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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 84/96

10:00 a.m., June 20, 1984

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
	A. Koné, Temporary
	H. G. Schneider
	X. Blandin
	J. Delgadillo, Temporary
	M. K. Bush
	T. Alhaimus
	T. Yamashita
J. E. Ismael	Jaafar A.
	D. I. S. Shaw, Temporary
	C. Robalino
G. Laske	G. Grosche
	N. Coumbis
	V. Govindarajan, Temporary
	J. E. Suraisry
J. J. Polak	
	K. G. Morrell
G. Salehkhou	O. Kabbaj
	S. M. Hassan, Temporary
M. A. Senior	
	A. K. Juusela, Temporary
	T. A. Clark
	J. Bulloch, Temporary
Zhang Z.	Wang E.

L. Van Houtven, Secretary
R. S. Franklin, Assistant

Also Present

Asian Department: I.-S. Kim. Central Banking Department: S. P. Leite. Exchange and Trade Relations Department: W. A. Beveridge, Deputy Director; M. Guitian, Deputy Director; D. Lee. Fiscal Affairs Department: A. L. Antonaya. Legal Department: P. L. Francotte, Ph. Lachman, S. A. Silard. Middle Eastern Department: F. Drees. Treasurer's Department: W. O. Habermeier, Counsellor and Treasurer; D. Berthet, J. A. Gons, D. Gupta, T. B. C. Leddy, A. F. Moustapha, M. Sami, T. M. Tran. Western Hemisphere Department: E. Wiesner, Director; S. T. Beza, Associate Director; M. E. Bonangelino, A. Caetano Filho, C. Cha, D. S. Hoelscher, A. Lopez-Claros, S. J. Stephens. Bureau of Statistics: K. W. Nahr. Advisors to Executive Directors: S. R. Abiad, H. A. Arias, S. El-Khouri, G. E. L. Nguyen, M. Z. M. Qureshi, D. C. Templeman. Assistants to Executive Directors: H. Alaoui-Abdallaoui, J. R. N. Almeida, R. L. Bernardo, M. Camara, M. B. Chatah, L. E. J. M. Coene, M. Eran, D. Hammann, H. Kobayashi, M. Lundsager, E. Portas, M. Rasyid, J. Reddy, D. J. Robinson, A. A. Scholten, Shao Z., A. J. Tregilgas, M. A. Weitz.

1. DESIGNATION PLAN AND OPERATIONAL BUDGET FOR JUNE-AUGUST 1984

The Executive Directors considered the proposed designation plan (EBS/84/122, 6/6/84) and operational budget (EBS/84/123, 6/6/84) for the quarterly period June-August 1984.

The staff representative from the Treasurer's Department observed that, since the issuance of the paper on the operational budget, a number of small transactions had been effected; and a number of transactions that had been pending had not yet been completed. Hence, it would be necessary to revise Table 1 slightly. No changes were needed in the designation plan.

Miss Bulloch stated that she could support the proposed decisions but wished to make a point concerning the ad hoc limitation on the use of currencies of four members whose reserves were high in relation to their quotas. In the two years since that ad hoc procedure had been introduced, her chair had from time to time expressed reservations about it because the procedure seemed to be inconsistent with the principle that quotas should be the basic measure of members' rights and obligations in the Fund. When the Executive Board had discussed the procedure in February 1984, her chair had gone along with the consensus to continue with the ad hoc limits, but it was not happy with them.

Mr. Laske stated that, in previous discussions of the designation plan, he had made the same point raised by Miss Bulloch, and he joined her in expressing reservations about the procedure for establishing ad hoc limits on the use of currencies of members whose reserves were high in relation to their quotas.

The staff representative from the Treasurer's Department replied that the matter raised by Miss Bulloch and Mr. Laske would be reviewed by the staff in advance of future budgets.

The Executive Board then adopted the following decisions:

SDR Department - Designation Plan for June-August 1984

The Executive Board approves the designation plan for the quarterly period beginning June 20, 1984 as set out in EBS/84/122 (6/6/84).

Decision No. 7733-(84/96) S, adopted
June 20, 1984

Operational Budget for June-August 1984

The Executive Board approves the list of members considered sufficiently strong as set out in EBS/84/123, page 3, footnote 1, and the operational budget for the quarterly period beginning June 20, 1984, as set out in EBS/84/123 (6/6/84).

Decision No. 7734-(84/96), adopted
June 20, 1984

2. ECUADOR - 1983 ARTICLE IV CONSULTATION, AND REVIEW UNDER STAND-BY ARRANGEMENT

The Executive Directors considered the staff report for the 1983 Article IV consultation with Ecuador and a review under the stand-by arrangement (EBS/84/92, 4/25/84; Cor. 1, 5/23/84; and Sup. 1, 6/18/84). They also had before them a report on recent economic developments in Ecuador (SM/84/106, 5/11/84; and Cor. 1, 5/17/84).

The staff representative from the Western Hemisphere Department observed that, since the issuance of EBS/84/92, Supplement 1 (6/18/84), the staff had received additional information regarding the breakdown of $218 million in external payments arrears as of May 31, 1984. Approximately $155 million was in arrears with banks, while the remainder represented arrears with suppliers, which were basically nonbank institutions.

On interest rates, officials in Ecuador had changed the modality in which the interest rates on short-term credits (of 180 days or less) were applied, the staff representative continued. In the past, rates had been charged in advance; henceforth, they would be charged quarterly on maturity, which would seem to have the effect of eliminating, or, even perhaps more than offsetting, the reported increase in interest rates insofar as credits of 180 days or less were concerned. The changes did not affect the recently adopted increase in deposit rates.

The Deputy Director of the Exchange and Trade Relations Department added that, in one sense, the move was in the wrong direction, although it would not affect credits of longer maturities, for which the recently adopted 2 percentage point increase would continue to apply. The increase in interest rates was one of the elements on which the staff had wanted to focus during the review, and it recognized that a 2 percentage point increase in rates effected by an outgoing government was a remarkable achievement. From an institutional point of view, the announced changes in the modality in which interest rates on short-term credits were applied was helpful in the sense that they reduced the differential between deposit and lending rates. However, from the point of view of the program, the change was a move in the wrong direction.

Mr. Robalino made the following statement:

I would like to thank the staff for the clarity of the papers prepared for the Article IV consultation, as well as for the review under the stand-by arrangement. My authorities are in general agreement with the contents of the documents.

The year 1983 was the second consecutive year that real per capita income in Ecuador declined, and my authorities expect a further 2.3 percent decline in 1984. The floods, landslides, and washouts that occurred in the recent past have played an important role in the decline of economic activity, especially with regard to agricultural production. The international economic recession, high interest rates in the world's capital markets, weak external demand, reduced export prices, and a decline in the access of foreign financing are other factors responsible for the decline in domestic activity in Ecuador.

In the face of the anguish and tragedy being suffered by Ecuador as a result of the natural disasters mentioned before, my authorities decided to continue their efforts to attack the serious economic imbalances originated in factors beyond their control, and in the practice of an expansive domestic demand policy before 1983.

The stabilization program implemented by my authorities and supported by a stand-by arrangement approved by the Board on June 1, 1983 has been working well.

All the performance criteria, except arrears, were met by the end of December 1983, and according to my authorities, on May 31, 1984, the limits and targets detailed in EBS/84/92 (pp. 34, 35, 36, and 37) had also been met.

As I told this Board last November, my authorities, during 1983, followed a tight domestic policy which was responsible for the successful recovery of the balance of payments position.

As the Board will recall, the main objectives of the 1983 financial program were to limit the losses of net international reserves to $100 million, as well as to reduce the deficit in the current account of the balance of payments to 4 percent of GDP. One of the quantitative key elements of the program was to narrow the fiscal gap to 4.2 percent of GDP.

My authorities are satisfied that the overall results of the financial program in 1983 have been successful: the fiscal deficit declined to 0.3 percent of GDP from 6.8 percent of GDP in 1982, and the deficit in the current account of the balance of payments declined to 1.6 percent of GDP from 10.5 percent of GDP in 1982.

The fiscal gap was narrowed in 1983 because of measures taken on the revenue side, as well as on the expenditure side. New taxes, increases in existing tax rates, increases in rates charged by public utilities, and increases in prices of oil products were some of the measures taken in order to expand total revenues of the nonfinancial public sector. Most of those measures were taken at midyear, and my authorities believe the full impact will be felt during the current year.

In 1983, there was a turnaround in the deficit of the current account of the nonfinancial public sector. From a dissaving of 0.7 percent of GDP in the current account of the Central Government, the situation turned into a saving of 1.1 percent of GDP because of a tight wage policy for public servants. On the investment-expenditure side, the Government decided to postpone the implementation of such projects as new roads (Guayaquil-Salinas Highway), construction of two international airports, building of a petrochemical complex in Guayaquil, and some other investment projects. The amount involved in those projects was $200 million.

My authorities consider that the drastic reduction in the deficit of the current account of the balance of payments has also been remarkable. This feature is reflected in the reduction in losses of international reserves. I would like to remind this Board that the losses of net official international reserves were $295 million in 1981, $460 million in 1982, and $58 million in 1983. In this way, one of the objectives of the program--to maintain a stable level of reserves--was fulfilled. My authorities recognize that at the end of December arrears still amounted to $102 million, while in June 1983 they had amounted to $641 million.

A restrictive demand policy on every front--fiscal, monetary, and incomes--implemented in 1983 created the necessary conditions for a reduction in the deficit of the external sector. The adjustment process has rested mainly on the import side, but my authorities hope that the flexibility of the exchange rate policy--which will continue in the future--will bear fruit, allowing exports to benefit from increasing competitiveness in the international market.

