-0.8	0.2	0.0	0.0
Primary balance (deficit -)	3.4	7.7	4.3	4.5	5.2	6.7
Interest bill	8.1	6.6	4.7	3.5	3.3	3.1
Overall balance (deficit -)	-4.6	1.0	-0.5	1.0	1.9	3.6
Other public sector operations (deficit -) 1/	-6.3	18.0	-0.6	0.9	0.7	0.3
Public sector borrowing requirement	11.0	-19.1	1.1	-1.9	-2.6	-3.9
Total public debt	101.6	91.4	70.2	59.6	51.7	44.1
Domestic	18.7	19.4	15.7	12.8	9.4	7.4
External	82.8	72.0	54.5	46.9	42.2	36.7
Saving investment balance						
National saving	20.5	26.4	23.2	20.7	20.2	22.2
Gross investment	14.7	20.1	25.7	25.7	25.5	26.2
Foreign saving = external current account deficit (+)	-5.7	-6.3	2.4	5.0	5.3	4.1
Memorandum items:						
Public sector external debt service (percent of exports of goods and nonfactor services)	27.7	28.7	26.5	22.3	22.5	20.8
Interest	21.5	22.9	13.6	10.6	10.6	9.5
Principal	6.2	5.8	12.8	11.7	11.9	11.3
Use of Fund resources (percent of quota)	0.0	37.5	75.0	75.0	100.2	85.1
Net foreign assets (in millions of US$)	872	1,180	1,074	1,008	919	1,154
Public sector deposits (US$ millions)	570	1,228	1,261	1,282	1,306	1,589
Central government deposits (US$ millions)	78	396	86	118	118	218

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

1/ Includes results of the public sector banks and below-the-line debt operations. In 2000, Ecuador received a 40 percent haircut on eligible external debt.

Table 2. Ecuador: Operations of the Nonfinancial Public Sector

	1999	2000	2001	Prel. 2002	Prog. 2003	Prog. 2004
(In millions of U.S. dollars)						
Revenue	**3,751**	**4,391**	**5,184**	**6,318**	**7,244**	**8,196**
Oil revenue 1/	1,039	1,461	1,351	1,393	1,686	1,925
Non-oil revenue	2,581	2,793	3,728	4,709	5,314	6,035
Taxes	1,517	1,870	2,590	3,047	3,419	3,849
Social security contributions	228	215	455	766	895	1,097
Other	836	708	683	896	1,000	1,089
Operating surplus of public enterprises	131	137	105	216	244	237
Primary expenditure	**3,177**	**3,169**	**4,127**	**5,273**	**5,859**	**6,227**
Current	2,181	2,287	2,719	3,719	4,328	4,603
Wages and salaries	1,181	910	1,446	1,991	2,240	2,213
Purchases of goods and services	511	521	670	870	912	996
Social Security Benefits	...	...	151	346	636	700
Other 2/	489	856	452	512	536	674
Social spending in FEIREP	0	0	0	0	4	21
Capital	995	882	1,408	1,554	1,531	1,624
Fixed capital spending	...	...	...	1,396	1,571	1,624
Net-lending	...	...	...	158	-40	0
Discrepancy (unrecorded operations)	0	0	-163	42	0	0
Primary balance	**575**	**1,222**	**894**	**1,087**	**1,385**	**1,969**
Interest	1,348	1,057	990	842	877	906
Overall balance nonfinancial public sector	**-773**	**165**	**-96**	**245**	**508**	**1,064**
PSBR 3/	**1,831**	**-3,038**	**232**	**-472**	**-691**	**-1,143**
(In percent of GDP)						
Revenue	**22.5**	**27.6**	**24.7**	**25.9**	**27.0**	**27.8**
Oil revenue 1/	6.2	9.2	6.4	5.7	6.3	6.5
Nonpetroleum revenue	15.5	17.5	17.7	19.3	19.8	20.5
Taxes	9.1	11.7	12.3	12.5	12.8	13.1
Social security contributions	1.4	1.3	2.2	3.1	3.3	3.7
Other	5.0	4.4	3.2	3.7	3.7	3.7
Operating surplus of public enterprises	0.8	0.9	0.5	0.9	0.9	0.8
Primary expenditure	**19.1**	**19.9**	**19.6**	**21.7**	**21.9**	**21.2**
Current	13.1	14.4	12.9	15.3	16.1	15.6
Wages and salaries	7.1	5.7	6.9	8.2	8.4	7.5
Purchases of goods and services	3.1	3.3	3.2	3.6	3.4	3.4
Social security benefits	...	...	...	1.4	2.4	2.4
Other	2.9	5.4	2.1	2.1	2.0	2.3
Capital	6.0	5.5	6.7	6.4	5.7	5.5
Fixed capital spending	...	...	...	5.7	5.9	5.5
Net-lending	...	...	...	0.6	-0.1	0.0
Discrepancy (unrecorded operations)	0.0	0.0	-0.8	0.2	0.0	0.0
Primary balance	**3.4**	**7.7**	**4.3**	**4.5**	**5.2**	**6.7**
Interest	8.1	6.6	4.7	3.5	3.3	3.1
Overall balance nonfinancial public sector	**-4.6**	**1.0**	**-0.5**	**1.0**	**1.9**	**3.6**
PSBR 3/	**11.0**	**-19.1**	**1.1**	**-1.9**	**-2.6**	**-3.9**
Memorandum items:						
Real growth in primary expenditure (percent)	-10.4	7.3	3.7	13.7	3.5	2.0
Fiscal balance excluding oil export revenue (percent of GDP)	...	...	-5.0	-3.0	-1.4	0.4
Implicit average interest rate on the debt (percent)	8.8	7.2	7.1	6.1	6.3	7.3
GDP (US$ millions)	16,674	15,934	21,024	24,347	26,808	29,432

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

3/ Includes a 40 percent haircut on external debt in 2000.

Table 3. Ecuador: Nonfinancial Public Sector Financing

(In millions of U.S. dollars)

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

				Prel.	Prog.	
	1999	2000	2001	2002	2003	2004
Assets	**91,135**	**140,400**	**114,438**	**116,488**	**104,117**	**106,423**
Deposits	570	1,228	1,261	1,282	1,306	1,589
Net worth BCE	1,032	1,343	1,037	1,037	1,142	1,253
Equity participation in enterprises and funds	5,485	4,430	4,749	5,389	5,978	6,606
Fixed capital stock, adjusted for depreciation 1/	11,271	11,204	11,701	12,819	13,623	14,778
Proven petroleum reserves 2/	60,381	104,440	75,002	82,817	66,325	65,740
Proven natural gas reserves 3/	8,103	13,653	15,276	6,877	8,834	8,831
FEIREP stabilization fund	0	0	0	0	8	50
NPV of biodiversity and carbon-dioxide capture 4/	4,293	4,102	5,412	6,268	6,902	7,577
Liabilities	**21,142**	**18,575**	**20,067**	**20,657**	**20,610**	**20,412**
NPV of shortfall in deposit insurance reserves 5/	2,131	2,036	2,686	3,111	3,426	3,761
NPV of shortfall in El Nino Contingent Insurance Fund 5/	2,073	1,981	2,614	3,027	3,333	3,659
Registered debt	15,962	13,227	13,979	13,730	13,782	12,932
Domestic	3,124	2,757	2,696	2,481	2,463	2,123
External	12,838	10,470	11,284	11,249	11,319	10,809
Net arrears and net accounts payable	976	1,331	788	789	69	60
Net worth	**69,993**	**121,825**	**94,370**	**95,831**	**83,507**	**86,011**
Net worth excluding oil and gas reserves	1,509	3,732	4,093	6,137	8,348	11,440
Net worth at constant oil and gas prices of 2001	96,479	96,374	94,370	94,139	95,506	97,320
Index: 1970 = 100	69	69	68	68	69	70
Memorandum items:						
Registered debt and arrears, in percent of GDP	101.6	91.4	70.2	59.6	51.7	44.1
Domestic	18.7	19.4	15.7	12.8	9.4	7.4
External	82.8	72.0	54.5	46.9	42.2	36.7
Contingent liability refund VAT to oil companies 6/	0	0	41	137	233	...
Actuarial shortfall in pension system 7/	6,279	6,000	7,531	8,464	9,009	9,331

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). CO_2 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 Nino), 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	Prel. 2002	Prog. 2003	Prog. 2004
(In millions of U.S. dollars, unless otherwise specified)						
I. Central Bank						
Net foreign assets 2/	**872**	**1,180**	**1,074**	**1,008**	**919**	**1,154**
Net domestic assets	**254**	**-919**	**-785**	**-704**	**-624**	**-834**
Net credit to the nonfinancial public sector	979	346	277	77	379	71
Net credit to the banking system	412	170	282	356	338	338
Other assets net	-1,138	-1,435	-1,345	-1,137	-1,341	-1,244
Central bank fully backed liabilities	**1,126**	**261**	**289**	**304**	**296**	**319**
II. Banking System						
Net foreign assets	**-224**	**137**	**506**	**721**	**721**	**791**
Net domestic assets	**3,497**	**3,770**	**4,363**	**5,018**	**5,657**	**6,225**
Net assets held in the central bank	149	225	124	193	114	133
Net credit to nonfinancial public sector	312	214	268	172	131	131
Net credit to the private sector	2,765	2,623	3,066	3,489	3,863	4,284
Other domestic assets	271	708	904	1,165	1,549	1,677
Liabilities to the private sector	**3,273**	**3,907**	**4,869**	**5,739**	**6,378**	**7,016**
Deposits	2,878	3,608	4,475	5,286	5,880	6,468
Other	395	299	393	452	498	547
III. Consolidated Banking System						
Net foreign assets	**648**	**1,316**	**1,580**	**1,729**	**1,640**	**1,945**
Net domestic assets	**2,986**	**2,626**	**3,316**	**4,049**	**4,786**	**5,124**
Net credit to the nonfinancial public sector	1,291	560	545	248	510	202
Net credit to the private sector	2,765	2,623	3,066	3,489	3,863	4,284
Other net domestic assets	-1,071	-558	-295	313	414	637
Liabilities to the private sector	**3,634**	**3,942**	**4,896**	**5,778**	**6,426**	**7,068**
(Flows, in millions of U.S. dollars)						
Consolidated banking system						
Net foreign assets	...	668	264	149	-89	304
Net domestic assets	...	-360	690	733	737	337
Net credit to the nonfinancial public sector	...	-731	-15	-297	262	-308
Net credit to the private sector	...	-142	443	422	374	422
Other assets	...	513	262	608	101	223
Liabilities to the private sector	...	308	954	882	648	642
Memorandum items:						
M2 (percentage change)	19.2	12.4	23.6	18.3	11.3	10.0
M1 (percentage change)	88.6	5.4	41.1	30.6	13.9	10.0
Net credit to private sector (percentage change)	...	-5.1	16.9	13.8	10.7	10.9
Public sector deposits at central bank	500	1,079	1,001	1,027	1,009	1,333
Central government deposits "cuenta unica"		396	86	118	118	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.

Table 6. Ecuador: Banking Soundness Indicators 1/

	December				
	1998	1999	2000	2001	2002
I. Profitability Ratios					
(In percent of total assets and contingencies)					
Operating revenue	19.3	70.4	22.1	9.9	11.6
Private banks	18.7	60.1	22.5	9.7	11.2
Public banks	19.9	86.2	21.4	11.4	15.3
Operating expenses	17.7	66.7	21.0	9.0	11.0
Private banks	18.6	56.4	20.5	8.2	9.8
Public banks	17.0	82.4	21.9	16.3	20.9
Net operating margin	1.6	3.7	1.1	0.9	0.7
Private banks	0.2	3.7	2.0	1.5	1.4
Public banks	3.0	3.8	-0.5	-4.8	-5.5
Profits	0.7	-3.7	-2.2	-0.4	1.2
Private banks	-0.1	0.6	0.7	1.1	1.3
Public banks	1.5	-10.3	-7.6	-14.6	0.3
Profits (percent of equity)	11.3	-34.3	-25.2	-5.2	15.0
Private banks	-1.8	9.8	10.4	15.5	17.6
Public banks	23.4	-57.0	-63.9	-68.1	2.1
II. Asset Quality Ratios					
Nonperforming loans/total loans (percent)	9.4	28.7	34.7	13.4	8.4
Private banks	13.3	14.3	12.2	7.4	6.0
Public banks	5.7	40.4	60.6	53.3	32.3
Loan provisions/total loans (percent)	10.6	23.8	28.9	15.5	11.0
Private banks	15.6	13.1	14.4	9.5	7.7
Public banks	5.6	32.4	45.5	55.5	43.9
Uncovered nonperforming loans/total loans (percent)	-1.1	4.9	5.9	-2.1	-2.6
Private banks	-2.3	1.1	-2.2	-2.1	-1.7
Public banks	0.0	8.0	15.1	-2.2	-11.6
Loan provisions/past-due loans (percent)	112.1	82.9	83.1	115.5	131.4
Private banks	117.6	92.1	118.0	127.9	129.0
Public banks	99.7	80.2	75.0	104.1	136.0
III. Liquidity Ratios					
Total loans/total deposits (percent)	88.8	134.8	94.4	76.1	70.7
Private banks	100.0	93.6	75.2	71.3	69.7
Public banks	80.1	209.3	133.4	139.1	82.2
Total liquid assets/total deposits (percent)	42.3	76.5	42.2	35.3	34.7
Private banks	47.5	76.9	45.4	33.8	31.0
Public banks	38.3	75.9	35.8	54.9	77.6
IV. Capital Adequacy Ratios 2/					
Capital/(assets plus contingencies) (percent)	7.0	7.1	6.5	8.1	9.3
Private banks	6.2	6.7	7.8	8.2	8.7
Public banks	7.8	7.7	4.3	6.9	13.9
Capital/risk-adjusted asssets (percent)	11.2	14.7	13.1	13.5	14.7
Private banks	9.7	14.9	16.1	13.7	13.5
Public banks	12.7	14.5	8.1	11.8	28.5
Deposits/capital = leverage (percent)	464.1	494.4	767.2	722.4	630.1
Memorandum items:					
Private banks' share of total assets (percent)	48.3	60.4	64.7	90.2	89.9
Public banks share of total assets (percent)	51.7	39.6	35.3	9.8	10.1

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

1/ For open banks.
2/ Capital in balance sheet at the end of the year net of profits.

