INTERNATIONAL MONETARY FUND

IMF Country Report No. 15/289

ECUADOR

2015 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR ECUADOR

October 2015

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2015 Article IV consultation with Ecuador, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its September 25, 2015 consideration of the staff report that concluded the Article IV consultation with Ecuador.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on September 25, 2015, following discussions that ended on July 15, 2015, 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 September 10, 2015.
- An **Informational Annex** prepared by the IMF staff.
- A **Statement by the Executive Director** for Ecuador.

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

Selected Issues

The IMF's transparency policy allows for the deletion of market-sensitive information and premature disclosure of the authorities' policy intentions in published staff reports and other documents.

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October 21, 2015

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

IMF Executive Board Concludes 2015 Article IV Consultation with Ecuador

On September 25, 2015, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with Ecuador.

Supported by positive terms of trade and large public investments, growth averaged 4.5 percent over the past decade, while social indicators improved. Reflecting Ecuador's goals of diversifying energy production and improving infrastructure and social equality, the overall fiscal position of the non-financial public sector (NFPS) deteriorated from balance in 2011 to a deficit of 3.5 percent of GDP in 2012–14, mainly driven by high capital spending. The poverty rate and the GINI coefficient fell, respectively, from 38 percent and 0.54 in 2006 to 22.5 percent and 0.47 in 2014, while the unemployment rate declined significantly. Financial stability was preserved, supported by dollarization. In 2014, growth moderated to 3.8 percent in line with developments in the region.

Since the fourth quarter of 2014, the economy has been hit by external shocks and is slowing down. The sharp decline in the international oil price, by about half for the Ecuadorian mix, significantly undercut oil revenues. In addition, competitiveness is being eroded by the real appreciation of the exchange rate—by 16 percent year-over-year through June 2015.

The authorities responded rapidly to the shocks by cutting public spending, introducing balance of payment safeguards, and containing minimum wage growth. As a result, non-oil imports have been declining significantly from April 2015, and the 2015 fiscal deficit is expected to be contained to the original budget target. Nonetheless gross financing needs remain large, and international access to credit has tightened.

In the face of the economic slowdown, bank liquidity conditions have tightened, credit growth has slowed, and non-performing loans have risen (albeit from a low level). Despite the slowdown, inflation is picking up, reflecting changes in transport tariffs as well as in food prices and utilities.

[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.

Due to the shocks and expected adjustment, the economy is projected to contract somewhat in 2015, while the external position deteriorates. Growth prospects are also revised down going forward, due to the need to restore competitiveness, and in light of the effect of lower oil prices on investment and production. Risks to the outlook relate mainly to availability of external financing, additional softness in oil prices, persistent dollar appreciation, potential domestic financial system pressure, and natural disasters.

Executive Board Assessment[2]

Executive Directors welcomed the resumption of successful on-site Article IV consultation discussions with Ecuador, and looked forward to enhanced collaboration. They commended the impressive results in economic and social indicators over the past decade. They noted, however, that as an economy that is heavily dependent on oil revenues and is fully dollarized, Ecuador has recently been hit by sharply declining commodity prices and real exchange rate appreciation. The outlook is further clouded by a possible tightening of external financing conditions and the country's exposure to natural disasters. Directors welcomed the authorities' response to these shocks so far and encouraged further efforts to build policy buffers, preserve financial stability, and strengthen competitiveness.

Directors commended the authorities for their significant adjustment efforts to contain the fiscal deficit, and encouraged them to develop a contingency plan ensuring that any shortfalls in financing are addressed through further cuts in non-priority expenditure, while avoiding short-term financing from the central bank. They also called for the removal of distortionary import surcharges as soon as possible and within the announced timeframe. Directors stressed the importance of rebuilding fiscal buffers over time and recommended the authorities to sustain efforts to rationalize expenditure, contain public sector wage growth, continue the plan to overhaul fuel subsidies while protecting the poor, improve tax collection, and continue the reform process of the pension system.

Directors agreed that near-term challenges will also center on securing adequate liquidity in the financial sector, and improving regulation and supervision. While financial stability indicators do not show signs of stress, possible lags in responses and the continuing economic slowdown warrant close monitoring. Directors encouraged the authorities to improve the clarity of regulations, strengthen crisis management and supervision, and verify the resolution framework with a view to maintaining confidence and ensuring a rapid response to shocks. If pressures persist, relaxing banks' reserve requirements should be considered. Regulatory restrictions on bank activities—especially interest rate caps, penalties on investing abroad, and domestic

[2] 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. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

liquidity requirements—should be progressively lifted, credibility in the system of electronic money should be ensured, and directed lending should be discontinued. Directors also encouraged the authorities to strengthen the AML/CFT framework, and undertake a new financial sector assessment (FSAP) in light of significant changes to the financial landscape since the last assessment.

Directors underscored that improving competitiveness is key to safeguard the external balance and sustain medium-term growth. They welcomed reforms and investment in infrastructure, education, and private sector development, but also stressed the importance of efforts to contain wage growth and address labor market rigidities. More broadly, Directors supported reforms aimed at improving productivity, crowding-in the private sector, attracting foreign direct investment, diversifying the economy, and promoting trade integration.

Ecuador: Selected Economic Indicators

	2010	2011	2012	2013	2014	Proj. 2015	Proj. 2016
Social Indicators							
Life expectancy at birth (years)	75.6	75.9	76.2	76.5	...	...	...
Infant mortality (per thousand live births)	20.9	20.3	19.7	19.1	...	...	...
Adult literacy rate	91.9	91.6	...	93.3	...	...	...
Poverty rate (total)	32.8	28.6	27.3	25.6	22.5	...	...
Unemployment rate	5.0	4.2	4.1	4.2	3.8	...	...
	(Percent change, unless otherwise indicated)						
Production and prices							
Real GDP	3.5	7.9	5.2	4.6	3.8	-0.6	0.1
Real domestic demand	8.0	7.5	4.2	6.1	3.8	-3.1	0.3
Consumer price index period average	3.6	4.5	5.1	2.7	3.6	4.1	2.9
Consumer price index end-of-period	3.3	5.4	4.2	2.7	3.7	3.7	2.5
External sector							
Exports	25.8	27.3	6.4	4.5	3.6	-26.9	-1.3
Imports	37.7	18.3	5.5	6.8	1.9	-19.8	-1.1
Terms of trade, national accounts data (deterioration -)	19.0	21.8	0.2	1.1	-5.4	-14.6	1.0
Real effective exchange rate (depreciation -)	-2.2	-1.6	4.1	2.2	3.0	...	...
Money and credit							
Broad money	20.6	20.5	16.0	13.0	11.4	0.1	1.0
Credit to the private sector	24.4	22.6	14.7	10.5	8.7	1.4	2.0
	(In percent of GDP)						
Public sector							
Revenue	33.3	39.3	39.5	39.4	38.8	35.4	33.7
Primary expenditure	34.1	38.7	39.6	43.0	43.2	39.1	35.3
Primary balance	-0.8	0.6	-0.2	-3.6	-4.3	-3.7	-1.6
Overall balance (deficit -)	-1.3	0.0	-0.9	-4.6	-5.4	-5.1	-3.7
External Sector							
External current account balance	-2.3	-0.3	-0.2	-1.0	-0.6	-2.6	-2.8
Net international reserves (US$ millions)	2,622	2,958	2,483	4,361	3,949	3,522	3,397
Debt							
Total external debt	20.6	20.4	18.7	21.5	25.4	31.9	35.9
Total public debt	19.7	19.4	21.7	26.0	31.3	37.4	40.4
Domestic	6.7	5.7	8.9	10.5	12.5	12.9	12.2
External	13.0	13.7	12.8	15.5	18.8	24.5	28.3
Total public debt, official definition 1/	19.2	18.4	21.3	24.2	29.9	34.7	38.3
Saving investment balance							
Gross investment	28.0	28.1	27.8	28.8	28.1	24.7	23.9
National saving	25.8	27.8	27.6	27.7	27.5	22.1	21.1
Memorandum items:							
Nominal GDP (US$ millions)	69,555	79,277	87,623	94,473	100,543	98,925	101,698
GDP per capita (US$)	4,633	5,193	5,645	5,989	...	...	...

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

1/ The official public debt definition does not include the outstanding balance for advance oil sales, which was about 1.5 percent of GDP at end-2014.

INTERNATIONAL MONETARY FUND

ECUADOR

STAFF REPORT FOR THE 2015 ARTICLE IV CONSULTATION

September 10, 2015

KEY ISSUES

Context: Article IV discussions with Ecuador were conducted on-site for the first time since 2007 (Annex I). After growing at an average of about 4½ percent over the past decade—on the wave of high oil prices, a strong public investment agenda, and the anchor of full dollarization—the economy has been hit by significant external shocks since late 2014. The sharp decline in oil prices and significant real exchange rate appreciation have undercut exports and fiscal revenues. The authorities responded rapidly with a large fiscal adjustment, introduction of temporary import surcharges, and moderation of minimum wage growth. The economy is projected to contract in 2015 and growth to remain subdued in 2016, while medium-term potential has been revised down given prospects of lower investment and employment growth.

Risks: Risks to the outlook are tilted to the downside. The main external risks are additional softness in oil prices, persistence of dollar appreciation, and global financial instability. Ecuador-specific risks center on limits to the availability of external financing, potential domestic financial system pressure associated with the economic adjustment and uncertainty about the policy response, and delays in strengthening Ecuador's energy balance, as well as possible natural disasters. On the upside, future oil production could be higher, especially if oil prices rise again facilitating the financing of larger investment plans.

Policy issues: The authorities' significant adjustment measures should fully offset the fiscal implications of the shocks, but—given limited policy alternatives in a dollarized economy—any shortfall in financing would have to be addressed through further spending retrenchment. To regain competitiveness in the face of overvaluation and prevent protracted slow growth, substantial real wage and price adjustments are called for. Diminishing liquidity in the banking system warrants close monitoring and rapid reaction if pressures continue, while eliminating restrictions and distortions in the banking system as well as enhancing supervision would make the system more resilient to systemic shocks. Import surcharges should be removed as soon as possible, and within the announced timeframe. Restoring private sector confidence by improving the business environment will be key both to stemming deposit declines and preserving dollarization, as well as to sustaining healthy medium-term growth and reducing oil dependence. A broad structural reform agenda will be essential to foster productivity, crowd-in the private sector, and attract FDI.

Approved By
Adrienne Cheasty and Bob Traa

Discussions took place in Quito during July 1–10, 2015 and the concluding meeting was held via a video-conference on July 15, 2015. The team comprised: Luca Antonio Ricci (Head), Pablo Druck, Melesse Tashu, Svetlana Vtyurina (all WHD), Phil de Imus (SPR), Ricardo Fenochietto (FAD), and Martin Saldias (MCM). Francisco Rivadeneira (OED) participated in the discussions. Adrienne Cheasty (WHD) joined the mission for the final meetings with Minister of Coordination of Economic Policy Patricio Rivera.

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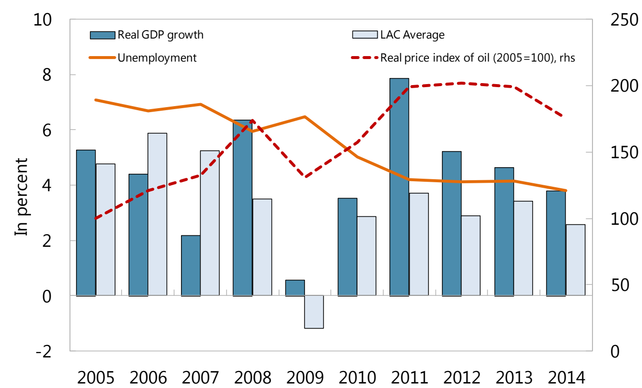
CONTEXT

1. Ecuador pursued a strategy of public sector-led growth during the oil boom, which yielded important social benefits. It was spearheaded by President Correa, since his election in 2007. His *Patria Altiva y Soberana* (PAIS) coalition holds a majority in congress; however, government poll ratings have been declining in 2015, until recently. President Correa can run in the 2017 presidential election only if the constitution is changed to allow reelection for a third term.

2. Growth averaged 4½ percent over the past decade—contributing to a solid improvement in social indicators—supported by the positive terms of trade and large public investments. Reflecting Ecuador's goals of diversifying energy production and improving infrastructure and social equity, the overall fiscal position of the non-financial public sector (NFPS) widened from a balance in 2011 to a deficit of 3½ percent of GDP in 2012–14—despite high oil prices—mainly driven by high capital spending. During the same period public debt rose about 9½ percentage points to 31.3 percent of GDP. Between 2006 and 2014, the poverty rate declined from 38 percent to 22.5 percent and the GINI coefficient from 0.54 to 0.47 in 2014, while the unemployment rate fell significantly. In 2014, the reference household income exceeded for the first time the cost of the basic consumption basket. Social convergence was in part achieved through growth in real wages in excess of productivity, which contributed to maintaining inflation at about 4 percent over the decade. Financial stability was preserved, supported by dollarization. In 2014, growth moderated to 3.8 percent, but remained higher than in the rest of the region—as in the past 7 years.

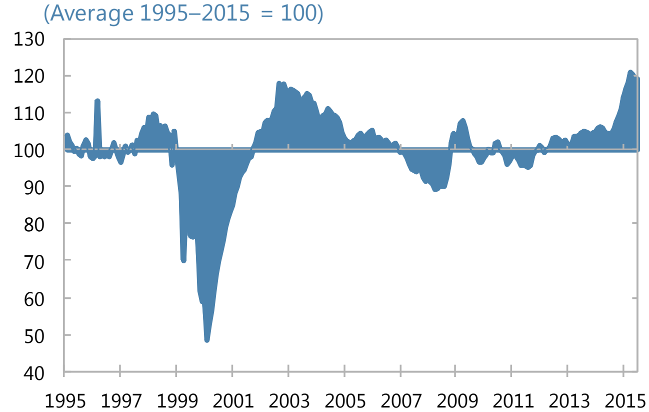
Ecuador: Oil Prices and Economic Performance



Sources: National Authorities; IMF (WEO); and Fund staff calculations.

3. Since the third quarter of 2014, the economy has suffered external shocks. The sharp decline in the international oil price (from US$97.5/barrel in 2014Q2 to below US$40/barrel in August 2015, for Ecuadorian mix) significantly undercut oil exports. The net oil balance declined by almost US$2.4 billion, yoy, for the January–June 2015 period. In addition, the real exchange rate (REER) appreciated by about 16 percent in June 2015, yoy, and there is now evidence of overvaluation (see Annex II).

Ecuador: Real Effective Exchange Rate
(Average 1995–2015 = 100)

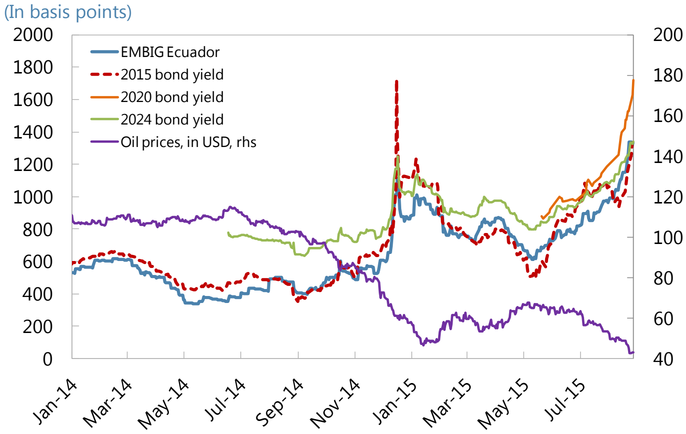


Source: IMF's International Financial Statistics.

4. The authorities responded to the shocks by implementing a strong fiscal adjustment plan, introducing balance of payment safeguards, and containing minimum wage growth. Spending was cut significantly and tax measures enacted, aiming at containing the fiscal deficit to the level envisaged in the original budget (see below). A freeze in public sector wages was announced for 2015 and the increase of the private minimum wage limited to 4.1 percent (from an average of 9 percent over the previous 7 years). On March 6, 2015, tariff surcharges were introduced on about 30 percent of imports for 15 months, which contributed to the decline in non-oil imports by 15 percent, yoy, in June, with durables and transport equipment taking the largest hit (of around 32 percent each).[1, 2]

5. Access to international credit has tightened substantially. The spread paid by the government over U.S. Treasuries rose from 530 bps in June 2014 to 900 bps in March 2015 when a US$750 million 5-year bond was issued.[3] The spread declined in May, when the bond was reopened (for another US$750 million), but has subsequently risen again, to above 1,300 at end-August. The movements in spreads broadly reflect the movements in oil prices, but are much larger than those experienced by other countries with similar oil dependence or similar spreads in the first half of 2014. In recent months, the increase in spreads is also due to concerns about natural disasters and internal debates on policy reforms. Net International Reserves (NIR) were about US$4.8 billion at end-July, around 2½ months of imports (Annex II).

Ecuador: Sovereign Yields and Country Risk
(In basis points)



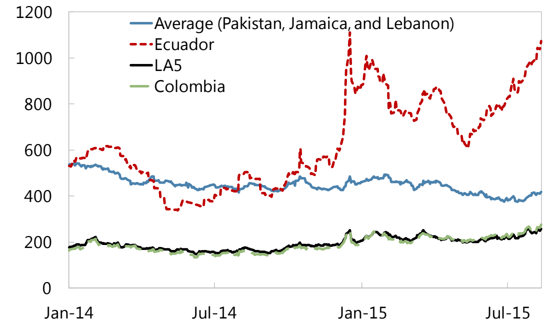
Source: Bloomberg.

[1] A 5 percent tariff on non-essential capital and primary capital goods imports, 15 percent on imports of "medium need", 25 percent on ceramics, tires, motorbikes, and electronic appliances (TVs), and 45 percent on final consumer goods were imposed, while the following goods remain exempt: raw material and capital goods, medicine and medical equipment, car parts, lubricants and fuels. A similar action was taken during the 2008–09. WTO members consulted with Ecuador on its import surcharges during a meeting of the Committee on Balance-of-Payments Restrictions in June 2015 and will resume consultations in September (see https://www.wto.org/english/news_e/news15_e/bop_29jun15_e.htm).

[2] Temporarily, in January–February 2015, Ecuador placed surcharges on imports from Colombia (21 percent on 8 percent of total imports) and Peru (7 percent on 4 percent of total imports) following the depreciation of their currencies against the dollar.

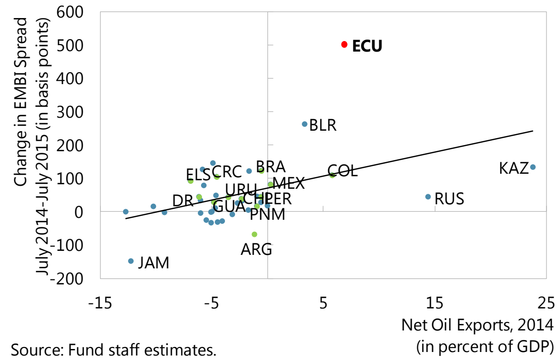
[3] A US$2 billion 10-year global bond issued in June 2014 was oversubscribed. On 19 December, 2014, Moody's upgraded Ecuador's rating to B3 from Caa1 and maintained the stable outlook, reaffirming it also in August 2015.

Selected Comparator Countries: Sovereign Spread
(In basis points)



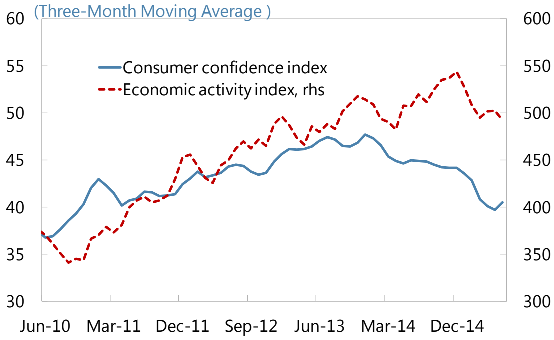
Source: Bloomberg

Changes in EMBI Spread and Oil Exports



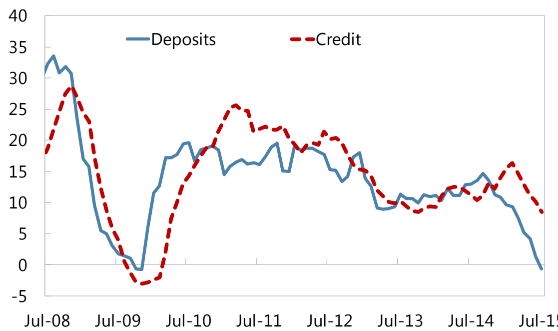
Source: Fund staff estimates.

Ecuador: Economic Activity and Consumer Confidence
(Three-Month Moving Average)



Sources: Central Bank of Ecuador and Fund staff calculations.

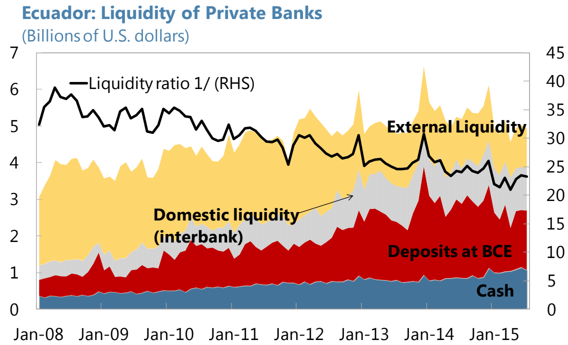
Ecuador: Deposits and Credit at Private Banks
(In percent, year-on-year change)



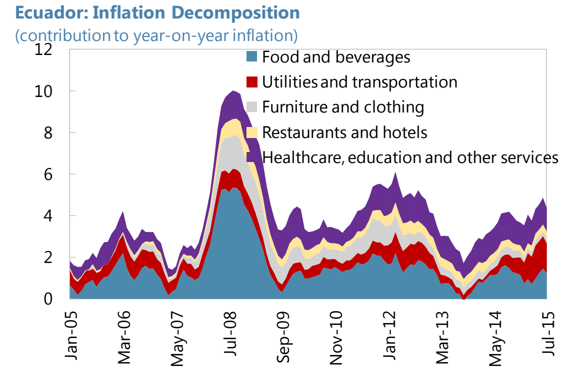
Sources: Superintendency of Banks.

6. **Economic growth is slowing and financial system's liquidity is declining.** Activity and consumer confidence declined sharply in the first half of 2015, and real GDP growth moderated to 3 percent (yoy) in Q1 2015. Inflation remains elevated, at 4.2 percent (yoy) in August 2015, reflecting changes in transport tariffs as well as in food and utilities prices. While the financial system remained well capitalized and liquid in 2014, private sector deposits declined by about US$2 billion from December 2014 to July 2015 (after growing by 11 percent in 2014), reflecting both an adjustment to the shocks and weakening confidence, and creating pockets of weaknesses in the financial system.[4] Banks' liquidity has declined (by about US$1.7 billion, by end-July), and banks have started to ration credit, which is affecting even the highest-quality customers. Over the same period, total non-performing loans have risen from 2.9 to 3.8 percent, especially in consumer, microfinance, and education loans. Nonetheless, main soundness indicators did not show signs of strain (Annex IV) and the authorities noted that the system remained sound and solvent.

[4] In part the decline is large as the December figure for deposits reflects sizable positive seasonal effects. Nonetheless, when comparing deposits in July 2015 versus a linear trend since 2008 the gap is also about US$2 billion, similar to the decline since December.



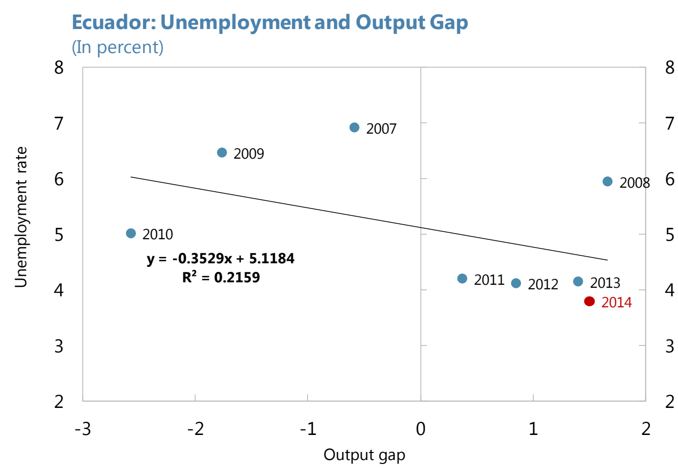
Source: Superintendency of Banks.
1/Liquid Assets to Short-Term Liabilities.



Source: Central Bank of Ecuador.

RISKS AND OUTLOOK

7. **Due to shocks and expected adjustments, the economy is projected to contract slightly in 2015, while the external position deteriorates**. Growth is expected to slow to about negative ½percent in 2015, and to remain around zero in 2016. Accordingly, unemployment is likely to edge up. Inflation is expected to stay elevated, about 3½ percent at end-2015, before moderating to about 1½ percent in the medium term. The 2015 current account deficit is projected to worsen to about 2½ percent of GDP, with a deterioration of the oil balance by about 4 percent of GDP being partly compensated by a decline in non-oil imports (following the imposition of tariff surcharges, scaled-back public investment, and consumption slowdown, which—combined—more than offset the effect of the real exchange rate appreciation).



Sources: Ecuador National Authorities and Fund staff calculations.

8. **The persistent effect of the shocks is expected to imply lower growth and a weaker financial system into the medium term.** Ecuador's medium-term potential growth has been revised down to about 3 percent, due to the effect of lower oil prices on investment and production as well as more limited scope for employment growth (Box 1). Growth is projected to remain below potential, until competitiveness is restored and the real exchange rate overvaluation eliminated. Inflation is expected to decline, after a temporary upward impact from the surcharges. The less favorable growth outlook and weaker confidence, as well as the U.S. monetary policy normalization, can be expected to put additional pressure on financial sector stability (by deteriorating the quality of bank assets and raising credit risk) and increase funding costs, thus setting the stage for unfavorable macro-financial dynamics. The authorities agreed that the adjustment is going to be difficult but considered the economy to be more resilient than in the staff's scenario. At the time of the mission, they projected growth at 1.9 percent in 2015 and 3.9 percent in 2016, driven by private consumption and investment.

9. **Moreover, risks to the outlook are tilted to the downside.** Main external risks are additional weakness in oil prices, global financial instability, persistent dollar appreciation, and weak growth of trading partners. Ecuador-specific risks center on limits to the availability of external financing, potential domestic financial system pressure associated with the economic adjustment and uncertainty about the policy response, delays in enhancing the country's energy balance, as well as possible natural disasters (including from El Niño and volcanic activity). On the upside, future oil production could be higher, especially if oil prices rise again facilitating the financing of larger investment plans.

Risk Assessment Matrix[1]

	Likelihood	*Impact*	*Policy Advice*
		Country-specific risks	
Difficulties in operating oil fields; delays in hydro projects, oil exploration, and reopening of Esmeraldas refinery	M	H (↓). Negative impact on growth, exports, fiscal accounts.	Ensure full funding and completion of hydro projects; promote private sector participation in oil exploration.
External financing shortfalls due to Ecuador-specific events	H	H (↓). Negative impact on country ratings, growth, future financing.	Take timely and appropriate spending cuts.
Erosion of confidence due to uncertainty about the policy response; pressure on the financial system	H	H (↓). Negative impact on investment and growth, as well as on deposits and capital outflows.	Clearly communicate the need for, and expected impact of, policy reforms; ensure adequate liquidity for the banking system, ease controls on interest rates, and strengthen macroprudential tools.
Potential natural disasters (eruption of the Cotopaxi volcano and/or worse-than-expected El Niño effect)	M	H (↓). Negative impact on investment, exports, and growth, as well as positive impact on inflation; negative impact on deposits.	Rationalize public spending, emphasizing priority relief and infrastructure investments; ensure adequate liquidity for the banking system; build fiscal buffers in the medium term.
		External risks	
Persistent dollar strength	H	M (↓). Pressure on the current account.	Undertake structural measures to improve productivity, competitiveness, and investment climate; facilitate wage and price adjustment.
Risks to energy prices: increased volatility/persistently low prices	M	H (↓). Pressure on fiscal and external accounts.	Rationalize public spending and build buffers; undertake structural measures to improve productivity and diversify the economy to reduce oil dependence.
Sharp asset price adjustment and decompression of credit spreads as investors respond to changes in growth prospects, Fed policy rate path, etc.	H	H (↓). External sovereign financing could shrink substantially and costs become prohibitive.	Build buffers; plan government spending contingent on financing; improve access to financing.
Structurally weak growth in key advanced economies/emerging markets/China	H/M/L	M/M/H (↓). Worsening of the current account deficit and weaker growth, especially through lower exports; lower access to financing from China.	Ensure the stability of the domestic financial sector; implement countercyclical fiscal policy if financing is available; improve access to financing.

[1] The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability between 30 and 50 percent). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly.

POLICY DISCUSSIONS

The current fiscal adjustment plan can be expected to absorb the fiscal consequences of the external shocks, but a broader strategy is called for to preserve macro and financial stability, bolster confidence, and restore competitiveness. A fiscal contingency plan should be in place to offset any financing shortfalls. The retention of adequate liquidity in the financial sector must be an over-arching objective, while financial sector regulation and supervision need to be upgraded. Regaining competitiveness and reviving growth will require further wage containment and improvements in the business environment, while policy buffers should be rebuilt as insurance against downside risks.