The measures taken to correct the serious imbalance in the external sector produced a surplus of almost $1,000 million in the trade balance during 1983, which was used to pay more than $700 million of interest on the external debt. My authorities are very concerned about the increase in the U.S. prime rate by 1.5 percentage points in 1984. Each time the prime rate in the U.S. market increases by 1 percent, Ecuador's interest payments rise by $45 million a year. The increase of 1.5 percent in the prime rate will add a burden to Ecuador's external position, since there will be a need to pay an additional $67.5 million annually on external debt service. This additional amount is equivalent to 15 days of crude oil exports for Ecuador.

With respect to monetary policy, in the past, the money supply (M-1) was growing slower than the rate of inflation. Last year, M-1 increased by 30 percent, and inflation was 52.5 percent. Recent data for this year point to the same direction, since M-1 grew by 27 percent (May 1984/May 1983) while during the same period the increase in domestic prices was 36.9 percent. The Central Bank's credit policy has been tight since the financial program supported by the Fund was launched and the ceilings set for net credit to the nonfinancial public sector, and net domestic assets of the Central Bank, were met at the end of 1983.

In the area of exchange rate policy, my authorities have continued with the crawling peg system adopted last year. As of yesterday, the free-market exchange rate (selling rate) was S/. 89.30 per $1, and the official rate was S/. 63.90 (selling rate), bringing the spread between the two markets to S/. 25.40 per $1. In June 1983 the average spread was S/. 43.92 per $1. The technique of transferring additional transactions from the official to the free market as a means of accelerating the pace of the unification of the two markets was again adopted at the end of February 1984. My authorities have also been taking additional measures to dismantle import and exchange restrictions.

Ecuador has shown additional flexibility with regard to interest rates. Recently it was decided to increase interest rates by 2 percentage points. Since inflation has been declining in 1984, the *negative real rate of interest has narrowed drastically in the* following way:

	December 1983	June 1984
Annual rate of interest for loans	19 percent	21 percent
Annual rate of interest for savings accounts	16 percent	18 percent
Annual rate of interest for time deposits (180 days)	17 percent	19 percent
Rate of inflation during past 12 months	53 percent	37 percent (May 1984)
Expected rate of inflation by August 1984		23 percent

At this time, my authorities could not authorize a higher increase in the rate of interest because of the weak financial situation of the savings and loan associations, which lend at 10 or 15 years' maturity. Ecuadoran law does not allow these institutions to change the rates on prior loans and, therefore, their portfolio is composed of various loans at different rates of interest, depending on when the loan was made. Because of this, these institutions are facing a very serious problem, since they are forced to pay higher interest rates on savings than the average rates charged to their customers. Each increase of 1 percent in the interest rate means S/. 25 million of losses to those institutions.

Financial savings, without considering M-1, grew in 1983 at a rate of 38 percent, indicating that savings accounts, time deposits, mortgage and development bonds, and other forms of savings have been increasing strongly.

As was mentioned during our last discussion, inflation has been decreasing as a result of two factors: the implementation of a tight demand policy, and the normalization of weather conditions. There has been a drastic deceleration in the rate of inflation, as shown in the following table:

Rate of Inflation
(Percentage change)

	Month	Total Annual	Foodstuffs Annual
1983	September	63.4	110.1
	October	61.1	110.0
	November	55.6	96.1
	December	52.5	86.1
1984	January	49.7	76.2
	February	48.8	72.8
	March	48.0	70.7
	April	44.7	61.6
	May	36.9	49.8

At this time, my authorities hold the point of view that the expected rate of inflation for the 12 months ending next August will be 23 percent. This expectation is based on the continuation of a tight domestic policy and a drastic increase in agricultural production for domestic consumption, thereby narrowing further the negative spread between nominal interest rates and inflation.

Incomes policy has been managed in a prudent way. Because of social pressures, my authorities increased basic minimum wages on July 1, 1983 for both the private and the public sectors. The increase was on average 22 percent for workers in both sectors, well below the rate of inflation.

Real wages were depressed in 1983, a development consistent with the tight fiscal and monetary policies pursued by my authorities. In the current year, incomes policy has followed the same path. Today the basic minimum wages for urban workers, household employees, rural workers, and artisans are higher by 17 percent than those prevailing at the end of last year, resulting in a further reduction of earnings for workers.

The present stand-by arrangement will end next July 24, and I hope that my colleagues can give their support to the proposed decisions.

Mr. Senior said that he was gratified to note that the necessary assurances had been received from foreign banks regarding the financial package required to facilitate the continuation of the current stabilization effort. He was in general agreement with the staff appraisal, which showed that substantial progress had been made toward correcting the main imbalances in the economy of Ecuador in 1982. On the domestic front, the substantial improvement in the finances of the public sector had been a most favorable development: the public sector deficit had been reduced by more than 6 percentage points of GDP, far more than the reduction originally targeted. Such strong fiscal adjustment had been the result of a firm implementation of a wide variety of revenue measures and adherence to a tight expenditure policy across all public sector entities.

On the external side, Mr. Senior continued, the position of the balance of payments had also improved significantly, with the current account deficit declining from 10.5 percent of GDP in 1982 to 1.6 percent of GDP in 1983, again well below the figure originally envisaged. That improvement had been due mostly to a drastic reduction in imports, although a slight increase in exports had also been observed. The substantial reduction in the current account deficit, however, had been partly offset by less favorable developments in the capital account, as capital flight and lower than expected flows of short-term credits had resulted in reduced net capital inflows and a loss of international reserves, albeit at a lower level than originally envisaged.

Although Ecuador had been able to meet most of the quantitative performance criteria--in some cases by a wide margin--its economic performance had to be judged in the light of the adverse effects that weather conditions had had on production and prices, Mr. Senior said. Real GDP had declined by more than 3 percentage points, while the inflation rate had accelerated to 53 percent. That weak performance had been the result mainly of a reduction in agricultural production, which itself had given rise to a substantial increase in prices.

For the remainder of the program period and for 1984 as a whole, it would not be unrealistic to expect that a continuation of the adjustment effort should bring about a modest rate of real growth in GDP and a significant reduction in the inflation rate, Mr. Senior remarked. The most recent information contained in the supplement to EBS/84/92 augured well in that respect. Since the latest trends in agricultural production pointed to a more favorable evolution in 1984 than in 1983, it was reasonable to expect a major contribution by agriculture to real growth and some easing of inflationary pressures along the lines that had been demonstrated by the behavior of food prices during the first five months of 1984.

On fiscal policy, Mr. Senior considered that the objective of equilibrium in the public sector finances was feasible, given the projected increase in revenues likely to result from the wide range of measures introduced in 1983. The authorities' efforts should be further helped by the expected increase in economic activity and the continuation of strict control and appropriate distribution of public expenditure. In that regard, the projected increase in public capital expenditures was particularly welcome. The prudent stance of fiscal policy was being properly accompanied, moreover, by a restrictive credit policy under which containment of the growth of central bank credit to the public sector should allow for a moderate growth in credit to the private sector.

He welcomed the adjustments made in 1982 and 1983 to increase interest rates and simplify their structure, Mr. Senior said. In particular, he welcomed the most recent decision to increase credit and deposit rates by a further 2 percentage points to 21 percent and 18 percent, respectively. Those adjustments did not appear sufficient to increase interest rates to positive levels in real terms; however, he had taken note of the strong growth in financial savings in 1983 and the projected growth in 1984. As pointed out by the staff, the banking system's liabilities to the private sector had increased by more than 30 percent in 1983--compared with an original projection of 33 percent--and were expected to increase by a further 30 percent in 1984. Such strong performance would seem to suggest that, while interest rates might still be negative in real terms, the reduction in the spread between nominal and real rates had represented an important incentive to domestic savings growth. Even taking account of the legal constraints that limited the implementation of more substantial increases in interest rates at present, it seemed that the adjustments already made showed at least a definite move toward the restoration of confidence.

He joined the staff in welcoming the significant steps already taken to restore competitiveness, Mr. Senior commented: the rate of depreciation contemplated for 1984 seemed consistent with the expected inflation rate, and important steps had been taken to unify the exchange markets. However, he was not certain that a prompt unification would in the final analysis be the most appropriate policy choice to follow. As had been pointed out many times by his chair in the past--most recently in the discussion on experience with multiple exchange rate regimes--there was no conclusive evidence to support the idea that a multiple exchange rate regime was a second-best alternative; indeed, it had been indicated that there might be circumstances justifying the temporary existence of a multiple exchange rate system as a first option. Such might be the case for some oil-exporting countries like Ecuador. Owing to the weight that oil exports had in total exports, an exchange market for oil exports could be compatible with a different market for all other transactions, given the greater need to maintain or increase the competitiveness of non-oil exports relative to the oil sector. Staff comment on that point would be welcome.

Mr. Delgadillo noted that, since 1981, Ecuador had been deeply affected by the world economic recession, high interest rates, the drop in international oil prices, the restrictive measures against its exports, and a deterioration in its terms of trade. Those factors, combined with expansionary demand management policies pursued in previous years, had led to a significant increase in the current account deficit. More recently, in spite of major natural disasters and adverse external conditions, the fiscal and balance of payments situations had registered strong improvement.