Table 7. Ecuador: Balance of Payments

	1999	2000	2001	Prel. 2002	Prog. 2003 Oil price Budget 1/	WEO 2/	Proj. 2004
(In millions of U.S. dollars)							
Current account	**955**	**1,004**	**-509**	**-1,214**	**-1,429**	**-1,228**	**-1,196**
Trade account	1,665	1,458	-302	-974	-1,191	-870	-1,017
Exports, f.o.b.	4,451	4,927	4,678	4,953	4,957	5,466	5,628
Of which: petroleum products	1,480	2,443	1,900	2,033	1,887	2,396	2,396
Imports (f.o.b.)	-2,786	-3,469	-4,981	-5,928	-6,147	-6,336	-6,645
Of which: oil sector investment 3/	-492	-544	-896	-845	-753	-753	-524
Services (net)	-1,811	-1,814	-1,867	-1,830	-1,876	-1,997	-1,911
Of which: interest payments	-1,134	-1,205	-999	-1,032	-1,050	-1,050	-941
Transfers (net)	1,101	1,360	1,660	1,590	1,639	1,639	1,731
Capital account	**-1,801**	**65**	**349**	**979**	**798**	**797**	**1,441**
Net public sector capital	210	540	-23	-311	-475	-475	-575
Direct investment	636	720	1,330	1,216	1,246	1,246	1,355
Of which: oil sector	615	680	1,120	1,057	1,076	1,076	805
Other net private sector capital 4/	-2,647	-1,195	-958	75	27	26	661
Banks	224	-361	-370	-215	0	0	-70
Other private sector	-2,871	-834	-588	289	27	26	731
Purchase of U.S. dollars for dollarization	...	-865	...	...	...	...	...
Overall balance	**-846**	**204**	**-160**	**-235**	**-630**	**-431**	**244**
Financing	**846**	**-204**	**160**	**235**	**57**	**57**	**-324**
NFA at the BCE (increase -) 5/	423	-165	152	177	219	219	-324
Net exceptional financing	423	-39	86	57	-163	-163	0
Public sector arrears (decrease -) 6/	331	-854	-9	-16	-163	-163	0
Debt relief obtained 7/	92	815	95	73	0	0	0
Public debt reduction	0	0	0	0	0	0	-15
Cash outlay from debt reduction	0	0	0	0	0	0	9
Capital gains from debt reduction	0	0	0	0	0	0	6
Others 8/	0	0	-78	0	0	0	0
Financing gap	**0**	**0**	**0**	**0**	**574**	**374**	**80**
Possible program loans	...	...	...	...	490	490	80
Possible debt relief 9/	...	...	...	...	84	84	0
Residual financing gap	**0**	**0**	**0**	**0**	**0**	**-200**	**0**
(In percent of GDP, unless otherwise specified)							
Current account	**5.7**	**6.3**	**-2.4**	**-5.0**	**-5.3**	**-4.6**	**-4.1**
Trade balance	10.0	9.2	-1.4	-4.0	-4.4	-3.2	42.6
Exports	26.7	30.9	22.3	20.4	18.6	20.5	19.5
Imports	16.7	21.8	23.7	-24.4	-23.0	-23.7	23.1
Public sector external debt	**82.8**	**72.0**	**54.5**	**46.9**	**42.2**	**42.2**	**36.7**
Total external debt service ratio							
(As percentage of exports of goods and nonfactor services)	**33.8**	**33.9**	**33.6**	**30.4**	**29.6**	**27.6**	**26.2**
Of which: public sector debt	27.7	28.7	26.9	24.1	24.6	22.1	24.3
Financing gap	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**-0.7**	**0.0**
(In percentage change)							
Exports, f.o.b.	5.9	10.7	-5.0	5.9	0.1	10.3	13.6
Petroleum	60.3	65.1	-22.2	7.0	-7.2	17.9	27.0
Non-oil	-9.4	-16.4	11.8	5.1	5.1	5.1	5.3
Import, f.o.b.	-46.4	24.5	43.6	19.0	3.7	6.9	8.1
Memorandum items:							
Current Account Balance excluding oil exports (In percent of GDI	-3.2	-9.0	-11.4	-13.3	-12.4	-13.5	-12.3
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	0.7	1.2
(In millions of US$)	872	1,037	884	707	488	488	813
Public sector external debt (end-of-period) 10/	**13,814**	**11,470**	**11,462**	**11,412**	**11,319**	**11,319**	**10,809**
Crude oil export prices							
(In U.S. dollars per barrel)	15.1	24.6	19.1	21.4	18.0	23.0	18.2
LIBOR interest rate (percent)	5.50	6.94	3.78	1.86	1.63	1.63	3.93

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$23 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	Prel. 2002	Prog. 2003 Oil price Budget 1/	Prog. 2003 Oil price WEO 2/	Proj. 2004
Total requirements	**3,224**	**2,832**	**2,385**	**2,029**	**2,212**	**2,011**	**2,054**
Current account deficit	**0**	**0**	**509**	**1,214**	**1,429**	**1,228**	**1,196**
Capital outflows	**3,224**	**2,832**	**1,876**	**815**	**783**	**783**	**870**
Scheduled public sector amortization	578	772	918	815	783	783	855
Nonfinancial public sector	556	606	731	710	726	726	776
Financial public sector	22	166	186	105	57	57	79
Public debt reduction	0	0	0	0	0	0	15
Private sector net outflows	2,647	1,195	958	0	0	0	0
Foreign exchange cost of dollarization	**0**	**865**	**0**	**0**	**0**	**0**	**0**
Total sources	**3,224**	**2,832**	**2,386**	**2,029**	**2,212**	**2,211**	**2,067**
Current account surplus	**955**	**1,004**	**0**	**0**	**0**	**0**	**0**
Capital inflows	**1,424**	**1,721**	**1,920**	**1,618**	**1,581**	**1,581**	**2,297**
Foreign direct investment	636	720	1,330	1,216	1,246	1,246	1,356
Disbursements to public sector 3/	788	1,001	590	329	308	308	280
Nonfinancial public sector	380	796	587	328	308	308	280
Financial public sector	408	205	3	0	0	0	0
Release of collateral from Brady bonds	0	171	0	0	0	0	0
Private sector net inflows	0	0	0	74	27	27	661
Exceptional financing	**92**	**954**	**401**	**250**	**574**	**574**	**80**
World Bank	...	...	61	0	100	100	40
Inter-American Development Bank	...	139	71	0	130	130	0
Andean Investment Corporation (CAF)	...	...	173	81	100	100	0
IMF	0	0	0	96	160	160	40
Debt relief 4/	92	815	96	73	84	84	0
Change in arrears, net (- decrease) 5/	330	-854	-9	-16	-163	-163	0
Change in net foreign assets at the BCE (- increase)	423	-165	152	177	219	219	-324
Cash outlay from debt buybacks	0	0	0	0	0	0	9
Capital gain from debt buybacks	0	0	0	0	0	0	6
Other 6/	0	0	-78	0	0	0	0
Residual financing gap	**0**	**0**	**0**	**0**	**0**	**-200**	**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$23 per barrel.
3/ Project loan disbursments; in 1999-2000 it 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/ Iincludes a discount on global bonds (2001).

Table 9. Ecuador: The Non-oil Economy

	1999	2000	2001	Prel. 2002	Prog. 2003	Prog. 2004
Total economy (including oil)						
Nominal GDP (in millions of US$)	16,674	15,934	21,024	24,347	26,808	29,432
(percentage change)	-28.3	-4.4	31.9	15.8	10.1	9.8
Real GDP, percentage change						
CPI inflation period average, percentage change (dollar based)	-29.2	-7.7	37.7	12.6	7.9	4.4
GDP deflator period average, percentage change (dollar based)	-23.5	-7.0	25.5	12.4	6.4	3.6
REER, percentage change	-30.8	-6.6	39.4	10.1	4.5	2.9
Primary balance, percent of GDP	3.4	7.7	4.3	4.5	5.2	6.7
Overall balance, percent of GDP	-4.6	1.0	-0.5	1.0	1.9	3.6
External current account balance, percent of GDP	5.7	6.3	-2.4	-5.0	-5.3	-4.1
Public sector debt, percent of GDP	101.6	91.4	70.2	59.6	51.7	44.1
Non-oil economy						
Nominal GDP (in millions of US$)	14,703	12,050	18,553	21,644	24,279	26,116
(percentage change)	-31.9	-18.0	54.0	16.7	12.2	7.6
Primary balance, percent of non-oil GDP	-3.2	-2.0	-2.5	-1.4	-1.2	0.2
Overall balance, percent of non-oil GDP	-12.3	-10.8	-7.8	-5.3	-4.8	-3.3
External current account balance, percent of non-oil GDP	-6.9	-23.9	-16.1	-18.1	-16.3	-17.3
Public sector debt, percent of non-oil GDP	115.2	120.8	79.6	67.1	57.1	49.7

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

Table 10. Ecuador: Baseline Medium-Term Scenario

	Prel.	Proj.					
	2002	2003	2004	2005	2006	2007	2008
Growth and prices							
Nominal GDP (US$ millions)	24,347	26,808	29,432	31,837	34,015	35,927	38,003
Annual percentage change	15.8	10.1	9.8	8.2	6.8	5.6	5.8
Real GDP (percentage change)	3.0	3.5	6.0	6.2	5.3	3.5	3.5
Domestic demand (contribution to growth)	7.6	3.6	4.6	4.6	4.1	3.2	3.3
Foreign balance (contribution to growth)	-4.5	-0.2	1.4	1.6	1.2	0.3	0.1
Consumer price inflation, period average	12.6	7.9	4.4	2.7	2.0	2.0	2.0
(In percent of GDP)							
Public sector operations							
NFPS Primary balance	4.5	5.2	6.7	7.0	6.8	6.2	5.9
NFPS overall balance	1.0	1.9	3.6	4.0	4.3	4.1	4.2
Public sector revenue, excluding oil export revenue	21.9	23.7	24.7	24.0	23.5	23.1	23.0
Public sector noninterest expenditure	21.7	21.9	21.2	20.6	20.3	20.3	20.3
Primary balance, excluding oil export revenue	0.3	1.9	3.5	3.4	3.3	2.8	2.7
NFPS balance, excluding oil export revenue	-3.0	-1.4	0.4	0.4	0.8	0.8	1.0
Growth in real primary expenditure (fiscal rule 1) 1/	13.7	3.5	2.0	3.5	3.5	3.5	3.5
Reduction in non-oil deficit (fiscal rule 2) 2/	2.0	1.6	1.8	0.0	0.4	0.0	0.2
Net amortization (scheduled and debt reduction)	4.6	4.4	4.0	4.3	4.6	4.2	3.6
Loan disbursements	2.3	2.7	1.1	0.9	0.9	0.8	0.8
Fiscal surplus (+) and other financing flows, net 3/	2.3	1.7	2.9	3.4	3.7	3.4	2.8
Program (gap) financing	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Public sector gross debt (including arrears)	59.6	51.7	44.1	37.2	30.9	25.7	21.3
Public sector net worth (in millions of US$) 4/	94,139	95,506	97,320	99,031	100,642	102,298	104,032
(In millions of U.S. dollars, unless otherwise indicated)							
Balance of payments and external financing							
Current account	-1,214	-1,429	-1,196	-1,165	-908	-807	-719
Oil exports	2,033	1,887	2,396	2,909	3,354	3,555	3,737
Non-oil exports	2,921	3,070	3,232	3,414	3,620	3,839	4,071
Imports	5,928	6,147	6,645	7,144	7,646	8,095	8,573
Services and transfers, net	-240	-238	-180	-345	-235	-105	46
Capital account	979	798	1,441	1,587	1,245	1,274	1,401
FDI	1,216	1,246	1,355	1,514	1,597	1,574	1,451
Other, net	-236	-448	86	73	-352	-300	-50
Overall balance (deficit -)	-235	-630	245	422	338	467	682
Public sector amortization (scheduled and debt reduction) 5/	578	772	918	815	812	870	1,296
Net private sector outflows (-)	75	27	661	716	380	384	486
Public sector disbursements	329	308	280	300	300	300	300
Program (gap) financing	0	0	0	0	0	0	0
Current account (percent of GDP)	-5.0	-5.3	-4.1	-3.7	-2.7	-2.2	-1.9
Nonoil export growth (percentage change)	5.1	5.1	5.3	5.6	6.0	6.1	6.1
Import growth (percentage change)	19.0	3.7	8.1	7.5	7.0	5.9	5.9

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

1/ Fiscal rule 1 of the Fiscal Discipline Law places a ceiling on budgetary real primary expenditure growth of 3.5 percent a year.
2/ Fiscal rule 2 of the Fiscal Discipline Law places a floor under the reduction of the budget deficit, excluding oil export revenue, (the non-oil budget deficit) of 0.2 percentage points a year.
3/ Includes revenue accruing to the publc sector from the new oil pipeline (OCP).
4/ Public sector assets minus liabilities, with oil and gas reserves valued at constant prices of 2001.
5/ Nonfinancial public sector.

Table 11. Ecuador: Proposed Disbursement Schedule

Earliest date available	Amounts (In millions of SDRs)	In percent of quota	Conditions
March 2003	30.2	10.0	Program approval.
June 2003	30.2	10.0	Completion of first review and observance of end-March 2003 quantitative and structural performance criteria
September 2003	30.2	10.0	Completion of second review and observance of end-June 2003 quantitative and structural performance criteria
December 2003	30.2	10.0	Completion of third review and observance of end-September 2003 quantitative and structural performance criteria
March 2004	30.2	10.0	Completion of fourth review and observance of end-December 2003 quantitative and structural performance criteria
Total access	**151.0**	**50.0**	

Table 12. Ecuador: Indicators of the External Position and Financial Vulnerability

	1998	1999	2000	2001	2002	2003
Financial indicators						
Public sector debt and arrears (percent of GDP)	65.9	101.6	91.4	70.2	59.6	51.7
Of which: external debt (percent of GDP)	56.2	82.8	72.0	54.5	46.9	42.2
Broad money (M2, 12-month percent change) 1/	1.8	85.3	8.5	24.2	18.0	11.2
Credit to the private sector (12-month percent change)	25.5	60.6	-5.1	16.9	13.8	10.7
Average lending interest rate (in percent)	...	16.5	16.3	15.1	14.4	...
Real lending interest rate (in percent) 2/	...	24.2	-21.4	2.5	6.5	...
External sector (in U.S. dollars value terms)						
Exports, f.o.b. (12-month change)	-20.2	5.9	10.7	-5.0	5.9	0.1
Imports, f.o.b. (12-month change)	11.4	-46.4	24.5	43.6	19.0	3.7
Terms of trade (12-month percentage change)	-14.3	9.1	10.7	-15.6	4.9	-2.2
External current account balance (US$ million)	-2,169	955	1,004	-509	-1,214	-1,428
Capital account balance (US$ million)	1,401	-1,801	65	349	979	798
Of which						
Direct investment	831	636	720	1,330	1,216	1,246
Net foreign assets of Central Bank (US$ million)	...	872	1,180	1,074	1,008	919
In months of imports of goods and nonfactor services	...	2.8	3.1	2.1	1.7	1.5
Public sector deposits (US$ million)	795	570	1,228	1,261	1,282	1,306
In percent of broad money (M2)	...	15.7	31.2	25.7	22.2	20.3
Amortization of public debt/deposits in cuenta unica (percent) 3/	...	...	...	282	1,299	978
Short-term external liabilities of central bank (US$ million)	382	188	19	83	68	68
Short-term external liabilities of commercial banks (US$ million)	1,489	854	597	507	508	508
Total debt of non-financial public sector (US$ million)	15,332	16,938	14,558	14,767	14,519	13,852
Of which						
External debt (US$ million)	13,061	13,814	11,470	11,462	11,412	11,319
Total public sector debt in percent of exports of goods and nonfactor services	306	322	246	259	239	226
Of which						
External debt	261	262	194	201	188	185
External interest payments in percent of exports of goods and nonfactor services	21.2	21.5	20.4	17.5	17.0	17.1
Real effective exchange rate (depreciation -)	1.6	-30.8	-6.6	39.4	10.1	...
Financial market indicators						
Guayaquil stock exchange index	66.9	32.6	40.0	49.4	74.0	75.6
Spread of EMBI + (basis points, eop) 4/	1,631	2,650	2,866	1,233	1,801	1,494
Foreign currency long-term debt rating (eop) 4/						
Moody's	B2-	Caa2	Caa3	Caa2	Caa2	Caa2
Standard and Poor's	...	...	B-	CCC+	CCC+	CCC+

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

1/ The figure for 2000 reflects the impact on M2 of the unfreezing of time deposits with bonds.
2/ Nominal interest minus annual average CPI inflation.
3/ Amortization payments falling due over freely available deposits (cuenta unica) at end of the previous year.
4/ Observation for 2003 as of February 20.

Ecuador: Fund Relations
(As of January 31, 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	511.88	169.33
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	2.38	7.23

IV. Outstanding Purchases and Loans:	**SDR Million**	**In percent of Quota**
Stand-By Arrangements	226.73	75.00

V. Safeguards Assessments:

The Central Bank of Ecuador (BCE) is subject to a full safeguards assessment with respect to the forthcoming arrangement. The necessary documentation has been provided by the authorities and reviewed by staff. At this time, no critical vulnerabilities have been identified but staff is planning to carry out an on-site assessment in the latter part of March 2003 so as to have conclusions and recommendations available by the time of the first review.

VI. Latest Financial Arrangements:

Type	**Approval Date**	**Expiration Date**	**Amount Approved (SDR Million)**	**Amount Drawn (SDR Million)**
Stand-By	04/19/2000	12/31/2001	226.73	226.73
Stand-By	05/11/1994	12/11/1995	173.90	98.90
Stand-By	12/11/1991	12/10/1992	75.00	18.56

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	34.24	103.92	79.12	9.45	
Charges/Interest	6.21	4.49	1.79	0.62	0.58
Total	**40.45**	**108.41**	**80.91**	**10.07**	**0.58**

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 August 28, 2000, and the approval was subsequently extended until December 31, 2001.

IX. Last Article IV Consultation and Recent Contacts:

The 2000 Article IV consultation was concluded by the Executive Board on August 28, 2000. Consultation with Ecuador is on the 12-month cycle. On December 10, 2001 the Executive Board concluded the last review under the 2001 SBA. During 2002, 5 negotiations and Article IV missions and a staff visit took place. In January 2003, the authorities visited Washington to discuss a possible program.

