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Ecuador

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: June 10, 1987

TO: Operations Committee

FROM: Vinod Dubey, Director, Economic Advisory Staff

EXT: 60061

SUBJECT: ECUADOR - Financial Sector Adjustment Loan
Initiating Memorandum

1. The Operations Committee will meet on Friday, June 12, 1987 at 4:00 p.m. in Room E-1208 to consider the Initiating Memorandum (IM) for a proposed Financial Sector Adjustment Loan to Ecuador in the amount of $75 million. The Region is planning a total program of $210 million for FY88 including, besides this operation, a trade policy loan and a national housing project. Lending to Ecuador was $159 million in FY87 and $253.5 million in FY86.

2. The loan would support a program of policy and institutional reforms in the financial sector, aiming at strengthening the sector's institutions and enhancing their independence from the Central Bank, and generally developing the capital market. The IM rightly emphasizes the crucial role that has to be played by exchange rate policy, and indicates the hardships and political costs that would ensue on the various reforms being pursued, including the containment of the fiscal deficit and the current account gap. The Region draws attention to the fact that there is considerable uncertainty over the Government's ability to undertake the proposed program prior to the January 1988 elections, but suggests that appraisal should proceed considering its low incremental cost and in order to ready the operation for the time when an external financial package is in place involving the foreign commercial banks.

3. A Stand-by arrangement was made with the Fund running from August 1986 to August 1987, but only one purchase was made under it before it became clear that not all the targets could be met, particularly in respect of the public sector deficit. In January 1987 the Government suspended payments to commercial banks, but reached an agreement with the Fund in February on the main parameters of the 1987 program, pending debt rescheduling by the commercial banks, and action on public revenues. The March earthquake changed this undertaking and the Government has indicated its willingness to negotiate a new Stand-by. Contacts with the commercial banks are said to be continuing, with the bankers scheduled to visit Ecuador in late May (IM, para. 12).

- Could the Region update the situation regarding the commercial banks and the size of the financial gap?

- What are the chances of a Stand-by materializing in the near future? And if a Stand-by is not concluded, can alternative measures be worked out to safeguard the implementation of the proposed financial reforms?

- o Would the reforms agreed with the present Ecuadorian administration be acceptable to the next administration?

Interest Rates

4. The loanable funds market is fragmented and ridden with regulations. The Central Bank offers direct and indirect lines of credit at preferential rates. During a period of annual inflation of about 25%, market rates on deposits are 22-30% while interest charged to borrowers on Central Bank credits directly or through financial institutions ranges from 12 to 21%. Many credit transactions are effected administratively at forced interest rates, and to complicate matters subsidized interest is set in nominal terms and, though adjustable, is not explicitly linked to the market rate: when inflation rises, the subsidies also rise (para. 13). Although the Government has moved over the past two years to restrict growth of preferred credit and the share of central bank credit in total credit, subsidized credit remains very large and hinders the efficient allocation of credit, development of the equity market, and monetary stability (para. 25). The attempt by the present Government in August 1986 to free interest rates came "under serious attack" (para. 31) and was declared unconstitutional in a March 1987 ruling by the constitutional tribunal. An impasse over this issue appears to prevail between the President and Congress which has supported the tribunal's ruling. Further interest rate reforms are judged to be "the most difficult part of the reform" (para. 31).

- o Against this background the Operations Committee may wish to assess Government commitment in the draft Declaration on Financial Policy to the effect that interest rates on BCE credit will be brought into closer alignment with market interest rates according to an agreed schedule (see below); that margins on retailing BCE credits will be reduced in order to reduce the financial institutions' stake in intermediating subsidized BCE credit; and that forced investments by the commercial banks of 10% of their demand deposits at subsidized Financial Funds terms will be reduced to 8%.

5. With the aim of reducing the subsidy element in preferential credit, the operation will seek to raise minimum lending rates on Central Bank credit while linking the latter rates to rates paid on Certificates of Deposit (CD). The IM (para. 43) states that in February 1987 the lowest interest charged to financial borrowers on Central Bank credit lines was 9 percentage points below the 90-day CD, yielding about 27%. The IM judges that a rapid reduction of this differential would not be politically feasible, but would be reduced to 7 percentage points by Board presentation and 5 percentage points by release of second tranche.

- o The Region may wish to comment on the feasibility of such a program given political resistance and the constitutional issue.

- o Even if such political hurdles are to be surmounted, what is the rationale for the Bank's support of the new set of interventions? Can a later target of liberalization of interest rates be determined and explicitly agreed to?

- In linking lending interest rates so passively to a CD or other market rates, does this not detract from the objective of making the Central Bank the ultimate authority over interest rates as a tool of monetary policy?

Strengthening Financial Institutions

6. The financial intermediaries are too numerous and fragmented and largely illiquid or insolvent. They are not adequately supervised by the weak Superintendency of Banks (SB) which seems to pay more attention to forced investments than to the quality of the banks' portfolios. Provisions for bad loans are not sufficient and it is possible that the obligations of many financial institutions equal or exceed their net assets. The fragmentation and insolvency of many institutions contribute to the high cost of intermediation. When the Central Bank "sucretized" and assumed the foreign debt, this was meant to reduce the indebtedness of the financial intermediaries and their clients, but the authorities have been disappointed in their hopes of converting this into equity. The present operation envisages that a strengthened SB will, by Board presentation, be able to issue regulations to prevent accrual of interest on non-performing loans and require that recognized losses be written off immediately. By second tranche release, draft legislation will have been prepared to regulate capital adequacy in relation to risk assets in specific categories instead of to total liabilities as at present. Supervision in the interval will entail using discretionary powers to raise capitalization and reduce the leverage of commercial banks. Such an exercise of judgment would seem to require greater resources and better management than seems to be available to SB.

- The Region may wish to elaborate on the brief account given in para. 38 of the technical assistance necessary to provide SB with the research and analytical powers that would make it effective, and the time needed for building it up to meet its projected functions.

- Should not SB rather than the banks' own auditors (para. 35) assess the quality of the portfolios?

Long-Term Finance

7. Expectations of high inflation have stifled the markets for fixed rate mortgage bonds and other DFI long-term paper. Virtually all long-term lending has ceased except that funded by the Central Bank at fixed rates which carry a large and variable subsidy depending on market rates that tend to reflect inflation. Variable interest rates were introduced in 1985 in the context of the Bank's Industrial Finance Loan (para. 46), but these were made subject to the administratively-determined "maximum prevailing rate", set lower than the CD rates. Financial intermediaries therefore have been unable to raise resources while onlending them long-term at variable interest rates. Productive firms are highly indebted to the financial institutions and could use longer term funds if these can be mobilized. This means that rates have to be truly variable and set with a mark-up above the rate on CDs. The operation contains various provisions

to reform this situation including linking World Bank loans to market rates; introducing an auction market in Central Bank notes (stabilization bonds) that would be instruments of monetary control; developing an interest capitalization system to reduce the front-loading of amortization schedules in periods of high inflation, and various institutional reforms to encourage equity finance. A program of financial reforms will be defined before second tranche release, which will be the nucleus of a later operation.

- o Would not issuing stabilization bonds at market rates squeeze the resources of the Central Bank? And if the deficit of the Central Bank is thus increased, how will it be financed?

- o If a declaration on positive interest rates on both borrowing and lending is to be obtained by the appraisal mission, how can this be implemented after release of the second tranche?

cc: Messrs. Eigen, Scherer, Bottelier, Wessels, Selowsky

Messrs. Baneth, Holsen, Lee, Rao, Shakow
Baudon, El Serafy, Levy

Mr. Dubey
N-536

THE WORLD BANK INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: May 29, 1987

TO: The Loan Committee

FROM: David Knox, Vice President, LCNVP

SUBJECT: ECUADOR - Financial Sector Adjustment Loan
Initiating Memorandum

1. Attached for the consideration of the Loan Committee is the Initiating Memorandum for a proposed Financial Sector Adjustment Loan to the Republic of Ecuador.

2. A previous draft of the memorandum was discussed at a working level meeting which included LC1PA, LCPDR, LCPI1, LEGLC, INDFD, CPDBA, and IMF staff. Comments made at the meeting have been incorporated.

3. Subject to the guidance and approval of the Loan Committee, we plan to send an appraisal mission for the FSAL to Ecuador in the third week of June. While there is considerable uncertainty of the Government's ability to undertake this program prior to elections in January 1988, we believe that the incremental costs of appraisal are justified since (i) senior officials have expressed the will to carry forward with the program, and they have so far demonstrated considerable firmness in pursuing these objectives, in spite of strong political opposition, (ii) no legislative action is proposed, and (iii) it would be important to advance preparation and processing of adjustment loans as far as possible at this time so that we could be in a position to respond quickly with fast-disbursing, policy-based lending when agreement is reached with commercial banks and the IMF on an external financing package. Assuming the alternative would be to do no further work on the project, the incremental staff costs of the appraisal mission would be 12 staff weeks. Upon return of the mission, we would review whether additional manpower should be invested in the project.

4. The FY88 program for Ecuador, which coincides with the last year of the current administration, is designed to continue supporting major policy reform. It includes the already appraised National Housing Project (US$60 million) and the proposed Financial Sector Adjustment Project (US$75 million). In addition, a Trade Policy Loan (US$75 million) has recently been identified for appraisal and processing in FY88. For FY89 and beyond, the program will depend upon the priorities of a new administration. Current strategy provides for project lending in priority sectors, some of which could be converted to policy-based operations, if circumstances warrant.

5. Please address any comments to Mr. Thomas L. Hutcheson (ext. 72720).

Cleared with Messrs. Eigen (LC1PA) and Flood (LCPI1)

Cleared in substance with Mr. Steckhan (LC1DR)

Cleared with and cc. Mr. Picciotto (LCPDR)

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ECUADOR: PROPOSED FINANCIAL SECTOR LOAN

INITIATING MEMORANDUM

I. INTRODUCTION

1. This memorandum proposes that we proceed to appraise a Financial Sector Adjustment Loan for Ecuador in the amount of US$ 75 million equivalent. The loan will support an ongoing program of institutional and policy reform in the financial sector aimed at a) strengthening financial institutions, b) reducing the dependence of financial institutions on the central bank (BCE), and c) improving conditions for long-term finance with locally mobilized resources. Because of the close links between financial reform and short run macroeconomic policy, preparation of this loan is being closely coordinated with the IMF and is expected to support the Government's efforts in the context of a Fund program to be negotiated later this year.

2. Bank strategy has supported Government initiatives in macroeconomic and financial sector reforms over the medium term. Beginning in FY86, the Bank responded to sectoral adjustment programs in agriculture and industry with policy-based loans. Trade, commodity pricing and interest rate reforms as well as adequate exchange rate measures were the key actions taken in this context. In addition to the operation proposed here for the financial sector, the Bank has undertaken intensive discussions on the energy sector and has prepared an overall analysis of the medium term growth strategy needed to overcome the constraints imposed by the current debt burden and the world oil price collapse. The latter has seriously affected both Ecuador's balance of payments and its fiscal accounts, since the country is so dependent on oil export revenues. A proposed Low Income Housing Project will reinforce changes in long-term lending conditions being pursued in the financial sector loan. A reconstruction loan has been approved which will assist Ecuador in dealing with the recent disastrous earthquake that destroyed the country's only oil exporting pipeline and infrastructure in the oil-producing region. Preparation is also beginning on an export development Loan to extend earlier policy reforms in this area. Some normal project lending is also programmed primarily to support productive sectors in the generation of employment and exports, and some development infrastructure.

3. The project supports a continuation of the financial sector reforms discussed in Ecuador: Brief Review of the Financial Sector (Report No. 5270-EC, dated April 1985). Support for the initial reforms -- positive real interest rates and variable interest rates on long term loans (paras 7 and 46) -- was part of four recent Bank loans: Agricultural Sector, Agricultural Credit, Small Scale Industry III, and Industrial Finance. The first tranche of the agricultural sector loan was disbursed in January 1986. The Bank and the Government of Ecuador (GOE) are in the process of renegotiating the conditions for second tranche release, given changed political and economic circumstances. Among other things, the

conditions include a sharp real reduction in preferential Central Bank credit including BCE credit to Banco Nacional de Fomento, and an increase in interest rates charged on foreign funds to agriculture.

II. THE MACROECONOMIC SITUATION

4. Since the 1970's economic strategy had relied on import substitution in the manufacturing sector financed by growing petroleum revenues. Although growth was initially high and substantial progress was made in social conditions, by the early 1980's it was becoming increasingly clear that the strategy was unsustainable. The exchange rate had become badly overvalued. Tariffs and quantitative restrictions on imports of finished goods and tariff exonerations on imported inputs gave high levels of effective protection to favored firms and subsectors. Petroleum exploration slowed and production stagnated while highly subsidized prices of petroleum products internally encouraged rising consumption of petroleum products and declining exports of crude oil. Agricultural output suffered from the policy-induced negative shift in the internal terms of trade. Imports rose and non-traditional exports made only limited progress.

5. This policy framework left the economy ill-prepared for a series of exogenous shocks, most notably the stagnation of the value of exports and the external credit crunch that affected the country after 1981. The value of exports stagnated from US$2,913 million in 1981 to an average of US$2,821 million for the 1982-1986 period, after having grown vigorously until 1981. Net external disbursements fell from US$1,255 million in 1981 to an average of US$469 million for the 1982-1986 period, also after strong growth up to 1981. This decline in external funding led the government to reduce the large public sector deficits of 1981 and 1982 that were financed by part of these resources. As a result of these shocks, aggregate economic performance faltered. The average rate of growth in 1982-1986 was only 1.5% compared to 6.1% p.a. in 1975-1981.

6. By the early 1980s distortions in the financial sector had also become widespread. Interest rates were controlled at levels that were often negative in real terms as inflation ranged from 15% to 48%. Mobilization of financial resources by the financial system faltered. An increasing share of domestic credit was channeled through the central bank (BCE). The shortage of domestic credit, the illusion of stability of the exchange rate, and the availability of international commercial credit encouraged local financial institutions (FIs) to guarantee short-term loans from foreign commercial banks to local firms without a careful evaluation of the commercial and exchange rate risks to which the firms and they were exposed. Eventually these loans and the even larger volume of loans to the public sector had to be renegotiated.

7. The present government that took office in August 1984 continued and accelerated the adjustment measures which had been initiated in response to the 1982 credit crunch. The dual official exchange rates were unified at the higher of the two previous rates and then devalued. Import restrictions were eased and most domestic price controls were lifted. Oil export volume increased substantially and new exploration has begun, with foreign participation. A public sector surplus was achieved in 1984 and 1985, a unique achievement in Latin America. At the end of 1984 interest

rates on financial savings were raised and a new certificate of deposit with a market determined rate was authorized, thereby stimulating an increase in real financial assets.

8. The economy responded well to the government's policy package, growing by 3.7% in 1985. Ecuador seemed poised for an accelerated recovery in 1986 when it was hit by the sharp fall in petroleum prices. The terms of trade index fell from 96.1 in 1985 (1984=100) to 60.6 in 1986. In reacting to this severe terms of trade shock, the Government took significant measures in August 1986 by free-floating the exchange rate, allowing interest rates to be freely determined except for BCE lines of credit, and cutting back subsidized credit from BCE. That the Government undertook these politically sensitive measures in the face of a majority opposition in Congress shows the extent of the Government's commitment to liberalization. The sucre depreciated by 35% during 1986 and by 70% over the average for the 1980-1983 period. The depreciation permitted the elimination of many of the quantitative restrictions put in place in 1982-83, somewhat reducing the distortions between agriculture and industry. Subsidies (via the preferential official exchange rate) on the imports of wheat and milk powder were eliminated even before the currency float, and procurement by ENAC which controls producer and wholesale prices, was reduced to four commodities -- rice, hard corn, soya, and cotton. Similarly, official consumer price ceilings were eliminated for most products including fresh milk. Thus, in spite of the fall in petroleum prices, well-conceived, though politically risky measures allowed the economy to grow by 1.7% in 1986 led again by agricultural production, petroleum output and a small but promising beginning of mining of gold and other minerals.

9. On March 5 and 6, 1987 the remote oil-producing northeastern region of Ecuador was hit by two major earthquakes accompanied by destructive landslides. The major economic cost to Ecuador is undoubtedly the interruption in oil production and exports which resulted from damage to major sections of the Trans-Ecuadorean Crude Oil and LPG Pipelines and the impact of these on the economy. The cost of restoring oil exports, through rebuilding the damaged pipeline system, construction of a connection to the Trans-Andean pipeline through Colombia, and related works is estimated at US$113 million. Damage to road and bridge infrastructure is estimated at US$20 million. Foregone oil revenues until the end of July 1987 are valued at about US$600 million, and the multiplier effect of reduced exports, decreased public expenditure, and restricted domestic oil consumption is likely to be substantial. All in all, a conservative estimate of the damage would be about US$1.0 billion, equivalent to over 8% of GDP.

10. Policies to mitigate the effects of the earthquake on the economy include a major increase in the domestic prices of petroleum products, building a new pipeline to Colombia, and arranging oil swaps with Venezuela and Nigeria. In addition, by temporarily curtailing debt service payments to commercial banks, the government has momentarily staved off foreign exchange cash flow problems so that imports have not had to be cut drastically. The net result of the contraction from the fiscal shortfall and reduced oil consumption, coupled with the expansionary impact of the reconstruction is expected to increase non-oil GDP in 1987 slightly; however total real GDP is expected to fall by about 1%.

11. The slow rate of economic growth in recent years and the far-reaching reforms achieved thus far have had a high political cost. One finance minister identified with the reform process was forced to resign and another impeached within a four month period. However, continued action is necessary to complete the reforms, consolidate the gains, and meet new challenges. The most urgent problem in 1987 is the balance of payments and fiscal deficits resulting from the fall in petroleum prices and the recent earthquake. The government would need to maintain a competitive exchange rate to permit continued growth in non-oil exports. It would also need to continue restraining public sector expenditures and monetary expansion. Almost as urgent is the necessity to strengthen a financial system badly weakened by a decade of misguided financial policies and imprudence on the part of bankers and their clients. Additional foreign resources will be necessary to support the reform process and smooth the adjustment to lower oil prices.

12. Ecuador's Relations with the IMF and Commercial Banks. Ecuador has entered into three IMF Standby arrangements since 1983. In addition, it received Compensatory Financing in 1983 as a result of lowered export revenues due to floods and in 1986 as a result of lower oil prices. In December 1984, Ecuador obtained a multiyear rescheduling with commercial banks for the period 1985-1989 and with the Paris Club in April 1985 for the period 1985-1987. Until 1986, all Standby targets were met, often with sizable margins. However, only one purchase was made under the August 1986 Standby arrangement because of nonobservance of two targets: net domestic assets and net international reserves. The non-compliance of targets was largely related to the public sector deficit. The targets were consistent with a public sector deficit of 3.2% of GDP; due to higher than expected public expenditures, the deficit turned out to be 4.2% of GDP. By January 1987, the Government and the Fund were negotiating targets for 1987 with the view that the August 1986 Standby would be reactivated and fully disbursed in 1987. In January 1987, while seeking ways of filling the agreed financing gap with commercial banks as a consequence of lower oil prices, the Ecuadorian Government stopped its payments to commercial banks citing shortage of foreign exchange. By February 1987 an agreement between the Fund and the Government had been reached on the main parameters of the 1987 program, with final agreement pending a rescheduling with commercial banks and some action on public revenues through domestic petroleum price increases. Following the earthquake, the authorities believe that it would be appropriate to negotiate a new Standby arrangement and have given indications to IMF staff of their intention to do so in the near future. Fund staff would support such course of action. Commercial banks are continuing negotiations with the Government. The Chairman and Vice Chairman of the Steering Committee are expected to visit Ecuador in the last week of May to agree on the new financing gap following the earthquake and to explore solutions.

Publication of new IMF staff Rpts to this opinion?

III. THE FINANCIAL SECTOR

BCE and Preferential Credit

13. The BCE is the dominant lender in Ecuador, although the current government is attempting to reduce its role. The growth of BCE direct and indirect credits, through the low interest rate rediscounts of the

Financial Funds (FF), accounted for about 50% of the increase in domestic credit between 1973 and 1980. The BCE's role became even more important during the 1980s, especially after 1983, when the BCE's "Sucretization" program converted the large foreign debts of the financial system into sucre debts to the BCE at a favorable interest rate with the BCE simultaneously assuming the foreign exchange obligations (commercial risk remains with the banks). During the period 1980-1984 BCE credit accounted for 56% of the increase in credit to the private sector (37% excluding Sucretization). Another important component of preferential credit is forced investments by the commercial banks in the same sectors and on the same terms as BCE's FF credits. By 1984 credit from BCE made up 46% of total private credit and total preferential credit reached about 55% of the total. Not only are the amounts of these credits large, but by 1984 they were channeled through some 44 separate credit lines. The interest rate charged by FIs on FF and BCE credits, 12%-21%, is below market rates on deposits (22%-30%) and in 1984 was the source of a subsidy to the FIs and their clients of S/49 billion (in 1986 prices), or 3.8% of GDP. The interest rate on these credits, although adjustable, is set in nominal terms and is not explicitly linked to the market, so that the size of the subsidy can balloon if inflation rises.

14. In 1985-86 the GOE reversed earlier trends and restricted the growth of preferential credit. Monetary emission remained high in 1985, however, due for the most part to an accumulation of international reserves and to the gradual elimination of prior import deposits. The total increase in these non-credit items was five times larger than the rise in BCE credits. This increased banking liquidity eased the demand for low cost BCE credit, and contributed to the decline in the free market interest rate and the faster rise in the parallel exchange rate in the second half of 1985. These non-credit items did not grow again in 1986. As a result of the fall in oil prices the credit program was tightened at mid-year. As part of the August 1986 measures a large program of subsidized export credit was canceled and the forced investments of banks were cut by more than half. As a result of these measures, between 1984 and 1986 the share of BCE credit in the total credit to the private sector from FIs dropped from 46% to 39% and that of preferential credit from 55% to 44%.

Commercial Banks and DFIs

15. The commercial banking sector consists of 34 private commercial banks (4 of which are foreign owned). At least 8 of the banks are part of industrial financial groups, which makes arms-length transactions less likely. The existence of these groups and the presence of so many relatively small banks [1] reflected, to a large extent, the profitability for firms associated with banks of gaining access to BCE rediscounts through opening a bank during the oil boom, even though the number of banks prevents them from taking full advantage of economies of scale and leads to high costs of intermediation. While access to external credit was easy, another important and profitable type of banking business was guaranteeing

1/ For example there are only 27 banks in Colombia and the average asset size of Colombian private banks is US$270 million versus US$170 million in Ecuador.

foreign direct loans to businesses, which contributed to a crisis in the financial system when new foreign loans to Ecuador were cut off and businesses could not service their foreign debts. Banks mobilized relatively few resources domestically, both because of the low ceiling on deposit rates mandated by the Monetary Board (JM) and because it was unprofitable, given the low spread that JM allowed and the reserve and forced investment requirements. Money plus time and savings deposits (M2) were about 31% of GDP in 1983, compared to an average of about 34 % for developing countries (Financial Intermediation Policy Paper).

16. With the decline in real BCE credit, the disappearance of the guarantee business, and acute portfolio problems, the intermediation tax represented by reserve requirements (between 20% and 30% of demand deposits throughout the 1980s, and currently at 27%) and forced investments [2] became more important and profitability in banking declined. Even during the boom years of 1977-79, the real return on bank equity was only 15%, indicating that the major beneficiaries of the subsidized credit regime were the firms associated with each bank group. With the onset of the financial crisis in 1982, administrative costs of the overdimensioned banking system rose to over 4% of assets and gross margins fell. Consequently, the real return on equity has averaged -11% since 1983.

17. Since 1981 ceilings on deposit rates have been raised several times to mobilize more domestic resources but, until recently, inflation has risen even faster. In 1984 inflation (December to December) was brought down to 29.7% p.a. from almost 48.1% the year before, while the ceilings on deposit rates were raised to 20-23%. In April 1985 a free market was created in the new certificate of deposit (CD). The initial interest rate was about 28%, which made CDs attractive enough to cause some repatriation of capital. In a politically controversial move, financial institutions were permitted to charge variable interest rates on long term loans (See para. 46). Reflecting these measures and falling inflation, real financial assets rose 27% during 1985, although some of this rise substituted for transactions that formerly took place outside the regulated system. With the introduction of market-rate CDs banks have been able to mobilize around $US400 equivalent through December 1986. In August, 1986 ceiling rates on all deposits were eliminated as were ceilings on lending rates for loans funded with free-rate deposits. By early 1987 deposit rates had settled at around 22 - 25% for the shortest term deposits which, with inflation over 25%, were negative in real terms. CDs, on the other hand were yielding 27-31%, depending on their maturity (down about 2 points since October), slightly positive in real terms. Under the new policies interest rates on term deposits can be expected to remain positive in real terms but will vary with the changing fortunes of the government's battle against inflation and with changing expectations about future exchange rate movements.

2/ Forced investments include 5% of savings deposits in bonds issued by Banco Ecuatoriano de Vivienda and 10% of portfolio to be lent in the same sectors and on the same terms as BCE's FF credits.

18. Banco Nacional de Fomento (BNF), a large public commercial and development bank, lends mainly for agriculture and is the source of around 88% of agricultural credit. It has 11 regional offices, 57 branches and 9 agencies all over the country. BNF is one of the largest users of BCE credit, accounting for 8.8% in 1986. Notwithstanding its extensive branch network, it has placed little emphasis on mobilizing resources from the public and these resources make up only about one quarter of its total resources. Under the recently approved Agricultural Credit Project BNF is committed to mobilizing more resources from the public as it adjusts to the prospect of reduced availability of credit from BCE by using its wide network to attract low-cost deposits. On the asset side the high political sensitivity to increases in BCE interest rates for agricultural credit has prevented BNF's following the liberalizing trend of private FIs.

How will it attract deposits?

19. Thirteen development finance institutions (DFI's),including the publicly owned Corporacion Financiera Nacional (CFN), provide medium- and long-term industrial finance mainly with funds from the international institutions, BCE, and (until recently) foreign commercial banks. They mobilize almost no resources directly from the public. Several are parts of financial/industrial groups. The DFI'S suffer from the same problems as the banks -- small size, undercapitalization, and non-performing loans as they had been even more heavily involved than banks in the guarantee of loans from foreign commercial banks. Moreover, most appear to be captives of a small group of favored borrowers. Although they have more modern management than many commercial banks and higher levels of provisions, their heavier involvement with foreign exchange guarantees entailed larger losses from these operations. Recognizing the weakened state of larger FIs, the Bank has required increases in share capital in order to be eligible under the Industrial Finance Loan. Some new capital has come into the private companies but until they are able to diversify their activities and begin using variable rate lending to permit transformation of financial certificates (virtually identical to commercial banks' CDs) into long term loans (see paras. 45-51), their role will be in doubt.

20. Credit for small scale enterprises has long been a problem. Controlled interest rates and fixed margins regardless of loan size or risk made banks very reluctant to lend to small firms which were also relatively disadvantaged by an industrial promotion law that relied on duty exemptions administered discretionarily. In an attempt to overcome some of these distortions, a special line of credit was set up from BCE funded in part by the Bank. Lending to small scale enterprise is handled through a two tier operation, with the lending institution, a DFI, BNF, or a commercial bank, discounting its loan with the Apex institution, FOPINAR. Although interest rates on SSE loans are equal to loans under Bank DFI loans, until the August 1986 interest rate reforms, FI had little incentive to lend their own funds to SSEs.

21. With very high debt/equity ratios in business firms (para. 47), partly induced by the availability of subsidized credit, the macroeconomic recession that began in 1981 and subsequent devaluations seriously limited the debt service ability of these firms, thereby impairing the portfolio of FIs. So far about 40% of banks and DFIs have lost more than 90% of their nominal equity and total losses may equal S/34 billion. The portfolio

problems of the FI have led the government to Sucretize the foreign debt of the FIs (para 13), establish rehabilitation programs (para. 33), liquidate one commercial bank, and take over another.

Housing Finance

22. The housing finance system consists of Banco de la Vivienda (BEV), the savings and loan associations, (Mutualistas), and the Social Security Institute (IESS). In addition, commercial banks finance a small amount of housing by rolling over short term loans. In the past, the Mutualistas were able to mobilize resources from the public because they were allowed to pay a slightly higher interest rate on savings deposits than were other commercial banks and because to be eligible for a low cost loan, mortgage borrowers had to deposit a compensating balance to be maintained until sometime after the loan was granted. When interest rates began to rise in the early 1980's, Mutualistas experienced large losses because of the mismatch between their low-interest, long-term assets and their short-term, higher rate liabilities (adjustable rate lending was illegal before 1985). When depositors became nervous and withdrew funds, the BCE had to step in and buy up much of the Mutualistas' outstanding portfolio. This left Mutualistas quite liquid, but unable to continue lending for housing since the prevailing market determined interest rates on deposits (22%) and the remaining interest rate controls on long term lending (para. 46) make long term lending risky, and the lack of interest capitalization or similar systems make the initial loan payments unaffordable for the borrower. There is, correspondingly, little demand for mortgages and the construction industry is suffering.

23. The publicly owned BEV was established in 1961 to provide housing finance and to regulate the Mutualista system created two years later. It provides about twice as much credit to the private sector as the Mutualistas. Although BEV is mobilizing an increasing amount of domestic resources from the public (saving accounts more than doubled in 1985), its medium and long term foreign liabilities, including Bank loans, are also a significant source of funds. The average interest on loans, 13%, is still moderately above the average cost of funds, 11%, but its current loan rates, 19% - 21%, are less than the rate it must pay on deposits, 22%. Thus, BEV still has to surmount a number of hurdles before it becomes an autonomous and market oriented institution.

24. The IESS mortgage lending is about equal to that of BEV and the Mutualistas combined. IESS has been making graduated payment loans, but it uses an initial low interest rate, rather than capitalization of interest. This procedure gives a large subsidy to the borrower (who, typically, is not poor) and, along with its holdings of low-interest government and mortgage bonds, is eroding the real value of IESS's assets quite rapidly. The GOE has only limited influence on the policies of IESS whose board is dominated by the military and the unions. IESS has recently raised its interest rate on mortgages to 12%, which is still very low when compared to prevailing CD rates of 27% to 30%; unless IESS earns a higher rate on its portfolio soon, the government will have to step in, either to cover IESS's payments to retirees, raise the already high social security taxes, or cut benefits. The government has arranged for IESS to receive technical assistance from ILO in assessing the looming problem of its unfunded

liabilities and dealing with its financial, operational, and information processing problems.

Summary of Current Issues

25. In sum then, the basic issues raised by the performance of FI are the following: First, subsidized credit is still very large and hinders the efficient allocation of credit, development of the equity market, and monetary stability. Second, the liability structure of FI still does not rely sufficiently on voluntary resource mobilization to insure efficient intermediation. Third, the availability of subsidized credit from BCE has promoted the existence of too many FIs not large enough to reap the benefits of economies of scale. Fourth, the agricultural sector is lagging behind current efforts to adjust interest rates to market conditions. Fifth, there are a significant number of FIs with large portfolio losses. Sixth, the housing finance system and the DFIs has not developed adequate instruments for long-term lending.

IV. MEDIUM RUN FRAMEWORK

26. If recent policy initiatives can be maintained, consolidated and extended, economic recovery should be sustainable. The key elements of the government's medium term economic adjustment and reactivation strategy include: a) the diversification of exports away from petroleum through the maintenance of a competitive exchange rate and the implementation of an effective import duty drawback mechanism; b) a continuation of the gradual reduction in import protection for industry and the removal of tariff exemptions in all sectors; c) improved public goods and services pricing, specially for electricity and petroleum; d) a more rational public investment program; and e) improved financial sector policies to permit greater mobilization and more efficient allocation of resources. These measures are summarized in Attachment 2.

27. As a part of this strategy, the government has taken significant steps toward financial sector liberalization -- raising real interest rates and adopting variable rates on preferential lending, freeing deposit rates and lending rates for non-preferential lending, and reducing the amount of BCE credits and forced investments by banks. The objective of the present stage of the financial reforms process is to support an orderly movement toward a more efficient financial sector. This process will increase the stability of FI's, improve the mobilization of resources domestically and ensure their more efficient allocation, while contributing to a more stable economy.

28. Ecuador is still at an early stage of financial development and should, given a favorable policy framework, be able to increase the volume of credit outstanding and financial assets of the public at rates somewhat faster than the growth of GDP for many years to come. This process of financial deepening will be facilitated by a consolidation in the number of financial institutions which should reduce the cost of financial intermediation and strengthen FIs. A continued reduction in BCE financing of the financial system would permit a more efficient allocation of credit, lower costs for presently non-favored firms and activities, and reduced pressures for inflationary monetary expansion. Long-term lending from

domestic resources - virtually non-existent today, except through BCE - should gradually rise. Notwithstanding the healthy growth in credit that is being sought, the growth of equity finance should be faster still, enabling both FIs and firms to reduce their dangerous degree of leverage.

29. The following paragraphs describe the objectives and content of the proposed Financial Sector Adjustment Loan. These in turn are followed by summaries of i) the expected impact of the FSAL-supported program on key indicators of financial sector performance and ii) the major risks associated with program implementation.

V. FINANCIAL SECTOR ADJUSTMENT LOAN DESCRIPTION

30. The proposed Loan of US$75 million would support both the substantial progress already achieved as well as a program of actions in 1987-88 (See Draft Declaration on Financial Policy, Attachment 1). The US$75 million loan would be disbursed in two approximately equal tranches and would be used to finance imports subject to a negative list. It would also help finance an external financing gap estimated to be about US$970 million for 1987 of which about US$300 million is expected to come from bilateral and multilateral sources, implying a 12% increase in exposure from both private and official sources.

31. The most pressing or politically controversial government actions would be carried out prior to Board presentation. The Government, having lost congressional elections in June 1986, is unable to make legislative changes. In addition, upcoming elections scheduled for January 1988 and opposition within factions of the military, have restricted the ability of the present government to take politically difficult measures. Interest rate reforms have proved particularly sensitive. This is evidenced by the fact that the legality of the August 11, 1986 measure allowing interest rates to be freely determined has come under serious attack. In March, 1987, the Tribunal of Constitutional Guarantees, in a politically motivated ruling, declared that this measure was unconstitutional. The decision was ratified by Congress in May and the President was formally asked to rescind the measure. The President, in turn, has declared the Tribunal's ruling unconstitutional. Thus, while the Executive remains desirous of maintaining and strengthening the interest rate reforms (as reflected in Attachment I, pp 25-26), further interest rate measures are likely to be the most difficult part of the reform program to negotiate. Conditions of Board presentation and Second Tranche release are summarized in Attachment 3. The proposed agreements under this Financial Sector Adjustment Loan have been discussed with the IMF and are being coordinated with the IMF's staff efforts in Ecuador. This loan would be presented to the Board only after a Stand-by arrangement with the Fund is in place. The government's program to promote its financial sector objectives may be grouped into three categories:

Likely sustainability of measures of loan?

i) Strengthening FIs through improvements in the regulatory framework,

ii) Reducing the dependence of FIs on BCE,

iii) Improving conditions for long-term finance.

Strengthening Financial Institutions

32. In order to strengthen FIs it is necessary to strengthen the Superintendency of Bank's (SB) capacity to regulate them. SB is an autonomous public body reporting to both the Congress and the President. Historically its supervision of FIs has been weak and concentrated on ensuring that they meet the requirements on forced investments, rather than on the quality of bank assets and the adequacy of provisions and capital. Until recently, regulatory and tax restrictions made it difficult for FIs to make provisions. Provisions for losses are only about 2% of portfolio among the DFIs and even more inadequate among banks. Writing off recognized losses is still deficient. Traditional accounting practices permit the accrual of interest on non-performing loans, thereby overstating profits and equity. Many banks and DFIs have large amounts of "Sucretized" loans arising out of the inability of their clients to service their foreign exchange debts on their original terms. The actual quality of these loans is largely unknown, although estimates by the Bank indicate that losses on these loans as well as on the ordinary portfolio may equal accounting equity of banks and may exceed the accounting equity of DFI's. FIs, in turn, are highly leveraged; the average debt/equity ratio of banks is more than 20:1 and that of the DFI's is around 15:1. Although the SB is to receive technical assistance under the Bank's Fifth Development Banking and Industrial Finance projects, the assistance has focused so far on analysis of the economic environment of FIs, bank operations under unstable conditions, credit analysis and strategic planning, and only minimally on assessing the financial soundness of FIs.

33. At present there are 3 banks and two DFI's that have entered "Rehabilitation Programs" consisting of a BCE "advance" (the least preferential of any BCE credit) combined with a workout over 5 years drawn up by SB and BCE. The workouts consist of non-payment of dividends, some contribution of fresh capital near the end of the work out period, and operational changes. Nevertheless, these programs are designed more to deal with liquidity than with solvency problems. So far the authorities have been reluctant to take the difficult political decisions involved in closing or forcing the merger of weak banks and DFIs.

34. SB has begun to take steps to force FIs to increase capital and provisions for loss. The ratio of total risk assets to equity of private banks decreased from 18.2 times in 1985 to 14.2 times in 1986; that of DFI's has fallen from 14.7 times in 1983 to 13.6 times in 1986. Overall, the ratio of provisions for loss to credit to the private sector has risen from 0.2% in 1980 to 1.6% in 1986. In 1986 SB disallowed distribution of profits in numerous institutions. Changes in the banking law have made mergers between institutions easier, but so far none have occurred. The authorities place considerable hopes on the conversion into equity of the foreign debt BCE assumed under the Sucretization program as a way of dealing with the indebtedness of FIs and their clients. These hopes may prove unfounded, however, since only firms with very poor prospects may be willing to give up the highly subsidized credits they now enjoy under the "Sucretization" program in return for equity.

Action Program

35. Superintendency of Banks. During the pre-appraisal mission SB agreed to a program of actions designed to tighten prudential regulation of FIs (See Annex to Attachment 1). Starting immediately SB will begin to require that provisions for loss be made on the basis of a review of portfolio quality rather than on the basis of arrears alone. SB will begin to implement its powers to suspend the management of troubled FIs. SB will also begin to enforce more strictly the exposure limits (15% of paid in capital and reserves of the FI with exceptions mainly for sucretized credits) on operations of an FI with firms and groups related to the FI's shareholders. Starting in financial year 1987, SB will require FIs to ask their auditors to provide supplementary information on portfolio quality, the true value of equity, and the adequacy of provisions. SB will also begin to exchange views with external auditors to harmonize criteria used for judging the financial soundness of FIs. Before Board presentation regulations will be issued to prevent the accrual of interest on non-performing loans and require that recognized losses be written off immediately rather than over 5 years. Before release of the second tranche the government will also prepare draft legislation that would allow SB to regulate capital adequacy in relation to risk assets in various categories rather than in relation to liabilities. Until such legislation is in place, SB will use its discretionary powers to require higher levels of capitalization; more specifically, beginning the second half of 1987 SB will take administrative actions (e.g., prohibition of dividend distribution, strict application of legal definition of debt) to reduce the leverage of commercial banks with a ratio of liabilities to equity that exceeds a critical value to be determined during appraisal (tentatively 15:1).

No on-site inspection? adequacy of SB staff no. & trained?

36. Dealing with Troubled Financial Institutions. Higher standards for capitalization, increased provisions, faster write-offs, restrictions on loans to clients related to the FI's shareholders, and reductions in the volume and subsidy element in BCE credits (discussed below) will reduce the incentive to control FIs. This will probably lead to the withdrawal of some investor groups and the liquidation or merger of many FI's with others whose owners find banking profitable as a business rather than as a source of cheap credit for related enterprises. Although the financial status of the Ecuadorean banking system is not nearly so precarious as those of several other Latin American countries where accumulated losses exceeded many times the value of equity, it requires strengthening. Therefore, the Bank will seek an agreement prior to Board presentation on principles to guide the process of consolidation including the following:

i) Once the SB determines that an FI does not meet critical capital adequacy or liquidity limits to be agreed with the government, a review would be undertaken by SB and BCE to determine whether the FI should be liquidated or recapitalized.

ii) Ownership of FIs is to be changed if the current owners refuse to inject the required new capital (bailouts for banks but not for bankers).

iii) Pending sale, merger or liquidation, intervened FIs are to be managed by professional staff drawn from the private sector.

37. The aggregate recapitalization needed by FIs is estimated at around s/30 billion (US$200 million). Prior to merger or sale, and assuming the existing shareholders are not prepared to recapitalize the FI, the necessary funding would have to be provided by the BCE. Although the total requirement is sizable, no all of it would be needed in one year, and the amounts that would have to be advanced can be accomodated within the total BCE credit outstanding of around S/200 billion. Within limits the liquidation or merger of a number of institutions should contribute to greater efficiency, lower spreads, and easier access to credit by formerly non-affiliated firms. To lay the foundation for institutionalizing the system for dealing with failing FIs and for insuring small depositors against future failures at such time as legislative action becomes feasible, the Government will draft a law, prior to second tranche release, to create a deposit guarantee fund (DGF) to be jointly funded and controlled by the private and public sectors and governed by the principles set forth above.

38. Technical Assistance. To carry out its increased responsibilities SB will contract for technical assistance in training its staff in portfolio review and examination of computerized accounting systems. Consultants will also conduct a study of SB's internal procedures, with a view particularly to strengthening systems for the organization and analysis of information. SB will contract experts as needed in the rehabilitation, liquidation, or merger of FIs. Finance of these types of technical assistance would be accommodated under the Industrial Finance Project.