A. Fiscal Adjustment to External Shocks

Near-term outlook

10. The current fiscal adjustment plan should offset the fiscal impact from the oil shock in the near term, while balancing the need to contain the contractionary effect of fiscal policy. The revision to the 2015 budget (originally published in October 2014) envisages that the decline in the net oil export revenue due to the shock will be mostly offset by expenditure cuts, leaving the overall fiscal balance broadly unchanged. Capital spending is planned to be cut by about 1.8 percent of GDP compared to the original budget (mainly with postponement of new projects in infrastructure and schools), while current expenditure will be trimmed by about 1.7 percent of GDP (mostly on goods and services and social transfers).[5] Compared to 2014, however, current expenditure is expected to increase while the adjustment falls entirely on capital expenditure. In the revision to the 2015 budget, higher tax revenue (than originally anticipated) from recently introduced changes to the tax system, a tax amnesty, and the import surcharges, will be partially offset by a reduction in non-tax revenue associated with the downturn and a downward revision in the social security contribution. Indeed, tax revenue

Ecuador: The Impact of the Oil Price Shock and Fiscal Adjustment, 2015
(In percent of GDP, unless otherwise indicated)

		2015 Projections 1/		
	2014	Budget (Init.)	Budget (Rev.)	IMF
Current oil balance	**6.8**	**6.3**	**2.2**	**2.5**
Gross revenue	17.2	17.1	11.4	11.6
Exports 2/	13.2	12.7	7.1	7.3
Domestic sales	4.0	4.4	4.3	4.3
Current expenditure	10.4	10.9	9.2	9.1
o/w cost of imports of refined oil	6.3	5.8	4.9	4.9
Non-oil balance	**-12.2**	**-11.6**	**-7.4**	**-7.6**
Non-oil revenue	24.0	26.8	27.5	26.6
Taxes	14.4	15.6	16.9	16.4
Non-taxes	9.6	11.1	10.5	10.2
Capital expenditure	15.3	15.0	13.2	12.4
Non-oil current expenditure	20.9	23.3	21.7	21.7
Overall balances	**-5.4**	**-5.3**	**-5.1**	**-5.1**
Memo items:				
Exports of oil (millions of barrels)	157	160	160	160
Oil price assumption (US$/barrel)	84.0	79.7	45.2	45.1
Net oil export revenue	6.8	6.9	2.3	2.4
GDP (US$ millions)	100,543	…	…	98,925

Sources: Ministry of Finance and Fund staff projections.
1/ In percent of GDP pojected by IMF. The initial budget, approved in October 2014, was revised in August 2015.
2/ Estimated from the BOP export revenues. The actual fiscal revenues may differ slightly from these amounts due to differences in recording time between the BOP and Fiscal accounts.

Ecuador: Non-Financial Public Sector Financing
(In percent of GDP)

		2015		
	2014	Disbursed	Expected	Total
Gross financing needs	**10.3**	**…**	**…**	**10.3**
Deficit	5.4	…	…	5.1
Amortization 1/	4.9	…	…	5.2
Identified financing	**10.3**	**5.6**	**4.7**	**10.3**
External	8.0	5.6	3.7	9.2
Multilaterals	1.5	1.3	0.4	1.7
Bilateral 1/	2.8	2.5	2.8	5.3
Private	3.7	1.7	0.4	2.2
Domestic 2/	1.4	0.0	1.5	1.5
Accounts payable	1.0	0.0	-0.5	-0.5

Source: Ministry of Finance.
1/ Includes financing through advance sales of oil.
2/ Domestic financing includes change in government deposits.

[5] Central government budgetary cuts of about 2¼ percent of GDP were announced in January and August 2015; the remaining cuts relate to the budget of state-owned enterprises.

collection in the first half of the year was better than anticipated. The authorities have for now withdrawn recent proposals to increase inheritance and real estate capital gains taxes, given strong public opposition. Staff projections are similar to the revised budget, with some differences in non-oil revenues—mainly reflecting differences in GDP growth assumptions—and capital spending.

11. Despite the fiscal adjustment, financing needs remain large and heavily dependent on external borrowing. Including the expected amortizations of US$650 million of the 2015 global bond and about US$1.7 billion of advance oil sales, total amortization will reach about US$5.1 billion (5.2 percent of GDP). Gross financing needs will be about 10.3 percent of GDP in 2015, of which 5.6 percent of GDP was secured in the first half of the year. Full execution of the budget will depend especially on the remaining external financing plans (about 3.7 percent of GDP), of which about 1 percent of GDP is fully committed so far from China, CAF and IDB.

12. Any shortfall in financing or a significant deterioration in market access will have to be addressed through further spending retrenchments. The need to preserve full backing for dollarization and assure private sector confidence in the monetary regime implies that central bank financing and government arrears will have to be avoided. Staff underscored that a fiscal contingency plan should be in place to address potential financing shortfalls through further cuts of lower-priority capital or current spending—while preserving high-priority ongoing hydroelectric and infrastructure projects—thus avoiding a liquidity decline in the financial system or delays in payments. Moreover, the authorities will need to make every effort to improve market access and lower spreads—also in light of the impending increase in U.S. interest rates—as well as deter capital outflows, particularly by strengthening private sector confidence in growth and policy prospects.

13. The authorities are confident that the expected financing will be secured and the revised budget will be fully executed. They agreed that financing shortfalls will need to be matched by cuts in lower-priority capital projects. They reiterated that financing from the central bank was done on a short-term basis to give the budget execution some flexibility while awaiting external disbursements, and will be discontinued by end-year.

14. The 2016 draft budget, which is not finalized yet, envisages further fiscal consolidations with the overall deficit declining to 3.7 percent of GDP. Oil revenue is expected to decline further based on an oil price assumption of US$40/barrel. However, this would be more than offset by corresponding expenditure retrenchments, with an improvement in the overall balance of about 1½ percent of GDP.

Medium-Term Fiscal Challenges

15. The authorities plan to reduce the fiscal deficit to 0.5 percent of GDP by 2018. In the medium term, the authorities plan to anchor the public sector wage bill to inflation and to contain growth in spending on goods and services and social transfers below GDP growth. They view the ongoing investment in hydroelectricity at the core of their plan to rationalize fuel subsidies—through, notably, switching from gas to electricity for domestic cooking, with annual savings of about US$0.9 billion starting in 2017 when the process is completed. At the same time, they plan to invest about US$4.3 billion over the medium term to develop the Ishpingo-Tambococha-Tiputini (ITT) oil fields and increase oil production by about 52 million barrels a year by 2020 from the current level of about 200 million. The public oil company, Petroamazonas, is expected to undertake the investment in cooperation with private sector service providers, with financing from international banks covered by sovereign guarantees.

16. Reflecting more cautious assumptions about oil investment, staff's baseline scenario envisages progressive fiscal consolidation to reach a deficit of about ½ percent of GDP in 2020. At current oil prices and given Petroamazonas' limited financial and technical capabilities, the scenario assumes an increase in oil investment sufficient to ensure that new production offsets declining production from ageing fields, so that oil production remains flat. Under staff's baseline scenario, gross public debt excluding advance oil sales, which is the official definition, reaches the legal limit of 40 percent of GDP in 2018 before declining to 39 percent of GDP in 2020, leaving virtually no space for countercyclical policy in the face of potential shocks.[6] The medium-term primary surplus of about 2.3 percent of GDP—to be reached progressively by 2020—is consistent with debt sustainability, and the medium-term non-oil primary deficit of about 0.7 percent of GDP is consistent with the long-term Fiscal Sustainability Framework (Annex III). Given the high financing needs and rapid accumulation of public debt, the envisaged fiscal adjustment will be required. If market conditions remain adverse and financing shortfalls materialize over the medium term, fiscal adjustment will need to become more front-loaded and rely not only on additional investment cuts, but also on a more comprehensive expenditure rationalization.

17. It will be important to rebuild fiscal buffers once the fiscal position strengthens and financing conditions improve. The recent external shocks have underscored the need to be able to mobilize timely financing, highlighting the importance of fiscal buffers in the form, for example, of stabilization funds to cope with downside risks (including natural disasters like those potentially arising from the *Cotopaxi* and *el Niño*). Also, to enhance transparency of public asset and liability positions, it would be valuable to publish detailed information on advance oil sales, delayed payments of the *Secretaría de Hidrocarburos*, debt issued to the BCE, short-term debt, and contingent liabilities.

18. Staff advised additional complementary fiscal measures going forward. These include:

- *Maintaining this year's freeze on public sector wage rates into the medium term.* This would also help to restore competitiveness, given the effect on private sector wage determination in an integrated labor market (more on this below); any alternative measure of fiscal consolidation could also contribute to the needed relative price adjustment.

[6] Staff's definition of gross public debt, which includes advance oil sales, peaks at about 41 percent of GDP in 2017 before declining to about 39½ percent of GDP by 2020 (Annex III).

- *In line with the authorities' intentions, overhauling the fuel subsidy system*, not only through ongoing projects to enhance hydro energy, but also through better targeting subsidies to the poor and allowing domestic fuel prices to reflect international conditions.

- *Improving tax collection,* through further enhancing administrative efficiency and enforcement (closing tax loopholes and addressing tax evasion), while reducing tax expenditures and deductions from personal income tax. Tax amnesties should be avoided, given their effect on expectations of further amnesties.

- *Start addressing the expected shortfall in the pension system*—which is expected to contribute negatively to the budget in the 2030s—by gradually increasing retirement age and anchoring pension benefits to lifetime contributions, while increasing efforts to reduce labor market informality.

- *Developing communication on the medium-term fiscal framework and strategy.* Timely announcements on revisions to medium-term plans will be instrumental to enhancing confidence.

19. The authorities broadly agreed with staff suggestions—and indicated they are already undertaking some of the mentioned reforms—but underscored the need to balance political sensitivities in pursuing these objectives. They indicated that their current plans to anchor public sector wage growth to inflation, together with productivity gains arising from the improvement in human capital, infrastructure, the energy balance, and the interaction with the private sector are sufficient to address competitiveness issues (more below). The authorities' plans for fuel subsidy rationalization envisage inducing consumers to switch from gas to electricity for domestic cooking. While highlighting their past advances, the authorities agreed that additional efforts are needed to improve the efficiency of tax collection. They clarified that they have no intention of repeating the tax amnesty. Finally, the authorities continue to believe that public savings should be deployed towards high-return projects related to the economic and social development of Ecuador rather than set aside in low-return fiscal funds.

B. Ensuring Financial Stability and System Liquidity

20. For a dollarized economy, preservation of liquidity at the central bank (BCE) and private banks must always take priority. This is especially important now, to limit systemic effects on the financial system from the recent shocks and subsequent slowdown, deterioration in confidence, and possible vicious cycle through macro-financial linkages (see Annex IV). The authorities should continue their frequent monitoring of liquidity—and if pressures persist, promptly adjust reserve requirements at the BCE. Current policies that affect liquidity need to be reversed:

- *The BCE has been providing direct financing to the government since October 2014*. Even if temporary, this raises concerns about ensuring central bank liquidity, in light of uncertainty of external disbursements, as well as about monetization of public spending. The authorities' plan to discontinue such financing within a few months is highly welcome.[7]

- *The BCE has also been providing credit to public corporations.* Such credit—about US$1.8 billion in July 2015—affects the BCE balance sheet. Its provision should therefore be closely linked to conservative scenarios of potential liquidity needs for the BCE, to ensure that BCE obligations with both banks and the public sector can be fulfilled on demand. The authorities explained that they carefully program the liquidity position of the BCE on a quarterly basis to ensure adequate liquidity.

- *A countercyclical measure announced in March 2015 envisages the provision of directed mortgage lending through private banks.* This requires banks to extend credit at a time when they need to maintain liquidity and contain credit growth in order to cope with the ongoing deposit withdrawal. Moreover, the associated mortgage securitization scheme backed by the BCE could also create liquidity pressure for the BCE itself (and contingent liabilities to the government), given default risks. The authorities stated that the liquidity levels and credit growth of the financial system are being carefully monitored and assessed quarterly, and any undue pressure on the system would lead to adjusting the lending targets.

- *The long-standing domestic liquidity requirements on banks were tightened further in 2012.* These affect the quality of banks' liquidity: coupled with the 3 percent tax on banks' external liquid assets, they force banks to hold substantial liquidity domestically, either at the central bank (which can be then lent to public banks) or in domestic debt instruments (for which there is not an active secondary market), thus impairing banks' optimal liquidity management (by limiting how liquid, diversifiable, and safe is the liquidity portfolio), especially for small banks.

21. The public's concerns about the proliferation of possible alternative money arrangements need to be dispelled. In particular, it would be important to allay any fears of monetization of public spending.

- *The electronic money system introduced by the BCE in December 2014 is backed by liquid assets (activos liquidos).* However, to maintain credibility, accounts should be explicitly backed by international highly-rated dollar-denominated liquid assets, and the authorities are planning to issue a regulation clarifying that this is indeed the intention. The funds fully remain the property of the account holder and there is no co-mingling of accounts, but they are fungible for the purpose of NIR management. The participation in such a scheme should remain voluntary, as originally planned. The authorities see this scheme as a way to reduce currency in circulation, as wear and tear of the bills implies a replacement cost for the BCE (about US$3 million per year),

[7] Financing averaged US$0.8 billion (0.8 percent of GDP) between October 2014 and July 2015, out of which US$0.4 billion related to central government bonds (5 year maturity) purchased from the National Finance Corporation (CFN), and the rest to short-term bills.

and argue that carrying the funds on the BCE balance sheet (rather than as an escrow account) bodes well for transparency.

- *A recent resolution authorizes the government to pay for services with BCE securities, and taxpayers may use such securities for tax amnesty payments.* This should be discontinued once the tax amnesty expires and issuance of bonds should be capped at the current legal limit of US$50 million. The authorities indicated that this scheme is very effective and functions purely as a clearing house between the government and the private sector, since these securities can only be used for tax payment purposes and cannot be traded or transferred.

22. Crisis management arrangements should be improved.

- *The speed and confidentiality of access to the Liquidity Fund should be explicitly outlined in financial regulations in order to enhance confidence.*[8] Also, the authorities should clarify that the assets of the Liquidity Fund, set up with the contributions of banks to provide liquidity at the time of pressure, will continue to be invested only in highly rated international securities, as is the case at present, dispelling public concerns resulting from overlapping regulations on the matter. The authorities stated that they were reviewing regulations for consistency and would clarify any confusing points if necessary.

- *The deposit insurance fund is overexposed to public debt and other domestic assets for which there is not an active secondary market.* Best international practices suggest investing these funds in high quality securities, to ensure their liquidity and safety. Staff also advised against the cross-borrowing arrangements between the two deposit insurance funds (for private banks and cooperatives). The authorities aim to achieve a well diversified and liquid portfolio gradually, while at the same time their intention has always been to invest the deposit insurance funds in productive domestic assets rather than in low-yielding liquid securities abroad. They also do not see any liquidity pressures arising from selling the assets when paying out depositors, given the gradual timeframe associated with bank resolution.

23. Reducing administrative controls on banks would enhance financial efficiency and stability.

The caps on lending interest rates distort banks' business decisions and risk assessments, and price some customers out of the market. Gradually lifting these caps would allow banks some margin to increase deposit rates in the context both of declining deposits and the expected U.S. monetary policy normalization. To mitigate any risks associated with the liberalization of interest rates, the authorities should consider introducing risk management tools such as tailoring concentration limits, adjusting sectoral risk weighted capital requirements, and monitoring loan-to-value ratios and credit gaps. The authorities are concerned about the adverse selection bias

[8] As of June 2015, fund's assets constituted US$2.3 billion, or 8 percent of banks' deposits, in line with the requirement.

as the system is historically highly concentrated, but are open to learning in greater detail about possible policy tools that could mitigate this concern.

- *An unlevel playing field in the mortgage market distorts competition.* The authorities should assess the implications of the special advantage of the bank of the pension fund (BIESS) in providing extensive mortgage lending (US$7 billion), in terms of cheaper access to credit and unique ability to collateralize payments with salaries.

24. Efforts to enhance broader financial sector supervision and regulation need to continue, together with strengthening the anti-money laundering and combating the financing of terrorism (AML/CFT) framework. Over the past several years, the authorities have taken steps to strengthen the financial system and safeguard liquidity. Since the 2004 FSAP, the Superintendency of Banks (SBS) implemented intense training programs for supervisors. Progress has been made in complying with Basel criteria, improving supervision of off-shore banks, and eliminating regulatory forbearance on bank loan classification. The authorities expressed interest in enhancing their stress-testing toolkit and more broadly on monitoring systemic risk, including through network analysis. Over the medium-term, the frameworks focusing on creditor rights, bank liquidation procedures, indebtedness assessments, and collateral resolution should be strengthened. Making sure that new regulations regarding the credit bureau continue to meet best international practice would also be essential to improve risk assessment and financial sector efficiency. Staff strongly suggested undertaking a new FSAP, and the authorities are currently reviewing the 2004 FSAP's conclusions to determine the necessity of a new one. Although significant progress has been made to improve the AML/CFT framework, continued political commitment and sustained implementation of AML/CFT measures are needed to exit the Financial Action Task Force monitoring, so as to safeguard financial stability from reputational risks.

C. Restoring Competitiveness and Promoting Private Sector Participation

25. Significant efforts to regain competitiveness are crucial to preserve external balance and dollarization, and to sustain healthy medium-term growth. While the country's external position was assessed to be broadly consistent with the medium-term outlook as of 2014, the steep fall in oil prices and the REER appreciation will require not only a significant improvement in the fiscal position but also a substantial real wage and price adjustment to reverse overvaluation, while achieving an improvement in access to market financing (Annex II). To safeguard external balance, the authorities have applied various measures over the past several years, such as a tax on transfers abroad (5 percent) since 2007,[9] a tax on liquid assets held abroad by financial institutions since 2008, and quality controls on imports since 2013. In 2015, import surcharges have been imposed.

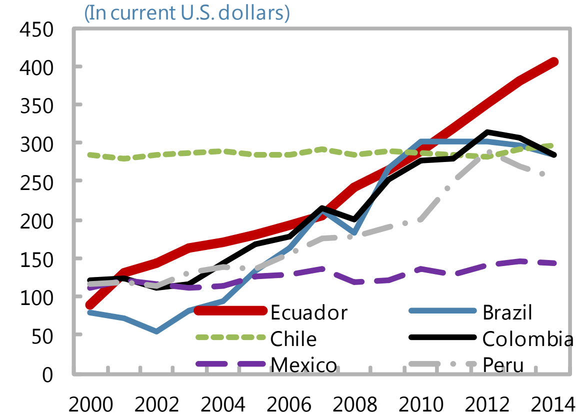
26. Staff underscored that the recent import surcharges should be removed as soon as possible, and within the announced timeframe, given the distortionary nature of such

[9] This measure gives rise to an unapproved exchange restriction under Article VIII, Section 2(a).

measures. The authorities stated that they are committed to a gradual elimination of the surcharges as well as to continuing the consultation with the WTO Balance of Payment Committee. They also indicated that the cuts in investment spending planned for the medium term fall heavily on imports, which would help cushion the impact of the elimination of the tariffs. Staff reiterated also the need to gradually dismantle the tax on transfers, as conditions permit, along with a gradual lifting of caps on lending interest rates. The authorities see this tax as a successful tool to prevent short-term capital outflows that create financial instability. In order to facilitate long-term capital inflows, they recently decided to eliminate the tax on transfers associated with bank loans of more than one year for lending to the sectors specified in the Production code (e.g. housing and micro lending). Staff recommended that such exemption be extended to all transfers associated with long-term inflows, and to eliminate the discretion of the Monetary and Financial Policy Board on the terms and conditions for qualifying long-term inflows, while improving financial regulation and supervision.[10]

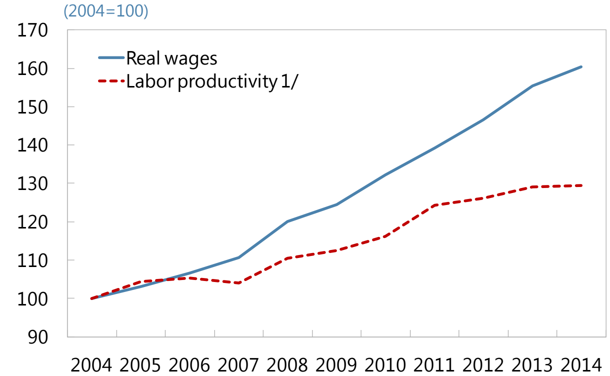
27. To regain competitiveness, substantial real wage and price adjustments are called for. The loss in competitiveness will be felt in full upon the removal of import surcharges. As real wages have increased faster than labor productivity over the past decade and the minimum wage is one of the highest in the region, restoring competitiveness in the face of the recent real exchange rate appreciation will require containing wage growth substantially below inflation for a few years. Hence the correction in wage dynamics needs to go beyond the authorities' current plan envisaging public wages to rise with inflation and private wages to rise with inflation plus productivity. The wage adjustment should also be complemented with gains in productivity and improvements in the business environment.

Ecuador and LA-5: Minimum Wage (2000-2014)
(In current U.S. dollars)



Source: Haver Analytics.

Ecuador: Labor Productivity and Real Wages 1/
(2004=100)



Source: Haver Analytics.
1/ Labor productivity refers to output per employed person.

28. The authorities have taken important steps to promote private sector participation and improve prospects for medium-term growth. They are of the opinion that the substantial reforms of the past few years aimed at improving infrastructure, human capital, and the

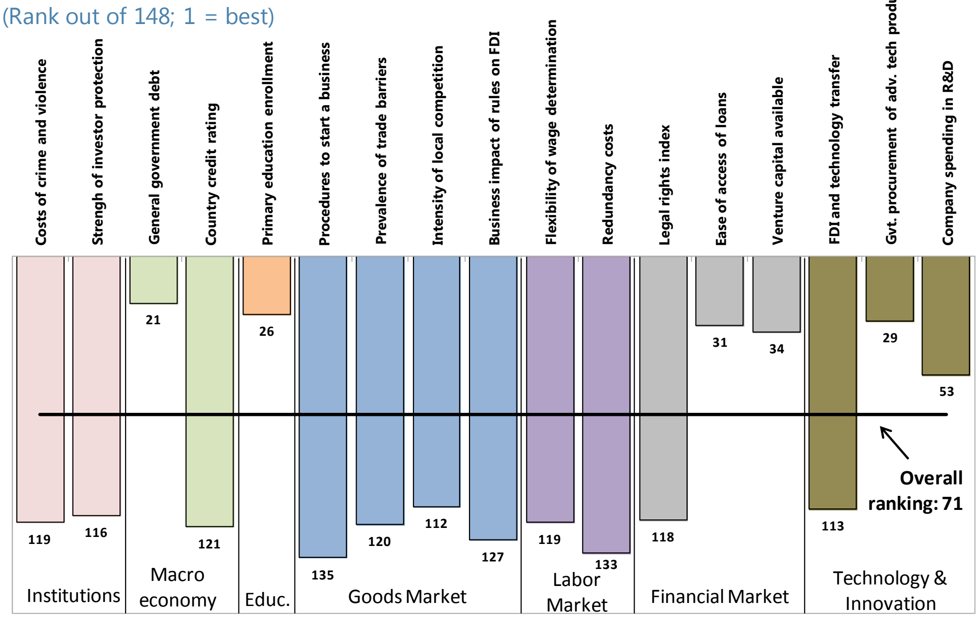
[10] Private sector flows in the balance of payments reflect also transactions between the domestic public and private sector affecting BCE reserves (based on Ecuador compiling practices, given dollarization) which do not necessarily mean inflows/outflows.

energy balance will have persistent effects on enhancing productivity and competitiveness. In addition, recent efforts have been devoted to promoting private sector investment in agriculture, industry, and social services (with an expected impact of about US$10 billion over the next decade), including through private-public partnerships, a reduced corporate tax rate for companies investing within the productive matrix, and a tax refund for exporters on imported intermediate inputs. In their view, such productivity gains, coupled with the new wage determination strategy, will be sufficient to regain competitiveness over the medium term.

29. Broader efforts towards improving the business environment via structural reforms would greatly contribute to the restoration of competitiveness and promote the development of a well-functioning non-oil economy. International surveys cite shortcomings in the functioning of institutions, and of goods, labor, and financial markets (mainly because of insufficient competition). Thus, a wide-ranging structural reform agenda should be adopted to foster productivity, crowd-in the private sector, and attract FDI. For example, labor market rigidities should be addressed through reducing the overall cost of dismissal, promoting the availability of short-term employment contracts, and facilitating labor force participation (for example by expanding child care access). Frequent changes in the tax and regulatory systems need to be limited as they increased business uncertainty. Promoting greater trade integration, including via the finalization of the Free Trade Area with the European Union, will greatly help exporters to compete in international markets.

Ecuador: Global Competitiveness Indicators, 2014

(Rank out of 148; 1 = best)



Source: World Economic Forum. Note: Categories listed are those in which Ecuador ranks in the top or bottom quartile of world distribution. Some categories were omitted due to space constrains, namely: (1) Organized crime [129]; (2) Costs of terrorism [122]; (3) Degree of customer orientation [115]; (4) Country capacity to attract talent [35]; (5) Days to start a business [130]; and (6) GG budget balance [35].

STAFF APPRAISAL

30. After a decade of growth averaging 4½ percent, supported by favorable terms of trade and large public investments, the economy is expected to contract in 2015 and growth to remain around zero in 2016. Since the third quarter of 2014, a sharp oil price drop and sizable REER appreciation affected growth and the external balance. Constrained by limited policy buffers and options, the authorities moved rapidly to announce a large fiscal adjustment to keep the deficit at the budgeted level. However, some external financing remains to be committed, while market access has become more expensive. Despite the recently imposed tariff surcharges, the current account deficit is expected to increase to about 2½ percent in 2015, while the loss of competitiveness is clouding the outlook for growth and external balance.

31. Risks are tilted to the downside. Main external risks are additional softness in oil prices which would threaten the external and fiscal positions, global financial instability which would affect access to external financing, and persistent dollar appreciation which would further erode competiveness. Domestic risks center on the availability of external financing and absence of buffers, delays in expanding energy production, natural disasters, as well as further pressure on the financial sector due to the economic and financial adjustment, existing distortions, and uncertainties about the policy response.

32. The authorities' initial fiscal policy response to the shocks is expected to offset the fiscal implications of the external shocks, but full financing of the remaining fiscal gap is yet to be secured. The planned expenditure cuts, together with tax measures, should broadly offset the impacts of revenue shortfalls and contain the fiscal deficit within the budget level. However, the final fiscal outcome will depend on the availability of financing and a fiscal contingency plan should be in place for additional measures if needed. Financing shortfalls should be dealt with further cuts in non-priority expenditure, while short-term financing by the central bank or arrears should be avoided in the future. The import surcharges are distortionary and should be removed as soon as possible and within the announced timeline. The adjustment to the minimum wage policy and new plans to promote private sector investments—jointly with further efforts towards enhancement in human capital and infrastructure—are welcome steps, although not sufficient to handle competitiveness concerns.

33. In the near term, challenges will also center on securing adequate liquidity in the financial sector, while improving financial sector regulation. Preserving financial stability will require that the financial system remains liquid and well supervised, with financial buffers invested in highly rated securities abroad. Improving the clarity of financial regulation, stregthening crisis management and supervision are key for ensuring stability and rapid response. If pressure on the system persists, relaxing banks' reserve requirements should be considered. Regulatory restrictions on bank activities, especially the interest rate caps and penalties on investing aboad should be lifted, and the practice of directed lending should be discontinued to allow banks to optimize thier portfolio allocation and appropriately assess risk. The system of electronic money will need to be fully backed by dollars to dispell any public preoccupation with the arrangement. The tax on transfers should be eliminated for all transactions associated with long-term inflows—as has been recently announced for such inflows when lent to specific sectors—in order to stimulate capital inflows.

34. Looking forward, it will be essential to restore competitiveness, improve the fiscal position, and enhance the business environment. Restoring competitiveness is essential to safeguard external balance and sustain healthy medium-term growth—which in turn will help preserve dollarization and financial stability. In this respect, it will be key to achieve a real wage adjustment by containing wage growth substantially below inflation for a few years, and address labor market rigidities through reducing the overall cost of employment. More broadly, reforms should be targeted at improving productivity, crowding-in the private sector, attracting FDI, and promoting trade integration. Medium-term fiscal consolidation should rely not only on spending cuts, but also on improving tax collection, overhauling the fuel subsidy system (while preserving subsidies to the poor), and adjusting the pension system, reforms which would help build fiscal buffers. Frequent changes in the tax regime and further tax amnesties should be avoided.

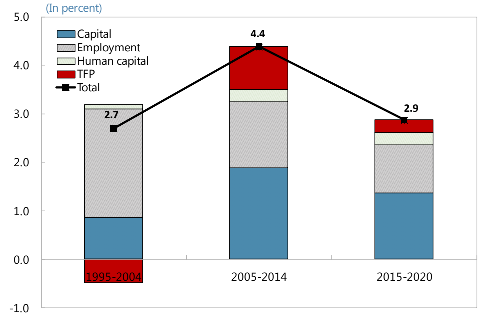
35. It is expected that the next Article IV consultation will take place on the standard 12-month cycle.

Box 1. Ecuador: Revisiting Medium-Term Potential Output Growth[1]

Potential medium-term output growth has been revised down by 1½ percentage points to about 3 percent in light of the drop in the international oil prices, the associated expected decline in public investment, as well as a more limited scope for employment growth (which was associated with a large decline in unemployment in recent years). The analysis is based on a growth accounting exercise, corroborated with an empirical relationship between the price of oil and growth.