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

(In millions of U.S. dollars)

	Commitments	Disbursements	Undisbursed	Repaid	Outstanding
I. IBRD/IDA Operations (as of December 31, 2002) 1/					
Total loans	2,385.0	2,192.4	192.5	1,295.2	847.2[2]
Active loans	361.2	168.7	192.5	n.a.	n.a.
Closed loans	2,023.8	2,023.7	0.0	n.a.	n.a.
Active loans (by loan purpose)					
Total	**361.2**	**168.7**	**192.5**		
Adjustment	121.5	71.5	50.0		
Rural development	69.8	33.6	36.2		
Health	45.0	14.9	30.1		
Water	32.0	3.8	28.2		
Technical assistance	67.9	20.9	47.0		
Other	25.0	24.0	1.0		

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 disbursed the first tranche (US$70 million) on June 12, 2001. At the government's request, the US$30 million Tax Reform tranche was cancelled in June 2002.

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 February 6, 2003)

I. IDB OPERATIONS

(In millions of U.S. dollars)

	Approved	Disbursed	Undisbursed
Total	**514.2**	**284.7**	**229.5**

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.

ECUADOR: STATISTICAL ISSUES

1. Real sector

Two series of national accounts (NA) are being compiled using 1975 and 1993 as base years and following the methodology of the *1968 SNA* and *1993 SNA*, respectively. Following a data ROSC mission in April 2002, the authorities have published, by the end of that year, GDP series for the period 1993–2001 in current and constant dollars of 2000. The authorities are planning a backward extension of these series up to the year 1965. Timeliness has improved with preliminary quarterly NA being reported with about a three-month lag. Publication of a monthly producer price index (PPI) started in 1998. Labor market data have become available in recent months from surveys compiled by a private university. Published survey results include employment, unemployment, and participation rates indices, and some private sector wage data. Reliable data on public sector employment continue to be unavailable.

2. Government finance

The compilation and reporting of central government data deteriorated following problems with the introduction of a new information system (SIGEF). Above-the-line data for some nonfinancial public sector entities continue to suffer from long reporting lags and unreliable information. When ownership of public companies was transferred to the Solidarity Fund in 1999, financial information on these companies was no longer recorded. In addition, data on the operations of local governments are only available on an annual basis. Data on domestic financing and debt remain unreliable.

The resumption of reporting annual data on the budgetary central government for publication in the GFS Yearbook is highly recommended. The most recently reported annual GFS data were for 1994.

3. Monetary accounts

A major effort was undertaken in 2000 by the central bank, with the support of the Fund, to adapt the presentation of its balance sheet to the requirements related to the adoption of dollarization. This took place at the same time as a major reclassification of accounts was underway to comply with international standards. Banking system data using dollarized accounts became available in the second quarter of the year. Further work is needed to improve the sectorization of financial data and apply the residence concept correctly; the adoption of a new system of accounts by commercial banks, and a strict adherence to the residence principle, are necessary to properly calculate the foreign assets and liabilities. An STA mission to the Central Bank of Ecuador (CBE) in November 2002 made improvements in the proper identification of public sector deposits in the banking system. A forthcoming monetary and financial statistics mission will help compile monetary data for the offshore units of the commercial banks.

4. External sector

Balance of payment statistics are compiled on a quarterly basis by the CBE. In October 2002, the authorities reported to STA quarterly balance of payments statistics for the period 1993–2001 as well as annual international investment position data (IIP) for the period 1993–2001 for publication in *IFS* and the *Balance of Payments Statistics Yearbook.*. The data are mainly compiled according to the methodology of the *Fifth Edition of the Balance of Payments Manual (BPM5).*

The IIP data were prepared with the assistance of an STA mission that visited Quito during July 2002. The mission also recommended improving the estimates of travel services, introducing surveys of direct investment and portfolio investment, improving the recording of external debt transactions, and the recording of reserve assets. The mission also made recommendations regarding the compilation of the IIP that Ecuador had recently initiated. The mission report also included a work plan for implementation of the recommendations, which for the most part, should be accomplished within a period of six to seven months.

Also, in August 2001, an STA mission assisted the authorities in resolving a number of technical issues pertaining to the Data Template on International Reserves and Foreign Currency Liquidity.

Ecuador: Core Statistical Indicators
As of March 11, 2003

	International Reserves	Central Bank Balance Sheet	Reserve/ Base Money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Government Balance	GDP/ GNP	External Debt/ Debt Service
Date of Latest Observation	12/31/02	12/31/02	12/31/02	06/30/02	31/12/02	Jan. 03	Dec. 02	12/31/01	8/30/01	2002Q2	8/30/01
Date Received	01/30/03	01/30/03	01/30/03	07/31/02	01/30/03	02/19/03	02/19/03	10/16/02	9/22/01	01/07/03	9/15/01
Frequency of Data 1/	D	W	D	W	W	M	M	Q	M	Q	M
Frequency of Reporting 1/	D	W	D	W	W	M	M	Q	irregular	Q	M
Source of Update 2/	A	A	A	A	A	A	A	A	A	A	A
Mode of Reporting	E	E	E	E	E	WWW	E	V	V	WWW	M
Confidentiality 3/	C	C	C	C	C	P	C	C	C	P	C
Frequency of Publication	D	W	W	W	W	M	M	Q	A	Q	M

1/ D= daily, M= monthly, W= weekly, Q= quarterly.
2/ E= electronic, A= authorities, WWW= website.
3/ B= for use by the staff and the Executive Board, P= public.

IDB-World Bank-Fund Review of Structural Reform

Country: Ecuador   Fund Arrangement/Expiration date: SBA 2003/04   IDB/World Bank Vehicles: PBL, SAL

Important Structural and Social Reform Measures	Key Structural Reform Measures over Next Year	Key Structural Reform Measures for Next Three Years	Bank/Fund Coverage (lead institution in italics)	Bank/Fund Loan Instruments Setting Conditionality	Type of Condition Within One Year 1/	Coverage by Other Institutions
Fiscal reform	Issue regulations to fiscal responsibility, stabilization, and transparency law.		Fund/World Bank	SBA Bank SAL	PA	
	Pass tax reform including phasing-out earmarking not mandated in constitution.		Fund	SBA	PC	
	Transfer control of customs administration to SRI		Fund	SBA	PC	
	Implementation of the SIGEF and consolidation of its information		World Bank	Bank SAL		
Public enterprise reform	Concession management of public electricity and telecommunication companies to international firms.					
	Reduce electricity subsidies		World Bank	Bank SAL		
	Restart tariff adjustments for telecoms and electricity sector.		Fund	SBA	PA	
	Conduct economic and environmental analysis, and prepare action plan with time table for cost efficient production, distribution, and sale of petroleum products.		Fund	SBA	PC	
Social security reform	Assess operating procedures and actuarial balances of IESS, ISSFA, and ISSPOL.	Adjust parameters through regulations, or legislation to ensure sustainability.	IMF, (World Bank and IDB staff assistance)	SBA	SB	

IDB-World Bank-Fund Review of Structural Reform

Country: Ecuador Fund Arrangement/Expiration date: SBA 2003/04 IDB/World Bank Vehicles: PBL, SAL

Important Structural and Social Reform Measures	Key Structural Reform Measures over Next Year	Key Structural Reform Measures for Next Three Years	Bank/Fund Coverage (lead institution in italics)	Bank/Fund Loan Instruments Setting Conditionality	Type of Condition Within One Year 1/	Coverage by Other Institutions
Civil service reform	Passage of law to unify wages initiate civil service reform		Fund	SBA	PC	
Financial sector reform	Prepare Banco de Pacifico for sale		Fund/World Bank	SBA	SB	Bank FSTAL
	Auction of restructured private sector debt of closed banks held in AGD		Fund	SBA	SB	
	Enter at least 8 closed banks in AGD into liquidation		Fund	SBA	PC	
	Compliance with corporate debt restructuring agreements		World Bank	Bank SAL		
	Strengthening of Banking Superintendency		World Bank			Bank FSTAL
	Access to information on offshores for Superintendency		World Bank	Bank SAL		
Elimination of exchange restriction under Art. VIII	Conclude returning all blocked deposits in Filanbanco and AGD banks in liquidation to depositors.		Fund	SBA	PC	
Social protection	Improve targeting of bono solidario and use SELBEN for all cash transfers.		IDB	Policy-based loan (PBL)		
	Rationalize overlapping social programs and establish permanent evaluation process.		IDB, World Bank	PBL, Bank PSAL Social I		
	Protection of basic social expenditures in budget.		World Bank	Bank SAL		

IDB-World Bank-Fund Review of Structural Reform

Country: Ecuador	Fund Arrangement/Expiration date: SBA 2003/04		IDB/World Bank Vehicles: PBL, SAL			
Important Structural and Social Reform Measures	Key Structural Reform Measures over Next Year	Key Structural Reform Measures for Next Three Years	Bank/Fund Coverage (lead institution in italics)	Bank/Fund Loan Instruments Setting Conditionality	Type of Condition Within One Year 1/	Coverage by Other Institutions
Transparency and accountability	PetroEcuador, TAME, and AGD will publish on webpages audited annual reports and six-month interim reports.		IMF	SBA		

1/ PA: prior action, SB: structural benchmark, PC: Performance criteria.

ECUADOR: PUBLIC DEBT SUSTAINABILITY SCENARIOS

I. BACKGROUND

The public debt in Ecuador has fallen after the economic crisis, from 102 percent of GDP in 1999 to 60 percent in 2002. The slowdown in economic activity and record low oil prices in 1998–99 worsened the fiscal position and increased the country risk, and the spread for Ecuadoran bonds ballooned as Ecuador defaulted on its public debt. The debt-GDP ratio has dropped sharply since then, reflecting both a 40 percent haircut in the restructuring agreement and the economic recovery.

However, new fiscal slippages occurred in 2002 and the country risk increased again, raising new concerns about the sustainability of the public debt. This appendix presents a medium-term scenario consistent with the adjustment policies proposed in the government's program (the baseline scenario), and a sensitivity analysis that examines how changes in key parameters could affect the public debt path.

II. BASELINE SCENARIO

The new oil pipeline—which is expected to come on stream later in 2003—and the *Fiscal Responsibility Law* play a critical role in the baseline scenario (Table 1). The increase in oil production is expected to boost real output growth during 2004–06. The increase in oil revenue, in combination with a comprehensive structural program that supports the fiscal responsibility law, would strengthen the primary fiscal position and reduce the interest bill. Oil exports would help to reduce the current account deficit from 5 percent of GDP in 2002 to around 2 percent in 2008.

The main assumptions and findings under the baseline scenario are:

- A recovery of real GDP growth to 5–6 percent during 2003–06 due to the increase in oil production. Afterwards, growth falls back down to potential of around 3.5 percent.

- A gradual convergence of inflation to international levels by 2005.

- An increase in the LIBOR over the medium term consistent with the latest WEO projection that is partially compensated by a fall in the sovereign spread on Ecuadoran debt as the fiscal consolidation proceeds and the debt reductions improve the public sector balance sheet and strengthen debt sustainability.

- Based on adherence to the expenditure limits of the *Fiscal Responsibility Law*, the primary surplus of the consolidated public sector would strengthen from 4.5 percent of GDP in 2002 to an average of 6.3 percent of GDP during 2003–08.

In this baseline scenario, the public debt declines substantially over the medium term from 60 percent in 2002 to about 22 percent of GDP by 2008 (Table 1).

III. SENSITIVITY ANALYSIS

Standard sensitivity tests were performed for the period 2002–08 (Table 2, Section I), which show that the decline in the debt ratio should be relatively robust to partial shocks.[1] These scenarios explore a two-year shock in 2003–04, and then assume that the economy returns to the baseline scenario.

- A scenario based on a primary deficit of 2¼ percent of GDP would leave the debt at about 38 percent of GDP in 2008.
- A second scenario of higher nominal interest rates did not noticeably affect the debt profile (the nominal interest rate has not varied substantially in the recent past either). However, a scenario of higher *real* interest rates (about 35 percent on average during 2003-04) would stabilize the debt ratio at 56 percent of GDP in the medium term, from 60 percent in 2002.
- In a third scenario, if real GDP falls by more than 4 percent in 2003–04, the debt ratio could still decline to 25 percent of GDP by 2008.
- A shock to primary expenditures in 2003 would leave the debt ratio at 31 percent of GDP by the end of the period.
- Finally, a return of real GDP growth, the real interest rate, and the primary balance to their recent historical averages in every year of the projection period 2003–08, would leave the debt ratio at 45 percent of GDP by 2008 (Figure 1a).

A second sensitivity analysis focuses on how *sustained* marginal changes (rather than a two-year shock) in the macroeconomic environment will affect the debt profile (Table 2, Section II, and Figure 1b).[2]

- For each percentage point that the interest rates exceed the assumption in the baseline, the debt stock would be higher by about 2.5 percentage points of GDP by 2008.

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[1] Following the methodology described in SM/02/166. In the Fund's standard sensitivity tests, the shocks are based on the historical average of the relevant variable plus or minus two standard deviations (in the period 1992–2001). Since Ecuador has passed through a major crisis, this methodology imparts a large shock to the variables in 2003–04.

[2] As the Fund's standard sensitivity tests perform partial equilibrium analysis (in most cases, analyzing the effect of shocks only to one variable), introducing large shocks may be misleading. These alternative sensitivity tests analyze changes that are not associated with a crisis but instead represent small but persistent deteriorations in key variables.

- A lower growth rate by 1 percentage point each year, again relative to the baseline scenario, would have a less significant effect in the medium term, leaving the debt ratio higher by about 1 percentage point of GDP in 2008.

- Finally, a sustained lower primary surplus by 1 percentage point of GDP, from the baseline scenario, would add 6 percentage points to the debt ratio by 2008.

A third sensitivity analysis explores the effects of lower oil prices on the debt profile. This exercise assumes an average oil price for Ecuador mix of US$12 per barrel during 2004–08 (against an average of more than US$18 per barrel in the baseline scenario). This reduces national income and the primary surplus (which would drop to around 3½ percent in the medium term), and the debt declines more slowly, to about 40 percent by 2008 (Table 3 and Figure 1c).[3]

IV. Conclusion

The new oil pipeline offers opportunities to place the public sector debt on a sustainable path. For this to happen, it is essential that Ecuador complies fully with the fiscal rules embedded in the *Fiscal Responsibility Law*; i.e., the expenditure limit is observed, and the new oil receipts are mostly used for debt reduction. Standard sensitivity tests around the baseline scenario suggest that this potential for debt reduction is robust. Even with some shocks, the economy could still achieve lower debt levels than those faced in the late 1990s.

[3] Low oil prices would also impact output performance in the economy, as the production volume would fall (see Table 3). An scenario that considers a lower production volume at baseline prices was also considered (by assuming a longer time horizon for the new pipeline to reach full capacity). The results do not differ significantly from the baseline scenario, and the debt ratio would reach about 26 percentage points of GDP by 2008.

Table 1. Ecuador: Baseline Scenario

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
I. Output and Prices													
(Annual percentage changes)													
Real GDP	2.4	4.1	2.1	-6.3	2.8	5.1	3.0	3.5	6.0	6.2	5.3	3.5	3.5
Consumer prices													
End of period	0.0	4.1	-0.6	-29.2	-7.7	37.7	12.6	7.9	4.4	2.7	2.0	2.0	2.0
Period average	0.9	4.2	4.7	-25.2	-10.1	22.4	9.4	6.5	4.0	2.0	2.0	2.0	2.0
Exchange rate (+ depreciation, pa)	0.1	7.6	1.6	-30.8	-6.6	39.4	10.1	...	...	...	...	...	...
(In percent, period average)													
Interest rate	7.0	7.0	6.7	8.8	7.2	7.1	5.7	6.0	6.5	7.3	7.1	7.0	7.0
(In percent of GDP, unless otherwise indicated)													
II. External Sector													
Current account	-0.7	-3.0	-9.3	5.7	6.3	-2.4	-5.0	-5.3	-4.1	-3.7	-2.7	-2.2	-1.9
III. Public Sector													
Nonfinancial public sector													
Primary balance	1.2	2.2	-0.9	3.4	7.7	4.3	4.5	5.2	6.7	7.0	6.8	6.2	5.9
Overall balance	-2.8	-2.1	-5.1	-4.6	1.0	-0.5	1.0	1.9	3.6	4.0	4.3	4.1	4.2
NFPS deposits	3.4	3.4	3.4	3.4	7.7	6.0	5.3	4.9	5.4	5.6	5.9	6.1	6.3
IV. Public Debt													
Total public debt	68.1	62.5	65.9	101.6	91.4	70.2	59.6	51.7	44.1	37.5	31.2	25.9	21.5
Domestic debt	8.8	8.9	9.8	18.7	19.4	15.7	12.8	9.4	7.4	6.2	5.1	4.2	3.4
External debt	59.4	53.6	56.2	82.8	72.0	54.5	46.9	42.2	36.7	31.3	26.0	21.7	18.1
Memorandum item:													
Oil price (US$ per barrel)	18.0	15.5	9.2	15.1	24.6	19.1	21.4	18.0	18.4	18.8	18.4	18.4	18.4

Sources: Ecuadoran authorities; and Fund staff estimates.