Reducing the Dependence of FI on BCE

39. The government seeks to change fundamentally the relationship between FI's and the BCE. BCE would return to its former role of controlling monetary and macroeconomic aggregates and reduce its influence on sector and sub-sector allocation of credit. FI would look to BCE as lender of last resort but would increasingly rely on their own resource mobilization efforts to satisfy their clients' demand for credit. In addition, the Government would seek to decrease the subsidy granted FIs through BCE's preferential lines of credit mainly by reducing the volume of BCE credit lines but also by increasing the interest rate and linking the rate to a freely determined market rate in order that the subsidy not increase as market rates rise.

Action Program

40. Credit Program. The reductions in the volume of BCE credits, increases in some interest rates, shifts of funds from lower to higher interest rate lines, and a decline in the rate of inflation has reduced the aggregate credit subsidy from S/49 billion in 1984 to S/6 billion in 1986.[3]

3/ As compared to inflation and based on year-end balances in 1986 prices.

To achieve a further reduction in the credit subsidy, an agreement will be sought both to reduce the volume of BCE lines and to raise the minimum interest rates on these lines. BCE has announced a credit program for 1987 that represents a further shrinkage in the real volume of preferential credit for the private sector through FIs. Under this program the expansion in credit would be held to no more than S/12.0 billion, a nominal increase of less than 7%. This announcement was made before the earthquake and the nominal amounts may be adjusted, but the real increase would still be significantly negative. A proposal for a significant further real decline in BCE credit in 1988, i.e., prior to second tranche release, would be developed during appraisal.

41. The restriction in the volume of BCE credit will be complemented by eliminating new operations during 1987 in 8 of its 33 credit lines. Elimination of new operations in 5-8 additional lines (with the precise minimum to be determined during appraisal) would be a condition of second tranche release. The reduction in the number of active BCE credit lines would contribute to restraining the volume of BCE credits and allows more scope for market allocation of credit even within the preferential portion. A smaller number of lines also helps BCE resist the political pressure to create new lines. To reduce the political support among FIs for subsidized BCE lending, BCE is considering reducing the margin FIs earn in on-lending BCE funds.

Why not reduce RRs?

42. The reduction in the volume of BCE credits and, if adopted, in the margin earned thereon will limit further FIs' already inadequate profits. This will be partially offset by foreign exchange trading and the consequent commission income this generates that was transferred from BCE to the FIs in August 1986. Prior to Board presentation, BCE would also lower the forced investment by banks on Financial Funds terms from 10% to 8% of their portfolio. Actions under the credit program should result in a fall in preferential credit from 44% of credit to the private sector in 1986 to 36% in 1987 and 28% in 1988. (See Para. 53) This program for private sector credit is expected to be consistent with the control of net domestic assets of the BCE which is likely to figure prominently in the Fund program.

43. Preferential Central Bank Interest Rates. To prevent fluctuations in market interest rates from changing the size of the subsidy element in preferential credit (See Paras. 13 and 39), an agreement will be sought to link interest rates on BCE credits to rates paid on CDs. Moreover, a further reduction in the subsidy element in preferential credit would be sought through raising the minimum rates on BCE credit. In February 1987 the lowest interest rate that FIs charged final borrowers on BC credit lines was 18%, some 9 percentage points below the 90 day CD which was yielding around 27%. While rapid reduction in this differential would not be politically feasible, it is proposed that, as a signal that the interest rate subsidies are to be reduced over time, BCE's minimum rate to final borrowers be raised to within 7 percentage points or less of the CD rate, by Board presentation and to within 5 points or less of the CD rate by release of the second tranche.

Making it entirely passive?

44. Sucretization. The largest single line of credit from BCE is Sucretization. Amortization of these credits is scheduled to begin in

1988. As the beneficiaries of these sucretized credits include a large number of important business firms, there is likely to be great political pressure to extend the maturities of these credits yet again, but in so far as these maturities are extended, it would be important to eliminate, or at least greatly reduce, the subsidy element in these loans. Assurances would therefore be sought that the Government's Declaration of Financial Policy to be submitted before Board presentation would state that the rate of interest to the intermediary bank will be adjustable at no less than the rate on CDs. The Declaration will also state that no more than 50% of the obligation falling due each year would be refinanced by BCE. Nevertheless, some Bank flexibility both on the total elimination of subsidy and the amount of contraction in the volume of Sucretization may be necessary. The appraisal mission will develop a fallback proposal if full attainment of the above commitments proves unfeasible. The terms on which any Sucretized debt is to be refinanced would be announced and in force before the release of the second tranche of the Loan.

Improving Conditions for Long-term Finance

45. As inflation became a more serious problem after 1981 and nominal interest rates had to be raised, the limited amounts of resources that FIs had been able to mobilize at long term dried up. Banks were no longer able to sell 10 year fixed rate mortgage bonds and DFIs could not issue more of their long-term obligations. The Mutualistas attempted to lend long-term at fixed rates while mobilizing resources with short-term deposits with catastrophic results. Consequently virtually all long term lending ceased except that funded by BCE (and IESS) and the fixed-rate commitments implied an arbitrarily large and variable subsidy as inflation and market interest rates changed.

46. Therefore, in 1985 in the context of discussions leading up to the Bank's Industrial Finance Loan, the government made legal changes that permit lending at variable interest rates. Nevertheless, interest rates on variable rate loans are subject to the "Maximum Prevailing Rate" (TMV), which is set by the JM. In February 1987 the TMV was some 4-5 percentage points below rates being paid on CDs. Therefore, under present JM regulations, FI's cannot mobilize resources from the market and on-lend them long term at variable interest rates.

47. Security markets exist in Quito and Guayaquil but trade mostly interest-bearing securities rather than equities. Firms are highly indebted, largely to FIs rather than to investors through market placement of firms' bonds or commercial paper. A survey of 9000 firms registered with the Superintendency of Companies found an average D/E ratio of 3.33:1. Each firm's equity, on the other hand, comes from a small number of large shareholders with very few companies having significant numbers of small shareholders. The security markets have suffered from the availability of subsidized loans from BCE, fiscal discrimination against equity finance, a lack of auditing and accounting standards to provide reliable information to outside investors, and insufficient protection for minority shareholders. In 1986 the government successfully issued a long-term bond whose adjustable rate was linked to the interest rate paid on CDs. In 1986 the Companies Law was revised to permit issuing of notes not secured by specific guarantees which may permit development of a

commercial paper market based on the new variable interest rates. The new Companies Law also facilitates the issuing of long-term adjustable-rate bonds by firms.

Action Program

48. Variable Rate Lending. In order for FIs to mobilize funds from the market and lend them with a margin at variable rates the JM regulations would be changed, prior to Board presentation, to permit variable rate lending at rates above the TMV. This would permit FIs to define their lending rate as the rate on CDs plus a margin. To facilitate agreements between borrowers and lenders on adjustable rate loans BCE will begin to collect and publish data on average interest rates paid on savings accounts and CDs of various maturities. Consistent with having long term lending linked to market rates, the government intends to enter discussions with the Bank and other international agencies to make the on-lending terms on lines of credit funded by these institutions compatible among themselves and with the recently liberalized interest rate regime. Besides exempting such lending from the TMV the government also expects eventually to define the interest rate on each line as the rate paid on savings accounts (SA), CDs, or other market-determined rate plus a margin. As interest rates on these lines are now below CD rates, [4] the new agreements would have to provide for an appropriate transition period, which might be longer for the agricultural sector where interest rate changes are most politically sensitive. Although the long run goal is to eliminate the subsidy element in these loans, the most important initial step is establishing the link to market rates. Thus, agreement to link interest rates on all World Bank loans to the CD or other market rate would be sought as a condition of Board presentation. In February of 1987, these interest rates were 4 percentage points below the CD rate.

49. Stabilization Bonds. So long as CD rates are market determined they are a workable indicator of credit market conditions. CD rates, however, suffer from being dependent on the perceived default risk of deposits in different FIs, a not insignificant factor in today's market. Therefore, before Board presentation BCE plans to introduce an auction market in stabilization bonds (BCE notes) that should permit both a better reference rate for variable rate lending and better monetary control.

Impact on BCE cash flow?

50. Interest Rate Capitalization. In light of the high nominal interest rates prevailing in the market, FIs will also need to develop principal indexing or interest capitalizing systems to ensure reasonable patterns of real amortization payments on long-term loans. Without capitalization of all or most of the inflation component in interest rates, borrowers' real amortization schedules are heavily front loaded. Such schedules bear little relation to the cash flow of the project being financed and there is likely to be little demand for such lending. Loan

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4/ Under the Industrial Finance Project and SSE Projects the minimum interest rate charged on subloans through June 30, 1987 is 85% of the CD rate or 2 percentage points less than inflation. Thereafter the rate must be at least within 2 percentage points of the CD rate and at least equal to inflation. As of Febrauay, these requirements were being met.

agreements of existing Bank DFI and SSE credit projects already permit partial capitalization of interest.

51. Even more than other FIs, BEV needs to develop a form of contract that combines market-linked interest rates with adjustable payment schedules. With the Bank's help, however, BEV is perhaps the institution that is most advanced in designing such a contract. One of the principal features of BEV'S Low Income Housing Project, which has been appraised, is the introduction of a housing contract whose interest rate is defined as the rate paid on savings deposits plus a margin but whose monthly payments are tied to the minimum wage, with installments in excess of the resulting monthly payments being capitalized. Market based interest rates will permit BEV to become progressively more self-supporting and able to mobilize funds from the market while interest rate capitalization will permit it to offer lower initial payments to its borrowers than it does now with subsidized rates of 19%. Introduction of such capitalization by BEV should pave the way for wider acceptance of the concept by FIs in Ecuador.

Cash flow impact of combination?

52. Encouraging Equity Finance. The most important policies to promote capital market development are the reduction in the volume and subsidy element in preferential credit (paras. 39-44), clarifying the legal status of variable interest rate loan contracts (para. 48), and continued use by the government of adjustable rate long-term bonds (para. 47). In addition the government plans to carry out a diagnosis of the fiscal and other factors that discourage equity finance such as:

i) preferential treatment of interest as opposed to dividend income;

ii) deductibility of the inflation component in nominal interest rates from company taxable income;

iii) lack of protection of minority shareholders;

iv) legislation inhibiting underwriting.

The Government would identify counterparts and contract consultants to develop the diagnosis (see page 34) before the release of the second tranche of the Loan. It is expected that a program of financial reform in this area could form the kernel of a subsequent financial sector adjustment loan.

Financial Sector Projections

53. Based on the stated program and the assumptions that the government maintains the stimulus to exports and improves pricing policy in public sector enterprises as described in the Country Economic Memorandum (Report No. 6592-EC), a set of projections of the evolution of the financial system during 1987-1991 have been prepared. These projections take into account the effect of the recent earthquake on GDP growth. Under those assumptions the projected current account deficit would be greater than the public sector deficit in 1987. As in previous years, external credit to finance the current account deficit would go mainly to the public sector, and some of the external financing will become available through the financial system to fund private investment in excess of private saving, thereby avoiding any crowding-out of private

financial system to fund private investment in excess of private saving, thereby avoiding any crowding-out of private sector credit. Moreover, an increase in the ratio of quasi-money to GDP should be observed if the government continues to permit market-determination of interest rates on deposits. Finally, under the agreed program to reduce the reliance of the financial system on BCE resources, the resulting allocation of credit to the private sector involves greater intermediation through private FIs. In later years foreign financing is expected to shrink as the projected current account deficit declines to permit the resumption of debt repayment, but the foreign sector is still expected to remain a (declining) source of domestic credit. The continued reduction in BCE credit should permit a gradual return to monetary stability characterized by falling rates of inflation and a rising ratio of money to GDP. It should be stressed that these projections depend heavily on the assumption that the government follows its stated program. The major risks that could undermine the projected results are discussed in paragraphs 55 and 56. The table below presents some of the actual and projected indicators of financial sector performance.

Indicators of Financial Sector Performance
(Percent)

Indicator	1980	1984	Est. 1986	High Policy Case 1987	1989	1991
Preferential Credit /Credit to Pvt. Sect.	37.5	54.9	44.0	36.0	20.6	12.3
Credit to Pvt. Sect. /Total FI Cap. (Ratio)	5.9	10.6	10.0	9.4	8.1	7.1
Credit to Pvt. Sect./ /GDP	40.4	55.8	42.8	45.3	45.3	46.2
Provisions/Credit to Pvt.	0.2	1.2	1.6	1.9	2.5	3.1
QM/GDP	14.5	19.2	19.3	21.1	22.2	23.3
Money/GDP	15.3	13.8	11.5	11.8	12.5	13.3
Money growth	11.6	42.2	20.1	26.0	23.2	19.6
Inflation	12.8	29.7	27.4	25.0	15.0	10.0
GDP growth	4.9	4.0	1.7	-1.2	4.0	5.0
Cur. Act. Balance(US$b.)	-0.6	-0.2	-0.6	-0.9	-0.2	-0.1
Cur. Act. Balance/GDP	-5.2	-2.4	-5.4	-7.8	-1.5	-0.5
Pub. Sec. Balance/GDP	-4.5	+1.7	-4.2	-5.4	-0.7	-0.1
Total Cred. Sub./GDP	0.7	3.8	0.9	0.8	0.1	0.1
Excess of Deposit Rate over Min. Lending Rate (% Points)	7.0	12.0	9.0	7.0	5.0	5.0

54. The substantial real depreciation that has been achieved, approximately 40% higher than the early 1970's before significant oil discoveries, has set the stage for faster and more sustainable growth. Under the floating exchange rate regime, the nominal rate may be expected to move more or less in line with the difference between domestic and external inflation. The April 1987 real exchange rate is probably adequate to stimulate growth of exports and promote additional efficient import

substitution. The issue of exchange rate adequacy is being taken up in the context of preparation of a possible Trade Policy and Export Development Loan and in close consultation with the IMF.

55. Under the "high-policy" scenario growth will also be stimulated by the increasing efficiency with which capital is allocated within the economy. Financial sector reforms, particularly the re-creation of an adequate environment for long term finance should have a positive effect, especially in the construction sector. Real interest rates will be subject to offsetting pressures. As inflation falls in response to tight monetary and credit policies, the tax deductibility of the inflationary component in nominal interest rates will become less important, thereby reducing the demand for credit and stimulating the use of equity finance. The reduction in the amounts of and subsidy element in preferential credit will also tend to reduce real interest rates in the non-preferential portion of the market. The process of consolidation that is likely to occur as weak financial intermediaries are weeded out should also reduce the costs of intermediation and the real cost of funds to borrowers. Competition from the development of a market in commercial paper and, eventually, of longer term obligations of firms may also be expected to force down the costs of intermediation. These tendencies toward lower real interest rates will be at work over the medium and long run, but in the short run the resumption of movement in the nominal exchange rate will remove the incentive for inflows of speculative capital which may place upward pressure on real interest rates.

56. Risks. There are two medium term risks to be considered in proceeding with a financial sector adjustment loan at this time. First, given the political situation, the GOE might find itself unable to make commitments on significant reforms, or, having made them, would be unable to carry them out. The recent ruling of the Tribunal of Constitutional Guarantees on the legality of the interest rate reforms, for example, makes further reform quite difficult. The recent decline in oil prices and the earthquake will also place the government under political pressure to slow the financial reform process and perhaps even reverse it. Moreover, it will create pressures for easier monetary policy and more subsidized BCE credit lines, bail outs of firms, and increased public spending to re-inflate the economy. This risk may be particularly acute over the next several months as nominal interest rates come under upward pressure when the exchange rate again starts moving up in response to the difference between domestic and international inflation and inflation accelerates because of the earthquake. Finally, the January 1988 elections could result in a government less inclined to continue with financial sector reforms. To minimize these risks the politically most difficult actions (reduction in the degree of preference in BCE credits, reduction in amount of, and subsidy in, refinanced sucretized debt and exemption of long-term variable rate lending from the "Maximum Prevailing Rate") would be taken as a condition of Board presentation.

57. Second, FIs are weak and undercapitalized. Even with vigorous efforts by SB and BCE to strengthen them and deal with FIs in difficulty, widespread insolvencies could result. Although over the medium term the entire program with the supervisory authorities is designed to prevent the occurrence of system-wide insolvency, accounting and regulatory changes in

the short run will uncover the existing weaknesses and may provoke the closure of some institutions. The government's fullest commitment to a set of principles for dealing with failing FIs and the eventual creation of a deposit guarantee fund or equivalent mechanism is the best way to deal with this contingency. An even greater danger could result, however, if the SB were unable to carry out opportunely the agreed program, thereby failing to uncover weaknesses and allowing the situation of a number of FI to deteriorate. This highlights the importance of the technical assistance to SB to be received under the Loan.

58. Over the longer term, the biggest risk to financial sector development would be a failure to return to macroeconomic stability. This risk is minimized through continuing economic dialogue with the Bank and the Fund, including additional adjustment programs with both institutions. While it is not certain that the Government can carry out or sustain the proposed financial sector reforms, we believe that the incremental costs of appraisal are justified since (i) senior officials have expressed the will to carry forward the program, and they have so far demonstrated considerable firmness in pursuing these objectives in spite of strong political opposition, and (ii) it would be important to advance preparation and processing of adjustment loans as far as possible at this time so that we could be in a position to respond quickly with fast-disbursing, policy-based lending when agreement is reached with commercial banks and the IMF on an external financing program.

T. Hutcheson/M. Carrizosa
May 21, 1987

Attachment 1

DRAFT

Declaration on Financial Policy
February 1987

The government of Ecuador has undertaken a far-reaching program of financial reform. The objectives of this program are to strengthen financial institutions (FI's) in order to allow them to intermediate a larger volume of financial resources and allocate them efficiently in accordance with the demands of the market.

The most important measures taken thus far to carry out this policy of financial reform are:

1. Moderation in the public sector deficit from 5.0% of GDP in 1980-82 to 2.2% in 1984-86;

2. Reduction in the rate of inflation from 48% in 1983 to 23% in 1986;

3. Floating of the exchange rate and allowing private sector foreign exchange transactions to go through markets outside the BCE;

4. Reforming the Banking law to facilitate mergers among and between banks and DFI's (financieras);

5. Encouraging FI to create or increase their provisions for bad debts;

6. Facilitating the more rapid write off of bad debts;

7. Expanding the capacity of the Superintendency of Banks to regulate FI's through training courses and acquisition of data processing equipment;

8. Developing "Rehabilitation Programs" for FI's in difficulty;

9. Creating a Certificate of Deposit (Poliza de Acumulacion Especial) whose interest rate was not controlled by the Junta Monetaria;

10. Subsequent freeing of the interest rates on all deposit instruments;

11. Reducing the real value of BCE credit to the private sector through FI;

12. Increasing the interest rates charged on BCE credit to bring them into closer alignment with market interest rates;

13. Creating adjustable interest rates on loans with resources from BCE or international institutions;

14. Merging of the eleven individual Fondos Financieros into one fund, and elimination of Operaciones Suigeneris, JM 123, and Anticipos BNF para ENAC y IMPROVIT;

15. Allowing the development of an inter-bank loan market;

16. Elimination of prior deposits on imports;

17. Reduction in the forced investments of FI's

18. Issuing of a government bond with a variable market-determined rate of interest;

19. Permitting FI's to partially capitalize interest in order to adjust the loan terms to the borrower's cash flow;

20. Changing the Companies Law to permit firms to issue bonds not backed by specific real assets, to require higher minimum capital, and to require auditing of larger firms;

21. Contracting consultants from ILO to examine the looming financial problems of IESS.

Notwithstanding an extremely difficult external environment -- the debt crisis and the fall in the price of petroleum --the results of the reforms in the financial sector have been clear and positive. Resource mobilization has accelerated; non-monetary deposits of the financial system have risen from 17.8% of GDP in 1983 to 19.2% in 1986. Over $400 million equivalent has been mobilized with the new CD. The proportion of credit to the private sector coming from BCE and forced investments has fallen from 55% in 1984 to 44% in 1986. The average real interest rate charged by BCE on its credit lines rose from -12.2% in 1984 to -3.2% in 1986. Consequently, the aggregate credit subsidy fell from S/ 49,161 million in 1984 to only S/ 6,180 in 1986. Provisions for bad debts as a percent of the portfolios of FI have risen from 0.9% in 1983 to 1.7% in 1986. The leverage of the consolidated financial system has declined somewhat from 10.6 times equity in 1984 to 10 times in 1986. The indebtedness of non-financial firms has declined from 3.8 times equity in 1984 to to 2.5 times in 1985. All these are indications that the economy has responded well to the policies adopted thus far.

Nevertheless, the Government is aware that additional measures are needed to consolidate and complement the reforms already undertaken. Consequently, the Government has designed a specific package of further reforms to be carried out during 1987 and has laid down guidelines for policy thereafter. These reforms are aimed at the following objectives:

1. Further strengthening of FI's

2. Reducing still more the dependency of FI's on BCE;

3. Creating conditions for long-term lending with resources mobilized from the market.

4. Promoting the development of equity finance

The specific policies to be carried out in each area are outlined below.

STRENGTHENING FINANCIAL INSTITUTIONS

FI's and their clients have been hard hit by the sudden cut-off of foreign credit, inflation and devaluations coming on the heels of a decade during which they had become highly dependent on BCE and foreign resources and lax in their credit policies. Many years will be required to restore FI's to full health and some will probably not survive. The Superintendency of Banks will be the key institution in guiding FI's back to financial strength. The government's strategy for strengthening FI's is three fold: 1) reforms in the ways FI's are regulated, 2) creation of a Deposit Guarantee Fund (DGF) to deal with troubled institutions, and 3) technical assistance for the SB and the DGF to enable them to carry out their augmented responsibilities.

Regulatory Changes. The Superintendency of Banks, over time and in a prudent manner, will introduce the following changes in the regulations applying to FI's:

a. FI's will be required to write off bad debts as soon as recognized whether or not any portion of the loan is overdue. Moreover, SB will require FI's to write off overdue debts over a shorter period than in the past.

b. Capital adequacy will be regulated in relation to the riskiness of the portfolio (including the guarantee portfolio) rather than in relation to liabilities. As this requires a change in the Banking Law, SB will administer the existing liability/equity limits to bring about a decline in the assets/equity relation until such time as asset/equity limits can be established.

c. FI's will be required to make provisions not in relation to amounts overdue but in relation to the possible losses from bad loans, as assessed by the FI, attested by external auditors, and examined by personnel of the SB.

d SB will propose legal changes making it easier to remove managers of FI's that infringe laws or violate SB instructions

e Interest accrued from overdue loans will not be included in income unless fully provisioned.

f SB will identify lending or guarantee operations with firms or individuals having financial links to the shareholders of the FI and strictly enforce existing limits on such operations while it seeks legal changes to establish more adequate and prudent limitations.

g SB will begin to collect and BCE will publish data on interest rates paid on deposits and charged on loans by FI.

h The external auditors will be required to prepare complementary information on FI's portfolio and profits for review with SB

Deposit Guarantee Fund. By early 1987 there were approximately 8 banks and 6 DFI's that, under sound accounting conventions, had lost most or all of their capital, some several times over. Five institutions are undergoing "Rehabilitation Programs" designed mainly to solve short-term liquidity problems rather than the underlying capital deficit. As stricter accounting and regulatory standards are applied by SB, the deficient capital and management structures of many of these FI will be progressively uncovered.

To deal with this problem in a positive way and avoid mistakes that can occur in a crisis situation, the Government will create a Deposit Guarantee Fund. The objectives of the Fund will be to protect the depositors and creditors of troubled FI's by having available a core group of professionals who can take over the direction of an institution when needed and make up capital deficits of the FI if the stockholders are unable or unwilling to do so. The shares thus acquired will be held only temporarily until they can be sold to other private shareholders.

The Fund will be created as a public entity whose board of directors will be drawn from the public sector and the insured institutions. It is expected that virtually all FI would choose to join the Fund. In order to join the Fund each institution will have to submit to a special examination aimed principally at determining the quality of its portfolio so that the fund will have a better idea of the size of its potential liabilities. The examination will consist of an extraordinary inspection by SB and a special audit by an external auditors contracted by the Fund. The fee charged by the Fund and its initial capital will be determined by technical and legal studies and incorporated into proposed legislation that should be ready by the time the Financial Sector Loan is presented to the Board of Directors of the World Bank in mid-1987.

Technical Assistance. SB will contract for four types of technical assistance: (i) routine training to reinforce present organizational objectives ; (ii) special training to support changing objectives such as intensified examination of banks, risk classification of loan portfolios and computer auditing; (iii) consulting studies to strengthen SB's operations and efficiency; and (iv) special consultants to provide advice on issues such as setting up and the Deposit Guarantee Fund and getting it underway. All can be financed from this or earlier Bank loans, but to the extent appropriate services can be financed at lower cost with bilateral or other multilateral institutions, these other sources will be used.

REDUCTION IN THE DEPENDENCY OF FIs ON BCE

The first aspect of this continued reduction in dependency is a further reduction in the volume of BCE credit and improvement in the way it is allocated. To this end BCE will conduct no new operation in the following 8 existing lines of credit that accounted for S/.9.4 billion in 1986:

a Development Bonds for Shrimp Larvae Laboratories

b Bankers Acceptances for Cotton

c Commercial Bankers Acceptances

d Capitalization of Firms

e Exchange Losses

f Guarantees and Performance Bonds

g Emergency Credit for Banco de Descuento

h Exchange Risk Commission

The total increase in the balances outstanding of BCE credit lines (excluding foreign funded lines), which came to 181.2 billion in 1986, will be held to just S/.12.0 billion. This represents an 8% nominal increase or a 20% fall in real terms at the expected rate of inflation of 25%. Forced investments by the commercial banks of 10% of their demand deposits on Financial Funds terms will be reduced to 8%.

Interest rates on BCE credit will be brought into closer alinement with market interest rates. BCE staff will begin to make monthly recommendations to the Junta Monetaria to enable it to make monthly adjustments in interest rates. Rates may be adjusted up or down but by the time the Financial Sector Loan is presented to the Board of Directors of the World Bank, the lowest adjustable rate (some fixed rates are lower still) which in February 1987 was 13% or some 14 - 15 percentage points below the rate paid on 90-119 day Polizas de Acumulacion, will be no more than 12 percentage points below the Polizas rate. Thereafter this differential will be reduced by at least 2 percentage points per semester until parity with the Poliza rate is achieved. (The Bank and the government may, of course agree to change this formula whenever convenient, particularly to substitute the yield on BCE Monetary Stabilization Bonds for the Poliza rate as a benchmark when a functioning auction in MSBs is established.) The allowable margins on BCE credit will also be reduced in order to reduce the financial stake that FI have in intermediating subsidized BCE credit.

The largest single line of credit from BCE is Sucretization. (Creditos de Estabilizacion). Amortization of these credits is scheduled to begin in 1988. It will almost certainly be necessary to extend the maturities of these credits yet again. To the extent that these maturities are extended, however, the rate of interest to the intermediary bank will be adjustable at no less than the going rate on Polizas, and no more than 50% of the obligation falling due each year will be refinanced by BCE. BCE will take offsetting measures such as foreign exchange operations or reductions in reserve requirements to insure that the rapid contraction in Sucretization credit does not lead to an undue overall contraction in private credit.

IMPROVEMENT IN THE CONDITIONS FOR LONG TERM FINANCE

The law that established adjustable rate lending for long-term contracts made reference to the "Maximum Prevailing Interest Rate" (Tasa Maxima Vigente, TMV). As the TMV is set by the Junta Monetaria and has not been kept in predictable alignment with market rates, private FI's have not been able to use adjustable rates on loans funded from the market. The institutions that are most immediately affected by this apparent limit are the mutualistas and BEV: mutualistas because they get almost all their funds from the market and BEV because under the Low Income Housing Project BEV is to raise an increasing share of its total funds from the market. If the limit on long term lending with adjustable interest rates is maintained, all long term lending will have to be funded by BCE in clear contradiction to the overall thrust of the financial program.

In order to overcome this problem the government proposes to exempt long-term lending from the TMV. This will be done by a Junta Monetaria resolution based on implied powers in the Monetary Law. The required resolution will be in effect by the time the Financial Sector Loan is presented to the Board of Directors of the World Bank.

There are four active World Bank loans that have covenants on interest rates to be charged to subborrowers. Unfortunately not all of these covenants are mutually consistent. An additional problem is that several make reference to "positive real interest rates" as measured by rates of inflation, notwithstanding that market-determined real rates may well be negative from time to time. The government proposes to enter negotiations with the World Bank and other international lenders to conclude an agreement whereby all interest rates to sub-borrowers would be set a certain number of percentage points above or below the rate on 90-119 day Polizas (or other suitable indicator of market interest rates) depending on whether any explicit subsidy was deemed desirable for the indicated credit user. Since interest rates on several loans are considerably below the rates that would probably be called for by such a formula, a transition period would be established so that the agreed rate would be achieved over time. A reasonable timetable for reaching such an agreement will be discussed during the Appraisal of the Financial Sector Loan.

Although interest rates on Polizas de Acumulacion are a fairly good indicator of market rates, they suffer from several imperfections. First, since Polizas are issued by institutions of different degrees of creditworthiness, movements in the rate for any one institution or group of institutions may result from changes in the risk premium in addition to a pure interest rate movement. Second, thus far no published series of actual (as opposed to advertised) rates has been available and it is recognized that actual rates have been more flexible than advertised rates. This will soon be corrected by having the SB collect data on average rates for 90-119 day Polizas on new operations each week. Third, some elements of monopsonistic rate setting, as banks attempted soon after the August 11 measures, cannot be ruled out.

For these reasons the government proposes to establish an auction market in Monetary Stabilization Bonds. Although such a market could be useful as a tool of monetary management, its chief benefit in the short run will be to allow observation of a market-determined nominal interest rate on a zero-risk asset. The existence of an indicator of market interest rates that is superior to the rate on Polizas should enable both issuers and purchasers of long term bonds to do so at lower intermediation costs. Such a rate could also be an alternative to the Poliza rate as a benchmark for long-term adjustable rate lending from financial institutions. The first auctions in this market will have been conducted by the time the Financial sector Loan is presented to the Board of Directors of the World Bank. The government also plans to issue additional adjustable rate bond during the year.

Relev to monet'y policy

STIMULATING EQUITY FINANCE

The Government is particularly interested in strengthening the capital base of financial institutions. To that effect the Superintendency of Banks has intensified its efforts to have institutions recover their lost equity and will continue to do so until FI's effective leverage falls within prudent limits. Moreover, measures have been enacted to allow the purchase of equity with sucretized external debt. These measures are to be accompanied by others that increase the cost of the sucretized debt, as discussed above, and raise the yield on equity.

The promotion of equity finance will also cover non-financial enterprises, where the debt ratio is close to 2.5 times equity. A high degree of business leverage, inasmuch as it raises the risk of business insolvency, is a contributing factor to financial sector instability. It appears, nonetheless, that one of the weaknesses of Ecuador's capital market is to discriminate unduly against equity finance. Of course, the availability of subsidized credit from BCE is the single most important factor discouraging capitalization. In addition to limiting and eventually eliminate the interest rate subsidy, the institutional and economic factors that may act as deterrents to equity finance will be identified, including the tax environment, inflation induced distortions, and the institutional framework to protect minority stockholders. Once the bias against equity is properly diagnosed, the government will propose a plan of action to correct this bias. This plan of action, including proposals for required legislative action will be ready by the end of 1987.

Attachment 1
Annex

MEMORANDO DE POLITICAS ACORDADAS CON LA SUPERINTENDENCIA DE BANCOS

Los representantes de la Superintendencia de Bancos y del Banco Mundial se reunieron varias veces entre el 17 y el 25 de febrero de 1987 para conversar sobre varias reformas referentes a la regulacion del sistema financiero. Se acordaron las siguientes medidas generales, cuyos detalles adicionales se especificaran en la evaluacion del prestamo propuesto:

1. La Superintendencia de Bancos (SB) acelerara la identificacion de aquellos activos de las instituciones financieras (IF) con razonables dudas sobre su recuperabilidad total y exigira su castigo contra las provisiones existentes, las utilidades acumuladas o corrientes, las reservas, y el capital (Desde marzo 1987). La Superintendencia dispondra que las IF efectuen, obligatoriamente, amortizaciones de cualesquiera activos o que formen fondos especiales de reserva destinados a ese objeto, en la cuantia y condiciones que senale, considerando el estado de situacion de la IF y los requerimientos para su liquidez o solvencia (Desde 1987). Al mismo tiempo, se dictaran normas sobre la documentacion que debera incluirse en los expedientes de deudores para que pueda ser calificada su situacion por los servicios de supervision (Hasta marzo 1987).

2. La SB intensificara la capacitacion necesaria de su personal para calificar los riesgos crediticios y analizar la solvencia de los acreditados de las IF y para auditar los sistemas computarizados. Ademas contratara consultores para examinar los sistemas y procedimientos de SB, y en especial del uso que hace de la informacion que recibe de las IF (Calendario por determinar en la evaluacion final del prestamo).

3. SB estudiara y sentara las bases legales para cambiar el criterio de suficiencia de capital, hoy definido respecto de los pasivos, de modo que consulte los diferentes activos segun sus grados de riesgo (Hasta diciembre 1987). Mientras se logra perfeccionar los cambios legales necesarios, la SB utilizara las atribuciones a su disposicion para elevar la relacion entre el capital y los activos totales de las IF (Desde marzo 1987).

4. La SB obligara a las IF a reservar mayores provisiones, de tal forma que el nivel de las provisiones totales cubra en todo momento las prudentes previsiones de perdida, en base a una real calificacion de activos, incluidos los no vencidos (Desde 1987).

5. La SB propondra los cambios legales necesarios para que pueda remover aquellos administradores cuya gestion no se ajuste a las normas legales y a las instrucciones emitidas por las SB (Hasta diciembre 1987). Mientras tanto, la SB hara un uso mas activo de su facultad de suspender estos administradores (Desde marzo 1987).

6. La SB reformara el instructivo al catalogo de cuentas, con el fin de evitar el abono a cuentas de resultados de los intereses devengados y no cobrados, cuando estos sean exigibles (Hasta marzo 1987).

7. La SB identificara detalladamente las operaciones de las IF con personas y empresas vinculadas, a fin de asegurar que estas se ajusten mas estrictamente a las disposiciones legales (Desde marzo 1987). Al mismo tiempo, gestionara los cambios legales necesarios para establecer limites mas adecuados y prudentes a estas operaciones (Hasta diciembre 1987).

8. La SB obtendra e informara al Banco Central del Ecuador los datos semanales de la tasa promedio de interes sobre las operaciones nuevas de captacion y colocacion con recursos de Polizas de Acumulacion y Certificados Financieros de 90 a 119 dias plazo (Desde marzo 1987).

9. La SB, en colaboracion con el Banco Central del Ecuador, estudiara y preparara un proyecto de ley para la creacion de un Fondo de Garantia de Depositos y con tal fin contratara consultores para el diseno y puesta en funcionamiento del Fondo (Hasta diciembre 1987). Las principales carateristicas de dicho Fondo serian: garantia de los depositos del publico, participacion de los sectores publico y privado en su gestion y facultades para liquidar, o recapitalizar, sanear, y vender o fusionar, segun el caso, aquellas IF que incurran en deficits patrimoniales. SB o el Fondo contratara, en la medida que sea necesario, asesores en el saneamiento y reflotacion de las IF con problemas. La administracion y gestion de dicho Fondo se realizara por profesionales idoneos procedentes de la actividad financiera. Las IF que participen en el fondo deberan someterse a una auditoria especial conforme a las directrices que establezca la comision de administracion del mismo.

10. La SB requerira de las IF que exijan a sus auditores externos la preparacion de un informe complementario sobre la calificacion de activos, la efectividad de los recursos propios, los resultados, los creditos con personas vinculadas, y otros aspectos que la SB senale (Desde junio 1987) . La SB comparara los resultados de dicho informe con los de sus propios inspectores y, en casos de divergencias sustanciales, se reunira con los auditores para conocer las razones de tales divergencias y homogeneizar criterios para el futuro (Desde junio 1987). Ademas, reglamentara severamente la calificacion de las auditorias externas, y dictara normas para acudir a los documentos de apoyo (Hasta diciembre 1987).

11. Se mejoraran los sistemas de procesamiento de datos de todas las entidades vigiladas por la SB, de tal forma que esta cuente con un sistema de informacion homogeneo e idoneo (Diciembre 1987).

ECUADOR
Policy Reforms

Policy Area	Medium Term Objectives	Recent Measures Taken	Further Measures Recommended
A. Exchange Rate	Maintain competitive exchange rate to promote and diversify exports and allow some reduction in industrial production.	Exchange rate unified and devalued in 1985 and early 1986; sucre free-floated in Aug. 86 resulting in a 35% real depreciation by end 1986.	Maintain free-float.
B. Trade	Reduce dispersion and level of effective protection to better allocate resources by increasing competitiveness and encouraging efficient production for the domestic market, lessening anti-export bias, and improving agricultural terms of trade.	1. Tariff reform in January 1986 reduced many tariffs; 2. Quantitative restrictions and tax exonerations were reduced significantly in 1986. 3. Distortionary system of export subsidies was removed in August 1986. 4. Duty drawback legislation was passed in early 1987.	1. Continue reducing qr. and tax exonerations. 2. Introduce maximum tariff. 3. Implement an effective system of duty drawbacks. 4. Continue reducing the level and dispersion of tariffs.
C. Goods Pricing	Prices should reflect their opportunity cost for economic efficiency and to raise fiscal revenues.	1. Many consumer price controls in agriculture were removed; producer price supports now more closely reflect their opportunity cost.	1. Remove remaining price controls in agriculture.
		2. Domestic petroleum prices were raised by about 73% in early 1985 and 62% in March 1987.	2. Introduce a system of crawl in petroleum prices to maintain and slightly increase their real price to bring it into line with world parity prices.
		3. Electricity tariffs to final consumer raised by 3% a month.	3. Have a one-shot increase followed by a crawl or a faster crawl in electricity tariffs to more rapidly approach marginal costs of production.
D. Public Investment	Investment program should reflect country priorities and include only high return projects to better allocate public resources and reduce public expenditure.	Vast majority of projects in recent investment programs are good.	See Annex B of the recent Country Economic Memorandum Report No. 6592-EC.
E. Financial Sector	1. Strengthen the financial condition of financial enterprises. 2. Have market-based interest rates for the sector. 3. Encourage long-term capital development and lending.	See paras 13 and 16.	See Attachment III.