Economic activity in oil-dependent economies relies heavily on developments in the oil price. Positive commodity price shocks raise expected real income, boosting private sector confidence and investment. Moreover, in countries where the commodity sector is under the government control, such as in Ecuador, the positive price shock raises government revenue, allowing governments to invest in infrastructure and human capital. In Ecuador, public investment was raised from about 4 percent of GDP in mid-2000s to about 15 percent of GDP in recent years. As a result, the price of oil is positively correlated with capital formation and economic growth. A simple empirical estimation of just the long-run relationship between the real price of oil and economic growth shows that a 40 percent decline in the price of oil, from about US$100/barrel a year earlier to about US$60/barrel in the medium term, could lead to a decline in the growth rate of GDP by about ½ to 1½ percentage points.[2]

Ecuador: Contributions to Growth
(In percent)



A more detailed growth accounting exercise using capital accumulation assumed in the baseline scenario, employment projection based on Okun's law, and an empirical relationship between TFP and the real price of oil suggests that potential growth could decline by about 1½ percentage points with respect to the average growth over the past decade (see chart).

In this calculation, the effect of the decline in oil prices on investment is estimated to reduce the growth contribution of capital from 1.9 percentage points (ppts) over the past decade to about 1.4ppts in the medium term. Similarly, the contribution of labor to growth is estimated to fall from 1.4ppts in the past decade to about 1ppt in the medium term due to a slowdown in employment growth (given the more limited scope for a further reduction in unemployment from an already low level), while the contribution of human capital is assumed to remain the same. Growth of TFP is expected to slowdown from 0.9 ppts in the past decade to about 0.3ppts in the medium term, reflecting the impacts of terms of trade deterioration (based on an econometric estimate of the impact of the oil price decline on TFP growth for Ecuador).

[1] Prepared by M. Tashu (WHD).

[2] The estimated long-run semi-elasticity of growth to the real price of oil is about 2, implying that a 40 percent decline in the price of oil (equivalent to a 0.5 units decline in natural log terms) entails a one percentage point decline in growth, with a confidence interval of about 1 percentage point.

Box 2. Ecuador: Recent Proposals and Tax Reforms[1]

The government has recently introduced two tax reforms with the aim of improving tax control and increasing revenue. First, in December 2014 the National Assembly enacted the "Organic Law to Promote Production and to Prevent Tax Fraud" (*Ley Orgánica de Incentivos a la Producción y Prevención del Fraude Fiscal*) introducing changes to the corporate income tax (CIT) and excise laws and regulating the tax stability contracts. Second, a Tax Amnesty Law (*Ley Orgánica de Remisión de Intereses, Multas y Recargos*) took effect in May 2015. The government plans to raise about US$0.5 billion from each measure in 2015.

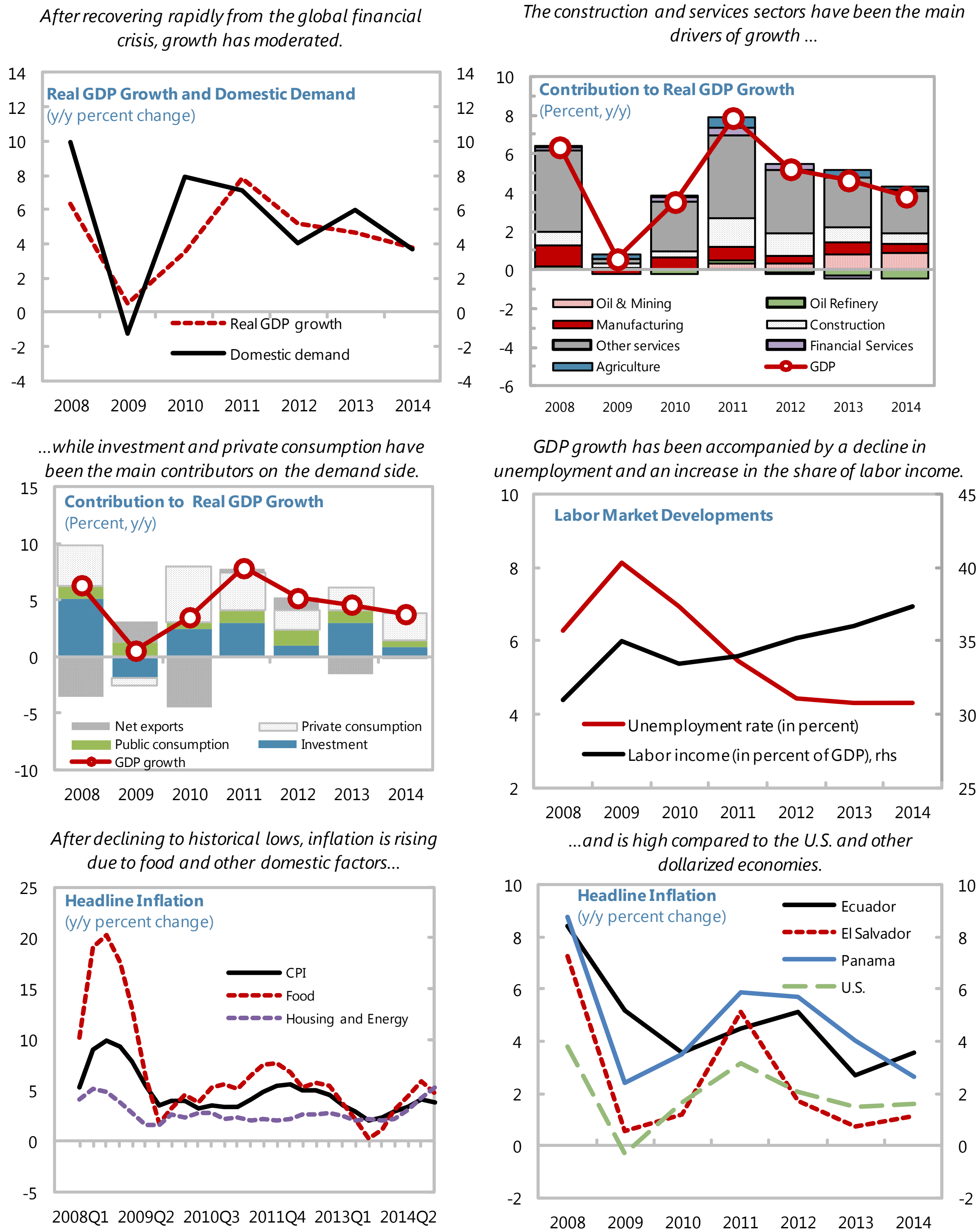
Main changes to the Tax Code and the CIT law focus on improving tax control and reducing avoidance. They include: (i) introducing in the CIT base income derived from the sale of shares or any other instruments that represent the capital of a company or a permanent establishment in Ecuador, (ii) increasing the CIT rate from 22 to 25 percent for Ecuadorian company whose owners are residents of tax havens and own more than 50 percent of the company, (iii) exempting companies for a period of 10 years for profits related to "new" and productive investments, (iv) phasing-out the exemption for interest income, unless paid by banks, (v) eliminating the deduction of expenses on junk food advertisements, (vi) introducing anti-avoidance rules (accounting and bookkeeping rules), and (vii) introducing a 35 percent withholding tax on payments to tax heaven residents. An additional measure includes increasing the excise rates on cigarettes and alcoholic beverages. Staff cautions against exempting companies for long periods.

The Tax Amnesty Law grants total relief of interest, penalties, and surcharges provided that full payment of the tax debt is made within 60 working days after May 5. The relief is reduced to 50 percent, if the full payment of the tax is made between 61 to 90 working days. Staff view is that tax amnesties are unfair for taxpayers with good compliance and weaken future compliance by raising expectations of future tax relief. Moreover, the Internal Revenue Service needs to divert resources to administer amnesties that could have been used for audits and other essential functions.

In addition, in June 2015, the government submitted two draft laws to the National Assembly to modify the inheritance tax and introduce a capital gain tax on immovable property sales. The main changes on the inheritance tax system include reducing the exempt threshold from US$77,000 to US$35,400, and significantly increasing the tax rates, placing the top marginal rates at 77.5 percent, among the highest in the world. The proposal for the tax on capital gains envisaged establishing a base as the difference between the value of the transfer and the original property cost value adjusted for inflation, and a rate of 75 percent on this base for sales' profits over the exemption threshold of US$8,500. The government withdrew these proposals shortly after due to public opposition.

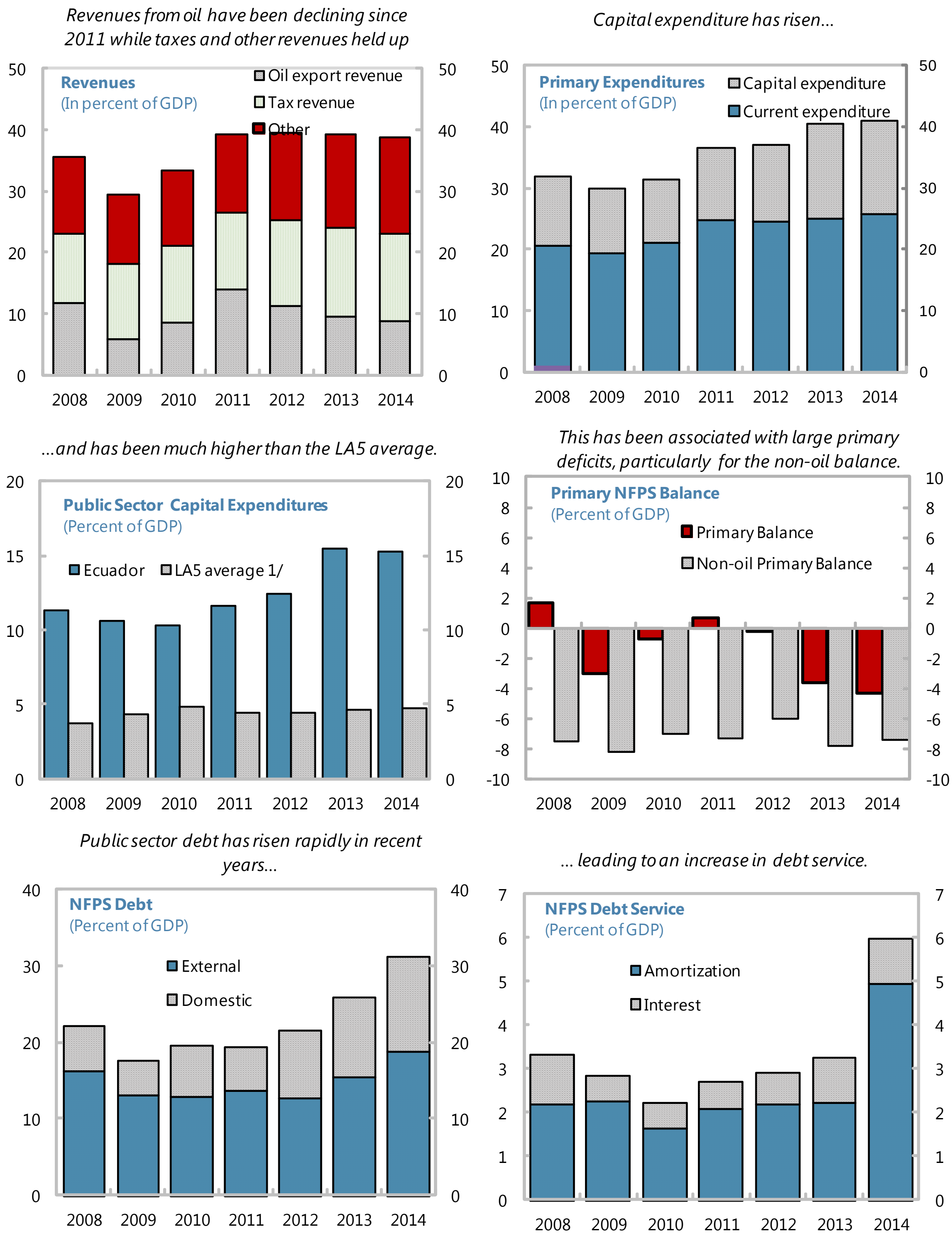
[1] Prepared by R. Fenochietto (FAD).

Figure 1. Ecuador: Real Sector Developments, 2008–14



Sources: Central Bank of Ecuador; National Statistical Institute of Ecuador (INEC); World Economic Outlook Database; and Fund staff calculations.

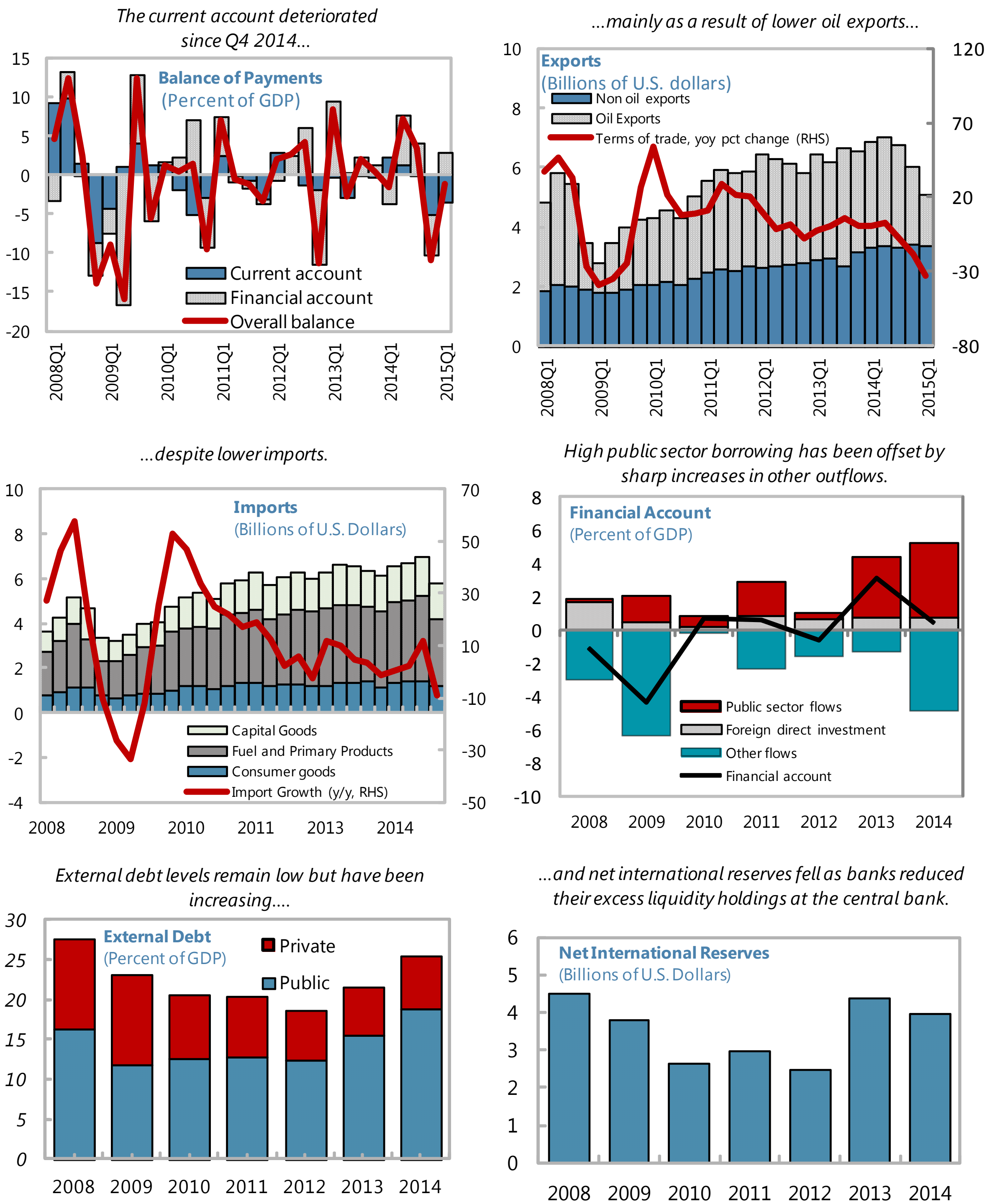
Figure 2. Ecuador: Fiscal Sector Developments, 2008–14



Sources: Haver Analytics; Ministry of Economy and Finance; and Fund staff calculations.

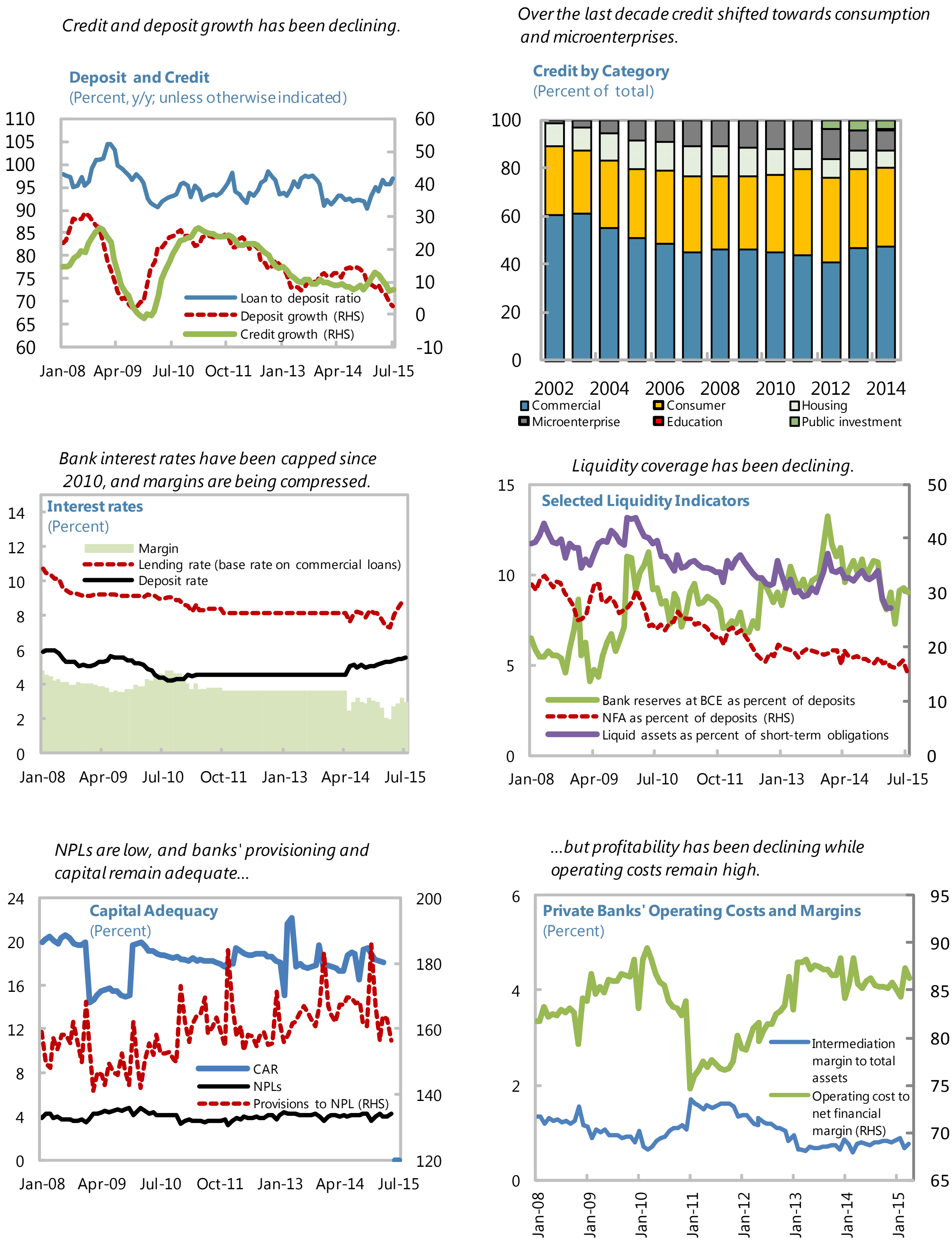
1/ LA5 stands for the five largest market economies in Latin America including Brazil, Chile, Colombia, Mexico and Peru.

Figure 3. Ecuador: External Sector Developments, 2008–15



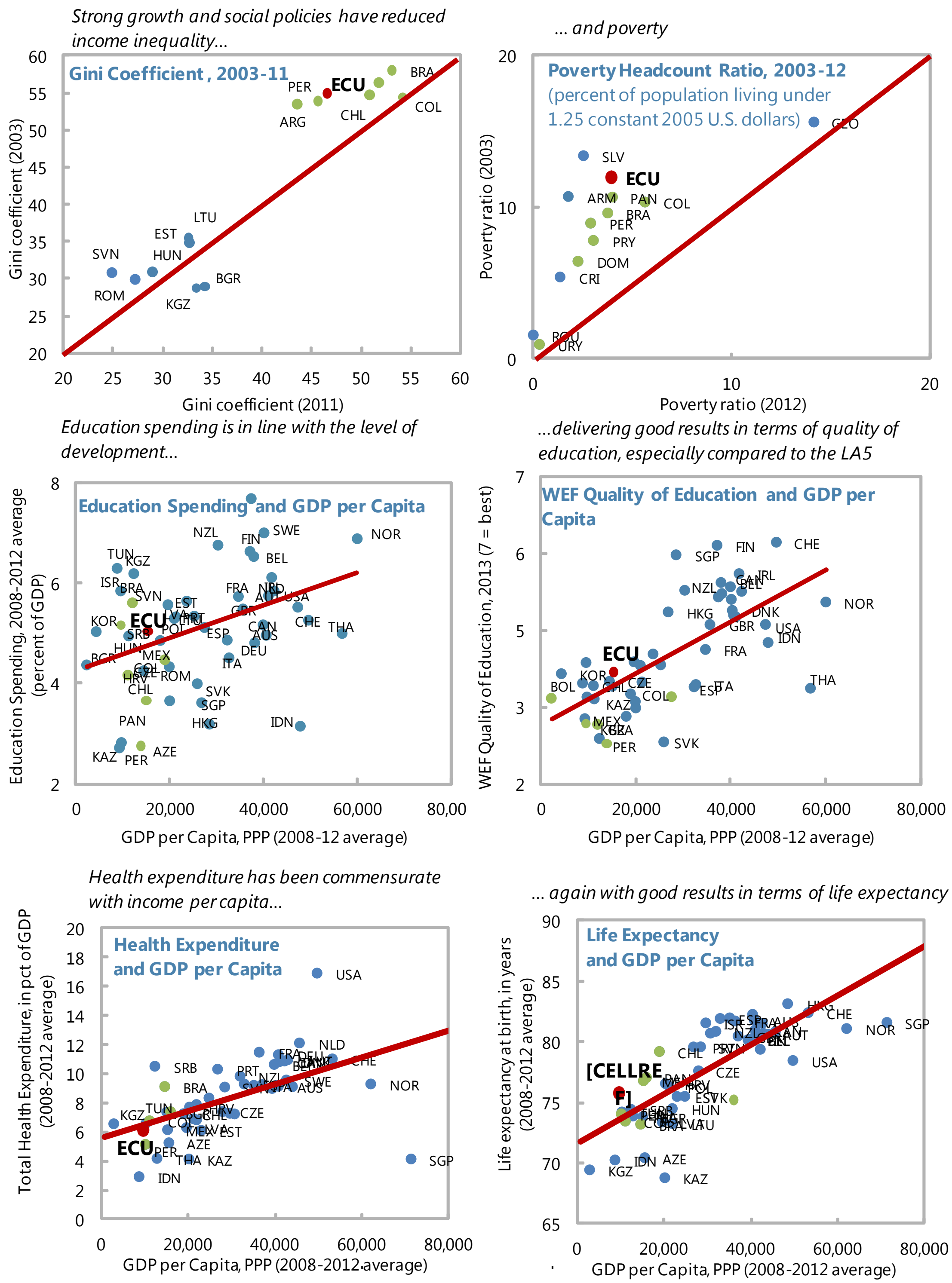
Sources: Central Bank of Ecuador; and Fund staff calculations.

Figure 4. Ecuador: Selected Banking and Financial System, 2002–15



Sources: Central Bank of Ecuador; Superintendency of Banks; and Fund staff calculations.

Figure 5. Ecuador: Social and Structural Indicators, 2003–14 1/



Sources: National Authorities; World Development Indicators; Global Competitiveness Report and IMF staff estimates and calculations.

1/ Green dots correspond to LAC countries.

Table 1. Ecuador: Selected Economic and Financial Indicators

								Proj.					
	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Social Indicators													
Life expectancy at birth (years)	75.2	75.4	75.6	75.9	76.2	76.5	...	...	...	...	...	...	...
Infant mortality (per thousand live births)	22.1	21.5	20.9	20.3	19.7	19.1	...	...	...	...	...	...	...
Adult literacy rate	...	84.2	91.9	91.6	...	93.3	...	...	...	...	...	...	...
Poverty rate (total)	35.1	36.0	32.8	28.6	27.3	25.6	22.5	...	...	...	...	...	...
Unemployment rate	6.0	6.5	5.0	4.2	4.1	4.2	3.8	...	...	...	...	...	...
Population (millions)	14.5	14.7	15.0	15.3	15.5	15.8	...	...	...	...	...	...	...
							(Percent change, unless otherwise indicated)						
National income and prices													
Real GDP	6.4	0.6	3.5	7.9	5.2	4.6	3.8	-0.6	0.1	0.6	1.2	1.5	1.8
Domestic demand (contribution to growth)	9.8	-1.2	8.0	7.5	4.2	6.1	3.8	-3.1	0.3	0.1	1.4	1.4	1.8
External Demand (contribution to growth) 1/	-3.5	1.8	-4.4	0.4	1.0	-1.5	0.0	2.4	-0.2	0.5	-0.2	0.1	0.1
Consumer price index period average	8.4	5.2	3.6	4.5	5.1	2.7	3.6	4.1	2.9	2.0	1.8	1.6	1.5
Consumer price index end-of-period	8.8	4.3	3.3	5.4	4.2	2.7	3.7	3.7	2.5	1.9	1.7	1.5	1.5
Banking system													
Net domestic assets	40.3	28.6	57.6	28.9	26.3	16.3	19.7	1.8	1.7	2.9	2.7	3.9	2.7
Liabilities	23.7	8.1	20.6	20.5	16.0	13.0	11.4	0.1	1.0	2.8	3.3	3.4	3.1
Credit to the private sector	27.6	2.2	24.4	22.6	14.7	10.5	8.7	1.4	2.0	3.0	3.5	3.6	3.3
External sector													
Exports	30.9	-25.9	25.8	27.3	6.4	4.5	3.6	-26.9	-1.3	6.5	4.6	4.9	2.6
Oil	40.7	-40.6	38.9	33.8	6.5	2.3	-5.7	-45.8	-6.5	9.6	5.1	6.9	1.3
Non-oil	18.3	-3.8	13.6	19.8	6.3	7.4	14.9	-8.0	1.7	4.8	4.4	3.7	3.4
Imports	37.3	-20.3	37.7	18.3	5.5	6.8	1.9	-19.8	-1.1	4.4	3.7	1.7	2.2
Terms of trade, nat. acct data (deterioration -)	20.0	-22.3	19.0	21.8	0.2	1.1	-5.4	-14.6	1.0	0.9	2.0	2.7	-0.1
Real effective exchange rate (depreciation -)	-1.0	7.8	-2.2	-1.6	4.1	2.2	3.0	...	...	...	...	...	
							(In percent of GDP)						
Public finances													
Revenue	35.7	29.4	33.3	39.3	39.5	39.4	38.8	35.4	33.7	33.4	33.4	33.6	33.5
Primary expenditure	34.1	32.4	34.1	38.7	39.6	43.0	43.2	39.1	35.3	33.0	32.4	31.7	31.2
Overall balance (deficit -)	0.5	-3.6	-1.3	0.0	-0.9	-4.6	-5.4	-5.1	-3.7	-1.9	-1.4	-0.7	-0.4
Total public debt	22.2	17.7	19.7	19.4	21.7	26.0	31.3	37.4	40.4	41.2	41.2	40.5	39.6
Domestic	5.9	4.5	6.7	5.7	8.9	10.5	12.5	12.9	12.2	11.9	11.1	10.1	9.1
External	16.3	13.2	13.0	13.7	12.8	15.5	18.8	24.5	28.3	29.3	30.2	30.3	30.5
Total public debt , official definition 2/	22.2	16.4	19.2	18.4	21.3	24.2	29.9	34.7	38.3	39.7	40.0	39.6	39.0
External current account balance	2.9	0.5	-2.3	-0.3	-0.2	-1.0	-0.6	-2.6	-2.8	-2.6	-2.4	-1.9	-1.8
Saving investment balance													
National saving	29.2	26.1	25.8	27.8	27.6	27.7	27.5	22.1	21.1	19.8	19.6	20.0	19.8
Gross investment	26.4	25.6	28.0	28.1	27.8	28.8	28.1	24.7	23.9	22.4	22.0	21.9	21.6
Private 3/	19.2	14.8	17.1	17.1	15.2	14.1	14.3	13.6	13.7	13.9	14.0	14.0	14.0
Public	7.2	10.9	10.9	11.0	12.6	14.7	13.7	11.1	10.2	8.5	8.0	7.9	7.7
Memorandum items:													
Nominal GDP (US$ millions)	61,763	62,520	69,555	79,277	87,623	94,473	100,543	98,925	101,698	104,773	108,468	112,418	116,105
GDP per capita (US$)	4,267	4,242	4,633	5,193	5,645	5,989	...	...	...	...	...	...	...
Foreign direct investment (US$ millions)	1,058	308	165	644	585	728	774	660	785	800	850	900	950
Net international reserves (US$ millions)	4,473	3,792	2,622	2,958	2,483	4,361	3,949	3,522	3,397	3,486	3,759	3,777	3,992
Oil price Ecuador mix (US$ per barrel)	82.1	53.2	71.9	96.7	98.6	95.7	84.0	45.1	43.9	48.3	52.2	54.2	54.9
Oil production (millions of barrels)	184.6	177.2	177.4	182.3	184.3	192.1	203.1	197.2	198.2	198.2	198.2	198.2	198.2

Sources: Central Bank of Ecuador; Ministry of Finance; Haver; World Bank (WDI); and Fund staff estimates and projections.