Table 2. Ecuador: Sensitivity Analysis
Temporary and Permanent Changes in the Macroeconomic Scenario Under Baseline Fiscal Policies

	2002	2003	2004	2005	2006	2007	2008
I. Standard Sensitivity Tests for Public Debt Ratio							
1. Real GDP growth, real interest rate, and primary balance are at historical averages in 2003-08	59.6	56.3	54.0	51.4	48.8	46.4	44.6
2. Real interest rate is at historical average plus two standard deviations in 2003 and 2004	59.6	68.8	78.2	71.0	64.8	60.0	55.9
3. Real GDP growth is at historical average minus two standard deviations in 2003 and 2004	59.6	56.2	53.0	44.6	37.0	30.6	25.1
4. Primary balance is at historical average minus two standard deviations in 2003 and 2004	59.6	59.5	60.7	53.6	47.3	42.3	38.0
5. Combination of 2-4 using one standard deviation shocks	59.6	69.0	81.0	70.5	61.0	53.0	45.7
6. One time 30 percent real depreciation in 2003	59.6	84.8	76.2	69.0	62.8	57.9	53.9
7. 10 percent of GDP increase in other debt-creating flows in 2003	59.6	62.0	54.1	47.1	40.8	35.7	31.4
Memorandum items: 1/							
Primary balance (average)	2.6						
Primary balance (standard deviation)	2.4						
Nominal interest rate (average)	6.1						
Nominal interest rate (standard deviation)	1.4						
Real interest rate (average)	1.5						
Real interest rate (standard deviation)	14.6						
Real GDP growth (average)	2.2						
Real GDP growth (standard deviation)	3.2						
II. Permanent Changes in Macroeconomic Scenario							
Total public debt if,							
1. Interest rate is 1% higher than in baseline after 2002	59.6	52.5	45.4	38.9	32.9	28.0	23.9
2. GDP growth is 1% lower than in baseline after 2002	59.6	52.5	45.3	38.6	32.3	27.1	22.6
3. Primary balance is at baseline minus 1 % of GDP for 2003-08	59.6	53.0	46.4	40.4	35.1	30.9	27.6
4. Combination of 1-3	59.6	54.1	48.5	43.4	38.9	35.5	32.9

1/ These are used to calculate the shocks to the variables in the baseline scenario. Averages and standard deviations calculated for the period 1992-2001.

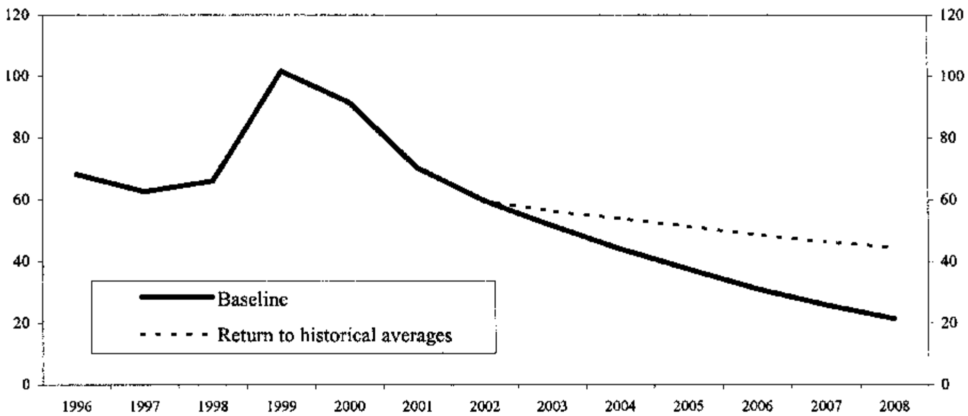
Table 3. Ecuador: Sensitivity Analysis
Low Oil Price Scenario

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
I. Output and Prices													
(Annual percentage changes)													
Real GDP	2.4	4.1	2.1	-6.3	2.8	5.1	3.0	3.5	3.5	3.7	3.6	3.0	3.0
Consumer prices													
End of period	0.0	4.1	-0.6	-29.2	-7.7	37.7	12.6	7.9	4.4	2.7	2.0	2.0	2.0
Period average	0.9	4.2	4.7	-25.2	-10.1	22.4	9.4	6.5	4.0	2.0	2.0	2.0	2.0
Exchange rate (+ depreciation, pa)	0.1	7.6	1.6	-30.8	-6.6	39.4	10.1	...	...	...	...	...	...
Interest rate	7.0	7.0	6.7	8.8	7.2	7.1	6.1	6.3	8.5	8.5	8.5	8.5	8.5
(In percent of GDP, unless otherwise indicated)													
II. External Sector													
Current account	-0.7	-3.0	-9.3	5.7	6.3	-2.4	-5.0	-5.3	-5.0	-5.1	-4.3	-3.8	-3.4
III. Public Sector													
Nonfinancial public sector													
Primary balance	1.2	2.2	-0.9	3.4	7.7	4.3	4.5	5.2	3.4	3.5	3.6	3.2	2.9
Overall balance	-2.8	-2.1	-5.1	-4.6	1.0	-0.5	1.0	1.9	-0.6	-0.3	0.1	-0.1	-0.2
NFPS deposits	3.4	3.4	3.4	3.4	7.7	6.0	5.3	4.9	4.6	4.4	4.2	4.1	3.9
IV. Public Debt													
Total public debt	68.1	62.5	65.9	101.6	91.4	70.2	59.6	51.7	48.5	45.9	43.4	41.3	39.3
Domestic debt	8.8	8.9	9.8	18.7	19.4	15.7	12.8	9.4	10.9	12.3	13.7	15.0	15.8
External debt	59.4	53.6	56.2	82.8	72.0	54.5	46.9	42.2	37.6	33.7	29.8	26.3	23.5
Memorandum item:													
Oil price (US$ per barrel)	18.0	15.5	9.2	15.1	24.6	19.1	21.4	18.0	12.0	12.0	12.0	12.0	12.0

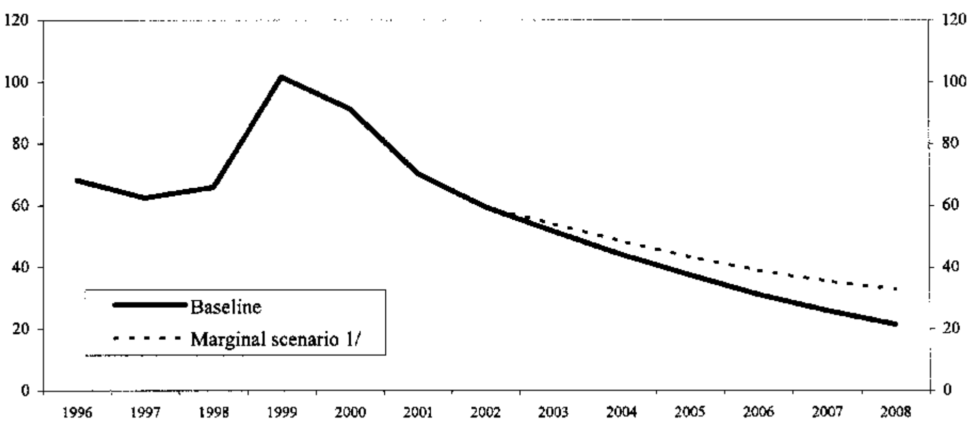
Sources: Ecuadoran authorities; and Fund staff estimates.

Figure 1. Public Debt Sensitivity Analysis
(In percent of GDP)

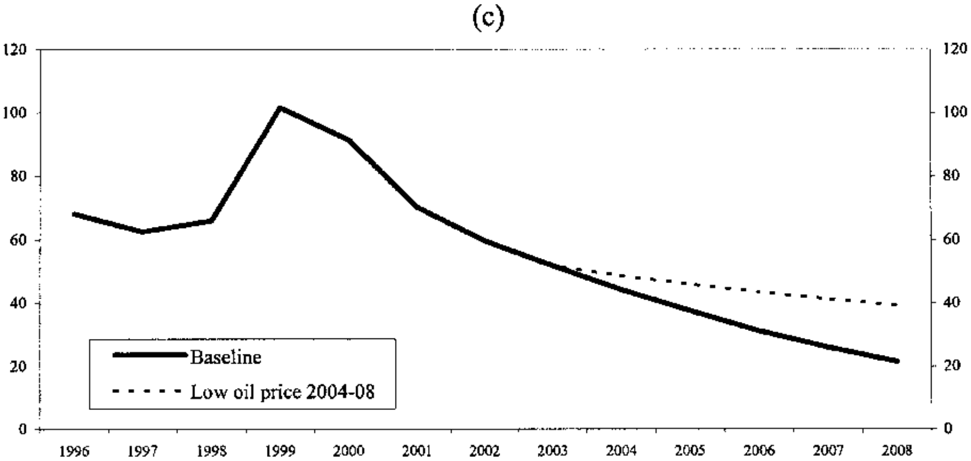
(a)



(b)



(c)



Source: Fund staff projections.

1/ In the marginal scenario, the primary surplus is 1 percentage point of GDP lower, GDP growth is 1 percent lower, and the interest rate is 1 percent higher than in the baseline scenario in 2003-08.

Ecuador—Stand-By Arrangement

Attached hereto is a letter (the "Letter"), with an annexed Memorandum of Economic Policies (the "Memorandum") and Technical Memorandum of Understanding (the "TMU"), dated February 10, 2003 and a letter (the "Supplementary Letter") and its attachments dated March 13, 2003 from the Minister of Economy and Finance and the President of the Central Bank of Ecuador requesting a stand-by arrangement and setting forth:

(a) the objectives and policies that the authorities of Ecuador intend to pursue for the period of this stand-by arrangement; and

(b) understandings of Ecuador with the Fund regarding reviews that will be made of progress in realizing the objectives of the program and of the policies and measures that the authorities of Ecuador will pursue for the period of the stand-by arrangement.

To support these objectives and policies, the International Monetary Fund grants this stand-by arrangement in accordance with the following provisions:

1. For a period of 13 months from March __, Ecuador will have the right to make purchases from the Fund in an amount equivalent to SDR 151 million, subject to paragraphs 2, 3, 4, and 5 below, without further review by the Fund.

2. (a) Purchases under this stand-by arrangement shall not, without the consent of the Fund, exceed the equivalent of SDR 30.2 million until June 15, 2003, the equivalent of SDR 60.4 million until September 15, 2003, the equivalent of SDR 90.6 million until December 15, 2003, and the equivalent of SDR 120.8 million until March 15, 2004.

(b) None of the limits in (a) above shall apply to a purchase under this stand-by arrangement that would not increase the Fund's holdings of Ecuador's currency subject to repurchase beyond 25 percent of quota.

3. Ecuador will not make purchases under this stand-by arrangement that would increase the Fund's holdings of Ecuador's currency subject to repurchase beyond 25 percent of quota:

(a) during any period in which the data at the end of the preceding period indicate that

(i) the ceiling on the overall balance of the nonfinancial public sector, or

(ii) the ceiling on the noninterest expenditure of the nonfinancial public sector, or

(iii) the floor on the stock of public sector deposits in the Central Bank of Ecuador and commercial banks, or

(iv) the floor of the central government deposits in the "cuenta unica" at the Central Bank of Ecuador, or

(v) the ceiling on the stock of registered public sector gross debt, or

(vi) the ceiling on the stock of external arrears, or

(vii) the ceiling on the stock of domestic arrears, or

specified in Table 1 of the Supplementary Letter and in the TMU, was not observed; or

(b) if Ecuador fails to carry out its intentions with respect to the following structural performance criteria:

(i) by April 5, 2003, signing contracts to conduct independent audits of at least eight closed banks as specified in paragraphs 5 and 6 and Annex II of the Supplementary LOI, or

(ii) by April 5, 2003, signing a contract with an independent international firm(s) to manage the Filanbanco liquidation trust fund containing the loan portfolio as specified in paragraphs 5 and 6 and Annex II of the Supplementary LOI, or

(iii) by April 30, 2003, passage of the legislation to transfer the control of the customs administration to the SRI, as specified in paragraph 13 of the Memorandum and Annex II of the Supplementary Letter, or

(iv) by April 30, 2003, submission to Congress of legislation for public sector wage unification and civil service reform, as specified in paragraph 13 of the Memorandum and Annex II of the Supplementary Letter, or

(v) by June 30, 2003, entering at least eight banks in the AGD into liquidation, as specified in paragraphs 5 and 6 and Annex II of the Supplementary Letter, or

(vi) by June 30, 2003, signing a contract with an independent international firm to manage the Filanbanco liquidation trust fund containing the bank's real estate assets, as specified in paragraphs 5 and 6 and Annex II of the Supplementary Letter, or

(vii) by June 30, 2003, conducting and publishing an economic and environmental analysis, and prepare an action plan with a time table, as specified in paragraph 20 of the Memorandum and Annex II of the Supplementary Letter, or

(viii) by June 30, 2003, placing under public sector management the electricity distribution companies and Andinatel and Pacifictel, as specified in paragraph 20 of the Memorandum and Annex II of the Supplementary Letter, or

(ix) by August 31, 2003, submission to congress of the tax reform law, as specified in paragraph 13 of the Memorandum and Annex II of the Supplementary Letter, or

(x) by August 31, 2003, passage of the law for public sector wage unification and civil service reform, as specified in paragraphs 7 and 13 of the Memorandum and Annex II of the Supplementary Letter, or

(xi) by November 30, 2003, passage of the tax reform law, as specified in paragraph 13 of the Memorandum and Annex II of the Supplementary Letter, or

(xii) by December 31, 2003, returning to depositors all blocked deposits in Filanbanco and AGD banks in liquidation, as specified in paragraphs 16 and 17 of the Memorandum and Annex II of the Supplementary Letter; or

(c) after June 14, 2003, September 14, 2003, December 14 2003 and March 14, 2004, until the respective reviews contemplated in the fourth paragraph of the Letter are completed; or

(d) if, at any time during the period of the stand-by arrangement the public sector accumulates new domestic or external arrears, as specified in paragraph 8 of the TMU; or

(e) if, at any time during the period of the stand-by arrangement, Ecuador

(i) imposes or intensifies restrictions on the making of payments and transfers for current international transactions, or

(ii) introduces or modifies multiple currency practices, or

(iii) concludes bilateral payments agreements which are inconsistent with Article VIII, or

(iv) imposes or intensifies import restrictions for balance of payments reasons.

When Ecuador is prevented from purchasing under this stand-by arrangement because of this paragraph 3, purchases will be resumed only after consultation has taken place between the Fund and Ecuador and understandings have been reached regarding the circumstances in which such purchases can be resumed.

4. Ecuador will not make purchases under this stand-by arrangement during any period in which Ecuador has (i) an overdue financial obligation to the Fund or is failing to meet a repurchase expectation (a) in respect of a noncomplying purchase pursuant to Decision No. 7842-(84/165) on the Guidelines on Corrective Action, or (b) in respect of a purchase of debt and debt service reduction operations pursuant to Decision No. 9331-(89/167), or (c) pursuant to subparagraph 17 or 31 of Decision No. 8955-(88/126), on the Compensatory Financing Facility, or (d) in respect of a purchase under Decision No. 11627-(97/123) SRF on the Supplemental Reserve Facility and Contingent Credit Lines, or (e) pursuant to paragraph 1(b) of Decision No. 5703-(78/39) or paragraph 10(a) of Decision No. 4377-(74/114); or (ii) is failing to meet a repayment obligation to the PRGF Trust established by Decision No. 8759-(87/176) PRGF, or a repayment expectation to that Trust pursuant to the provisions of Appendix I to the PRGF Trust Instrument.

5. Ecuador's right to engage in the transactions covered by this stand-by arrangement can be suspended only with respect to requests received by the Fund after (a) a formal ineligibility, or (b) a decision of the Executive Board to suspend transactions, either generally or in order to consider a proposal, made by an Executive Director or the Managing Director, formally to suppress or to limit the eligibility of Ecuador. When notice of a decision of formal ineligibility or of a decision to consider a proposal is given pursuant to this paragraph 5, purchases under this arrangement will be resumed only after consultation has taken place between the Fund and Ecuador and understandings have been reached regarding the circumstances in which such purchases can be resumed.