Severe flooding in the coastal plains had adversely affected agricultural production and exports, thus contributing to a higher than expected rate of inflation and a lower rate of economic growth, Mr. Delgadillo continued. In the fiscal area, however, the overall public sector deficit had declined from 7 percent of GDP in 1982 to 0.3 percent of GDP in 1983 as a result of faster revenue growth and a slower rate of increase in expenditures than originally envisaged. Wage and salary increases in particular had been kept below the rise in the consumer price index, and curbs had been placed on the payment of overtime to public sector employees. In addition, revenues had increased from 25 percent of GDP in 1982 to almost 28 percent in 1983, while expenditures had declined from 32 percent to 28 percent of GDP over the same period. He could support the intention of the authorities to implement a prudent fiscal policy in 1984 to achieve overall equilibrium in the accounts of the public sector.

On the external side, Mr. Delgadillo noted that the current account deficit had declined from 10.5 percent of GDP in 1982 to 1.6 percent of GDP in 1983, although that performance had been partly offset by smaller net capital inflows, which reflected capital flight and a decline in short-term credits. As observed by the staff, the authorities had made a strong effort to reduce payments arrears; indeed, in 1983, Ecuador had paid off a larger amount of arrears than originally targeted, and he supported the continuing efforts of the authorities to resolve the arrears problem. He could also support the continuation of a policy initiated in 1983 to strengthen competitiveness through the pursuit of a more realistic exchange rate policy. In February 1984, the Ecuadoran authorities had lifted the ban on a long list of imports that had been prohibited since late 1982.

The authorities appeared to be fully committed to returning to the lower inflation rates of the past, Mr. Delgadillo said. Their objective should be facilitated by Ecuador's long tradition of low inflation, which provided the sort of context that would encourage the perception of current rates of inflation as only a transitory phenomenon. In that sense, continued prudence in fiscal management was essential. In sum, Ecuador had made a great effort to adjust its economy, and the results achieved thus far had been remarkable; hence, he could support the proposed decisions.

Mr. Coumbis said that he too could support the staff appraisal and proposed decisions. In 1983, Ecuador had made considerable progress in a number of areas, despite severe floods and unforeseen falls in capital inflows. The determination of the authorities to implement the program in 1983 had resulted in a strong improvement in the fiscal and balance of payments positions. Interest rates had been increased significantly, although they remained negative in real terms; the spread between the official and the free-market exchange rate had been reduced, and serious efforts had been made to cut import restrictions. Finally, external payments arrears were expected to be eliminated as soon as a financial package with a group of foreign banks was completed.

He agreed with the staff that, in 1984, the authorities should continue working toward a complete unification of the exchange rate in the free and official markets, elimination of the remaining external payments arrears and import restrictions, and further adjustment of interest rates so as to make them positive in real terms, Mr. Coumbis said. The authorities had indicated that they were determined to continue the adjustment process in 1984 with a view to further strengthening the balance of payments and that their efforts would likely result in a significant deceleration of inflation together with a small increase in real GDP. There was little doubt about the determination of the authorities to implement the policies described in their letter to the Managing Director; their success in 1983 had demonstrated their ability and commitment to restore external and internal equilibrium in the economy.

Still, Mr. Coumbis remarked, there were areas of concern. The authorities expected that, in 1984, the rate of price increase would drop to 25 percent, from 53 percent in 1983; at the same time, they expected a small increase in real GDP. It was important for Ecuador to bring inflation down to avoid jeopardizing the stabilization program. The achievement of that objective would depend on the ability of the authorities to continue the implementation of prudent wage policies and to keep the growth of public expenditure under strict control. On both fronts, however, they would face serious difficulties. Real wages had fallen by 7 percent in 1981, by 9 percent in 1982, and by more than 10 percent in 1983; hence, there would be strong pressure to increase real wages in 1984. Moreover, the authorities' objective to increase real GDP in 1984 would require, in his view, a substantial increase in public sector investment, since it was not likely that private investment in 1984 would recover. Unfortunately, a substantial increase in public investment could undermine the efforts of the authorities to control inflation.

Another area requiring careful examination was the medium-term outlook for Ecuador's external debt situation, Mr. Coumbis commented. According to the staff's projections, the debt service ratio would average 66 percent of exports of goods and services during the next six years, and the ratio of interest payments to exports of goods and services would average 20 percent, which implied a significant transfer of real resources abroad. The mediumterm balance of payments projections showed that Ecuador would need to reschedule the payments falling due over the next several years. In the circumstances, it seemed that Ecuador would have to increase exports as much as possible; had the authorities made any concrete plans for increasing exports? Was Ecuador planning to negotiate with its creditors a rescheduling of its debt for the coming years? Finally, would the interest rate changes announced by the staff at the beginning of the meeting affect the profitability of Ecuador's banks?

Mr. Polak recalled that he had objected to the incomplete character of the previous review (EBM/83/161, 11/23/83), because it had done nothing to determine policies for the future, even though at the time the staff had not been satisfied with the level of interest rates, the spread between the two exchange rates, or the lack of progress toward removing import restrictions. At that meeting, it had been suggested that the Ecuadoran case should be discussed again within a month or so, but it had taken a good deal longer. However, the fiscal adjustment in particular and the current account improvement had been much better than originally expected, and combined with some progress in the three areas mentioned above, had led to a more positive staff appraisal and a proposed decision that he could support.

He had the impression that, in many areas, the authorities were guided by a strong aversion to price adjustments, an impression that had been confirmed by the supplemental information provided by the staff at the beginning of the meeting, Mr. Polak continued. In contrast to their reluctance to change prices, the authorities had moved forward quickly with strong fiscal adjustment, which had as a result been somewhat lopsided and was unlikely to be sustainable. He considered it essential that improved demand management should be complemented by more progress toward structural adjustment.

It seemed odd that the significant decline in the public sector deficit from 7 percent of GDP in 1982 to a small fraction of a percentage point in 1983 had apparently in no way contributed to the unexpected decline in real GDP, which the staff had explained as the result of bad weather, Mr. Polak said. He hoped that he was correct in assuming that the impact of that fiscal adjustment had been almost entirely on the balance of payments and not on GDP. Still the better than expected current account performance had gone hand in hand with larger than expected private capital outflows, which had made it impossible to meet the net official reserve targets while eliminating arrears. It seemed that incentives to retain financial savings in the country were not sufficient and, in that regard, he had not been impressed either by the 2 percentage point increase in interest rates or by the argument that the need to wait for legal changes had prevented the country from doing anything else.

The inadequacy of interest rates and of efforts to keep capital in the country deserved more attention in the staff paper, Mr. Polak considered. The unexpected net capital outflow in 1983 had exceeded $300 million, against a programmed capital inflow of about $50 million. The outflow was equivalent to twice the amount in the entire stand-by arrangement with the Fund, and it had been due in part to capital flight, and in part to the fact that trade credits had not been as large as had been hoped. It should be realized that trade credits were also affected by the low interest rate in Ecuador in comparison with rates abroad. It was not clear why the measures currently being contemplated would permit a general move toward positive real interest rates. Even if banks or savings institutions were allowed to offer variable-rate mortgages, they would still be "stuck" with their present fixed-rate mortgages. Existing banks could surely not offer much higher interest rates without affecting their profit-and-loss statements; perhaps newly organized banks might be able to do so, but the result would be a withdrawal of deposits from older institutions. There was no question that the Government faced a dilemma, and the authorities had attempted to resolve it by protecting the balance sheets of the savings institutions while accepting a terrific beating on the capital account of the balance of payments. A much more balanced solution should be found whereby the capital acount was given priority and the profitability of the savings institutions was not axiomatically protected.

On another point of structural adjustment, Mr. Polak noted that the gasoline price in sucres had been kept constant, which meant that the real price--or the price in dollars--had rapidly declined. At some stage, the real price would have to be increased; at present what seemed to be lacking was a mechanism whereby petroleum product prices were automatically increased in small steps as inflation proceeded or as the exchange rate depreciated.

Also to be answered was the question of the adequacy of the present rate of depreciation of the official exchange rate, Mr. Polak commented. Of course, if there were to be massive transfers of transactions to the free market, the point would be moot; however, since only 50 percent of nonpetroleum exports were currently at the free market rate, the question remained important. If his calculations were correct, the daily adjustment in the rate by 0.05 sucre per U.S. dollar would, over one year, only halve the present difference between the official and the free market rates. In passing, he noted that the authorities' early expectation of continued strong appreciation of the free rate had not materialized; hence, the exchange rate remained an issue that warranted close attention in the next program. He was not so much insisting on immediate official unification of the rate as on progress toward de facto unification. In that regard, he could endorse the idea of a follow-on program with the Fund, contingent on the definitive elimination of the remaining arrears and of import restrictions.

On the medium-term scenario for Ecuador, Mr. Polak observed that the authorities would face enormous debt service obligations for many years to come, and continuing rescheduling operations would thus need to be arranged. At the same time, assuming the calculations in the scenario were realistic, Ecuador did not appear to need any new money from private sources to finance an ongoing current account deficit. In the circumstances, and assuming good policy performance with regard to exchange and interest rates, Ecuador seemed to be a clear case for a multiyear rescheduling exercise.

Mr. Grosche recalled that, in 1983, the authorities in Ecuador had undertaken a substantial and rather successful effort to improve the fiscal and balance of payments positions. Progress had been made in various areas, as described in the staff papers, which however gave no indication of comprehensive policy measures to be taken in 1984 that would consolidate the progress achieved in 1983 and improve the situation where little progress had been achieved thus far. He had also found nothing in the reports on structural deficiencies or measures to attack them; for example, nothing had been said about developments in the agricultural sector or about unemployment.