1/ The negative contribution in 2018 reflects the planned closure of the main oil refinery for maintenance, and the associated fall (increase) in refined oil exports (imports). The refinery is expected to reopen in 2019.

2/ The official public debt definition does not include the outstanding balance for advance oil sales, which was about 1.5 percent of GDP at end-2014.

3/ Includes inventories.

Table 2. Ecuador: Operations of the Nonfinancial Public Sector, Net Accounting

(In millions of U.S. dollars, unless otherwise indicated)

							Prel.	Proj.					
	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Revenue	**22,062**	**18,378**	**23,186**	**31,190**	**34,570**	**37,260**	**39,016**	**35,066**	**34,267**	**35,005**	**36,273**	**37,801**	**38,880**
Oil revenue, net 1/	8,675	5,212	7,845	12,935	12,220	11,433	10,906	7,968	7,053	7,162	7,519	8,011	8,103
Revenue from oil exports	7,354	3,763	6,061	11,214	9,895	9,153	8,857	5,628	4,775	4,966	5,410	5,858	5,883
Domestic sales of oil derivatives (CFDD)	1,321	1,448	1,784	1,721	2,325	2,280	2,049	2,340	2,278	2,196	2,109	2,153	2,220
Non-oil revenue	12,494	12,373	13,994	16,489	19,783	22,630	23,944	26,310	25,837	26,271	27,126	28,104	29,036
Taxes	6,919	7,553	8,667	9,765	12,255	13,668	14,460	16,176	15,693	15,820	16,307	16,890	17,454
Social security contributions 2/	2,097	2,061	2,549	3,971	4,756	4,547	4,723	5,137	5,329	5,490	5,683	5,890	6,084
Other	3,478	2,759	2,778	2,753	2,772	4,416	4,761	4,996	4,816	4,961	5,136	5,323	5,498
Operating surplus of public enterprises	893	794	1,346	1,766	2,567	3,196	4,166	789	1,376	1,572	1,627	1,686	1,742
O/w profits of oil companies withheld for investment	582	517	877	1,151	1,818	2,593	3,987	815	1,017	1,572	1,627	1,686	1,742
Primary expenditure	**21,058**	**20,261**	**23,710**	**30,693**	**34,741**	**40,637**	**43,388**	**38,692**	**35,927**	**34,572**	**35,142**	**35,632**	**36,219**
Current	14,057	13,581	16,492	21,468	23,779	26,006	28,022	26,367	24,146	24,195	25,044	25,271	25,732
Wages and salaries	4,869	5,929	6,786	7,265	8,345	8,896	9,479	9,869	9,571	9,450	9,566	9,719	9,864
Purchases of goods and services	2,086	1,924	2,090	2,543	3,473	4,435	5,325	4,710	4,645	4,627	4,746	4,919	5,080
Social Security Benefits 2/	1,563	1,875	2,245	3,225	3,338	3,410	3,640	4,003	4,181	4,329	4,471	4,610	4,748
Other	5,538	3,853	5,371	8,436	8,623	9,265	9,578	7,784	5,749	5,789	6,261	6,023	6,039
Cost of imports of oil derivatives	3,042	1,966	3,466	4,850	5,363	5,735	6,363	4,798	3,141	3,180	3,777	3,568	3,613
Payments to private oil companies (SH) 3/	…	…	…	1,765	1,788	1,674	1,683	1,526	1,227	1,200	1,150	1,100	1,050
Other	2,495.9	1,887.2	1,904.7	1,820.3	1,471.4	1,855.5	1,531.4	1,460.5	1,381.0	1,409.2	1,334.3	1,355.6	1,376.0
Capital	7,001	6,680	7,218	9,224	10,963	14,631	15,366	12,326	11,780	10,377	10,098	10,361	10,487
Fixed capital spending	6,930	6,310	6,571	8,891	10,312	14,039	13,991	11,113	10,508	9,066	8,741	8,955	9,035
Net-lending	71	370	647	334	650	592	1,375	1,213	1,272	1,311	1,357	1,406	1,453
Primary balance	**1,004**	**-1,883**	**-524**	**497**	**-172**	**-3,377**	**-4,372**	**-3,626**	**-1,660**	**433**	**1,131**	**2,169**	**2,661**
Interest	**705**	**349**	**413**	**502**	**652**	**971**	**1,024**	**1,436**	**2,072**	**2,465**	**2,697**	**2,949**	**3,158**
O/w external	660	323	377	452	533	714	829	1,188	1,630	2,032	2,253	2,507	2,719
Current balance	**7,300**	**4,448**	**6,281**	**9,219**	**10,139**	**10,283**	**9,970**	**7,263**	**8,048**	**8,345**	**8,532**	**9,582**	**9,990**
Overall balance	**300**	**-2,232**	**-937**	**-5**	**-824**	**-4,348**	**-5,395**	**-5,062**	**-3,732**	**-2,032**	**-1,567**	**-780**	**-497**
Memorandum items:													
Real growth in primary spending (percent change)	36.1	-8.5	13.0	16.8	7.7	13.9	2.9	-14.8	-6.9	1.7	2.5	3.2	3.1
Current oil balance 4/	6,215	3,763	5,256	7,470	6,886	6,617	6,846	2,459	3,702	4,353	4,220	5,030	5,181
Nonoil primary balance 5/	-4,629	-5,129	-4,903	-5,822	-5,240	-7,401	-7,231	-5,270	-4,345	-2,349	-1,462	-1,174	-779
Nominal GDP (US$ millions)	61,763	62,520	69,555	79,277	87,623	94,473	100,543	98,925	101,698	104,773	108,468	112,418	116,105

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

1/ Net of operational cost.

2/ From 2011 on, includes additional public pension sytems which previously had not been consolidated into the NFPS accounts.

3/ Reflects service contract payments to private oil companies beginning in 2011.

4/ Oil revenue plus profits of state-owned oil companies, which is retained for investment in the oil sector, less oil-related current expenditure (the costs of imports of oil derivatives and payments to private oil companies).

5/ The primary balance plus current oil balance, less profits of state-owned oil companies, which is offset by a corresponding oil investment under capital expenditure.

Table 3. Ecuador: Operations of the Nonfinancial Public Sector, Net Accounting

(In percent of GDP, unless otherwise indicated)

							Prel.	Proj.					
	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Revenue	**35.7**	**29.4**	**33.3**	**39.3**	**39.5**	**39.4**	**38.8**	**35.4**	**33.7**	**33.4**	**33.4**	**33.6**	**33.5**
Oil revenue, net 1/	14.0	8.3	11.3	16.3	13.9	12.1	10.8	8.1	6.9	6.8	6.9	7.1	7.0
Revenue from oil exports	11.9	6.0	8.7	14.1	11.3	9.7	8.8	5.7	4.7	4.7	5.0	5.2	5.1
Domestic sales of oil derivatives (CADID)	2.1	2.3	2.6	2.2	2.7	2.4	2.0	2.4	2.2	2.1	1.9	1.9	1.9
Nonpetroleum revenue	20.2	19.8	20.1	20.8	22.6	24.0	23.8	26.6	25.4	25.1	25.0	25.0	25.0
Taxes	11.2	12.1	12.5	12.3	14.0	14.5	14.4	16.4	15.4	15.1	15.0	15.0	15.0
Social security contributions 2/	3.4	3.3	3.7	5.0	5.4	4.8	4.7	5.2	5.2	5.2	5.2	5.2	5.2
Other	5.6	4.4	4.0	3.5	3.2	4.7	4.7	5.1	4.7	4.7	4.7	4.7	4.7
Operating surplus of public enterprises	1.4	1.3	1.9	2.2	2.9	3.4	4.1	0.8	1.4	1.5	1.5	1.5	1.5
O/w profits of oil companies withheld for investment	0.9	0.8	1.3	1.5	2.1	2.7	4.0	0.8	1.0	1.5	1.5	1.5	1.5
Primary expenditure	**34.1**	**32.4**	**34.1**	**38.7**	**39.6**	**43.0**	**43.2**	**39.1**	**35.3**	**33.0**	**32.4**	**31.7**	**31.2**
Current	22.8	21.7	23.7	27.1	27.1	27.5	27.9	26.7	23.7	23.1	23.1	22.5	22.2
Wages and salaries	7.9	9.5	9.8	9.2	9.5	9.4	9.4	10.0	9.4	9.0	8.8	8.6	8.5
Purchases of goods and services	3.4	3.1	3.0	3.2	4.0	4.7	5.3	4.8	4.6	4.4	4.4	4.4	4.4
Social security benefits 2/	2.5	3.0	3.2	4.1	3.8	3.6	3.6	4.0	4.1	4.1	4.1	4.1	4.1
Other current expenditure	9.0	6.2	7.7	10.6	9.8	9.8	9.5	7.9	5.7	5.5	5.8	5.4	5.2
Cost of imports of oil derivatives	4.9	3.1	5.0	6.1	6.1	6.1	6.3	4.9	3.1	3.0	3.5	3.2	3.1
Payments to private oil companies (SH) 3/	...	...	...	2.2	2.0	1.8	1.7	1.5	1.2	1.1	1.1	1.0	0.9
Other	4.0	3.0	2.7	2.3	1.7	2.0	1.5	1.5	1.4	1.3	1.2	1.2	1.2
Capital	11.3	10.7	10.4	11.6	12.5	15.5	15.3	12.5	11.6	9.9	9.3	9.2	9.0
Fixed capital spending	11.2	10.1	9.4	11.2	11.8	14.9	13.9	11.2	10.3	8.7	8.1	8.0	7.8
Net-lending	0.1	0.6	0.9	0.4	0.7	0.6	1.4	1.2	1.3	1.3	1.3	1.3	1.3
Primary balance	**1.6**	**-3.0**	**-0.8**	**0.6**	**-0.2**	**-3.6**	**-4.3**	**-3.7**	**-1.6**	**0.4**	**1.0**	**1.9**	**2.3**
Interest	**1.1**	**0.6**	**0.6**	**0.6**	**0.7**	**1.0**	**1.0**	**1.5**	**2.0**	**2.4**	**2.5**	**2.6**	**2.7**
O/w external	1.1	0.5	0.5	0.6	0.6	0.8	0.8	1.2	1.6	1.9	2.1	2.2	2.3
Current balance	**11.8**	**7.1**	**9.0**	**11.6**	**11.6**	**10.9**	**9.9**	**7.3**	**7.9**	**8.0**	**7.9**	**8.5**	**8.6**
Overall balance	**0.5**	**-3.6**	**-1.3**	**0.0**	**-0.9**	**-4.6**	**-5.4**	**-5.1**	**-3.7**	**-1.9**	**-1.4**	**-0.7**	**-0.4**
Memorandum items:													
Current oil balance 4/	10.1	6.0	7.6	9.4	7.9	7.0	6.8	2.5	3.6	4.2	3.9	4.5	4.5
Nonoil primary balance 5/	-7.5	-8.2	-7.0	-7.3	-6.0	-7.8	-7.2	-5.3	-4.3	-2.2	-1.3	-1.0	-0.7
Output gap (in percent)	1.7	-1.8	-2.6	0.4	0.8	1.4	1.5	-1.5	-2.9	-3.0	-2.5	-2.0	-1.5
Structural nonoil primary balance	-7.8	-7.8	-6.4	-7.3	-6.2	-8.2	-7.6	-4.8	-3.4	-1.2	-0.3	0.0	0.3
Fiscal impulse (- = expansionary) 6/	-4.9	0.0	1.4	-1.0	1.2	-2.0	0.6	2.8	1.5	2.2	0.9	0.2	0.3

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

1/ Net of operational cost.

2/ From 2011 on, includes additional public pension sytems which previously had not been consolidated into the NFPS accounts.

3/ Reflects service contract payments to private oil companies beginning in 2011.

4/ Oil revenue plus profits of state-owned oil companies, which is retained for investment in the oil sector, less oil-related current expenditure (the costs of imports of oil derivatives and payments to private oil companies).

5/ The primary balance plus current oil balance, less profits of state-owned oil companies, which is offset by a corresponding oil investment under capital expenditure.

6/ Change in structural nonoil primary balance.

Table 4. Ecuador: Nonfinancial Public Sector Financing

(In millions of U.S. dollars, unless otherwise indicated)

							Prel.	Proj.					
	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Gross financing needs	**1,048**	**3,654**	**2,077**	**1,653**	**2,742**	**6,454**	**10,371**	**10,167**	**8,669**	**6,758**	**6,650**	**6,145**	**8,239**
Nonfinancial public sector deficit	-300	2,232	937	5	824	4,348	5,395	5,062	3,732	2,032	1,567	780	497
Amortization	1,347	1,422	1,140	1,648	1,918	2,107	4,976	5,105	4,937	4,726	5,083	5,366	7,742
External	1,338	1,422	1,104	1,549	1,611	1,706	3,556	3,762	3,308	3,486	3,328	3,455	5,665
Domestic	10	0	36	99	307	401	1,420	1,343	1,629	1,240	1,756	1,911	2,076
Gross financing	**1,048**	**3,693**	**2,080**	**1,653**	**2,742**	**6,454**	**10,371**	**10,167**	**8,669**	**6,758**	**6,650**	**6,145**	**8,239**
External	1,462	2,390	1,531	3,222	1,919	5,172	8,013	9,114	7,811	5,407	5,357	4,852	6,946
Domestic	-789	1,338	1,320	-26	762	1,672	1,367	1,506	1,274	1,351	1,293	1,293	1,293
O/w deposit build up(-)	-794	962	1,000	-623	-293	240	-120	0	0	0	0	0	0
Other financing	374	-35	-771	-1,542	60	-389	992	-453	-416	0	0	0	0
External arrears	61	24	23	32	31	21	7	0	0	0	0	0	0
Other items 1/	313	-59	-794	-1,574	29	-410	984	-453	-416	0	0	0	0
							(In percent of GDP)						
Gross financing needs	**1.7**	**5.8**	**3.0**	**2.1**	**3.1**	**6.8**	**10.3**	**10.3**	**8.5**	**6.5**	**6.1**	**5.5**	**7.1**
Nonfinancial public sector deficit	-0.5	3.6	1.3	0.0	0.9	4.6	5.4	5.1	3.7	1.9	1.4	0.7	0.4
Amortization	2.2	2.3	1.6	2.1	2.2	2.2	4.9	5.2	4.9	4.5	4.7	4.8	6.7
External	2.2	2.3	1.6	2.0	1.8	1.8	3.5	3.8	3.3	3.3	3.1	3.1	4.9
Domestic	0.0	0.0	0.1	0.1	0.4	0.4	1.4	1.4	1.6	1.2	1.6	1.7	1.8
Gross financing	**1.7**	**5.9**	**3.0**	**2.1**	**3.1**	**6.8**	**10.3**	**10.3**	**8.5**	**6.5**	**6.1**	**5.5**	**7.1**
External	2.4	3.8	2.2	4.1	2.2	5.5	8.0	9.2	7.7	5.2	4.9	4.3	6.0
Domestic	-1.3	2.1	1.9	0.0	0.9	1.8	1.4	1.5	1.3	1.3	1.2	1.2	1.1
O/w deposit build up(-)	-1.3	1.5	1.4	-0.8	-0.3	0.3	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Other financing	0.6	-0.1	-1.1	-1.9	0.1	-0.4	1.0	-0.5	-0.4	0.0	0.0	0.0	0.0
External arrears	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other items 1/	0.5	-0.1	-1.1	-2.0	0.0	-0.4	1.0	-0.5	-0.4	0.0	0.0	0.0	0.0
Memorandum Items:													
NFPS deposits (US$ millions) 2/	5,690	4,728	3,729	4,352	4,645	4,405	4,525	…	…	…	…	…	…
Total debt (in percent of GDP)	22.2	17.7	19.7	19.4	21.7	26.0	31.3	37.4	40.4	41.2	41.2	40.5	39.6
External	16.3	13.2	13.0	13.7	12.8	15.5	18.8	24.5	28.3	29.3	30.2	30.3	30.5
Domestic 3/	5.9	4.5	6.7	5.7	8.9	10.5	12.5	12.9	12.2	11.9	11.1	10.1	9.1

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

1/ Includes domestic floating debt and statistical discrepancy.

2/ Includes deposits of pension funds, which are reported as nonfinancial public sector.

3/ Does not include outstanding treasury certificates or arrears.

Table 5. Ecuador: Balance of Payments
(In millions of U.S. dollars, unless otherwise indicated)

							Prel.			Proj.			
	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Current account	**1,767**	**309**	**-1,586**	**-261**	**-165**	**-983**	**-601**	**-2,529**	**-2,853**	**-2,724**	**-2,579**	**-2,081**	**-2,131**
Trade account	1,549	144	-1,504	-160	50	-493	-67	-1,948	-1,969	-1,648	-1,521	-868	-798
Exports, f.o.b.	19,461	14,412	18,137	23,082	24,569	25,686	26,604	19,441	19,185	20,432	21,379	22,416	23,005
Oil	11,721	6,965	9,673	12,945	13,792	14,108	13,302	7,207	6,739	7,386	7,763	8,298	8,403
Non-Oil	7,740	7,447	8,464	10,137	10,777	11,578	13,302	12,234	12,445	13,047	13,616	14,119	14,602
Imports (f.o.b.)	-17,912	-14,268	-19,641	-23,243	-24,519	-26,178	-26,672	-21,389	-21,154	-22,081	-22,900	-23,284	-23,803
Oil	-3,358	-2,338	-4,043	-5,087	-5,441	-5,927	-6,417	-4,494	-2,942	-2,979	-3,538	-3,342	-3,384
Non-Oil	-14,554	-11,930	-15,598	-18,156	-19,078	-20,251	-20,254	-16,894	-18,212	-19,102	-19,362	-19,942	-20,419
Services (net)	-3,003	-2,556	-2,564	-2,823	-2,695	-2,890	-2,798	-2,964	-3,405	-3,746	-3,884	-4,101	-4,346
Transfers (net)	3,221	2,722	2,481	2,722	2,480	2,399	2,264	2,383	2,522	2,670	2,826	2,888	3,013
Capital and Financial account	**-653**	**-2,712**	**479**	**453**	**-516**	**2,959**	**394**	**2,102**	**2,728**	**2,814**	**2,852**	**2,099**	**2,346**
NFPS sector flows, net	124	969	426	1,673	309	3,466	4,457	5,352	4,503	1,921	2,029	1,397	1,280
Disbursements	1,462	2,390	1,531	3,222	1,919	5,172	8,013	9,114	7,811	5,407	5,357	4,852	6,946
o/w Multilateral	5	1,004	1,074	2,713	751	4,391	2,780	5,274	5,311	2,907	2,857	2,352	4,446
o/w Bilateral	340	1,259	797	721	1,219	732	1,497	1,670	1,500	1,500	1,500	1,500	1,500
o/w Advance oil sales, net	0	1,000	0	1,000	0	1,900	1,600	2,900	905	400	695	695	695
Amortization	1,338	1,422	1,104	1,549	1,611	1,706	3,556	3,762	3,308	3,486	3,328	3,455	5,665
Private sector flows, net 1/	-1,835	-3,989	-113	-1,863	-1,409	-1,235	-4,837	-3,910	-2,560	92	-27	-198	116
Banking system	46	-91	82	-85	37	-32	20	-30	-30	-80	-50	-60	-59
Other flows 2/	-1,881	-3,898	-194	-1,779	-1,446	-1,204	-4,857	-3,880	-2,530	172	23	-138	175
Foreign direct investment	1,058	308	165	644	585	728	774	660	785	800	850	900	950
Errors and Omissions	**-180**	**-244**	**-105**	**79**	**97**	**-130**	**-217**	**0**	**0**	**0**	**0**	**0**	**0**
Overall balance	**934**	**-2,647**	**-1,212**	**272**	**-582**	**1,846**	**-424**	**-427**	**-125**	**89**	**273**	**17**	**216**
Financing	**-934**	**2,647**	**1,212**	**-272**	**582**	**-1,846**	**424**	**427**	**125**	**-89**	**-273**	**-17**	**-216**
Net int'l reserves (- = accum.)	-952	681	1,170	-336	475	-1,878	411	427	125	-89	-273	-17	-216
Net exceptional financing 3/	18	1,966	42	64	107	32	13	0	0	0	0	0	1
							(In percent of GDP)						
Current account	**2.9**	**0.5**	**-2.3**	**-0.3**	**-0.2**	**-1.0**	**-0.6**	**-2.6**	**-2.8**	**-2.6**	**-2.4**	**-1.9**	**-1.8**
Trade account	2.5	0.2	-2.2	-0.2	0.1	-0.5	-0.1	-2.0	-1.9	-1.6	-1.4	-0.8	-0.7
Exports, f.o.b.	31.5	23.1	26.1	29.1	28.0	27.2	26.5	19.7	18.9	19.5	19.7	19.9	19.8
Oil	19.0	11.1	13.9	16.3	15.7	14.9	13.2	7.3	6.6	7.0	7.2	7.4	7.2
Non-Oil	12.5	11.9	12.2	12.8	12.3	12.3	13.2	12.4	12.2	12.5	12.6	12.6	12.6
Imports (f.o.b.)	-29.0	-22.8	-28.2	-29.3	-28.0	-27.7	-26.5	-21.6	-20.8	-21.1	-21.1	-20.7	-20.5
Oil	-5.4	-3.7	-5.8	-6.4	-6.2	-6.3	-6.4	-4.5	-2.9	-2.8	-3.3	-3.0	-2.9
Non-Oil	-23.6	-19.1	-22.4	-22.9	-21.8	-21.4	-20.1	-17.1	-17.9	-18.2	-17.9	-17.7	-17.6
Services (net)	-4.9	-4.1	-3.7	-3.6	-3.1	-3.1	-2.8	-3.0	-3.3	-3.6	-3.6	-3.6	-3.7
Transfers (net)	5.2	4.4	3.6	3.4	2.8	2.5	2.3	2.4	2.5	2.5	2.6	2.6	2.6
Capital and Financial account	**-1.1**	**-4.3**	**0.7**	**0.6**	**-0.6**	**3.1**	**0.4**	**2.1**	**2.7**	**2.7**	**2.6**	**1.9**	**2.0**
Public sector flows, net	0.2	1.5	0.6	2.1	0.4	3.7	4.4	5.4	4.4	1.8	1.9	1.2	1.1
Private sector flows, net 1/	-3.0	-6.4	-0.2	-2.4	-1.6	-1.3	-4.8	-4.0	-2.5	0.1	0.0	-0.2	0.1
Foreign direct investment	1.7	0.5	0.2	0.8	0.7	0.8	0.8	0.7	0.8	0.8	0.8	0.8	0.8
Errors and Omissions	**-0.3**	**-0.4**	**-0.2**	**0.1**	**0.1**	**-0.1**	**-0.2**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Overall balance	**1.5**	**-4.2**	**-1.7**	**0.3**	**-0.7**	**2.0**	**-0.4**	**-0.4**	**-0.1**	**0.1**	**0.3**	**0.0**	**0.2**
Memorandum item:													
Oil trade balance	13.5	7.4	8.1	9.9	9.5	8.7	6.8	2.7	3.7	4.2	3.9	4.4	4.3
Non-oil trade balance:	-11.0	-7.2	-10.3	-10.1	-9.5	-9.2	-6.9	-4.7	-5.7	-5.8	-5.3	-5.2	-5.0

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

1/ Private sector flows in the balance of payments reflect also transactions between the domestic public and private sector affecting BCE reserves (based on Ecuador compiling practices, given dollarization) which do not necessarily mean inflows/outflows.

2/ Includes public financial sector and monetary authority.

3/ Includes foreign arrears and net flows from oil funds held abroad and flows associated with debt default and restructuring.

Table 6. Ecuador: Monetary Survey
(In millions of U.S. dollars, unless otherwise indicated)

	2008	2009	2010	2011	2012	2013	2014	Proj. 2015	Proj. 2016
I. Central Bank									
Net Foreign Assets	5,872	4,982	3,856	4,584	4,659	5,216	4,536	4,108	3,984
o/w NIR	4,473	3,792	2,622	2,958	2,483	4,361	3,949	3,522	3,397
Net Domestic Assets	-3,300	-2,072	-1,175	-1,733	-735	500	1,321	1,040	1,045
Public sector	-2,616	-2,052	-1,260	-1,873	-1,768	-1,488	-552	-552	-552
Banking system	106	625	1,012	1,433	2,108	2,736	2,530	2,650	2,677
Other	-789	-645	-927	-1,293	-1,075	-748	-658	-1,058	-1,080
Liabilities 1/	2,572	2,910	2,681	2,851	3,924	5,716	5,857	5,149	5,028
II. Depository Institutions 2/									
Net Foreign Assets	3,585	4,234	4,934	5,164	5,323	5,534	5,891	5,950	6,010
Net Domestic Assets	9,430	10,063	12,693	16,106	19,237	22,163	24,643	24,894	25,143
Net assets held in the BCE	1,250	1,049	740	739	804	532	229	318	299
Net credit to the public sector	-1,352	-1,028	-647	-550	236	976	1,675	1,368	1,393
Net credit to the private sector	13,539	13,829	17,220	21,120	24,223	26,785	29,131	29,520	30,122
Other	-4,007	-3,786	-4,620	-5,203	-6,026	-7,141	-7,075	-6,352	-6,710
Liabilities 2/	13,015	14,297	17,628	21,270	24,560	27,697	30,534	30,845	31,153
III. Consolidated Banking System									
Net Foreign Assets	9,457	9,216	8,790	9,748	9,982	10,750	10,426	10,059	9,994
Net Domestic Assets	4,892	6,289	9,911	12,779	16,141	18,765	22,458	22,855	23,234
Net credit to the public sector	-3,968	-3,081	-1,906	-2,423	-1,532	-511	1,123	816	841
Net credit to the private sector	13,576	13,869	17,255	21,153	24,259	26,812	29,156	29,561	30,165
Other	-4,716	-4,500	-5,437	-5,951	-6,585	-7,536	-7,822	-7,522	-7,773
Liabilities 2/	14,348	15,505	18,702	22,527	26,123	29,515	32,884	32,914	33,227
(Change in respect to liabilities of the previous year)									
Consolidated banking system									
Net foreign assets	11.6	-1.7	-2.7	5.1	1.0	2.9	-1.1	-1.1	-0.2
Net domestic assets	12.1	9.7	23.4	15.3	14.9	10.0	12.5	1.2	1.1
Net credit public sector	-14.5	6.2	7.6	-2.8	4.0	3.9	5.5	-0.9	0.1
Net credit private sector	25.3	2.0	21.8	20.8	13.8	9.8	7.9	1.2	1.8
Other	1.3	1.5	-6.0	-2.7	-2.8	-3.6	-1.0	0.9	-0.8
Liabilities 2/	23.7	8.1	20.6	20.5	16.0	13.0	11.4	0.1	1.0
Memorandum items:									
Liabilities (percent of GDP)	23.2	24.8	26.9	28.4	29.8	31.2	32.7	33.3	32.7
Net credit to the private sector (percent of GDP)	22.0	22.2	24.8	26.7	27.7	28.4	29.0	29.9	29.7

Sources: Central Bank of Ecuador and Fund staff estimates.
1/ Includes deposits by local and regional governments and public enterprises.
2/ Includes private banks, cooperatives and other financial institutions. Does not include BIESS.

Table 7. Ecuador: Financial Soundness Indicators 1/

	2008	2009	2010	2011	2012	2013	2014
	(In percent, unless otherwise indicated; end-of-period values)						
Capital Adequacy							
Regulatory capital to risk-weighted assets	19.9	19.7	18.3	18.1	18.3	17.7	19.1
Regulatory Tier 1 capital to risk-weighted assets	17.3	17.6	17.0	16.1	16.1	16.1	16.8
Nonperforming loans net of provisions to capital	-1.0	-0.7	-1.9	-2.7	-1.3	-1.8	-2.8
Asset Quality and Distribution							
Nonperforming loans to gross loans	3.4	4.1	3.4	3.2	3.8	3.6	3.6
Provisions to nonperforming loans	106.7	104.4	112.6	118.4	108.1	112.5	118.4
Gross loans to assets	62.4	57.8	60.0	62.3	59.3	56.3	58.3
Earnings and Profitability							
Return on average assets	1.6	1.4	1.4	1.7	1.3	1.1	1.3
Return on average equity	11.4	10.3	11.1	13.9	10.7	8.6	11.1
Interest margin to gross income	42.2	43.2	45.5	47.7	49.4	50.1	48.1
Noninterest expenses to gross income	43.7	46.0	45.4	44.4	44.9	46.8	45.7
Liquidity							
Liquid assets to total assets	25.0	28.2	23.6	23.1	22.3	22.9	20.7
Liquid assets to short-term liabilities	38.3	43.8	37.0	35.9	35.9	37.1	34.1
Deposit to loan ratio	105.7	111.8	108.4	106.5	107.7	110.1	112.8

Source: Superintendency of Banks.
1/ Consolidated banking system.