6. Purchases under this stand-by arrangement shall be made in the currencies of other members selected in accordance with the policies and procedures of the Fund, unless, at the request of Ecuador, the Fund agrees to provide SDRs at the time of the purchase.

7. Ecuador shall pay a charge for this stand-by arrangement in accordance with the decisions of the Fund.

8. (a) Ecuador shall repurchase the amount of its currency that results from a purchase under this stand-by arrangement in accordance with the provisions of the Articles of Agreement and decisions of the Fund, including those relating to repurchase as Ecuador's balance of payments and reserve position improves.

(b) Any reductions in Ecuador's currency held by the Fund shall reduce the amounts subject to repurchase under (a) above in accordance with the principles applied by the Fund for this purpose at the time of the reduction.

9. During the period of the stand-by arrangement Ecuador shall remain in close consultation with the Fund. These consultations may include correspondence and visits of officials of the Fund to Ecuador or of representatives of Ecuador to the Fund. Ecuador shall provide the Fund, through reports at intervals or dates requested by the Fund, with such information as the Fund requests in connection with the progress of Ecuador in achieving the objectives and policies set forth in the Letter, the Supplementary Letter and Memorandum.

10. In accordance with the third paragraph of the Letter, Ecuador will consult the Fund on the adoption of any measures that may be appropriate at the initiative of the Government or whenever the Managing Director requests consultation because any of the criteria in paragraph 3 of this arrangement have not been observed or because the Managing Director considers that consultation on the program is desirable. In addition, after the period of the arrangement and while Ecuador has outstanding purchases in the upper credit tranches, the Government will consult with the Fund from time to time, at the initiative of the Government or at the request of the Managing Director, concerning Ecuador's balance of payments policies.

Quito, Ecuador
March 13, 2003

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

Dear Mr. Köhler:

1. The government of Ecuador wishes to propose some modifications to the letter of intent that we signed on February 10, 2003. These modifications reflect that Congress approved the 2003 budget with small changes, requiring a US$42 million upward revision in the noninterest expenditure ceiling and some associated modifications in the quarterly quantitative performance criteria (Table 1). The revenues also were revised upward slightly, so the program overall and primary balance targets for the year are unaltered. The Government is also requesting modifications to the prior action on the clearance of nonreschedulable external arrears. Finally, the Government is requesting an extension of the time period to complete the signing of contracts with companies to manage the Filanbanco liquidation trust funds and to audit at least 8 closed banks in the Deposit Guaranty Agency (AGD).

2. The proposed modifications based on the amendments introduced to the 2003 budget and the extension of the dates for the completion of the prior actions do not alter the objectives of the economic program described in our Memorandum of Economic Policies of February 10, 2003. The modified budget also remains fully consistent with the fiscal rules in the *Fiscal Responsibility and Transparency Law.* As you know, we attach great importance to this law as it is the cornerstone of our medium-term economic strategy.

3. The modifications to the budget are:

- Congress increased revenues and expenditures by about US$40 million reflecting updated estimates for some taxes, interest, and non-interest outlays. The increase in revenues is less than 1 percent of total revenues in the fiscal program.

- Congress also provided authorization to increase education spending by up to US$165 million if the resources to pay for it can be obtained, and provided that the level of noninterest spending in the budget remain consistent with the limits in the *Fiscal Responsibility and Transparency Law*. The Government agrees with Congress that we should not, and will not, increase overall noninterest expenditure in excess of what is permitted by law, and, therefore, we will only increase education outlays if it is possible to reduce the same amount of noninterest expenditures elsewhere.

4. The government of Ecuador will not make any changes to the wage structure for public employees ahead of an agreed civil service reform.

5. The Paris Club agreed on March 11 that the payment of all nonreschedulable arrears outstanding at end-February 2003 be deferred by two weeks, and that the payment of all reschedulable arrears be deferred by a maximum of four weeks. On this basis, we would like to request that the prior action on clearance of nonreschedulable arrears be considered met, although the prior action was completed five working days before the Board meeting, instead of two weeks before the Board meeting, as specified in the LOI signed on February 10, 2003.

6. While we have made progress in selecting independent international firms to manage the liquidation of one Filanbanco trust fund containing the bank's loan portfolio, these firms are conducting their own due diligence, which has delayed the completion of the prior action. The signing of the contract to manage this trust fund is now envisaged before April 5, 2003. We also request an extension of the time period to sign the second contract for the Filanbanco trust fund containing the bank's real estate assets to June 30, 2003, reflecting the need for more time for due diligence and legal consultation on this trust fund. Finally, we request an extension of the time period to sign the contracts for audits in at least eight banks in the Deposit Guarantee Agency to April 5. The Government has just appointed new management to the AGD, which has meant a delay in the completion of this objective beyond February 28, as was envisaged. Because the audits will be slightly delayed, we also request that the performance criterion on entering these banks into liquidation, which is the follow-up action, be delayed as well, from May 31 to June 30, 2003.

7. As of March 10, the prior actions, with the above noted modifications to the LOI of February 10, 2003, have been observed, as reflected in the revised Annex I. The shifting of the commitments regarding the two Filanbanco trust funds and the AGD banks from prior actions to structural performance criteria is reflected in the attached revised Annex II.

Sincerely,

/s/

Mauricio Yepez Najas
President
Central Bank of Ecuador

/s/

Mauricio Pozo Crespo
Minister of Economy
and Finance

Attachments

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

(In millions of U.S. dollars)

	Dec. 31, 2002	2003			
		January-March	January-June	January-September	January-December
	Est.	Target	Target	Target	Target
1. NFPS overall balance (ceiling)		186	420	552	508
2. NFPS noninterest expenditure (ceiling)		1,251	2,734	4,245	5,860
3. Stock of public sector deposits in the BCE and commercial banks (floor) 2/	1,282	1,150	1,226	1,275	1,416
4. Stock of central government deposits in the "cuenta unica" at the central bank (floor) 2/	118	89	187	148	192
5. Stock of registered public sector gross debt (ceiling)	13,730	13,770	13,862	13,845	13,782
6. Stock of external arrears, e.o.p. (ceiling)	163	0	0	0	0
7. Stock of domestic arrears, e.o.p. (ceiling)	452	211	22	22	0

1/ As defined in the attached Technical Memorandum of Understanding.
2/ For 2002 reflects end-of-period stocks; for 2003 reflects quarterly average stocks.

Ecuador—Revised Prior Actions

	Objective	Status
1.	Clearance of all non-reschedulable external arrears (paragraphs 5 and 11, and as modified by paragraph 5 in the supplementary LOI).[1]	Observed
2.	Issue regulations, agreed with Fund staff, for the implementation of the Fiscal Responsibility and Transparency Law (paragraph 14).	Observed
3.	Conelec and Conatel to issue resolutions to restart the price adjustments for electricity and telephone tariffs (paragraph 20).	Observed
4.	Submission to Congress of urgent legislation to transfer control over the customs administration to the SRI. (paragraph 13).	Observed
5.	Issue regulations for the tourism law, discussed with Fund staff and consistent with the objectives of the program, aimed at preventing new tax loopholes from opening up (paragraph 12)	Observed
6.	COMEXI to issue a resolution to reverse the selective import tariff concessions issued in the last 4 months of the previous government (paragraph 7).	Observed
7.	Passage of the 2003 budget containing a freeze in wage rates, and an average oil price assumption of US$18 per barrel (paragraph 8 and 12, and as modified by paragraphs 1–4 in the supplementary LOI).	Observed

[1] Unless otherwise indicated, all paragraph reference numbers refer to the Memorandum of Economic Policies.

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

	Objective	Date	PC/SB
		For the first review:	
1.	Auction off all restructured private sector debt portfolios of closed banks held in the AGD. (paragraph 18).	Before Mar. 31, 2003	SB
2.	Sign contract with an international investment bank to prepare Banco del Pacífico for sale (paragraph 19).	Before Mar. 31, 2003	SB
3.	Sign contracts to conduct independent audits of at least eight closed banks in the AGD (paragraphs 6 and 7 of the supplementary LOI)	Before Apr. 5, 2003	PC
4.	Sign contract with independent international firm(s) to manage the Filanbanco liquidation trust fund containing the loan portfolio (paragraphs 6 and 7 of the supplementary LOI)	Before Apr. 5, 2003	PC
5.	Passage of the legislation to transfer control of the customs administration to the SRI (paragraph 13).	Before Apr. 30, 2003	PC
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 13).	Before Apr. 30, 2003	PC
		For the second review:	
7.	Enter at least 8 closed banks in the AGD into liquidation (paragraph 15, and paragraphs 6 and 7 of the supplementary LOI).	Before Jun 30, 2003	PC
8.	Sign contract with independent international firm(s) to manage the Filanbanco liquidation trust fund containing the real estate assets (paragraphs 6 and 7 of the supplementary LOI)	Before Jun 30, 2003	PC

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

	Objective	Date	PC/SB
9.	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 20).	Before Jun 30, 2003	PC
10.	Concession the management of the electricity distribution companies and Andinatel and Pacifictel to reputable international firms (paragraph 20).	Before Jun. 30, 2003	PC
11.	Sign contracts with independent international firm(s) to manage the liquidation trust funds of the AGD banks (paragraph 17).	Before Jun. 30, 2003	SB
12.	Bring Banco del Pacífico to the point of sale (paragraph 19)	Before Jul. 31, 2003	SB
13.	Submission to Congress of the tax reform law including the gradual elimination of revenue earmarking not mandated in the Constitution, and tax exemptions (paragraph 13).	Before Aug. 31, 2003	PC
14.	Passage of the law for public sector wage unification and civil service reform (paragraph 13).	Before Aug. 31, 2003	PC
		For the third review:	
15.	With technical assistance from international institutions, conduct an assessment of the operating procedures and actuarial balances of the IESS, ISFA, and ISPOL (paragraph 9).	Before Sep. 31, 2003	SB
16.	Passage of the tax reform law, including the elimination of revenue earmarking not mandated by the constitution (paragraph 13).	Before Nov. 30, 2003	PC
17.	Conclude returning all blocked deposits in Filanbanco and the AGD banks in liquidation to depositors (paragraphs 16 and 17).	Before Dec. 31, 2003	PC

Quito, Ecuador
February 10, 2003

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

Dear Mr. Köhler:

The attached policy memorandum and annexes describe the economic policies and objectives of the government of Ecuador for the period March 2003–March 2004, in support of which the government requests a 13-month Stand-By Arrangement from the Fund in the amount of SDR 151 million (46 percent of quota on an annual basis). The government is convinced that these policies will promote sustainable growth while addressing priority social needs, controlling inflation, strengthening public sector solvency, and bolstering external viability.

During the period of the arrangement, the government will maintain close relations with the Fund, including regarding the adoption of any measures that may be needed to achieve the program's objectives, in accordance with the Fund's practices. In particular, it will take additional measures during the arrangement, including on the fiscal side, if the expected decline in the rate of inflation does not materialize, the external current account deficit rises above that envisaged in the program (unless it reflects additional FDI), or the fiscal program appears to be moving off-track. The government will not incur any new domestic or external arrears at any time during the arrangement, nor impose new international trade restrictions, and it will maintain prudent borrowing practices to reduce the debt to GDP ratio.

The government is returning gradually the blocked deposits in closed banks managed by the Deposit Guarantee Agency. This is an exchange restriction subject to Article VIII of the Fund's Articles of Agreement, for which the government requests approval until end-2003. The Government also requests that the repurchase expectations arising during the arrangement period be moved to an obligations basis, equivalent to SDR 14 million (4.7 percent of quota).

Four reviews are envisaged, no later than end-June, September, December 2003, and March 2004. The first review will assess progress under the program, including with respect to the government's efforts to focus subsidies more equitably and restarting the structural reforms.

The government is committed to maintain prudent macroeconomic policies and building further on its reform program in 2004. While at this time, the government does not envisage a need for additional financing from the Fund beyond the present arrangement, we will maintain close relations with the Fund, and for this purpose we plan to request a precautionary arrangement with the Fund for 2004.

Sincerely,

/s/
Mauricio Yepez Najas
President
Central Bank of Ecuador

/s/
Mauricio Pozo
Minister of Economy
and Finance

Attachment

ECUADOR—MEMORANDUM OF ECONOMIC POLICIES

I. BACKGROUND

1. **In early 2000, after a severe economic and political crisis, Ecuador formally replaced the Sucre with the U.S. dollar.** With this strong exchange rate anchor, the economy quickly stabilized and started to recover, led by domestic demand. The recovery was also helped by rising oil prices and by debt relief through the restructuring of Brady bonds and a rescheduling of Paris Club obligations. However, after a promising start, fiscal policies in 2001–02 were not strengthened in step with the requirements of dollarization, as public sector wages ballooned, imposing significant fiscal rigidities for the subsequent years, and the primary surplus declined. Moreover, while the banking system recovered rapidly after the economic crisis, there was little progress in cleaning up closed banks, and the privatization program of public enterprises and other important structural reforms were halted. As a result of these slippages, by end-2002, the central government was again facing domestic and external payments arrears, the treasury was running out of cash with few options to obtain new financing, and economic activity was slowing.

II. THE ECONOMIC PROGRAM FOR 2003

2. **The government of President Gutierrez was inaugurated on January 15, 2003, and it already has adopted specific economic measures to correct the situation described above**. The main objective of the government is to improve the living conditions of all Ecuadorans, particularly the poor, through sustained growth with low inflation, improvements in the social safety net, and the provision of better public services. Ecuador remains committed to dollarization, and sustained growth under dollarization requires achieving a strong fiscal position, fully restoring credit worthiness, and structural reforms to improve the economy's competitiveness. The economic program for 2003 reflects these policy objectives.

A. The Macroeconomic Framework

3. **The macroeconomic framework for 2003 projects moderate output growth, with continued progress in lowering inflation.** Output growth in 2003 is projected to be around 3½ percent, led by an expansion of oil exports, although there will be some slowing of investment after the completion of the new oil pipeline (OCP). Consumption is expected to expand at a more moderate pace from previous years following a period of catch-up spending on consumer durables. The widening in the external current account deficit is expected to moderate in 2003, while consumer price inflation is projected to decline to around 6 percent by end-2003, notwithstanding an increase in some administered prices.

4. **Sustained prudent fiscal policies and continued structural reforms are essential to achieving strong output growth and other medium-term goals.** The fiscal primary

surplus will need to be maintained at a high level in 2004 and beyond, while revenues from extra oil exports will be used in large part to reduce the public debt. The government is confident that a diligent implementation of this strategy will boost confidence in fiscal and debt sustainability and bring down the current account deficit, consistent with dollarization, thus contributing to reducing significantly the very high interest rates and EMBI risk spread still faced by Ecuador. Bringing down risk spreads will enhance private sector growth.

B. Fiscal Policies

5. **The government's fiscal policies are geared towards the following main objectives:** (i) resolving immediate liquidity pressures and regularizing arrears left by the previous administration; (ii) tightening the fiscal stance to recover from the slippages of 2001 and 2002; (iii) protecting the poor by stabilizing their income levels and strengthening social programs; and (iv) improving the flexibility of fiscal policy and prioritizing expenditures.

6. **The public sector needs a strong primary balance to bring down inflation, to narrow the large external current account deficit, and to meet debt servicing obligations.** Within one week of taking office, the government implemented a set of corrective measures, described below, consistent with strengthening the primary balance of the nonfinancial public sector (NFPS) from 4.5 percent of GDP in 2002 to 5.2 percent in 2003. The overall NFPS balance in 2003 is targeted to be US$509 million, or 1.9 percent of GDP, resulting in a drop of the public sector debt ratio from 59 percent of GDP at end-2002 to 52 percent by end-2003.

7. **Revenues of the NFPS are programmed to increase by 0.9 percentage points to 26.9 percent of GDP in 2003.** As a cornerstone of the adjustment effort, on January 19, the prices for fuels were increased by an average of 25 percent, yielding close to US$400 million (1.5 percent of GDP) in 2003. This step was complemented by resolutions issued by COMEXI reversing selective and highly distortionary import tariff cuts (for US$30 million; see prior actions, item 6) that were implemented in the last few weeks of the outgoing administration. The government is also committed to reducing subsidies on government services, including in utility prices. By August, the government is also seeking approval of legislation to unify the public sector wage structure (see paragraph 13), which is projected to yield US$20 million in 2003 in additional social security revenues.