ATTACHMENT 3

LOAN OBJECTIVES, POLICY MEASURES, AND TIMING

OBJECTIVE I: STRENGTHEN FINANCIAL INSTITUTIONS

MEASURES TO BE TAKEN	MONITORABLE POLICY ACTIONS NEEDED	PROPOSED TIMING
Require FIs to write off bad debts immediately rather than over five years.	Administrative actions by SB	Begin immediately
Regulate capital adequacy in relation to assets.	Prepare draft legislation.	Before release of second tranche.
Require injection of additional capital when debt-equity ratio exceeds 15:1.	Administrative actions by SB.	Begin immediately
Provisions made in relation to riskiness of portfolio.	"	"
Suspend management of failing institutions	"	"
Prohibit accrual of interest from overdue loans.	Issue regulations	Before Board presentation
Restrict concentration of risk, especially in operations with related parties, to 15% of paid in capital and reserves, with exceptions mainly for sucretized credits.	Stricter enforcement of existing rules	Begin immediately
Require external auditors to prepare supplementary information on portfolio quality and discuss it with SB.	Issue regulations	Before Board presentation
Adopt principles (See Para. 36 of main text) to guide handling of failing FIs.	Include in Declaration of Financial Policies	Before Board presentation
Develop concrete proposal for creating institution for closing or refloating failing FIs.	Prepare draft law	Before release of second tranche
Carry out training of personnel in portfolio analysis and examination of computerized accounting systems.	Prepare TOR	Before Board presentation
	Select consultants and hold course	Before release of second tranche

Conduct study of SB internal procedures, particularly of its use of information.	Select consultants and begins study	Before release of second tranche

OBJECTIVE II: REDUCE DEPENDENCY OF FINANCIAL INSTITUTIONS ON THE CENTRAL BANK

MEASURES TO BE TAKEN	MONITORABLE POLICY ACTIONS NEEDED	PROPOSED TIMING
Increase BCE credit by no more than S/12.0 billion.	Year-long program	Beginning in January 1987
Continue significant real reduction of BCE credit in 1988 (to be quantified during appraisal).	"	Before Release of Second Tranche
Reduce FF forced investments by banks to 8% of their portfolio.	Junta Monetaria Res.	Before Board presentation
No new operations in 8 of BCE lines of credit.	Year-long program	Beginning January 1987
No new operations in 5 to 8 additional BCE lines of credit.	Year-long program	Before release of second tranche
Reduce difference between the minimum interest rate on BCE credit and CD rate to no more than 7%.	Junta Monetaria Res.	Before Board presentation
Further reductions in the difference between minimum interest rate on BCE credits and CD rate to no more than 5%.	"	Before release of second tranche
Any refinancing of Sucretized debt only at market rates. Refinancing should not exceed one half of obligations falling due.	Include in Declaration of Financial Policies	Before Board presentation
Implement refinancing of Sucretized debt in line with above conditions.	Junta Monetaria Res.	Before release of second tranche

OBJECTIVE III: CREATE CONDITIONS FOR LONG TERM FINANCE

MEASURES TO BE TAKEN	MONITORABLE POLICY ACTIONS NEEDED	PROPOSED TIMING
Exempt long-term lending from ceiling on interest rates	Junta Monetaria Res.	Before Board presentation
Use variable interest rate tied to CD's for government bonds	continue to use present terms	Throughout year
Study actuarial problems of IESS	contract consultants	Before board presentation
Establish auction in BCE notes	Begin auctions of notes	Before Board presentation
Agree to link interest rates on all Bank loans to CD or other market rates.	Junta Monetaria Res.	Before board presentation
Study preferential tax treatment of interest income	Identify counterparts and contract consultants	Before Release of Second Tranche
Study deductibility of inflation component in company income tax	"	"
Study means to protect minority shareholders	"	"

ECUADOR - Key Macroeconomic Indicators
High Policy Case
(Percent)

	Actual		Estimate	Projected				
	1984	1985	1986	1987	1988	1989	1990	1991
GDP Growth Rate	4.0	3.7	1.7	-1.2	8.8	4.0	4.5	5.0
GDY Growth Rate		2.6	-9.1	4.2	2.3	2.6	5.5	5.6
GDY/Capita Growth Rate		-0.2	-11.6	1.3	-0.5	-0.2	2.7	2.7
Debt Service (million US $)	1075	1064	1070	1184	1214	1270	1322	1442
Debt Service/XGS	36.2	32.0	40.9	48.1	36.2	35.1	34.9	35.3
Debt Service/GDP	10.2	8.5	9.0	10.0	8.9	8.7	8.9	9.0
Gross Investment/GDP	18.3	18.3	18.4	19.8	18.1	18.0	18.0	18.0
Domestic Savings/GDP	26.5	28.3	21.2	20.5	23.2	23.3	24.0	23.9
National Savings/GDP	15.9	19.5	13.9	13.0	16.3	16.7	17.4	17.6
Marginal National Savings Rate		1.2	0.7	-0.3	2.1	0.4	0.3	0.2
Public Investment/GDP	6.4	7.6	8.7	8.9	7.7	7.7	7.6	7.6
Public Savings/GDP	8.1	8.6	4.5	3.5	6.0	7.0	7.5	7.5
Private Investment/GDP	10.0	9.0	8.8	9.2	8.6	8.6	8.7	8.7
Private Savings/GDP	7.9	10.9	11.6	9.5	10.3	9.7	9.9	10.1
Ratio of Public/Private Investment	35.1	41.9	42.9	44.9	42.9	42.7	42.5	42.0
Government Revenues/GDP	28.2	28.2	24.5	22.0	25.0	26.3	27.0	27
Government Expenditures/GDP	26.5	27.3	28.7	27.4	26.7	27.0	27.1	27.1
Deficit(-) or Surplus(+)/GDP	1.7	0.9	-4.2	-5.4	-1.7	-0.7	-0.1	-0.1
Export Growth Rate	13.3	17.1	5.6	-20.1	44.0	5.4	4.3	3.3
Exports/GDP	27.6	31.1	32.3	26.2	34.6	35.1	35.0	34.5
Import Growth Rate	1.1	7.3	-8.5	3.0	-0.2	-1.0	4.9	4.8
Imports/GDP	19.4	20.0	18.0	18.8	17.2	16.4	16.5	16.4
Current Account (million US $)	-248	126	-641	-924	-324	-223	-117	-72
Current Account/GDP	-2.4	1.0	-5.4	-7.8	-2.4	-1.5	-0.8	-0.5

Source: Central Bank of Ecuador for historic data; World Bank estimates for projected data.

ECUADOR -- BALANCE OF PAYMENTS
High Policy Case
(US$ millions at Current Prices)

	Actual					Est.	Projected				
	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991
A. Exports of Goods & NFS	2912.9	2686.6	2642.9	2894.8	3294.0	2588.9	2433.0	3325.8	3594.9	3767.0	4062.9
1. Merchandise	2526.9	2327.6	2347.9	2621.8	2905.0	2185.9	2013.7	2859.6	3093.4	3260.5	3522.2
2. Non-Factor Services	386.0	359.0	295.0	273.0	389.0	403.0	419.3	466.2	501.4	506.6	540.6
B. Imports of Goods & NFS	3158.5	2865.2	1821.6	2040.0	2197.7	2267.0	2362.2	2583.0	2723.2	2767.5	2988.0
1. Merchandise	2352.5	2187.2	1420.6	1567.0	1610.5	1631.0	1726.2	1819.0	1895.1	1926.9	2082.0
2. Non-Factor Services	806.0	678.0	401.0	473.0	587.2	636.0	636.0	764.0	828.1	840.6	906.0
C. Resource Balance	-245.6	-178.6	821.3	854.8	1096.3	321.9	70.8	742.8	871.7	999.6	1074.9
D. Net Factor Income	-772.0	-1042.0	-984.0	-1123.0	-1050.3	-1008.3	-1064.6	-1117.2	-1144.5	-1166.9	-1197.1
1. Factor Receipts	87.0	48.0	45.0	77.0	33.0	28.0	28.6	26.1	26.4	19.6	21.6
2. Factor Payments	-859.0	-1090.0	-1029.0	-1200.0	-1083.3	-1036.3	-1093.2	-1143.3	-1170.9	-1186.4	-1218.7
(interest payments)	-626.0	-821.0	-772.0	-955.0	-856.8	-776.3	-818.2	-853.3	-860.9	-856.4	-868.7
E. Net Current Transfers	25.0	20.0	24.0	20.0	80.0	45.0	70.0	50.0	50.0	50.0	50.0
F. Current Account Balance	-992.6	-1200.6	-138.7	-248.2	126.0	-641.4	-923.9	-324.4	-222.8	-117.3	-72.2
G. Long-Term Capital Inflow	1315.0	400.0	597.0	351.0	401.0	718.4	929.0	324.5	217.9	102.5	62.5
1. Direct Investment	60.0	40.0	50.0	50.0	60.0	70.0	80.0	90.0	100.0	120.0	140.0
2. Net MLT Loans	1255.0	360.0	547.0	301.0	401.0	718.4	929.0	324.5	217.9	102.5	62.5
H. Total Other Items	-609.4	340.6	-516.3	-83.8	-502.0	-129.0	79.9	89.9	99.8	119.8	139.7
I. Changes in Net Reserves	287.0	460.0	58.0	-19.0	-25.0	52.0	-85.0	-90.0	-95.0	-105.0	-130.0
1. Net Credit from the IMF	0.0	0.0	217.6	40.4	85.7	76.7	--	--	--	--	--
2. Other Reserve Changes	287.0	460.0	-159.6	-59.4	-110.7	-24.7	--	--	--	--	--
[- indicates increase]											
Shares of GDP (current US$)											
1. Resource Balance	-1.8	-1.4	7.8	8.4	8.7	2.7	0.6	5.4	6.0	6.7	6.7
2. Total Interest Payments	-4.5	-6.6	-7.3	-9.4	-6.8	-6.5	-6.9	-6.2	-5.9	-5.7	-5.4
3. Current Account Balance	-7.1	-9.6	-1.3	-2.4	1.0	-5.4	-7.8	-2.4	-1.5	-0.8	-0.5
4. LT Capital Inflow (line G)	9.4	3.2	5.6	3.5	3.2	6.0	7.8	2.4	1.5	0.7	0.4
5. Net Credit from IMF	0.0	0.0	2.1	0.4	0.7	0.6	--	--	--	--	--
Memorandum Item:											
GDP (millions of current US$)	13,946	12,447	10,591	10,135	12,545	11,912	11,860	13,662	14,609	14,924	16,011
Foreign Exchange Reserves:											
1. Int'l Reserves	632.4	304.2	644.5	611.2	718.2	644.1	--	--	--	--	--
2. Gold (end yr. London price)	17.5	124.3	124.3	124.3	124.3	124.3	--	--	--	--	--
3. Gross Reserves Including Gold	649.9	428.5	768.8	735.5	842.5	768.4	--	--	--	--	--
4. Gr. Res. in Months Imports	2.5	1.8	5.1	4.3	4.6	4.1	--	--	--	--	--
Exchange Rates (Sucres/US$):											
1. Nom. Off. X-Rate	25.0	30.0	44.1	62.5	69.6	122.5	--	--	--	--	--
2. Real Eff. X-Rate (1980=100)	91.4	103.2	109.6	127.1	121.6	171.8	--	--	--	--	--
3. X-Rate for GDP Conversion	25.0	33.4	52.9	79.5	91.5	122.5	151.9	179.4	218.1	278.8	341.2

Source: Central Bank of Ecuador for historic data; World Bank estimates for projected data.

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: May 28, 1986

TO: Operations Policy Sub-Committee

FROM: Vinod Dubey, Director, CPD

EXT.: 60061

SUBJECT: ECUADOR: Medium-Term Growth Strategy Paper

A meeting of the OPSC is scheduled for Thursday, June 5, 1986 at 2:30 p.m. in Room E-1208 to discuss the attached draft medium-term growth strategy paper prepared by the LAC Region.

Attachment

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

A C rec'd copies

AC
Do we arrange OPSC review?
VD 5/7

CONFIDENTIAL

Yes. I have sent it to SST for his review. SST says this is fine for OPSC. A

DATE: May 2, 1986

TO: Mr. Vinod Dubey, CPDDR

THROUGH: Mr. Rainer B. Steckhan, Director, LC1

FROM: Peter Eigen, Division Chief, LC1PA

EXTENSION: 75791

SUBJECT: **ECUADOR - Medium-Term Growth Strategy Paper**

1. Attached is a revised version of the Ecuador paper for further review by the OPSC. It incorporates comments by Mr. Knox, the results of the meeting of April 24, 1986, chaired by CPD, and informal feedback from Fund staff.

2. The Ecuadorian Authorities have been negotiating a program to support a Stand-by arrangement with the Fund since early March. Negotiations will continue on the week of May 5, when the Ecuadorian Authorities visit Washington.

Attachment

Cleared with and cc: Mr. Meo, LC1DR

cc: Messrs. Knox, LCNVP
Pfeffermann, LCNVP
Quijano, LCNVP
Choksi, CPD
Tyler, LCPDR
Kanchuger, LC1PA
Barham, LC1PA
Jones-Carroll, LC1PA (o/r)

HSaenz-Jimenez:ab

DRAFT
4-29-86- CJC/PM
CONFIDENTIAL

ECUADOR - MEDIUM-TERM GROWTH STRATEGY

Initial Conditions

Overview

1. While Ecuador began the 1970s as one of the least developed Latin American countries, the discovery, exploitation and subsequent world price hikes of oil placed it firmly among the middle-income countries of the hemisphere by the end of the decade. Oil changed Ecuador's economy dramatically. Two-thirds of 1970 export revenues were from agriculture; by 1980, nearly two-thirds were from petroleum and only a quarter was from traditional agricultural crops. In addition to financing much of public sector investment, these oil revenues were channeled through Central Bank credit lines to the private sector. Real GDP grew an average nine percent a year in the 1970s. With this rapid income growth, much social progress was also made in spite of population growth of 2.8 percent yearly. Significant increases in education enrollment were achieved, infant mortality was halved and life expectancy increased by 15 years.

2. Much of the resources generated from oil exploitation were used to improve priority physical infrastructure needed for development: trunk roads, oil pipelines, airports, seaports, power generation. However, the Government's role grew: total public expenditures rose from 24 percent of GDP in 1973 to 34 percent in 1982. Government subsidies--to urban consumers, fuel and electricity users, exporters--grew in importance and created distortions in consumption and investment patterns. The public sector's external borrowing also grew; medium- and long-term debt outstanding rose from around $600 million in 1977 to $6 billion in 1984. In spite of the expansion, the country's institutions remained weak. Moreover, the benefits of growth not only created severe structural problems, they were also not evenly distributed: a sizeable middle class emerged but about 40 percent of the urban and 65 percent of the rural population still live in absolute poverty.

3. During the oil boom, the public sector became swollen; over half of 1984 fiscal revenues came from petroleum. Oil revenues were heavily earmarked, and by 1985, only 60 percent of General Government current revenues were under the discretionary control of the Finance Ministry. Furthermore, the non-oil revenue effort was seriously weakened: income taxes represented less than 2 percent of GDP, while income and import taxes collected represented less than a quarter of their theoretical yield. Internal energy prices remained low, creating distortions in consumption and private investment patterns.

4. Further structural problems developed as a result of the trade policies followed since the 1960s, which gave high protection to the industrial sector. The protection, in turn, permitted industrial expansion

in spite of growing real appreciation of the sucre. These policies allowed real manufacturing output to rise 150 percent during 1972-1982, virtually all based on import-substitution. With one or two exceptions, Ecuador's non-oil exports stagnated and by 1982, two-thirds of exports came from oil. These underlying problems made Ecuador's economy very vulnerable to world petroleum prices and the availability of foreign credit lines, and helped bring the period of prosperity to an end by 1982-1983.

Economic Performance in Recent Years

5. A recession developed after oil prices ended their real rise in 1981, foreign credit lines were reduced drastically in 1982, and then natural disasters occurred in 1983. Real GDP dropped 3 percent in the latter year (see Table 1). The Authorities initially borrowed heavily abroad to counteract the fall in oil prices, then placed temporary restrictions in imports, but as Ecuador's access to external funds dwindled, an IMF-supported stabilization program became necessary. This adjusted the exchange rate and introduced mini-devaluations. Ecuador also undertook a debt rescheduling and initiated a fiscal austerity program. Inflation, however, surged to 50 percent in 1983. By 1984, economic growth resumed (4.1 percent), and inflation was halved. With new petroleum fields coming on stream, the volume of oil production rose 18 percent between 1983 and 1985. Non-oil exports, responding to improved exchange rates and better weather, also rebounded.

6. Following a close election, a new Administration took office in August 1984. Its economic philosophy is market-oriented. While key economic officials are technically well-prepared to manage the fundamental reforms this Government hopes to put in place, their supporting bureaucracies are poorly equipped to handle the economic management the country now needs.

7. The new Government took a number of significant measures aimed at consolidating economic recovery and initiating structural reforms: a further devaluation, increases in petroleum prices, electricity tariffs, and interest rates, removal of those emergency import controls introduced in 1982, promotion of direct foreign investment, and elimination of most administered prices in agriculture. It also negotiated a new Stand-by, which focussed on achieving balance of payments equilibrium and a reduction in inflation. Supported by the Stand-by, Ecuador unified the two Central Bank exchange rates,1/ introduced a new savings instrument (certificates of deposit), generated a public sector surplus in 1985, eliminated some prior import deposits and tightened monetary control. The results of all the above measures, together with continued recovery from the 1983 disasters, allowed GDP to grow by 3 percent, inflation to decline to a 22 percent annual rate, export volume to grow by 8 percent, net official reserves to rise by nearly $90 million to the equivalent of one month of imports, and private savings mobilization to increase significantly, mostly through the new certificate of deposit.

1/ While all current account transactions are--in theory--eligible for payment at the Central Bank rate, there remains a legal, floating rate used for some invisible transactions.

May 1, 1986

Table 1: ECUADOR: HISTORIC ECONOMIC INDICATORS *

	Actual					Est.
	1980	1981	1982	1983	1984	1985
GDP Growth Rate (%)	4.90	3.90	1.19	-3.05	4.10	3.16
GNP Growth Rate (%)	4.01	3.25	-0.90	-3.56	2.97	4.10
GNP/capita Growth Rate (%)	1.47	0.35	-3.69	-6.35	0.06	1.26
Consumption/capita Growth Rate (%)	4.62	1.87	-1.08	-5.65	0.60	-0.51
Total DOD (Current Mill. US$) 1/	4652	5868	6186	6690	6948	7186
DOD/EXPGS (%)	156.3	195.6	226.2	248.9	233.8	218.8
DOD/GDP (%)	39.6	42.1	44.7	53.1	55.4	54.8
Debt Service (Current Mill. US$)	559	922	1107	530	1048	994
Debt Service/GDP (%)	4.8	6.6	8.0	4.2	8.4	7.6
Debt Service/EXPGS (%)	18.8	30.7	40.5	19.7	35.3	30.3
Interest/EXPGS (%)	9.7	14.7	20.6	13.9	28.1	23.3
Interest/GDP (%)	2.5	3.2	4.1	3.0	6.3	5.8
Gross Investment/GDP (%)	29.31	24.92	26.83	18.80	19.64	19.00
Domestic Savings/GDP (%)	28.74	22.49	24.94	25.82	26.45	26.38
National Savings/GDP (%)	24.04	17.42	17.66	18.49	17.55	18.31
Marginal National Savings Rate (%)	0.17	-1.16	-3.28	-0.09	-0.31	0.50
Public Investment/GDP (%)	10.30	9.75	9.32	6.91	7.50	8.33
Public Savings/GDP (%)	5.50	4.60	2.60	5.90	7.50	10.40
Private Investment/GDP (%)	19.02	15.17	17.51	11.89	12.14	12.06
Private Savings/GDP (%)	19.54	12.82	15.06	12.59	10.05	7.91
Ratio of Public/Private Investment	0.54	0.64	0.53	0.58	0.62	0.75
ICOR	5.4	6.9	20.2	-7.8	4.4	6.2
XGNFS Growth Rate (%)	-2.57	3.94	-3.38	-2.11	9.39	15.19
Non-Oil XGoods Growth Rate (%)	-1.74	-7.63	0.49	-36.54	31.04	14.76
XGNFS/GDP (%)	22.37	22.34	21.48	21.80	23.07	25.73
MGNFS Growth Rate (%)	10.10	16.68	-9.20	-37.59	8.99	11.96
MGNFS/GDP (%)	23.75	26.65	23.92	15.40	16.25	17.63
Current Account (Current Mill. US$)	-642	-1002	-1195	-126	-263	-99
Current Account/GDP (%)	5.47	7.18	8.63	1.00	2.10	0.76
Terms of Trade Index (1984 = 100)	107.7	115.9	113.1	109.8	100.0	96.9

Sources: 1984 CEM, World Debt Tables, Central Bank, Staff estimates.
* Unless noted, values are for constant 1984 Sucres

1/ Public and Private Medium & Long-term debt; excludes debt to IMF

8. A prime concern of the Government was the external debt, servicing of which would have consumed three-fourths of export earnings had further reschedulings not been arranged. The Government's multi-year debt rescheduling was finalized in an agreement signed with commercial banks in December 1985. The Fund and Bank played a supportive role in key Steering Committee meetings. That rescheduling requires a further IMF Stand-by in 1986. All principal falling due to commercial banks between 1985 and 1989 (about $4.2 billion) has been rescheduled, and virtually no fresh money is provided. Similarly, a multi-year arrangement was worked out with the Paris Club in April 1985, dealing with 1984 arrears and principal falling due in 1985-87, about $400 million.

9. Assuming world petroleum prices had stayed more or less constant in real terms, the Government believed its program would lead to future GDP growth of 4-5 percent p.a. with only a modest level of additional external financing restricted to official sources. The precipitous fall in oil prices in early 1986, however, has significantly changed Ecuador's prospects. At a projected $13/bbl average, petroleum export revenues stand to decline by over $850 million in 1986 alone (29 percent of total 1985 exports of goods), while fiscal revenues from oil could fall by $460 million, 5 percent of GDP. 2/ Partly offsetting the oil export losses, agricultural exports are expected to bring in an additional $250 million partly because of higher coffee prices and Ecuador's good policies during 1984-1985. Nevertheless, these net losses mean that over a quarter of Ecuador's 1986 domestic savings and 28 percent of its exports will be needed for foreign interest payments. Moreover, per capita private consumption will likely drop by one eighth in purchasing power. The presumption--that no net involuntary commercial loans would be necessary after 1985--is now obsolete.

Productive Sector Problems

10. **General:** Ecuador has good human and natural resources. Although its population growth rate is still high, its 12 years of oil exploitation and rapid growth mean the country could withstand a certain amount of austerity without drastically undercutting living standards. Physical infrastructure needed for development was significantly improved during the 1970s. Paved roads doubled in total length; the major port was expanded; significant expansion in hydroelectric power generation and transmission occurred and improvements took place in the two international airports. Yet significant structural problems remain in the sectors and must be addressed. Meanwhile, the greatly depressed oil prices and Ecuador's dependence on oil means there is no way per capita consumption can be raised in the next two years. Nevertheless, no program would be politically viable unless these levels could be expected to improve beginning in three years or so. Obviously, then, at some projected low oil price, Ecuador cannot expect to both service its debt and expand its economy; petroleum must continue to be the main growth sector even at lower prices, as diversifying to other sectors can only be accomplished in the longer run.

2/ But for the accelerated production program (see below), the fiscal fall would have been $600 million.

11. **Petroleum:** Oil exports will drop drastically in the early nineties unless new discoveries are made in the very near future and put into production rapidly. The country has a sound petroleum investment program of US$1.6 billion for the next five-year period, of which CEPE, the state enterprise, will undertake about two-thirds. To hold the future reserve/production ratio at its present level of 14, about 100 million barrels of new oil reserves must be discovered yearly during the next decade. The Government realizes that declining reserves were in part the result of insufficient exploration in the past decade (itself the consequence of inadequate incentives to foreign oil companies) and has embarked on an aggressive exploration promotion effort, based on a revised, and more favorable, petroleum legislation issued in August 1982. This effort has been very successful: six new contracts have since been signed with Occidental, Belco, Exxon/Hispanoil, Texaco/Pecten, BP and Conoco. Occidental has already found a new deposit and is carrying out a program to determine characteristics and size. Signs point to additional companies' keen interest. The new fields in the Oriente have operating costs around US$5 per barrel, one of the lowest in this hemisphere. The vigorous efforts of the Government seem to have overcome the serious image problem Ecuador had as a result of its past policies. The new private exploration efforts as well as revised government investment plans resulting from the price drops are reflected in our recent revision of earlier Bank production estimates:

Petroleum Production in Ecuador

(Millions of Barrels per Year)

	1985	1986	1987	1988
Mid-1985 Projection	96.5	99.0	96.2	96.9
March 1986 Projection	102.5a/	111.2	115.3	122.6

a/ Actual.

Assuming a continuation of present policies, production is projected to reach a high of 147 million barrels in 1992. Exports will not only depend on production, but also on local consumption and on control of smuggling, which the Government intends to reduce through rationalization of domestic prices. Domestic prices were increased by an average 73 percent in late 1984, and world prices (60 cents a gallon) are now being paid for gasoline by Ecuadorian consumers--the first time since 1973. Nevertheless, any devaluation would require a further sucre price rise, and presently lower kerosene, fuel oil, and diesel prices mean the average of all oil product prices still is only 70 percent of world prices.

12. **Agriculture** has the capacity to grow by 50 percent over the next ten years or 4-5 percent p.a. compared to less than 3 percent p.a. in the 1970s, but a number of long-neglected structural factors will have to be tackled and the currently low productivity of land utilized will have to be improved. An overvalued exchange rate, consumer-oriented price controls, and a local price support system that ignored world market prices all helped to keep farmgate prices depressed and discouraged production of food crops for export or import substitution. Industrial protection also attracted resources away from agriculture. Products such as rice, cotton, soybeans and hard corn could have been exported on a regular basis if production and export incentives had been in place.

13. Policies to encourage agricultural growth were finally begun in 1984, when the exchange rate was adjusted, and 1985 when price controls started to be eliminated and industrial protection reduced. Partly as a result, rice, wheat, barley, hard corn and cotton output went up substantially. External factors also helped agriculture in 1986: Brazilian drought raised coffee prices, and good weather and policies brought a 25 percent increase in banana exports.

14. To sustain the good performance of agriculture beyond 1986, many more farmers will have to start using fertilizer and other productivity-improving techniques. Extension services must gear up to promote this. Improved credit availability should help farmers make the necessary investments. In the fishing subsector, shrimp could achieve its good medium-term growth potential if the product's fragile ecological conditions are carefully managed.

15. **Manufacturing** remains at an early stage of development in Ecuador, as activities such as food processing, textiles, and wood products still account for about 75 percent of manufacturing value added. It had high growth rates (9.5 percent p.a.) during 1972-1982 when local entrepreneurs responded to very attractive incentives (effective rates of protection, as high as 300 percent) encouraging import substitution. Virtually all growth of the sector was directed toward the domestic market, with only 6 percent of growth during that period stemming from exports, most of it to the Andean Common Market. Many medium and large firms had also built up large foreign debts during the late 1970s and early 1980s. The devaluations of 1982 and 1983 imposed a severe burden on all these firms and affected significantly their performance, particularly during the 1982-1984 period. A debt service ("sucretization") program established in March 1983 improved the foreign debt structure of these private firms and allowed their continuation in business, although the Central Bank--for substantial fees--accepted some of the foreign exchange risk.

16. Manufacturing absorbed the major part of foreign investment--about 50 percent--during the last five years. Since the advent of the new Government, foreign investment in manufacturing has increased by 33 percent in real terms. While an increasing share of net direct foreign investment (which totalled $60 million in 1985) will go to the oil sector following the recent opening of fields to foreign exploration, an important part can still help the manufacturing sector to restructure itself. In order to continue attracting this investment, the Government has introduced some flexibility on certain restrictions established under the Andean Pact Agreement, particularly regarding profit remittances, and has joined the Bank-sponsored MIGA and ICSID.

17. Prospects for growth of manufacturing are modest in the short term. The required adjustment of the economy to the oil price crisis will necessarily take its toll in terms of a decreased availability of imported inputs and a contraction of domestic demand, to date the major source of the sector's growth. Manufacturing exports might experience a moderate recovery in the short term, because of penetration of new markets (plywood in the USA and Canada, for example), a reopening of the now more buoyant Andean market for some products, and good prospects for agricultural and fishing production. The medium-term prospects for the country's manufacturing would depend heavily upon the deepening and completion of the

liberalization process and improvement of the industrial incentive system started recently by the current administration, which aims at encouraging efficient import substitution and export development. With the right policies, growth of 3 to 4 percent per year is the best to be expected from manufacturing for the remainder of the 1980s.

18. **Mining:** To stimulate growth in the long-dormant mining sector, on August 22, 1985, legislation was streamlined to make mining attractive to both domestic and foreign investors. Since then, 77 contracts have been awarded and 180 are being negotiated for prospecting, exploration and exploitation. Ten foreign firms have negotiated or are in the process of negotiating their participation in gold and silver mines. The Government has contracted an independent consulting firm to assess reserves in several promising areas. With such assistance, mining could eventually generate a modest share of foreign exchange and Government revenue, given reasonable gold and silver prices on the world market.

Negotiations with the IMF

19. The Government plans to continue its stabilization programs and to enter into another Stand-by arrangement with the Fund to cover 1986/87, a condition of the multi-year commercial debt rescheduling and Paris Club. The new arrangement will take into account the new oil prices, reduce economic distortions, and encourage the role of market forces in the economy while containing the deterioration of the overall balance of payments. While the negotiations are not yet concluded, Fund staff and the Authorities have tentatively agreed to drop the oil price expectation to $11.20/bbl for 1986, rather than the $13/bbl used here. While this can be accommodated within our projections, if the expectation for 1987 is around $13/bbl, we would find this (see below) inconsistent with an orderly workout program.

Objectives and Rationale for Medium-Term Growth Program

19. Given the recent enormous loss of oil income, Ecuador is likely to suffer a recession in 1986; in the medium term it will need good policies and management indeed just to maintain average GDP growth rates of 3 to 4 percent unless oil prices rise significantly. This would represent little per capita growth but, given the large adjustments needed to offset lost revenues, it is probably the maximum achievable. Although a 3-4 percent growth objective would not lead to a quick recovery of the 1985 income and consumption standards of the population, it is likely to be the minimum growth path acceptable to this--or any other administration. 3/ Since the Government desires to reestablish Ecuador's creditworthiness for voluntary commercial lending, we have assumed another key objective is to have declining debt servicing ratios over the period. These objectives are only achievable if: (i) exports--of both petroleum and other products--can be stimulated; (ii) the economy can be made more efficient through removal of the many distortions stemming from the oil boom; and (iii) given the constraint on consumption and savings, a rapid improvement of the

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3/ In fact, when adjusted for the terms of trade deterioration, even 4-4.5 percent GDP growth would lead per capita consumption levels in 1990 to be below 1985.

efficiency of investment can take place. Furthermore, these two objectives will be impossible to achieve if oil prices stabilize at less than $13/barrel over the remainder of the decade.

Implications of Objectives

21. This paper assumes that Ecuador will choose to use up more of its oil potential, by increasing production to offset price drops, than it would have if prices had remained high. It also assumes that, as a marginal oil exporter compared to the Middle East, Ecuador will be able to find buyers for its oil. The alternative to using up petroleum in the medium term is a much more severe--perhaps unsustainable--domestic expenditure reduction. Exports will need to accelerate--and petroleum and agriculture exports will likely account for virtually all the incremental exports over the next five years--to help generate the savings and foreign exchange needed to service debt.

22. Ecuador's sound public finances, achieved during 1984-1985, provided the monetary system with resources to increase in real terms--if only slightly--credit to the private sector. In 1986, however, there will be a public deficit; the drop in oil-generated fiscal revenues cannot be quickly and totally replaced by other sources and expenditures are hard to cut massively in the short run. Moreover, the Government will need additional investment funds for the petroleum sector.

23. The lack of a fiscal surplus makes even more important efforts for more selective and efficient investment, better private savings mobilization and financial restructuring for troubled firms. Public investment, if it concentrates on petroleum and on completing ongoing priority projects, can show greater efficiency. Private sector efficiency can increase as incremental investment is focussed on export production and efficient import substitution, plus using formerly idle existing capacity. The appropriate use of exchange rate and trade policy could promote this; so, too, could the new industrial incentives and planned financial sector reforms. Investment efficiency must be improved such that the 1980-1985 ICOR of 7.1 can be dropped rapidly to 4:1.

24. After a few years, Ecuador's fisc must again capture the oil rent in growing public savings; as in most oil exporters this rent must then be transferred--at least partially--to efficient private investment. Our recommendations thus focus on continuing to capture the petroleum sector's potential to help provide Ecuador time to restructure other sectors and on making agriculture the second leading growth sector. Manufacturing, which had impressive growth in the 1970s, is likely to contribute very little in the next few years to GDP growth, since the effects of trade liberalization aimed at redirecting manufacturing away from import substitution and into export oriented activities will take some time. Nevertheless, our recommendations stress continuation of the reduction of industrial protection as a means of eliminating the distortions in the economy that depressed other sectors, especially agriculture. While mining will be promoted, the base is very small and sizeable output can only be expected after several years. We assume that services will grow little in the aggregate because of several offsetting trends: government services will be contracting while financial and commercial sectors may expand after an initial downturn.

Four Scenarios and the Policies they Require

25. The following analysis will look at base and high policy cases under the three oil price scenarios through the 1986-1990 period (referred to as $13, $15 and $17 per barrel cases). Oil price assumptions of the scenarios are as follows:

Table 2: ECUADOR - OIL PRICE ASSUMPTIONS

(US$ per Barrel)

	1986	1987	1988	1989	1990
$15 Oil Base and High Cases	13	15	15.5	16	16.5
$13 Oil High Case	13	13	13.4	13.8	14.2
$17 Oil High Case	13	17	17.5	18	18.5
EPD Forecasts (4/1/86)	13.5	17	19.5	21	22

The $15 scenario will be discussed in detail. The $17 high policy case will be used to demonstrate the relief a $2 per barrel higher price would give to the economy. In the same vein, the $13 high policy case will be analyzed to show the additional measures required to attempt to master such a situation.

26. A major assumption in all cases is that the Government will continue to apply recent policies, which have contributed much to increase the production of petroleum. However, although Ecuador, especially in its new fields, is a rather low-cost producer, foreign investors, who are essential for keeping the country on its present oil production path, will certainly lose interest if the oil price drops below a certain level. This cut-off price is not known, but it may be unrealistic to expect production increases stemming from new exploration for price projections below the $13 range. Moreover, given the dominance of oil in the economy of Ecuador, the uncertainty of future oil prices, and the looming 1988 Presidential elections, speculation on development beyond 1990 at this point is not likely to produce many valid conclusions.

27. The base case takes into account all the policy reforms already begun. These are detailed in the matrices in Annex II and include: (i) liberalization of agricultural pricing at wholesale and consumer levels; (ii) reduction of industrial protection; (iii) planning for divestiture of inefficient state enterprises; (iv) introduction of adjustability in term lending interest rates and in savings instruments; (v) gradual adjustments of the exchange rate to maintain competitive levels; (vi) streamlining industrial incentives and (vii) increased utility tariffs and petroleum prices.

28. The high policy case accelerates all of these reforms to complete major adjustment by end of1987 (taking into account the 1988 elections). No specific year-by-year targetting is suggested because, first, so much has begun already and second, remaining changes will have to be done over the next 18-20 months. Thereafter, policies must be maintained. The high

case also introduces a flexible exchange rate system to maintain the real value achieved in January 1986, rather than the continuation of occasional devaluations that serve the same purpose but with lags. Exporters are likely to respond with full confidence only to the initiation of a system geared to respond automatically to economic forces. This more aggressive approach could further promote exports, but this further export expansion will only occur over the medium term as farmers and manufacturers shift into new products. Because oil, shrimp, and bananas loom so large in Ecuador's present exports, and all three are constrained by non-exchange rate factors, it will then take some time for these new exports to have an effect on Ecuador's growth and balance of payments prospects.

Ecuador - 1985 Exports

	Percent	$Million
Petroleum	67.2	1,926
Bananas	6.6	190
Shrimp	5.3	154
Other	20.9	600
	100.0	$2,870

Finally, the high case reflects a more determined effort by the Government to control public expenditures, postponing or eliminating less attractive, costly investments, and divesting or closing inefficient state enterprises.

29. The base case scenario for $15 oil, is inconsistent with both a recovery of per capita income levels and enhanced creditworthiness (see Annex I.A). GDP growth in 1986 would be virtually nil, but thereafter would pick up somewhat to 2.5 percent. Exports respond only moderately in 1987-90 because the Government signals its support to exports only through irregular step devaluations to allow an appreciating exchange rate to catch up to its previous attractive levels. Imports will experience drops because tightening of monetary and fiscal policy of the 1986 surcharge, or tight monetary policy, and the revamped petroleum refinery which by 1988 should end imports of derivatives. The Government would be unable fully to control pressures for lower return investments and thus would undertake an increasing part of the investment activity, leading to a continued high ICOR, while public savings fall consistently short in financing investment. Private investment stabilizes, in terms of a proportion of GDP, at a 50 percent lower level than achieved in 1980-84, and private savings are consistently below private investment. More financing from abroad would thus be required, which sends the debt service ratio to almost 50 percent (assuming such financing from abroad could be mobilized, unlikely on a voluntary basis). In this situation, given population growth, it would be impossible for private consumption per capita to recover its 1985 level; indeed, it steadily deteriorates.

30. In the high policy case scenario for $15 oil (Annex I.B) an aggressive foreign exchange rate policy and continued trade liberalization increase the confidence of investors in export sectors. Furthermore, the public sector investment program is composed largely of completing ongoing efficient projects and essential new petroleum sector investments. Further restructuring of external debt is assumed to be possible for the 1987-1990 period for three debt categories: commercial banks, suppliers and official export credits because of the Government's good macropolicy performance. It has also been assumed for this scenario that Ecuador will receive net resources from an SDR 105 million 1986/87 Stand-by arrangement with the IMF, as well as from the US through PL480 or ESF loans.

31. These measures, together with accelerating the ongoing agricultural, industrial and financial sector reforms, will be conducive to creating a better investment climate and, in general, the perception of the business community and of the public at-large will be that the Government is giving the appropriate signals to the economy for a quick recovery from the 1986 recession and for sustained growth thereafter. GDP growth would be above population growth after 1986 (4.0 to 4.5 percent), investments will recover and the private sector will gradually expand its proportion in total investments. The public sector, after 1987, would generate a small surplus, which--transferred to the private sector--would help finance private investments. With a current account deficit under 3.5 percent of GDP, total debt outstanding and disbursed would grow to $8.6 billion by 1990, but the debt-service ratio would drop to below 30 percent of exports of goods and services. We assume under this scenario that the new money the economy needs to finance its activities ($200 million p.a. on average) will be made available from commercial and official sources in addition to net drawdowns of around the same amounts from already programmed official lending. The $15 high policy case suggests that with this relatively low price for oil it is still possible to achieve recovery with the appropriate set of measures. Private consumption per capita can virtually be maintained over the period.

32. If the $15 high policy case is a viable scenario, the $17 high policy case will obviously present less problems than the $15 case after 1986. In 1987 and 1988, the current account deficit is equal to 2.5 percent of GDP, so financing required from abroad is less than in the $15 high policy case, but in 1989-90, the $17 case embarks on a higher GDP growth pattern so financing needs increase further. This higher growth is feasible because the debt appears more manageable. In the $17 high policy case, private per capita consumption increases every year after 1986 although only gradually. (See Annex I.C.)

33. In the high policy case scenario for $13 oil, the situation remains grim. Even with some more grant capital from abroad ($50 million per year for two years from the US, instead of $25 million), drawing down reserves and devaluing the real exchange rate 20 percent in 1986 and retaining it thereafter, the picture hardly brightens. GDP growth would remain relatively low (1-3 percent) and, because of lower income, savings in this scenario are low as people attempt to keep consumption up. Maintaining investment levels would therefore require more external financing but this is unlikely to develop as creditors seek to avoid

increasing exposure to a distressed economy. Even further rescheduling agreements will be hard to achieve. Thus investment declines except for "high-yielding" operations in the petroleum sector. (If oil prices stabilize at below $13/barrel, even these investments would probably not materialize and the volume of oil exports would go down.)

34. There is clearly some medium term oil price at which oil-exporting countries will be unable to service their foreign debt and expect an economic recovery. In Ecuador's case, it is our judgement that this threshold is reached at a medium term oil price below $15/bbl (in 1987 prices). In spite of relatively good policies, the $13 high policy case demonstrates it would be imprudent for the Bank--and Ecuador's commercial creditors--to expect the Government to avoid default. If the still-to-be-negotiated 1986/87 Stand-by Arrangement has an oil price below $15/bbl for 1987--as well as the $11.20/bbl price for 1986--we would expect some form of interest payment relief would be necessary. Whether and how the World Bank could mediate such a relief remains a question.

Policies and Institutions

35. Acceleration of ongoing policy reforms described in paragraph 27 and Annex II is an integral part of the medium-term growth program because of the important subsidies (to farmers, consumers, exporters and industrialists) will be phased out, that only efficient local import substituting industry will be supported, that exports and agriculture will be promoted and that the monetary program will be designed to keep inflation under control.

36. The Government must also make every effort to maximize oil production and exports. Indications are that Ecuador's reserves will prove adequate to support the gradual increase from 305,000 bbl/day in 1986 to 403,000 bbl/day in 1992, if the oil pipeline's capacity is expanded gradually so that by 1990, the additional 100,000 bbl/day can be carried from the Amazon to coastal ports and refineries. Planning for this pipeline is underway and should be accelerated. Exports can increase because of the increased exploration (both foreign and public), which will permit higher overall production. However, in order to reduce more quickly the growth of domestic consumption of petroleum products, the Government must raise average local product prices to international levels by 1987. Besides the six foreign firms which have undertaken to expand exploration, CEPE, the State oil company, must also be adequately financed and allowed sufficient flexibility to carry out exploration in the fields reserved to it. The Government plans to optimize the configuration of refining during its expansion of the main refinery, which should be undertaken as soon as possible so as to eliminate imports of derivatives by 1988.

37. The Government must also improve its public sector management. It would help the management of the economy considerably, for instance, if an increasing share of the fiscal flows now earmarked could be made part of the regular and controllable budget process. The Government should take advantage of the low oil prices to eliminate the current excessive earmarking of oil revenues. Efforts to improve tax collection are already underway with some success, and measures to expand revenue sources other than petroleum are now essential.

38. The 1986 public sector budget was prepared in late 1985 with an oil price of $25/bbl. Therefore, the Government has had to take measures to cope with an expected shortfall in fiscal revenue of $460 million or about 5 percent of GDP. Three specific measures have so far been taken; allowing imports of cars (which have high customs taxes), an import surcharge to cover devaluation risk and provide fiscal revenue, and an across-the-board 5 percent cut in budget outlays. Together they are expected to generate $300 million in revenues and savings. The Government has also calculated that lower interest rates on its external debt may lower its expenditures by close to $70 million but this may be overestimated as lower rates will only apply during part of the year. Some adjustments in the tax credit certificates (CATS) being granted to exporters are also being considered. Finally, the Government is considering a substantial increase in oil product prices after the June elections. A 40 percent increase would yield about $30 million p.a. in revenues. Still, all these measures will not likely fully replace the revenue losses and a public sector deficit of perhaps 1 percent of GDP is likely to occur in 1986, and continue to a lesser extent in 1987.

39. Current expenditures must be tightened. Efficiency of public services (education, health) could be greatly improved; the Bank has been discussing, through sector work, ways to do this and could support social sector reforms with appropriate lending as well. The reform of the State-owned enterprise sector (improved prices and management and a divestiture effort) should accelerate to generate a larger current surplus and eliminate subsidies. Corrective pricing measures have been taken for oil products, electricity rates, and telephone charges, but further adjustments are required, although the timing of their introduction will not only be determined by fiscal needs, but also by political reality. The Bank's public sector management loan provides support for efforts to improve fiscal management and public expenditure monitoring.