Table 8. Ecuador: Financial and External Vulnerability Indicators

	2008	2009	2010	2011	2012	2013	2014
Financial indicators							
Public sector debt/GDP	22.2	17.7	19.7	19.4	21.7	26.0	31.3
Velocity of money 1/	4.3	4.0	3.7	3.5	3.4	3.2	3.1
Net credit to the private sector/GDP 2/	22.0	22.2	24.8	26.7	27.7	28.4	29.0
External indicators							
Exports, U.S. dollars (percent change)	30.9	-25.9	25.8	27.3	6.4	4.5	3.6
Imports, U.S. dollars (percent change)	37.3	-20.3	37.7	18.3	5.5	6.8	1.9
Terms of trade (percent change) (deterioration -)	20.0	-22.3	19.0	21.8	0.2	1.1	-5.4
Real effective exchange rate, (end of period, percent change) 3/	-1.0	7.8	-2.2	-1.6	4.1	2.2	3.0
Current account balance (percent of GDP)	2.9	0.5	-2.3	-0.3	-0.2	-1.0	-0.6
Capital and financial account balance (percent of GDP)	-1.1	-4.3	0.7	0.6	-0.6	3.1	0.4
Total external debt (percent of GDP)	27.5	23.0	20.6	20.4	18.7	21.5	25.4
Medium- and long-term public debt (in percent of GDP)	16.3	13.2	13.0	13.7	12.8	15.5	18.8
Medium- and long-term private debt (in percent of GDP)	8.5	7.7	6.5	5.7	5.2	5.4	6.0
Short-term public and private debt (in percent of GDP)	2.6	2.1	1.1	0.9	0.7	0.6	0.6
Total external debt (in percent of exports of goods and services)	87.2	94.0	73.1	65.5	62.0	73.3	88.4
Total debt service (in percent of exports of goods and services)	16.2	19.8	12.7	12.8	12.2	13.2	22.1
Net international reserves							
In millions of U.S. dollars	4,473	3,792	2,622	2,958	2,483	4,361	3,949
In percent of broad money	31.2	24.5	14.0	13.1	9.5	14.8	12.0
In months of imports of goods and services	2.6	2.7	1.4	1.3	1.1	1.8	1.6

Sources: Central Bank of Ecuador; IMF Information Notice System (INS); and Fund staff estimates/projections.
1/ Defined as the inverse of the ratio of end-period broad money to annual GDP.
2/ Corresponds to the consolidated banking system.
3/ End of period; data from INS.

Table 9. Ecuador: Medium-Term Macroeconomic Framework

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
								Projections					
							(Percent change, unless otherwise indicated)						
Production													
GDP at constant prices	6.4	0.6	3.5	7.9	5.2	4.6	3.8	-0.6	0.1	0.6	1.2	1.5	1.8
Consumer prices (end of period)	8.8	4.3	3.3	5.4	4.2	2.7	3.7	3.7	2.5	1.9	1.7	1.5	1.5
GDP deflator	13.8	0.7	7.5	5.7	5.0	3.0	2.5	-1.0	2.7	2.4	2.3	2.1	1.4
Trade													
Merchandise trade													
Exports, f.o.b.	30.9	-25.9	25.8	27.3	6.4	4.5	3.6	-26.9	-1.3	6.5	4.6	4.9	2.6
Imports, f.o.b.	37.3	-20.3	37.7	18.3	5.5	6.8	1.9	-19.8	-1.1	4.4	3.7	1.7	2.2
Terms of trade (deterioration -)	20.0	-22.3	19.0	21.8	0.2	1.1	-5.4	-14.6	1.0	0.9	2.0	2.7	-0.1
							(In percent of GDP; unless otherwise indicated)						
Total external debt service	5.1	4.8	3.6	4.0	3.7	3.9	6.4	7.4	7.5	8.0	8.0	8.1	9.9
Medium- and long-term	5.0	4.7	3.5	3.9	3.6	3.9	5.5	7.4	7.5	8.0	7.9	8.0	9.9
Nonfinancial public sector	3.2	2.8	2.1	2.5	2.4	2.6	3.5	5.0	4.9	5.3	5.1	5.3	7.2
Private sector	1.7	1.9	1.4	1.4	1.2	1.3	2.0	2.4	2.6	2.7	2.8	2.7	2.6
Public sector													
NFPS primary balance	1.6	-3.0	-0.8	0.6	-0.2	-3.6	-4.3	-3.7	-1.6	0.4	1.0	1.9	2.3
Gen. govt. revenue	35.7	29.4	33.3	39.3	39.5	39.4	38.8	35.4	33.7	33.4	33.4	33.6	33.5
Gen. govt. non-interest exp.	34.1	32.4	34.1	38.7	39.6	43.0	43.2	39.1	35.3	33.0	32.4	31.7	31.2
NFPS interest due	1.1	0.6	0.6	0.6	0.7	1.0	1.0	1.5	2.0	2.4	2.5	2.6	2.7
NFPS overall balance	0.5	-3.6	-1.3	0.0	-0.9	-4.6	-5.4	-5.1	-3.7	-1.9	-1.4	-0.7	-0.4
Public sector debt	22.2	17.7	19.7	19.4	21.7	26.0	31.3	37.4	40.4	41.2	41.2	40.5	39.6
Total public debt , official definition 1/	22.2	16.4	19.2	18.4	21.3	24.2	29.9	34.7	38.3	39.7	40.0	39.6	39.0
Savings and investment													
Gross domestic investment	26.4	25.6	28.0	28.1	27.8	28.8	28.1	24.7	23.9	22.4	22.0	21.9	21.6
National savings	29.2	26.1	25.8	27.8	27.6	27.7	27.5	22.1	21.1	19.8	19.6	20.0	19.8
External current account	2.9	0.5	-2.3	-0.3	-0.2	-1.0	-0.6	-2.6	-2.8	-2.6	-2.4	-1.9	-1.8
Memorandum items:													
Nominal GDP (billions of U.S. dollars	61.8	62.5	69.6	79.3	87.6	94.5	100.5	98.9	101.7	104.8	108.5	112.4	116.1
Total external debt service (percent of exports of GNFS)	15.1	19.1	12.7	12.8	12.2	13.2	22.1	33.8	35.5	36.8	35.8	36.0	44.5
Public external debt service (percent of exports of GNFS)	10.3	12.1	8.2	8.7	8.7	9.4	16.5	25.5	25.7	27.0	26.1	26.6	36.4

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

1/ The official public debt definition does not include the outstanding balance for advance oil sales, which was about 1.5 percent of GDP at end-2014.

Annex I. Implementation of Advice in Previous Article IV Consultations

1. **Ecuador re-engaged with the Fund in 2014, with the first (off-site) Article IV consultation since 2008.** Discussions focused on rebuilding fiscal space and preserving financial system stability.

2. **Fiscal policy:** Staff supported the authorities' strategy to reduce oil dependency through scaled-up investment in energy within a multi-year framework of gradual fiscal consolidation. Going forward, staff advised rebuilding fiscal space through spending restraint and eventually a fiscal stabilization fund. The authorities continued to hold the view that investment in infrastructure and social areas generates a greater return than a savings mechanism, especially in the current environment of low global interest rates, and helps to increase growth potential. However, their planned fiscal adjustment for 2015 demonstrates a strategy of adjusting spending depending on the availability of oil revenues. Staff also called for raising non-oil related revenues, focusing on achieving better enforcement of tax laws and greater efficiency in tax administration. Progress has been made in enhancing tax collection.

3. **Energy reform:** Staff supported the authorities' plans for a broad overhaul of fuel subsidies. In the event, the authorities have pursued a more contained subsidy reform: the key strategy is to safeguard the welfare of the poor while reducing the drain on the budget, not least through mandatory usage of electric stoves as electricity becomes cheaper due to completion of hydro projects.

4. **Financial system:** With respect to safeguarding financial system's stability, the authorities continued to enhance supervision and asked banks to increase their contribution to the Liquidity Fund. However, directed credit and interest rate caps have continued, and legislation was introduced that could inhibit the system's liquidity. A tax on transfers for amortization and interest payments on certain loans with a maturity of more than one year has been eliminated, in line with staff advice, but the authorities still consider it a prudential measure necessary to deal with volatile cross border capital movements.

5. **Structural reforms:** Staff emphasized the importance of deeper structural reforms to enhance productivity, competitiveness, and the role of the private sector. The authorities are following an economic development plan (Productive Matrix) aimed at addressing these issues, but details have not been fully delineated. They have also reduced the pace of increase in minimum wages as part of the response to external shocks.

Annex II. External Sector Assessment[1]

The country's real exchange rate is assessed to be stronger than warranted by medium-term fundamentals and desirable policies, as of developments so far in 2015. The drop in oil prices since late last year and the dollar's sharp appreciation have weakened Ecuador's external position. The current account deficit is projected to worsen, although the deterioration is mitigated by the authorities' response in scaling back public spending and by the imposition of temporary import surcharges. Prices relative to the U.S. are now substantially above benchmark, while wages have grown faster than productivity over the past decade and are now higher than in neighbors. Also, access to international markets has worsened. Ecuador will need to regain competitiveness—including by facilitating further relative wage and price adjustments and enhancing productivity—while creating fiscal space and improving access to credit.

1. **Fund metrics indicate a current account imbalance in 2015, and over the medium-term the current account deficit (CAD) is expected to remain above the historical average since 2000 (which was about 0) due to weaker competitiveness**. The CAD was small over the last few years and in 2014 it was at 0.6 percent of GDP. The sharp decline in oil prices since late last year, coupled with a sizable real exchange rate appreciation, is placing significant pressure on Ecuador's current account. Even when offset by the compression of imports following the imposition of surcharges, scaled back public spending, and economic slowdown, the CAD is projected to widen to 2.6 percent of GDP in 2015.

2. **Two standard Fund methodologies (the EBA-lite current account and external sustainability approaches) suggest that the CAD is somewhat wider than warranted by fundamentals**. Two other methodologies, the CGER-inspired macro balance (MB) and one that uses a small open economy model with frictions in private and public investment (OEM), point to smaller gaps (see Table 1 and Figure 1).[2]The OEM is based on the short-term adjustment of the current account consistent with the inter-temporally optimal response of the economy to the oil shock.[3] However, none of these methodologies takes into account that the 2015 current account would be larger (probably by more than 1 percent of GDP) in the absence of import surcharges. Hence the current account is substantively worse than warranted by fundamentals and desirable policies (notably, without surcharges)—in a range of 1 percent to 4 percent of GDP. Staff

[1] Prepared by P. de Imus (SPR) and Carlos Goes. See the companion Selected Issues paper for further analysis.

[2] These estimates are sensitive to key parameter assumptions. In particular the EBA-lite current account model estimates a large constant which contributes by about -4 percent of GDP to the current account norm. The large constant suggests the model cannot explain the average excess of investment needs over saving needs across the significant number of emerging and developing countries present in the estimation. Since it is unclear the extent to which such "ignorance" of the model applies to Ecuador, the constant was not included in the calculation of the norm.

[3] Araujo, J., G. Bin Li, M. Poplawski-Ribeiro, and L-F. Zanna, 2013, "Current Account Norms in Natural Resource Rich and Capital Scarce Economies," IMF Working Paper No. 13/80. Also see Box 1 in the Selected Issues paper.

projections indicate that in the absence of a recovery in competitiveness, the current account deficit will remain well above historical standards over the medium term.

3. The real effective exchange rate (REER) appreciated strongly since mid-2014 and is now stronger than warranted by medium-term fundamentals and desirable policies, by 10 to 30 percent. The REER appreciated by about 16 percent from June 2014 to June 2015 as the currencies of trading partners weakened against the US dollar. The three Fund metrics relying on CPI-based-REER indices (CGER-inspired real equilibrium real exchange rate, purchasing power parity, and EBA-lite real exchange rate; ELER, PPP, ELRER, respectively) offer evidence of substantial overvaluation as of the latest REER data in 2015 (see Table 1). A separate approach (GDPR) based on a panel regression of PPP GDP price levels on PPP GDP per capita (both World Bank series) offer consistent evidence: the level of Ecuadorean prices relative to the U.S. was not out of line with model predictions in 2014[4]; however, using the 2015 projection for GDP per capita (see Figure 1) and assuming relative prices rise in the same fashion as the REER appreciation from 2014 to mid-2015, the price level would be much higher than predicted by the model.

Table 1. Ecuador: Real Exchange Rate Assessments for 2015 (in percent) 1/

	CA Norm	NFA	NFA-stabilizing CA	Underlying CA	Gap	Elasticity	Misalignment
Macroeconomic Balance Approach (MB)	-1.9			-2.6	-0.6	-18.0	3.6
EBA-lite Current Account (ECA)	1.0			-2.6	-3.6	-18.0	19.8
Open economy CA model (OEM)	-1.9			-2.6	-0.7	-18.0	3.7
EBA-lite External Sustainability (EES)		-18.9	-0.2	-2.6	-2.4	-18.0	13.1
Equilibrium Real Exchange Rate (ERER)							29.1
EBA-lite Real Exchange Rate (ELRER)							18.2
Purchasing Power Parity (PPP)							12.3
GDP price level regression (GDPR)							25.3

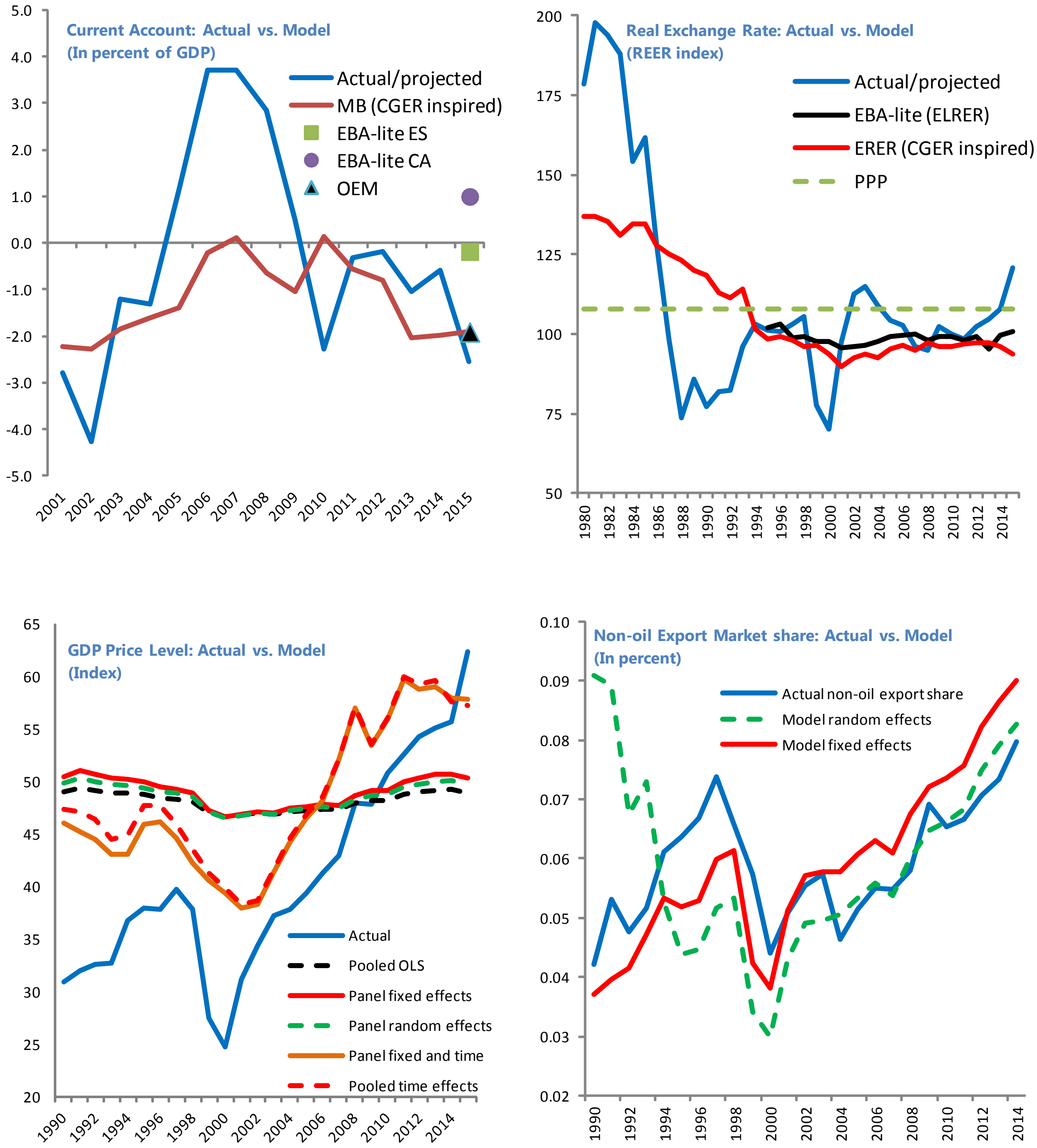
Source: Fund staff calculations.

1/ The MB, ECA, and OEM approaches calculate the difference between the CA balance and an estimated CA "norm".
The EES approach calculates the difference between the actual CA balance and the NFA-stabilizing CA balance.
The ERER, ELRER, and PPP approaches calculate the difference between the RER and an estimated RER "norm".
The GDPR gap/misalignment is the difference between the projected log relative GDP price level in PPP terms and a model-based estimate.

4. Wages have risen significantly over the last 15 years, raising concerns about cost competitiveness. Since the mid-2000's real wages have grown faster than labor productivity, and more recently unit labor costs have grown more rapidly than in trading partners (see Figure 2). In 2014, Ecuador's nominal minimum wage (roughly US$400 a month) was about 30 percent higher than US$288 average of Brazil, Chile, and Colombia (which have the next highest minimum wages among the LA5 countries). As of 2015 Q1, it is 50 percent higher, in part owing to relative exchange rate movements. In terms of minimum wage relative to GDP per

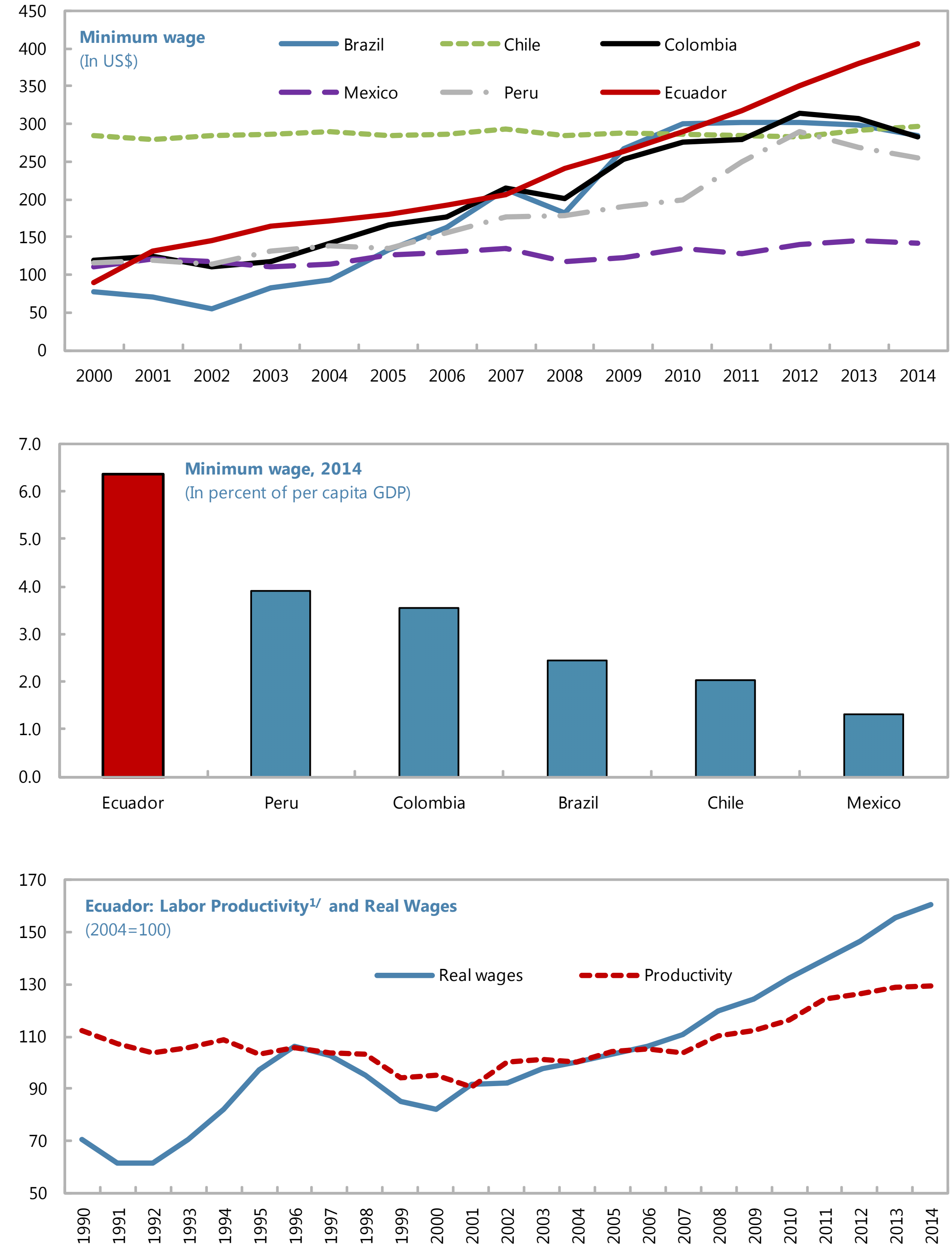
[4] The model uses a panel of the World Bank's internationally-consistent PPP GDP price level data regressed against per capita GDP; five regression specifications are adopted (pooled, random effects, fixed effects, pooled with time effects, and fixed as well as time effects). The results are not very different across specifications. The absence of fixed effects allows a full price level comparison across countries, something not feasible with CPI-based REERs; introducing the fixed effects shows whether results would change substantially when considering a possible omitted variable bias.

Figure 1. Ecuador: External Sector Assessment



Source: IMF World Economic Outlook database, Haver Analytics, IMF staff estimates.

Figure 2. Ecuador: Relative Wages



1/ Output per employed person

Source: IMF World Economic Outlook database, Haver Analytics, IMF staff estimates capita, Ecuador's ratio in 2014 was more than twice the average of the same three countries and 60 percent higher than the ratio for Peru (the next highest among the LA5).

5. Ecuador's global market share in non-oil exports is below a simple GDP-based benchmark, which also hints at competitiveness issues. Standard trade theory suggests that the global trade market share of a country should depend on its world GDP share, among other factors. However, Ecuador's market share in 2014 fell short of its predicted value by 4 to 13 percent (of the actual share), depending on the empirical specification.[5] Non-oil exports have been rising in recent years as Ecuador entered new markets, such as flowers in Russia and shrimp in Asia. However, the downturn in Russia and the end of a shrimp disease in Asia have made those markets more challenging, affecting non-oil exports this year. Starting in 2016, if Ecuador meets the necessary requirements, a trade agreement with the European Union will come into effect and would help non-oil exports to Europe.

6. After large external borrowing by the public sector in 2013 and 2014, financing conditions have tightened for Ecuador, mainly because of the expected effect of the fall in oil prices on public balances. Inflows were coming in from bilateral loans and advance oil sales, notably from China, and loans from multilateral agencies. The sovereign returned to the global bond markets in 2014 with an issuance of US$2 billion in a 10-year bond with a spread over U.S. Treasuries of about 500bps. However, in March and May 2015 the sovereign issued a total of US$1.5 billion in a 5-year bond at an average spread of about 800bps. Going forward, the cost of financing should also increase, *ceteris paribus*, because of the anticipated tightening of U.S. monetary policy.

7. Ecuador's Net International Reserves are low.[6] NIR were about US$4.8 billion at end-July 2015 or about 4.8 percent of projected 2015 GDP. This level is below those recommended by a number of standard reserve adequacy metrics. As of July-2015, reserves covered about 45 percent of the IMF's reserve adequacy metric (2.7 months of imports, and 13 percent of broad money). However, for fully dollarized economies like Ecuador it is difficult to precisely calibrate the need for a foreign exchange liquidity buffer. This need differs from other countries since dollarized economies do not face the risk of exchange rate fluctuations and currency mismatches affecting domestic balance sheets. Nonetheless, a fully dollarized economy may need liquidity for two reasons: to protect the financial system from a liquidity shock and as a fiscal buffer against potential government financing gaps. Additionally, commodity intensive economies may have higher precautionary reserve needs since they have more volatile terms of trade and have greater difficulty in adjusting to commodity price shocks due to lower trade elasticities.[7] Hence, even if Ecuador's balance of payments would eventually adjust automatically to an external financing

[5] A simple panel regression of non-oil export market share on the respective share of world GDP (encompassing 175 countries) has very large explanatory power (the R2 is 0.71 with random effects and 0.97 with fixed effects).

[6] NIR are mainly counterparts of government's and banks' deposits (including reserve requirements) held at the central bank *(*BCE).

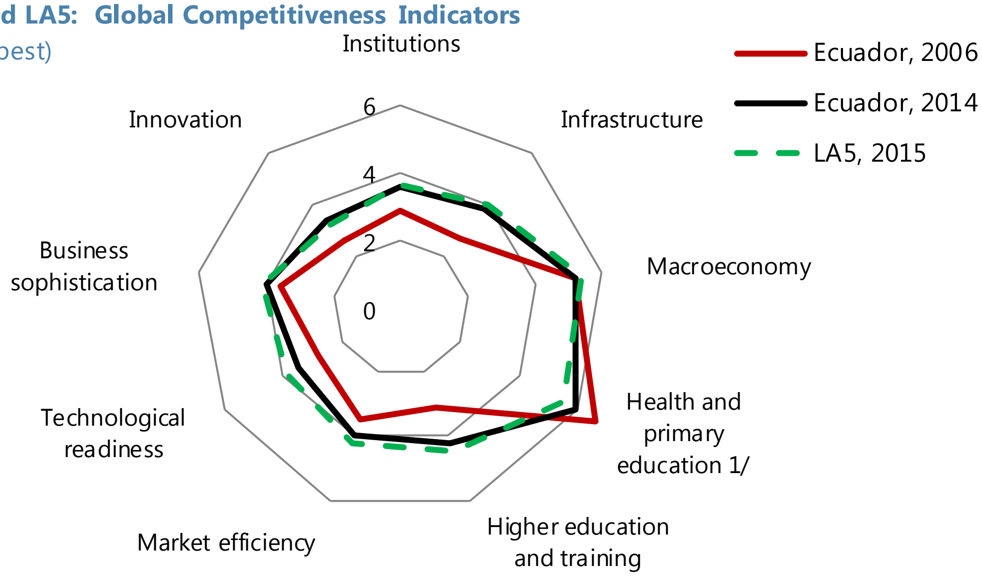
[7] IMF, Assessing Reserve Adequacy—Specific Proposals, December 2014. Adjusting the IMF metric for petroleum price risk as suggested by the paper, would imply a slightly lower reserve adequacy.

shock via a reduction in liquidity and lower domestic demand, the costly adjustment would take time and buffers remain essential to smooth such adjustment.

8. The analysis of international investment position (IIP) does not reveal major vulnerabilities at present. Since 2005, Ecuador has experienced an improving IIP from -38 percent of GDP to about -11 percent in 2014, despite recent government borrowing, due to the large current account surpluses in mid-2000s and strong GDP growth. Indeed, the past decade witnessed a rapid accumulation of foreign assets (deposits) and lower growth of investment and debt stocks. The stock of portfolio liabilities has increased as the sovereign regained international market access after defaulting in 2008. The stock of FDI liabilities has been falling consistently since 2005 and was at 14.5 percent of GDP at end-2014. The stock of loan liabilities has increased in each year in 2013 and 2014. It is now at about 19 percent of GDP, the largest position since 2007. There has been a coinciding rise in currency and deposit assets to about 25 percent of GDP.

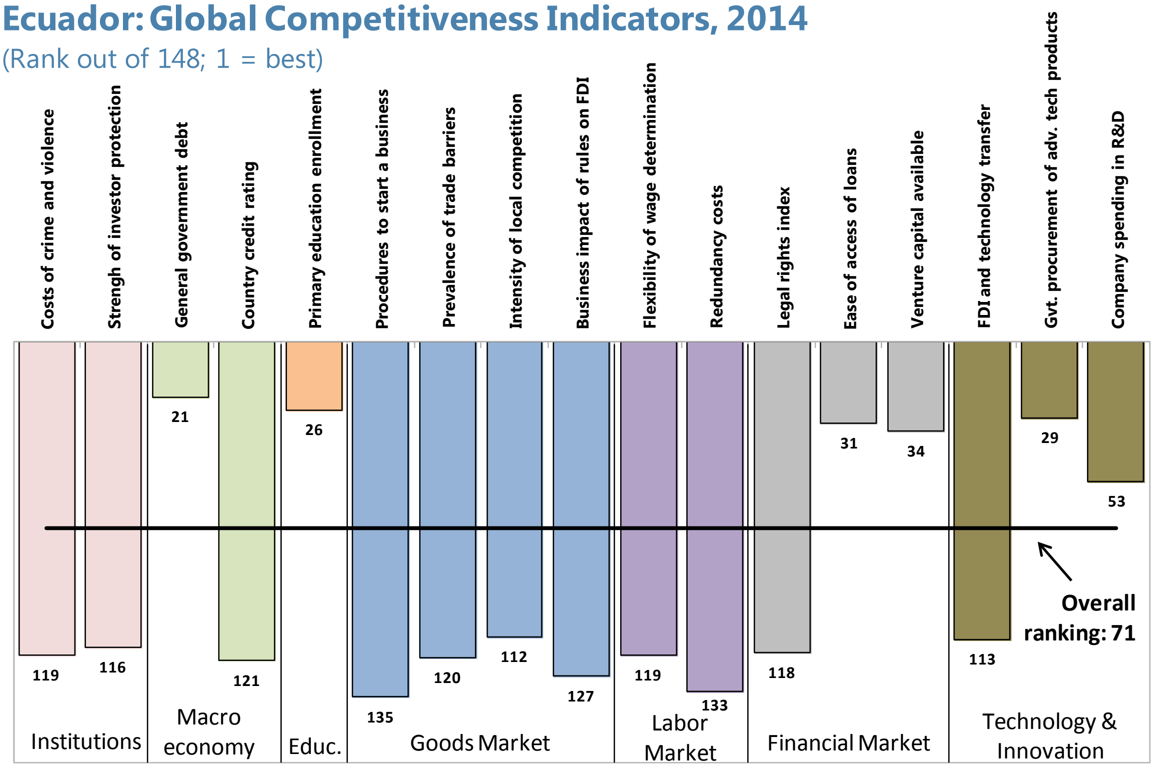
9. Ecuador's international survey-based competitiveness rankings remain low. Broad survey-based competitiveness indicators (such as those of the World Economic Forum's Global Competitiveness Report) improved in most categories over the last decade, and were in 2014 roughly in line with Latin American peers. However, rankings are still poor: the 2013–14 report highlighted inefficiencies in the functioning of institutions, and in goods, labor, and financial markets, mainly because of insufficient competition. In the 2015 World Bank Ease of Doing Business rankings, Ecuador scored 115th out of 189 countries, similar to the previous year (although under a new methodology). Relative to its regional peers, it ranks worse than the average, but better than Venezuela, Bolivia, Argentina, and Brazil. Ecuador's rank was relatively worse in the areas of business regulation, paying taxes, getting access to credit and electricity.