8. **Primary expenditures of the NFPS are projected to stabilize at 21.7 percent of GDP in 2003.**

- This reflects mainly the austerity decree issued by President Gutierrez on January 22. In this decree, wage rates for regular civil servants were frozen for 2003; overtime allowances were cut; the president's salary was reduced by 20 percent; and the salaries of government appointees with monthly earnings over US$1,000 were lowered by 10 percent. Moreover, the number of positions that can be filled by the new government was also reduced by 10 percent. Notwithstanding these measures, in dollar terms, the NFPS wage bill will still increase by US$260 million to US$2,251 million because of the carryover from the large increases granted in 2002, an increase in the 14th salary imposed by congress in December 2002, and normal promotions.

- The austerity decree also restrains spending on goods and services in the central government, including restrictions on official travel abroad, the use of vehicles and cell phones, and a prohibition on the purchase of new offices and furnishings.
- The government has reduced by some US$100 million the budgetary expenditure allowance for PetroEcuador.
- Spending on the social safety net will increase in 2003. The cash transfer program to the poor (*bono solidario*) was increased from US$11.50 to US$15.00 per eligible person per month, to help them deal with the increase in fuels prices, and welfare assistance for the elderly poor was increased by US$5 per person a month, effective January 2003, at a combined cost of some US$60 million.
- Pension benefits from the social security institute (IESS) were sharply eroded by the collapse of the currency in the crisis of 1999. As a result, they were increased substantially in 2001–02, were raised again by 25 percent in January 2003, but they will not be increased further this year. To help cover the costs of the large pension increases, the IESS will suspend making loans to affiliates, thereby reducing lending operations from US$158 million in 2002 to repayments of US$40 million in 2003.

9. **Efforts to strengthen the social security system will continue.** With technical assistance from international institutions, the government will assess the operating procedures and actuarial balances of the three social security funds (IESS, ISFA, ISPOL) by end-September 2003. This assessment is intended to result in a reform strategy aimed at ensuring a reasonable and reliable income for retirees on a sustainable basis, including by eliminating the actuarial deficits and minimizing transfers from the central government.

10. **The government wants to target the cooking gas subsidy more equitably.** The current large subsidy is an important distortion in the economy, gives rise to smuggling and corruption, and benefits disproportionately the higher income groups in society. In the first semester, the government will undertake a project, with help from the IDB, to improve the data base of the *bono solidario* to focus better the cash assistance on the truly poor, and remove the subsidy in the cooking gas price. These steps are programmed to yield US$40 million (net) in 2003.

11. **The financing requirements of the non-financial public sector in 2003 are projected to amount to nearly US$2.0 billion.** The main component is debt amortization, which is projected to amount to US$1.2 billion (including a US$29 million debt reduction in the last quarter of the year from the new oil stabilization fund (*FEIREP*)). Also included are

nonreschedulable external arrears (amounting to some US$100 million), which will be cleared as a prior action under the program, and domestic arrears, estimated at US$0.4 billion that are also being cleared. The financing needs are programmed to be met from the fiscal surplus of US$0.5 billion; rolling over some US$0.4 billion of domestic debt falling due in the year; US$0.3 billion in project financing; and with exceptional program financing of just over US$0.6 billion (US$130 million from the World Bank, US$100 million from the IDB and the CAF each, US$160 million from the Fund, and the government is seeking cooperation of Paris Club and other official creditors to resolve intrayear cash flow pressures through US$150 million in external debt rescheduling). With these amounts, the 2003 program would be fully financed. Ecuador will not seek an oil-backed loan.

12. **The budget for 2003, which is expected to be approved in congress before end-February, is consistent with the program.** The budget includes a freeze on wages (see prior actions, item 9) and is based on an oil price assumption of US$18 per barrel for Ecuador mix. If realized petroleum revenues fall below the programmed level, the government would fully compensate the shortfall with expenditure cuts. If petroleum revenues turn out higher than programmed, they will be used in full to build up central government deposits in the central bank (in the *Fondo de Estabilizacion Petrolero por Liquidar*) or to lower the public debt. Any higher than programmed revenues for the social security system will also be saved, and used to increase its asset base. Finally, to protect budgetary revenue, the government has issued regulations to the new tourism law that prevent the opening of new tax loopholes.

13. **While these policies address immediate fiscal needs, the government will also send several bills to congress this year to bolster the fiscal and structural outlook for 2004 and the medium term.**

- Before end-February 2003 (a prior action under the program), the government will submit to congress, as urgent legislation, a **reform of the customs administration**. This reform aims to allow an overhaul of the administrative and personnel structure of the customs office, permit the SRI to upgrade the information systems in customs, and bring the customs tax administration under the internal tax administration (SRI). The government believes that this reform will make a major contribution to reducing corruption in customs, and improve the collection of revenues.

- Before end-April 2003, the government will submit to congress a bill for **public sector wage unification and civil service reform** (including amendments to the *Ley de Servicio Civil y Carrera Administrativa*). Under the wage unification, the various components of remuneration will be brought together in one salary statement, which will then be the new basis for the assessment of social security contributions. The higher social security contributions will be withheld from the employees (phased in over four years) without increasing the public sector wage bill. The civil service reform will seek a reduction in the number of public sector employees so that the central government nominal wage bill in the 2004 budget will be lower than that in the 2003 budget. The government has requested technical assistance and financial support (for severance payments) from the World Bank and the IDB for this reform. The government seeks congressional approval of this reform by end-August 2003.

- Before end-August 2003, the government will submit to congress a comprehensive **tax reform bill** intended to allow for a more efficient allocation of public spending and to expand the tax base. The reform will include: (i) the elimination of revenue earmarking that is not mandated in the constitution; (ii) the elimination of tax exemptions; (iii) the removal of small taxes with low yields and high administrative costs ("nuisance taxes"); (iv) an increase in vehicle tax revenues; (v) a reduction in the standard deduction (*minimo imponible*) for personal income taxes; and (vi) the closing of some tax loopholes that allow enterprises to deduct artificially inflated costs. The government seeks congressional approval of this reform by end-November 2003.

14. **The reforms described above will provide the basis to achieve an overall budget surplus on an enduring basis, with the objective of reducing the public sector debt.** The new private sector oil pipeline (the OCP) has the capacity to more than double oil exports, which significantly boosts the medium-term prospects for exports and growth. However, this increase could also intensify the dependence on oil and Dutch disease problems in the economy, if the new oil revenues are not managed prudently. Therefore, in January 2003, and as a prior action for the program, the government issued regulations to put in place the *Fiscal Responsibility and Transparency Law* that was adopted by congress in September 2002. A key aspect of the legislation and its regulation is that the bulk of the public sector revenues accruing from the new pipeline will not be used to augment current spending but rather be placed in an oil stabilization fund (the FEIREP). Ten percent of the resources in the FEIREP are dedicated to social spending; 20 percent will be saved to help deal with contingencies, such as a natural disaster or a sharp decline in oil prices; and 70 percent would be dedicated to debt buybacks (not for regularly scheduled budgetary amortizations). The new pipeline is expected to come on stream in the last quarter of 2003. The government's medium-term policy of fiscal surpluses, combined with the debt buyback capacity from the FEIREP, are projected to reduce the debt to GDP ratio from 59 percent at end 2002 to below 40 percent by end-2006, as stipulated in the *Fiscal Responsibility and Transparency Law*.

C. Financial System Policies

15. **The government will make a strong and immediate effort to liquidate Filanbanco and at least eight of the closed banks in the AGD to end the painful experience of the 1999 banking crisis.** This has priority because the unpaid debts in the moribund banks tolerate the damaging culture of nonpayment of debts, while some deposits still remain blocked. Moreover, with technical assistance from the Fund and others, the government will also continue to develop more comprehensive policies to maintain a sound financial system. These include the reinforcement of banking supervision, reforming the liquidity support system, and improving mechanisms for the recovery of nonperforming loans.

16. **Filanbanco.** By end-February 2003, and as a prior action under the program, the authorities will sign contracts with independent firms that will manage the trust fund containing the fixed assets of Filanbanco, and to recover/sell the loan portfolio of the bank. The proceeds from the portfolio recovery will be distributed to claimants via a second trust fund that also already has been constituted to facilitate the liquidation of the bank. The return of deposits and other liabilities from the trust funds will begin in March and be completed by end-December 2003.

17. **The liquidation of the closed banks held in the deposit guarantee agency (AGD) will be done in two steps.** First, the legally required independent audits of at least 8 banks will be conducted by end-April 2003. The contracts for these audits will be signed as a prior action under the program. Once audited, the banks will be placed into formal liquidation before end-May 2003. Then, the remaining assets and liabilities of these banks will be placed into trust funds, managed by independent managers, as with Filanbanco, in accordance with the contracts to be signed by end-June 2003 (see structural performance benchmark, item 8). These managers are to conduct the sale of assets and return the blocked deposits and other liabilities before end-December 2003. For the other 10 banks in the AGD, the government will move expeditiously to remove the legal obstacles to their liquidation.

18. **Parallel with the efforts to liquidate the AGD banks, the private sector debt portfolios of these banks that were already restructured will be auctioned off by end-March 2003.** Any cash proceeds produced by the auctions will be used to pay off the blocked deposits first, before settling any other liabilities.

19. **The privatization of Banco del Pacífico will be conducted in two-steps.** First, before end-March 2003, the bank itself will hire an international investment firm. This firm will then conduct an analysis of the bank, so that Pacífico is brought to the point of sale by end-July 2003.

D. Other Structural Policies

20. **Strengthening competitiveness is essential for sustaining growth and preserving dollarization in Ecuador.** Fiscal expenditures have driven up costs in the economy, and these outlays need to be controlled as described above. At the same time, productivity growth needs to be accelerated with structural reforms. In this area, the government is implementing several measures in 2003:

- **The electricity distribution and telephone companies (Pacifictel and Andinatel) must be made more efficient.** For this purpose, by end-June 2003 the companies will be placed under private sector management of reputable international firms. At the same time, the subsidies to these enterprises need to be gradually eliminated. In January 2003, the suspension of the tariff increases was lifted by the regulatory agencies (Conelec and Conatel; see prior action item 3) and tariffs are now being adjusted on a monthly basis until these reach levels matching economic costs. The

World Bank and the IDB are providing technical assistance to establish, by end-June 2003, the appropriate structure of tariffs, taking account of measures to strengthen collections.

- **Petroleum sector.** Before end-June 2003, and with assistance from international experts, the government will conduct an economic and environmental analysis and prepare an action plan and time table to improve the efficiency of the production, distribution, and sale of petroleum and its derivatives. Improvements in these areas could produce substantial savings for the economy.

- To provide the citizens with better information on public sector operations, the government will improve **public sector disclosure and transparency**. The monthly fiscal spreadsheets used to frame the program and follow its implementation will be published on the web pages of the ministry of economy (revenue and expenditure data) and the Central Bank of Ecuador (debt and arrears data). *PetroEcuador, TAME* (the airline), and all enterprises in the Solidarity Fund, will publish on the web their annual reports approved by the Boards of Directors, beginning with the report for 2002, before April 2003; and their interim January–June reports before end-September 2003. These reports will contain the companies' profit and loss and cash flow statements, and the balance sheet. Moreover, in April 2002, Ecuador received a mission from the Fund to prepare a Report on the Observance of Standards and Codes (ROSC) for statistical dissemination. The final report will be published by the authorities and on the Fund's web site before approval of the Stand-By Arrangement.

ECUADOR—PRIOR ACTIONS

Objective	Date
1. Clearance of all nonreschedulable external arrears (paragraphs 5 and 11).[1]	At least two weeks before the Board meeting
2. Issue regulations, discussed with Fund staff, for the implementation of the Fiscal Responsibility and Transparency Law (paragraph 14).	Before Jan. 31, 2003
3. Conelec and Conatel to issue resolutions to restart the price adjustments for electricity and telephone tariffs (paragraph 20).	Before Jan. 31, 2003
4. Submission to congress of urgent legislation to transfer control over the customs administration to the SRI (paragraph 13).	Before Feb. 7, 2003
5. Issue regulations for the tourism law, discussed with Fund staff and consistent with the objectives of the program, aimed at preventing new tax loopholes from opening up (paragraph 12).	Before Feb. 7, 2003
6. COMEXI to issue a resolution to reverse the selective import tariff concessions issued in the last 4 months of the previous government (paragraph 7).	Before Feb. 14, 2003
7. Sign contracts with independent international firm(s) to manage the Filanbanco liquidation trust funds (paragraph 16).	Before Feb. 28, 2003
8. Sign contracts to conduct independent audits of at least 8 closed banks in the AGD (paragraph 17).	Before Feb. 28, 2003
9. Passage of the 2003 budget containing a freeze in wage rates, and an average oil price assumption of US$18 per barrel (paragraphs 8 and 12).	At least five working days before the Board approval of the SBA

[1] All paragraph reference numbers refer to the Memorandum of Economic Policies.

ECUADOR—STRUCTURAL PERFORMANCE CRITERIA (PC) AND BENCHMARKS (SB)

	Objective	Date	PC/SB
		For the first review:	
1.	Auction off all restructured private sector debt portfolios of closed banks held in the AGD (paragraph 18).	Before Mar. 31, 2003	SB
2.	Sign contract with an international investment bank to prepare Banco del Pacífico for sale (paragraph 19).	Before Mar. 31, 2003	SB
3.	Passage of the legislation to transfer control of the customs administration to the SRI (paragraph 13).	Before Apr. 30, 2003	PC
4.	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 13).	Before Apr. 30, 2003	PC
5.	Enter at least 8 closed banks in the AGD into liquidation (paragraph 15).	Before May 31, 2003	PC
		For the second review:	
6.	Conduct and publish an economic and environmental analysis, and prepare an action plan with timetable for the cost effective production, distribution, and sale of fuels and other petroleum products in Ecuador (paragraph 20).	Before Jun 30, 2003	PC
7.	Concession the management of the electricity distribution companies and Andinatel and Pacifictel to reputable international firms (paragraph 20).	Before Jun 30, 2003	PC

ECUADOR—STRUCTURAL PERFORMANCE CRITERIA (PC) AND BENCHMARKS (SB)

	Objective	Date	PC/SB
8.	Sign contracts with independent international firm(s) to manage the liquidation trust funds of the AGD banks (paragraph 17).	Before Jun. 30, 2003	SB
9.	Bring Banco del Pacífico to the point of sale (paragraph 19).	Before Jul. 31, 2003	SB
10.	Submission to congress of the tax reform law including the elimination of revenue earmarking not mandated in the constitution, and tax exemptions (paragraph 13).	Before Aug. 31, 2003	PC
11.	Passage of the law for public sector wage unification and civil service reform (paragraph 13).	Before Aug. 31, 2003	PC
		For the third review:	
12.	With technical assistance from international institutions, conduct an assessment of the operating procedures and actuarial balances of the IESS, ISSFA, and ISSPOL (paragraph 9).	Before Sep. 31, 2003	SB
13.	Passage of the tax reform law, including the elimination of revenue earmarking not mandated by the constitution (paragraph 13).	Before Nov. 30, 2003	PC
14.	Conclude returning all blocked deposits in Filanbanco and the AGD banks in liquidation to depositors (paragraphs 16 and 17).	Before Dec. 31, 2003	PC

ECUADOR—TECHNICAL MEMORANDUM OF UNDERSTANDING

1. This Technical Memorandum of Understanding (TMU) defines the quantitative performance criteria under the program as presented in Tables 1 and 2 attached to the Letter of Intent (LOI) of February 10, 2003, and the Memorandum of Economic Policies (MEP).

2. **Ceiling 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 from below the line, defined as the change in the NFPS gross debt, minus the change in public sector deposits in the Central Bank of Ecuador (BCE) and in the commercial banks (defined in point 4). NFPS gross debt comprises total registered NFPS gross debt (defined in point 6), and external and domestic arrears and accounts payable (as defined in point 7). 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).

As indicated in paragraph 12 of the MEP, 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 or 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 and capital spending (including net lending) of the public sector as reflected in the table on *Public Sector Operations* in the staff report.

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 as reflected in the table on *The Public Sector Balance Sheet (preliminary)*, in the staff report. 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. 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 (defined as all current debt and principal in arrears on external debt; it excludes domestic debt servicing arrears and external interest in arrears) is defined as the total domestic and foreign debt of the nonfinancial and financial public sector, and government guaranteed debt, as reflected in the below-the-line fiscal accounts and in the table on *The Public Sector Balance Sheet (preliminary),* in the staff report. 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.** The attached Table 2 on the arrears clearance program for 2003 presents the stocks, at end-of-period, of identified external and domestic arrears, and a schedule of the clearance for 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 arrears, domestic or external.