40. The Government should further rationalize its public investment program. Under an earlier analysis, the Bank had recommended a program of investments for 1985-1988 which postponed or dropped some planned projects (specifically the new primary roads, new airports, railway rehabilitation and hydro-electric projects). It also recommended that no major new public investments be initiated prior to 1988, and that public investment be kept at about 8 percent of GDP. The National Development Plan for 1985-88, issued by the Government in October 1985 presents an investment program closer to 11 percent of GDP and includes some low return projects (Trasvase Santa Elena, electrification of Guayaquil - Quito railroad, Guayaquil by-pass). However, under the present financial circumstances, a public investment program of at most 7 percent of GDP appears more appropriate. Nevertheless, strong regional pressures to finance large, low-return projects continue and appear to be hard to resist, as congressional elections take place this year and presidential campaigning gets underway next year. The Authorities have asked the Bank to assist in preparing and organizing a meeting this year to which international financial institutions and some of the major bilateral donors and commercial banks would be invited to discuss options for financing public investment. They understand that an agreed public investment program is a condition sine qua

non, both for such a meeting and for IBRD support for an expanded, nonproject lending program.

41. Finally, financial and industrial sector reforms would be key to improving the efficiency of the financial, housing and manufacturing sectors, and investment in general. The Social Security Institute, in particular, has a distorting effect on the financial sector because of its low mortgage lending rates and will also become a major public liability as it is being decapitalized. Revisions to the banking laws were recently issued which should help strengthen the financial institutions of the country if properly supervised. Equity participation from foreign banks could improve competition and risk distribution among currently oligopolistic financial institutions. Accounting problems (especially regarding revaluation of assets) must be overcome. Regulatory and control capacity of the Superintendency of Banks and Superintendency of Companies needs to be strengthened. Similarly, housing finance issues, principally savings instruments, interest rates and home buyer cash flow problems, must be addressed, and the Government has requested Bank assistance to this end. In a related vein, the recently revised industrial incentives law should help streamline industrial incentives, and make better use of installed capacity and domestic resources. Annex II provides further details for the policy actions needed in all these sectors.

Priorities

42. The reforms are described above in order of their priority. The Government must, as a first priority, continue with its present course of liberalizing and opening the economy, linking it more closely with market forces, if it expects these signals to be perceived by investors and producers as sustained over the medium term. Backsliding now will only undercut the progress achieved to date in encouraging growth and reorientation of the economy. Secondly, the Government must focus on oil production; thirdly, on its own fiscal management and finally on reforming the broader financial sector.

Near-Term Action Program

43. Ecuador has little choice but to implement the accelerated and additional policies associated with the high case scenarios if oil prices remain around $13-15 per barrel. Under the $13/bbl. case, even good policies do not reduce the high probability of default. Under the $15/bbl. base case, the consumption losses are not likely to be sustainable, and the level of needed additional borrowing is not going to be easily arranged. Only if oil regains a US$20/barrel average export price could Ecuador maintain modest growth by just continuing its current policies, as significant as they are. The near term program described here --the "high policy" case--thus begins with the agriculture, trade and industry measures already initiated and carries on with the additional measures needed to increase exports further and improve investment efficiency and fiscal management.

44. The 1986 Action Program would focus on: (i) continuing adjustments to exchange rates--ideally through a floating or crawling peg regime--to maintain competitiveness; (ii) tariff reform, implementing actions approved in January 1986 to reduce industrial protection and increase attractiveness of agriculture; (iii) interest rate flexibility, putting into effect the August 1985 law permitting interest rates on term loans to be periodically adjusted, as well as adjustments to short-term rates in line with inflation; (iv) removal of about 20 percent of quantitative restrictions on imports, substituting them with tariffs; (v) continuing a tight monetary program and related measures to keep inflation under control; (vi) stringent fiscal management, and an acceptable, efficient and equitable investment program; and (vii) continuing regular adjustments of utility tariffs and elimination of most agricultural price controls. All of these actions are underway and have been supported through Bank agricultural and industrial sectors lending and economic reports (see matrices in Annex II.)

45. Further actions which should be undertaken in 1986 include:

(a) installation of additional pumps to augment the petroleum pipeline capacity;

(b) introduction of higher domestic prices for petroleum derivatives relative to international prices (as soon as possible, but reaching parity with international prices not later than 1987) to cut down contraband and expand the export surplus;

(c) reduction and diversion of new public investment from lower return, postponeable projects to the most productive investments as specified in recent Bank public investment and energy assessment reports;

(d) accelerated efforts to install systems for public investment monitoring in the Finance Ministry and financial monitoring in the principal state enterprises (CEPE, INECEL, IETEL); and

(e) more thorough efforts to reduce earmarking of public sector revenues, to rationalize current expenditures and to sell or close inefficient state enterprises.

For 1987, in addition to continuation of the policies laid down in 1986, Ecuador would have to broaden financial sector reforms and introduce new, more coordinated procedures for public expenditure planning and new revenue measures.

46. Agreements with the IMF will also be part of the near term action program. The measures cited above are consistent with the 1986-87 Stand-by in the process of being negotiated. While the Bank and the IMF have been recommending for years many of the policy measures discussed above (exchange rates, interest rates, energy pricing, public investment management, trade liberalization), the Bank's lending program has until

this year not been used to support major structural adjustments. With the FY86 Agricultural and Industrial Sector Policy Loans this has been changed. To support a workout for Ecuador, we would propose to link further policy lending in CY87-88 to accomplishment of the future recommended actions in the matrices of Annex II. Also, our sponsorship of any coordination meeting of creditors would be pre-conditioned on a satisfactory public investment program and adjustment measures, as well as an 1986-1987 agreement with the Fund. Both the Bank and the Fund can thus provide support and leadership to the proposed workout program. Gross disbursements from the Fund would be around $100 million during 1986/87. The Bank's net flows could remain over $100 million p.a. if currently planned operation are approved, including two further policy loans.

47. For foreign exchange policies, overall fiscal balance, monetary programs and inflation, the IMF would be monitoring progress and defining targets in the context of their 1986-1987 arrangement. Furthermore, Ecuador has a commitment, undertaken in the process of the recent debt rescheduling, to conduct with the Fund semiannual enhanced Article IV consultations throughout 1987-1996. These consultations would serve the monitoring purpose even if further stand-by arrangements did not materialize. The Bank will undertake monitoring of agricultural pricing, interest rates in general (obviously with the IMF), intersectoral terms of trade, tariff reform and import restrictions and industrial incentives through existing loan programs. Inflation's impact and utility pricing policies will also be closely monitored by the Bank. The composition of public sector expenditures--particularly investment--will be analyzed, particularly if the Bank becomes involved in a creditor coordination meeting later this year. An update of the 1984 public investment review will be necessary. To ensure commitment to a leaner investment program, this should largely be undertaken by the Government itself, albeit with some Bank support. To the extent that the Bank becomes involved in future policy-based lending, in particular for the financial sector and trade diversification as well as the petroleum sector, it will monitor reforms in these areas. Close cooperation with the Fund will continue, given the overlapping effects of the respective reform programs, especially with regard to trade, foreign exchange rate, fiscal, and interest rate reforms.

Difficulties and Risks in Implementing Policy Reforms

48. Since mid-1985, the current Administration has enjoyed a fragile but workable majority in Congress which it has used to introduce significant reforms. The President is also willing to move aggressively on those actions which can be implemented by the executive branch alone, when he is convinced that the changes will produce the economic reforms he seeks. If the June 1986 elections favor the ruling coalition, urgent measures such as domestic petroleum pricing and full flexibility of the exchange rate may be passed. If not, actions on these fronts will probably occur but will be more modest and in line with current law and tradition.

49. Most reforms will have to be introduced by the end of 1987. A hiatus in implementing structural reforms can be expected during 1988, an election year. Whatever new Government comes to power, continued attention to maintaining the reforms introduced is essential, but backsliding,

especially in trade areas, is definitely a risk. As elections approach,going forward with large--often low return--public investment projects will be politically attractive, and some areas (e.g. housing finance) will be difficult to reform thoroughly since prior campaign promises are generating countervailing pressures. Finally, given the past history of military governments, there will be little incentive to exert strong control on military expenditures, almost a fifth of total public expenditures in 1982. Armed forces, together with teachers, were given special treatment during the last wage policy decisions and the military pension system will be a particularly sensitive aspect of any Social Security reform.

50. While the political difficulties mentioned above are very real constraints to timely introduction of reforms, an equally serious limitation is the fact of the country's weak institutions and cumbersome procedures. From budget planning to procurement, highly complicated regulations and bureaucratic traditions negatively affect the public sector's ability to carry out its programs even on a non-emergency basis. While this can generally be described as a problem of developing countries, experience suggests that, in Ecuador, it may be worse. For instance, CEPE has lost millions of dollars because of delays in procuring pumps for its wells. These delays are all the more ominous in view of the fact that the major difference between our base and high cases stems from accelerated implementation of policies and programs.

51. A further risk to the workout of Ecuador's financial crisis is the potential for oil prices to remain below a real (1987) price of $13/barrel. While Bank-generated projections suggest a modest recovery in oil price levels, our experts also acknowledge the possibility of a further fall in prices and IMF staff seem more bearish than EDP for 1987. The risk here is that any package of policy reforms that can be considered socially or politically viable would be inadequate to offset the enormous income losses sustained under an extremely low oil price situation, and default or extraordinary interest payment relief become probable alternatives.

Financing Requirements

52. With the best (i.e. high case) policy package that can be expected within the constraints described, Ecuador will have to increase its medium- and long-term debt by over 2.3 billion over 1986-1990 if oil prices average $15/barrel (Annex III). Meeting the estimated net disbursements of $2.3 billion over 1986-1990 would require net disbursements of close to $450 million on average each year. Net borrowing would be in addition to an average $155 million p.a. of net foreign direct investment (compared to $50 million in 1984, before oil companies entered the scene). Approximately $200 million in net borrowing are estimated to come each year from official sources, and the remaining $250 million p.a. from sources to be identified. Of this latter amount, enhanced Bank lending could provide a net additional $50 million annually in 1989-1990, the Inter-American Development Bank, long a major lender to Ecuador, could provide another US$50 million p.a. (the US, which is said to be considering economic support financing, is already assumed to be providing $25 million p.a. in the high case). Over $200 million in 1986 and up to $380 million in 1990 would need to come from private sources, with maturities of at least seven years. It may be possible to associate some of this fresh money from bilateral sources or private banks with Bank involvement in Ecuador's public investment program, for example the petroleum sector or the power sector, or with proposed sector adjustment loans. There has recently been some indication of interest on the part of commercial banks for co-financing Bank-appraised projects in the petroleum sector. This and other cofinancing possibilities could be followed up on through the creditor coordination meeting discussed earlier.

May 1, 1986
Ecuador RMSM -- 15 Base Case

ECUADOR: KEY ECONOMIC INDICATORS

ANNEX I.A

	Actual					Est.	Projected				
	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990
GDP Growth Rate (%)	4.90	3.90	1.19	-3.05	4.10	3.16	0.30	1.50	2.50	2.50	2.50
GNP Growth Rate (%)	4.01	3.25	-0.90	-3.56	2.97	4.10	1.02	2.05	2.93	2.97	3.10
GNP/capita Growth Rate (%)	1.47	0.35	-3.69	-6.35	0.06	1.26	-1.73	-0.73	0.13	0.16	0.29
Consumption/capita Growth Rate (%)	4.62	1.87	-1.08	-5.65	0.60	-0.51	-3.17	-1.68	-1.70	-1.49	-1.21
Total DOD (Current Mill. US$) 1/	4652	5868	6186	6690	6948	7186	7618	7916	8101	8211	8189
DOD/EXPGS (%)	156.3	195.6	226.2	248.9	233.8	218.8	288.0	266.4	258.7	243.8	223.6
DOD/GDP (%)	39.6	42.1	44.7	53.1	55.4	54.8	54.1	52.9	50.2	47.1	43.4
Debt Service (Current Mill. US$)	559	922	1107	530	1048	994	1046	1123	1241	1398	1777
Debt Service/GDP (%)	4.8	6.6	8.0	4.2	8.4	7.6	7.4	7.5	7.7	8.0	9.4
Debt Service/EXPGS (%)	18.8	30.7	40.5	19.7	35.3	30.3	39.6	37.8	39.6	41.5	48.5
Interest/EXPGS (%)	9.7	14.7	20.6	13.9	28.1	23.3	28.0	24.7	24.0	22.7	20.7
Interest/GDP (%)	2.5	3.2	4.1	3.0	6.3	5.8	5.3	4.9	4.6	4.4	4.0
Gross Investment/GDP (%)	29.31	24.92	26.83	18.80	19.64	19.00	17.00	17.00	17.50	18.00	18.00
Domestic Savings/GDP (%)	28.74	22.49	24.94	25.82	26.45	26.38	20.87	22.41	22.04	21.87	21.90
National Savings/GDP (%)	24.04	17.42	17.66	18.49	17.55	18.31	13.48	15.55	15.59	15.86	16.44
Marginal National Savings Rate (%)	0.17	-1.16	-3.28	-0.09	-0.31	0.50	0.76	1.22	0.58	0.44	0.45
Public Investment/GDP (%)	10.30	9.75	9.32	6.91	7.50	8.33	6.50	7.00	7.50	8.00	8.00
Public Savings/GDP (%)	5.50	4.60	2.60	5.90	7.50	10.40	5.50	6.50	6.50	6.50	6.50
Private Investment/GDP (%)	19.02	15.17	17.51	11.89	12.14	12.06	10.50	10.00	10.00	10.00	10.00
Private Savings/GDP (%)	18.54	12.82	15.06	12.59	10.05	7.91	7.98	9.05	9.09	9.36	9.94
Ratio of Public/Private Investment	0.54	0.64	0.53	0.58	0.62	0.75	0.62	0.70	0.75	0.80	0.80
[illegible]	5.4	6.9	20.2	-7.8	4.4	6.2	10.00	11.33	7.20	7.20	7.20
XGNFS Growth Rate (%)	-2.57	3.94	-3.38	-2.11	9.39	15.19	9.83	3.75	3.29	5.58	4.28
Non-Oil XGoods Growth Rate (%)	-1.74	-7.63	0.49	-36.54	31.04	14.76	18.10	3.63	4.05	4.58	5.20
XGNFS/GDP (%)	22.37	22.34	21.48	21.80	23.07	25.73	28.18	28.80	29.02	29.90	30.41
MGNFS Growth Rate (%)	10.10	16.68	-9.20	-37.59	8.99	11.96	-6.85	2.66	-4.66	2.83	2.83
MGNFS/GDP (%)	23.75	26.65	23.92	15.40	16.25	17.63	16.38	16.56	15.41	15.46	15.51
Current Account (Current Mill. US$)	-642	-1002	-1195	-126	-263	-99	-588	-363	-289	-245	-133
Current Account/GDP (%)	5.47	7.18	8.63	1.00	2.10	0.76	4.17	2.43	1.79	1.41	0.70
Terms of Trade Index (1984 = 100)	107.7	115.9	113.1	109.8	100.0	96.9	69.3	70.2	63.8	61.3	60.3

Sources: 1984 CEM, World Debt Tables, Central Bank, Staff estimates.
* Unless noted, values are for constant 1984 Sucres

1/ Public and Private Medium & Long-term debt; excludes debt to IMF

May 1, 1986
Ecuador CMSM -- 15 High Case

ECUADOR: KEY ECONOMIC INDICATORS

	Actual					Est.	Projected				
	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990
GDP Growth Rate (%)	4.90	3.90	1.19	-3.05	4.10	3.16	0.30	4.00	4.00	4.20	4.50
GNP Growth Rate (%)	4.01	3.25	-0.90	-3.56	2.97	4.10	0.82	4.65	4.47	4.63	5.09
GNP/capita Growth Rate (%)	1.47	0.35	-3.69	-6.35	0.06	1.26	-1.93	1.80	1.63	1.78	2.23
Consumption/capita Growth Rate (%)	4.62	1.87	-1.08	-5.65	0.60	-0.51	-0.91	0.98	-0.83	0.29	0.09
Total DOD (Current Mill. US$) 1/	4652	5868	6186	6690	6948	7186	7631	8036	8503	8991	9456
DOD/EXPGS (%)	156.3	195.6	226.2	248.9	233.8	218.8	288.5	268.1	267.0	259.8	248.8
DOD/GDP (%)	39.6	42.1	44.7	53.1	55.4	54.8	54.2	52.4	50.7	48.8	46.5
Debt Service (Current Mill. US$)	559	922	1107	530	1048	994	1048	945	953	1044	1139
Debt Service/GDP (%)	4.8	6.6	8.0	4.2	8.4	7.6	7.4	6.2	5.7	5.7	5.6
Debt Service/EXPGS (%)	18.8	30.7	40.5	19.7	35.3	30.3	39.6	31.5	29.9	30.2	30.0
Interest/EXPGS (%)	9.7	14.7	20.6	13.9	28.1	23.3	28.1	24.2	23.6	22.6	20.8
Interest/GDP (%)	2.5	3.2	4.1	3.0	6.3	5.8	5.3	4.7	4.5	4.2	3.9
Gross Investment/GDP (%)	29.31	24.92	26.83	18.80	19.64	19.00	17.00	18.00	19.00	19.50	20.00
Domestic Savings/GDP (%)	28.74	22.49	24.94	25.82	26.45	26.38	20.78	21.77	21.49	21.44	21.51
National Savings/GDP (%)	24.04	17.42	17.66	18.49	17.55	18.31	13.21	14.80	14.96	15.30	15.90
Marginal National Savings Rate (%)	0.17	-1.16	-3.28	-0.09	-0.31	0.50	0.78	0.49	0.36	0.32	0.32
Public Investment/GDP (%)	10.30	9.75	9.32	6.91	7.50	8.33	6.50	7.30	7.65	7.75	7.90
Public Savings/GDP (%)	5.50	4.60	2.60	5.90	7.50	10.40	5.50	7.00	8.00	8.50	9.00
Private Investment/GDP (%)	19.02	15.17	17.51	11.89	12.14	12.06	10.50	10.70	11.35	11.75	12.10
Private Savings/GDP (%)	18.54	12.82	15.06	12.59	10.05	7.91	7.71	7.80	6.96	6.80	6.90
Ratio of Public/Private Investment	0.54	0.64	0.53	0.58	0.62	0.75	0.62	0.68	0.67	0.66	0.65
ICOR	5.4	6.9	20.2	-7.8	4.4	6.2	10.00	4.25	4.50	4.52	4.33
XGNFS Growth Rate (%)	-2.57	3.94	-3.38	-2.11	9.39	15.19	9.83	4.48	3.52	6.24	4.92
Non-Oil XGoods Growth Rate (%)	-1.74	-7.63	0.49	-36.54	31.04	14.76	18.10	6.14	7.46	7.85	8.28
XGNFS/GDP (%)	22.37	22.34	21.48	21.80	23.07	25.73	28.18	28.31	28.18	28.73	28.84
MGNFS Growth Rate (%)	10.10	16.68	-9.20	-37.59	8.99	11.96	-6.40	7.77	0.76	6.22	6.58
MGNFS/GDP (%)	23.75	26.65	23.92	15.40	16.25	17.63	16.45	17.05	16.52	16.84	17.17
Current Account (Current Mill. US$)	-642	-1002	-1195	-126	-263	-99	-625	-495	-571	-623	-636
Current Account/GDP (%)	5.47	7.18	8.63	1.00	2.10	0.76	4.44	3.23	3.40	3.38	3.12
Terms of Trade Index (1984 = 100)	107.7	115.9	113.1	109.8	100.0	96.9	69.3	71.0	64.3	62.1	61.4

Sources: 1984 CEM, World Debt Tables, Central Bank, Staff estimates.
* Unless noted, values are for constant 1984 Sucres

1/ Public and Private Medium & Long-term debt; excludes debt to IMF

ANNEX I.C

May 1, 1986
Ecuador -- RMSM 17 High Case

ECUADOR: KEY ECONOMIC INDICATORS

	Actual					Est.	Projected				
	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990
GDP Growth Rate (%)	4.90	3.90	1.19	-3.05	4.10	3.16	0.30	4.25	4.75	5.25	5.50
GNP Growth Rate (%)	4.01	3.25	-0.90	-3.56	2.97	4.10	0.82	5.17	5.50	5.86	6.16
GNP/capita Growth Rate (%)	1.47	0.35	-3.69	-6.35	0.06	1.26	-1.93	2.31	2.63	2.98	3.27
Consumption/capita Growth Rate (%)	4.62	1.87	-1.08	-5.65	0.60	-0.51	-0.91	1.37	-0.41	1.39	1.10
Total DOD (Current Mill. US$) 1/	4652	5868	6186	6690	6948	7186	7632	7943	8206	8560	8980
DOD/EXPGS (%)	156.3	195.6	226.2	248.9	233.8	218.8	288.5	247.5	239.1	228.6	218.1
DOD/GDP (%)	39.6	42.1	44.7	53.1	55.4	54.8	54.2	50.6	46.7	43.4	40.7
Debt Service (Current Mill. US$)	559	922	1107	530	1048	994	1048	937	926	1005	1096
Debt Service/GDP (%)	4.8	6.6	8.0	4.2	8.4	7.6	7.4	6.0	5.3	5.1	5.0
Debt Service/EXPGS (%)	18.8	30.7	40.5	19.7	35.3	30.3	39.6	29.2	27.0	26.8	26.6
Interest/EXPGS (%)	9.7	14.7	20.6	13.9	28.1	23.3	28.1	22.3	21.1	19.8	18.1
Interest/GDP (%)	2.5	3.2	4.1	3.0	6.3	5.8	5.3	4.6	4.1	3.8	3.4
Gross Investment/GDP (%)	29.31	24.92	26.83	18.80	19.64	19.00	17.00	18.00	19.00	20.00	21.00
Domestic Savings/GDP (%)	28.74	22.49	24.94	25.82	26.45	26.38	20.78	22.58	22.49	22.43	22.52
National Savings/GDP (%)	24.04	17.42	17.66	18.49	17.55	18.31	13.21	15.84	16.43	16.91	17.59
Marginal National Savings Rate (%)	0.17	-1.16	-3.28	-0.09	-0.31	0.50	0.78	0.56	0.45	0.32	0.32
Public Investment/GDP (%)	10.30	9.75	9.32	6.91	7.50	8.33	6.50	7.25	7.56	7.80	8.10
Public Savings/GDP (%)	5.50	4.60	2.60	5.90	7.50	10.40	5.50	8.00	9.00	9.50	10.50
Pri[illegible]vestment/GDP (%)	19.02	15.17	17.51	11.89	12.14	12.06	10.50	10.75	11.44	12.20	12.90
Pri[illegible]avings/GDP (%)	18.54	12.82	15.06	12.59	10.05	7.91	7.71	7.84	7.43	7.41	7.09
Ratio of Public/Private Investment	0.54	0.64	0.53	0.58	0.62	0.75	0.62	0.67	0.66	0.64	0.63
ICOR	5.4	6.9	20.2	-7.8	4.4	6.2	10.00	4.00	3.79	3.62	3.64
XGNFS Growth Rate (%)	-2.57	3.94	-3.38	-2.11	9.39	15.19	9.83	4.48	3.30	5.99	4.68
Non-Oil XGoods Growth Rate (%)	-1.74	-7.63	0.49	-36.54	31.04	14.76	18.10	6.14	7.46	7.85	8.28
XGNFS/GDP (%)	22.37	22.34	21.48	21.80	23.07	25.73	28.18	28.24	27.85	28.05	27.83
MGNFS Growth Rate (%)	10.10	16.68	-9.20	-37.59	8.99	11.96	-6.40	8.23	-1.36	8.66	8.94
MGNFS/GDP (%)	23.75	26.65	23.92	15.40	16.25	17.63	16.45	17.08	16.09	16.61	17.15
Current Account (Current Mill. US$)	-642	-1002	-1195	-126	-263	-99	-625	-351	-337	-449	-537
Current Account/GDP (%)	5.47	7.18	8.63	1.00	2.10	0.76	4.44	2.24	1.92	2.28	2.44
Terms of Trade Index (1984 = 100)	107.7	115.9	113.1	109.8	100.0	96.9	69.3	74.5	67.4	64.8	63.9

Sources: 1984 CEM, World Debt Tables, Central Bank, Staff estimates.
* Unless noted, values are for constant 1984 Sucres

1/ Public and Private Medium & Long-term debt; excludes debt to IMF

May 1, 1986
Ecuador RMSM -- 13 High Case

ECUADOR: KEY ECONOMIC INDICATORS

	Actual					Est.	Projected				
	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990
GDP Growth Rate (%)	4.90	3.90	1.19	-3.05	4.10	3.16	0.30	1.00	2.50	3.00	3.00
GNP Growth Rate (%)	4.01	3.25	-0.90	-3.56	2.97	4.10	0.84	1.14	2.89	3.42	3.64
GNP/capita Growth Rate (%)	1.47	0.35	-3.69	-6.35	0.06	1.26	-1.91	-1.62	0.08	0.60	0.82
Consumption/capita Growth Rate (%)	4.62	1.87	-1.08	-5.65	0.60	-0.51	-2.04	0.31	-1.75	-2.65	-0.77
Total DOD (Current Mill. US$) 1/	4652	5868	6186	6690	6948	7186	7604	8018	8370	8622	8679
DOD/EXPGS (%)	156.3	195.6	226.2	248.9	233.8	218.8	287.5	289.0	283.4	269.5	248.0
DOD/GDP (%)	39.6	42.1	44.7	53.1	55.4	54.8	54.0	55.6	54.1	51.9	48.7
Debt Service (Current Mill. US$)	559	922	1107	530	1048	994	1045	944	942	1015	1071
Debt Service/GDP (%)	4.8	6.6	8.0	4.2	8.4	7.6	7.4	6.5	6.1	6.1	6.0
Debt Service/EXPGS (%)	18.8	30.7	40.5	19.7	35.3	30.3	39.5	34.0	31.9	31.7	30.6
Interest/EXPGS (%)	9.7	14.7	20.6	13.9	28.1	23.3	28.0	26.1	25.1	23.5	20.8
Interest/GDP (%)	2.5	3.2	4.1	3.0	6.3	5.8	5.3	5.0	4.8	4.5	4.1
Gross Investment/GDP (%)	29.31	24.92	26.83	18.80	19.64	19.00	17.00	15.00	15.00	16.00	16.00
Domestic Savings/GDP (%)	28.74	22.49	24.94	25.82	26.45	26.38	20.78	19.29	19.51	20.64	21.02
National Savings/GDP (%)	24.04	17.42	17.66	18.49	17.55	18.31	13.23	11.89	12.48	14.00	14.97
Marginal National Savings Rate (%)	0.17	-1.16	-3.28	-0.09	-0.31	0.50	0.78	-2.21	0.56	0.98	0.51
Public Investment/GDP (%)	10.30	9.75	9.32	6.91	7.50	8.33	6.50	6.10	6.00	6.35	6.30
Public Savings/GDP (%)	5.50	4.60	2.60	5.90	7.50	10.40	5.50	4.50	5.00	5.50	6.00
Private Investment/GDP (%)	19.02	15.17	17.51	11.89	12.14	12.06	10.50	8.90	9.00	9.65	9.70
Private Savings/GDP (%)	18.54	12.82	15.06	12.59	10.05	7.91	7.73	7.39	7.48	8.50	8.97
Ratio of Public/Private Investment	0.54	0.64	0.53	0.58	0.62	0.75	0.62	0.69	0.67	0.66	0.65
	5.4	6.9	20.2	-7.8	4.4	6.2	10.00	17.00	6.00	5.00	5.33
XGNFS Growth Rate (%)	-2.57	3.94	-3.38	-2.11	9.39	15.19	9.83	4.48	4.47	6.55	5.23
Non-Oil XGoods Growth Rate (%)	-1.74	-7.63	0.49	-36.54	31.04	14.76	18.10	6.15	7.46	7.85	8.27
XGNFS/GDP (%)	22.37	22.34	21.48	21.80	23.07	25.73	28.18	29.15	29.71	30.74	31.40
MGNFS Growth Rate (%)	10.10	16.68	-9.20	-37.59	8.99	11.96	-6.40	1.28	-0.61	3.00	3.00
MGNFS/GDP (%)	23.75	26.65	23.92	15.40	16.25	17.63	16.45	16.50	16.00	16.00	16.00
Current Account (Current Mill. US$)	-642	-1002	-1195	-126	-263	-99	-623	-529	-458	-388	-227
Current Account/GDP (%)	5.47	7.18	8.63	1.00	2.10	0.76	4.42	3.67	2.96	2.33	1.27
Terms of Trade Index (1984 = 100)	107.7	115.9	113.1	109.8	100.0	96.9	69.3	68.6	66.1	64.1	63.8

Sources: 1984 CEM, World Debt Tables, Central Bank, Staff estimates.
* Unless noted, values are for constant 1984 Sucres

1/ Public and Private Medium & Long-term debt; excludes debt to IMF

ECUADOR

AGRICULTURAL SECTOR POLICY

Policy Area	Medium-Term Objectives	Recent Actions Taken	Further Measures Recommended
A. Pricing	Liberalization of official prices at the wholesale and consumer levels on agricultural commodities.	Reduction of the number of agricultural commodities under official price controls to three at the consumer level, and 17 at the wholesale level. Of the 17, coffee, cocoa, and bananas are set by international prices. Sugar is a mixed product entering into the US quota, and because of oligopolization in processing requires some price controls. Other than wheat (through a quota system), rice and hard corn, the Government is no longer supporting minimum prices at the wholesale level. At the consumer level, the three staple commodities (wheat flour, milk and sugar) still with controlled prices will be available only at ENPROVIT outlets in low-income areas.	- Elimination of remaining procurement by ENAC or other public enterprises to support minimum wholesale prices. - Elimination of the maximum consumer price on wheat flour.
B. Import Restrictions	Removal of quantitative restrictions on imports of agricultural commodities.	Removal of quantitative restrictions imposed during 1982 and 1983.	Elimination of quotas, and other quantitative restrictions on the imports of agricultural products, inputs, and substitution by generally uniform tariffs at levels to be determined from the internal terms of trade.
C. Export Incentives Policy Area	Adjustment of exchange rate to maintain real rates and unification of exchange rates.	Unification of exchange rate.	Continued progress on export incentives to agricultural commodities via introduction of a flexible exchange rate, maintaining the January 1986 value of the sucre.
D. Inter-Sectoral Terms of Trade	Improve the terms of trade of agriculture vis-a-vis the rest of the economy.	Removal of many 1982/83 quantitative restrictions on imports of industrial products.	Reduction of the level, and dispersion of tariffs on industrial commodities. Removal of quantitative restrictions on most industrial products. Imposition of tariffs on imports of agricultural commodities (see Trade Sector).
E. Public Enterprises	Divestiture of designated public enterprises.	Consulting firm to help prepare sales is being appointed.	Development and execution of plan for state enterprise sector, including sale or closure of inefficient firms.
F. Interest Rates	Positive real interest rates and variability of long-term rates. Uniform rates except as justified by transactions costs.	- Increase (January 1985) of interest rates. - Unification of agricultural lending rates except as justified by transaction costs. - Maintenance of positive rates of interest through adjustment of nominal rates as necessary.	Maintenance of positive real rates of interest through adjustment of nominal rates as necessary, and elimination of rate dispersion between agriculture and other sectors, and between different sources of foods or different borrowers within the agricultural sector.
G. Public Investment	Efficient allocation of public sector resources.	1985-88 Public Investment Review.	Optimal public investment program for agriculture, stressing productivity and marketing, rather than large-scale infrastructure.

ECUADOR

TRADE AND INDUSTRIAL SECTOR POLICY REFORMS

Policy Area	Medium-Term Objectives	Recent Actions Taken	Further Measures Recommended
A. Export Incentives	Encourage nontraditional export development by eliminating distortions affectin relative profitability of exports vis-a-vis import substitution production.	- Non-oil exports were given full access to the higher rate of foreign exchange of the intervened market of the Central Bank, September 1984. - Multiple official exchange rates formally unified November 1985; exchange rate adjusted to maintain real level January 1986.	- Continued adjustments of exchange rate to maintain real level (introduction of flexibility). - Rationalize granting of CATs to encourage exports with high domestic value added and to lessen fiscal burden. - Increase resources for export financing.
B. Industrial Incentives	Streamlining of industrial incentives to encourage manufacturing exports, efficient import substitution, more extensive use of domestic resources and a better use of installed industrial capacity.	- New regulations for Industrial Incentive Law issued in January 1985 to: (i) grant tax benefits based on export performance; (ii) reduce income tax exonerations for sectors with excess capacity; and (iii) provide for progressive reduction and time limitation on tariff exonerations for raw materials and intermediate products. The new regulations call for elimination of these tariff exonerations by June 1988, for all existing industrial benefiting from the industrial incentive law.	- Introduce minimum tariff for imports of machinery and equipment.
C. Import Restrictions	- Elimination of distortions in the allocation of resources caused by quantitative restrictions. - Improve efficiency and competitiveness of domestic production.	1. Removal in March 1985 of the import prohibitions introduced in 1982. 2. Removal of about 20 percent of the remaining import prohibitions in January 1986 and the remaining by August 1988. 3. Lifting of import licensing requirements for about 50 industrial inputs in February 1986.	- Implementation of the elimination of remaining import prohibitions and their substitution by tariffs conforming with levels of tariff structure adopted in January 1986. - Implementation of the elimination of remaining import licensing requirement. - Substitution of tariffs for non-tariff barriers now used for agricultural commodities.
D. Tariff Reform	- Increase competitiveness and encouraging efficient production for domestic market. - Lessen anti-export bias. - Improve domestic terms of trade between industry and agriculture. Improve resource allocation by reducing tariff dispersion.	A revised import tariff structure has been adopted. It reduces import tariff peaks from a maximum of 220 percent to 100 percent (except for a few items), and reduces tariff dispersion so that over 75 percent of commodities have tariffs of 70 percent or less. Average tariffs and tariff dispersion have been reduced by about 30 percent and 50 percent, respectively.	- Further reductions in level and dispersion of tariffs.
E. Employment	Increase sources of employment provided by industrial sector by improving relative prices of capital and labor and introducing greater wage flexibility.	None.	- Study measures to introduce greater flexibility on labor policies and to encourage more labor-intensive processes of production.

ECUADOR

ENERGY SECTOR POLICY REFORMS

Policy Area	Medium-Term Objectives	Recent Measures Taken	Further Measures Recommended
A. Pricing			
1. Electricity Subsector	Improve levels of internal cost-generation to permit greater auto-financing of sector.	Electricity tariffs to final consumers raised 3 percent per month (42 percent p.a.).	Continuation of regular real tariff increases commensurate with sector investment program.
2. Petroleum Subsector	To rationalize domestic consumption of petroleum derivatives and limit its growth to maximize exportable surplus.	Sucre prices hiked 73 percent on average in early 1985, thereby increasing domestic prices to 70 percent of world prices.	- Reduction of interfuel pricing distortions. - Full parity with international price levels by 1987. - Petroleum law revised to permit pricing in line with opportunity costs.
B. Investment Program			
1. Electricity Subsector	Optimize program.	Master Plan completed in 1982.	Revise existing Master Plan by mid-1986.
2. Petroleum Subsector	- Attract private sector investment (risk capital in exploration and joint venture in production and downstream operations). - Streamline petroleum investment planning.	- Amended Hydrocarbons Law (1983) to attract foreign investment; signature of six exploration contracts with foreign firms. - Refinery expansion (with improved configuration) initiated. - Cancelled plans for large uneconomic projects (petrochemical complex etc.).	- Continue efforts to promote exploration by foreign oil companies. - Expand pipeline capacity from 310,000 to 400,000 bb/day. - Secondary recovery where still economically feasible. - Promote closer cooperation between CEPE and private sector on field development (e.g. thru joint-ventures or management contract).
C. Institutional			
1. Electricity Subsector	Improve sector's institutional efficiency, especially regarding relationship between INECEL and regional companies.	Studies completed with technical assistance from Spain (ENDESA).	- Organizational reform of INECEL including strengthening INECEL's role on regional company boards.
2. Petroleum	- Improve CEPE's efficiency and increase management/financial autonomy. - Develop CEPE into a creditworthy borrower in international markets.	- Public Sector Management Project and Power Engineering Project developed to support institutional development in CEPE and INECEL. - Organizational changes being implemented in CEPE.	- Improve management information systems of INECEL and CEPE. - Improve planning and programming with INECEL and CEPE. - Provide managing directors of INECEL and CEPE more autonomy for routine management within framework of performance indicators set by Central Government. - Improve quality and frequency of CEPE's audits.
D. Technical Electricity	- Complete 220 kV transmission ring. - Reduce distribution losses. - Expand electric service in rural areas. - Expand and rehabilitate the distribution systems.	Loss studies underway with Belgian technical assistance.	- Construct line Ambato-Paute. - Reduce distribution losses to acceptable levels (now about 20%). - Increase investment in rural electrification and distribution systems.

ECUADOR

FINANCIAL SECTOR POLICY REFORMS

Policy Area	Medium-Term Objectives	Recent Actions Taken	Further Measures Recommended
A. Interest Rate Levels	Interest rates which are market-based or positive in real terms to encourage mobilization of domestic resources and their efficient allocation.	Increases in official interest rates at the end of 1984 and the introduction of market-based rates on large denomination (over one million sucres) certificates of deposit. Agricultural lending rates unified and aligned more closely with industrial rates. Official interest rates set at positive levels.	- Maintenance of (i) positive interest rates on long-term loans; and (ii) adequate levels of domestic financial resource mobilization. - Reduce dispersion in lending interest rates among sectors. - Reduce the share of Fondos Financieros as a source of financing for industrial and agricultural loans.
B. Interest Rate Variability on Long-Term Loans	To strengthen financial condition of financial institutions, encourage resource mobilization and lessen lenders and borrowers risks of fixed interest rates in environment of variable rates of inflation.	In August 1985 the Government issued new legislation to allow long-term financial instruments to carry variable rates to be adjusted at frequencies determined by the Monetary Board. Necessary regulations have been issued by the monetary authorities to make the variable rate system effective for the industrial sector.	- Introduce interest rate variability on long-term loans for all sectors of the economy. - Permit partial capitalization of interest payments on long-term loans.
C. Financial Condition of Financial Institutions	Strengthening the financial condition of financial institutions.	Revision in August 1985 of the Banking and Monetary Laws to (i) shorten the minimum term of certificates of deposits issued by private financieras; (ii) increase debt/equity limits of financial institutions from 10:1 to 15:1, but requiring the establishment of reserves for doubtful accounts equal to 10 percent of loans; and (iii) reduce the exposure limits of the financial institutions.	- Measures to increase competition and capitalize banks (e.g. foreign equity participation). - Establish clear accounting rules for enterprises and financial institutions. - Strengthen control an supervision of Superintendency of Companies. - Eliminate requirement on commercial banks regarding minimum proportion of Fondos Financieros loans in their total lending portfolio.

ECUADOR

FINANCIAL SECTOR POLICY REFORMS

Policy Area	Medium-Term Objectives	Recent Actions Taken	Further Measures Recommended
D. Housing Finance	Strengthen housing financing institutions, improve affordability of housing and increase resource mobilization in sector.		- Bring interest rate in line with market determined interest rate levels. - Introduction of new mortgage instruments effectively permitting capitalization of interest. - Recapitalization of savings and loan system. - Introduction of mechanisms to mobilize resources for the housing sector. - Eliminate requirements which obliges commercial banks to purchase Housing Bonds from Banco Ecuatoriano de la Vivienda.
E. Social Security	Reverse decapitalization of IESS and remove distortions generated by IESS in financial sector.		- Improve IESS' housing sector financial policies (e.g. more market-oriented interest rates). - Conduct a study of IESS to identify remedial actions for its legal, actuarial and operational problems.
F. Capital Market	Strengthen confidence in and depth of capital market.	- Introduction of certificates of deposit at the end of 1984. - Government, with USAID financial assistance, is undertaking a study of identify major policy targeted at capital market development.	- Development of quasi-equity markets. - Strengthen control and supervision of Superintendency of Companies.