Like Mr. Polak, he was concerned about the reluctance of the authorities in Ecuador to adjust relative prices, Mr. Grosche continued. Of course, the elections in January and May 1984, and the change in government that would take place later in August, had made life more difficult for policymakers; nonetheless, given the medium-term external debt projections, there was no room for delaying comprehensive and decisive policy actions. He had four main concerns in that regard. First, it had taken about four months to conclude the negotiations of the program for 1984, and the Board was in the curious situation at present of discussing the remainder of a program that was about to expire. At the same time, he had missed any clear assessment by the staff of whether policies were adequate to meet the 1984 objectives, although he had noted from the supplementary paper and from Mr. Robalino's statement that price increases were continuing to decelerate and that performance criteria, except for arrears, had been met as of end-May 1984.

Second, on fiscal policy, the staff had stressed in its appraisal the importance of keeping expenditure under control to achieve the objective of overall equilibrium in the public sector, Mr. Grosche recalled. The authorities were aiming at a small real increase in current expenditures and a substantial increase in capital expenditures, and he wondered whether those objectives were reconcilable. Third, there seemed to be general agreement that incomes policy would play a crucial role in achieving the expected substantial deceleration in inflation. However, it remained uncertain which kind of wage policy was likely to be followed for the remainder of 1984. Finally, on monetary policy, interest rates in Ecuador were still quite negative, despite recent increases. He understood that positive real interest rates would be established as soon as the proposed legal changes were approved; however, no mention had been made about when that might happen.

Despite his concerns, Mr. Grosche said, he could support the proposed decisions. The authorities' record in implementing the first part of the current arrangement deserved commendation, and they should be given an opportunity to continue their efforts with a view to achieving the structural adjustments that were clearly needed. He would be grateful if, during the next consultation, the staff could pay more attention to structural problems--perhaps in consultation with the World Bank--particularly those concerning unemployment, excessive migration from rural to urban areas, and the possible neglect of the agricultural sector.

Ms. Bush agreed with Mr. Grosche that the Board had been placed in a somewhat unusual position by being asked to approve performance criteria for a program that would end in about five weeks. The awkwardness of the timing raised questions about the prospects for a new program later in the year, since the overall financing package for 1984 depended on a new Fund program that would encourage the commercial banks to provide net new financing. She would appreciate hearing some assessment from the staff or Mr. Robalino on the prospects for a new program. In addition, she urged the authorities to take measures to regularize arrears.

Ecuador's performance record in the fiscal and balance of payments areas in 1983 had been good, although real growth and inflation had not been in line with targets, Ms. Bush continued. She was also rather concerned about the medium-term balance of payments and debt outlook and about the adequacy of exchange rate and interest rate policies. For 1984, the staff foresaw a modest recovery, with slightly positive real growth but with a rate of inflation of about 25 percent, still unacceptably high. She had noted that, in the final quarter of 1983 and early in 1984, the rise in the consumer price index had apparently decelerated, which suggested that Ecuador might be able to do better on the inflation front than had been forecast by the staff.

The reduction in the ratio of the current account deficit to GDP from 10.5 percent in 1982 to 1.6 percent in 1983 had been remarkable, Ms. Bush considered. However, much of the improvement had been due to a strong compression of imports, which raised questions about whether debt improvement could be sustained. Of course, there had been major reductions in some categories of imports--for example, consumer durables and transport equipment--that might not be essential to a recovery of economic growth. Staff comment on that matter would be welcome.

On the fiscal side, progress in 1983 had been impressive, with the public sector deficit falling from 6.8 percent of GDP in 1982 to only 0.3 percent in 1983, well below the 4.2 percent target, Ms. Bush commented. It was encouraging that the reduced deficit had come about not simply from an increase in the tax burden or from a sharp cutback in public investment but also from a rather general constraint on expenditure. As for monetary policy, the pattern of lower than expected credit to the public sector and higher than expected credit to the private sector was somewhat unusual and, generally, to be welcomed. However, she questioned the impact on private credit of the assumption by the Central Bank of foreign debt of the private sector. She would welcome a brief explanation by the staff of the nature of those arrangements and an indication of whether similar developments could be expected in 1984. She was concerned about the potential monetary and fiscal impact of the arrangements and about the need to restore and maintain the access of the private sector to foreign credit in future.

Some steps to increase interest rates had been taken by the authorities, Ms. Bush noted. However, she strongly urged them to formulate and adhere to a policy that would ensure positive real interest rates for deposits and lending so as to improve the efficiency of domestic resource allocation and avoid continued capital flight of the sort that had occurred in 1983 and earlier.

The projections for Ecuador's foreign debt situation over the medium term were worrying, Ms. Bush remarked. Although the ratio of debt service to exports of goods and services had been reduced through rescheduling from more than 100 percent in 1982 and 1983, the ratio was expected to average 66-67 percent for the period 1985-90, which raised questions about the sustainability of the medium-term balance of payments position. In that regard, the 7 percent annual growth in exports assumed for the medium-term scenario in Table 8 of the staff report did not seem sufficiently ambitious and posed a related question about the adequacy of exchange rate policy, a matter that her chair had raised during the previous discussion on Ecuador. She would be interested in hearing whether the staff felt that the present exchange rate and policy were adequate contributors to Ecuador's international competitiveness. Evidence from the pattern of nontraditional exports--excluding petroleum and traditional agricultural exports--was not particularly encouraging on that score; also, the persistent outflow of short-term capital, including errors and omissions, raised questions about both the exchange rate and the adverse effects of negative real interest rates.

On the restrictive trade system, Ms. Bush said, she was pleased that the import deposit scheme had been eliminated at the beginning of the year, although she remained disappointed that more progress had not been made in eliminating trade restrictions. The February 1984 lifting of the prohibition on imports, covering 75 percent of the items formerly on the list, was a positive step; however, the commitment to the Fund was to eliminate all import restrictions by the end of the program period. Evidently the definition of "all restrictions" as contained in the commitment to the Fund was meant to refer only to the prohibited import list, where it appeared that 25 percent of the items were still prohibited. That definition was in her view somewhat misleading, since there also remained on the books a minimum financing requirement or alternative barter trade provision, as well as two bilateral agreements. She wondered whether the authorities planned to remove the remaining prohibited items from the list and suggested that the other trade restrictions deserved attention in any new stand-by arrangement. In sum, Ecuador had made good progress in some areas, although the timing of the present exercise and some elements of the program left room for improvement. She could support the decision, since the authorities had continued to pursue their adjustment efforts during the long negotiating period; however, she hoped that the authorities would reinforce their efforts before Ecuador's case again appeared on the agenda of the Board.

Mr. Suraisry stated that he was in general agreement with the staff analysis and conclusions and could therefore support the proposed decisions. During 1983, the fiscal and balance of payments position of Ecuador had improved markedly, mainly because of the authorities' strong adjustment effort. The public sector, current account, and overall balance of payments deficits had all been significantly below the program targets. Despite those achievements, however, Ecuador's external financial position was likely to be under pressure over the medium term, and it was therefore important for the authorities to persist in their adjustment efforts in order to achieve balance of payments sustainability in a growth-oriented context. The program for the remainder of the stand-by arrangement was strong, and he could support it; in particular, he welcomed the continued emphasis on fiscal restraint. The public sector was projected to show a small overall surplus in 1984, which should contribute to an easing of inflationary pressures. Also to be welcomed was the projected rise in the share of investment expenditure in total public sector expenditures. Part of Ecuador's infrastructure had been damaged by floods in 1983, and the Central Government would be concentrating on rebuilding that infrastructure in order to pave the way for economic growth.

The monetary program for 1984 appeared appropriate in the light of the targets for inflation, growth, and the balance of payments, Mr. Suraisry continued. The targeted increase in net foreign reserves was particularly important, since reserves had declined substantially over the past three years. It was encouraging to learn that the authorities had been successful in implementing the monetary program thus far in 1984. Also encouraging was the indication that they had followed a prudent wage policy throughout the program period. In view of the expected deceleration in the rate of inflation and the wage increases already granted at the beginning of 1984, caution should be exercised in granting further wage increases during the year. Inflation, despite the recent deceleration, remained too high; it was important that the anti-inflationary effort not be disrupted.

In the external sector, the authorities had taken commendable steps in late February 1984 toward unifying the exchange markets and reducing import restrictions, Mr. Suraisry said. Those steps should help increase economic efficiency and improve resource allocation, and he welcomed the the authorities' intention to make further progress in those areas. The elimination of external arrears was a key condition for the normalization of Ecuador's relations with its creditors and, hence, for the success of the adjustment effort. He could therefore support the provision in the stand-by arrangement regarding the elimination of all external arrears. The indication that the necessary financing for the program had been secured was welcome; however, he would appreciate elaboration by the staff on the reasons for the delays that had been encountered in attaining that financing. In conclusion, while Ecuador had made substantial progress in implementing the program under the stand-by arrangement, difficult problems remained, and adjustment would have to continue for some time. Ecuador might require a follow-on program with the Fund once the present program expired, and successful completion of the current arrangement was therefore essential.

Mr. Ismael stated that he had no difficulty in supporting the proposed decisions and was satisfied with the performance under the stand-by arrangement. The economy had recovered from the severe floods in 1983, and good progress had been made toward structural adjustment; hence, he could limit his remarks to a few points on the prospects for 1984.

First, Mr. Ismael said, the intention to unify the foreign exchange markets beginning in February 1984 was a welcome development, because unification would reduce the distorting effects of the current arrangement. The recent narrowing of the spread between the two markets was a hopeful sign that the situation was returning to normal, although there remained some way to go, judging from the charts on page 26a of the staff report. He encouraged the authorities to continue with their transfers of transactions to the free exchange market and hoped that they would carry through on their expressed intention to hasten unification.