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

(In millions of U.S. dollars)

	Dec. 31, 2002	2003			
		January-March	January-June	January-September	January-December
	Est.	Target	Target	Target	Target
1. NFPS overall balance (ceiling)		182	413	543	509
2. NFPS noninterest expenditure (ceiling)		1,243	2,717	4,218	5,818
3. Stock of public sector deposits in the BCE and commercial banks (floor) 2/	1,282	1,131	1,212	1,266	1,409
4. Stock of central government deposits in the "cuenta unica" at the central bank (floor) 2/	118	80	176	155	213
5. Stock of registered public sector gross debt (ceiling)	13,730	13,836	13,950	13,933	13,871
6. Stock of external arrears, e.o.p. (ceiling)	163	0	0	0	0
7. Stock of domestic arrears, e.o.p. (ceiling)	452	211	22	22	0

1/ As defined in the attached Technical Memorandum of Understanding.
2/ For 2002 reflects end-of-period stocks; for 2003 reflects quarterly average stocks.

Table 2. Ecuador: Arrears Clearance Program for 2003

	Dec-02	Jan-03	Feb-03	Mar-03	Apr-Jun 2003	Jul-Sep 2003	Oct-Dec 2003
Stock, end-of-period	**615**	**470**	**383**	**211**	**23**	**23**	**0**
External	**163**	**147**	**66**	**0**	**0**	**0**	**0**
Paris Club, Governments	111	114	66	0	0	0	0
WB, IDB, CAF	18	0	0	0	0	0	0
Banks	33	33	0	0	0	0	0
Other	0	0	0	0	0	0	0
Identified domestic, central government	**452**	**323**	**317**	**211**	**23**	**23**	**0**
Wages	117	0	0	0	0	0	0
ISSFA, ISSPOL	115	115	115	115	0	0	0
Transfers to local governments	41	41	41	20	0	0	0
Preasignaciones	30	30	30	0	0	0	0
IESS	26	26	26	26	0	0	0
Bienes y servicios (current and capital)	114	102	96	41	23	23	0
Other	9	9	9	9	0	0	0
Flows		**-144**	**-87**	**-172**	**-188**	**0**	**-23**
External		**-15**	**-81**	**-66**	**0**	**0**	**0**
Paris Club, Governments		3	-48	-66			
WB, IDB, CAF		-18					
Banks			-33				
Other							
Identified domestic, central government		**-129**	**-6**	**-106**	**-188**	**0**	**-23**
Wages		-117					
ISSFA, ISSPOL					-115		
Transfers to local governments				-21	-20		
Preasignaciones				-30			
IESS					-26		
Goods and services		-12	-6	-55	-18		-23
Other					-9		

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

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 03/47
April 7, 2003

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Concludes 2003 Article IV Consultation with Ecuador

On March 21, 2003, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Ecuador.[1]

Background

Ecuador experienced severe economic stress in 1999, involving accelerating inflation, public debt default, and a currency and banking crisis. Following the adoption of the U.S. dollar as legal tender in January 2000, expectations stabilized, confidence returned to the banking system, and economic activity began to turn around. Demand was given further impetus by the start of the construction of a new oil pipeline, and escalating public sector spending.

However, economic growth slowed again in 2002 due to policy slippages and faltering confidence. Fiscal discipline weakened with large increases in the public wage bill, new revenue earmarking, and discretionary tax cuts. Moreover, oil output dropped because of inefficiencies in PetroEcuador; the structural reform agenda was suspended; and there was a high level corruption scandal in June. By the end of the year, the treasury was very short of cash and facing payment arrears. Nevertheless, in September, the Ecuadorian congress approved the *Fiscal Responsibility and Transparency* Law, which sets medium-term fiscal rules. This law could substantially lower the public debt and the country risk spreads, thereby crowding in investment and employment in the non-oil economy.

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

The government that took office on January 15, 2003 has taken bold measures aimed at strengthening the fiscal balance and helping to eliminate arrears. The new government's program also includes ambitious structural reforms to reduce rigidities in fiscal policy, resolve remaining problems with closed banks, and modernize the state enterprises. Completion of the oil pipeline will boost output growth over the medium term, and provide revenues that should provide the basis for a rapid reduction in public sector debt under the terms of the Fiscal Responsibility Law.

Executive Board Assessment

The Executive Directors commended the new government's quick and comprehensive actions to strengthen policies and address the challenges imposed by dollarization, while emphasizing the need for sustained implementation of the program.

While the economy had begun to recover following dollarization, Directors expressed concern that performance had not been sustained in 2002. Rapid public sector wage increases had undermined the fiscal position and contributed to excessive inflation for a dollarized economy, and to a further appreciation of the real effective exchange rate. Moreover, structural reforms had been suspended in key sectors, further jeopardizing competitiveness. Directors regretted the build up of large payments arrears to domestic and external creditors. Directors also expressed concern about institutional weaknesses that give rise to poor governance and corruption.

Under these circumstances, Directors considered that Ecuador faces major economic challenges. They, therefore, welcomed the bold measures taken swiftly by the new government after taking office on January 15. They commended the comprehensive nature of the authorities' program, which contains four main building blocks: immediate fiscal measures to boost revenues and control expenditures; fiscal structural reforms; liquidation of closed banks and other steps to resolve outstanding issues from the banking crisis; and reforms in the state enterprises. Directors also appreciated the authorities' efforts to build a social and political consensus for the program, and underscored that timely congressional approval of the reform laws is crucial. While recognizing that the program is ambitious, Directors called for its rigorous and timely implementation.

Directors agreed that the upfront fiscal measures are necessary in view of the immediate liquidity needs, and because expenditure growth needs to be brought back in line with the demands of dollarization. Given the substantial increases in the wage bill in recent years, Directors agreed that a wage freeze is essential for 2003. At the same time, Directors fully supported the authorities' steps to strengthen the social safety net to compensate the poor for the effects of some of the revenue measures. Directors encouraged the authorities to improve targeting ahead of the planned elimination of the cooking gas subsidy at mid-year.

Directors welcomed the plans to enhance the flexibility of fiscal policy by reforms in customs, civil service, and tax policy. These reforms are an integral part of the effort to limit the growth in public sector spending, maintain revenue buoyancy, and reduce revenue earmarking. Directors saw these reforms as necessary to establish a sustainable fiscal position over the medium term. Directors also strongly endorsed the authorities' efforts in setting up institutional and legal procedures to strengthen the foundation of fiscal policy. In particular, they welcomed the passage of the Fiscal Responsibility and Transparency Law, which creates a stabilization fund that provides a medium-term framework to substantially reduce Ecuador's debt and to protect the economy from external shocks. Many Directors expressed concern about the rapid growth in social security spending and urged the authorities to take precautionary steps to preserve the long-term solvency of the system.

Directors expressed concern about the pace at which outstanding issues left from the 1999 banking crisis were being resolved. In particular, the Deposit Guarantee Agency (AGD) has yet to collect on most of the loans held by the bankrupt banks, risking severe asset erosion, and Directors strongly supported the authorities' recent efforts to audit these banks and liquidate them. Directors also noted the poor functioning of the public sector development banks and urged their early and comprehensive reform. Directors looked forward to the results of the planned Financial Sector Assessment Program exercise.

Directors cautioned that, while Ecuador's medium-term growth potential is high, it can only be realized by sustained program implementation and strengthening competitiveness of the non-oil economy. The coming on stream of the new oil pipeline by end-2003 could alleviate pressures on the external current account, but it would be important to avoid crowding out the non-oil economy, and to cut debt levels rapidly. Therefore, Directors urged the authorities to adhere strictly to their fiscal reform and consolidation plan, and to press ahead with productivity-enhancing structural reforms, especially in the state enterprises. Such reforms would help strengthen competitiveness, and were seen as particularly crucial given the likely effects of real exchange rate appreciation and Dutch disease on the non-oil economy. Directors noted that, by strengthening savings and lowering the debt, Ecuador could reduce its risk profile and, thus, boost investment and employment in the non-oil economy. Directors also called for steps to improve governance, including reform of the politicized judicial system and strengthening of the rule of law, which would help improve the climate for domestic and foreign investment.

Directors considered that statistical information provided to the Fund is generally adequate, but urged the authorities to improve the timeliness of fiscal data and the accuracy of revenue and expenditure data to enhance the monitoring of economic developments.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board.

Ecuador: Selected Economic and Financial Indicators

	1999	2000	2001	Prel. 2002	Proj. 2003
(Annual percentage changes; unless otherwise indicated)					
National income and prices					
Real GDP	-6.3	2.8	5.1	3.0	3.5
Real GDP per capita	-8.2	0.9	3.2	1.1	1.6
Consumer price index, end-of-period	-25.2	-10.1	22.4	9.4	6.5
Real effective exchange rate (depreciation -)	-30.8	-6.6	39.4	10.1	...
Banking system					
Liabilities to the private sector	19.2	8.5	24.2	18.0	11.2
Credit to the private sector	...	-5.1	16.9	13.8	10.8
EMBI Ecuador (percentage points spread)	2,650	2,866	1,233	1,801	...
(In percent of GDP)					
Public finances					
Revenue	22.5	27.6	24.7	26.1	27.0
Noninterest expenditure 1/	19.1	19.9	20.4	21.7	21.9
Primary balance (deficit -)	3.4	7.7	4.3	4.5	5.2
Overall balance (deficit -)	-4.6	1.0	-0.5	1.0	1.9
Total public debt	**101.6**	**91.4**	**70.2**	**59.6**	**51.7**
Domestic	18.7	19.4	15.7	12.8	9.5
External	82.8	72.0	54.5	46.9	42.2
Saving, investment, and external balance					
National saving	20.5	26.4	23.2	20.7	20.2
Gross investment	14.7	20.1	25.7	25.7	25.5
Foreign saving=external current account deficit (+)	-5.7	-6.3	2.4	5.0	5.3

Sources: Central Bank of Ecuador; Ministry of Finance; and IMF staff estimates and projections.
1/ It includes unrecorded operations in 2001/02.

Press Release No. 03/39
FOR IMMEDIATE RELEASE
March 21, 2003

International Monetary Fund
Washington, D.C. 20431 USA

IMF Approves US$205 Million Stand-By Arrangement for Ecuador

The Executive Board of the International Monetary Fund (IMF) today approved a 13-month SDR 151 million (about US$205 million) Stand-By Arrangement for Ecuador to support the country's economic and financial program through March 2004. The approval opens the way for the immediate release of SDR 30.2 million (about US$41 million).

In addition, the Executive Board approved the authorities' request to extend by one year the repayment expectations arising from a purchase under a Stand-By Arrangement approved on April 19, 2000. These repayments in an aggregate amount are equivalent to SDR 14 million (about US$19 million) and were expected to be made on August 30, 2003; November 30, 2003; and February 29, 2004. Purchases in the credit tranches are expected to be repaid in eight quarterly installments made within 2.25 and 4 years after the date of purchase. The extension granted by the Executive Board is allowed under the Fund's general policies governing repurchase expectations which authorize the Executive Board to extend repurchase expectations on request by a member with an insufficiently strong external position.

Following the Executive Board discussion, Horst Köhler, Managing Director, said:

"While the Ecuadoran economy had begun to recover following dollarization, policy slippages in 2002 led to a slowing of economic growth, continued payments arrears in the public sector, and rising concerns about the inconsistency of fiscal and wage policies with dollarization. In particular, rapid public sector wage increases undercut the fiscal position and contributed to the continued relatively high rate of inflation. In addition, structural reforms were suspended in key areas.

"The new administration has shown impressive leadership in dealing with a difficult economic situation. Immediately upon taking office, the new government acted to reverse the policy slippages in 2002 by implementing important decisive measures to boost revenues and control expenditures, balanced with social safety net support, and by announcing a broad program of economic reforms. These efforts aim at strengthening fiscal performance and boosting confidence and competitiveness, thus laying the basis for sustained improvement in the growth performance.

"Upfront fiscal measures are already helping to raise the public sector primary surplus and overcome the very difficult liquidity position in the Central Government that the authorities faced upon assuming office. It remains imperative to sustain the government's fiscal consolidation objectives, including through the customs reform that is already being advanced through Congress, and with the important reforms contemplated later this year in the civil service and the tax and revenue earmarking system. At the same time, greater attention should be paid to improving the living conditions of the poor, including by improving the targeting of the social safety net.

"The government has already acted to revive the reform agenda in other areas, including by unfreezing the tariffs of the public enterprises, and steps to deal with the lingering problem of the closed banks. The authorities are contemplating additional important initiatives to improve the functioning of the public enterprises in the electricity, telephone, and petroleum sectors. Directors strongly support these steps, because they can make a substantial contribution to lowering production costs in the economy.

"Recognizing the strong start made by the new government, the Fund anticipates continuing to work closely with the Ecuadoran authorities as they proceed with the implementation of their ambitious and comprehensive economic program," Mr. Köhler said.

ANNEX

Recent Economic Developments

Ecuador went through a difficult period in the 1990s, and per capita income stagnated. The 1998 oil price slump, damage from the *El Niño* weather phenomenon, and disease in the shrimp industry further complicated the situation. As a result, Ecuador experienced severe economic stress, culminating in accelerating inflation, which spilled over into a banking crisis, a deposit freeze, and the closure of some 18 banks, affecting half of total deposits and ended in a currency crisis.

The adoption of the U.S. dollar in January 2000 stabilized expectations, and economic activity began to turn around. Oil prices recovered, while imports surged due to a boom in domestic demand associated with the exchange rate-based stabilization. In 2001, demand was given further impetus by the start of the construction of a new private oil pipeline (*Oleoducto de Crudos Pesados*, OCP) and higher public sector spending.

However, economic growth slowed again to 3 percent of GDP in 2002 from 5.1 percent in 2001 due to policy slippages and faltering confidence. Fiscal discipline weakened with large increases in the wage bill, the granting of new revenue earmarking, and discretionary tax cuts. Inflation has dropped but remained still too high for a dollarized economy. Consumer price inflation came down from 91 percent at end-2000 to 9.4 percent by end-2002, but strong domestic demand (fiscal expansion), weak domestic supply (suspension of structural reforms), and wage-driven cost increases have prevented it from dropping to international levels. Wages have more than doubled since dollarization in early 2000 (led by the public sector), exceeding inflation over this period. The unemployment rate has dropped by half since 2000, to 8.5 percent at end-2002 recovering by end-2001 its pre-crisis level.

The external current account deficit widened to 5 percent of GDP in 2002 from 2.4 percent in 2001. While merchandise exports benefited from higher oil prices and continued growth of non-oil exports, imports grew rapidly on strong domestic demand, and an appreciating real effective exchange rate.

Program Summary

Within days of taking office on January 15, 2003, the new authorities started implementing a comprehensive and ambitious economic program. The program projects **real GDP** growth of 3.5 percent in 2003, and a decline in consumer price **inflation** to an end-of-period rate of 6-7 percent, after the initial adverse effect of the unfreezing of utility, fuels, and other prices. Assuming a cautious oil price of US$18 per barrel, the **external current account** deficit is projected at just over 5 percent of GDP in 2003.

The authorities' program has four building blocks: a package of immediate fiscal measures; fiscal structural reforms; liquidating closed banks and resolving other outstanding issues from the banking crisis; and reforms in the state enterprises.

The main objectives of the **fiscal program** are to address immediate liquidity constraints and to bring expenditure growth under control, consistent with the demands of dollarization. The government has already moved quickly to implement a package of revenue measures. Spending growth has been limited by a budgetary freeze on wages and other expenditure controls. According to the Fiscal Responsibility law approved in 2002, primary expenditures can grow annually to a maximum of 3.5 percent in real terms. The budget sent by the government and approved by congress in February is consistent with the primary expenditures fiscal rule. The **social safety net** has been strengthened to compensate the poor for the effects of some of the revenue measures.

In order to limit the growth in public sector spending and maintain revenue buoyancy, the authorities are planning a **customs, civil service, and tax reform**, thus laying a strong foundation for sustainable fiscal policies in the medium term.

The government has submitted to Congress a law to overhaul the customs administration and to bring it under the umbrella of the tax administration office (SRI).After passage of the customs law, the government will seek approval for a public sector wage unification and **civil service reform** law, which aims at achieving a lower nominal wage bill in 2004 through shrinking the size of government and reducing personnel. The wage unification aims at phasing in a broadening of the base for social security contributions and income taxes, akin to the reform in the private sector.