LC1PA
5/1/86

ECUADOR - PROJECTIONS OF DEBT OUTSTANDING, AND NET DISBURSEMENTS, 1986 - 1990: BASE CASE 1/

(US$ Millions)

	1986	1987	1988	1989	1990
Net Disbursements MLT Debt	433	298	185	110	-22
(Gross Disb.)	(738)	(688)	(675)	(745)	(996)
(Amortization)	(-305)	(-390)	(-490)	(-635)	(-1018)
Net Disb. Official Sources	220	150	90	-8	-54
(Gross Disbursements)	(393)	(362)	(323)	(262)	(240)
(Amortization)	(-173)	(-212)	(-233)	(-370)	(-294)
of which:					
World Bank	68	84	76	42	29
(Gross WB Disb.)	(100)	(121)	(112)	(86)	(88)
(WB Amortization)	(-32)	(-37)	(-36)	(-44)	(-59)
WB Debt Outst. & Disb.	349	433	509	551	580
IDB Net Disb.	126	100	60	41	22
(Gross IDB Disb.)	(170)	(150)	(120)	(115)	(120)
(IDB Amortization)	(-44)	(-50)	(-60)	(-74)	(-98)
IDB Debt Outst. & Disb.	737	837	897	938	960
Net Disbursements - Private Sources	213	148	95	118	32
(Gross Disb.)	(345)	(326)	(553)	(484)	(757)
(Amortization)	(-132)	(-178)	(-458)	(-366)	(-725)
Private Debt Outst. & Disb.	5664	5812	5907	6025	6057
Total MLT Debt Outstanding and Disbursed	7618	7916	8101	8211	8189

1/ Assumes $15/barrel oil price

LC1PA
5/1/86

ECUADOR - PROJECTIONS OF DEBT OUTSTANDING, AND NET DISBURSEMENTS, 1986 - 1990: HIGH CASE 1/

(US$ Millions)

	1986	1987	1988	1989	1990
Net Disbursements MLT Debt	446	405	467	488	466
Net Official	223	233	256	195	86
(Gross Disbursements)	(397)	(446)	(453)	(443)	(379)
(Amortization)	(-174)	(-212)	(-197)	(-248)	(-293)
of which:					
World Bank	68	109	110	126	103
(Gross WB Disb.)	(100)	(146)	(146)	(170)	(162)
(WB Amortization)	(-32)	(-37)	(-36)	(-44)	(-59)
Debt Outs & Disb. WB	349	458	568	694	797
Net IDB Disb.	126	150	140	116	62
(Gross IDB Disb.)	(170)	(200)	(200)	(190)	(160)
(IDB Amortization)	(-44)	(-50)	(-60)	(-74)	(-98)
Debt Outs & Disb. IDB	737	887	1027	1143	1205
Net Disbursements - Private Sources	223	171	211	293	380
(Disbursements)	(355)	(179)	(216)	(307)	(436)
(Amortization)	(-132)	(-8)	(-5)	(-14)	(-56)
Private Outst. & Disb.	5674	5845	6056	6349	6729
Total MLT Debt Outstanding and Disbursed	7631	8036	8502	8990	9456

1/ Using $15/barrel oil scenario

LC1PA
5/1/86

ECUADOR - WORLD BANK COMMITMENTS AND DISBURSEMENTS (Base Case) 1/

(US$ Millions by CY)

	Loan Amount	1986	1987	1988	1989	1990
Disbursements from Ongoing Loans through FY85: 1/		40	30	20	10	-
Approved Loans (FY86):						
Agriculture Sector	100	40	40	20	-	-
Small Scale Enterprises	30	3	8	8	7	4
Industrial Finance	115	15	35	30	20	10
Proposed Loans (FY86-90):						
CY86:						
Power Engineering	8	-	2	3	2	1
Agricultural Credit	48	2	6	7	7	6
Guayaquil Water	34	-	-	5	5	8
CY87:						
Petroleum (R)	60	-	-	7	10	3
Urban Transport	5	-	-	2	2	1
CY88:						
Power Transmission	70	-	-	10	15	15
Highways VII	40	-	-	-	2	5
CY89:						
Industrial Finance II	50	-	-	-	5	10
Guayas Flood Control	40	-	-	-	-	6
CY90:						
Telecommunications	30	-	-	-	-	7
Health (R)	10	-	-	-	-	2
Total Gross Disbursements		100	121	112	85	88
Commitments by CY: (average $108 million p.a.)		235	65	110	90	40

1/ Assumes some cancellations.

LC1PA
5/1/86

ECUADOR - WORLD BANK COMMITMENTS AND DISBURSEMENTS (High Case) 1/

(US$ Millions by CY)

	Loan Amount	1986	1987	1988	1989	1990
Disbursements from Ongoing Loans through FY85: 2/		40	30	20	10	-
Approved Loans (FY86):						
Agriculture Sector	100	40	40	20	-	-
Small Scale Enterprises	30	3	8	8	7	4
Industrial Finance	115	15	35	30	20	10
Proposed Loans (FY86-90):						
CY86:						
Power Engineering	8	-	2	3	2	1
Agricultural Credit	48	2	6	7	7	6
Guayaquil Water	34	-	-	5	5	8
CY87:						
Financial Policy	75	-	25	25	25	-
Petroleum (R)	60	-	-	7	10	12
Urban Transport	5	-	-	2	2	1
Power Transmission	70	-	-	10	15	15
CY88:						
National Housing	60	-	-	9	10	12
Export policy	100	-	-	-	50	50
Highways VII	40	-	-	-	2	14
CY89:						
Industrial Finance II	75	-	-	-	5	15
Guayas Flood Control	40	-	-	-	-	6
CY90:						
Telecommunications	30	-	-	-	-	6
Health (R)	10	-	-	-	-	2
Total Gross Disbursements		100	146	146	170	162
Commitments by CY: (average $160 million p.a.)		235	235	200	115	40

1/ Includes disbursements of CY88 Export Policy Loan, which adds $50 million p.a. to estimated Bank gross disbursements above the levels noted in Annex III.

2/ Assumes some cancellations.

LC1PA
4/29/86

THE WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: April 18, 1986

TO: Distribution Below

FROM: Armeane Choksi, CPD

EXT.: 60063

SUBJECT: Ecuador - Draft Medium-Term Growth Strategy Paper

We are having a review meeting to discuss the attached paper on Ecuador - Draft Medium-Term Growth Strategy Paper - scheduled on Thursday, April 24, at 11:00 a.m. in Room N-610.

Distribution

Messrs. Pfeffermann (LCNVP), Meo (LC1DR), Kanchuger (LC1PA)
Barham (LC1PA), Saenz-Jimenez (LC1PA), Ms. Jones-Carroll (LC1PA)
Rischard (FPAMA), Jansen/McMullen (PBDCP)
Walters (WUDDR), Rajapatirana/Cortes (VPERS)
Dubey (CPDDR), Huang (CPDBAP), Selowsky (CPDTA), Squire (CPDRM)

THE WORLD BANK INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

CONFIDENTIAL

DATE: April 14, 1986

TO: Mr. A. David Knox

THROUGH: Mr. Pieter Bottelier, Acting Director LC1

FROM: Peter Eigen, Division Chief, LC1 PA

EXTENSION: 75791

SUBJECT: **ECUADOR - Draft Medium-Term Growth Strategy Paper**

Attached is the draft Ecuador medium-term growth strategy paper, which has been reviewed by Messrs. Pfeffermann and Meo. Upon your approval, we will advise Mr. Choksi to arrange a working level meeting. We expect to follow up this paper with a draft Country Economic Memorandum by September of this year.

Attachment

Distribution

Messrs. Choksi, CPD
Pfeffermann, LCNVP
Steckhan o/r, LC1DR
Meo, LC1DR
van der Meer, LCPDR
Finzi, LCPDR
Kanchuger, LC1PA
Barham, LC1PA
Saenz-Jimenez, LC1PA

CJones-Carroll/tw

DRAFT
4-14-86- MAC
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ECUADOR - MEDIUM-TERM GROWTH STRATEGY

Initial Conditions

Overview

1. While Ecuador began the 1970s as one of the least developed Latin American countries, the discovery, exploitation and subsequent world price hikes of oil placed it firmly among the middle-income countries of the hemisphere by the end of the decade. Oil changed Ecuador's economy dramatically. Two-thirds of 1970 export revenues were from agriculture; by 1980, nearly two-thirds were from petroleum and only a quarter was from traditional agricultural crops. In addition to financing much of public sector investment, these oil revenues were channeled through Central Bank credit lines to the private sector. Real GDP grew an average nine percent a year in the 1970s. With this rapid income growth, much social progress was also made in spite of rapid population growth (2.8%). Significant increases in education enrollment were achieved, infant mortality was halved and life expectancy increased by 15 years.

2. Resources generated from oil exploitation were, in general, used to improve priority physical infrastructure needed for development: trunk roads, pipelines, airports, seaports, power generation. However, the Government's role grew: total public expenditures rose from 24 percent of GDP in 1973 to 34 percent in 1982. Earmarking of oil revenues created budget rigidities and reduced the central Government's control of fiscal flows. Government subsidies--to urban consumers, fuel and electricity users, exporters--grew in importance and created distortions in consumption and investment patterns. The public sector's use of external borrowing also grew; medium- and long-term debt outstanding rose from around $600 million in 1977 to $6 billion in 1984. Nevertheless, the country's institutions remained weak. Moreover, the benefits of growth not only created severe structural problems, they were also not evenly distributed: a sizeable middle class emerged but about 40 percent of the urban and 65 percent of the rural population still live in absolute poverty.

3. During the oil boom, the public sector became swollen; over half of 1984 fiscal revenues came from petroleum. Oil revenues were heavily earmarked, and by 1985, only 60 percent of General Government current revenues were channeled through the budget. Furtheremore, the non-oil revenue effort was seriously weakened: income taxes represented less than 2 percent of GDP; while income and import taxes collected represented less than a quarter of their theoretical yield. Internal energy prices remained low, creating distortions in consumption and private investment patterns.

4. Further structural problems developed as a result of the trade policies followed since the 1960s, which gave high protection to the industrial sector. The protection, in turn, permitted industrial expansion

in spite of growing real appreciation of the exchange rate. These policies allowed real manufacturing output to rise 150 percent during 1972-1982, virtually all based on import-substitution. With one or two exceptions, Ecuador's non-oil exports stagnated and by 1982, two-thirds of foreign exchange came from oil exports. These underlying problems made Ecuador's economy very vulnerable to world petroleum prices and the availability of foreign credit lines, and helped bring the period of prosperity to an end by 1982-1983.

Economic Performance in Recent Years

5. A recession developed after oil prices ended their real rise in 1981, foreign credit lines were reduced drastically in 1982, and then natural disasters occurred in 1983. GDP dropped by 3 percent in the latter year (see Table 1). The Authorities initially borrowed heavily abroad to counteract the fall in oil prices, but as Ecuador's access to external funds dwindled, an IMF-supported stabilization program became necessary. This adjusted the exchange rate, introduced mini-devaluations, and placed temporary restrictions on imports. Ecuador also undertook a debt rescheduling and initiated a fiscal austerity program. Inflation, however, surged to 50 percent in 1983 owing to flood-related output disruptions and the short-term effects of the adjustment measures. By 1984, economic growth resumed (4.1 percent GDP), the public sector deficit was virtually eliminated, and inflation was halved. With new petroleum fields coming on stream, the volume of oil production rose 18 percent between 1983 and 1985. Non-oil exports, responding to improved exchange rates and better weather, also rebounded.

6. Following a close election, a new Administration took office in August 1984. Its economic philosophy is very much market-oriented. While key economic officials are technically well-prepared to manage the fundamental reforms this Government hopes to put in place, their supporting bureaucracies are poorly equipped to handle the economic management the country now needs.

7. The new Government took a number of significant measures aimed at consolidating economic recovery and initiating structural reforms: a further devaluation, increases in petroleum prices, electricity tariffs, and interest rates, removal of those emergency import controls introduced in 1982, promotion of direct foreign investment, and elimination of most administered prices in agriculture. It also negotiated a new Stand-by, which focussed on achieving balance of payments equilibrium and a reduction in inflation. Supported by the Stand-by, Ecuador unified two official exchange rates,1/ introduced a new savings instrument (certificates of deposit), generated a public sector surplus, eliminated some prior import deposits and tightened monetary control. The results of all the above measures, together with continued recovery from the 1983 disasters, allowed GDP to grow by 3 percent, inflation to decline to a 22 percent annual rate, export volume to grow by 8 percent, net reserves to improve to nearly $200 million (equivalent to one month of imports) and private savings mobilization to increase significantly, mostly through the new certificate of deposit.

1/ There still remains a legal, floating rate used for certain invisible transactions.

April 8, 1986

Table 1: ECUADOR: HISTORIC ECONOMIC INDICATORS *

	Actual					Est.
	1980	1981	1982	1983	1984	1985
* GDP Growth Rate (%)	4.90	3.90	1.19	-3.05	4.10	3.18
GNP Growth Rate (%)	4.01	3.25	-0.90	-3.56	2.97	4.12
GNP/capita Growth Rate (%)	1.47	0.35	-3.69	-6.35	0.06	1.29
Consumption/capita Growth Rate (%)	4.62	1.87	-1.08	-5.65	0.60	-1.93
Total DOD (Current Mill. US$) 1/	4652	5868	6186	6690	6948	7431
* DOD/EXPGS (%)	156.3	195.6	226.2	248.9	233.8	227.7
* DOD/GDP (%)	39.6	42.1	44.7	53.1	55.4	56.7
Debt Service (Current Mill. US$)	559	922	1107	530	1048	1044
Debt Service/GDP (%)	4.8	6.6	8.0	4.2	8.4	6.9
* Debt Service/EXPGS (%)	18.8	30.7	40.5	19.7	35.3	32.0
* Interest/EXPGS (%)	9.7	14.7	20.6	13.9	28.1	23.8
Interest/GDP (%)	2.5	3.2	4.1	3.0	6.3	5.1
Gross Investment/GDP (%)	29.31	24.92	26.83	18.80	19.64	19.62
Domestic Savings/GDP (%)	28.74	22.49	24.94	25.82	26.45	27.36
National Savings/GDP (%)	24.04	17.42	17.66	19.49	17.55	19.31
Marginal National Savings Rate (%)	0.17	-1.16	-3.28	-0.09	-0.31	0.80
Public Investment/GDP (%)	10.30	9.75	9.32	6.91	7.50	8.33
Public Savings/GDP (%)	5.50	4.60	2.60	5.90	7.50	10.40
Private Investment/GDP (%)	19.02	15.17	17.51	11.89	12.14	11.29
Private Savings/GDP (%)	18.54	12.82	15.06	12.59	10.05	8.91
Ratio of Public/Private Investment	0.54	0.64	0.53	0.58	0.62	0.74
ICOR	5.4	6.9	20.2	-7.8	4.4	5.7
*XGNFS Growth Rate (%)	-2.57	3.94	-3.38	-2.11	9.39	14.88
XGNFS/GDP (%)	22.37	22.34	21.48	21.80	23.07	25.68
*MGNFS Growth Rate (%)	10.10	16.68	-9.20	-37.59	8.99	13.90
MGNFS/GDP (%)	23.75	26.65	23.92	15.40	16.25	17.94
*Current Account (Current Mill. US$)	-642	-1002	-1195	-126	-263	-149
Current Account/GDP (%)	5.47	7.18	8.63	1.00	2.10	1.14
*Terms of Trade Index (1984 = 100)	107.7	115.9	113.1	109.8	100.0	96.7

Sources: 1984 CEM, World Debt Tables, Central Bank, Staff estimates.

* Unless noted, values are for constant 1984 Sucres

1/ Public and Private Medium & Long-term debt

8. A prime target of the Government's program was its external debt, servicing of which would have consumed three-fourths of export earnings had further reschedulings not been arranged. The Government's multi-year debt rescheduling was finalized in an agreement signed with commercial banks in December 1985. The Fund and Bank played a supportive role in key Steering Group meetings. That rescheduling assumes that a further IMF Stand-by will be approved in 1986. All principal falling due to commercial banks between 1985 and 1989 (about $4.2 billion) has been rescheduled, and virtually no fresh money is provided. Similarly, a multi-year arrangement was worked out with the Paris Club in April 1985, dealing with 1984 arrears and principal falling due in 1985-87, about $400 million. The Government, assuming world petroleum prices would stay more or less constant in real terms, believed they could achieve GDP growth of 4-5 percent p.a. with only a modest level of additional external financing restricted to official sources.

9. The precipitous fall in oil prices in early 1986, however, has significantly changed Ecuador's prospects. Petroleum revenues stand to decline by over $800 million in 1986 alone (27% of total 1985 exports of goods), while fiscal revenues from oil could fall by $460 million, 5 percent of GDP. Partly offsetting the oil export losses, agricultural exports are expected to bring in an additional $250 million partly because of higher coffee prices and Ecuador's good policies during 1984-1985. Nevertheless, these net losses mean that over a quarter of Ecuador's 1986 domestic savings and 28 percent of its exports will be needed for foreign interest payments. The prior presumption--that no net involuntary commercial loans would be necessary--is now obsolete.

Productive Sector Problems

10. **General:** If oil prices stabilize at $15/barrel or above at 1986 prices for the rest of the decade, Ecuador will have the human and natural resources to achieve success with the adjustment programs it is undertaking, and must now accelerate. Although its population growth rate is still high, its 12 years of oil exploitation and rapid growth mean the country could withstand a certain amount of austerity without drastically undercutting living standards. Physical infrastructure needed for development was significantly improved during the 1970s. Paved roads doubled in total length; the major port was expanded; significant expansion in hydroelectric power generation and transmission occurred and improvements took place in the two international airports. Yet siginficant structural problems remain in the sectors and must be addressed. Meanwhile, the greatly depressed oil prices and Ecuador's dependence on oil means there is no way per capita consumption can be raised in the next two years. Nevertheless, no program would be politically viable unless these levels could be expected to improve beginning in 3 years or so. To do this, petroleum must continue to be the main growth sector despite the price fall, as diversifying to other sectors can only be accomplished in the longer run.

11. **Petroleum:** Oil exports will drop drastically in the early nineties unless new discoveries are made in the very near future and put into production rapidly. The country has a sound petroleum sector investment program of US$1.6 billion for the next five-year period, of which CEPE, the state enterprise, will undertake about two-thirds. To hold the future reserve/production ratio at its present level of 14, about 100 million barrels of new oil reserves must be discovered yearly during the next decade. The Government realizes that declining reserves were in part the result of insufficient exploration in the past decade (itself the consequence of inadequate incentives to foreign oil companies) and has embarked on an aggressive exploration promotion effort, based on a revised, and more favorable, petroleum legislation issued in August 1982. This effort has been very successful: six new contracts have since been signed with Occidental, Belco, Exxon/Hispanoil, Texaco/Pecten, BP and Conoco. Occidental has already found a new deposit and is carrying out a program to determine characteristics and size. Signs point to additional companies' keen interest. The new fields in the Oriente have exploration, development and operating costs around US$5 per barrel, one of the lowest in this hemisphere. The vigorous efforts of the Government seem to have overcome the serious image problem Ecuador had as a result of its past policies. This change is also reflected in our recent revision of earlier Bank production estimates:

Petroleum Production in Ecuador
(millions of barrels per year)

	1985	1986	1987	1988
Mid-1985 Projection	96.5	99.0	96.2	96.9
March 1986 Projection	102.5a/	111.2	115.3	122.6

a/ Actual.

Assuming a continuation of present policies, production is projected to reach a high of 147 million barrels in 1992. Exports will not only depend on production, but also on local consumption and on control of smuggling, which the Government intends to reduce through rationalization of domestic prices. Domestic prices were increased by an average 73 percent in late 1984, and world prices (60 cents a gallon) are now being paid for gasoline by Ecuadorian consumers--the first time since 1973. Lower kerosene, fuel oil, and diesel prices, however, mean the average of all oil product prices still is only 70 percent of world prices.

12. **Agriculture** has the capacity to grow by 50 percent over the next ten years or 4-5 percent p.a. compared to less than 3 percent p.a. in the 1970 s, but a number of long-neglected structural factors will have to be tackled and the currently low productivity of land utilized will have to be improved. In particular, ineffective subsidy programs kept farmgate prices depressed and discouraged production of food crops for export, while industrial protection directed resources away from agriculture. Products

such as rice, cotton, soybeans and hard corn could have been exported on a regular basis if production and export incentives had been in place. Policies to encourage agricultural growth were begun in 1984 (e.g., elimination of price controls; reduction of industrial protection; an attractive exchange rate). The real producer prices for rice, wheat, barley, hard corn and cotton have been higher for two consecutive years and, for all five products, output has increased substantially. In 1986, coffee prices doubled owing to drought in Brazil, a phenomenon which should keep prices high for several years. Also this year, banana exports are likely to rise by 25 percent owing to very favorable weather. The medium-term growth potential is great for shrimp, one of Ecuador's most buoyant exports, so long as the product's fragile ecological conditions are carefully managed.

13. In spite of an anticipated fall in fertilizer prices, the good performance of agriculture in 1986 is not expected to be maintained fully as many farmers do not use fertilizer and extension services are still very weak. Ongoing irrigation and flood control projects may also gradually contribute to higher and more stable production levels while improved credit availability is needed to help ease the financing constraint faced by the private sector. Increased growth could also come from expanding the land utilized, especially in the Oriente region, but the related investment in infrastructure seems too costly in the middle of the oil crisis to convert this potential to reality now.

14. **Manufacturing** remains at an early stage of development in Ecuador, as activities such as food processing, textiles, and wood products still account for about 75 percent of manufacturing value added. It had high growth rates (9.5 percent p.a.) during 1972-1982 when local entrepreneurs responded to very attractive incentives (effective rates of protection, as high as 300 percent) encouraging import substitution. Virtually all growth of the sector was directed toward the domestic market, with only 6 percent of growth during that period stemming from exports, most of it to the Andean Common Market. Many medium and large firms had also built up large foreign debts during the late 1970s and early 1980s. The devaluations of 1982 and 1983 imposed a severe burden on all these firms and affected significantly their performance, particularly during the 1982-1984 period. A debt service subsidy ("sucretization") program established in March 1983 improved the debt structure of these private firms and allowed their continuation in business, although at the expense of shifting the burden to the Central Bank.

15. Manufacturing absorbed the major part of foreign investment--about 50 percent--during the last five years. Since the advent of the new Government, foreign investment in manufacturing has increased by 33 percent in real terms. While an increasing share of net direct foreign investment (which totalled $75 million in 1985) will go to the oil sector following the recent opening of fields to foreign exploration, an important part can still help the manufacturing sector to restructure itself. In order to continue attracting this investment, the Government has introduced some flexibility on certain restrictions established under the Andean Pact Agreement, particularly regarding profit remittances, as well as joining the Bank-sponsored MIGA and ICSID.

16. Prospects for growth of manufacturing are modest in the short term. The required adjustment of the economy to the oil price crisis will necessarily take its toll in terms of a decreased availability of imported inputs and a contraction of domestic demand, to date the major source of the sector's growth. Many of the more inefficient firms are likely to be negatively affected by the trade liberalization policies of the Government. Manufacturing exports might experience a moderate recovery in the short term, because of penetration of new markets (plywood in the USA and Canada, for example), a reopening of the now more buoyant Andean market for some products, and good prospects for agricultural and fishing production. The medium-term prospects for the country's manufacturing would depend heavily upon the deepening and completion of the liberalization process and improvement of the industrial incentive system started recently by the current administration, which aims at encouraging efficient import substitution and export development. With the right policies, growth of 2 to 4 percent per year is the best to be expected from manufacturing for the remaining of the 1980s.

17. **Mining:** To stimulate growth in the long-dormant mining sector, on August 22, 1985, legislation was streamlined to make mining attractive to both domestic and foreign investors. Since then, 77 contracts have been awarded and 180 are being negotiated for prospecting, exploration and exploitation. Ten foreign firms have negotiated or are in the process of negotiating their participation in gold and silver mines. The Government has contracted an independent consulting firm to assess reserves in several promising areas. With such assistance, mining could eventually generate a modest share of foreign exchange and Government revenue, given reasonable gold and silver prices on the world market.

Negotiations with the IMF

18. The Government plans to continue its stabilization programs and to enter into another Stand-by arrangement with the Fund to cover 1986/87, a condition of the multi-year commercial debt rescheduling. The new arrangement will have to take into account the new oil prices and will concentrate on minimizing economic distortions and further encouraging the role of market forces in the economy, within the larger context of containing new balance of payments disequilibria.

Objectives and Rationale for Medium-Term Growth Program

19. Given the recent enormous loss of oil income, Ecuador is likely to suffer a recession in 1986; in the medium term it will need good management indeed just to maintain average GDP growth rates of 3 percent. This would represent little or no per capita growth but, given the large adjustments needed to offset lost revenues, it is probably the maximum achievable. Although a 3 percent growth objective would not quite maintain current income and consumption standards of the population, it is likely to be the minimum growth path acceptable to this--or any other civilian--Administration. A further medium-term objective is to have declining debt

servicing ratios and improving creditworthiness over the period. These objectives are only achievable if: (i) exports--of both petroleum and other products--can be stimulated; (ii) the economy can be made more efficient through removal of the many factor distortions stemming from the oil boom and (iii) given the constraint on consumption and savings, a rapid improvement of the efficiency of investment can take place. Furthermore, these two objectives will be extremely difficult to achieve if oil prices stabilize at less than $13/barrel over the remainder of the decade.

Implications of Objectives

20. This paper assumes that Ecuador will choose to use up more of its oil potential, by increasing volume of production to offset price drops, than it would have if prices had remained high. The alternative in the medium term is a much more severe--probably unsustainable--domestic expenditure reduction.

21. Ecuador's public sector surplus, achieved during 1984-1985, provided the monetary system with resources to increase--if only slightly--credit to the private sector while absorbing Central Bank foreign exchange losses. In 1986, however, there will be a public deficit; the drop in oil-generated fiscal revenues cannot be quickly replaced from other sources and expenditures are hard to cut massively in the short run. Moreover, the Government will need additional investment funds for the petroleum sector. The lack of a fiscal surplus makes even more important efforts for more selective and efficient investment, better private savings mobilization and financial restructuring for troubled firms. Private investment required to achieve reasonable growth rates could be less than in recent years if investment efficiency can be improved through more appropriate industrial incentives and financial sector reforms. Exports will need to accelerate--and petroleum and agriculture exports will likely account for virtually all the incremental exports over the next five years--to help generate the savings and foreign exchange needed to service debt. Investment efficiency must be improved such that the 1980-85 ICOR of 7.1 can be dropped to 4:1 by 1990.

22. Our recommendations focus on continuing to capture the petroleum sector's potential to help provide Ecuador time to restructure other sectors. Agriculture could become the second leading growth sector, while manufacturing, which had impressive growth in the 1970s, is likely to contribute very little in the next few years to GDP growth. The effects of trade liberalization aimed at redirecting manufacturing away from import substitution and into export oriented activities will take quite some time. While mining will be promoted, the base is very small and sizeable output can only be expected after several years. Services will grow little in the aggregate but have several offsetting trends: government services will be contracting while financial and commercial sectors may expand after an initial downturn.

Four Scenarios and the Policies they Support

23. The following analysis will look at base and high policy cases under the three oil price scenarios through the 1986-1990 period (referred to as $13, $15 and $17 per barrel cases). Oil price assumptions of the scenarios are as follows:

Table 2: Oil Price Assumptions
(US $ per barrel)

	1986	1987	1988	1989	1990
$15 Oil Base and High Cases	13	15	15.5	16	16.5
$13 Oil High Case	13	13	13.4	13.8	14.2
$17 Oil High Case	13	17	17.5	18	18.5
EPD Forecasts (4/1/86)	13.5	17	19.5	21	22

The $15 scenario will be discussed in detail. The $17 high policy case will be used to demonstrate the relief a $2 per barrel higher price would give to the economy. In the same vein, the $13 high policy case will be analyzed to show the additional measures required to attempt to master such a situation.

24. A major assumption in all cases is that the Government will continue to apply recent policies, which have contributed much to increase the production of petroleum. However, although Ecuador, especially in its new fields, is a rather low-cost producer, foreign investors, who are essential for keeping the country on its present oil production path, will certainly lose interest if the oil price drops below a certain level. This cut-off price is not known, but it seems unrealistic to maintain production forecasts at the same level for price projections below the $13 range. If this were to happen, maintaining the debt repayment condition in full would require draconian measures elsewhere, to an extent difficult to square with a continuing democratic and orderly process. In other words, if the price of oil would remain for a considerable time at levels below $13, the whole approach to the debt problem would have to be reconsidered, as the damage to an economy so dominated by oil as the Ecuadorian one could not be repaired anymore by a package of economic measures alone. Given the dominance of oil in the economy of Ecuador, the uncertainty of future oil prices, and the looming 1988 Presidential elections, speculation on development beyond 1990 at this point is not likely to produce many valid conclusions.

25. The base case takes into account all the policy reforms already begun. These are detailed in the matrices in Annex II and include: (i) liberalization of agricultural pricing at wholesale and consumer levels; (ii) reduction of industrial protection; (iii) planning for divestiture of inefficient state enterprises; (iv) introduction of adjustability in term lending interest rates and in savings instruments; (v) gradual adjustments of the exchange rate to maintain attractive levels; (vi) streamlining

industrial incentives and (vii) increased utility tariffs and petroleum prices. The high policy case accelerates all of these reforms and then introduces a flexible exchange rate system to maintain the real value achieved in January 1986 rather than the continuation of occasional devaluations that served the same purpose but with lags. Exporters are likely to respond with full confidence only to the initiation of a system geared to respond automatically to economic forces. Additionally, the high case reflects a more determined effort by the Government to control public expenditures, postponing or eliminating less attractive, costly investments, and divesting or closing inefficient state enterprises.

26. The base case scenario for $15 oil, is inconsistent with both a recovery of per capita income levels and enhanced creditworthiness (see Annex I.A). GDP in 1986 would be virtually stagnant, but thereafter would pick up somewhat to 2.5 percent. Exports respond only moderately in 1987-90 because the Government signals its support to exports only through irregular step devaluations to allow an appreciating exchange rate to catch up to its previous attractive levels. Imports will experience drops because of the 1986 surcharge and the revamped petroleum refinery which by 1988 should end imports of derivatives. The Government would be unable fully to control pressures for lower return investments and thus would undertake an increasing part of the investment activity, leading to a continued high ICOR, while public savings fall consistently short in financing investment. Private investment stabilizes, in terms of a proportion of GDP, at a 50 percent lower level than achieved in 1980-84, and private savings are consistently below private investment. More financing from abroad would thus be required, which sends the debt service ratio to 50 percent (assuming such financing from abroad could be mobilized, unlikely on a voluntary basis). In this situation, given population growth, it would be impossible for private consumption per capita to recover its 1985 level; it steadily deteriorates by an average 1.5 percent per year.

27. In the high policy case scenario for $15 oil (Annex I.B) an aggressive foreign exchange rate policy and continued trade liberalization increase the confidence of investors in export sectors. Furthermore, the public sector investment program is composed largely of completing ongoing efficient projects and essential new petroleum sector investments. It has been assumed for this scenario that Ecuador will receive some resources from a 1986/87 Stand-by agreement with the IMF as well as from the US through PL480 or ESF loans. Further restructuring of external debt has also been assumed for the 1988-1990 period for three debt categories: commercial banks, suppliers and official export credits.

28. These measures, together with accelerating the ongoing agricultural, industrial and financial sector reforms, will be conducive to creating a better investment climate and, in general, the perception of the business community and of the public at-large will be that the Government is giving the appropriate signals to the economy for a quick recovery from the 1986 recession and for sustained growth thereafter. GDP growth would be above population growth after 1987 (3.5 to 4.8 percent), investments will recover and the private sector will gradually expand its proportion in

total investments. The public sector, after 1987, would generate a small surplus, which will help finance private investments as the private sector continues to suffer from relatively low savings despite the success of the certificates of deposit in mobilizing resources. With a current account deficit of about 3 percent of GDP, total debt outstanding and disbursed would grow to $8.6 billion by 1990, but the debt-service ratio would drop to below 30 percent of exports of goods and services. We assume under this scenario that the new money the economy needs to finance its activities ($200 million p.a. on average after drawing down reserves) will be made available from commercial and official sources in addition to net drawdowns of around the same amounts from already programmed official lending. The $15 high policy case suggests that with this relatively low price for oil it is still possible to achieve recovery with the appropriate set of measures. Private consumption per capita can virtually be maintained over the period.

29. If the $15 high policy case is a viable scenario, the $17 high policy case will obviously present less problems than the $15 case after 1986. In 1987 and 1988, the current account deficit is equal to 2 percent of GDP, so financing required from abroad is less than in the $15 high policy case, but in 1989-90, the $17 case embarks on a higher GDP growth pattern so financing needs increase further. This higher growth is feasible because the debt appears more manageable. In the $17 high policy case, private per capita consumption increases every year after 1986 although only gradually. (See Annex I.C.)

30. In the high policy case scenario for $13 oil, the situation remains grim. Even with some more grant capital from abroad ($50 million per year for two years from the US, instead of $25 million), drawing down reserves a bit more and devaluing the real exchange rate 20 percent in 1986 and retaining it thereafter, the picture hardly brightens. GDP growth would remain relatively low (1-3 percent) and, because of lower income, savings in this scenario are low as people attempt to keep consumption up. Maintaining investment levels would therefore require more external financing but this is unlikely to develop as creditors seek to avoid increasing exposure to a distressed economy. Even further rescheduling agreements will be hard to achieve. Thus investment declines except for "high-yielding" operations in the petroleum sector. (If oil prices stabilize at below $13/barrel, even these investments would probably not materialize and the volume of oil exports would go down.) With $13/barrel oil prices, we have clearly reached a border case, where the trade-offs between suffering consumption loss with low growth and paying debt do not seem reasonable for a democracy.

Policies and Institutions

31. Acceleration of ongoing policy reforms described in paragraph 25 and Annex II is an integral part of the medium-term growth program because of the important structural adjustments they introduce--rationalization of intersectoral terms of trade and increased efficiency of both public and private investment--as well as the need to assure continuity in the signals given the private sector. The above policies reflect signals that

subsidies (to farmers, consumers, exporters and industrialists) will be phased out, that only efficient local import substituting industry will be supported, that exports and agriculture will be promoted and that the monetary program will be designed to keep inflation under control.

32. The Government must also make every effort to maximize oil production and exports. Indications are that Ecuador's reserves will prove adequate to support the gradual increase from 305,000 bbl/day in 1986 to 403,000 bbl/day in 1992, if the oil pipeline's capacity is expanded gradually so that by 1990, the additional 100,000 bbl/day can be carried from the Amazon to coastal ports and refineries. Planning for this pipeline is underway and should be accelerated. Exports can increase because of the increased exploration (both foreign and public), which will permit higher overall production. However, in order to reduce more quickly the growth of domestic consumption of petroleum products, the Government must raise average local product prices to international levels by 1987. Besides the six foreign firms which have undertaken to expand exploration, CEPE, the State oil company, must also be adequately financed and allowed sufficient flexibility to carry out exploration in the fields reserved to it. The Government plans to optimize the configuration of refining during its expansion of the main refinery, which should be undertaken as soon as possible so as to eliminate imports of derivatives by 1988.

33. The Government must also improve its public sector management. It would help the management of the economy considerably, for instance, if an increasing share (over the current 60 percent) of the fiscal flows could be made part of the regular and controllable budget process. The Government should take advantage of the low oil prices to eliminate the current excessive earmarking of oil revenues. Efforts to improve tax collection are already underway with some success, and measures to expand revenue sources other than petroleum are now essential.

34. The 1986 public sector budget was prepared in late 1985 with an oil price of $25 per barrel. Therefore, the Government has had to take measures to cope with an expected shortfall in fiscal revenue of $460 million or about 5 percent of GDP. Three specific measures have so far been taken; allowing imports of small cars (which have high customs taxes), an import surcharge to cover devaluation risk and an across-the-board 5 percent cut in budget outlays. Together they are expected to generate $300 million in revenues and savings. The Government has also calculated that lower interest rates on its external debt may lower its expenditures by close to $70 million but this may be overestimated as lower rates will only apply during part of the year. Some adjustments in the tax credit certificates (CATS) being granted to exporters are also being considered which could reduce the Government's subsidy to exporters, given the recent changes in the exchange rate. Finally, the Government is considering a substantial increase in oil product prices after the June elections. A 40 percent increase would yield about $30 million p.a. in revenues.

35. Current expenditures must be tightened. Efficiency of public services (education, health) could be greatly improved; the Bank has been discussing, through sector work, ways to do this and could support social sector reforms with appropriate lending as well. The reform of the State-owned enterprise sector (improved prices and management and a divestiture effort) should accelerate to generate a larger current surplus and eliminate subsidies. Corrective pricing measures have been taken for oil products, electricity rates, and telephone charges, but further adjustments are required, although the timing of their introduction will not only be determined by fiscal needs, but also by political reality. The Bank's public sector management loan provides support for efforts to improve fiscal management and public expenditure monitoring.

36. The Government should further rationalize its public investment program. Under an earlier analysis, the Bank had recommended a program of investments for 1985-1988 which postponed or dropped some planned projects (specifically the new primary roads, new airports, railway rehabilitation and hydro-electric projects). It also recommended that no major new public investments be initiated prior to 1988, and that public investment be kept at about 8 percent of GDP. The National Development Plan for 1985-88, issued by the Government in October 1985 presents an investment program closer to 11 percent of GDP and includes some low return projects (Trasvase Santa Elena, electrification of Guayaquil - Quito railroad, Guayaquil by-pass). However, under the present financial circumstances, a public investment program of at most 7 percent of GDP appears more appropriate. Nevertheless, strong regional pressures to finance large, low-return projects continue and appear to be hard for political leaders to resist, as congressional elections take place this year and presidential campaigning gets underway next year. The economic team has asked the Bank to assist in preparing and organizing a meeting this year to which international financial institutions and some of the major bilateral donors and commercial banks would be invited to discuss options for financing public investment. The economic team understands that an agreed public investment program is a condition sine qua non, both for such a meeting and for IBRD support for an expanded, nonproject lending program.

37. Finally, financial and industrial sector reforms would be key to improving the efficiency of the financial, housing and manufacturing sectors, and investment in general. The Social Security Institute, in particular, has a distorting effect on the financial sector because of its low mortgage lending rates and will also become a major public liability as it is being decapitalized. Revisions to the banking laws were recently issued which should help strengthen the financial institutions of the country if properly supervised. Equity participation from foreign banks could improve competition and risk distribution among currently oligopolistic financial institutions. Accounting problems (especially regarding revaluation of assets) must be overcome. Regulatory and control capacity of the Superintendency of Banks and Superintendency of Companies needs to be strengthened. Similarly, housing finance issues, principally savings instruments, interest rates and home buyer cash flow problems, must

be addressed, and the Government has requested Bank assistance to this end. In a related vein, the recently revised industrial incentives law should help streamline industrial incentives, and make better use of installed capacity and domestic resources. Annex II provides further details for the policy actions needed in all these sectors.

Priorities

38. The reforms are described above in order of their priority. The Government must, as a first priority, continue with its present course of liberalizing and opening the economy, linking it more closely with market forces, if it expects these signals to be perceived by investors and producers as sustained over the medium term. Backsliding now will only undercut the progress achieved to date in encouraging growth and reorientation of the economy. Secondly, the Government must focus on oil production; thirdly, on its own fiscal management and finally on reforming the broader financial sector.

Near-Term Action Program

39. Ecuador has little choice but to implement the accelerated and additional policies associated with the high case scenarios if oil prices remain around $13-15 per barrel. Under the base case, the consumption losses are not likely to be well tolerated by Ecuadorian voters, and the level of needed additional borrowing is not going to be easily arranged. Only if oil regains a US$20/barrel average export price could Ecuador maintain modest growth by just continuing its current policies, as significant as they are. The near term program described here thus begins with the agriculture, trade and industry measures already initiated and carries on with the additional measures needed to increase exports further and improve investment efficiency and fiscal management.

40. The 1986 Action Program would focus on: (i) continuing adjustments to exchange rates--ideally through a floating or crawling peg regime--to maintain competitiveness; (ii) tariff reform, implementing actions approved in January 1986; (iii) interest rate flexibility, putting into effect the August 1985 law permitting interest rates on term loans to be periodically adjusted, as well as adjustments to short-term rates in line with inflation; (iv) removal of about 20 percent of quantitative restrictions on imports, substituting them with tariffs; (v) continuing a tight monetary program and related measures to keep inflation under control; (vi) stringent fiscal management, including implementing the 5 percent budget cut and pursuing an acceptable, efficient and equitable investment program; and (vii) continuing regular adjustments of utility tariffs.

41. Further actions which should be initiated in 1986 include:

(a) installation of additional pumps to augment the petroleum pipeline capacity;

(b) introduction after the June election of higher domestic prices for petroleum derivatives relative to international prices (as soon as possible, but reaching parity with international prices not later than 1987) to cut down contraband and expand the export surplus;

(c) reduction and diversion of new public investment from lower return, postponeable projects to the most productive investments as specified in recent Bank public investment and energy assessment reports;

(d) accelerated efforts to install systems for public investment monitoring in the Finance Ministry and financial monitoring in the principal state enterprises (CEPE, INECEL, IETEL);

(e) more thorough efforts to reduce earmarking of public sector revenues, to rationalize current expenditures and to sell or close inefficient state enterprises; and

(f) facilitating term financing for agricultural and industrial investments, especially where this would lead to potential exports.

For 1987, in addition to continuation of the policies laid down in 1986, Ecuador would have to broaden financial sector reforms and introduce new, more coordinated procedures for public expenditure planning and new revenue measures.

42. Agreements with the IMF will also be part of the near term action program as earlier alluded. The measures cited above are consistent with the 1986-87 Stand-by in the process of being negotiated and some will be defined and monitored chiefly by the Fund rather than the Bank.

Monitoring of Policies

43. For foreign exchange policies, overall fiscal balance, monetary programs and inflation, the IMF would be monitoring progress and defining targets in the context of their 1986-1987 arrangement, which is currently in the negotiation phase. Furthermore, Ecuador has a commitment, undertaken in the process of the recent debt rescheduling, to conduct with the Fund semiannual enhanced Article IV consultations throughout 1987-1996. These consultations would serve the monitoring purpose even if further stand-by agreements did not materialize. The Bank will undertake monitoring of agricultural pricing, interest rates in general, intersectoral terms of trade, tariff reform and import restrictions and industrial incentives through existing loan programs. Inflation's impact and utility pricing policies will also be closely monitored by the Bank. The composition of public sector expenditures--particularly investment--will be analyzed, particularly if the Bank becomes involved in a creditor coordination meeting later this year. An update of the 1984 public investment review will be necessary, which will largely be undertaken by the Government itself, with some Bank support. To the extent

that the Bank becomes involved in future policy-based lending, in particular for the financial sector and trade diversification as well as the petroleum sector, it will monitor reforms in these areas. Close cooperation with the Fund will continue, given the overlapping effects of the respective reform programs, especially with regard to trade, foreign exchange rate, fiscal, and interest rate reforms.