Second, he encouraged the authorities to maintain external competitiveness, Mr. Ismael remarked. The gains from the devaluation in 1983 should be sustained through supply-side measures as well as prudent demand management policies. It was important that domestic inflation should be brought under control; inflation in 1983 had been adversely affected by the severe flooding, as had the effort to liberalize prices, but those once-and-for-all effects should subside. More positive factors, such as the removal of price controls and subsidies, should encourage a return to normal market conditions; in the circumstances, it was the developments leading to upward price pressures that should concern Directors. The recent wage and salary increases in the public sector were worrying, especially as they were likely to lead to demands for increases in wages in the private sector, which would no doubt be difficult to resist. Fortunately, Ecuador did not have to contend with wage indexation; still, the authorities should try to resist any demand for wage increases in 1984 to avoid feeding inflationary expectations.

Third, the authorities should be encouraged to move domestic interest rates further upward to positive levels with a view to encouraging savings and improving the efficiency of resource allocation, Mr. Ismael commented. The ratio of national savings to GDP--approximately 1:7--was relatively low, and it was important that domestic savings should be raised, in view of Ecuador's substantial external debt. Resort to external savings, unless they were obtained on concessional terms, was not the appropriate course to take for the time being. Indeed, the external debt situation in Ecuador was becoming worrisome. The magnitude of the ratio of debt to GDP, as well as the large resources required to service that debt in the medium term, left the authorities with little room for maneuver. The ratio of debt to GDP would average about 2:3 over the next few years, and debt servicing would be somewhat higher toward the end of the decade, according to the staff report. However, judging from recent developments in interest rates, even those figures might be on the optimistic side. The call by the staff for restraint in the public sector's use of foreign commercial bank credits was, in the interest of a lasting solution to the debt problem, indeed well taken. However, it should also be noted that a fall in international interest rates and more rapid world economic growth would help Ecuador to resolve its debt problems in a far more fundamental way.

Mr. Shaw joined others in commending the achievement of Ecuador in 1983, particularly in controlling government finances and reducing the current account deficit. However, in light of the projected increase in the debt service ratio, there would be a need for additional reschedulings over the next few years, and the authorities would have to work hard in 1984 to further consolidate the progress achieved on the fiscal front. They would also have to redouble their efforts to strengthen some areas of the adjustment program where implementation of policies had not been as strong as had been hoped. In particular, interest rates would have to be increased to positive figures in real terms, and the authorities should repay the outstanding external arrears, remove the remaining import restrictions, accelerate the transfer of transactions to the free exchange market, and unify the dual exchange rates as quickly as possible.

On the fiscal side, public finances had been strengthened considerably in 1983, and he was optimistic that the objective of achieving a balanced budget in 1984 could be met, Mr. Shaw continued. Government revenue should increase as the economy stopped contracting and as the measures already introduced began to take effect. On the expenditure side, the authorities seemed to have outlays under relatively firm control, and the emergency transfers of 1983 relating to the floods should not be required again in 1984. He encouraged the authorities to keep salary increases below the rise in inflation, and he agreed with the staff and other Directors that a further adjustment in public sector wages--beyond the increase granted at the beginning of 1984--should be avoided in order to help contain government expenditures and ensure that the target for cutting inflation could be met.

Commenting on monetary policy, Mr. Shaw expressed concern about the current stance, which kept interest rates substantially negative in real terms. Despite the recent increase in credit and deposit rates to 21 percent and 18 percent, respectively, interest rates were still inappropriate, given the year-on-year inflation rate in May of 36.9 percent and the projected average rate of inflation for 1984 of 28 percent. He was also concerned about the staff's opening announcement on the short-term rates. Higher interest rates were required in order to attract domestic savings into the financial system and, as others had indicated, to discourage the continuing outflow of capital from the economy. He welcomed the intention of the authorities to increase interest rates further as soon as legislation had been passed permitting savings and loan associations to charge adjustable interest rates on future loans.

On the external side, Mr. Shaw urged the authorities to consider accelerating the rate of the depreciation of the sucre in the official market with a view to closing the still large gap between the offical and the free-market rates, and to make further transfers of transactions to the free market. Those measures should encourage non-oil exports, providing both export revenues and the needed diversification away from oil exports. In that regard, he had noted from Table 42 on page 112 of SM/84/106 that non-oil exports had declined in three of the past four years, and, in 1983, had been 37 percent below the 1979 level. He had also noted that the medium-term scenario in the staff report assumed a 10 percent annual increase in 1985-90 in non-oil exports. That would seem to represent a dramatic turnaround, unless significant corrections were made. Hence, unification of the exchange rate would, in fact, increase government revenues in sucres through its effect on petroleum exports and other trade taxes and would help to restrain imports as import restrictions were removed. Another worrying factor on the external side was the dramatic increase in arrears.

As mentioned by Mr. Polak, several Directors--including his chair--had had strong reservations in November 1983 about the method by which the performance criteria would be established for the second half of Ecuador's program, Mr. Shaw recalled. Those criteria were to have been established before the end of 1983 but, in the event, had not. The setting of targets and ceilings at such a late date in the program had substantially lessened its usefulness as a guide to the authorities in establishing appropriate policies for the balance of the stand-by period. Nonetheless, he could support the proposed decisions and hoped that the new President would follow through on his stated intention to negotiate a follow-on program with the Fund and to allow market forces to determine the exchange rate and interest rates in the economy.

Mr. Alhaimus agreed with others that Ecuador had made notable progress over the past year in the fiscal and external areas. Still, some setbacks had been experienced, as real GDP had declined by about 3 percent, the rate of inflation had more than doubled, and external payments arrears had persisted. Certainly, better performance would have been possible but for the serious weather conditions and floods that the country had suffered in 1983.

The achievements on the fiscal front in 1983 had been particularly encouraging, as the overall public sector deficit had been sharply curtailed well below the program target as a result of tight control over expenditures, particularly in central government outlays, Mr. Alhaimus continued. Revenues had also improved, although mainly because of a large increase in petroleum and other nontax revenues. It was encouraging to note that the authorities were determined to continue implementing prudent fiscal policies in 1984 with the objective of achieving overall equilibrium in the accounts of the public sector. That objective might seem moderate, given that the deficit had already been reduced to 0.3 percent of GDP; however, it would be appropriate in present circumstances to consolidate the sharp gains achieved in the previous year.

On the external side, progress had also been made in 1983, as the current account deficit had been reduced from 10.5 percent of GDP to 1.6 percent, Mr. Alhaimus commented. It was interesting to note that that improvement had been made possible not only by the large cut in imports but also by a 39 percent increase in the volume of crude petroleum exports, mainly due to the coming on stream of new oil wells in the northwestern region. The sharp increase in export volume had averted a significant reduction in the value of exports, which would have been inevitable following the deceleration in unit prices.

The staff had rightly stressed the importance of a strong export effort by the authorities, in light of the medium-term outlook for Ecuador's external debt, Mr. Alhaimus remarked. They had already encountered serious difficulties in meeting Ecuador's commitment to eliminate arrears, despite the improvements in the current account achieved in 1983. For the future, the staff was projecting a large average debt service ratio of 66 percent over the next six years, which implied a need for a considerable rescheduling exercise. In his opening statement, Mr. Robalino had already quantified the further burdens of rising interest rates on Ecuador's external debt service, but the authorities might have to face various policy issues in trying to create the conditions most conducive to producing an adequate export performance. One fundamental issue was how to continue cautious demand management policies while paying due regard to the need for expanding the productive base of the economy. Without effective structural adjustment measures, it was difficult to envisage sustainable gains in the external sector for the medium and longer terms.

Mr. Zhang observed that the economic difficulties that had beset the Ecuadoran economy since 1980 had been caused by continuing adverse external developments and, more recently, by a series of natural calamities, all of which had been beyond the control of the authorities. Nonetheless, the difficulties had also been related to the expansionary demand management policies that the authorities had adopted in an effort to counter the slowdown of domestic economic activities. As a result, the external deficit had increased drastically, reaching 10.5 percent of GDP in 1982, and adjustment had become inevitable; hence, a one-year stand-by arrangement had been agreed with the Fund in July 1983. Under the program, the authorities had undertaken restrictive demand management policies in the fiscal, monetary, and incomes fields. The successful implementation of the program during the second half of 1983 had been remarkable: all quantitative performance criteria--excepting arrears--had been met or exceeded by December 1983, and the authorities had been able to make three purchases under the arrangement. Moreover, the various targets and limits set for the financial variables for the program period in 1984 had also been met on May 31, 1984; and the authorities were planning to eliminate all arrears before the end of the program period. In the circumstances, he could fully support the draft decision allowing the authorities to make the last of the purchases under the program.

The drastic reduction in the current account deficit had been due mainly to a compression of imports, and the staff was therefore looking in the medium term toward an expansion of exports to ensure a viable balance of payments, Mr. Zhang noted. The staff felt that an improvement in exports could be realized because of the increase competitiveness resulting from the present flexible exchange rate policy; however, the medium-term scenario suggested that, in contrast to a projected 17 percent increase in imports, oil exports--amounting to more than 70 percent of total exports in 1983--were projected to increase by only 4 percent, while non-oil exports would increase by 10 percent. It followed that there would a widening in the projected trade deficit, from $820 million in 1984 to $1,160 million in 1990. He would appreciate some explanation of that apparent contradiction as well as of how the devaluation would fundamentally change the prospects for Ecuador's exports. It should also be noted that the sharp drop in imports in 1983 had been possible only because of a drastic cutback in domestic investment, which had declined by more than one third between 1982 and 1983. Given current world demand, he wondered what would happen to the balance of trade in 1984 and 1985 if there were a recovery in domestic investment. Was it truly a matter of urgency that all import restrictions--including the multiple exchange rate regime--should be removed by the end of the program period or soon thereafter?