Finally, the authorities will seek the passage of a **tax reform** law to eliminate revenue earmarking not mandated in the constitution, and most tax exemptions, including special rules in the income tax system. The law would also cut some low-yielding taxes; increase fees for vehicles; and reduce the currently high standard deduction for income taxes .

The government also intends to reassess, with outside technical assistance, the operations of the **social security system** and the actuarial position of the general social security system (IESS) and the pension funds for the military and the police (ISSFA and ISSPOL).

While the private banking system has recovered well, the authorities plan to address some still unresolved issues, including the liquidation of Filanbanco, and the preparation for sale of Banco del Pacífico. The private banks and the authorities also have been discussing a strategy to replace the existing Liquidity Fund It is contemplated that the new Liquidity Fund would be administered by an independent private manager, who would keep most of the liquidity abroad.

Ecuador is an original member of the IMF. Its quota[1] is SDR 302.3 million (about US$410 million); and its outstanding use of IMF credit currently totals SDR 226.7 million (about US$308 million).

[1] A member's quota in the IMF determines, in particular, the amount of its subscription, its voting weight, its access to IMF financing, and its allocation of SDRs.

Table 1. Ecuador: Selected Economic and Financial Indicators

				Prel.	Prog.	
	1999	2000	2001	2002	2003	2004
(Annual percentage changes; unless otherwise indicated)						
National income and prices						
Real GDP	-6.3	2.8	5.1	3.0	3.5	6.0
Domestic demand (contribution to growth)	-19.7	7.5	10.9	7.6	3.6	4.6
Consumption	-6.8	3.9	4.8	6.9	3.5	2.8
Gross fixed investment	-27.7	12.1	12.1	11.1	2.8	9.9
Foreign balance (contribution to growth)	13.4	-4.7	-5.8	-4.5	-0.2	1.4
Exports of goods and nonfactor services	7.8	-1.0	-1.3	2.7	1.7	11.1
Imports of goods and nonfactor services	-29.5	15.8	17.2	15.8	1.9	6.2
Real GDP per capita	-8.2	0.9	3.2	1.1	1.6	4.1
Consumer price index period average	-29.2	-7.7	37.7	12.6	7.9	4.4
Consumer price index end-of-period	-25.2	-10.1	22.4	9.4	6.5	4.0
Unemployment	14.4	14.1	10.4	8.7	...	...
Banking system						
Liabilities to the private sector	19.2	8.5	24.2	18.0	11.2	10.0
Net domestic assets	23.6	-12.1	26.3	22.1	18.2	7.1
Credit to the private sector	...	-5.1	16.9	13.8	10.7	10.9
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	5.9	0.1	13.6
Oil	60.3	65.1	-22.2	7.0	-7.2	27.0
Non-oil	-9.4	-16.4	11.8	5.1	5.1	5.3
Imports	-46.4	24.5	43.6	19.0	3.7	8.1
Terms of trade, national accounts data (deterioration -)	9.1	10.7	-15.6	4.9	-2.2	-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	25.9	27.0	27.8
Noninterest expenditure	19.1	19.9	19.6	21.7	21.9	21.2
Discrepancy (unrecorded expenditure -)	0.0	0.0	-0.8	0.2	0.0	0.0
Primary balance (deficit -)	3.4	7.7	4.3	4.5	5.2	6.7
Interest bill	8.1	6.6	4.7	3.5	3.3	3.1
Overall balance (deficit -)	-4.6	1.0	-0.5	1.0	1.9	3.6
Other public sector operations (deficit -) 1/	-6.3	18.0	-0.6	0.9	0.7	0.3
Public sector borrowing requirement	11.0	-19.1	1.1	-1.9	-2.6	-3.9
Total public debt	101.6	91.4	70.2	59.6	51.7	44.1
Domestic	18.7	19.4	15.7	12.8	9.4	7.4
External	82.8	72.0	54.5	46.9	42.2	36.7
Saving investment balance						
National saving	20.5	26.4	23.2	20.7	20.2	22.2
Gross investment	14.7	20.1	25.7	25.7	25.5	26.2
Foreign saving = external current account deficit (+)	-5.7	-6.3	2.4	5.0	5.3	4.1
Memorandum items:						
Public sector external debt service (percent of exports of goods and nonfactor services)	27.7	28.7	26.5	22.3	22.5	20.8
Interest	21.5	22.9	13.6	10.6	10.6	9.5

Principal	6.2	5.8	12.8	11.7	11.9	11.3
Use of Fund resources (percent of quota)	0.0	37.5	75.0	75.0	100.2	85.1
Net foreign assets (in millions of US$)	872	1,180	1,074	1,008	919	1,154
Public sector deposits (US$ millions)	570	1,228	1,261	1,282	1,306	1,589
Central government deposits (US$ millions)	78	396	86	118	118	218

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

1/ Includes results of the public sector banks and below-the-line debt operations. In 2000, Ecuador received a 40 percent haircut on eligible external debt.

Statement by Murilo Portugal, Executive Director for Ecuador and Jorge Gallardo, Advisor to Executive Director
March 21, 2003

1. We want to thank staff for the set of well-written papers and for their candid and thorough analysis on the Ecuadorian economy. Since Ecuador took the decision to officially dollarize its economy three years ago, the main economic indicators have stabilized, economic activity has recovered, and expectations have improved. Real GDP grew 2.8 percent in 2000 after a 6.3 percent decline in 1999. In 2001, growth remained strong at 5.1 percent, but slowed in 2002 to 3.0 percent due to fiscal slippages that affected confidence, a fall in oil production, and slower global economic activity. Notwithstanding, in both years, the rate of growth was the highest in the Region. Fiscal discipline weakened in 2002 with large increases in the wage bill and expenditures in goods and services. Unemployment has been reduced from 14.4 percent in 1999 to 8.7 percent at end-2002. Inflation has come down sharply. The 12-month rate of inflation fell from 91 percent at end-2000 to 9.4 percent at end-2002, but remains still too high for a dollarized economy. However, using the data reported by the staff to calculate US dollar inflation since end of 1998, the consumer price index would still be below that of 1998 by end-2002.

2. The non-financial public sector (NFPS) registered a primary fiscal balance of 7.7 percent of GDP in 2000 helped by high international oil prices, improved tax collections, and the fact that the 2000 budget was approved by Congress in September 1999 at a much lower exchange rate than the exchange rate used for dollarization. In 2001 and 2002, the primary fiscal balances were 4.3 and 4.5 percent of GDP, respectively, due to the recovery of government spending and the drop in oil prices. The overall fiscal result was a surplus of 1.0 percent of GDP in 2000, but turned negative in 2001 registering a deficit of -0.5 percent of GDP. In 2002, the overall fiscal balance was again positive registering a 1.0 percent of GDP surplus. However, despite an overall NFPS surplus, the central government's own cash position in third and fourth quarters of 2002 was very tight. Extensive constitutional earmarking resulting in automatic higher expenditures that, together with the sharp increases in the wage bill and in goods and services expenditures, forced the Treasury to end 2002 with over US$700 million in domestic and external arrears.

3. After registering a surplus of 6.3 percent of GDP in 2000, the external current account recorded a deficit of 5.0 percent of GDP at end-2002.The decline mainly reflected strong import growth associated with the recovery of economic activity and with the imports for the construction of the new oil pipeline (OCP). Also, the appreciation (after the sharp depreciation of 1999 and 2000) of the real effective exchange rate contributed to the surge in imports. Government deposits, a better measure of public sector liquidity than net international reserves in a dollarized economy, were 5.2 percent of GDP at end-2002, enough to cover more than a year of interest payments, which amounted to 3.46 percent of GDP. Foreign Direct Investment, driven mainly by the oil sector, was 5.1 percent of GDP at end-2002. The public debt-to-GDP ratio declined from 102 percent at end-1999 to 60 percent at end-2002. The external debt-to-GDP ratio declined from 82.8 percent in 1999 to 46.9 percent in 2002, reflecting mainly the 40 percent reduction of external debt agreed with bondholders,

the appreciation of the real effective exchange rate and the rapid GDP growth of the last three years. The high ratio in 1999 also reflected the high depreciation of the real exchange rate.

4. The private banking system has recovered after being affected by the currency and banking crises. The liquidation of 16 closed banks under the administration of the Deposit Insurance Agency (AGD), and the resolution of the government owned Filanbanco, once the largest bank in the system, have been more turbulent than anticipated. Legal difficulties and political pressures have delayed the collection of US$1.6 billion in defaulted loans previously granted by the closed banks to big private debtors. These banks still have blocked deposits. About US$275 million deposits are unpaid in early 2003. Banco del Pacífico, the private bank in the hands of the Central Bank, which has been under private management since end-2001, recorded profits at end-2002 and has been consistently ranked among the four largest banks in the system. Private bank deposits increased by 30 percent over 2001-2002. The foreign net position was positive at end-2002 and enough to cover 14.5 percent of the banking system total liabilities, 46 percent of demand deposits, and up to 30-day maturity time deposits.

5. The banking system soundness indicators have improved. The share of non-performing loans to total loans declined from 42.3 percent in 1999 to 6 percent in 2002. The private bank's profit margins have been high in the last two years. Average deposits rates have remained around 5 percent and average lending rates were close to 14 percent at end-2002. The high interest spread reflects the high cost of maintaining a liquidity cushion deposited abroad, efforts to restore profitability and the continued high EMBI spread on sovereign bonds that serves as a benchmark to determine domestic interest rates. Furthermore, it reflects a change in the composition of loan portfolios, which have shifted from corporate lending to consumer lending. In this scenario, private external corporate debt has increased from 15.2 percent of GDP at end-1999 to 20.0 percent of GDP at end-2002. Overall, monetary aggregates expanded rapidly during 2001-2002 as improved stability and real economic growth led to re-intermediation of the financial system. Despite improvements in its financial soundness, the financial system remains vulnerable in the absence of a lender of last resort. However, this vulnerability has to be counterweighted with the reduction of a persistent moral hazard risk.

6. In December 2002, one month before taking office, the newly elected authorities began substantive negotiations with Fund staff for a Stand-By Arrangement. After taking office in January 15, 2003, the government implemented measures to tighten the fiscal position and announced a very ambitious program of structural reforms to be submitted to Congress during 2003. On January 19, prices for gasoline and other fuels were increased by an average of 25 percent. Together with improved operational cost control in the oil estate company and at the retail level, these decisions are expected to yield 1.5 percent of GDP equivalent to US$400 million. Also, some import tariff concessions that were granted in late 2002 were reversed, expecting to yield 0.1 percent of GDP, equivalent to US$30 million.

7. On February 10, during the visit of President Gutierrez to Washington, the Minister of Finance and the President of the Central Bank requested on behalf of the government of Ecuador, a 13-month Stand-By Arrangement in the amount of SDR 151 million equivalent to 46 percent of quota.

8. According to the fiscal program, the cooking gas subsidy will be eliminated before end-June, generating a gross yield of US$75 million or 0.3 percent of GDP. As part of the structural reforms, the government will send to Congress a law to unify the public sector wages that will widen the base for social security contributions. This is expected to yield about US$20 million, equivalent to 0.1 percent of GDP for 2002, with a much higher projection for 2003. On January 22, in order to control expenditures, the government issued an Austerity Decree that included a freeze on central government wages for regular employees and cut spending on goods and services. To compensate the poor for some of the above revenue measures, the government raised the cash assistance program (bono solidario), effective January 2003, from US$11.50 to US$15.0 per eligible person per month, while welfare assistance for the elderly poor was increased by US$5.0 per person. More than 1.4 million family heads are covered by this program.

9. In January, the new government sent to Congress the 2003-budget proposal consistent with the program. The budget includes a freeze on wages and is based on an oil price assumption of US$18 dollars per barrel for the Ecuador mix that is on average US$3 to US$4 dollars less than the WTI price. The government is committed to cut expenditures if oil revenues fall below those envisaged in the program. The 2003 fiscal program projects to strengthen the primary surplus from 4.5 percent of GDP in 2002 to 5 ¼ percent. This target is consistent with an overall surplus of 2.0 percent of GDP higher than the 1.0 percent registered in 2002.

10. In September 2002, Congress approved the Fiscal Responsibility and Transparency Law (FRTL), and in January 2003 the new government issued regulations for its implementation. This law improves transparency of the budgetary process, and has set up important macro fiscal rules to manage the fiscal policy with a long-term fiscal approach. Basically, it establishes rules to limit the growth in the primary budgetary expenditures to 3.5 percent in real terms annually, to reduce the non-oil public sector deficit in 0.2 of GDP per year and to improve the public debt/GDP ratio in 16 percentage points in the next four years. It also creates an oil stabilization fund, which allows the government to save 90 percent of the fiscal revenues coming from the new oil pipeline. Twenty percent of the revenue inflows from the new pipeline will go to a fund for oil price stabilization and emergencies, and 70 percent will be allocated for debt buy-backs aiming to reduce the ratio of public debt to GDP to a maximum of 40 percent, not to be exceeded once this objective is reached. The other 10 percent will be spent in social programs and subject to the fiscal rule of 3.5 percent.

11. The external current account deficit is projected at 5.3 percent of GDP in 2003, higher than the 5.0 percent registered at end-2002 due basically to a conservative oil price for the projections (US$18 per barrel). A one dollar increase in the oil price represents more than US$90 million in a year basis. The capital account would remain strong, reflecting continued FDI inflows, dominated by the oil industry, which needs to invest in wells to fill the new pipeline.

12. The structural fiscal reforms agenda is very ambitious and aims to build institutions consistent with dollarization. The authorities have sent to Congress, on a fast track basis, a Custom Reform Law to overhaul the customs administration and to bring it under the

umbrella of the Internal Revenue Service (SRI). In the second week of March, Congress amended the proposal to merge customs with the SRI administration. According to the Ecuadorian Constitution, the President has the legal power to veto what the Congress has approved and to re-write new provisions. Before April 30, the government will submit a public sector Wage Unification and Civil Service Reform, which aims at achieving a lower nominal wage bill in 2004 by reducing the number of public sector employees. Under the wage unification, the various components of remuneration will be brought together in one salary statement, which then will be the new basis for the assessment of social security contributions that will yield about US$20 million in 2003.

13. Before end-August 2003, the government will submit to Congress a comprehensive tax reform bill intended to allow for a more efficient allocation of public spending and to expand the tax base. One of the main features of the proposal is to eliminate all revenues earmarked that are not mandated in the Constitution. The government will seek congressional approval of this reform by end-November 2003.

14. The authorities are committed to develop and implement a set of policies to maintain a sound financial system. These include the strengthening of banking supervision, reforming the liquidity support system, and improving mechanisms for the recovery of nonperforming loans. The Association of Private Banks (ABPE) has been analyzing with the authorities the possibility to pool their liquidity to structure a new liquidity facility. This new fund could cover 35-45 percent of total deposits, giving it an ample margin to act as lender of last resort and to serve as a guarantor of the payment system. The authorities are committed to liquidate Filanbanco and eight of the closed banks in the hands of the AGD. Parallel to the liquidations of the closed banks, the private sector debt portfolios of the banks that were already restructured will be auctioned off. Banco del Pacífico will be brought to the point of sale to the private sector by end-July 2003. The program envisages US$2,212 million in total financing, and US$574 million in exceptional financing. The WB, IDB and CAF will contribute with US$330 million, the IMF with US$160 million, with the remaining US$84 million coming from expected debt relief from Paris Club creditors on a rescheduling of arrears and current maturities.

15. According to the stress tests of the public debt sustainability analysis conducted by staff, which takes into consideration the operation of the new oil pipeline (OCP) and the implementation of the FRTL, the potential for debt reduction is robust even if the economy is affected by strong shocks. The public sector debt to GDP would come down to 37.2 in 2005 and 25.7 percent in 2007. The NFPS overall fiscal surplus would increase from 2.0 percent in 2003 to 4.0 percent in 2005. In this scenario, inflation would fall to international levels by 2005 and GDP would grow 6 percent in 2004 and 6.5 percent in 2005, with growth remaining strong thereafter. The external current account deficits that have been around 5 percent of GDP in the last two years would also decline in the medium term, backed by the boost in oil exports from the new pipeline.

16. We ask the members of the Executive Board to support the program, and approve the exchange restriction in the form of blocked deposits in the closed banks until end-December 2003 and the extension of repurchase expectations to an obligations basis during the period of the Stand-By Arrangement. On behalf of our Ecuadorian authorities, we would like to

thank staff, Management, and the Executive Board for the support given to Ecuador. Our Ecuadorian authorities have ownership of the economic program, and are fully committed to its implementation and, if necessary, to take the appropriate decisions to secure fiscal and external sustainability in the medium term.