44. The Bank is also prepared to encourage and assist the Government to monitor the impact of its stabilization and reform efforts on wages, employment and the lower-income groups in general, although we would need to focus economic and sector work more on poverty issues to support such an effort. Income disparities could increase as a result of the freeing of the economy, even though total income improves. A policy group within agriculture is being strengthened and could develop the capacity to monitor impact on different rural income groups. In the industrial sector, the employment and income impact of reforms is followed through World Bank-financed industrial loans.

Difficulties and Risks in Implementing Policy Reforms

45. Since mid-1985, the current Administration has enjoyed a fragile but workable majority in Congress which it has used to introduce sweeping reforms. The President is also willing to move aggressively on those actions which can be implemented by the executive branch alone, when he is convinced that the changes will produce the economic reforms he seeks. If the June 1986 local elections help in consolidating the ruling coalition's legislative power, urgent measures such as domestic petroleum pricing and full flexibility of the exchange rate are likely to be passed. If not, actions on these fronts will probably occur but will be more modest and in line with current law and tradition. The main opposition group, when it was in power in the early 1980s, did take corrective action in interest rate and exchange rate areas as well as petroleum pricing, but was averse to trade liberalization.

46. Most reforms will be introduced by the end of 1987. A hiatus in implementing structural reforms can be expected during 1988, when this Government ends its term. Whatever new Government comes to power, continued attention to maintaining the reforms introduced is essential, but backsliding, especially in trade areas, is definitely a risk. Even with this Administration, going forward with large--often low return--public investment projects will be politically attractive, and some areas (e.g. housing finance) will be difficult to reform thoroughly since campaign promises made by this Government are generating countervailing pressures. Finally, given the past history of military governments, there will be little incentive to exert strong control on military expenditures, almost a fifth of total public expenditures in 1982. Armed forces, together with teachers, were given special treatment during the last wage policy decisions and the military pension system will be a particularly sensitive aspect of any Social Security reform.

47. While the political difficulties mentioned above are very real constraints to timely introduction of reforms, an equally serious limitation is the fact of the country's weak institutions and cumbersome procedures. From budget planning to procurement, highly complicated regulations and bureaucratic traditions negatively affect the public sector's ability to carry out its programs even on a non-emergency basis. While this can generally be described as a problem of developing countries, experience suggests that, in Ecuador, it may be worse. For instance, CEPE has lost millions of dollars because of delays in procuring pumps for its wells. These delays are all the more ominous in view of the fact that the major difference between our base and high cases stems from accelerated implementation of policies and programs.

48. A further risk to the workout of Ecuador's financial crisis is the potential for oil prices to remain below a real (1986) price of $13/barrel over a prolonged period. While Bank-generated projections suggest a modest recovery in oil price levels, our experts also acknowledge the possibility of a fall to prices as low as $6/barrel. The risk here is that any package of policy reforms that can be considered socially or politically viable would be inadequate to offset the enormous income losses sustained under an extremely low oil price situation.

49. While the Bank and the IMF have been recommending for years many of the policy measures discussed above (exchange rates, interest rates, energy pricing, public investment management, trade liberalization), the Bank's lending program has until this year not been used to support major structural adjustments. With the FY86 Agricultural and Industrial Sector Policy Loans this has been changed. To support a workout for Ecuador, we would propose to link further policy lending in CY87-88 to accomplishment of the future recommended actions in the matrices of Annex II. Also, our sponsorship of any coordination meeting of creditors would be pre-conditioned on a satisfactory public investment program and adjustment measures, as well as an 1986-1987 agreement with the Fund.

Financing Requirements

50. With the best (i.e. high case) policy package that can be expected within the constraints described, Ecuador will have to increase its medium- and long-term debt by $2 billion over 1986-1990 if oil prices average $15/barrel (Annex III). The bulk of this would be required in the 1986-1988 period, over $500 million in 1986 alone, because of the loss of oil revenues. While over half of this 1986 level is likely to come from already committed official sources, the private sector would have to provide $200-250 million. The Ecuadorians have been pursuing the possibility of closing that gap by a short term oil trade facility.

51. Assuming Ecuador can sell its oil, after 1986, for $15/barrel and could implement the reforms proposed, meeting the estimated net disbursements of $2 billion over 1986-1990 would require net disbursements of close to $400 million on average each year. This compares to $200 million p.a. in 1984 and 1985, and $500 million in 1983. Net borrowing would be in addition to an average $150 million p.a. of net foreign direct investment

(compared to $50 million in 1984, before oil companies entered the scene). Approximately $200 million in net borrowing are estimated to come each year from official sources, and the remaining $200 million p.a. from sources to be identified. Of this latter amount, enhanced Bank lending could provide a net additional $50 million annually in 1989-1990 (above the $30-60 million programmed) through further policy lending (Annex IV). The Inter-American Development Bank, long a major lender to Ecuador, could provide another US$50 million p.a. (the US, which is said to be considering economic support financing, is already assumed to be providing $25 million p.a. in the high case). Over $200 million in 1986 and the remaining $100-150 million per year in later years would need to come from private sources, with maturities of at least seven years. It may be possible to associate some of this fresh money from bilateral sources or private banks with Bank involvement in Ecuador's public investment program, for example the petroleum sector or the power sector, or with proposed sector adjustment loans. There has recently been some indication of interest on the part of commercial banks for co-financing Bank-appraised projects in the petroleum sector. This and other cofinancing possibilities could be followed up on through the creditor coordination meeting discussed earlier.

[illegible]l 8, 1986
[illegible]ch 15 Base Case

ECUADOR: KEY ECONOMIC INDICATORS *

	Actual					Est.	Projected				
	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990
GDP Growth Rate (%)	4.90	3.90	1.19	-3.05	4.10	3.18	0.30	1.50	2.50	2.50	2.50
GNP Growth Rate (%)	4.01	3.25	-0.90	-3.56	2.97	4.12	1.03	2.07	2.94	2.96	3.04
GNP/capita Growth Rate (%)	1.47	0.35	-3.69	-6.35	0.06	1.29	-1.73	-0.71	0.13	0.16	0.23
Consumption/capita Growth Rate (%)	4.62	1.87	-1.08	-5.65	0.60	-1.93	-2.28	-2.06	-1.69	-1.48	-1.20
Total DOD (Current Mill. US$) 1/	4652	5868	6186	6690	6948	7431	7780	8215	8352	8445	8423
DOD/EXPGS (%)	156.3	195.6	226.2	248.9	233.8	227.7	294.2	275.5	266.3	250.6	230.3
DOD/GDP (%)	39.6	42.1	44.7	53.1	55.4	56.7	55.2	54.9	51.7	48.4	44.6
Debt Service (Current Mill. US$)	559	922	1107	530	1048	1044	1060	1145	1258	1405	1828
Debt Service/GDP (%)	4.8	6.6	8.0	4.2	8.4	6.9	7.5	7.7	7.8	8.1	9.7
Debt Service/EXPGS (%)	18.8	30.7	40.5	19.7	35.3	32.0	40.1	38.4	40.1	41.7	50.0
Interest/EXPGS (%)	9.7	14.7	20.6	13.9	28.1	23.8	28.5	25.3	24.4	23.1	21.3
Interest/GDP (%)	2.5	3.2	4.1	3.0	6.3	5.1	5.4	5.0	4.8	4.5	4.1
Gross Investment/GDP (%)	29.31	24.92	26.83	18.80	19.64	19.62	17.00	17.00	17.50	18.00	18.00
Domestic Savings/GDP (%)	28.74	22.49	24.94	25.82	26.45	27.36	20.44	22.27	21.91	21.74	21.76
National Savings/GDP (%)	24.04	17.42	17.66	18.49	17.55	19.31	13.09	15.46	15.51	15.78	16.30
Marginal National Savings Rate (%)	0.17	-1.16	-3.28	-0.09	-0.31	0.80	0.86	1.36	0.58	0.44	0.44
[illegible]ic Investment/GDP (%)	10.30	9.75	9.32	6.91	7.50	8.33	6.50	7.00	7.50	8.00	8.00
[illegible]blic Savings/GDP (%)	5.50	4.60	2.60	5.90	7.50	10.40	5.50	6.50	6.50	6.50	6.50
Private Investment/GDP (%)	19.02	15.17	17.51	11.89	12.14	11.29	10.50	10.00	10.00	10.00	10.00
Private Savings/GDP (%)	18.54	12.82	15.06	12.59	10.05	8.91	7.59	8.96	9.01	9.28	9.80
Ratio of Public/Private Investment	0.54	0.64	0.53	0.58	0.62	0.74	61.90	70.00	75.00	80.00	80.00
ICOR	5.4	6.9	20.2	-7.8	4.4	5.7	10.00	11.33	7.20	7.20	7.20
XGNFS Growth Rate (%)	-2.57	3.94	-3.38	-2.11	9.39	14.88	9.80	3.75	3.27	5.57	4.26
XGNFS/GDP (%)	22.37	22.34	21.48	21.80	23.07	25.68	28.09	28.71	28.93	29.80	30.31
MGNFS Growth Rate (%)	10.10	16.68	-9.20	-37.59	8.99	13.90	-6.85	0.92	-4.66	2.83	2.83
MGNFS/GDP (%)	23.75	26.65	23.92	15.40	16.25	17.94	16.66	16.56	15.41	15.46	15.51
Current Account (Current Mill. US$)	-642	-1002	-1195	-126	-263	-149	-602	-375	-301	-258	-159
Current Account/GDP (%)	5.47	7.18	8.63	1.00	2.10	1.14	4.27	2.51	1.86	1.48	0.84
Terms of Trade Index (1984 = 100)	107.7	115.9	113.1	109.8	100.0	96.7	69.0	69.9	63.6	61.1	60.1

Sources: 1984 CEM, World Debt Tables, Central Bank, Staff estimates.
* Unless noted, values are for constant 1984 Sucres

1/ Public and Private Medium & Long-term debt

9, 1986
Rnsh 15 High Case

ECUADOR: KEY ECONOMIC INDICATORS *

	Actual					Est.	Projected				
	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990
GDP Growth Rate (%)	4.90	3.90	1.19	-3.05	4.10	3.18	0.30	2.50	3.50	4.20	4.80
GNP Growth Rate (%)	4.01	3.25	-0.90	-3.56	2.97	4.12	0.86	2.99	4.09	4.69	5.44
GNP/capita Growth Rate (%)	1.47	0.35	-3.69	-6.35	0.06	1.29	-1.89	0.19	1.26	1.84	2.56
Consumption/capita Growth Rate (%)	4.62	1.87	-1.08	-5.65	0.60	-1.93	-1.00	-1.72	-1.47	0.27	0.55
Total DOD (Current Mill. US$) 1/	4652	5868	6186	6690	6948	7431	7781	8168	8618	8973	9320
DOD/EXPGS (%)	156.3	195.6	226.2	248.9	233.8	227.7	294.2	272.2	269.2	258.1	244.4
DOD/GDP (%)	39.6	42.1	44.7	53.1	55.4	56.7	55.2	54.1	52.3	49.6	46.6
Debt Service (Current Mill. US$)	559	922	1107	530	1048	1044	1055	1132	953	1023	1138
Debt Service/GDP (%)	4.8	6.6	8.0	4.2	8.4	6.9	7.5	7.5	5.8	5.7	5.7
Debt Service/EXPGS (%)	18.8	30.7	40.5	19.7	35.3	32.0	39.9	37.7	29.8	29.4	29.8
Interest/EXPGS (%)	9.7	14.7	20.6	13.9	28.1	23.8	28.3	24.7	23.4	22.2	20.3
Interest/GDP (%)	2.5	3.2	4.1	3.0	6.3	5.1	5.3	4.9	4.6	4.3	3.9
Gross Investment/GDP (%)	29.31	24.92	26.83	18.80	19.64	19.62	17.00	18.00	19.00	19.50	20.00
Domestic Savings/GDP (%)	28.74	22.49	24.94	25.82	26.45	27.36	20.35	22.02	21.84	21.78	21.77
National Savings/GDP (%)	24.04	17.42	17.66	18.49	17.55	19.31	12.86	14.99	15.35	15.75	16.30
Marginal National Savings Rate (%)	0.17	-1.16	-3.28	-0.09	-0.31	0.80	0.78	0.89	0.50	0.33	0.30
[illegible]ic Investment/GDP (%)	10.30	9.75	9.32	6.91	7.50	8.33	6.50	7.30	7.65	7.75	7.90
Public Savings/GDP (%)	5.50	4.60	2.60	5.90	7.50	10.40	5.50	7.00	8.00	8.50	9.00
Private Investment/GDP (%)	19.02	15.17	17.51	11.89	12.14	11.29	10.50	10.70	11.35	11.75	12.10
Private Savings/GDP (%)	18.54	12.82	15.06	12.59	10.05	8.91	7.36	7.99	7.35	7.25	7.30
Ratio of Public/Private Investment	0.54	0.64	0.53	0.58	0.62	0.74	61.90	68.22	67.40	65.96	65.29
ICOR	5.4	6.9	20.2	-7.8	4.4	5.7	10.00	6.80	5.14	4.52	4.06
XGNFS Growth Rate (%)	-2.57	3.94	-3.38	-2.11	9.39	14.88	9.80	4.46	3.92	6.24	4.80
XGNFS/GDP (%)	22.37	22.34	21.48	21.80	23.07	25.68	28.09	28.63	28.75	29.31	29.31
MGNFS Growth Rate (%)	10.10	16.68	-9.20	-37.59	8.99	13.90	-6.40	3.20	1.15	6.22	6.94
MGNFS/GDP (%)	23.75	26.65	23.92	15.40	16.25	17.94	16.74	16.85	16.47	16.79	17.13
Current Account (Current Mill. US$)	-642	-1002	-1195	-126	-263	-149	-633	-452	-496	-531	-546
Current Account/GDP (%)	5.47	7.18	8.63	1.00	2.10	1.14	4.49	2.99	3.01	2.93	2.73
Terms of Trade Index (1984 = 100)	107.7	115.9	113.1	109.8	100.0	96.7	69.0	70.3	64.0	61.8	61.1

Sources: 1984 CEM, World Debt Tables, Central Bank, Staff estimates.
* Unless noted, values are for constant 1984 Sucres

1/ Public and Private Medium & Long-term debt

April 8, 1986
RMSM 17 High Case

ECUADOR: KEY ECONOMIC INDICATORS *

	Actual					Est.	Projected				
	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990
GDP Growth Rate (%)	4.90	3.90	1.19	-3.05	4.10	3.18	0.30	3.00	4.50	5.00	5.50
GNP Growth Rate (%)	4.01	3.25	-0.90	-3.56	2.97	4.12	0.85	3.55	5.39	5.66	6.19
GNP/capita Growth Rate (%)	1.47	0.35	-3.69	-6.35	0.06	1.29	-1.89	0.73	2.52	2.78	3.30
Consumption/capita Growth Rate (%)	4.62	1.87	-1.08	-5.65	0.60	-1.93	.00	-0.95	-0.70	1.00	1.12
Total DOD (Current Mill. US$) 1/	4652	5868	6186	6690	6948	7431	7781	8102	8355	8595	8874
DOD/EXPGS (%)	156.3	195.6	226.2	248.9	233.8	227.7	294.3	252.3	242.6	228.9	215.3
DOD/GDP (%)	39.6	42.1	44.7	53.1	55.4	56.7	55.2	52.2	48.2	44.4	40.9
Debt Service (Current Mill. US$)	559	922	1107	530	1048	1044	1055	1155	953	1012	1121
Debt Service/GDP (%)	4.8	6.6	8.0	4.2	8.4	6.9	7.5	7.4	5.5	5.2	5.2
Debt Service/EXPGS (%)	18.8	30.7	40.5	19.7	35.3	32.0	39.9	36.0	27.7	26.9	27.2
Interest/EXPGS (%)	9.7	14.7	20.6	13.9	28.1	23.8	28.4	23.8	22.0	20.4	18.5
Interest/GDP (%)	2.5	3.2	4.1	3.0	6.3	5.1	5.3	4.9	4.4	3.9	3.5
Gross Investment/GDP (%)	29.31	24.92	26.83	18.80	19.64	19.62	17.00	18.00	19.00	20.00	21.00
Domestic Savings/GDP (%)	28.74	22.49	24.94	25.82	26.45	27.36	20.35	22.79	22.74	22.73	22.80
National Savings/GDP (%)	24.04	17.42	17.66	18.49	17.55	19.31	12.85	15.80	16.55	17.13	17.83
Marginal National Savings Rate (%)	0.17	-1.16	-3.28	-0.09	-0.31	0.80	0.87	0.80	0.51	0.35	0.32
Public Investment/GDP (%)	10.30	9.75	9.32	6.91	7.50	8.33	6.50	7.25	7.56	7.80	8.10
Public Savings/GDP (%)	5.50	4.60	2.60	5.90	7.50	10.40	5.50	8.00	9.00	9.50	10.50
Private Investment/GDP (%)	19.02	15.17	17.51	11.89	12.14	11.29	10.50	10.75	11.44	12.20	12.90
Private Savings/GDP (%)	18.54	12.82	15.06	12.59	10.05	8.91	7.35	7.80	7.55	7.63	7.33
Ratio of Public/Private Investment	0.54	0.64	0.53	0.58	0.62	0.74	61.90	67.44	66.08	63.93	62.79
ICOR	5.4	6.9	20.2	-7.8	4.4	5.7	10.00	5.67	4.00	3.80	3.64
XGNFS Growth Rate (%)	-2.57	3.94	-3.38	-2.11	9.39	14.88	9.80	4.46	3.60	6.04	4.64
XGNFS/GDP (%)	22.37	22.34	21.48	21.80	23.07	25.68	28.09	28.49	28.25	28.53	28.29
MGNFS Growth Rate (%)	10.10	16.68	-9.20	-37.59	8.99	13.90	-6.40	4.11	-0.91	8.36	8.94
MGNFS/GDP (%)	23.75	26.65	23.92	15.40	16.25	17.94	16.74	16.92	16.04	16.56	17.09
Current Account (Current Mill. US$)	-642	-1002	-1195	-126	-263	-149	-633	-349	-312	-400	-478
Current Account/GDP (%)	5.47	7.18	8.63	1.00	2.10	1.14	4.50	2.25	1.80	2.07	2.21
Terms of Trade Index (1984 = 100)	107.7	115.9	113.1	109.8	100.0	98.7	69.0	73.9	67.1	64.5	63.6

Sources: 1984 CEM, World Debt Tables, Central Bank, Staff estimates.
* Unless noted, values are for constant 1984 Sucres

1/ Public and Private Medium & Long-term debt

il 8, 1986
MSM 13 High Case

ECUADOR: KEY ECONOMIC INDICATORS *

	Actual					Est.	Projected				
	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990
GDP Growth Rate (%)	4.90	3.90	1.19	-3.05	4.10	3.18	0.30	1.00	2.50	3.00	3.00
GNP Growth Rate (%)	4.01	3.25	-0.90	-3.56	2.97	4.12	0.99	1.09	3.23	3.43	3.62
GNP/capita Growth Rate (%)	1.47	0.35	-3.69	-6.35	0.06	1.29	-1.76	-1.67	0.42	0.61	0.80
Consumption/capita Growth Rate (%)	4.62	1.87	-1.08	-5.65	0.60	-1.93	-1.14	-0.08	-1.74	-2.63	-0.74
Total DOD (Current Mill. US$) 1/	4652	5868	6186	6690	6948	7431	7646	7993	8214	8448	8392
DOD/EXPGS (%)	156.3	195.6	226.2	248.9	233.8	227.7	288.8	288.1	278.6	264.4	240.6
DOD/GDP (%)	39.6	42.1	44.7	53.1	55.4	56.7	54.3	55.4	53.1	50.8	47.1
Debt Service (Current Mill. US$)	559	922	1107	530	1048	1044	1043	1117	887	919	1000
Debt Service/GDP (%)	4.8	6.6	8.0	4.2	8.4	6.9	7.4	7.7	5.7	5.5	5.6
Debt Service/EXPGS (%)	18.8	30.7	40.5	19.7	35.3	32.0	39.4	40.3	30.1	28.8	28.7
Interest/EXPGS (%)	9.7	14.7	20.6	13.9	28.1	23.8	27.9	26.2	23.4	21.9	19.1
Interest/GDP (%)	2.5	3.2	4.1	3.0	6.3	5.1	5.2	5.0	4.5	4.2	3.7
Gross Investment/GDP (%)	29.31	24.92	26.83	18.80	19.64	19.62	17.00	15.00	15.00	16.00	16.00
Domestic Savings/GDP (%)	29.74	22.49	24.94	25.82	26.45	27.36	20.35	19.14	19.36	20.49	20.85
National Savings/GDP (%)	24.04	17.42	17.66	18.49	17.55	19.31	12.96	11.86	12.76	14.29	15.22
Marginal National Savings Rate (%)	0.17	-1.16	-3.28	-0.09	-0.31	0.80	0.87	-1.94	0.63	0.98	0.50
lic Investment/GDP (%)	10.30	9.75	9.32	6.91	7.50	8.33	6.50	6.10	6.00	6.35	6.30
Public Savings/GDP (%)	5.50	4.60	2.60	5.90	7.50	10.40	5.50	4.50	5.00	5.50	6.00
Private Investment/GDP (%)	19.02	15.17	17.51	11.89	12.14	11.29	10.50	8.90	9.00	9.65	9.70
Private Savings/GDP (%)	18.54	12.82	15.06	12.59	10.05	8.91	7.46	7.36	7.76	8.79	9.22
Ratio of Public/Private Investment	0.54	0.64	0.53	0.58	0.62	0.74	61.90	68.54	66.67	65.80	64.95
ICOR	5.4	6.9	20.2	-7.8	4.4	5.7	10.00	17.00	6.00	5.00	5.33
XGNFS Growth Rate (%)	-2.57	3.94	-3.38	-2.11	9.39	14.88	9.80	4.47	4.45	6.52	5.18
XGNFS/GDP (%)	22.37	22.34	21.48	21.80	23.07	25.68	28.09	29.06	29.61	30.62	31.27
MGNFS Growth Rate (%)	10.10	16.68	-9.20	-37.59	8.99	13.90	-6.40	-0.44	-0.61	3.00	3.00
MGNFS/GDP (%)	23.75	26.65	23.92	15.40	16.25	17.94	16.74	16.50	16.00	16.00	16.00
Current Account (Current Mill. US$)	-642	-1002	-1195	-126	-263	-149	-618	-494	-374	-296	-135
Current Account/GDP (%)	5.47	7.18	8.63	1.00	2.10	1.14	4.39	3.42	2.42	1.78	0.76
Terms of Trade Index (1984 = 100)	107.7	115.9	113.1	109.8	100.0	96.7	69.0	68.2	65.8	63.8	63.5

Sources: 1984 CEM, World Debt Tables, Central Bank, Staff estimates.
* Unless noted, values are for constant 1984 Sucres

1/ Public and Private Medium & Long-term debt

ECUADOR

AGRICULTURAL SECTOR POLICY

Policy Area	Medium Term Objectives	Recent Actions Taken	Further Measures Recommended
A. Pricing	Liberalization of official prices at the wholesale and consumer levels on agricultural commodities.	Reduction of the number of agricultural commodities under official price controls to three at the consumer level, and 17 at the wholesale level. Of the 17, coffee, cocoa, and bananas are set by international prices. Sugar is a mixed product entering into the US quota, and because of oligopolization in processing requires some price controls. Other than wheat (through a quota system), rice and hard corn, the Government is no longer supporting minimum prices at the wholesale level. At the consumer level, the four staple commodities (wheat flour, milk, rice and sugar) still with controlled prices will be available only at ENPROVIT outlets in low-income areas.	- Elimination of remaining procurement by ENAC or other public enterprises to support minimum wholesale prices. - Elimination of the maximum consumer price on wheat flour (except at official outlets in low-income areas).
B. Import Restrictions	Removal of quantitative restrictions on imports of agricultural commodities.	Removal of quantitative restrictions imposed during 1982 and 1983.	Elimination of quotas, and other quantitative restrictions on the imports of agricultural products, inputs, and substitution by generally uniform tariffs at levels to be determined from the internal terms of trade.
C. Export Incentives Policy Area	Adjustment of exchange rate to maintain real rates and unification of exchange rates.	Unification of exchange rate.	Continued progress on export incentives to agricultural commodities via introduction of a flexible exchange rate, maintaining the January 1986 value of the sucre.
D. Inter-Sectoral Terms of Trade	Improve the terms of trade of agriculture vis-a-vis the rest of the economy.	Removal of many 1982/83 quantitative restrictions on imports of industrial products.	Reduction of the level, and dispersion of tariffs on industrial commodities. Removal of quantitative restrictions on most industrial products. Imposition of tariffs on imports of agricultural commodities (see Trade Sector).
E. Public Enterprises	Divestiture of designated public enterprises.	Consulting firm to help preparesales is being appointed.	Development and execution of plan for state enterprise sector, including sale or closure of inefficient firms.
F. Interest Rates	Positive real interest rates and variability of long-term rates. Uniform rates except as justified by transactions costs.	- Increase (January 1985) of interest rates. - Unification of agricultural lending rates except as justified by transaction costs. - Maintenance of positive rates of interest through adjustment of nominal rates as necessary.	Maintenance of positive real rates of interest through adjustment of nominal rates as necessary, and elimination of rate dispersion between agriculture and other sectors, and between different sources of foods or different borrowers within the agricultural sector.
G. Public Investment	Efficient allocation of public sector resources.	1985-88 Public Investment Review.	Optimal public investment program for agriculture, stressing productivity and marketing, rather than large-scale infrastructure.

ECUADOR

TRADE AND INDUSTRIAL SECTOR POLICY REFORMS

POLICY AREA	MEDIUM-TERM OBJECTIVES	RECENT ACTIONS TAKEN	FURTHER MEASURES RECOMMENDED
A. Export Incentives	Encourage non-traditional export development by eliminating distortions affecting relative profitability of exports vis-a-vis import substitution production.	- Non-oil exports were given full access to the higher rate of foreign exchange of the intervened market of the Central Bank, September 1984. - Multiple official exchange rates formally unified November 1985; exchange rate adjusted to maintain real level January 1986. - Reintroduction of export tax certificates (CATs) to stimulate exports.	- Continued adjustments of exchange rate to maintain real level (introduction of flexibility). - Rationalize granting of CATs to encourage expors with high domestic value added and to lessen fiscal burden. - Increase resources for export financing.
B. Industrial Incentives	Streamlining of industrial incentives to encourage manufacturing exports, efficient import substitution, more extensive use of domestic resources and a better use of installed industrial capacity.	New regulations for industrial incentive Law issued in January 1985 to (i) grant tax benefits based on export performance; (ii) reduce income tax exonerations for sectors with excess capacity; and (iii) provide for progressive reduction and time limitation on tariff exonerations for raw materials and intermediate products. The new regulations call for elimination of these tariff exonerations by June 1988, for all existing industries benefiting from the industrial incentive Law.	Introduce minimum tariff for imports of machinery and equipment.

ECUADOR

TRADE AND INDUSTRIAL SECTOR POLICY REFORMS

C. Import Restrictions	- Elimination of distortions in the allocation of resources caused by quantitative restrictions. - Improve efficiency and competitiveness of domestic production.	1. Removal in March 1985 of the import prohibitions introduced in 1982. 2. Removal of about 20% of the remaining import prohibitions in January 1986 and the remaining by August 1988. 3. Lifting of import licensing requirements for about 50 industrial inputs in February 1986. 4. lifting of import licensing requirements for about 500 items of raw materials for pharmaceutical industry, by December 1986. 5. Monetary Board's Resolution of January 1986, calls for establishing a program to eliminate remaining import licensing requirements.	- Implementation of the elimination of remaining import prohibitions and their substitution by tariffs conforming with levels of tariff structure adopted in January 1986. - Implementation of the elimination of remaining import licensing requirement.
D. Tariff Reform	- Increase competitiveness and encourage efficient production for domestic market. - Lessen anti-export bias. - Improve domestic term of trade between industry and agriculture. - Improve resource allocation by reducing tariff dispersion.	A revised import tariff structure has been adopted. It reduces import tariff peaks from a maximum of 220% to 100% (except for a few items), and reduces tariff dispersion so that over 75% of commodities have tariffs of 70% or less. Average tariffs and tariff dispersion have been reduced by about 30% and 50%, respectively.	Further reductions in level and dispersion of tariffs.
E. Employment	Increase sources of employment provided by industrial sector by improving relative prices of capital and labor and introducing greater wage flexibility.	None	Study measures to introduce greater flexibility on labor policies and to encourage more labor-intensive processes of production.

ECUADOR

ENERGY SECTOR POLICY REFORMS

Policy Area	Medium-Term Objectives	Recent Measures Taken	Further Measures Recommended
A. Pricing			
1. Electricity Subsector	Improve levels of internal cost-generation to permit greater auto-financing of sector.	Electricity tariffs to final consumers raised 3 percent per month (42 percent p.a.).	Continuation of regular real tariff increases commensurate with sector investment program.
2. Petroleum Subsector	To rationalize domestic consumption of petroleum derivatives and limit its growth to maximize exportable surplus.	Sucre prices hiked 73 percent on average in early 1985, thereby increasing domestic prices to 70 percent of world prices.	- Reduction of interfuel pricing distortions. - Full parity with international price levels by 1987. - Petroleum law revised to permit pricing in line with opportunity costs.
B. Investment Program			
1. Electricity Subsector	Optimize program.	Master Plan completed in 1982.	Revise existing Master Plan by mid-1986.
2. Petroleum Subsector	- Attract private sector investment (risk capital in exploration and joint venture in production and downstream operations). - Streamline petroleum investment planning.	- Amended Hydrocarbons Law (1983) to attract foreign investment; signature of six exploration contracts with foreign firms. - Refinery expansion (with improved configuration) initiated. - Cancelled plans for large uneconomic projects (petrochemical complex etc.).	- Continue efforts to promote exploration by foreign oil companies. - Expand pipeline capacity from 310,000 to 400,000 bb/day. - Secondary recovery where still economically feasible. - Promote closer cooperation between CEPE and private sector on field development (e.g. thru joint-ventures or management contract).
C. Institutional			
1. Electricity Subsector	Improve sector's institutional efficiency, especially regarding relationship between INECEL and regional companies.	Studies completed with technical assistance from Spain (ENDESA).	Organizational reform of INECEL including strengthening INECEL's role on regional company boards.
2. Petroleum	- Improve CEPE's efficiency and increase management/financial autonomy. - Develop CEPE into a creditworthy borrower in international markets.	- Public Sector Management Project and Power Engineering Project developed to support institutional development in CEPE and INECEL. - Organizational changes being implemented in CEPE.	- Improve management information systems of INECEL and CEPE. - Improve planning and programming with INECEL and CEPE. - Provide managing directors of INECEL and CEPE more autonomy for routine management within framework of performance indicators set by Central Government. - Improve quality and frequency of CEPE's audits.
D. Technical			
Electricity	- Complete 220 kV transmission ring. - Reduce distribution losses. - Expand electric service in rural areas. - Expand and rehabilitate the distribution systems.	Loss studies underway with Belgian technical assistance.	- Construct line Ambato-Paute. - Reduce distribution losses to acceptable levels (now about 20%). - Increase investment in rural electrification and distribution systems.

ECUADOR

FINANCIAL SECTOR POLICY REFORMS

POLICY AREA	MEDIUM TERM OBJECTIVES	RECENT ACTIONS TAKEN	FURTHER MEASURES RECOMMENDED
A. Interest Rate Levels	Interest rates which are market-based or positive in real terms to encourage mobilization of domestic resources and their efficient allocation.	Increases in official interest rates at the end of 1984 and the introduction of market-based rates on large denomination (over one million sucres) certificates of deposit. Agricultural lending rates unified and aligned more closely withindustrial rates. Official interest rates set at positive levels.	- Maintenance of (i) positive interest rates on long-term loans; and (ii) adequate levels of domestic financial resource mobilization. - Reduce dispersion in lending interest rates among sectors. - Reduce the share of Fondos Financieros as a source of financing for industrial and agricultural loans.
B. Interest Rate Variability on Long-Term Loans	To strengthen financial condition of financial institutions, encourage resource mobilization and lessen lenders and borrowers risks of fixed interest rates in environment of variable rates of inflation.	In August 1985 the Government issued new legislation to allow long-term financial instruments to carry variable rates to be adjusted at frequencies determined by the Monetary Board. Necessary regulations have been issued by the monetary authorities to make the variable rate system effective for the industrial sector.	- Introduce interest rate variability on long-term loans for all sectors of the economy. - Permit partial capitalization of interest payments on long-term loans.
C. Financial Condition of Financial Institutions	Strengthening the financial condition of financial institutions.	Revision in August 1985 of the Banking and Monetary Laws to (i) shorten the minimum term of certificates of deposits issued by private financieras; (ii) increase debt/equity limits of financial institutions from 10:1 to 15:1, but requiring the establishment of resrves for doubtful accounts equal to 10% of loans; and (iii) reduce the exposure limits of the financial institutions.	- Measures to increase competition and capitalize banks (e.g. foreign equity participation). - Establish clear accounting rules for enterprises and financial institutions. - Strengthen control and supervision of Superintendency of Companies. - Eliminate requirement on commercial banks regarding minimum proportion of Fondos Financieros loans in their total lending portfolio.

ECUADOR

FINANCIAL SECTOR POLICY REFORMS

POLICY AREA	MEDIUM TERM OBJECTIVES	RECENT ACTIONS TAKEN	FURTHER MEASURES RECOMMENDED
D. Housing Finance	Strengthen housing financing institutions, improve affordability of housing and increase resource mobilization in sector.		- Bring interest rate in line with market determined interest rate levels. - Introduction of new mortgage instruments effectively permitting capitalization of interest. - Recapitalization of savings and loan system. - Introduction of mechanisms to mobilize resources for the housing sector. - Eliminate requirements which obliges commercial banks to purchase Housing Bonds from Banco Ecuatoriano de la Vivienda.
E. Social Security	Reverse decapitalization of IESS and remove distortions generated by IESS in financial sector.		- Improve IESS' housing sector financial policies (e.g. more market-oriented interest rates). - conduct a study of IESS to identify remedial actions for its legal, actuarial and operational problems.
F. Capital Market	Strengthen confidence in and depth of capital market.	- Introduction of certificates of deposit at the end of 1984. - Government, with USAID financial assistance, is undertaking a study to identify major policy targeted at capital market development.	- Development of quasi-equity markets. - Strengthen control and supervision of Superintendency of Companies.

ECUADOR - PROJECTIONS OF DEBT OUTSTANDING, AND NET DISBURSEMENTS, 1986 - 1990: BASE CASE 1/

(US$ Millions)

	1986	1987	1988	1989	1990
Net Disbursements MLT Debt	644	435	137	93	-22
(Gross Disb.)	(950)	(825)	(628)	(721)	(1026)
(Amortization)	(-306)	(-390)	(-491)	(-628)	(-1048)
Net Disb. Official Sources	248	173	105	-0-	52
(Gross Disbursements)	(421)	(385)	(338)	(270)	(241)
(Amortization)	(-173)	(-212)	(-233)	(-270)	(-293)
of which:					
World Bank	91	93	87	58	29
(Gross WB Disb.)	(123)	(130)	(123)	(102)	(88)
(WB Amortization)	(-32)	(-37)	(-36)	(-44)	(-59)
WB Debt Outst. & Disb.	358	451	538	596	625
IDB Net Disb.	131	114	64	32	20
(Gross IDB Disb.)	(175)	(164)	(124)	(106)	(118)
(IDB Amortization)	(-44)	(-50)	(-60)	(-74)	(-98)
IDB Debt Outst. & Disb.	737	851	915	947	967
Net Disbursements - Private Sources	396	262	32	93	88
(Gross Disb.)	(528)	(440)	(290)	(452)	(843)
(Amortization)	(-132)	(-178)	(-258)	(-359)	(-755)
Private Debt Outst. & Disb.	5812	6074	6107	6200	6288
Total MLT Debt Outstanding and Disbursed	7780	8215	8352	8445	8423

1/ Assumes $15/barrel oil price

LC1PA
4/14/86

ECUADOR - PROJECTIONS OF DEBT OUTSTANDING, AND NET DISBURSEMENTS, 1986 - 1990: HIGH CASE 1/

(US$ Millions)

	1986	1987	1988	1989	1990
Net Disbursements MLT Debt	531	409	436	345	334
Net Official	296	273	291	182	50
(Gross Disbursements)	(470)	(485)	(488)	(430)	(343)
(Amortization)	(-174)	(-212)	(-197)	(-248)	(-293)
of which:					
World Bank	116	133	135	108	84
(Gross WB Disb.)	(148)	(170)	(171)	(152)	(143)
(WB Amortization)	(-32)	(-37)	(-36)	(-44)	(-59)
Debt Outs & Disb. WB	397	530	665	773	857
Net IDB Disb.	151	165	150	121	45
(Gross IDB Disb.)	(195)	(215)	(210)	(195)	(143)
(IDB Amortization)	(-44)	(-50)	(-60)	(-74)	(-98)
Debt Outs & Disb. IDB	757	922	1,072	1,193	1,238
Net Disbursements - Private Sources	235	136	145	163	284
(Disbursements)	(367)	(314)	(150)	(167)	(333)
(Amortization)	(-132)	(-178)	(-5)	(-4)	(-49)
Private Outst. & Disb.	5750	5865	6025	6197	6494
Total MLT Debt Outstanding and Disbursed	7666	8075	8511	8856	9190

1/ Using $15/barrel oil scenario

LC1PA
4/10/86

ECUADOR - WORLD BANK COMMITMENTS AND DISBURSEMENTS (Base Case)

(US$ Millions by CY)

	Loan Amount	1986	1987	1988	1989	1990
Disbursements from Ongoing Loans through FY85 1/:		40	30	20	10	-
Approved Loans (FY86):						
Agriculture Sector	100	40	40	20	-	-
Small Scale Enterprises	30	3	8	8	11	-
Industrial Finance	115	30	40	30	10	5
Proposed Loans (FY86-90):						
CY86:						
Power Engineering	8	-	2	3	2	1
Agricultural Credit	48	10	10	10	10	8
Guayaquil Water	34	-	-	10	10	10
CY87:						
Petroleum	60	-	-	10	15	15
Urban Transport	5	-	-	2	2	1
CY88:						
Power Transmission	70	-	-	10	20	20
Highways VII	40	-	-	-	2	4
CY89:						
Industrial Finance II	50	-	-	-	5	10
Guayas Flood Control	40	-	-	-	5	6
CY90:						
Telecommunications	30	-	-	-	-	6
Health (R)	10	-	-	-	-	2
Total Gross Disbursements		123	130	123	102	88
Commitments by CY: (average $108 million p.a.)		235	65	110	90	40

1/ Assumes some cancellations

LC1PA
4/10/86

ECUADOR - WORLD BANK COMMITMENTS AND DISBURSEMENTS (High Case) 1/

(US$ Millions by CY)

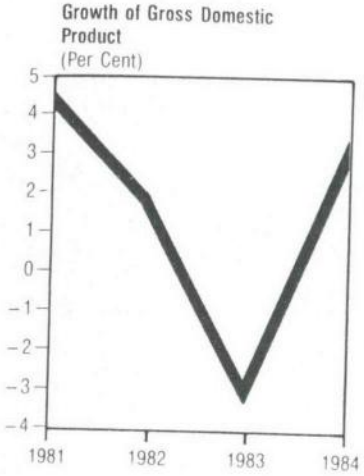
	Loan Amount	1986	1987	1988	1989	1990
Disbursements from Ongoing Loans through FY85:		40	40	40	25	20
Approved Loans (FY86):						
Agriculture Sector	100	60	40	-	-	-
Small Scale Enterprises	30	8	8	8	6	-
Industrial Finance	115	30	40	30	10	5
Proposed Loans (FY86-90):						
CY86:						
Power Engineering	8	-	2	3	2	1
Agricultural Credit	48	10	10	10	10	8
Guayaquil Water	34	-	-	10	10	10
CY87:						
Financial Policy	100	-	30	40	30	-
Petroleum (R)	60	-	-	10	15	15
Urban Transport	5	-	-	2	2	1
Power Transmission	70	-	-	20	20	20
CY88:						
National Housing	60	-	-	9	10	15
Export policy	100	-	-	-	50	50
Highways VII	40	-	-	-	2	14
CY89:						
Industrial Finance II	75	-	-	-	5	15
Guayas Flood Control	40	-	-	-	5	11
CY90:						
Telecommunications	30	-	-	-	-	6
Health (R)	10	-	-	-	-	2
Total Gross Disbursements		148	170	171	202	193
Commitments by CY: (average $165 million p.a.)		235	235	200	115	40

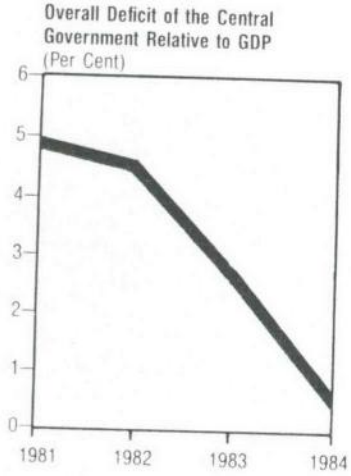
1/ Includes disbursements of CY88 Export Policy Loan, which adds $50 million p.a. to estimated Bank gross disbursements above the levels noted in Annex III.