Second, it was discouraging to read from the staff report that the economy of Ecuador would be able to achieve only a 2 percent annual real rate of growth for the remainder of the decade, even after successful implementation of the present adjustment program, Mr. Zhang said. Since the present annual rate of growth of the population was 2.8 percent, the result would be a continuous decrease in real per capita income.

Third, on interest rate policy, Mr. Zhang remarked that the authorities had shown considerable flexibility in responding to the advice of the staff. Recently, for example, the interest rate had been further raised by 2 percentage points; in spite of that increase, the real rate of interest remained negative, and the staff had urged the authorities to take stronger action. He agreed with Mr. Robalino that a further increase in interest rates at present could create serious problems for savings and loan institutions in Ecuador. Finally, on a related matter, he wondered whether the decline in the ratio of gross national savings to GDP since 1980 had been caused mainly by the negative real rate of interest or whether increased debt service payments abroad during the period had been a contributing factor.

Mr. Clark joined other speakers in noting that considerable progress had been made in a number of areas under the present program, a commendable achievement, given the natural disasters that had occurred in early 1983. Still, much remained to be done, and it was worrying that a large part of the adjustment thus far had relied on a fall in gross domestic investment, which in 1983 had declined by more than 8 percentage points in relation to GDP. That decline had more than accounted for the total fall in domestic absorption and, arithmetically at least, the improvement in the balance of trade.

As Executive Directors had noted in the previous discussion on Ecuador in November 1983, in a number of areas action was urgently required, Mr. Clark continued. Those included the unification of the exchange rate system, the removal of import restrictions, and the introduction of positive real interest rates. Since November 1983, the authorities had taken steps in each of those areas, but more needed to be done. And, while he welcomed the authorities' commitment to removing import restrictions by the end of the arrangement, he was disappointed not to see explicit timetables for action in the other areas that he had mentioned. Certainly, decisive measures related to those areas should be an essential part of any follow-on arrangement with the Fund.

On more specific elements of the program and of Ecuador's economy, Mr. Clark noted, first, that despite the depreciation of the sucre against the dollar, domestic gasoline prices had not been increased in Ecuador since 1982. Indeed, as observed by the staff, gasoline prices in dollar terms had fallen by 50 percent in 1983 and were at present among the lowest in the Western Hemisphere. He would be interested in comments from the staff or Mr. Robalino on that matter. Second, he had noted from the background paper that receipts from nonpetroleum taxes had fallen by 0.3 percent of GDP in 1982, due to growing tax evasion. Efforts to tighten tax administration had been delayed--although he was not yet certain why--and income taxes had fallen by another 0.2 percent of GDP in 1983. He urged the authorities to redouble their efforts to discourage tax evasion.

On monetary policy, Mr. Clark considered it important to establish positive real rates of interest so as to bring domestic savings back to more normal levels and to curb capital outflows. While he welcomed the authorities' move to increase credit and deposit rates by 2 percentage points, he noted that, with inflation projected at 30 percent for 1984 as a whole, real interest rates would remain substantially negative. He urged the authorities to implement the necessary legislation to allow savings and loan institutions to charge adjustable rates and then to move quickly to establish positive real rates.

Finally, the staff's medium-term scenario showed deficits on both the capital and the current accounts through the end of the 1980s, a high debt service ratio, and large and persistent financing gaps, Mr. Clark commented. That picture was disturbing indeed, and, as the staff and previous speakers had noted, rescheduling was likely to be necessary for a number of years. In the circumstances, the dramatic reduction in the current account deficit in 1983 had been necessary. As Table 6 in the staff report showed, however, the decline had been largely due to a sharp reduction in imports. Although imports of foodstuffs had increased in 1983 because of the effects of the flood, the recovery of agricultural output projected for 1984 should allow for a reversal of that trend; any substantial further improvement in the trade balance would have to come from export growth. In that context, he was troubled by the slump in nontraditional exports since 1981 which, according to the staff, had been largely due to a loss in competitiveness. He welcomed the measures the authorities had taken to transfer transactions to the free market but felt that further progress was needed.

The measures adopted in February 1984 to remove trade restrictions were also welcome, and he looked forward to the elimination of all restrictions by the end of the arrangement, Mr. Clark said. However, the continued existence of external arrears, including the increase in the early part of 1984, was disappointing. That increase had been partly due to the upward revision of outstanding arrears after the program had begun and to the fact that the authorities had paid off more arrears in 1983 than had originally been targeted. Still, he urged them to eliminate the remaining arrears as soon as possible.

Mr. Salehkhou considered that the performance of the Ecuadoran economy under the 1983 Fund-supported stand-by arrangement had been mixed. Except for the criterion on payments arrears, all other performance criteria had thus far been met, and the attainment of other targets--particularly the target for the overall public sector deficit--had been achieved because of the authorities' determination. The small remaining deficit had been financed externally, and the stance of monetary policy had been appropriate and had resulted in full compliance with the targeted ceilings for the net domestic assets of the Central Bank and for net central bank credit to the public sector.

On the external side, the current account deficit had declined substantially to 1.6 percent of GDP in 1983, reflecting a heavy fall in imports, Mr. Salehkhou continued. However, the highly satisfactory current account performance had not been matched by an improvement in the capital account, which had been marked by smaller net capital inflows, continuing capital flight, and reduced trade credits. Despite nonobservance of the external arrears target, Ecuador had reduced arrears by close to $0.5 billion, a significant achievement considering that the accumulation of arrears had been entirely due to the need to maintain essential imports.

The satisfactory financial performance in Ecuador had been overshadowed by a serious deterioration in the real economy, Mr. Salehkhou remarked. Real GDP growth had become negative by over 3 percent in 1983, against a program target of zero growth; and the deterioration had spread throughout the spectrum of the manufacturing, construction, and agricultural sectors, the latter having been severely affected by extensive flooding and related natural calamities. Following successive increases in recent years, agriculture and livestock production had fallen by 15 percent in 1983, and construction activities had similarly declined. In fact, apart from the petroleum and mining industries, there had been all-around declines in almost all other GDP components, ranging from manufacturing and commerce to electricity generation, gas, and water. That trend should be compared with an average annual GDP growth rate of almost 11 percent during the 1970s.

Against that background, there had been a sharp increase in inflation, which had tripled to almost 50 percent in 1983, Mr. Salehkhou commented. The inflation rate cast serious doubts on performance under the program. In the circumstances, he welcomed the latest cost of living figures, which indicated a substantial moderation in inflation. However, despite the authorities' determination to halve the inflation rate in 1984, much more remained to be done--within the framework of the adopted measures--effectively to contain inflation and inflationary expectations. In addition to an increase in inflation, the deterioration in the terms of trade had continued unabated. The decline had manifested itself more in the petroleum sector, but non-oil commodity prices had been adversely affected as well. With a 36 percent decline in imports of capital and intermediate goods in 1983, gross domestic investment as a percentage of GDP had fallen by almost 10 percent to its lowest rate in many years.

The continuing decline in agriculture and agro-exports had adversely affected the balance of payments: with the fall in food production, Ecuador had been forced to earmark an increasing share of foreign exchange reserves for food imports, Mr. Salehkhou said. Production of the major domestically consumed agricultural crops--like potatoes, rice, and African palm--had steadily declined in the past few years; and exports of agricultural products like sugarcane and bananas had been on a downward trend since 1979. For example, in 1983, agricultural exports had accounted for only one fourth of total exports, down from 45 percent in 1979. Unfortunately, the sharp decline in agricultural and industrial output was at variance with the stated goal of the authorities to lay the basis for a gradual reactivation of economic growth. In that connection, he would appreciate staff comment on efforts by the World Bank to encourage agricultural and industrial development in Ecuador. He would also welcome further comment on any initiatives the authorities might have proposed in the agricultural sector.

On performance criteria for the remainder of the program period, Mr. Salehkhou noted that he was unclear about the continuation of the restrictive stance of monetary policy, despite the reduction in capital expenditures of the Central Government in 1983 and the supply origin of inflation. In particular, he wondered how accommodating the ceiling on net domestic assets of the Central Bank would be in 1984, given the prospects for a gradual recovery.

The continued flexibility displayed by the authorities in managing the exchange rate was welcome, Mr. Salehkhou commented. However, the structure of the economy, the prevailing inflation rate, supply shortages, and other considerations cautioned against excessive reliance on the exchange rate. The assumptions for the medium-term scenario, 1985-90, included a 4 percent inflation rate and a 2 percent real growth rate, both of which would require a more active economy.

Continued debt rescheduling was crucial if the authorities' efforts to improve the economy were to be sustained, Mr. Salehkhou considered. Their intention to shift reliance away from the petroleum sector, the depletable nature of the petroleum reserves, the revival of the economy, and the abatement of inflation all called for massive investments and injections of new capital into the economy, which would be possible only if rescheduling agreements were drafted in a way that took account of the need to apportion the amortization and interest payments over a longer period and on easier terms, so as to allow sufficient foreign exchange for essential imports. He hoped the possibility of continued rescheduling would be followed up with banks and other creditors. In his view, Ecuador qualified as a good performer, and the dismal performance of its economy of late had been due to a lack of sufficient development finance, which had affected investments and aggravated inflation and unemployment. It was to be hoped that the importance of maintaining growth momentum alongside the adjustment program could be stressed in the rescheduling meetings. In conclusion, he could support the porposed decisions.