Ecuador and LA5: Global Competitiveness Indicators
(Index; 7 = best)



Source: World Economic Forum.
1/ There was a methodological change in the calculation health and primary education score between the two vintages.

Ecuador: Global Competitiveness Indicators, 2014
(Rank out of 148; 1 = best)

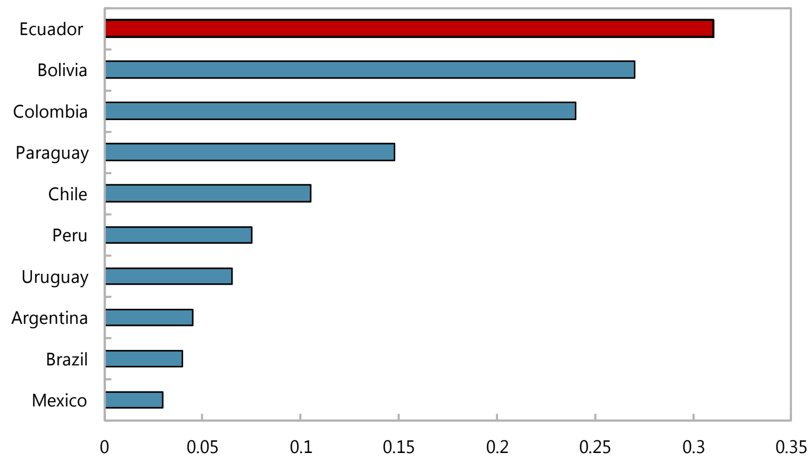


Source: World Economic Forum. Note: Categories listed are those in which Ecuador ranks in the top or bottom quartile of world distribution. Some categories were omitted due to space constrains, namely: (1) Organized crime [129]; (2) Costs of terrorism [122]; (3) Degree of customer orientation [115]; (4) Country capacity to attract talent [35]; (5) Days to start a business [130]; and (6) GG budget balance [35].

10. Recent research by the Fund also points to a poor ranking in economic diversification and complexity, which have been found to matter for long-term growth.[8] These indicators relate to the range and sophistication of products a country produces. In this regard, Ecuador ranks low relative to its regional neighbors, which is not surprising in light of its high product concentration. The study shows that bringing the country's complexity score to the average of Latin American and the Caribbean countries would increase growth by approximately 0.4 percentage points. Recent studies indicate that infrastructure, education, and market openness are keys to inducing greater sophistication. Ecuador's efforts to lower energy costs via hydroelectric projects and improve tertiary education could have a positive effect on this front. However, foreign direct investment has been relatively low, which, with trade openness, has long been highlighted as a source of knowledge spillovers crucial to enhance complexity in developing countries.

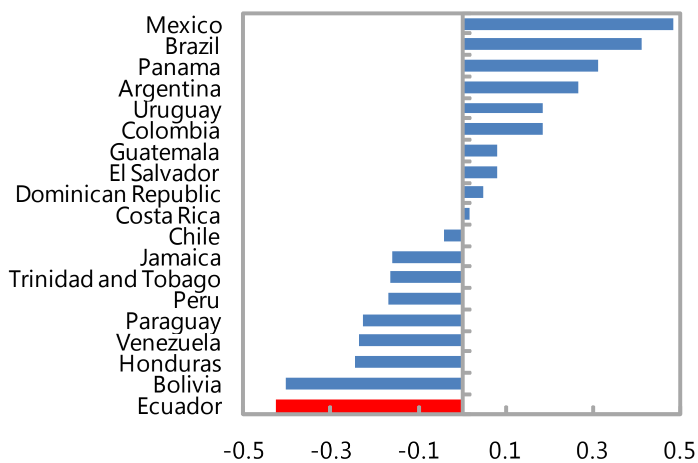
[8] IMF, Regional Economic Outlook: Western Hemisphere, Chapter 5, April 2015.

Herfindahl-Hirschman Product Concentration Index 1/



Sources: World Integrated Trade Solution (WTIS).
1/ This indicator is a measure of the dispersion of trade value across an exporter's products. A preponderance of trade value concentrated in a very few products imply an index value close to 1.

Net Impact on Predicted GDP per Capita Growth Rates: Own Complexity Versus LAC Average Complexity (In percentage points, annual averages)



Source: Rodrigues Bastos and Wang (2015).

Annex III. Debt Sustainability Analysis

While Ecuador's current level of public debt—at 31.3 percent of GDP in 2014—is low by international standards, it has grown rapidly in recent years and is projected to reach about 41 percent of GDP in 2017[1]. The gross financing need is projected to reach about 10.3 percent of GDP in 2015. Medium-term risks remain manageable, in part because the fiscal position is projected to improve after the completion of ongoing large public investment projects. Both the public debt and financing needs will remain below the respective benchmarks even under standard macroeconomic shocks. Assessment of the realism of baseline assumptions for major macroeconomic variables does not point to significant one-sided error, particularly in recent years.

1. **Definition and debt profile:** The public sector debt in this debt sustainability analysis (DSA) includes the obligations of the non-financial public sector (central government and non-financial sector state-owned enterprises), as reported by the authorities, as well as liabilities under advance oil sales. After declining to 17.7 of GDP in 2009, following the 2008 default, the public debt increased to 31.3 percent of GDP in 2014. External debt accounted for about 60 percent of total debt at end-2014, of which about 75 percent was owed to official creditors. Medium- and long-term loans constitute 100 percent of the total public debt stock.

2. **Baseline macroeconomic and fiscal assumptions:** Under staff's baseline scenario, which underpins the DSA, growth is projected at about 1¾ percent and inflation (GDP deflator) at about 1½ percent in the medium term. The fiscal position is projected to improve with a primary surplus of about 2⅓ percent of GDP in 2020 on the back of significant expenditure retrenchment (in part due to the completion of ongoing large public investment projects). Under these assumptions, the gross financing need of the public sector is projected to fall to about 7 percent of GDP in 2020. After peaking at about 41 percent of GDP in 2017, the public-debt-to GDP ratio is projected to decline to about 39½ percent in 2020. The DSA tool that assesses the realism of projections for real GDP growth, primary balance, and inflation does not indicate significant systematic biases.

3. **Stress tests:** Both the gross financing needs and the public debt-to-GDP ratio remain within the corresponding low-risk thresholds under the standard macroeconomic shocks (i.e., shocks in real GDP growth, primary balance, real interest rate, and exchange rate). The public-debt-to GDP ratio remains below 50 percent and the gross financing need below 15 percent of GDP even under the combined macro-fiscal shock. Note that the as long as the

[1] Staff's definition of public debt figures include liabilities under advance oil sales, which are not considered as public debt in the official (authorities') definition. Public debt excluding liabilities under advance oil sales—which is the relevant official definition for the legal ceiling of 40 percent—was about 30 percent of GDP in 2014 and will reach about 40 percent of GDP in 2018.

legal limit of 40 percent is binding, corrective fiscal actions are likely to be triggered when debt approaches 40 percent.

4. Risks and vulnerabilities: The public DSA risk assessment identifies market perception and the ratio of public debt held by non-residents as high risks for Ecuador. At 60 percent of the total debt, non-residents' holding of Ecuador's public debt gives the appearance of being a source of vulnerability, but about 75 percent of the external debt is owed to official creditors and there is limited vulnerability. The high market perception risk is a reflection of both high sovereign spreads in part associated with the 2008 default and the recent hike in spreads following the recent decline in oil prices.[2] However, near-term rollover risks are limited to the US$650 million 2015 bond, the only sovereign bond maturing before 2020.

5. Fiscal Sustainability Frameworks: The analysis from the Fund's Fiscal Sustainability Frameworks for resource dependent economies suggest that the strong fiscal consolidation planned over the next few years—imposed by the decline in oil prices—implies that the medium-term non-oil primary deficit (about ¾ percent of GDP) is consistent with long-term fiscal sustainability (associated with a non-oil primary deficit ranging from about 3½ to 6 percent of GDP, depending on the methodology; see Figure 5).

6. External DSA: The current account deficit is projected to widen to about 2¾ percent of GDP in 2016, from about ½ a percentage point in 2014, due to lower oil exports (Ecuador's main export commodity) and continuing large fiscal deficits. The expected improvement in the fiscal position will, however, help reduce the current account deficit in the medium term to about 1¾ percent of GDP. The current account deficit is expected to be financed mostly by public external borrowing. Consequently, the external debt-to-GDP ratio is projected to increase to about 37½ percent of GDP in 2018, from 25.4 percent in 2014, before stabilizing at about 37⅓ percent of GDP in 2020. The external debt trajectory is sensitive to the non-interest current account shock (e.g. terms of trade shock) and a large (30 percent) real exchange rate depreciation. But such a large real depreciation is unlikely to materialize due to dollarization.

[2] Ecuador's EMBIG Sovereign spread has increased significantly to 1315 bps as of August 26, 2015, from 475 bps a year a go.

Table 1. Ecuador: Public Sector Debt Sustainability Analysis (DSA) - Baseline Scenario

(In percent of GDP unless otherwise indicated)

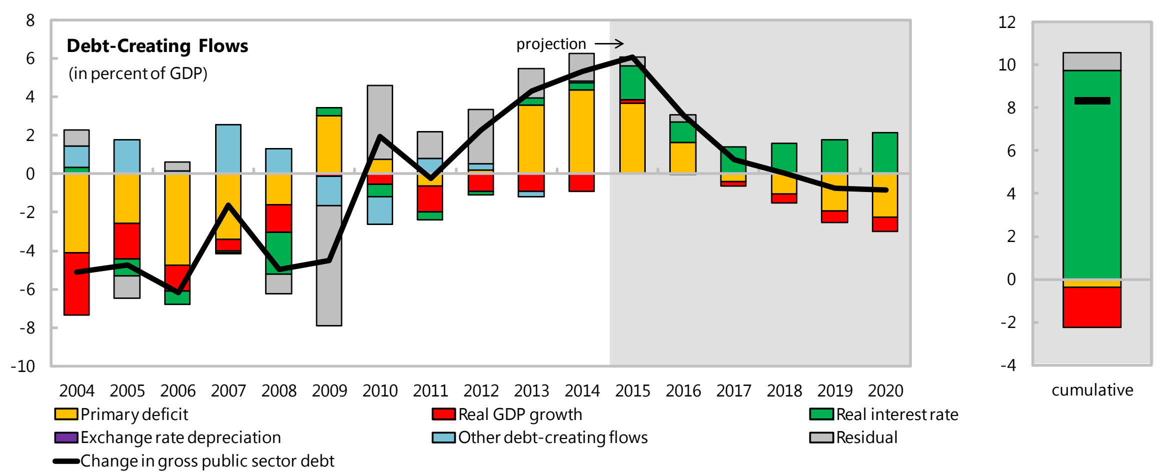
Debt, Economic and Market Indicators [1/]

	Actual			Projections					
	2004-2012 [2/]	2013	2014	2015	2016	2017	2018	2019	2020
Nominal gross public debt	25.7	26.0	31.3	37.4	40.4	41.2	41.2	40.5	39.6
Public gross financing needs	2.8	6.8	10.3	10.3	8.5	6.5	6.1	5.5	7.1
Real GDP growth (in percent)	4.8	4.6	3.8	-0.6	0.1	0.6	1.2	1.5	1.8
Inflation (GDP deflator, in percent)	6.6	3.0	2.5	-1.0	2.7	2.4	2.3	2.1	1.4
Nominal GDP growth (in percent)	11.8	7.8	6.4	-1.6	2.8	3.0	3.5	3.6	3.3
Effective interest rate (in percent) [4/]	4.8	5.1	4.2	4.6	5.6	6.0	6.2	6.6	6.9

As of August 26, 2015		
Sovereign Spreads		
EMBIG (bp) 3/		1315
5Y CDS (bp)		n.a.
Ratings	Foreign	Local
Moody's	B3	B3
S&Ps	B	B
Fitch	B	B

Contribution to Changes in Public Debt

	Actual			Projections							
	2004-2012	2013	2014	2015	2016	2017	2018	2019	2020	cumulative	debt-stabilizing primary balance [9/]
Change in gross public sector debt	-2.6	4.3	5.3	6.1	3.1	0.8	0.0	-0.8	-0.9	8.3	
Identified debt-creating flows	-2.7	2.8	3.9	5.6	2.7	0.8	0.0	-0.8	-0.9	7.5	
Primary deficit	-1.5	3.6	4.3	3.7	1.6	-0.4	-1.0	-1.9	-2.3	-0.4	1.4
Primary (noninterest) revenue and grants	30.2	39.4	38.8	35.4	33.7	33.4	33.4	33.6	33.5	203.1	
Primary (noninterest) expenditure	28.8	43.0	43.2	39.1	35.3	33.0	32.4	31.7	31.2	202.7	
Automatic debt dynamics [5/]	-1.8	-0.5	-0.6	2.0	1.0	1.2	1.1	1.2	1.4	7.8	
Interest rate/growth differential [6/]	-1.8	-0.5	-0.6	2.0	1.0	1.2	1.1	1.2	1.4	7.8	
Of which: real interest rate	-0.5	0.4	0.4	1.8	1.0	1.4	1.6	1.8	2.2	9.7	
Of which: real GDP growth	-1.3	-0.9	-0.9	0.2	0.0	-0.2	-0.5	-0.6	-0.7	-1.9	
Exchange rate depreciation [7/]	0.0	0.0	0.0	…	…	…	…	…	…	…	
Other identified debt-creating flows	0.6	-0.3	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes [8/]	0.1	1.5	1.4	0.5	0.4	0.0	0.0	0.0	0.0	0.9	



Source: Fund staff.

1/ Public sector is defined as non-financial public sector.

2/ Based on available data.

3/ Long-term bond spread over U.S. bonds.

4/ Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.

5/ Derived as [(r - π(1+g) - g + ae(1+r)]/(1+g+π+gπ)) times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

6/ The real interest rate contribution is derived from the numerator in footnote 5 as r - π (1+g) and the real growth contribution as -g.

7/ The exchange rate contribution is derived from the numerator in footnote 5 as ae(1+r).

8/ Includes asset changes and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

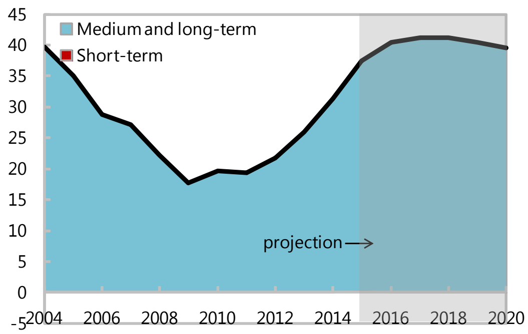
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Figure 1. Ecuador: Public DSA - Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

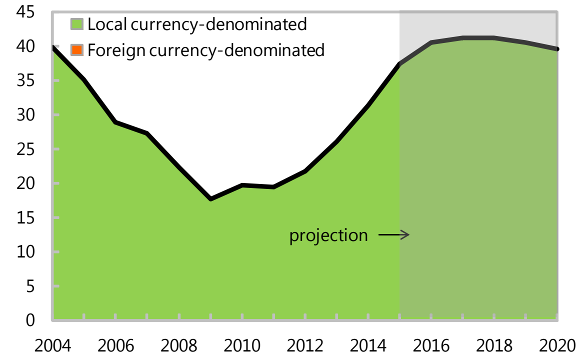
By Maturity

(In percent of GDP)



By Currency

(In percent of GDP)

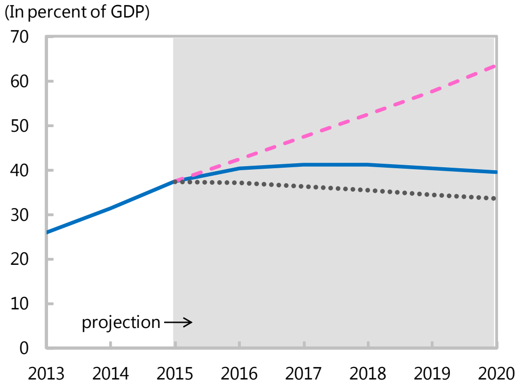


Alternative Scenarios

Baseline Historical Constant Primary Balance

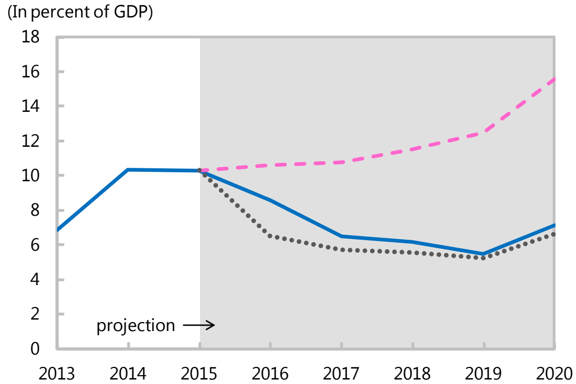
Gross Nominal Public Debt

(In percent of GDP)



Public Gross Financing Needs

(In percent of GDP)



Underlying Assumptions

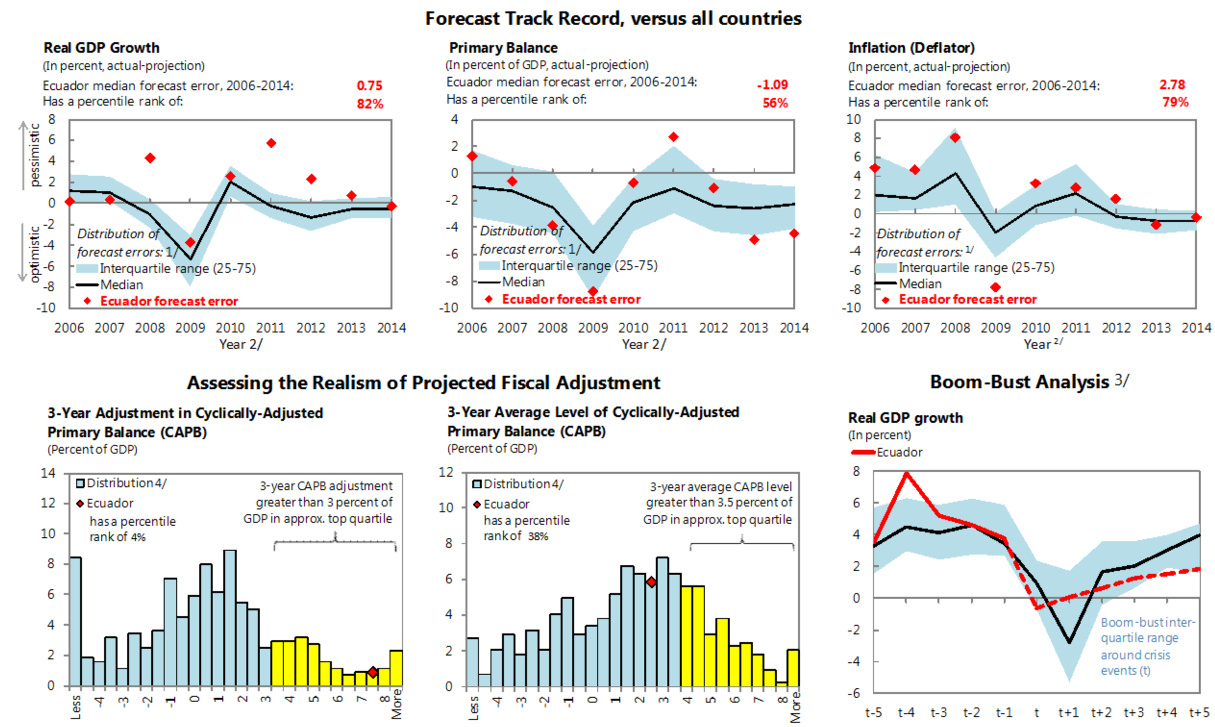
(in percent)

Baseline Scenario	2015	2016	2017	2018	2019	2020
Real GDP growth	-0.6	0.1	0.6	1.2	1.5	1.8
Inflation	-1.0	2.7	2.4	2.3	2.1	1.4
Primary Balance	-3.7	-1.6	0.4	1.1	1.9	2.3
Effective interest rate	4.6	5.6	6.0	6.2	6.6	6.9
Constant Primary Balance Scenario						
Real GDP growth	-0.6	0.1	0.6	1.2	1.5	1.8
Inflation	-1.0	2.7	2.4	2.3	2.1	1.4
Primary Balance	-3.7	-3.7	-3.7	-3.7	-3.7	-3.7
Effective interest rate	4.6	5.6	6.0	6.4	6.8	7.2

Historical Scenario	2015	2016	2017	2018	2019	2020
Real GDP growth	-0.6	4.4	4.4	4.4	4.4	4.4
Inflation	-1.0	2.7	2.4	2.3	2.1	1.4
Primary Balance	-3.7	0.1	0.1	0.1	0.1	0.1
Effective interest rate	4.6	5.6	4.9	4.4	4.0	3.8

Source: Fund staff.

Figure 2. Ecuador: Public DSA - Realism of Baseline Assumptions



Source : Fund Staff.

1/ Plotted distribution includes all countries, percentile rank refers to all countries.

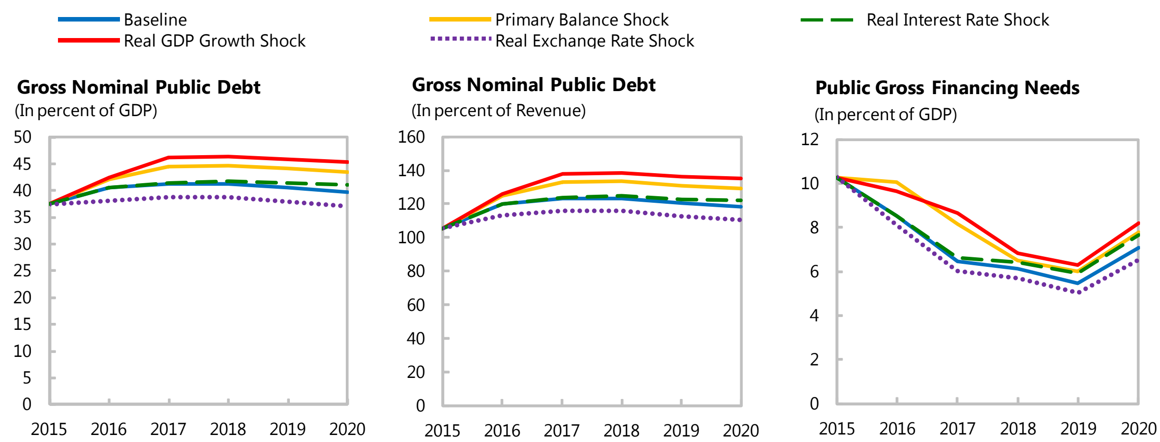
2/ Projections made in the spring WEO vintage of the preceding year.

3/ Ecuador has had a positive output gap for 3 consecutive years, 2012-2014. For Ecuador, t corresponds to 2015; for the distribution, t corresponds to the first year of the crisis.

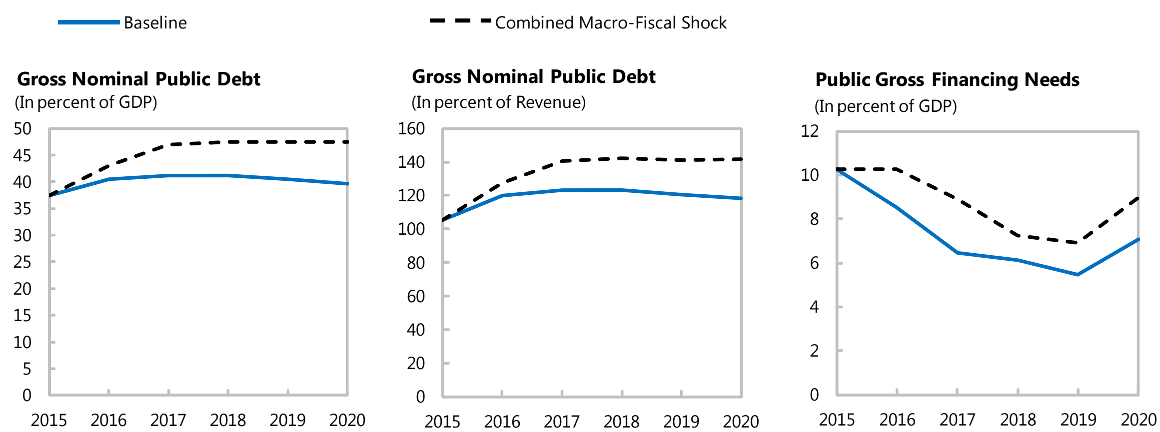
4/ Data cover annual obervations from 1990 to 2011 for advanced and emerging economies with debt greater than 60 percent of GDP. Percent of sample on vertical axis.

Figure 3. Ecuador Public DSA - Stress Tests

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions

(In percent)

Primary Balance Shock	2015	2016	2017	2018	2019	2020
Real GDP growth	-0.6	0.1	0.6	1.2	1.5	1.8
Inflation	-1.0	2.7	2.4	2.3	2.1	1.4
Primary balance	-3.7	-3.2	-1.1	1.1	1.9	2.3
Effective interest rate	4.6	5.6	6.1	6.5	6.8	7.1
Real Interest Rate Shock						
Real GDP growth	-0.6	0.1	0.6	1.2	1.5	1.8
Inflation	-1.0	2.7	2.4	2.3	2.1	1.4
Primary balance	-3.7	-1.6	0.4	1.1	1.9	2.3
Effective interest rate	4.6	5.6	6.4	7.0	7.6	8.1
Combined Shock						
Real GDP growth	-0.6	-2.0	-1.5	1.2	1.5	1.8
Inflation	-1.0	2.2	1.9	2.3	2.1	1.4
Primary balance	-3.7	-3.2	-1.3	1.1	1.9	2.3
Effective interest rate	4.6	5.6	6.5	7.1	7.7	8.3

Real GDP Growth Shock	2015	2016	2017	2018	2019	2020
Real GDP growth	-0.6	-2.0	-1.5	1.2	1.5	1.8
Inflation	-1.0	2.2	1.9	2.3	2.1	1.4
Primary balance	-3.7	-2.6	-1.3	1.1	1.9	2.3
Effective interest rate	4.6	5.6	6.1	6.4	6.8	7.1
Real Exchange Rate Shock						
Real GDP growth	-0.6	0.1	0.6	1.2	1.5	1.8
Inflation	-1.0	9.4	2.4	2.3	2.1	1.4
Primary balance	-3.7	-1.6	0.4	1.1	1.9	2.3
Effective interest rate	4.6	5.6	6.0	6.3	6.6	6.9

Source: Fund staff.

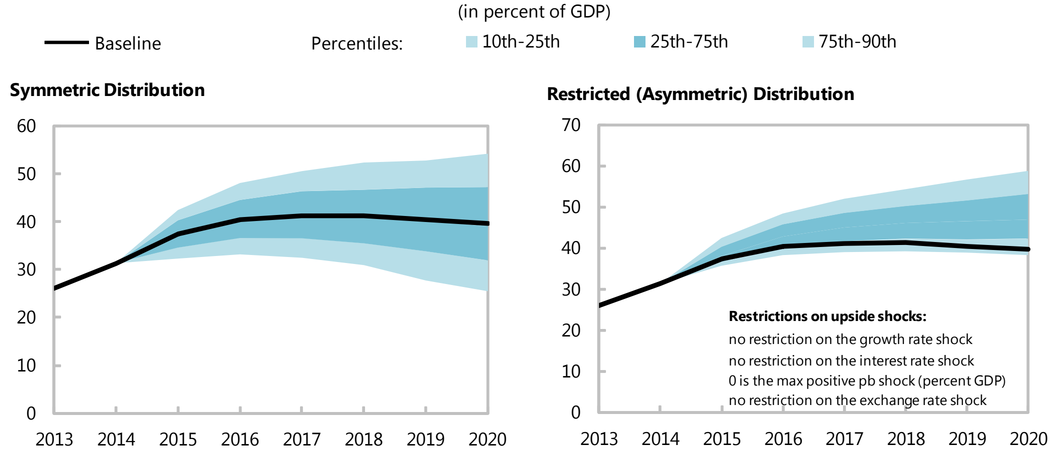
Figure 4. Ecuador Public DSA Risk Assessment

Heat Map

Debt level 1/	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability shock
Gross financing needs 2/	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability Shock
Debt profile 3/	Market Perception	External Financing Requirements	Change in the Share of Short-Term Debt	Public Debt Held by Non-Residents	Foreign Currency Debt

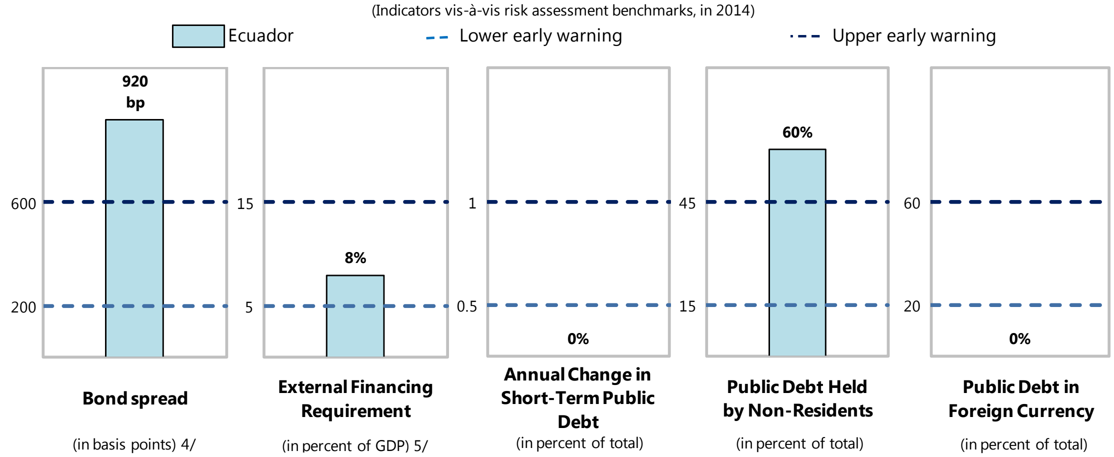
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2014)



Source: Fund staff.