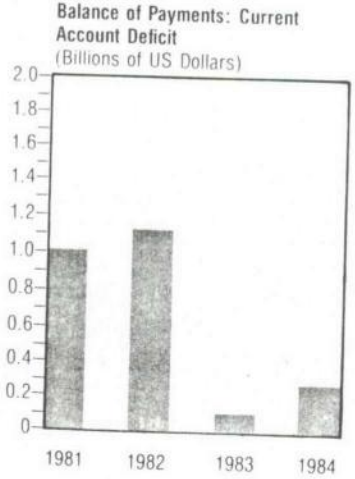
C1PA
4/10/86

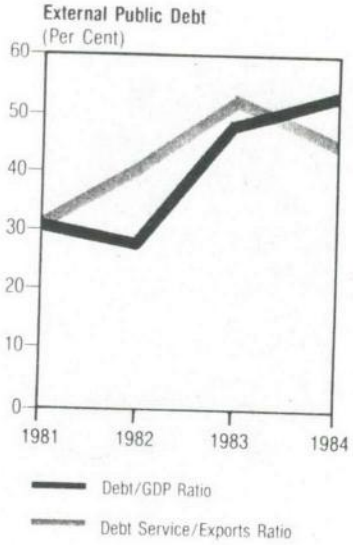
Ecuador

Economic Indicators









Statistical Profile*

Area (Km²)		*270,670*	
Total population 1984 (thousands of inhabitants)		*9,115*	
(Percentage of urban population 50.7; rural 49.3)			
Annual rate of growth of total population			
Average 1970–84 (percentage)		*3.1*	
Birth rate per 1,000 inhabitants (1984)		*36.7*	
Mortality per 1,000 inhabitants (1984)		*8.0*	
Infant mortality per 1,000 live births (1984)		*68.4*	
Years of life expectancy at birth (1982)		*64.3*	
Percentage of literacy (1982)		*85.6*	
Labor force by sector (1980)		(Percentages)	
Agriculture		*51.6*	
Mining		*0.3*	
Manufacturing		*14.4*	
Construction		*4.9*	
Others		*28.8*	
	1982	**1983**	**1984***
Real production		(Growth rates)	
Total GDP (market prices)	1.8	−3.3	3.0
Agricultural sector[1]	2.2	−13.5	11.7
Mining sector[1]	−3.3	24.5	10.3
Manufacturing sector[1]	6.9	−1.9	−1.4
Construction sector[1]	−0.6	−12.0	0.5
Central government		(Percentages of GDP)	
Current revenues	11.0	10.5	14.6
Current expenditures	12.8	10.8	12.9
Current savings	−1.8	−0.3	1.7
Capital expenditures	2.7	2.4	2.3
Deficit or surplus	−4.5	−2.7	−0.6
Domestic financing	2.1	3.1	0.9
Money and prices		(Growth rates)	
Consumer prices	16.2	48.5	31.2
Money supply	18.3	30.4	40.5
Domestic credit	38.8	59.2	65.1
Public	−11.7	−57.3	−9.5
Private	25.7	60.0	61.3
Exchange rate, average			
(units of national currency per dollar)	30.0	44.1	62.5
Balance of payments		(Millions of dollars)	
Merchandise exports (FOB)	2,207.4	2,365.0	2,490.0
Merchandise imports (FOB)	2,054.7	1,408.0	1,580.0
Merchandise balance	152.7	957.0	910.0
Net services	−1,297.2	−1,085.0	−1,210.0
Current account balance	−1,125.7	−104.0	−280.0
Official capital	305.3	n.a.	n.a.
Private capital	668.0	n.a.	n.a.
Change in net reserves (− increase)	320.0	−136.8	111.0
External public debt		(Millions of dollars)	
Total	4,932	7,348	n.a.
Disbursed	3,919	6,239	6,450
Debt service (interest and amortization)	1,102	874	1,266
Debt service as a percentage of exports of goods and non-factor services	40.3	51.7	n.a.

* The data in this section have been obtained from the sources listed on page 255. Any clarification or interpretation of the data should be referred directly to the pertinent source.
** Preliminary estimate.
[1] At factor cost.
n.a. Not available.

Ecuador

Recent Economic Trends

The recovery of the Ecuadorian economy from the enormous losses in productive capacity and highway infrastructure caused by the rains and flooding in 1983 is reflected in provisional data from the Central Bank of Ecuador, which indicate a 3 per cent increase in the gross domestic product (GDP) in 1984. This rise not only exceeds population growth, but also contrasts with the 3.3 per cent decline in the previous year. This positive economic performance was chiefly attributable to increased output in agriculture and mining (basically hydrocarbons), a 9 per cent rise in the volume of exports and a modest rebound in domestic demand. In addition, the overall disequilibrium in the public sector was eliminated and inflation was substantially reduced.

The return of normal weather conditions, coupled with crop rehabilitation programs carried out during the course of the year, led to a rapid recovery in the output of traditional export products (bananas, coffee, and cocoa) as well as in that of other crops intended primarily for domestic consumption. In addition, a larger shrimp catch enabled the agricultural sector to increase its share of GDP and reverse the decline that occurred in 1983. The entry into production of new oil fields and the start-up in mid-1984 of the Program for Secondary Recovery in others helped raise oil output from an estimated 86.3 million barrels in 1983 to 91.4 million in 1984.

Although the recovery of the agricultural sector contributed to the revival of agro-industry, the situation remained difficult for most enterprises producing intermediate and durable goods, which use a high proportion of imported inputs. In the face of persistent difficulties in obtaining raw materials and depressed domestic and external markets for a large proportion of such enterprises, industrial sector output continued on the downward trend of the previous year.

Construction activities began a recovery during the first quarter of 1984, stimulated by highway reconstruction projects and an acceleration in the execution of other public works. However, lack of financing, the rise in prices of building materials and difficulties in obtaining some of them, particularly iron, continued to hinder the recovery of private construction; consequently, the volume of construction for the year as a whole increased by only 0.5 per cent.

The financial position of the consolidated public sector improved in 1984 when revenues and expenditures were brought into balance. Tax revenues from petroleum, expressed as a proportion of GDP, rose significantly when regula-

tions transfering a portion of the export earnings of that product to the national budget were applied. In contrast, receipts from non-petroleum sources declined, despite the tax measures adopted early in the year and improvements in tax administration. These measures together produced an increase in the aggregate tax burden. Wage and salary increases and interest payments on the public debt resulted in higher current expenditures. On the other hand, capital expenditures as a proportion of GDP did not increase, despite the demands imposed on the country by the need to rebuild the infrastructure destroyed by the floods of 1983.

The above-mentioned improvement in the financial position of the public sector helped the Government not only to achieve the quantitative performance goals stipulated in the Stand-by Arrangement with the International Monetary Fund (IMF), whose last disbursement was made as originally scheduled on July 24, 1984, but also to comply with the monetary program for that year. While net credit from the banking system to the private sector grew moderately, there was a substantial increase in the net credit the Central Bank made available to financial institutions for financing the service on the external private debt it had assumed in compliance with the "sucretization" program launched in March 1983. In contrast, net credit to the public sector remained negative.

The recovery of agricultural output, the repair of the country's principal roads and imports of certain consumer goods helped improve market supply and regularize prices during the first half of 1984. Furthermore, inflationary expectations were apparently lowered by the budget austerity policy carried out by the Government authorities. Together, these factors more than offset the inflationary pressures generated by the maintenance of a flexible exchange rate and the limited supply of imported industrial inputs; as a result, the consumer price index rose by 31.2 per cent in 1984, compared with 48.5 per cent in 1983.

Petroleum, which accounts for 72 per cent of export earnings, produced $1.9 billion in revenues in 1984. The remaining revenues, $586 million, were derived from fishery products and traditional agricultural exports. Moreover, the need to replenish stocks and the elimination of restrictions led to a 12.2 per cent rise in imports; even so, the merchandise account of the balance of payments showed a $910 million surplus. Despite this favorable balance, the current account deficit was equal to 1.9 per cent of GDP, chiefly because of $819 million in interest payments on the external debt.

The shift in the net flow of private capital, from a negative balance in 1983 to a positive balance in 1984, appears to have been the result of the favorable domestic conditions created by the flexible interest and exchange rate policies adopted by the authorities in 1984. Moreover, external debt refinancing operations led to a positive balance in the public capital account, with the result that the balance of payments showed a loss of reserves of only $111 million, which contrasts with a gain in the previous year.

The difficulties facing the Ecuadorian authorities in their efforts to eliminate the persistent arrears in their external debt obligations and the gloomy financial outlook resulting from the heavy debt service payments programmed for 1985 through 1989 induced the Government, as indicated below, to renegotiate virtually the entire debt with the international private banks.

Economic Policies

The Government that took office on August 10, 1984 adopted a package of economic measures on September 4, designed to stimulate exports, trim imports, encourage capital inflows, maintain a reasonable level of reserves, and eliminate some price controls.

In addition to the repeal of the regulations that instituted the daily mini-devaluations of the sucre in March 1983, three foreign exchange markets were established. In the first of these, the exchange rate was set at 66.5 sucres to the dollar; this rate is applied to oil exports and imports of agricultural products, food, medicine, and fuel, as well as to profit remittances and capital transfers. To the second market, the intervention market, whose exchange rate is controlled by the Central Bank, most external trade transactions by the public sector and a large portion of private import activities were transferred. The third, or parallel market, in which the exchange rate is determined by the supply and demand for foreign currency, was maintained. This market will be used for the remainder of foreign trade activities. At the end of December 1984, the exchange rate in this market hovered around 120 sucres to the dollar.

With the exception of automobiles, imports of finished goods were decontrolled. Import duties on some industrial inputs and certain goods likely to be smuggled were lowered. Price controls were eliminated on all products except refined sugar, salt, wheat flour, processed milk, rice, pharmaceuticals, and cardboard boxes for export goods. The new pricing policy will provide incentives for agricultural production by granting real prices to the sector. To this end the authorities drew up a list of 18 agricultural products, to which shrimp was added; these items remained subject to control, and official minimum support prices for producers were set.

Consistent with the goals of attaining real positive levels of interest and thus providing incentives for domestic financial savings was the decision of the Monetary Board to raise the ceiling on lending and deposit interest rates in June and December 1984. The authorities also decided in December 1984 to legalize the "extra-bank" market, which in the past had reputedly captured resources totaling more than 30 billion sucres a year by offering variable interest rates. Thus, savings certificates *(pólizas de acumulación)*, for 1 million sucres or more with a minimum 90-day term, and financial certificates for 1 million sucres or more with a minimum 279-day term, were exempted from the ceiling on interest rates. In addition, loans from banks and finance companies using resources derived from these savings instruments were exempted from the interest ceiling.

To alleviate the difficult financial situation of many businesses, chiefly in the industrial sector, on December 11, 1984, the Monetary Board extended the

maturity of stabilization credits derived from the conversion of the external private debt (sucretization) to seven years.

Although the refinancing agreements of 1983 reduced the pressure of the external debt service on the balance of payments, additional negotiations had to be opened in 1984 to improve the medium-term profile of this debt. On August 7, the Government of Ecuador signed an agreement with the international private banks for the refinancing of $350 million in debts that matured between January 31 and December 31, 1984. Subsequently, on December 14, Ecuadorian authorities concluded a second agreement with the private banks, covering several years; this arrangement included the refinancing of $4.63 billion in debts maturing between January 1985 and December 1989, on substantially better terms than those negotiated in earlier years. The maturity was extended to 12 years with a three-year grace period, a margin of 1⅜ per cent over variable interest rates was set, and the refinancing commission was eliminated.

In addition, the Government launched an ambitious program designed to alleviate the housing problem; the goal of this program is to construct 120,000 housing units for the middle- and low-income strata of the population. Furthermore, the Central Bank of Ecuador was authorized to assign a special rediscount line of credit for financing housing construction. This rediscount line will be drawn from domestic resources and external financing from international agencies.

Outlook

The Government of Ecuador has prepared a financial program compatible with the new one-year Stand-by Arrangement approved by the IMF on March 11, 1985. Under this program the authorities propose to unify the official and intervention markets for foreign exchange, transfer the transactions of the parallel market to this combined market and then establish a flexible exchange rate policy. Increases in public capital expenditures will be offset by reductions in current expenditures. Current expenditure will reflect the ceilings established for wage and salary increases and for purchases of goods and services by the public sector. Moreover, the control of public financial operations will be improved, the disbursement of loans from official sources for development projects will be speeded up, and accounting and budgetary systems will be streamlined.

The Ecuadorian authorities intend to raise oil output by 9 per cent in 1985. This, coupled with a more realistic domestic fuel pricing policy that will help curtail the growth of domestic consumption, will make more oil available for export. Furthermore, normal weather conditions plus incentives to the agricultural sector are expected to increase and diversify production for agro-industry and export. In addition, the prospects for the growth and diversification of industrial exports seem good in the short term. Preliminary results of a study of the efficiency, and the level of effective protection, of a

representative group of industrial enterprises indicate that 63.2 per cent of these companies can be rated efficient.

However, the achievement of the Government's objectives will depend to some extent on the effects of flexible interest rate policies and limited credit on medium- and small-scale enterprises and on the many companies whose debt levels have been described as critical in recent studies. Many of these enterprises operate at low levels of capacity utilization.

Sources of Data in the Statistical Profile:

Area:
Organization of American States, *América en Cifras 1972—Situación Demográfica: Estado y Movimiento de la Población*.

Population:
Information furnished to the IDB by the Instituto Nacional de Estadística y Censos, March 1985.

Birth Rate:
Information furnished to the IDB by the Instituto Nacional de Estadística y Censos, March 1985.

General and Infant Mortality Rates:
Information furnished to the IDB by the Instituto Nacional de Estadística y Censos, March 1985.

Years of Life Expectancy at Birth:
Information furnished to the IDB by the Instituto Nacional de Estadística y Censos, March 1985.

Literacy Rate:
Information furnished to the IDB by the Instituto Nacional de Estadística y Censos, March 1985.

Labor Force:
PREALC, International Labor Office, *Mercado del Trabajo en Cifras, 1950–80*.

Real GDP:
Information furnished to the IDB by the Banco Central del Ecuador, April 1985.

Central Government:
1982–83: Information furnished to the IDB by the Banco Central del Ecuador, December 1984.
1984: IDB estimate based on information furnished to the IDB by the Banco Central del Ecuador, December 1984.

Money and Prices:
Information furnished to the IDB by the Banco Central del Ecuador, December 1984.

Exchange Rate:
International Monetary Fund, *International Financial Statistics*, March 1985.

Balance of Payments:
1982–83: International Monetary Fund, *Balance of Payments Statistics*, (magnetic tapes).
1984: Information furnished to the IDB by the Banco Central del Ecuador, December 1984.

External Public Debt:
Information furnished by the Government of Ecuador and processed by the IBRD and the IDB.

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

CONFIDENTIAL

DATE: March 7, 1986

TO: Mr. Armeane Choksi, CPDTA

FROM: Peter Eigen, Division Chief, LC1PA

SUBJECT: **ECUADOR: Draft Medium-Term Growth Strategy Paper**

EXTENSION: 75791

1. Attached is a first draft of a medium-term growth strategy paper for Ecuador. We would appreciate your designating someone to work with us on refining this paper. As you are aware, we have an economic mission in the field now checking the validity of our assumptions. This includes a petroleum engineer to confirm that the levels of oil production we assume in the models can really be achieved. Since EGY has considerable knowledge about Ecuador already, we do not expect significant variations in that regard. Another member of the mission will be deepening our understanding of the impact of oil price declines on fiscal revenues and expenditures.

2. Since our policy matrices reflect reforms by sector (trade, industry, financial, agriculture, energy) we have not produced separate annexes on sector policies. Our strategy to date has been to support Ecuador's reforms through sector adjustment program loans. The principle macroeconomic reforms are captured through the sector approach. However, we are not yet in a position to define targets for most of these reforms on a year by year basis over the next five years.

3. We will depend on the IMF mission, which is also in the field, for the ultimate 1986 projections.

cc: Messrs. Steckhan, LC1DR
Meo, LC1DR
Barham, LC1PA
Saenz-Jimenez, LC1PA (o/r)
den Tuinder (consultant), LC1PA (o/r)
Quijano, LCNVP
Rischard, FPA

CJones-Carroll:ab

DRAFT
3-7-86 - CJC
CONFIDENTIAL

ECUADOR - MEDIUM-TERM GROWTH STRATEGY

I. INITIAL CONDITIONS

1. While Ecuador began the 1970s as one of the least developed Latin American countries, the discovery, exploitation and subsequent world price hikes of oil placed it firmly among the middle-income countries of the hemisphere by the end of the decade. Oil changed Ecuador's economy dramatically. Two-thirds of all 1970 export revenues were from agriculture; by 1980, nearly two-thirds of export revenues were from petroleum and only a quarter were the traditional agricultural crops. Real GDP grew an average nine percent a year in the 1970s. With this rapid income growth, much progress on social infrastructure was also made. Resources were, in general, used to improve the physical infrastructure needed for development: trunk roads, pipelines, airports, seaports, power generation. The Government's role grew: total public expenditures rose from 24 percent of GDP in 1973 to 34 percent in 1982. The public sector's use of external borrowing grew from around $600 million medium- and long-term debt outstanding in 1977 to $6 billion in 1984. Nevertheless, the country's institutions remained weak. Moreover, benefits of growth were not evenly distributed: a sizeable middle class emerged but about 40 percent of the urban and 65 percent of the rural population still live in absolute poverty.

2. Ecuador's 1970's development path is no longer sustainable. The country benefited greatly from rising oil prices but serious structural problems developed that helped bring the period of prosperity to an end by 1982-1983. Fiscal revenues as well as foreign exchange generation became very dependent on oil. Internal energy prices remained low, creating distortions in consumption and private investment patterns. The swollen public sector became difficult for the country to continue supporting. Further

structural problems developed as a result of the trade policies followed since the 1960s, which gave high protection to the industrial sector. These policies allowed real manufacturing output to rise 150 percent during 1972-1982, but virtually all this growth was based on import-substitution. With one or two exceptions, Ecuador's non-oil exports stagnated. These underlying problems made Ecuador's economy very vulnerable to world petroleum prices and the availability of foreign credit lines.

3. By 1983, Ecuador's economy was suffering from a recession; GDP dropped by three percent. That recession was brought on when oil prices ended their real rise in 1981, Ecuador's foreign credit lines were reduced drastically in 1982, and then natural disasters occurred in 1983. The Authorities initially borrowed heavily abroad to counteract the fall in oil prices. In an open economy with a fixed exchange rate, this borrowing increased imports until Ecuador's access to external funds ended. The Administration then initiated an IMF-supported stabilization program; it adjusted the exchange rate, introduced mini-devaluations, and placed temporary restrictions on imports. It undertook a debt rescheduling and initiated a fiscal austerity program. This stabilization program helped reduce the public sector deficit from 8 percent of GDP in 1982 to 1.4 percent in 1983. Prices, however, surged to a 50 percent annual inflation rate owing to flood-related output disruptions and the short-term effects of the adjustment measures.

4. By 1984, economic growth resumed, the public sector deficit was virtually eliminated, and inflation was halved. New petroleum fields began producing and the volume of oil exports rose 40 percent. Non-oil exports, responding to improved exchange rates and better weather, also rebounded.

Table 1: ECUADOR - HISTORIC DATA

(%)

	1980	1981	1982	1983	1984	1985 (Preliminary)
GDP Growth Rate	4.9	3.9	1.2	-3.1	4.1	3.0
Debt/Exports GNFS 1/	1.2	1.6	2.2	2.3	2.3	2.2
Interest/Exports GNFS 2/	.18	.22	.28	.27	.28	.24
Debt/GDP	.30	.30	.42	.49	.53	.45
Interest/GDP	.04	.04	.06	.06	.07	.05
Debt Service Ratio 3/	47.3	71.3	76.7	33.7	35.1	36.0
Terms of Trade (1975=100)	146	157	153	148	135	
Growth of Exports 4/	9.7	4.7	-1.6	4.9		8.0
Growth of Imports 4/	10.1	-9.3	-7.1	-24.0		2.7
Current Account Balance (US$ millions)	-642	-1,002	-1,195	-126	-293	-262

1/ MLT Debt only; ST debt in 1985 was $300 million.
2/ Interest on MLT.
3/ Taking into account debt rescheduling, actual DS/EXGNFS (IMF).
4/ GNFS 1975 Sucres, 1980-1983 from Table 2.4, Report 5094-EC, 10.

5. Following a close election, a new Administration took office in 1984 and implemented several immediate measures including a de facto devaluation. Their economic philosophy is very much market-oriented. While key economic officials are technically well-prepared to manage the fundamental reforms this Government hopes to put in place, their supporting bureaucracies have more limited analytical and management expertise. Initially, moreover, the governing coalition did not enjoy a majority in Congress, and was unable to undertake policy changes requiring legislative action.

6. Nevertheless, in 1985, the Government took a number of significant measures aimed at consolidating economic recovery and initiating structural reforms: increases in petroleum prices and electricity tariffs, improvements in the interest rate structure such as initial steps toward rate adjustability for term loans, approval of a fiscal surplus budget, removal of import prohibitions introduced in 1982, and elimination of most administered prices in agriculture. It also obtained further IMF support through a new stand-by, which focussed on achieving balance of payments equilibrium and a reduction in inflation. The results of all these measures, together with continued dynamism of the recovering economy in 1985, allowed GDP to grow by 3 percent, inflation to decline to a 15 percent annual rate based on the second semester, estimated export volume to grow by 8 percent, net reserves to improve further to nearly $200 million and private savings mobilization to increase significantly, mostly through a new certificate of deposit.

7. A prime target of the Government's program was its external debt, servicing of which would have consumed three-fourths of export earnings had further reschedulings not been arranged. With the IMF stand-by agreement as a cornerstone, the Government's multi-year debt rescheduling was finalized in an agreement signed with commercial banks in December 1985. The Bank also played a supportive role in key Steering Group meetings. That rescheduling assumes that a further IMF stand-by will be approved in 1986. All principal falling due to commercial banks between 1985 and 1989 (about $4.2 billion) has been rescheduled, and virtually no fresh money is provided. Similarly, a multi-year arrangement was worked out with the Paris Club in April 1985, dealing with 1984 arrears and principal falling due in

1985-87, about $400 million. The Government, assuming world petroleum prices would stay more or less constant in real terms, believed they could achieve GDP growth of 4-5 percent p.a. with only a modest (US$200 million p.a.) level of additional external financing from official sources. The precipitous fall in these prices in early 1986 has significantly changed Ecuador's prospects, since export revenues stand to decline by $500-700 million in 1986 alone.

8. Elements of Ecuador's development strategy include: (i) a more open economy; (ii) realistic pricing, especially of the exchange and interest rates, and elimination of subsidies; (iii) promotion of agriculture, mining, efficient industries and exports; (iv) incentives to foreign investment; and (v) a rational investment plan. The Government has so far applied its policy reforms gradually but coherently.

Objectives and Rationale for Medium-Term Growth Program

9. The objective for Ecuador's medium term will be to maintain average growth rates of at least 3 percent and preferably 4 percent. This, given population growth of 2.8 percent may represent little or no per capita growth but, given oil price drops and the large adjustments needed to offset lost revenues, it is probably the maximum achievable in the current atmosphere. This growth objective, by avoiding another prolonged recession, will enable the private sector, banking and manufacturing in particular, to continue recovering from the recent recessions. It will nearly maintain current income and consumption standards of the population. This is important because Ecuador's Government must work within the constraints of its democratic system, where the Administration's control is fragile. A further objective is for debt servicing ratios to remain under 40 percent of exports

(which incorporates debt relief already achieved) and creditworthiness to improve over the period to support the Government's aim to return to voluntary lending. Finally, a third objective is to recapture some of the efficiency of investment. The country's ICOR over 1974-1979 was 4:1, while during 1980-1985, it rose to 7:1. By 1990, it should be possible to achieve an ICOR of 4:1 again, if the growth objectives are met.

10. The Government plans to continue its stabilization programs and to enter into another stand-by arrangement with the Fund to cover 1986/87, which is a condition of the most recent multi-year debt rescheduling. The new arrangement will have to take into account the new oil prices and will concentrate on minimizing economic distortions and further encouraging the role of market forces in the economy, within the larger context of containing new balance of payments disequilibria.

Implications of Objectives

11. This paper assumes that Ecuador will choose to use up more of its oil by increasing volume of production to offset price drops than it would have if prices had remained high. The alternative in the medium term is much more severe domestic expenditures adjustments. The Government's strategy had been to reactivate the private sector, in part by running a fiscal surplus, which could provide the monetary system with resources to increase credit to the private sector. In 1985, this surplus amounted to around 2 percent of GDP. This strategy will have to change somewhat. First, the Government will have to put additional resources into the petroleum sector. Secondly, continuing to achieve a surplus will be much more difficult be-

cause the drop in oil-generated fiscal revenues cannot be quickly replaced by other revenue sources and expenditures are hard to cut in the short run. The lack of fiscal surplus-generated resources for the monetary system can be ameliorated by more efficient investment, better private savings mobilization and financial restructuring programs for troubled firms. Private investment required to achieve reasonable growth rates could be less than in recent years if the needed improvements in investment efficiency can be achieved through the ongoing industrial incentives and financial sector reforms. Domestic resource mobilization is improving already and can continue to do so as instruments with attractive interest rates are used more and more broadly. Exports will need to contribute an increasing share of GDP growth (25 percent in 1986 to 30 percent in 1990 with petroleum and agriculture exports accounting for virtually all of total exports over the next five years) to help generate the savings and foreign exchange needed to service the debt. Consumption can almost be maintained, but only if investment can decrease without affecting growth targets.

12. Ecuador has the human and natural resources to achieve a certain amount of success with the adjustment programs it is undertaking, and must now accelerate, although its population growth rate is still high (2.8 percent). Its 12 years of oil exploitation have pumped enough resources into the economy that the country could withstand a certain amount of austerity without drastically undercutting living standards. Physical infrastructure needed for development was also significantly improved during the 1970s. Paved roads doubled in total length; the major port was expanded and improvements took place in the two international airports. Two concerns should be noted however and will be discussed later in the paper: the limits of policy reform possibilities in a democracy, and the potential impact on the lowest income level population of both the current liberalization policies and any new measures.

Sources of Growth

13. Of the sectors that could contribute to modest levels of growth, petroleum will continue to be the most important despite the price fall. The extent to which the economy has grown dependent on that product makes diversifying to other sectors something that can only be achieved in the medium to long run. 1/ Thus, our recommendations focus on recapturing some of the petroleum sector's potential to provide Ecuador time to restructure other sectors. Agriculture could become the second leading growth sector, while manufacturing, which had impressive growth in the 1970s, is likely to contribute very little in the next few years to GDP growth both because of residual problems of the recent recession and the effects of trade liberalization now being implemented. Of remaining sectors, contributions are also expected to be modest. While mining (gold in particular) will be promoted, the base is very small and sizeable output can only be expected after several years. Services will have several offsetting trends: government services will be contracting while financial and commercial sectors will be expanding. Since Quito is the center of government and (protected) industry, it is certainly likely to be harder hit by the proposed adjustments than Guayaquil, the financial and commercial center of Ecuador.

14. Petroleum: At 1983 production levels, Ecuador has enough proven reserves for 13 years. However, at domestic consumption growth rates of 6 percent p.a., annual production must increase by two million barrels yearly

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1/ The value of Ecuador's entire banana exports is equivalent to around a $2.00 per barrel change in petroleum exports.

just to maintain export levels. Increasing production beyond short-term limits depends on investments in exploration to find new reserves and on adequate investment in production and transport facilities. Ecuador has recently signed six oil exploration contracts with foreign firms. At least one of these companies has reportedly already found oil at one of its exploration wells. Pipeline expansion (prepared under a PPF) could follow quickly. Increasing exports will depend on expanding production sufficiently and should also be accomplished through reduced growth of domestic consumption, through rationalization of domestic prices. Although the Government increased domestic prices by an average 73 percent in late 1984, these prices are still only 62 percent of world prices.

15. Agriculture has the capacity to grow perhaps by 50 percent over the next ten years, or 4-5 percent per annum. Such growth could come from increasing the currently low productivity of land utilized (a 25 percent increase in productivity could yield a 30 percent increase in output) and expand the land cultivated. While considerable potential exists in the Oriente region for such expansion, related infrastructure investment will be needed in the long run to convert this potential to reality. Policies to encourage agricultural growth have already begun (e.g. elimination of price controls; reduction of industrial protection; an attractive exchange rate). Growth potential is great for new tradeables (rice, cotton, soybeans, hard corn) and for import substitutes (e.g. rice for wheat), but more sporadic for traditional crops (coffee, cocoa, bananas).

16. This sector also includes fishing. Shrimp has been a particularly buoyant export in the past, increasing in value 48 percent yearly between 1979 and 1983. Demand for this product remains strong. However, Ecuador's

shrimp ecology is very fragile and serious constraints could develop unless some environmental control is assumed by the industry and further technification occurs (switch to larvae production from current larval harvesting). Fishing for other species has good prospects.

17. Manufacturing: Manufacturing remains at an early stage of development in Ecuador, representing only 17 percent of GDP value-added. It has had high growth rates (9.5 percent p.a.) during 1972-1982 when local entrepreneurs responded to very attractive incentives (effective rates of protection as high as 300 percent) encouraging import substitution. Virtually all growth of the sector was directed toward the domestic market, with only 6 percent of growth during that period going to exports, and much of this was to the Andean Common Market. Both the domestic market and the Andean Market remain in recession. Many firms have also built up large foreign debts and only remain in operation after the devaluations because of the Central Bank's subsidies (e.g. debt "sucretization" program). Potential for growth in this sector is modest in the near term, because it must change its structural orientation from highly protected import substitution to one of more efficient production patterns. Many of the more inefficient firms are likely to be negatively affected by trade liberalization policies in the next few years. In the longer term, if incentives attract investment to the more efficient and more export-oriented firms, growth may rebound.

Four Scenarios and the Policies they Support

18. Within this context, the following analysis will look at base and high cases under two oil price scenarios. The base case takes into account

all the policy reforms already begun and applies real world petroleum price projections of $20 per barrel through the 1986-1990 period (around $19 for Ecuador's quality of oil). Second, a high case scenario introduces additional policy adjustments to the $20 oil base case. Then, two scenarios using a $15 per barrel oil price with the base and high case policy adjustments will be explored. However, the additional policy adjustments are not a great deal different from ongoing structural reforms; rather they represent a speeding up of the Government's current directions, specifically in domestic pricing of petroleum derivatives and in private sector efficiency. Many of the "easy" reforms have already begun; much of what is left to do will require harder and longer-term efforts to achieve more modest results.

19. In the base case scenario for $20 oil, GDP growth is only 2.8 percent, equivalent to population growth and the significant policy reforms in agriculture, industry and financial sectors are maintained at their current pace. In this scenario, Ecuador expands external indebtedness by about $5.50 billion over 1986-1990, but can keep the debt service ratio below 40 percent. A sharp drop in export and fiscal revenues, both heavily dependent on oil income, will require some offsetting actions even within the current policy context. Specifically, oil production will have to be increased to the limits technically possible in the medium term. Otherwise, after a 1987 peak, export volume of oil would drop off because of reserve and pipeline constraints. This scenario suggests that, if oil were to remain around $20 per barrel, Ecuador could avoid a prolonged recession but would sacrifice growth and private consumption (which on average falls 1.2 percent p.a.). ICOR also remains above 7:1 for the period.

Table 2: ECUADOR - BASE CASE, $20 OIL PRICE

KEY VARIABLES

	1984	1985	1986	1987	1988	1989	1990
GDP gr (target)	4.10	3.18	2.79	2.80	2.80	2.80	2.80
GDP/capita	854	857	857	857	857	857	857
Debt/X (target)	2.2	2.2	2.7	2.6	2.4	2.2	2.0
DOD	6,677	6,949	7,176	7,544	7,713	7,731	7,492
Debt/GDP (%)	53	58	86	88	88	85	81
Int/GDP (%)	6.7	6.5	8.5	8.4	8.0	7.6	7.0
DS/X (%)	35	33	36	36	36	36	40
Pub Inv/GDP (%)	7.1	7.3	6.0	5.9	5.6	5.4	5.2
Pri Inv/GDP (%)	11.2	11.7	13.0	13.1	13.4	14.6	14.8
GDS/GDP (%)	26.3	28.2	27.7	28.3	30.3	32.9	34.5
Pri/Pub Inv (%)	158	162	218	221	241	272	286
Export Growth		8.1	1.7	3.1	9.6	9.6	9.1
Petro X Gr		11.9	-1.6	2.6	13.5	12.0	11.0
Exports/GDP (%)	23	24	24	24	26	28	29
Import Growth		2.7	3.4	-0.2	-0.1	3.5	3.5
Imports/GDP (%)	17	17	17	16	16	16	16
PC/Cap Growth		-1.8	2.7	.0	-2.3	-3.9	-2.6
GNP Growth		3.2	4.3	3.4	3.5	3.4	3.5
GNP/Cap	776	779	791	795	801	805	810

Note for all Scenarios

1. The sucre was devalued from S/.66.5:US$1 in 1985 to S/.108:US$1 in 1986; this affects the dollar value of GDP and any ratios using that. GDP/cap and GNP/cap use constant 1986 dollars.
2. Debt is MLT only; ST Debt in 1985 was about $300 million.
3. Exports in Debt/X and DS/X are Goods and Services. Export Growth and Export/GDP are Goods and NF Services.
4. The multi-year debt rescheduling would end in 1990 so major amortization increases occur in the model that year.

20. In the high case scenario for $20 oil, measures to further increase oil exports are introduced (e.g. curbing growth of domestic petroleum consumption, including contraband, by increasing local prices in 1987 to the international level). An immediate savings of around 10 percent of oil

consumption could result as incentives for contraband disappear; the overall effect is to raise petroleum export volume growth in 1988 by 14 percent more than if this measure were not taken. Furthermore, additional measures to increase fiscal revenues and improve the efficiency of private sector investment are added to the continued trade liberalization and private sector reactivation policies. By increasing exports and reducing investment requirements, Ecuador could actually decrease its debt outstanding by $118 million overall to achieve a 3.5 to 4.5 percent growth objective and keep the debt service ratio below 40 percent. Such an improvement in creditworthiness occurs only in this scenario. Since this higher growth is achieved partly by increased exports, though, private consumption per capita stagnates over the period. Because of more efficient investment, the ICOR reaches the 4:1 target by 1990. In the public sector, only higher-yielding projects are assumed to be undertaken in the context of constrained fiscal revenues, while private investment responds positively to the signals of interest and exchange rates and elimination of import and price controls.

Table 3: ECUADOR - HIGH CASE, $20 OIL PRICE

KEY VARIABLES

	1984	1985	1986	1987	1988	1989	1990
GDP gr (target)	4.10	3.18	2.44	3.38	4.00	4.16	4.46
GDP/capita	854	857	854	858	869	880	894
Debt/X (target)	2.2	2.2	2.6	2.4	2.2	1.9	1.7
DOD	6,677	6,949	7,408	7,422	7,417	7,252	6,830
Debt/GDP (%)	53	58	89	87	83	78	70
Int/GDP (%)	6.7	6.5	8.6	8.3	8.0	7.7	7.2
DS/X (%)	35	33	35	35	35	34	38
Pub Inv/GDP (%)	7.1	7.3	6.0	5.9	5.5	5.3	5.1
Pri Inv/GDP (%)	11.2	11.7	12.5	12.2	12.3	12.3	12.4
GDS/GDP (%)	26.3	28.2	28.3	28.8	30.7	32.1	33.4
Pri/Pub Inv (%)	158	162	210	209	225	234	246
Export Growth		8.1	5.4	4.6	10.9	10.3	9.5
Petro X Gr		11.9	5.8	5.0	15.6	12.8	11.3
Exports/GDP (%)	23	24	25	26	27	29	30
Import Growth		2.7	2.6	-0.3	0.3	4.1	4.4
Imports/GDP (%)	17	17	17	16	16	16	16
PC/Cap Growth		-1.8	-1.8	0.6	-1.0	-0.9	-0.6
GNP Growth		3.3	3.3	4.0	4.7	4.8	5.2
GNP/Cap	777	781	781	798	813	829	848

21. If oil prices drop to $15 per barrel on a permanent basis, Ecuador will experience, in the base case, growth of only 2 percent p.a., even if they continue their current policies. To achieve this level, the country will have to borrow over US$3.4 billion more during 1986-1990 and draw down its reserves (from three months of imports in 1985 to two months in 1990). The somewhat increased oil exports are inadequate to offset the fall in prices. Private investment increases as a share of GDP but output does not respond; per capita consumption drops 1.5 percent p.a. on average. Creditworthiness deteriorates and, in general, an unsustainable course develops.

Table 4: ECUADOR - BASE CASE, $15 OIL PRICE

KEY VARIABLES

	1984	1985	1986	1987	1988	1989	1990
GDP gr (target)	4.10	3.18	1.92	1.94	1.95	1.96	1.97
GDP/capita 1/	854	857	849	842	835	828	822
Debt/X (target)	2.2	2.2	3.2	3.4	3.5	3.5	3.4
DOD	6,677	6,949	7,502	8,261	9,036	9,788	10,364
Debt/GDP (%)	53	58	109	147	190	235	279
Int/GDP (%)	6.7	6.5	10.3	12.2	13.2	13.4	12.1
DS/X (%)	35	33	41	43	43	41	43
Pub Inv/GDP (%)	7.1	7.3	5.1	4.9	4.7	4.5	4.4
Pri Inv/GDP (%)	11.2	11.7	13.9	14.1	14.3	15.5	15.6
GDS/GDP (%)	26.3	28.2	27.9	28.6	29.2	31.7	33.4
Pri/Pub Inv (%)	158	162	269	291	306	341	354
Export Growth		8.1	1.7	3.1	2.7	8.8	9.0
Petroleum X Gr		11.9	-1.6	2.6	1.4	12.0	11.0
Exports/GDP (%)	23	24	24	25	25	27	28
Import Growth		2.7	2.7	-0.8	-0.8	2.8	2.9
Imports/GDP (%)	17	17	17	16	16	16	16
PC/Cap Growth		-1.8	5.6	-0.3	-1.4	-4.6	-3.6
GNP Growth		3.3	3.3	2.4	2.5	2.5	2.6
GNP/Cap	776	779	783	780	778	775	774

22. In the $15 oil high case, with more aggressive curbing of domestic petroleum consumption and improved private sector efficiency, Ecuador could achieve annual GDP growth rates of from 3 percent to 4.5 percent with additional borrowing of $2.7 billion and some drawing on reserves (as in the base case). Private consumption per capita would not quite be maintained (it declines 0.2 percent p.a. on average) but would drop much less than in the base case $15 oil scenario because investment requires less resources to achieve the higher growth. There is little improvement in creditworthiness however.

Table 5: ECUADOR - HIGH CASE, $15 OIL PRICE

KEY VARIABLES

	1984	1985	1986	1987	1988	1989	1990
GDP gr (target)	4.10	3.18	2.02	3.00	3.75	4.07	4.46
GDP/capita 1/	854	857	850	852	860	870	884
Debt/X (target)	2.2	2.2	3.1	3.2	3.1	2.9	2.8
DOD	6,677	6,949	7,523	8,163	8,728	9,265	9,640
Debt/GDP (%)	53	58	91	96	99	101	100
Int/GDP (%)	6.7	6.5	8.6	8.0	7.3	6.4	5.2
DS/X (%)	35	33	40	41	40	37	39
Pub Inv/GDP (%)	7.1	7.3	5.1	4.8	4.5	4.3	4.2
Pri Inv/GDP (%)	11.2	11.7	13.4	13.2	13.0	12.7	12.8
GDS/GDP (%)	26.3	28.2	28.4	28.8	30.7	31.8	33.2
Pri/Pub Inv (%)	158	162	264	279	293	296	309
Export Growth		8.1	5.4	4.6	10.9	10.3	9.5
Petroleum X Gr		11.9	5.8	5.0	15.6	12.8	11.3
Exports/GDP (%)	23	24	25	26	27	29	31
Import Growth		2.7	2.2	-0.6	.0	3.9	4.3
Imports/GDP (%)	17	17	17	16	16	16	15
PC/Cap Growth		-1.8	0.8	0.5	-1.1	-0.5	-0.8
GNP Growth		3.3	3.3	3.5	4.4	4.7	5.2
GNP/Cap	777	781	784	790	802	817	836

Policies, Institutions and Priorities

23. The specific policies currently being introduced in the agriculture and industrial sectors are supported by Bank loans and are detailed in the matrices in Annex I. In summary, they promote maintenance of an attractive exchange rate as an export incentive, liberalization of pricing at wholesale and consumer levels, removal of import restrictions and reduction of tariffs on manufactures, introduction of positive and adjustable real interest rates on term lending, divestiture where appropriate of public companies and efficient allocation of public resources through a sound investment program. Acceleration of these policy reforms must be the top priority of the medium-term growth program because of the important structural adjustments they introduce--rationalization of intersectoral terms of trade and increased efficiency of both public and private investment--as well as the need to assure continuity in the signals given the private sector. The above policies reflect signals that subsidies will be phased out, that only efficient local import substituting industry will be supported, that exports and agriculture will be promoted and that the monetary program will be designed to keep inflation under control.