Mr. Morrell stated that he too could endorse the trust of the staff appraisal and could support the proposed decisions. He welcomed the strong adjustments made in the fiscal area that had resulted in a surpassing of program targets. Partly as a result of that good performance, there had been a sharp reduction in the current account deficit, the improvement in which had also been due in large measure to import compression arising out of the reduction of aggregate demand as well as of import restrictions. However, exports had also declined slightly in 1983, and it should be emphasized that the key to the resolution of Ecuador's debt problems lay in buoyant export growth. After all, even under projections of 7 percent annual export growth, the debt service ratio would persist at an average of 66 percent over the next six years.

A greater supply response from the export sector required greater exchange rate flexibility, Mr. Morrell continued. The authorities had been increasing the coverage of the free rate, and he encouraged them to take further action in that direction. Until exports responded, it was inevitable that reliance on import restrictions would be necessary, and he hoped that the Fund would take an understanding view of those restrictions. He underlined that the import restrictions had been taken not in isolation but only in conjunction with rigorous constraints on aggregate demand. The relationship between the two policies could be seen clearly in the fiscal sector, where the deficit had been cut sharply through a combination of increased taxation and expenditure reductions.

The contribution that positive interest rates could make in stemming capital outflows and encouraging reflows was deserving of emphasis, Mr. Morrell said. Unfortunately, the measures already adopted hardly seemed adequate, in view of the prevailing inflation rate.

He welcomed the agreement reached between the authorities and the banks to reschedule existing debt, to provide new monies, and to consider rescheduling of debt coming due in 1985, Mr. Morrell remarked. The provision of new credits should enable Ecuador to eliminate remaining arrears at an early opportunity. However, the staff had indicated: "Ecuador's debt management will be solved on a lasting basis only through restraint in the public sector's use of foreign commercial borrowing and the achievement of a strong and sustained growth of exports. To the extent that the rescheduling of 1984 maturities may involve the assumption of private sector debt by the Central Bank, as was the case in 1983, the Government should charge the private sector commissions that are high enough to cover the risk of exchange losses from these operations." He hoped that the Fund would help the authorities in their efforts to limit the public sector assumption of private debt, where that was considered desirable.

The staff representative from the Western Hemisphere Department, referring to the timing problem associated with the arrangement for Ecuador, observed that the first stage of the negotiation process had been concluded in December 1983. Unfortunately, because of the pending elections at end-January 1984 and again in May 1984, it had been difficult for the authorities to make decisions on the required action on the interest rate and exchange rate fronts. Only in mid-February 1984 had the staff and authorities even been able finally to agree on the nature and extent of actions to be undertaken so that a mission could return to Ecuador to conclude the negotiations in early March. Moreover, even then, it had been necessary to wait for the banks. Immediately after the mission had returned from Ecuador, the staff had accompanied the authorities to meet with the bankers in New York with the objective of working out a financial arrangement with the Steering Committee; it had then been necessary to wait until the Steering Committee had submitted the proposal to all the banks involved and the banks, in turn, had replied.

On a related matter, some Directors had wondered about the usefulness to the authorities of requesting the Board to approve performance criteria and various ceilings and targets so late in the program period, the staff representative continued. The targets and ceilings for the first quarter and for the second quarter of the year had been set when the negotiations had been concluded, had complied with all of them except for that relating to payments arrears. In that respect, the establishment of the performance criteria had been quite useful to the authorities.

In response to a number of questions on interest rates, the staff representative noted that the staff had not been successful in its attempt to persuade the authorities of the value of a larger upward adjustment in interest rates. As mentioned in the staff report, the authorities had experienced some difficulties with respect to the savings and loan associations. The proposed legal changes designed to alleviate those difficulties would not really solve the problem of past loans granted at lower interest rates, but they would at least help the institutions avoid further losses in future, which was why the authorities had felt it necessary to secure the legal changes before introducing further adjustments in interest rates. In the meantime, the Central Bank had been forced to grant the savings and loan associations some loans at low interest rates in order to help them compensate for the losses from loans already granted. On the status of the proposed legal changes, it was the staff's understanding that the provisions were before the Assembly, although there was no way to predict when they might be approved.

Replying to questions on exchange rates, the staff representative agreed with Directors that further transfers of transactions to the free market would be needed. On the basis of actions already taken, and assuming that the targeted inflation rate of 25 percent was achieved for 1984, the present exchange rate arrangements should lead to an increase in competitiveness of about 15 percent. However, the total gain in competitiveness, even with the 5 percent gain in 1983, was still below the total estimated loss in competitiveness of some 30 percent, as measured against the base year of 1971.

As noted by Directors, the spread between the official and the free market rates had declined somewhat, although it was still about 30 percent, the staff representative continued. However, the relevance of the reduction of the spread diminished as more transfers to the free market were effected. Actions taken in February meant that, at present, between 55 percent and 60 percent of private sector transactions were conducted in the free market. Over the medium term, of course, a continued flexible exchange rate policy would be necessary.

For the medium-term balance of payments projections, the staff had assumed that non-oil exports would grow by 10 percent, the staff representative remarked. Measured against what had been happening over the past two or three years--when exports had been adversely affected by a number of domestic policies as well as external difficulties--such a rate of increase did not seem unreachable; still, the assumed increase was significant, and the authorities would have to pursue a realistic exchange rate policy, supported by other complementary domestic policies, to ensure that the target was attained. For obvious reasons, it was difficult to make medium-term projections of oil exports; the staff had conservatively assumed only a 4 percent increase a year in the value in U.S. dollars of such exports, based on any combination of volume and price increases.

As mentioned by a number of Directors, Ecuador would need new debt reschedulings, the staff representative commented. It was worth noting that the projections for debt over the medium term were particularly sensitive to interest rate changes; for any given percentage point change in interest rates, there would be a 3-4 percentage point change in the debt service ratio. The basic assumptions about future rescheduling and about new financing had been based on the terms secured by Ecuador in 1983. As far as the rescheduling was concerned, those terms had been far less favorable than those currently being contemplated for 1984. If the latest terms were used in the projections, the medium-term scenario would show a debt service ratio of about 50 percent, by 1990, instead of the projected average of 65 percent, a significant decline.

The staff was not aware of any concrete plans for increasing exports, the staff representative said. The authorities realized, that it was important to promote the diversification of exports, and that appropriate exchange rate and other policies must be in place to support the needed export growth.

Reference had been made to a projected increase in expenditure for 1984, and it had been asked how that increase could be consistent with the effort to maintain the deficit at zero, the staff representative recalled. Basically, current expenditures were assumed to move pari passu with GDP. Excluding payments of interest, the remaining expenditures were supposed to decline by close to 1 percentage point of GDP, offset by an increase in capital expenditures, which had declined in 1983 in terms of GDP.

Answering a question about the impact of public sector spending policies on economic activity in 1983, the staff representative indicated that GDP in that year had been affected in large part by the floods and their damage to agriculture. Of course, government expenditure policies--including the decline in investment expenditures in terms of GDP in 1983--had had some impact on the outcome.

When the Government had decided to raise gasoline prices toward the end of 1982, the Assembly had established a freeze on further changes in gasoline prices until July 1984, the staff representative explained. While the authorities had been unable to change gasoline prices since 1983 they had been periodically raising prices for all other petroleum derivatives.

Responding to questions on wage policy in Ecuador, the staff representative observed that, beyond the 18 percent increase in salaries granted at the beginning of 1984, no other increases had been granted. It was clear that pressures for salary increases were quite strong, but the authorities thus far had stood firm; he understood that they intended to maintain their stance until they were in office in early August. Of course, their position would be helped if the recent decline in inflationary pressures continued; in that regard, the staff believed that the projected rate of inflation of 25 percent for the year ending December 1984 was achievable.

A number of questions had been raised relating to the decline in imports, the staff representative recalled. It was of course correct to say that the remarkable adjustment in the current account had been due in large part to the compression of imports; however, following the substantial decline in imports in 1982 and 1983, the staff was assuming that they would return to their more normal trends of the past, which was why a 12 percent increase was projected for 1984. Also, for the medium term, the staff had assumed that imports would maintain a historical relationship to GDP of about 17 percent. The authorities had agreed with the staff's assumption and with the medium-term scenario drawn up on that basis. As to the composition of imports, the fall had occurred more or less in all sectors, although there had been a somewhat greater decline in consumer durables. Food imports had increased in 1983 because of scarcities due to the floods; imports of raw materials and intermediate products had declined less rapidly than other consumer durables and capital goods. To the extent that the economy began to improve and exports began to grow, imports would also rise, which should allow for an increase in capital imports and further increases in imports of raw materials and inputs necessary to sustain economic growth.