1/ The cell is highlighted in green if debt burden benchmark of 70% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

2/ The cell is highlighted in green if gross financing needs benchmark of 15% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

3/ The cell is highlighted in green if country value is less than the lower risk-assessment benchmark, red if country value exceeds the upper risk-assessment benchmark, yellow if country value is between the lower and upper risk-assessment benchmarks. If data are unavailable or indicator is not relevant, cell is white.

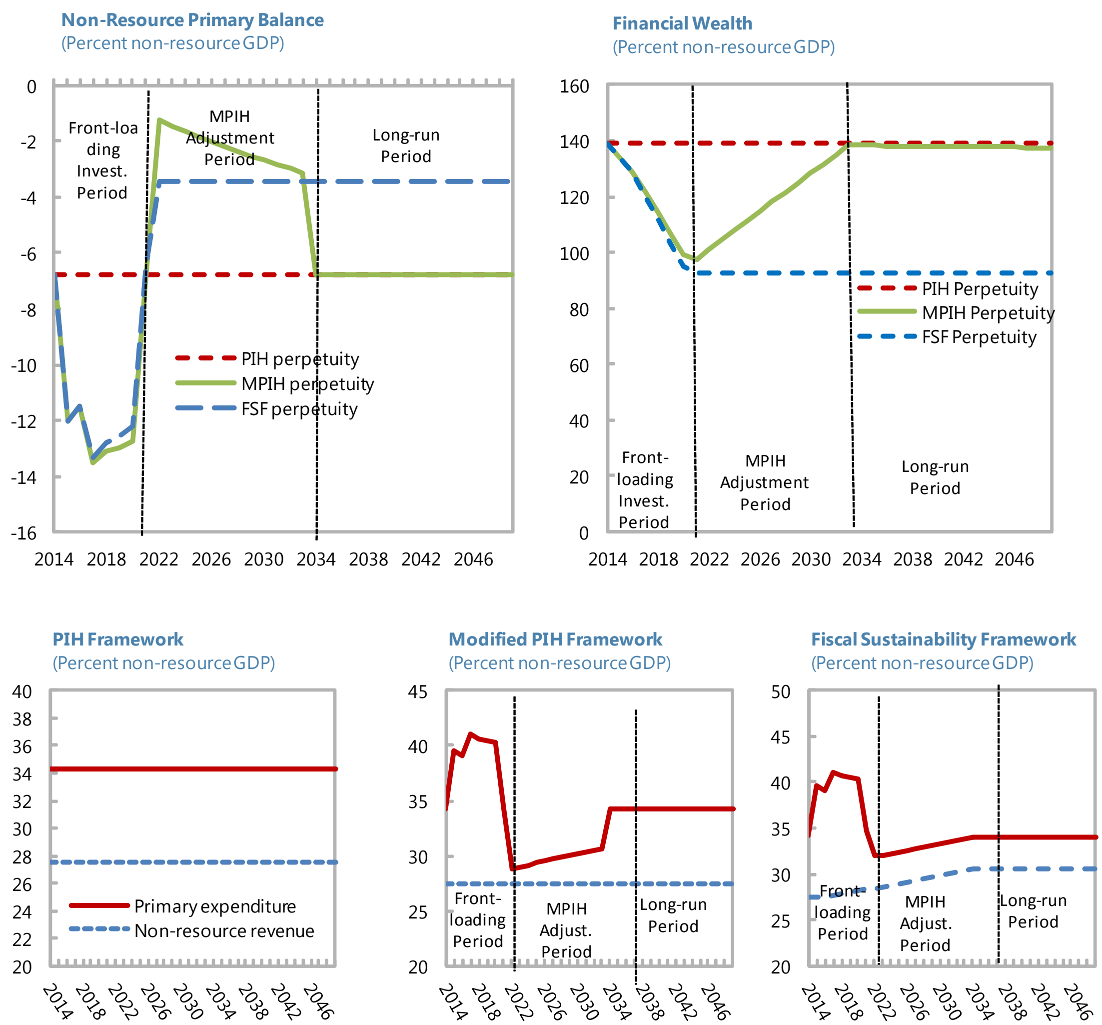
Lower and upper risk-assessment benchmarks are:

200 and 600 basis points for bond spreads; 5 and 15 percent of GDP for external financing requirement; 0.5 and 1 percent for change in the share of short-term debt; 15 and 45 percent for the public debt held by non-residents; and 20 and 60 percent for the share of foreign-currency denominated debt.

4/ Long-term bond spread over U.S. bonds, an average over the last 3 months, 28-May-15 through 26-Aug-15.

5/ External financing requirement is defined as the sum of current account deficit, amortization of medium and long-term total external debt, and short-term total external debt at the end of previous period.

Figure 5. Ecuador: Fiscal Sustainability Frameworks 1/



Source: Fund staff calculations.

1/ See "Macroeconomic Policy Frameworks for Resource-Rich Developing Countries" for methodology. PIH= permanent income hypothesis; MPIH= modified permanent income hypothesis; FSF= fiscal sustainability framework.

Table 2. Ecuador: External Debt Sustainability Framework, 2010-2020

(In percent of GDP, unless otherwise indicated)

	Actual							Projections						
	2010	2011	2012	2013	2014	10-Year Historical Average	10-Year Standard Deviation	2015	2016	2017	2018	2019	2020	Debt-stabilizing non-interest current account 6/
Baseline: External debt	**20.6**	**20.4**	**18.7**	**21.5**	**25.4**			**31.9**	**35.9**	**36.9**	**37.6**	**37.5**	**37.3**	**2.4**
Change in external debt	-2.4	-0.2	-1.7	2.8	3.9			6.5	4.0	1.0	0.7	-0.1	-0.2	
Identified external debt-creating flows (4+8+9)	0.2	-1.4	-1.1	0.5	0.1			3.0	2.9	2.5	2.5	1.8	1.7	
Current account deficit, excluding interest payments	1.4	-0.5	-0.7	0.1	-0.5			0.7	0.3	-0.4	-0.4	-1.1	-1.2	
Deficit in balance of goods and services	4.4	2.2	1.5	2.1	1.3			2.4	2.0	1.5	1.6	0.8	0.8	
Exports	28.2	31.1	30.1	29.3	28.8			22.7	22.8	23.5	23.6	23.7	23.6	
Imports	32.5	33.3	31.6	31.4	30.1			25.2	24.8	25.0	25.2	24.6	24.3	
Net non-debt creating capital inflows (negative)	0.2	0.8	0.7	0.8	0.8			0.7	0.8	0.8	0.8	0.8	0.8	
Automatic debt dynamics 1/	-1.4	-1.7	-1.1	-0.4	-0.2			1.6	1.9	2.1	2.1	2.2	2.1	
Contribution from nominal interest rate	0.9	0.9	0.9	1.0	1.1			1.5	1.9	2.3	2.5	2.7	2.8	
Contribution from real GDP growth	-0.7	-1.4	-1.0	-0.8	-0.8			0.2	0.0	-0.2	-0.4	-0.5	-0.7	
Contribution from price and exchange rate changes 2/	-1.6	-1.1	-1.0	-0.5	-0.5			...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	-2.6	1.2	-0.6	2.4	3.9			3.5	1.0	-1.5	-1.8	-1.9	-1.9	
External debt-to-exports ratio (in percent)	73.1	65.5	62.0	73.3	88.4			140.5	157.5	157.3	159.4	157.8	158.1	
Gross external financing need (in billions of U.S. dollars) 4/	4.8	3.5	3.3	4.4	6.5			8.6	8.5	8.6	8.8	8.4	10.7	
in percent of GDP	6.9	4.4	3.8	4.6	6.5			8.7	8.4	8.2	8.1	7.5	9.2	
Scenario with key variables at their historical averages 5/								**31.9**	**30.7**	**27.2**	**23.6**	**20.1**	**16.6**	**0.0**
Key Macroeconomic Assumptions Underlying Baseline														
Real GDP growth (in percent)	3.5	7.9	5.2	4.6	3.8	4.4	2.1	-0.6	0.1	0.6	1.2	1.5	1.8	
GDP deflator in U.S. dollars (change in percent)	7.5	5.7	5.0	3.0	2.5	6.1	3.7	-1.0	2.7	2.4	2.3	2.1	1.4	
Nominal external interest rate (in percent)	4.3	4.8	4.7	5.7	5.2	5.7	1.4	5.6	6.2	6.7	7.1	7.4	7.7	
Growth of exports (U.S. dollar terms, in percent)	24.5	25.8	6.9	5.1	4.4	13.7	16.7	-22.3	3.0	6.0	4.0	4.4	2.6	
Growth of imports (U.S. dollar terms, in percent)	34.0	16.6	5.0	7.2	1.8	13.2	15.9	-17.7	1.4	3.6	4.4	1.1	2.4	
Current account balance, excluding interest payments	-1.4	0.5	0.7	-0.1	0.5	2.3	2.8	-0.7	-0.3	0.4	0.4	1.1	1.2	
Net non-debt creating capital inflows	-0.2	-0.8	-0.7	-0.8	-0.8	-0.8	0.4	-0.7	-0.8	-0.8	-0.8	-0.8	-0.8	

Source: Fund staff.

1/ Derived as [r - g - r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as [-r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock. r increases with an appreciating domestic currency (e > 0) and rising inflation (based on GDP deflator).

3/ For projection, line includes the impact of price and exchange rate changes.

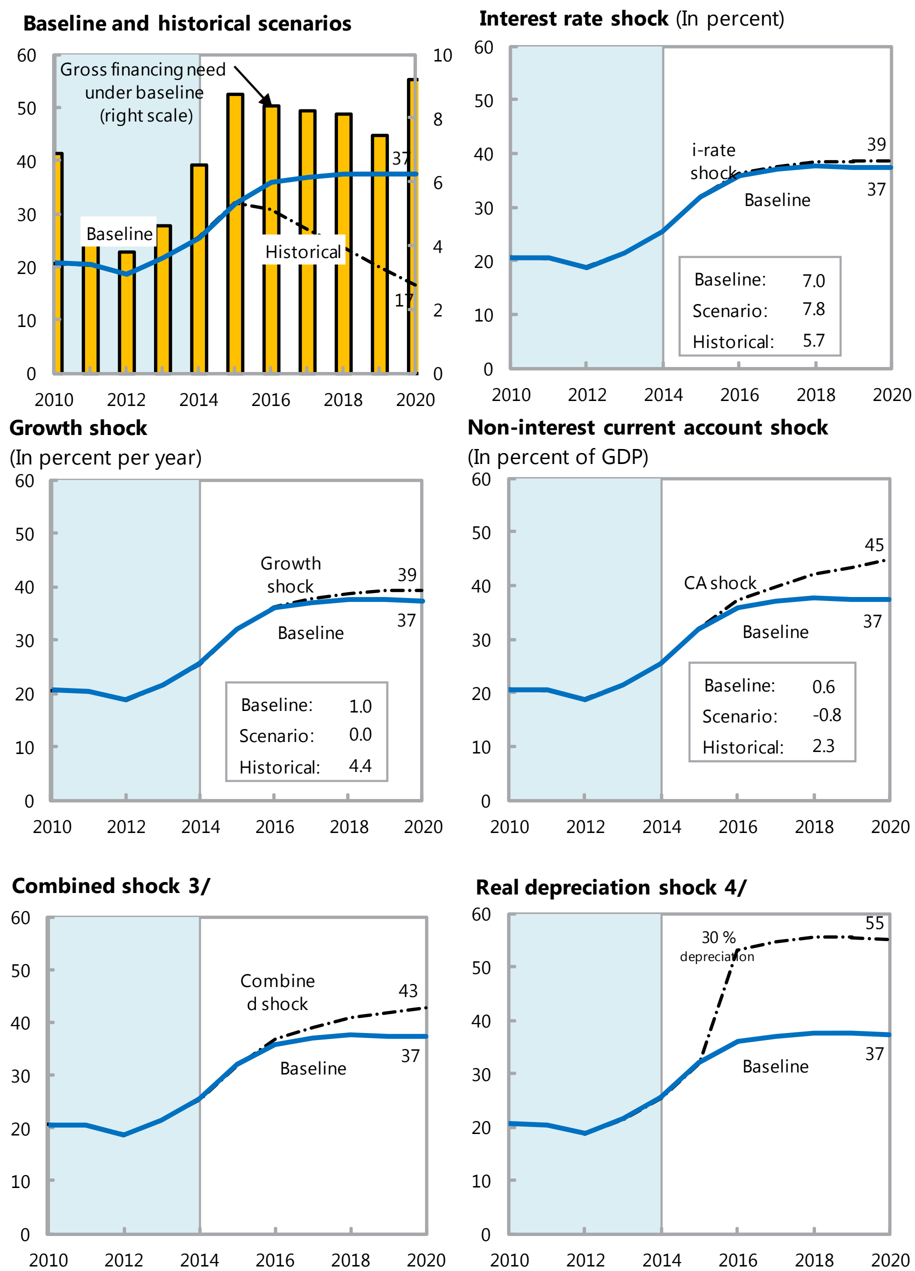
4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

Figure 6. Ecuador: External Debt Sustainability: Bound Tests 1/ 2/

(External debt in percent of GDP)



Sources: International Monetary Fund, Country desk data, and staff estimates.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.

2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.

3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.

4/ One-time real depreciation of 30 percent occurs in 2010.

Annex IV. Financial Stability Assessment[1]

This annex briefly discusses recent developments in Ecuador's banking system, highlights potential vulnerabilities going forward, especially in light of the economic downturn, and briefly highlights policy implications.

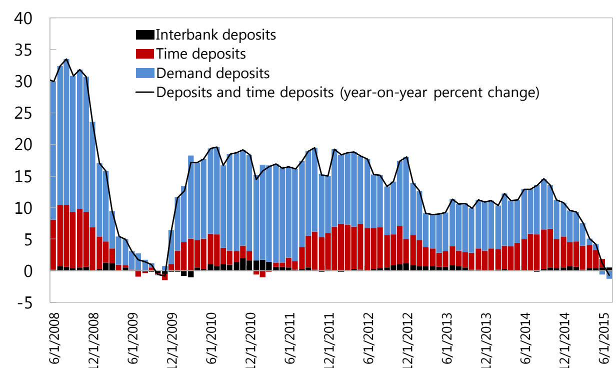
1. **The external shocks would naturally imply a downward adjustment in the extent of financial intermediation.** The external shocks, and particularly the oil price shock, are reducing the amount of liquidity available in the system. This is a natural adjustment process in a dollarized economy, and can be expected to be reflected in a decline in the rate of growth or in the level of deposits and credit.

2. **Indeed, after an improvement in 2014, Ecuador's financial system conditions have been worsening during the first half of 2015.** In 2014, financial buffers, such as deposits to loan ratios, profitability and NPLs have marginally improved. Capital adequacy ratios continued to be above the legal requirement of 9 percent and Basel's 8 percent, and bank relied on ample liquidity. However, since the beginning of 2015, deposits, liquidity and credit have progressively declined while the leverage ratio and NPLs have edged up, albeit moderately. In addition, sovereign spreads have increased substantially since end-2014 (by about 800 basis points until July 2015), indicating a much higher risk of government debt which is rated at zero risk under Basel (although banks consider this debt quite illiquid in their stress tests).[2] The following sections offer a description of recent developments, highlighting possible risks (focusing in particular on the key liquidity, credit, and interest rate risks).

Liquidity Risk: Evolution of Deposits, Credit and Liquidity Buffers

3. **Deposit growth decelerated sharply in the first half of 2015, following several years of high growth.** From December 2014 to July 2015, total deposits dropped by about US$2 billion to US$25.7 billion. Growth of private sector demand deposits (70 percent of the total) became negative in June (-0.9 percent). Overall, the downward trend is similar to the one during the 2009 downturn. Term deposits, growing above 10 percent for the last five years, have experienced an even sharper slowdown since end-2014, staying flat

Ecuador: Deposit Growth Contributions
(Contribution to total deposit growth y/y, in percentage points)



Source: Superindendency of Banks.

[1] Prepared by M. Saldias (MCM) and S. Vtyurina (WHD). See accompanying Selected Issues paper for more detail.

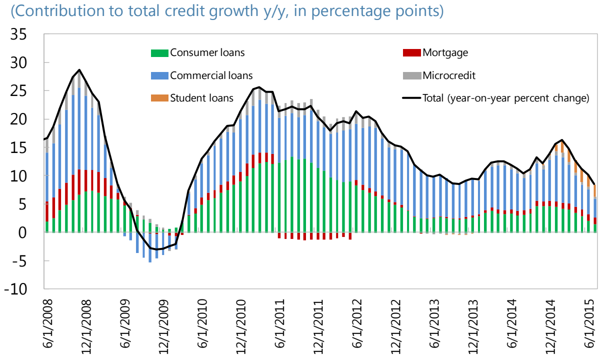
[2] The total commercial banking system's credit to the public sector (in the form of securities) is about 7 percent of their assets.

in July. The deposit decline reflects mainly the adjustment to the economic downturn, but also confidence-driven shocks seem responsible.

4. **Banks have responded quickly to deposit decline.** They allowed liquid assets to decline by US$1.8 billion between December 2014 and April 2015. Since April, banks have also been rationing credit, which declined by almost $0.5 billion between April and July, affecting even the highest quality customers. Given the higher contraction of deposit growth than credit growth, the loan-to-deposit ratio of the private banking sector started to increase, reversing the 2014 trend. It increased on average from 73.5 percent in 2014 to a historical maximum at 81.7 percent in July 2015, pointing to potential funding pressures in spite of the corresponding slower credit growth and to the emergence of pockets of weaknesses in the financial sector.

Ecuador: Credit Growth Contribution

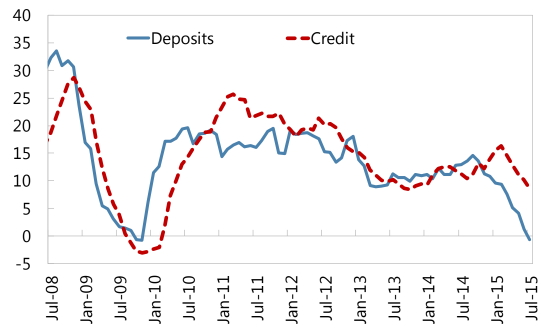
(Contribution to total credit growth y/y, in percentage points)



Source: Superindendency of Banks.

Ecuador: Deposits and Credit at Private Banks

(In percent, year-on-year change)

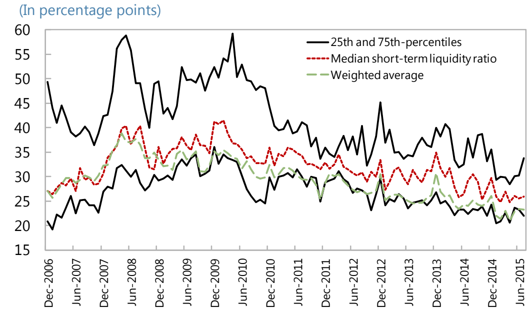


Sources: Superintendency of Banks.

5. **In addition, short-term liquidity in private banks has been declining, in fact, continuously since 2008.** Short-term liquidity represents around 70 percent of liquid assets, hence short-term liquidity ratios deserve close monitoring. The key ratio (defined as short-term liquid assets to short-term liabilities) reached historically low levels in April 2015 (20.9 percent), before slightly recovering (to 23.3 percent) in July 2015.

Ecuador: Short-term Liquidity Ratio Distribution

(In percentage points)



Source: Superintendency of Banks.

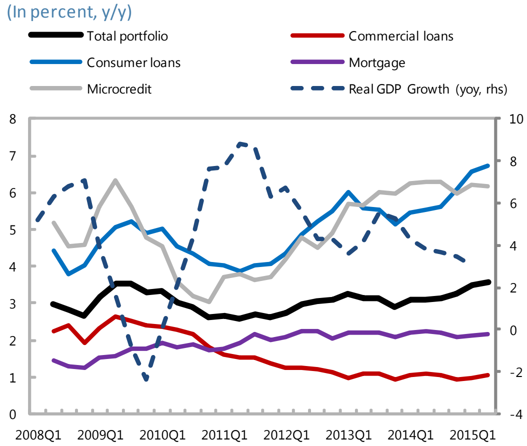
6. **Due to the liquidity cushions accumulated by banks in cash and in deposits at the central bank, the current pace of deposit withdrawal should not cause significant liquidity stress in 2015.** A baseline liquidity decline scenario performed by Fund staff over a six-month horizon shows that if deposits continue to decline at the pace of the first seven months of 2015, and banks can access their liquid assets, no bank would need to access external sources of

liquidity—including the Liquidity Fund—this year.[3] Obviously, if deposits decline at a significantly faster pace, banks' external liquidity needs are more likely to arise. In addition, the liquidity analysis shows that assumptions about liquidity recovery from deposits held in other domestic banks, and especially in government paper, play a very important role for potential stress. The latter is directly linked to the liquidity of government debt in secondary markets.

Credit risk: Evolution of Non-Performing Loans and Banks' Profitability

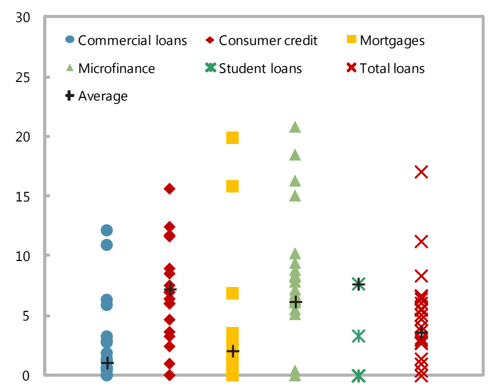
7. Correlation of NPL with real GDP growth point out to potential credit risk during a downturn.[4] While correlation was high between banks' overall NPL and real GDP over the period 1993–2003 in Ecuador, it is much less so since 2008. However, consumer and microcredit loans are still highly correlated with real GDP growth, and both their share in the banks' portfolio and their corresponding NPLs are increasing. This suggests that credit risk would rise if the economic downturn remains persistent.

Ecuador: NPLs by Loan Type[1] and Real GDP Growth
(In percent, y/y)



Source: , Superintendency of Banks, Haver Analitycs and IMF staff calculations.
[1]NPLs by loan type in percent of total loans.

Ecuador: NPLs by Loan Type and Bank



Source: Superindendency of Banks. July 2015.

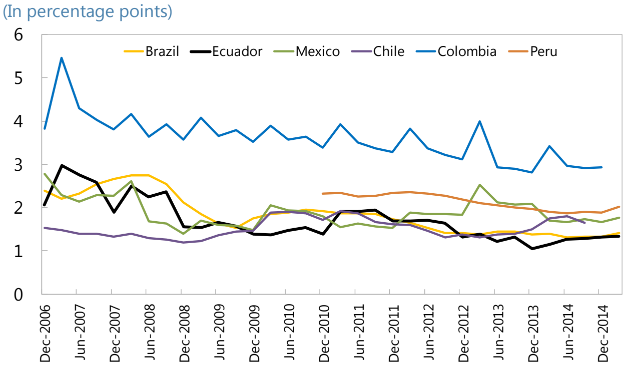
[3] The baseline scenario assumes a monthly decline of 1.5 percent in demand deposits and 0.4 percent in term deposits, to reflect the average decline registered between December 2014 and July 2015. Based on the following assumptions, the monthly implied liquid assets availability is calculated as the sum of: 100 percent of cash, 95 percent of deposits at the BCE, 80 percent of deposits in foreign and domestic banks as well as interbank positions, 50 percent of debt holdings, and 1 percent of illiquid assets (and it corresponds to about 89 percent of total liquid assets). The faster decline scenario refers to a persistent decline equal to the maximum month-on-month deposits decline recorded in 2015 for each bank.

[4] For empirical evidence on this link see: Mwanza N (2011) "Nonperforming Loans and Macrofinancial Vulnerabilities in Advanced Economies" IMF Working Papers 11/161, International Monetary Fund. and Espinoza, R. and Prasad, A. (2010) "Nonperforming Loans in the GCC Banking System and their Macroeconomic Effects," IMF Working Papers 10/224, International Monetary Fund. Di Bella (2011) "The Impact of the Global Financial Crisis on Microfinance and Policy Implications" IMF Working Papers 11/175, International Monetary Fund provides specific evidence for microfinance loans NPL over the cycle.

8. NPL have edged up in 2015, but they remain reasonably low by international standards in aggregate terms. NPL in private banks increased from 2.9 in December 2014 to 3.8 in July 2015 and are higher in consumer, microfinance, and education loans. Moreover, their distribution by bank and by loan type now shows that potential losses are unevenly distributed, suggesting that potential credit risks could be more severe in banks with concentrated exposures to specific sectors. Although the general pattern is that smaller banks tend to have larger NPL, several large and medium sized banks also show high values in some segments.

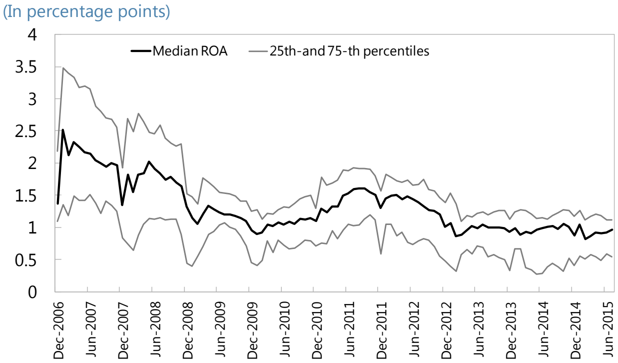
9. Bank profitability has been on a declining trend for a few years, and is lower than in other countries of the region. Profitability of private banks has declined over the past few years—with return on assets declining from above 2 percent in 2006-2007 to about 1 percent in 2014—as the government eliminated fees and charges on provision of basic financial services and introduced new tax in 2012 (to finance social spending). Profitability edged up briefly in 2014, due to higher provisioning by some banks and new service fees introduced by banks (e.g. additional ATM fees, fees for air miles accumulation on credit cards, etc.) as banks tried to make up for lost income.[5] However, profitability remained the lowest among large countries in the region, and it declined again in 2015 (to below 1 percent in July 2015). Gross financial margins as well as operating costs remain high, reflecting high liquidity needs, a high cost of holding liquidity abroad due to high taxes, and high provisions due to rigidities in the bankruptcy framework. As measured by ROA, the profitability dispersion has decreased over the years, with some banks presenting very low profitability ratios relative to the system.

Selected Countries: Return on Assets
(In percentage points)



Source: Financial Soundness Indicators.

Ecuador: Return on Assets
(In percentage points)

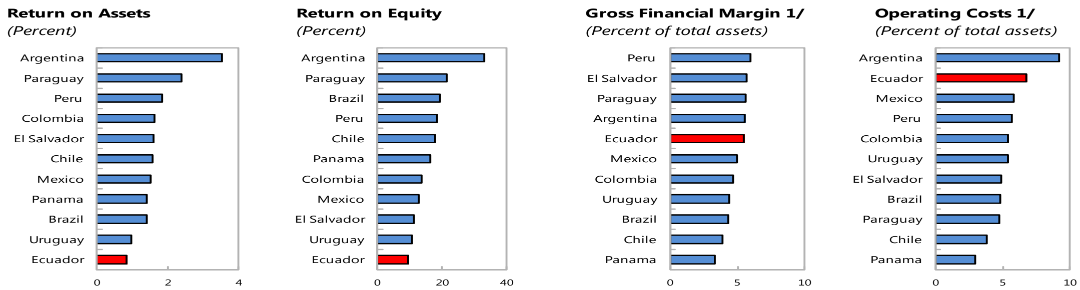


Source: Superintendency of Banks.

[5] A maximum ATM fee was set at 50 cents when a customer did not use his own bank's machine and was eliminated if the bank's machine was used. Charges for maintaining checking and savings accounts were eliminated. Maximum fees were established for other financial transactions (issuing credit cards, transfers between banks, etc.). New financial products are now required to be approved by the authorities.