24. The Central Bank, Agriculture and Industry and Finance Ministries must be fortified to monitor the impact of these policies (technical assistance for this is available under Bank loans). Middle level technicians, with the possible exception of the Central Bank, are generally inadequately trained to take on the kind of tight economic management needed in this crisis, even though the top economic team is composed of a handful of capable economists. Achieving the reforms proposed in the high case scenarios

presumes that the Administration is able at least to maintain its slim majority in Congress to effect those reforms that require legislative action. The situation with Congress should be clearer following June 1986 local and congressional elections.

25. Regarding additional policy reforms needed for the high case scenarios to materialize, the Government should give next highest priority to maximizing oil production and exports. Indications are that Ecuador's reserves will prove adequate to support the gradual increase of barrels produced per day from 300,000 in 1986 to 400,000 in 1990, if essential infrastructure is put in place in a timely way. Exports can increase even under the base case scenarios because of the increased exploration (both foreign and public), which will permit higher overall production. However, in order to reduce more quickly the growth of domestic consumption of petroleum products, the Government could raise local prices to international levels by 1987. Foreign firms are already contracted to undertake exploration, but CEPE, the State oil company, must also be adequately financed to carry out exploration in the fields reserved to it. Pipeline capacity expansion is needed to carry an additional 90,000 barrels of oil per day from the Amazon to coastal ports and refineries; planning for this is underway and should be accelerated. The Government plans to optimize the configuration of refining during its expansion of the main refinery, which should be undertaken as soon as possible to help reduce imports of derivatives. Secondary recovery investments where still economically feasible should be undertaken. Whenever possible, joint financing with international oil firms will be a crucial factor in obtaining the needed resources to carry out this

accelerated oil production, since government revenues are still adversely affected by the drop in oil prices. Also, CEPE itself has not been an efficient state enterprise. Its routine management has been overcontrolled by central Government officials and it is overstaffed by unionized employees. It must follow special but cumbersome procurement procedures. Some improvements have been planned through a Bank loan supporting public sector management.

26. The Government must also improve its fiscal management. It should take advantage of the low oil prices to eliminate the current excessive earmarking of oil revenues, and has indicated it intends to do so. Other earmarking should similarly be reduced. Efforts to improve tax collection are already underway with some success, and measures to expand revenue sources other than petroleum are now essential. Also, the net impact on the fisc of oil price drops could be minimized to the extent that increased oil volume offsets the drop in prices. Current expenditures must be tightened. Efficiency of public services (education, health) could be greatly improved and the State-owned enterprise sector could be reformed (improved prices and management and perhaps some divestiture) to generate a larger current surplus and eliminate subsidies.

27. Capital expenditures could also be further rationalized. Under an earlier analysis, the Bank had recommended a program of investments for 1985-1988 which postponed or dropped some planned projects (specifically the new primary roads, new airports, railway rehabilitation and a hydroelectric project). It also recommended that no major new public investments be initiated prior to 1988. Our estimates indicated that investing more

than $3.2 billion over 1985
fiscal availabilities would
urgently needed by

the private sector. This recommendation remains valid; the essential oil sector investments mentioned above were already contemplated in the investment plan we reviewed. Again, the Bank's public sector management loan provides support for efforts to improve public investment monitoring and fiscal management.

29. Finally, financial sector reforms would be key to improving the efficiency of the financial, housing and manufacturing sectors, and investment in general. The Ecuadorian Social Security Institute in particular has a distorting effect on the financial sector and will also become a major public liability if action is not taken to reverse its decapitalization. Revisions to the banking laws were recently issued which should help strengthen the financial institutions of the country if properly supervised, but other problems must be addressed too. The oligopolistic nature of the banking system probably influences allocation of credit in a non-neutral way and concentrates risk on few enterprises. Equity participation from foreign banks in the country's banking system could improve competition and risk distribution. Accounting problems (especially regarding revaluation of assets) must be overcome. Finally, regulatory and control capacity of the Superintendency of Banks and Superintendency of Companies needs to be strengthened. Housing finance issues outside of social security-financed housing also should be addressed (particularly interest rate policies which are not yet market-oriented). In a related vein, the recently revised industrial incentives law should help streamline industrial incentives, and make better use of installed capacity and domestic resources. Annex I provides further details for the policy actions needed in this sector.

Near-Term Action Program

30. Ecuador has little choice but to implement the additional policies associated with the high case scenarios if oil prices remain around US$15/barrel. Under the base case, the consumption losses are not likely to be well tolerated by the Ecuadorian private sector and the level of additional borrowing is not going to be easily arranged. Only if oil regains a US$20/barrel average export price could Ecuador maintain modest growth by just continuing its current policies, as significant as they are. The near term program described here thus begins with the agriculture, trade and industry measures already initiated and carries on with the additional measures needed to increase exports further and improve investment efficiency and fiscal management.

31. The 1986 Action Program would focus on: (i) continuing adjustments to exchange rates as needed to maintain competitiveness;(ii) tariff reform, implementing actions approved in January 1986; (iii) interest rate flexibility, putting into effect the August 1985 law permitting interest rates on term loans to be periodically adjusted; (iv) removal of about 20 percent of quantitative restrictions on imports, substituting them with tariffs; (v) continuing a tight monetary program and related measures to keep inflation under control; (v) stringent fiscal management; and (vii) continuing regular adjustments of utility tariffs. Further actions which should be initiated in 1986 include: (i) installation of additional pumps to augment the petroleum pipeline capacity; (ii) introduction as soon as politically feasible of higher domestic prices for petroleum derivatives

relative to international prices (as soon as possible and not later than 100 percent of international prices by 1987) to cut down contraband and begin to slow growth of domestic consumption; (iii) diversion of public investment from lower return, postponeable projects to the most productive investments as specified in recent Bank public investment and energy assessment reports; (iv) accelerated efforts to install systems for public investment monitoring in the Finance Ministry and financial monitoring in the principal state enterprises (CEPE, INECEL, IETEL); (v) more thorough efforts to reduce earmarking of public sector revenues and to rationalize current expenditures; (vi) development of a program for financial sector reform; and (vii) facilitating term financing for agricultural and industrial investments, especially where this would lead to potential exports.

32. For 1987, in addition to continuation of the policies laid down in 1986, Ecuador would have to initiate financial sector reforms defined in 1986 (see para. 29 and Annex I); begin to rationalize the State-owned enterprise sector, based on studies now being undertaken; introduce new, more coordinated procedures for public investment planning and new revenue measures, given the probable fiscal constraints arising from the oil price drop.

33. Agreements with the IMF will also be part of the near term action program as earlier alluded. The measures cited above are consistent with the 1986 Stand-by in the process of being negotiated and some will be defined and monitored chiefly by the Fund rather than the Bank.

Monitoring of Policies

34. For foreign exchange policies, overall fiscal balance, monetary programs and inflation, the IMF will be monitoring progress and defining targets in the context of their current and 1986 agreements. Furthermore, Ecuador has a commitment undertaken in the process of the recent debt rescheduling to conduct with the Fund semiannual enhanced Article IV consultations throughout the period of debt repayment, i.e. 1987-1996. These consultations would serve the monitoring purpose even if further stand-by agreements did not materialize. The Bank will undertake monitoring of agricultural pricing, interest rates in general, intersectoral terms of trade, tariff reform and import restrictions and industrial incentives through existing loan programs. Inflation's impact will also be closely monitored by the Bank, as will the composition of public sector investment and utility pricing policies. To the extent that the Bank becomes involved in future policy-based lending, in particular for the financial sector and trade diversification, it will monitor reforms in these areas. Close cooperation with the Fund will continue, given the overlapping effects of the respective reform programs, especially with regard to trade and interest rate reforms.

35. The Bank should also be prepared to encourage and assist the Government to monitor the impact of its stabilization and reform efforts on the lower-income groups in Ecuador. Analysis undertaken during preparation of the Agriculture Sector Loan suggests that while small farmers' incomes could rise by almost 50 percent over the medium-term, thanks to the new

sector policies, large farmers could expect a rise in income of 70 percent. This indicates that income disparities could increase as a result of the freeing of the economy, even though all would be better off. On the other hand, the employment potential is greater not only in the agriculture sector, under the proposed reforms, but also in industry as it becomes more export-oriented. Past studies showed that it cost Ecuador five times as much to create a job in a typical import-substitution industry as in an export industry. It is not clear that the current Administration has the capability or commitment to initiate these aspects of policy monitoring; it is simply convinced that all population groups will be better off with the more market-oriented policies it is putting into place. If decision-makers had reliable information on hand about negative impact of policies on income distribution and other equity measures, they could at least begin examining program modifications or supplementary policies that could correct such inequities when adjustment policies were further along. The Bank would have to put more staff resources in poverty-focused economic and sector work to help the Government in this regard.

Difficulties in Implementing Policy Reforms

36. Since mid-1985, the current Administration has enjoyed a fragile but workable majority in Congress which it has used to introduce sweeping reforms. The President is also willing to move aggressively on those actions which can be implemented by the executive branch alone, when he is convinced that the changes will produce the economic reforms he seeks. If the June 1986 local elections consolidate the ruling coalition's legislative

power, urgent measures such as domestic petroleum pricing and full flexibility of the exchange rate are likely to be passed. If not, actions on these fronts will probably occur but will be more modest and in line with current law and tradition. After 1987, very little fundamental reform of structural problems can be expected, since this Government ends its term in mid-1988 and elections preparations will be underway well before then. It is also fair to say that some areas--housing finance is one--will be difficult to reform as thoroughly as they ought to be since campaign promises made by this Government are generating countervailing pressures. Finally, given the past history of military governments, there will be little incentive to exert strong control on military expenditures, which represented 19 percent of total public expenditures in 1982. Armed forces, together with teachers, were given special treatment during the last wage policy decisions and the military pension system will be a particularly sensitive aspect of any Social Security reform.

37. While the political difficulties mentioned above are very real constraints to timely introduction of reforms, an equally serious limitation is the fact of the country's weak institutions and cumbersome procedures. From budget planning to procurement, highly complicated regulations and bureaucratic traditions negatively affect the public sector's ability to carry out its programs even on a non-emergency basis. Procedural delays make obtaining a loan or license something often avoided by the private sector, especially smaller enterprises. While this can generally be described as a problem of developing countries, examples suggest that in Ecuador, it may be worse., For instance, CEPE has lost millions of dollars in foregone petroleum production because of delays in procuring

pumps for its wells. As another example, three of the Bank's last six loans to Ecuador took over a year to sign following Board approval. While this Administration is openly committed to streamlining the procedures of its bureaucracy, the day-to-day crises it has faced have diverted attention from routine but fundamental problems such as these.

Financing Requirements

38. With the best (i.e. high case) policy package that can be expected within the constraints described, Ecuador will require no additional borrowing from commercial sources between 1986 and 1990, if oil prices average $20/barrel, but will need to increase its medium- and long-term debt by $2.7 billion over that period if oil prices average $15/barrel (Annex II). The bulk of this would be required in the 1987-1989 period. While the additional borrowing amounts in the $20/barrel base case scenario ($.5 billion) are quite manageable, the net borrowing levels required by Ecuador as oil prices drop farther become considerably less manageable. The Government estimates that for each US$1 drop in barrel price of oil, the economy loses US$60 million in export revenues and $50 million in fiscal revenues. However, the Authorities also believe that the effect of the oil price collapse on international interest rates and on growth in developed countries will correct some of Ecuador's problems in the medium-term. This is probably overoptimistic, since we estimate that a one percentage point drop in interest rates on Ecuador's outstanding debt would result in a savings of $50 million in interest payments. As recent events suggest, a US$10 drop in oil prices proves much more likely and sudden than a 10 percentage point decline in interest rates.

39. Assuming Ecuador must sell its oil for $15/barrel and could implement the domestic petroleum price and financial sector reforms proposed, meeting the estimated net disbursements of $2.7 billion over 1986-1990 would require net disbursements of close to $550 million on average each year. Of this approximately $300 million are estimated to come each year from official sources, already considerably higher than in previous years, and the remaining $250 million p.a. from sources to be identified. Of this latter amount, enhanced Bank lending could provide a net additional $50 million annually in 1988-1990 through increased fast disbursing commitments in FY88 and 89. The Inter-American Development Bank, long a major lender to Ecuador, could provide another US$50-75 million p.a. and bilateral sources, especially the US, which is said to be considering economic support financing, another $25 million p.a. The remaining $100-125 million per year would need to come from sources such as private banks, with maturities of at least seven years. It may be possible to associate some of this fresh money from bilateral sources or private banks with Bank involvement in Ecuador's public investment program, for example the petroleum sector or the power sector, or with proposed sector adjustment loans. Some discussion has already taken place about how the proposed financial sector adjustment loan might encourage increased foreign equity participation in local banks. While direct foreign investment rises significantly in the various scenarios discussed above, to take into account new oil and mining investments, any further addition to direct foreign investment would obviously reduce the need to increase external debt.

ECUADOR

FINANCIAL SECTOR POLICY REFORMS

Policy Area	Medium-Term Objectives	Recent Actions Taken	Further Measures Recommended
A. Interest Rate Levels	Interest rates which are market-based or positive in real terms to mobilize savings and to encourage efficient resource allocation.	Increases in official interest rates at the end of 1984 and the introduction of market-based rates on large denomination (over one million sucres) certificates of deposit. Agricultural lending rates unified and aligned more closely with industrial rates. Official interest rates set at positive levels.	Maintenance of (i) positive interest rates on long-term loans; and (ii) adequate levels of domestic financial resource mobilization.
B. Interest Rate Variability on Long-Term Loans	Permit lenders and borrowers to avoid the risks of fixed interest rates in environment of variable rates of inflation.	In August 1985 the Government issued new legislation to allow long-term financial instruments to carry variable rates to be adjusted at frequencies determined by the Monetary Board. Necessary regulations have been issued by the monetary authorities to make the variable rate system effective for the industrial sector.	None.
C. Financial Condition of Financial Institutions	Strengthening the financial condition of financial institutions.	Revision in August 1985 of the Banking and Monetary Laws to (i) shorten the minimum term of certificates of deposits issued by private financieras; (ii) increase debt/equity limits of financial institutions from 10:1 to 15:1, but requiring the establishment of reserves for doubtful accounts equal to 10 percent of loans; and (iii) reduce the exposure limits of the financial institutions.	Measures to increase competition and capitalize banks (e.g. foreign equity participation).
D. Housing Finance	Improve affordability of housing and increase resource mobilization in sector.	None.	- Introduction of new mortgage instruments effectively permitting capitalization of interest. - Recapitalization of savings and loan system. - Introduction of mechanisms to mobilize resources for the housing sector.
E. Social Security	Reverse decapitalization of IESS and remove distortions generated by IESS in financial sector.	None.	- Improve IESS' housing sector financial policies (e.g. more market-oriented interest rates). - Redress actuarial imbalances.
F. Capital Market	Strengthen confidence in and depth of capital market.	None	- Development of quasi-equity markets. - Strengthen control and supervision of Superintendency of Companies.

ECUADOR

TRADE AND INDUSTRIAL SECTOR POLICY REFORMS

Policy Area	Medium-Term Objectives	Recent Actions Taken	Further Measures Recommended
A. Export Incentives	Adjustment of exchange rate to maintain real level and unification of exchange rates.	Multiple official exchange rates formally unified November 1985; exchange rate adjusted to maintain real level January 1986.	Continued adjustments to maintain real level (introduction of flexibility).
B. Industrial Incentives	Streamlining of industrial incentives to encourage manufacturing exports, more extensive use of domestic resources and a better use of installed industrial capacity.	New regulations for Industrial Incentive Law issued in January 1985 to (i) grant tax benefits based on export performance; (ii) reduce income tax exonerations for sectors with excess capacity; and (iii) provide for progressive reduction and time limitation on tariff exonerations for raw materials and intermediate products.	None.
C. Import Restrictions	Elimination of distortions in the allocation of resources caused by quantitative restrictions.	1. Removal in March 1985 of the import prohibitions introduced in 1982. 2. Removal of about 20 percent of the remaining import prohibitions in January 1986. 3. Lifting of import licensing requirements for about 50 industrial inputs in February 1986.	- Progressive substitution of remaining import prohibitions by tariffs. - Continued progress on removing prior authorizations to imports.
D. Tariff Reform	Reduction of tariff levels on manufactured products which encouraged production for the domestic market and attracted resources to manufacturing, thereby discriminating against agriculture and discouraging exports. Reduction of tariff dispersion which discriminated against many types of manufacturing activities hindering efficient resource allocation.	A revised import tariff structure has been adopted. It reduces import tariff peaks from a maximum of 220 percent to 100 percent (except for a few items), and reduces tariff dispersion so that over 75 percent of commodities have tariffs of 70 percent or less. Average tariffs and tariff dispersion have been reduced by about 30 percent and 50 percent, respectively.	Further reductions in level and dispersion of tariffs.

ECUADOR

AGRICULTURAL SECTOR POLICY

Policy Area	Recent Actions Taken	Further Actions Recommended	Further Measures Recommended
A. Pricing	Liberalization of official prices at the wholesale and consumer levels on agricultural commodities.	Reduction of the number of agricultural commodities under official price controls to three at the consumer level, and 17 at the wholesale level. Of the 17, coffee, cocoa, and bananas are set by international prices. Sugar is a mixed product entering into the US quota, and because of oligopolization in processing requires some price controls. Other than wheat (through a quota system), rice and hard corn, the Government is no longer supporting minimum prices at the wholesale level. At the consumer level, the three staple commodities (wheat flour, milk and sugar) still with controlled prices will be available only at ENPROVIT outlets in low-income areas.	- Elimination of remaining procurement by ENAC or other public enterprises to support minimum wholesale prices. - Elimination of the maximum consumer price on wheat flour.
B. Import Restrictions	Removal of quantitative restrictions on imports of agricultural commodities.	Removal of quantitative restrictions imposed during 1982 and 1983.	Elimination of quotas, and other quantitative restrictions on the imports of agricultural products, inputs, and substitution by generally uniform tariffs at levels to be determined from the internal terms of trade.
C. Export Incentives Policy Area	Adjustment of exchange rate to maintain real rates and unification of exchange rates.	Unification of exchange rate.	Continued progress on export incentives to agricultural commodities via attractive exchange rate.
D. Inter-Sectoral Terms of Trade	Improve the terms of trade of agriculture vis-a-vis the rest of the economy.	Removal of many 1982/83 quantitative restrictions on imports of industrial products.	Reduction of the level, and dispersion of tariffs on industrial commodities. Removal of quantitative restrictions on most industrial products. Imposition of tariffs on imports of agricultural commodiities (see Trade Sector).
E. Public Enterprises	Divestiture of designated public enterprises.		Development and execution of plan for SOE sector including divestiture where and when appropriate.
F. Interest Rates	Positive real interest rates and variability of long-term rates. Uniform rates except as justified by transactions costs.	- Increase (January 1985) of interest rates. - Unification of agricultural lending rates except as justified by transaction costs. - Maintenance of positive rates of interest through adjustment of nominal rates as necessary.	Maintenance of positive real rates of interest through adjustment of nominal rates as necessary, and elimination of rate dispersion between agriculture and other sectors.
G. Publi[illegible]ment	Efficient allocation of public sector resources.	1985-88 Publi[illegible]ment Review.	Optimal public investment program for agriculture.

ECUADOR

ENERGY SECTOR POLICY REFORMS

Policy Area	Medium-Term Objectives	Actions to Date	Further Actions Recommended
A. Pricing			
1. Electricity Subsector	Improve levels of cost recovery to permit greater auto-financing of sector.	Electricity tariffs to final consumers raised 3 percent per month (42 percent p.a.).	Continuation of regular real tariff increases commensurate with sector investment program.
2. Petroleum Subsector	To rationalize domestic consumption of petroleum derivatives and limit its growth to maximize exportable surplus.	Sucre prices hiked 73 percent on average in early 1985, thereby increasing domestic prices to 62 percent of world prices.	- Full parity with international price levels by 1987. - Petroleum law revised to permit pricing in line with opportunity costs.
B. Investment Program			
1. Electricity Subsector	Optimize program.	Master Plan completed in 1982.	-Revise existing Master Plan.
2. Petroleum Subsector	Optimize production.	- Amended Hydrocarbons Law (1983) to attract foreign investment; signature of six exploration contracts with foreign firms. - Refinery expansion (with improved configuration) initiated.	- Accelerate CEPE exploration as well as foreign. - Expand pipeline capacity from 310,000 to 400,000 bb/day. - Secondary recovery where still economically feasible.
C. Institutional			
1. Electricity Subsector	Improve sector's institutional efficiency, especially regarding relationship between INECEL and regional companies.	Studies completed with technical assistance from Spain (ENDESA).	Strengthen INECEL's role on regional company boards.
2. Petroleum	Improve CEPE's management efficiency.	Public Sector Management Project and Power Engineering Project developed to support institutional development in CEPE and INECEL.	- Improve management information systems of INECEL and CEPE. - Improve planning and programming with INECEL and CEPE. - Provide managing directors of INECEL and CEPE more autonomy for routine management within framework of performance indicators set by Central Government.
D. Technical			
Electricity	Reduce distribution losses.	Loss studies underway with Belgian technical assistance.	Reduce transmission losses (now 5 percent) and distribution losses (about 22 percent) to ___ and ___, respectively.

LC1PA
CJones-C[illegible]ab
3/10/86

ECUADOR - TOTAL CAPITAL REQUIREMENTS

BASE CASE - $15 OIL

(US$ Millions)

	1986	1987	1988	1989	1990	Total
Total Net External Capital Required	553	759	775	752	576	3,415
Net Disbursements Official Sources	326	362	341	356	363	1,748
World Bank	165	141	120	121	128	675
Other (IDB, etc.)	161	221	221	235	235	1,073
Net Disbursements Private Sources	227	397	434	396	213 1/	1,667

HIGH CASE - $15 OIL

(US$ Millions)

	1986	1987	1988	1989	1990	Total
Total Net External Capital Required	574	640	565	538	375	2,692
Net Disbursements Official Sources	326	412	441	456	375	2,010
World Bank	165	165	170	171	158	829
Other (IDB, etc.)	161	247	271	285	217	1,181
Net Disbursements Private Sources	248	228	124	82	- 1/	682

1/ Current multi-year commercial bank debt rescheduling postpones principal repayments due 1985-1989; resumption of major amortization payments thus results in little or no net private borrowing.

LC1PA
CJones-Carroll:ab
3/7/86

N-623

THE WORLD BANK INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

→ Ec. BB.

DATE: February 26, 1986

TO: Distribution

FROM: Peter Eigen, Chief, LC1PA

RE: **ECUADOR: Economic Mission**

1. An economic mission is scheduled to depart for Ecuador on March 2, 1986. The draft Terms of Reference are attached. While I do not plan to call a full-scale meeting to discuss these Terms of Reference, I would arrange one should any of you feel it would be generally useful.

2. If you have any comments, please contact Mr. Bastiaan den Tuinder on Ext. 75924 before c.o.b. Thursday, February 27.

Attachments

Distribution

Within Region

Messrs./Mesdames Pfeffermann, LCNVP
Quijano, LCNVP
Steckhan, LC1DR
Finzi, LCPDR
Otten, LCPAC
Flood, LCPI1
Barham, LC1PA
Jones-Carroll, LC1PA
Saenz-Jimenez, LC1PA

Outside Region

Choksi, CPDTA
Kohli, INDDR
Iskander, EGYD2
Vibert, VPCAU
Rischard, FPAMA
Bonangelino, IMF

PEigen/brw
cw & cc: Mr. P. Meo (LC1DR-o/r)

DRAFT

DATE: February 26, 1986

TO: Mr. Bastiaan A. den Tuinder, Consultant, LC1PA

FROM: Peter Eigen, Chief, LC1PA

RE: **ECUADOR: Economic Mission**
Terms of Reference

1. On or about March 2, 1986, you will travel to Ecuador to lead an economic mission, which will remain in the field for about three weeks. Your visit will coincide with an IMF mission to prepare a Stand-by, starting February 27; in the field you will continue the fruitful cooperation begun at Headquarters.

2. It is essential that the Bank obtain soonest a comprehensive and consistent picture of recent developments in and revised prospects for Ecuador in general, and of the impact of the recent drop in world oil prices in particular. The mission should also assist in refining the medium-term strategy paper on Ecuador, of which a first draft will be ready before the mission's departure. Therefore, the objectives of this mission are relatively limited. The mission will: (i) update macro-economic information and data on selected sectors; (ii) continue to explore with the Government plans and policies towards economic growth, especially in the light of the recent drop in world oil prices; and, in this context, (iii) prepare a macroeconomic framework and develop with the Government alternative scenarios and policies to find the best response to major recent changes in conditions and outlook.

3. The mission will update the macroeconomic framework. The latest economic mission visited Ecuador in November 1984; since then the Bank has acquired much information about the economy in general and various sectors in particular, which now has to be brought together in a consistent and coordinated fashion. Also, the recent development in oil prices and the Government's alert reaction to it has to be brought into the picture. The update will provide the building blocks for a medium-term projection of future development and estimate probable resources available and required.

4. Before the recent downward cascade in oil prices, the authorities had undertaken structural and far reaching programs of economic reforms to turn around the recession the country experienced in 1982-84. It basically intended to set the economy on a course of responding to free market forces, lowering obstacles to the import of goods and foreign private investments and encouraging exports. The mission will have to evaluate the impact to date of these reforms. The Government has agreed with the Bank on a number of general and sector policies in the context of an agricultural sector program signed recently and the industrial sector program just negotiated. Initial dialogue on financial sector reforms and possible Bank support for this has also taken place. The mission will discuss with the GOE further need, room and options for policy changes to enhance sustained growth.

5. In this context, and based on an updated macroeconomic framework, the mission will develop, with the GOE, alternative scenarios as to how to counter best the adverse effects the recent brutal drop in the world oil price will have on the economy. After a period of ample revenue from oil in the 1970s, the country, consistent with Bank recommendations, in late 1984 and 1985 had been set on a course to turn a public sector deficit into a surplus to substitute a substantial part of the generous foreign borrowings of the late 1970s and the early 1980s the country had become used to. This program may now be in jeopardy. Deeper cuts in spending may be required, which may lead to insignificant growth in the years to come. The mission will discuss with the GOE where the program stands and whether additional foreign funds, and if so, how much, would be helpful and appropriate to allow the economy to continue to grow at a meaningful pace.

6. The mission should give particular attention to the oil sector, because of its overwhelming impact on the economy of Ecuador. In 1984, petroleum accounted for about 72 percent of all commodity exports, about 15 percent of the country's GDP, and 50 percent of Central Government revenues. The country is so dependent on oil that whatever happens to the volume of oil production, or to international oil prices, overshadows development in the rest of the economy. Fortunately, two years ago the Government opened up this sector for foreign investors and as a result the country is very close to boosting its oil exports substantially. However, it may in the short-run even increase the country's dependence on oil. Therefore, it remains imperative for the mission to evaluate the effect of recent policy changes (trade rationalization/liberalization, exchange rate adjustment, interest rate and pricing policies and the like), partly designed to reorient the economy towards non-oil exports and away from inefficient import substitution.

7. A full fledged public investment review was carried out in 1984. It submitted various recommendations as to speeding up, delaying or abandoning certain investments. Since then it is evident from various signals that the GOE is acting upon some of these recommendations, but in other cases the status is not quite clear. In particular, for the more substantial investments the current mission will clarify the status and see whether any major new investments are being considered. Because not only the volume, but also the quality of the proposed investments is crucial in the presently very tight financial situation, the Bank is financing a Public Sector Mangement Project, signed in January 1986, and designed to help the Government improve its systems for macroeconomic management and the efficiency of public investment. A sound public investment program would be a condition for the Bank to get involved in a Consultative Group Meeting. Therefore, the mission should seek agreement from the GOE for a full fledged public investment review update later in CY86.

8. You will be joined by Messrs. Hernan Saenz-Jimenez (macroeconomics), Humberto Petrei (public finance expert); Jose Olivares (agricultural economist); Oscar Ruiz (agricultural expert); George Khoury-Haddad (petroleum engineer); Gabriel Sanchez-Sierra (energy planner); Mario Reyes (industrial economist); and Nirmaljit Singh Paul (modelling and statistical expert). Several of the mission members have a thorough knowledge of the country and it has been preferred to have their short-term involvement rather than have staff new to the country go over ground already covered so many times before.

9. Your responsiblities will be the following: (i) coordinate the mission's work and ensure that all tasks are performed effectively; (ii) obtain all necessary macroeconomic information and discuss with Government officials the key variables to be adopted for medium-term projections; (iii) assess the efficiency of resource use; (iv) discuss viable scenario's with the GOE; and (v) liaise with other Bank missions in the field at the same time, with the IMF and with other donors as you see fit.

10. Before leaving Ecuador, you will discuss with Government officials the tentative results and conclusions of the mission. Mr. Meo will join you at some point during the mission to review progress. Upon return to Headquarters, you will prepare a brief Back-to-Office Report and provide refined information as required for the ongoing medium-term growth strategy exercise. Your draft Full Report should be ready by the middle of May 1986; the target date for the Green Cover Report is end-June 1986.

BdenTuinder/brw

cc: Messrs./Mesdames Dubey (CPDDR/2); Schuh (AGRDR); Habte (EDTDR); North (PHNDR); Pouliquen (TRPDR); Churchill (WUDDR); Golan (INDDR); Richardson (IFC/CDD); Pfeffermann (LCNVP); Steckhan, Meo (o/r), Eigen, Saenz-Jimenez, Jones-Carroll (LC1); Otten, Martinez, Moscote, Flood, Schultz, Keare, Thys, Thint (LCP)

Regional Information Center

DRAFT

DATE: February 26, 1986

TO: Messrs. H. Saenz-Jimenez (LC1PA); J. Olivares (AGREP); N.S. Paul (FPAMA); G. Khoury-Haddad (EGYD2); G. Sanchez-Sierra (EGYS2); M. Reyes-Vidal (LCPI1); H. Petrei, O. Ruiz (CON)

FROM: Bastiaan A. den Tuinder, Consultant, LC1PA

RE: **ECUADOR: Economic Mission Terms of Reference**

1. On or about March 2, 1986, a mission will depart for Ecuador for about three weeks to gather information for an update of the macroeconomic and sector framework and to provide the input for realistic medium-term development scenarios for the economy, which should form the basis for a dialogue with Government officials on the options available and the road to go.

2. Mr. Saenz-Jimenez, as the country economist, will join the mission for its entire duration. He will, with me, review on a selective basis the public investment program. He will make sure that, together with Mr. Petrei's efforts, the entire public sector is covered. He will coordinate with the IMF the balance of payments projections. He will coordinate with Mr. Paul the macroeconomic framework modelling and ensure that all inputs demanded by the model are being collected and agreed upon by the sources.

3. Mr. Petrei will join the mission for its entire duration. He will be responsible for examining the public finance sector, with the exclusion of public investments and public debt. More in particular, he will:

(a) update existing information on revenue and expenditure;

(b) evaluate recent performance, especially in the light of policy changes to date;

(c) assess revenue implications of the present tax system, of the recent drop in world oil prices, and indicate room for futher policy changes, prepare a realistic timetable for the introduction of such changes and estimate the consequences for future revenue;

(d) verify whether any progress has been made to correct problems identified in the review he made in 1984 on the institutional aspects of budgeting and forecasting of public revenue and expenditure;

(e) estimate future expenditures;

(f) together with Mr. Saenz-Jimenez update and assess the efficiency of resource use of the main Government-owned enterprises, paying particular attention to CEPE, INECEL, IETEL and IESS; and

(g) together with Mr. Saenz-Jimenez assess what progress has been made in the reduction of tax ermarking.

As a framework, Mr. Petrei will apply the model for public finance flow projections as used in LC1PA. He will contact the two fiscal experts who are members of the IMF field mission.

4. Mr. Olivares will join the mission for two weeks. He will be responsible for the agricultural sector input. In January 1986, the Bank signed a policy-oriented agricultural sector loan. It is obviously too early to evaluate its impact. However, the impact of new circumstances should be evaluated; is it possible to introduce the policy reforms stipulated in the agricultural sector program at the same pace as assumed before and to what extent is the quantified effect on production and foreign trade going to be affected. The effects as calculated have to be integrated into the macroeconomic framework. Also the comparative advantage calculations carried out by the Bank for certain crops will be looked into in the light of relative price changes. In these exercises Mr. Olivares will be assisted by Mr. Ruiz, who participated in preparing the agricultural sector loan; he will join the mission for one week. Mr. Olivares, drawing on LCPAC knowledge as well as field contacts, will also:

(a) update Bank information on the sector;

(b) forecast the sector's need for inputs, its potential for exports in the medium-term and its contribution to medium-term growth;

(c) determine the status of some major public investment proposals for flood control and irrigation (e.g., Daule-Peripa; Santa Elena; Jubones; Guayas Basin), together with Mr. Sanchez-Sierra, who should look at the power element in some of these schemes;

(d) prepare a brief status report on the fish and shrimp sector, the major policy issues and its impact on future income and the trade balance.

5. Mr. Reyes-Vidal will join the mission for two weeks. The Bank has just negotiated an Industrial Finance Project, which aims at supporting changes in trade, industrial and financial policy, and encouraging more efficient domestic resource mobilization and allocation through an adequate interest rate structure as well as through strengthening of institutions. A major task for Mr. Reyes will be to try to quantify the impact of these and other policies on growth, industrial employment, and the trade balance as well as on public sector revenue and expenditure; the results will be incorporated in the macroeconomic framework. He will coordinate with the IMF mission checking on developments in the financial sector. On a selective basis, Mr. Reyes will also review the major exporting industries and, for instance, look into wood processing, determine why plywood exports have dropped so substantially and why the wood processing sector is not contributing more to export than it does. The Government also seems to intend to emphasize mining as a sector with prospects. This should be

checked as mining generally is a sector where possible returns lag far behind huge investments, a model less appropriate for the present Ecuadorian situation.

6. Mr. Khoury-Haddad will follow the attached Terms of Reference; he will join the mission for about a week. Mr. Sanchez-Sierra will join the mission for one week. As one of the principal authors of the report **"Ecuador - Issues and Options in the Energy Sector"** of December 1985, his responsibilities are to:

(a) update the Bank information on the energy sector;

(b) discuss with Mr. Khoury-Haddad his findings, determine how many long-term oil contracts Ecuador has and at what price; and look into possible foreign market constraints of selling more oil;

(c) evaluate the Government's domestic pricing policies for energy products and estimate when and to what extent a more realistic pricing would increase oil available for export through lower domestic consumption and less illegal border trade; and

(d) review, on a selective basis, any changes in the public investment program as far as energy and power are concerned and recommend a strategy to cut or delay investments intelligently and to improve the efficiency of existing infrastructure in the sector.

7. Mr. Paul will join the mission for its entire duration. He will:

(a) prepare at Headquarters and carry "clean" forecasts to the field for alternative policy scenarios;

(b) carry all necessary hard and software to run and print in the field the RMSM, public finance model and flow of fund model as used in LC1PA;

(c) collect, in cooperation with Mr. Saenz-Jimenez and the IMF mission, all data on debt and prepare and run alternative scenarios as to how to best fill a gap in the event a gap would occur; and

(d) coordinate with the IMF and within the mission the updating of the statistical appendix and make sure all material is being collected before the departure of the mission.

BdenTuinder/brw

cc: Messrs./Mesdames Dubey (CPDDR/2); Schuh (AGRDR); Habte (EDTDR); North (PHNDR); Pouliquen (TRPDR); Churchill (WUDDR); Golan (INDDR); Richardson (IFC/CDD); Pfeffermann (LCNVP); Steckhan, Meo (o/r), Eigen, Jones-Carroll (LC1); Otten, Martinez, Moscote, Flood, Schultz, Keare, Thys, Thint (LCP)

Regional Information Center

DRAFT

DATE: February 26, 1986

TO: Mr. G. Khoury-Haddad, EGYD2

FROM: F. Batzella, Acting Chief, EFGD2

RE: **ECUADOR: Mission to Update Economic Memorandum Terms of Reference**

1. On or about March 3, 1986, you will proceed to Quito to join a Bank economic mission for about a week.

2. During your stay, you will coordinate with the members of the mission to update our information on the production/investment program of operating companies (Cepe, Texaco, Cities). You will obtain information on new discoveries (Oxy--production, investment, timing), and exploration programs for new contractors. You will include the results of those findings for production levels, local consumption quantities and public as well as private investments in a brief paper to be left with the Chief of Mission. In this sense it will be an update of the petroleum and natural gas sections of the December 1985 report **"Ecuador: Issues and Options in the Energy Sector,"** and of the revised **"Ecuador-Proposed First Petroleum Project Brief"** of February 5, 1986 with which you should be fully familiar.

3. Upon your return, you will prepare a Back-to-Office Report on your mission.

cw&cc: Mr. B. den Tuinder, LC1PA
cc: Messrs./Mesdames Dubey (CPDDR/2); Schuh (AGRDR); Habte (EDTDR); North (PHNDR); Pouliquen (TRPDR); Churchill (WUDDR); Golan (INDDR); Richardson (IFC/CDD); Pfeffermann (LCNVP); Steckhan, Meo (o/r), Eigen, Saenz-Jimenez, Jones-Carroll (LC1); Otten, Martinez, Moscote, Flood, Schultz, Keare, Thys,Thint (LCP); Bourcier, Hume, Saunders, Heron, Khelil, Barbu, Labib (EGY)
Regional Information Center

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

→ Sc RB.

DATE: February 18, 1986

CONFIDENTIAL

TO: Mr. Ernest Stern

THROUGH: Mr. Rainer Steckhan, Acting RVP

FROM: Peter Eigen, Division Chief, LC1PA

EXTENSION: 75791

SUBJECT: **ECUADOR - Discussions on Enhanced Bank Assistance**

1. Following the collapse of international petroleum prices, both the Ecuadorians and their commercial bank creditors have contacted the Bank to ascertain what additional assistance we could provide. We had already begun in late January to prepare a medium-term workout analysis, a process which now becomes more urgent and more complex in view of the economic difficulties potentially arising from the loss of oil-based revenues. Messrs. Vibert and Rischard have joined Regional staff discussions.

2. The Ecuadorian economic team last week visited the Bank, Fund, US Government officials and private banks. They indicated that their calculations show that a drop of oil prices to US$15 per barrel will translate into a foreign exchange gap of US$500 to US$700 million in 1986, in spite of already programmed higher loan disbursements from official sources, and their fiscal revenues would drop by US$500 million. They felt their gap was a short-term one and inquired what possibilities existed for quickly arranging co-financing within the context of Bank lending. We pointed out that, unless oil prices recover, their increased financing needs were likely to continue over the medium-term. We planned an economic mission for later this month, to coincide with a Fund mission, and proposed that our two agencies come to an agreement with the Government on a realistic medium-term scenario. Based on that, we would all be in a better position to discuss with the banks mechanisms for co-financing. The Ecuadorians agreed.

3. The economic team had been discussing with a group of banks a possible US$300 million additional short-term loan to pre-finance oil exports. This facility had been part of an earlier US$700 million trade facility already agreed, but the Ecuadorians thought they might be able to separate it out and increase their total short-term trade lines. (They did not suggest to these banks at this time their potential interest in arranging co-financing with the Bank.) The Steering Committee responded to this request by agreeing to ask other banks whether they were willing to participate. Parallel to this, I had a call from David Driscoll (Vice-Chairman of Ecuador's Steering Committee) asking us to discuss Ecuador's prospects and general options for associating any disbursements of fresh money they might make to Ecuador with Bank lending. Encouraged by the Ecuadorians, I responded positively, though without fixing a time.

4. Our plan now is to complete a very preliminary draft medium-term growth paper for Regional discussions by end-February, take into account the findings of the Bank and Fund missions, which should be back by mid-March, and reach some preliminary agreements with Bank management by end-April about enhanced participation in a workout for Ecuador, including the possibilities of (i) arranging co-financing with loans we are processing this year, such as the industrial finance loan; and (ii) using a consultative group-cum-Steering Committee approach to help Ecuador obtain the additional resources it needs.

Cleared and cc: Mr. Meo, LC1DR

cc: Messrs. Knox o/r, Dolenc, Quijano, LCNVP; Rischard, FPAMA
Vibert, VPCAU; Saenz-Jimenez, Barham, LC1PA
Choksi, CPDTA; Flood, LCPI1

CJones-Carroll/tw

→ Ecuador BB.

CONFIDENTIAL NOTE

February 5, 1986

TO: Ms. Charlotte Jones-Carroll

RE: ECUADOR: Production Schedule of Medium-Term Growth Paper

Today I called Mr. Choksi to tell him that in view of the drastic change of oil prices we foresee a delay in the production of the above paper. When he asked if this did not merely mean rerunning our RMSM with different assumptions, I pointed out that the change was much more fundamental. Two weeks ago we had a relatively easy scenario, which could be handled on the basis of a plausible package more or less agreed with the Government, the banks and the Fund. We now had a practically unviable scenario, requiring annually about $200-300 million more in external financing (at $19 per barrel), which would probably not be forthcoming on a voluntary basis. The policy package would have to go beyond what the Government had so far in mind, rising the specter of political feasibility. I told Mr. Choksi that, off-the-cuff, I estimated that we needed about two weeks more for the first draft, and that I would send him a detailed new production schedule within the next few days.

PEigen/br
cc: Messrs. Knox (o/r), Steckhan (o/r), Meo (LC1); Choksi (CPDTA)