Latin America: Selected Financial Indicators, 2014

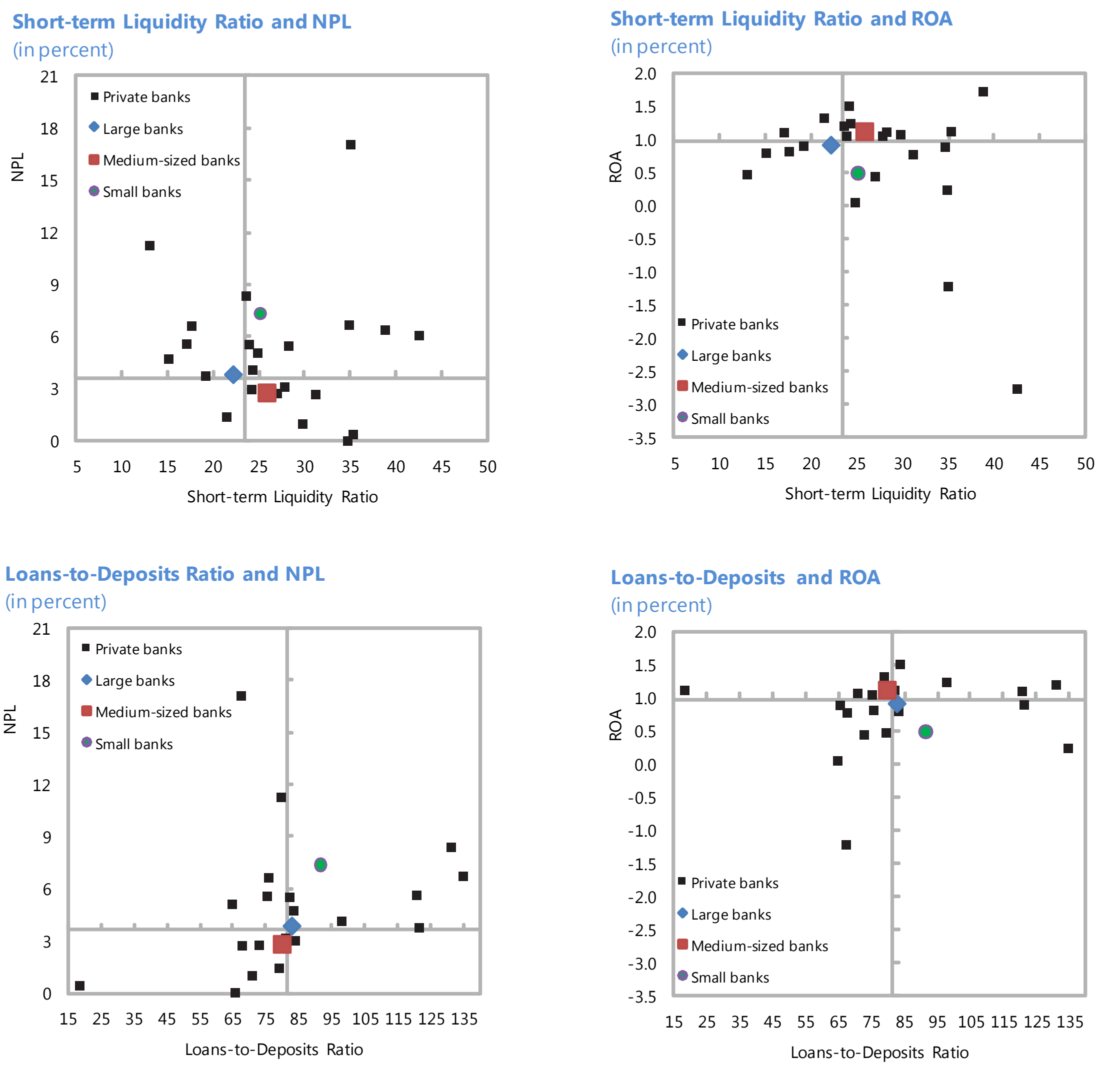
(Asset weighted average)



Source: Bankscope.
1/ Operating costs exclude interest; gross financial margin is the net interest revenue.

10. Some banks with larger losses and lower profitability also have a weaker liquidity position. The figures in the panel show that several banks (totaling a non-trivial aggregate asset size) that are experiencing relatively larger non-performing loans and lower return on assets, relative to the system, also face weaker liquidity indicators.

Ecuador: Selected Liquidity and Solvency Indicators (July 2015)



Source: Superindendency of Banks.

Interest rate risk: uneven between private and public sector

11. Interest rate risk is likely to be more limited for the private domestic financial sector and more prominent for the public sector. Interest rate risk within the banking sector has traditionally been limited, given the regulatory controls on lending rates. As U.S. monetary policy normalization is expected to raise the international reference interest rates, there may be a pressure to adjust interest rates domestically. However, such pass-through has generally been limited, and interest rate risk should rise mainly to the extent regulated interest rates will be adjusted to reflect international conditions. Nonetheless, the effect of international rates on the terms at which the government and the private sector can access international funding will certainly be present. Within this context, it is important to note that the sovereign spread has been increasing extensively, as clearly documented in the main test of the Staff Report.

Conclusions

12. In light of recent developments, supervision of liquidity and credit risks needs to be heightened, and policies should be particularly targeted to ensuring liquidity in the system. The authorities should remain vigilant and continue to monitor carefully financial and liquidity trends, particularly if heterogenous developments across banks arise. If pressures persist, the authorities should promptly adjust banks' reserve requirements at the BCE and stand ready to provide prompt support with the Liquidity Fund (holding US$2.3 billion as of end-July). Other current policies that affect liquidity—such as lending by the BCE to the government and state corporations, and directing private credit towards mortgages—need to be reversed. Going forward, financial buffers should be built further; policies that affect banks liquidity management such as the domestic liquidity requirement should be modified, to allow larger holding of liquid assets abroad if necessary; and the distortionary regulation (interest rate ceilings, directed credit) need to be lifted.

INTERNATIONAL MONETARY FUND

ECUADOR

STAFF REPORT FOR THE 2015 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

September 10, 2015

Prepared By | The Western Hemisphere Department
(In Consultation with Other Departments)

CONTENTS

FUND RELATIONS

A. Financial Relations

(As of July 31, 2015)

Membership status: Joined: December 28, 1945

General Resources Account:

	SDR million	Percent Quota
Quota	347.80	100
Fund holding of currency (Exchange Rate)	319.27	91.80
Reserve Position	28.53	8.20

SDR Department:

	SDR million	Percent Quota
New cumulative holdings	288.36	100
Holdings	17.81	6.18

Outstanding Purchases and Loans: None.

Latest Financial Arrangements:

			In million of SDR	
Type	**Data of Arrangement**	**Expiration Date**	**Amount Approved**	**Amount Drawn**
Stand-By	Mar 21, 2003	Apr 20, 2004	151.00	60.40
Stand-By	Apr 19, 2000	Dec 31, 2001	226.73	226.73
Stand-By	May 11, 1994	Dec 11, 1995	173.90	98.90

Overdue Obligations and Projected Payments to the Fund (in SDR million; based on existing use of resources and present holdings of SDRs):

			forthcoming		
	2015	2016	2017	2018	2019
Principal					
Charges/Interest	0.07	0.14	0.14	0.14	0.14
Total	0.07	0.14	0.14	0.14	0.14

Implementation of HIPC Initiative: Not Applicable

Implementation of Multilateral Debt Relief Initiative (MDRI): Not Applicable

Implementation of Post-Catastrophe Debt Relief (PCDR): Not Applicable

Safeguards Assessment:
An on-site safeguard assessment was conducted in March 2003 and the safeguards assessment report was approved by management on June 23, 2003. The assessment identified a need to strengthen the audit oversight and reporting frameworks at the BCE. At that time, the BCE committed to the implementation of the safeguards recommendations, including the timely publication of its annual audited financial statements, which are yet to be published.

B. Nonfinancial Relations

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 US dollar. The de jure and de facto exchange rate arrangement is an arrangement with no separate legal tender; there are local coins (small denomination) in circulation in the amount of about US$80 million. Ecuador has accepted the obligations of Article VIII, Sections 2, 3, and 4 but maintains an exchange restriction subject to Fund approval arising from a 5 percent tax on transfers for the making of payments and transfers on current international transactions. The tax has recently been waived for the outflows relating to bank loans of over one year for specific sectors identified in the Productive code (e.g. housing and microfinance).

FSAP: FSAP took place in 2004.

Last Article IV Consultation:
On July 31, 2014, the Executive Board concluded the 2014 Article IV consultation.

Technical Assistance:

STA	Monetary and Financial Statistics, December 2013
FAD	Single Treasury Account, October 2007
LEG	Workshop to supervisors on ML/CFT, July 2007

RELATIONS WITH THE WORLD BANK

A. Country Strategy

The current World Bank Group's support to Ecuador was defined in the Interim Strategy Note (ISN) FY 14−15 discussed with local authorities and approved by the Board in April 2013. As a result of extensive consultations with the Government of Ecuador, the ISN identifies three main areas of support: (i) Sustainable and Inclusive Growth; (ii) Access to Social Protection and Quality Basic Services for All; and (iii) Strengthening Public Sector Capacity to Provide Access to Quality Services.

Based on the ISN, the lending program focuses on building of the subnational capacity in the short term, implementing key national strategies, and improving service delivery at the local level.

In addition, the Bank is undertaking an extensive program of analytical and advisory activities for FY 14–15, including both economic and sector work and technical assistance. The economic and sector work covers but is not limited to areas such as labor markets, safety nets, housing, environmental management, and poverty analysis.

Finally, the Trust Fund (TF) portfolio complements Bank-funded operations in core engagement areas identified in the ISN, such as transport, disaster risk management, and nutrition to support knowledge, advisory services and technical assistance.

As of July 21, 2015, there are four approved projects in Ecuador (see Table 1). The Manta Public Services Improvement Project is under implementation, while three other investment projects are pending effectiveness: (i) Sustainable Family Farming Modernization project; (ii) Guayaquil Wastewater Management project; and (iii) the Quito Metro Line One project. Total net commitment on these projects is US$487.5 million. There are two projects currently under preparation for presentation to the Board in FY 16: Supporting Education Reform in Targeted Circuits for US$175 million; and Transport Infrastructure Improvement in Ibarra for US$52 million.

B. Lending

(As of July 21, 2015, and in millions of US$)

Ecuador: IBRD Portfolio Status

Project Name	Lending Instrument	Net Commitment Amount	Total Disbursement	Total Undisbursed	Total Disbursed in Fiscal Year 15
Sustainable Family Farming Modernization	IPF	80.00	0.00	80.00	0.00
Guayaquil Wastewater Management Project	IPF	102.5	0.00	102.5	0.00
Quito Metro Line One	IPF	205.00	0.00	205.00	0.00
Manta Public Services Improvement Project	IPF	100.00	5.00	95.00	5.00
Total		**487.5**	**5.00**	**482.5**	**5.00**

Ecuador: IFC Committed and Disbursed Outstanding Investment Portfolio

Commitment Fiscal Year	Institution Short Name	LN Cmtd-IFC	LN Repayment-IFC	ET Cmtd-IFC	QL + QE Cmtd - IFC	GT Cmtd-IFC	RM Cmtd-IFC	ALL Cmtd-IFC	ALL Cmtd-Part	LN Out-IFC	ET Out-IFC	QL+QE Out-IFC	GT Out-IFC	RM Out-IFC	ALL Out-IFC	ALL Out-Part
2007/2008/2009/ 2014/2015	Banco Guayaquil	0.00	0.00	0.00	0.00	0.47	0.00	0.47	0.00	0.00	0.00	0.00	0.47	0.00	0.47	0.00
2008/2009/2014/ 2015	Banco Internacional	40.00	0.00	0.00	0.00	0.00	0.00	40.00	0.00	40.00	0.00	0.00	0.00	0.00	40.00	0.00
2015	Banco Pichincha	30.00	0.00	0.00	0.00	0.00	0.00	30.00	0.00	30.00	0.00	0.00	0.00	0.00	30.00	0.00
2007/2008/2015	Bolivariano	30.00	0.00	0.00	0.00	1.10	0.00	31.10	0.00	30.00	0.00	0.00	1.10	0.00	31.10	0.00
2004/2007/2009	Cartones America	0.00	0.00	0.00	0.00	0.00	0.01	0.01	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
1999/2003/2008/ 2011	Favorita Fruit	10.06	39.11	0.00	7.00	0.00	0.00	17.06	2.74	10.06	0.00	7.00	0.00	0.00	17.06	2.74
2010	Moderna	2.91	5.09	0.00	0.00	0.00	0.00	2.91	0.00	2.91	0.00	0.00	0.00	0.00	2.91	0.00
2005/2009/2013	PRONACA	23.96	21.04	0.00	10.00	0.00	0.00	33.96	0.00	23.96	0.00	10.00	0.00	0.00	33.96	0.00
2007/2008/2009/ 2015	Produbanco	0.00	0.00	0.00	0.00	0.15	0.00	0.15	0.00	0.00	0.00	0.00	0.15	0.00	0.15	0.00
2012	Tonicorp Holding	26.78	3.22	0.00	0.00	0.00	0.00	26.78	0.00	16.78	0.00	0.00	0.00	0.00	16.78	0.00
Total Portfolio		**163.71**	**68.46**	**0.00**	**17.00**	**1.72**	**0.01**	**182.44**	**2.74**	**153.71**	**0.00**	**17.00**	**1.72**	**0.00**	**172.43**	**2.74**

Ecuador: IBRD/IDA Operations

(As of June 2015

Status	IBRD	IDA Credits	IDA Grants	TOTAL
Net Commitments	3,660,980,000.00	39,037,527.58	0.00	3,700,017,527.58
Disbursed	2,427,694,367.50	37,535,688.46	0.00	2,465,230,055.96
Undisbursed	1,233,285,632.51	1,501,569.12	0.00	1,234,787,201.63
Repaid	2,275,728,100.85	32,742,866.57	0.00	2,308,470,967.42
Outstanding	151,966,266.65	4,792,821.89	0.00	156,759,088.54

RELATIONS WITH THE INTER-AMERICAN DEVELOPMENT BANK

A. Country Strategy

Ecuador's current Country Strategy covers the period 2012–17. The strategy focuses on three main lines of action: (i) infrastructure, to foster the development of domestic and external markets and boost productivity; (ii) human capital, to ensure greater opportunities for income generation and to stimulate total factor productivity; and (iii) public management, to adapt the new legal mandates to the needs of the productive sector and to social demands.

IDB's strategic engagement with Ecuador prioritizes eight sectors: (i) energy; (ii) transportation and logistics; (iii) social development (education, health and social protection); (iv) access to finance; (v) fiscal management; (vi) urban sustainability (urban planning, housing, water and sanitation, public transit); (vii) rural development; and (viii) natural risk management. In addition, the Country Strategy prioritizes two cross-sector areas of intervention: (i) diversity; and (ii) climate change and environmental sustainability.

The lending scenario contemplated in the current Strategy for Ecuador foresaw average approvals of US$350 million and an average net positive cash flow of US$124 million for the period 2012–17. Approvals so far, have exceeded these projections, reaching US$450 million in 2012, US$495 million in 2013, and 1,246 million in 2014 (this last figure includes two contingent credit lines for an amount of US$300 million each). As a result, the IDB is currently Ecuador's largest multilateral creditor.[1]

B. Lending

As of May 31, 2015, the Bank's portfolio of active **public sector operations** consisted of 33 loans for a total amount of US$2,799.2 million, of which US$1,523.5 million (54 percent) have been disbursed. In addition, the Bank is currently executing 37 technical operations in Ecuador for a total amount of US$44.6 million, of which US$18.8 million have already been disbursed. The public sector lending program for 2015 comprises two operations for a total amount of US$580 million, both of which concentrate on the electricity sector. The first of these two operations (support for the transformation of the energy matrix) has already been approved and fully disbursed in the amount of US$500 million. In addition, in February 2015 the Bank disbursed US$300 million from one of the two contingent credit facilities that were approved in 2014.

As of April 2015, the Bank's portfolio of active **private sector operations** included the following: the Structured Corporate Finance Department's (SCF) portfolio in execution consists of seven operations

[1] As of March 2015, Ecuador's sovereign debt with IDB of US$3,822.4 million amounted to 52.5 percent of the country's total multilateral financial obligations.

amounting to US$175.6 million mostly in the financial services industry; the IIC portfolio comprises 13 operations for US$61.9 million, and the Opportunities for the Majority (OMJ) department portfolio consists of two operations amounting US$41.3 million that focus on access to finance. This portfolio is expected to continue growing: the private sector lending Pipeline for 2015 includes two SCF projects (US$59 million) in financial markets and Infrastructure sector, one OMJ operation for (US$5 million) in financial markets, five MIF projects (US$3.6 million), and eight IIC operations for an amount of US$81 million.

Ecuador: IDB SG Active Loan Portfolio by Sector (Sovereign Guarantee)
As of May, 31, 2015
(In millions of U.S. dollars)

Sector	Commitments	Disbursements	Percent Disbursed
Institutional Capacity of State	658.0	522.06	84
Transportation	610.0	320.49	53
Fiscal and Municipal Management	248.84	131.83	53
Energy	522.7	293.92	56
Water and Sanitation	341.25	72.68	21
Social Protection and Health	220.0	34.12	16
Environment and Rural Development	105	67.91	65
Education	75	48	64
Capital Markets and Financial Institutions	2.45	2.45	100
Trade and Investment	16	0	0
Total	2799.24	1523.46	54

STATISTICAL ISSUES

ECUADOR—STATISTICAL ISSUES APPENDIX As of June 30, 2015
I. Assessment of Data Adequacy for Surveillance
General: In spite of some shortcomings, macroeconomic data are adequate for surveillance purposes.
National Accounts: The authorities published the new GDP series in 2012 with the 2007 as the base year. Currently, quarterly and annual National Accounts data are published based on the expenditure and production approaches, both in current and constant 2007 prices. Quarterly figures are available up to 2015Q1, while annual series up to 2014.The income-based National Accounts are published on an annual basis, up to 2013 (data for 2012 and 2013 are provisional). Similarly, the supply and use tables (at current and constant prices), and the integrated economic accounts are disseminated only for the period 2007–13. Although annual gross fixed capital formation is disseminated by product under the expenditure based GDP, sectoral breakdown is available up to 2013 only. In national accounts at constant prices, private investment is not disaggregated from the total capital formation.
Price Statistics: The CPI has national coverage of urban cities and is based on 2003/2004 weights. Since January 2015, the CPI base year has been changed to 2014. The PPI is a fixed base Laspeyres-type index with weights based on the 1995 figures of the national accounts. International good practices recommend updating prices weights every five years.
Government Finance Statistics: The authorities publish central government and nonfinancial public sector operation statistics based on the 1986 GFS Manual. It would be advisable for the authorities to switch to the GFS 2001 method, and to improve the classification of expenditures and revenues. In particular, it would be useful to report oil revenues and expenditures on gross bases and explicitly show gross revenue from exports and domestic sales separately.
Monetary and Financial Statistics: Responding to a request from the Central Bank of Ecuador (CBE), STA provided technical assistance in monetary and financial statistics (MFS) in December 2013. The main purpose of the mission was to re-establish the regular reporting of monetary data to STA in compliance with international standards and using the standardized report forms (SRFs), for publication in *International Financial Statistics (IFS)*. As a result of this mission, in early 2014 Ecuador's country page in IFS was reinstated with data for the central bank and other depository corporations (ODCs). In the meantime, with remote support from STA, the CBE made progress in the compilation of the other financial corporation's (OFC) survey and is close to start reporting OFC data to STA on a regular basis. Further technical assistance is foreseen to support the authorities in achieving a comprehensive coverage of the OFC survey, and developing a balance sheet approach matrix and macro-prudential indicators, both based on the information generated by the SRFs.

<table>
<tr><td colspan="2">External sector statistics: Balance of payment and international investment position (IIP) statistics are compiled and disseminated by the CBE. As a SDDS subscriber, Ecuador also disseminates monthly data on the Template on International Reserves and Foreign Currency Liquidity and quarterly data on the SDDS prescribed external debt category. It was recommended to compile and submit IIP data on a quarterly basis, but the authorities have no short-term plans of doing so because of the lack of key source data. It is also recommended to improve the compilation of private and public flows with nonresidents in the BOP, which at present are not fully distinguished from transactions between residents affecting net international reserves (given the accounting difficulties imposed by full dollarization).</td></tr>
<tr><td colspan="2" align="center">II. Data Standards and Quality</td></tr>
<tr><td>The country is a GDDS participant since 1998. However, most of its metadata, with the exception of the real sector and socio-demographic metadata, have not been updated since October 2002. At the authorities' request, STA has conducted an SDDS assessment, providing a draft action plan that could lead to SDDS subscription.</td><td>A data ROSC module was completed in March 2003.</td></tr>
</table>

Reporting to Fund for Publication:

No high frequency data are reported for publication in *International Financial Statistics (IFS)*. Ecuador reports to STA quarterly balance of payments statistics as well as annual IIP data for publication in IFS and the Balance of Payments Statistics Yearbook, although with delays.

Ecuador: Table of Common Indicators Required for Surveillance
(As of August 31, 2015)

	Date of Latest Observation	Date Received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of Publication[7]	Memo Items: Data Quality – Methodological Soundness[8]	Memo Items: Data Quality – Accuracy and Reliability[9]
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	7/30/15	8/5/15	W	M	M		
Interest Rates[2]	7/30/15	8/5/15	M	M	M		
Consumer Price Index	7/30/15	8/20/15	M	M	M	O, LO, O, LO	LO, O, O, O, O
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	June 2015	8/22/15	M	M	M	LO, LO, LO, O	LNO, LO, LO, O, NO
Revenue, Expenditure, Balance and Composition of Financing[3] – Central Government	June 2015	8/22/15	M	M	M		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	June 2015	8/22/15	M	M	M		
External Current Account Balance	Q1 2015	6/31/15	Q	Q	Q	LO, LO, LO, LO	LO, LO, O, LO, NO
Exports and Imports of Goods and Services	Q1 2015	6/31/15	M	M	M		
GDP/GNP	Q1 2015	6/31/15	Q	Q	Q	O, O, LO, LO	LO, O, O, O, LO
Gross External Debt	Q4 2014	3/31/15	Q	Q	Q		
International Investment Position[6]	Q4 2014	3/31/15	A	A	A		

[1] Any reserve assets that are pledged or otherwise encumbered should be specified separately. Also, data should comprise short-term liabilities linked to a foreign currency but settled by other means as well as the notional values of financial derivatives to pay and to receive foreign currency, including those linked to a foreign currency but settled by other means.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5] Including currency and maturity composition.
[6] Includes external gross financial asset and liability positions vis-à-vis nonresidents.
[7] Daily (D); weekly (W); monthly (M); quarterly (Q); annually (A); irregular (I); and not available (NA).
[8] This reflects the assessment provided in the data ROSC (published in March 2003, and based on the findings of the mission that took place during April 2002). for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O); largely observed (LO); largely not observed (LNO); not observed (NO); and not available (NA).
[9] Same as footnote 8, except referring to international standards concerning (respectively) source data, assessment of sourcedata, statistical techniques, assessment and validation of intermediate data and statistical outputs, and revision studies.

Statement by Otaviano Canuto, Executive Director for Ecuador,
Pedro Fachada, Alternate Executive Director, and
Francisco Rivadeneira, Advisor to Executive Director
September 25, 2015

1. On behalf of our Ecuadorian authorities, we thank staff for the productive dialogue during this year's Article IV consultation and for the high-quality documents on the Ecuadorian economic and financial outlook. The authorities would like to convey in particular their appreciation for the engagement and effort of the mission chief.

2. Following last year's off-site consultation, the mission team was able this year to meet *in situ* with all the relevant actors from the public and private sectors, as well as the academia. The authorities value the renewed partnership with staff and will continue to work with the Fund in a technical and mutually respectful manner.

Economic Outlook

3. As the staff report highlights, the Ecuadorian economy has been hit in recent quarters by a series of unexpected, exogenous shocks. Some of those shocks were common to commodity exporters, but others were idiosyncratic in nature. Specifically, Ecuador has been strongly affected by the collapse in oil prices, which accounted in 2014 for roughly half of its export revenues, as well as by the reduction in international prices of most of its other relevant commodity exports. Some of the country's main import markets have slowed down quite abruptly, as is the case of Russia and China. Finally, Ecuador is a dollarized economy and has therefore been impacted by the sharp appreciation of the dollar against most currencies, including the currencies of its two neighbors.

4. More recently, two country-specific events that have received far less attention in the staff report have further contributed to the deterioration of Ecuador's economic outlook: (i) the entry into activity of the Cotopaxi volcano; and (ii) the *El Niño* phenomenon. Both occurrences are likely to have considerable negative effects on the domestic economy and on Ecuador's exports.

5. The Cotopaxi volcano is located close to the capital in the Central Andean Region, an area that produces dairy and flowers, among other primary goods (Ecuador is the third largest flower exporter in the world). Among other major effects, the volcano's activity has the potential to affect the water supply of Quito.

6. The *El Niño* threatens the coastal area with massive floods, where fishery and tropical agriculture are notable economic activities. Meteorologists are predicting that this *El Niño* season may be the worst on record. As staff highlights in Box 1 of the

Selected Issues Paper "Comparing Economic Effects of External Shocks, 2008-09 and 2014-15", the rains and flooding caused by *El Niño* are expected to affect agriculture output and damage infrastructure. Although the authorities do not have an estimate of the potential costs, staff informs that, in 1997-98 (worst occurrence in the last two decades), it had a net negative effect on GDP in the 0.6-1.2 percentage point range and provoked losses above 2 percent of GDP.

7. The authorities have been working intensively since the beginning of the year to increase the resilience of the economy to these adverse shocks and mitigate their effects. In light of the circumstances, they are mindful that the economy will decelerate substantially in 2015, but they expect some pickup during 2016. They see staff's forecasts for GDP growth next year (0.1 percent) as somewhat on the pessimistic side.

Fiscal Policy

8. In recent years, Ecuador has maintained a prudent fiscal stance, as attested by the fact that total public debt closed 2014 at around 30 percent of GDP, one of the lowest in the world. It is true that, between 2011 and 2014, available fiscal space was used and the fiscal deficit widened as a result of social and capital spending. However, the authorities are fully aware that the new international scenario requires significant narrowing of the public deficit. Partly, this will be accomplished through a reduction in capital spending, as most of the ongoing investment projects will be over next year.

9. The 2015 budget has already included measures to reduce current spending (for instance, suspension of the wage increases previously planned and diminution of the highest salaries in the civil service). The 2016 budget, currently in elaboration, will propose additional cuts in current spending and rationalization of certain subsidies. The budget, however, will need to take into account potential spending pressures stemming from the Cotopaxi volcano and the *El Niño*. In any case, the authorities are committed to do whatever is necessary to ensure a more balanced fiscal position.

10. The authorities are convinced that financing the 2015 and 2016 public deficits will not be difficult. Ecuador intends to continue to access international capital markets as a source of financing, complementing the support already received from multilateral financial institutions. A cornerstone in Ecuador's relation with the international community will be reached in December, with the payment of the maturing 2015 bond. The authorities are confident that this payment will lead to a very significant reduction of the country's sovereign risk.

Dollarization and Financial System

11. The authorities want to emphasize that they are committed to and will maintain the current monetary regime. They are cognizant of the extremely negative impact that a de-dollarization process would have on the domestic economy, on the stability of the financial system, and especially on the Ecuadorian population.

12. In a dollarized economy, safeguarding the liquidity of the banking system is a permanent challenge. As mentioned in the staff report, the banking system has faced a liquidity crunch in recent months and the Central Bank of Ecuador is closely monitoring the situation. Nonetheless, the banking system is essentially sound, well-capitalized and profitable. Non-performing loans (NPL) are low for international standards and there is no risk whatsoever of a systemic crisis. Additionally, banking regulation and supervision have been substantially strengthened in recent years.

13. As the staff report mentions, the government has taken several measures to facilitate capital inflows. For instance, by eliminating the tax on transfers associated with certain bank loans with maturity above one year. The authorities stand ready to adopt new initiatives if global risk aversion escalates and international financial conditions worsen.

14. The authorities reaffirm their commitment to fighting money laundering and the financing of terrorism. Progress in this area has been substantial, especially in criminalizing money laundering and terrorist financing, establishing procedures to identify and freeze terrorist assets and confiscate funds related to money laundering, and improving coordination among financial sector supervisors, as recognized by the Financial Action Task Force (FATF) earlier this year.

Competitiveness, Infrastructure and Private Investment

15. The recent appreciation of the dollar has affected the competitiveness of the Ecuadorian economy. Given the lack of exchange rate flexibility, the government has been working to boost the country's competiveness through structural reforms and infrastructure investment. As mentioned in the report, the government has invested heavily to eliminate infrastructure bottlenecks, particularly in the areas of transportation (highways, maritime ports, airports, multimodal logistics, among others), technology (fiber optics, cellular communication) and energy (renewable – hydroelectric, solar and wind – as well as nonrenewable – oil and gas).

16. The authorities continue to promote Public-Private Partnerships (PPP) as a mechanism to boost investment. Local and foreign private investors are actively participating in the development of projects in strategic sectors.

17. The Ecuadorian government does not accept the notion that competitiveness can be gained by paying lower salaries to the work force. This is the main reason why the authorities have strived to increase the salary level up to a point where a household can acquire the basic basket of goods. Needless to say, the authorities are mindful that salary increases must essentially reflect productivity gains. The wage policy going forward will take into account productivity and inflation developments.

18. For the longer term, the government has developed a strategy to change the country's productive matrix. The objective is to move towards higher value-added products and develop the services sector. If in the short term the authorities aim to develop sectors that have comparative advantage such as the agro-industrial sector, in the long term there is a clear strategy to move to knowledge-intensive sectors such as biotechnology.

19. It is worth emphasizing that, independently of the current commodity prices cycle, Ecuador has a huge potential in the mining sector. This is particularly true for copper, gold and silver. The increase in output of these metals will provide new significant resources to the state and reduce the relative importance of oil in the Ecuadorian economy.

20. Foreign markets access is a priority in the government's strategic vision. There are several ongoing negotiations of trade agreements. This is the case of the trade agreement with the European Union, which is expected to come into force in the second half of 2016. Ecuador has also begun negotiations with South Korea and with European Free Trade Association (EFTA) countries. Finally, the government is strengthening its ties with Central America, having concluded a trade agreement with Guatemala and started negotiations with El Salvador, Nicaragua and Honduras.