The observation that the adjustment had been weighted toward the fiscal side, was, to some extent, correct, the staff representative noted, and the matter would have to be considered by the staff in the future as it reviewed exchange rate and interest rate policies. On the effects of monetary policy on the private sector, the staff had been asked to assess how the ceilings for 1984 might affect the growth of GDP. The net domestic assets of the Central Bank were practically flat, so that it was necessary to look at what was implied in terms of credit to the private sector. The staff had estimated that the program was consistent with an increase in credit to support private sector activities of 20-25 percent, more or less in line with the expected rate of inflation, and excluding credit granted in relation to the assumption of private debt. That rate represented a considerable improvement over 1983, when such credit had risen far more slowly than the rate of inflation. The staff had long been against any assumption of private sector external debt by the public sector, but unfortunately, the domestic private sector had joined the banks in favor of an assumption, and the authorities had eventually yielded. In 1983, the Central Bank had had to assume nearly $1 billion of private sector external debt, whereas in 1984 the total amount would be only about $250 million. Still, the staff had insisted that the authorities take measures to ensure that they would compensate for the exchange risk. The Central Bank could not legally assume the debt vis-à-vis foreign creditors and transfer the restructuring terms to the private sector; it could not extend credit beyond three years initially, with the possibility of an additional year; the terms of the rescheduling had extended beyond that period. The moment the debt was assumed, it became like a credit from the Central Bank to the private sector, with terms exceeding those legally permitted, and it had been necessary to go through the mechanism of granting rediscounts to the commercial banks that in turn gave credit to the private sector to cover payment of the debt in sucres to the Central Bank. When the Central Bank granted the credit, it also charged a commission to cover the estimated exchange risk; there was a range of commissions, because the Central Bank assumed the debt at a certain moment in time and would repay five to six years later, whenever the new restructured terms had matured. From a monetary point of view, that operation had a neutral effect, because the private sector did not receive any money; a book entry was established in which credit was granted, and the Central Bank used that entry to charge the payments on the debt in sucres and then acquired a foreign liability that would be paid when the restructured liabilities fell due.

With regard to prospects for a new program, the staff had not had any direct or formal indication from the incoming Administration, the staff representative commented. Still, the President elect had suggested in a speech that the authorities intended to seek negotiations on a new program, and he assumed that they would do so, especially as the authorities were well aware that continued support from commercial banks would probably depend upon a financial program with the Fund.

A timetable for actions by the authorities had been established, but the nature of the required actions had changed over time, and the timetable had become obsolete, the staff representative noted. For example, earlier in the negotiations, the staff had emphasized the need to reduce the spread between the official and free-market exchange rates, one of the options being a maximum quarterly spread that would have brought the rates close to unification in due course. The authorities had preferred to move toward unification by transferring transactions to the free market. In that respect, the timetable for unification had become irrelevant, although a certain amount of transfers had been made a prior condition for the review.

On World Bank involvement in Ecuador, the staff representative said that the Bank seemed to be working toward promoting recovery of the agricultural sector and, indeed, had several projects in that sector. The Bank staff apparently had sensed some problem with respect to the adequacy of credit to the agricultural sector and was working to determine, inter alia, whether the problem was the amount of credit in absolute terms or the allocation of credit. The Bank and Fund had also joined in emphasizing the need for more realistic interest rate policies in order to foster the growth of savings, which would facilitate the financing of the agricultural sector.

One speaker had asked specifically how the recently announced changes in the modalities for charging interest rates would affect the profitability of banks, the staff representative from the Western Hemisphere Department recalled. As he understood it, banks' profitability would be reduced, although the banks would not lose on a net basis. No precise quantification of the effect was available. The staff had in general been concerned about the need for a more realistic interest rate policy directed toward positive real interest rates. There had been some improvement in that regard, but rates continued to be negative. Finally, while the idea of multiyear debt rescheduling would no doubt be appealing to the authorities, it would have to be seen in due course whether the banks would be prepared to enter into such an arrangement. In his view, much would depend on a new program with the Fund.

The Deputy Director the Exchange and Trade Relations Department said that he had general comments on three different subjects: the unification of exchange rates and the liberalization of restrictions, the question of timing and the usefulness of performance criteria in cases like that of Ecuador, and the medium-term scenarios. On exchange rate unification, Mr. Senior had inquired whether the staff was not being sanguine about requesting too rapid a unification. The staff did not wish to be dogmatic on the issue and was of course well aware that there might be situations in which multiple exchange rates would be acceptable on a temporary basis. However, the emphasis must be on "temporary," because the distortions caused by prolonged resort to a multiple exchange rate system accumulated rapidly. In Ecuador's case, the medium-term debt burden was projected to be quite heavy, and any judgment about the appropriateness of the exchange rate system must take account of levels of debt and debt servicing that the economy had to generate as well as of competitiveness. From that point of view, the staff would prefer to see more progress toward the unification of exchange rates in Ecuador.

In arguing for the continuation of a multiple exchange rate system, Mr. Senior had raised the issue of petroleum exports, the Deputy Director continued. However, Ecuador was not one of those countries in which petroleum exports threatened to drive up the exchange rate to a point that would endanger the competitiveness of other sectors. Inadequate pricing of foreign exchange might nonetheless lead to situations of the sort described by Mr. Clark, wherein the price of gasoline in dollar terms on the basis of the official exchange rate was extremely low in Ecuador and was giving wrong signals about the efficiency of use of one source of wealth in the country. In sum, the staff would prefer to see a unification of the exchange rates and a liberalization of restrictions from a position of policy strength. Once domestic policies had been put in place and were taking hold, liberalization could begin. Of course, sometimes it was not possible to wait until the policies took hold, and there was a need to act decisively on the exchange rate. The authorities in his view were not moving quickly enough on that front, and similar concerns had been expressed with regard to a lack of progress on interest rates.

On the timing of the review and usefulness of performance criteria under the program, the Deputy Director recalled that, following the November 1983 discussion, the review provision had acquired certain dimensions beyond those described originally in the letter of intent, which had suggested that the staff would review progress in policy orientation before November 15, 1983, at which time the opportunity would be taken to set performance criteria for 1984. When the case had gone to the Board in November, strong views had been expressed about the adoption of specific measures, particularly affecting interest rates, exchange rates, and restrictions. Therefore, the staff had had to negotiate with the authorities the type and timing of actions to be taken and to have the required understandings in place as a requirement for the completion of the review. Such an approach had meant that, if the authorities had been unable or unwilling to reach agreement with the staff, the completion of the review itself would have had to be postponed. In such a case, an alternative would have been to allow the arrangement to become inoperative and to submit only the Article IV consultation report to the Executive Board for discussion. However, the normal consultation cycle had not yet lapsed, and thus there had been no particular pressure to complete the consultation at the present time. It had to be remembered that actions, albeit modest ones, had been taken and a further postponement had not seemed reasonable. In the case of Ecuador as well as in others, the staff had been attempting to put several elements together in the program, including policy measures from the Government and financing from banks or other governments, that entailed risks regarding the timing of the various actions. Those risks had been well illustrated in Ecuador, where the timing of the program had been off track from the beginning.

In the circumstances, before letting the program lapse without a review, it had seemed reasonable to focus on the substance of the case, the Deputy Director continued. In that respect, the important part of the exercise had been to reach agreement on quantified policies for the first half of the year, which the country had undertaken to implement. Of course, it might have been better if the review had been conducted earlier; however, a review at present gave the Board the opportunity to assess performance so far; the evidence was that--except for arrears--the program had been on track for the first four or five months of 1984.

Finally, the medium-term scenarios were based on a great many assumptions and were sensitive to those made regarding both interest rates and maturities, the Deputy Director said. They reflected expectations not only about the evolution of domestic policies but also about developments in the rest of the world; it was impossible to know with any precision how those elements would turn out. In the practices that the Fund had developed over the past 18 months, the first concern had been to ensure that the required amounts of financing to support the adjustment efforts were in place. What had been given consideration recently--by the Managing Director in his speeches and by the central bankers themselves--were not just the amounts but the terms of new financing and of debt rescheduling as well. In that context, multiyear reschedulings made sense, especially when linked to the performance of an economy and the adjustment effort, because it was on that basis that the creditworthiness of a particular economy improved. If creditworthiness improved, risk premiums should be reduced, while the willingness of creditors to keep assets on a longer-term basis in a country with good economic performance should increase.

Mr. Zhang said that he remained puzzled by the assumptions for the medium-term scenario with respect to imports. First, why had the staff used an average figure from the 1960s rather than, say, the 1970s? Second, what would be the effect of the proposed devaluation on the future trend of imports? The staff had assumed that imports would become more expensive; perhaps the devaluation would have some effect on the volume of imports.

The staff representative from the Western Hemisphere Department, responding to Mr. Zhang's first question, said that the period had been chosen in consultation with the authorities. It had been felt that the most appropriate approach was to look at the period before the oil price boom, when the economy had been growing at a relatively normal pace.

With regard to the exchange rate, the staff representative observed, it was difficult to estimate precisely the effect on imports of changes in the exchange rate. The underlying assumption was that the authorities would pursue a realistic exchange rate policy in order to facilitate growth or, in other words, to recover the competitiveness that had been lost and to maintain it throughout the period covered by the scenario.

The Deputy Director of the Exchange and Trade Relations Department added that it was almost impossible to assess the exchange rate by itself, without other elements of economic policy. However, one could argue that, when evidence existed that prices in an economy were more inclined to rise than to fall, and when initially the real exchange rate was not an equilibrium rate, then a nominal exchange rate change, supported by appropriate domestic policies, was perhaps the least costly way of bringing about a real exchange rate adjustment. Conceptually, of course, such relationships were relatively simple, but they became much more difficult when they had to be measured in quantitative terms. The staff had had to make some assumptions; the act of extrapolating from a historical position of an economy where relative prices and other indicators appeared to be in balance was one of the shortcuts that would continue to be necessary in economics until a better approach was developed.

Mr. Zhang said that he was still troubled by the use of the historical rate for imports in the scenario for 1985-90. For example, the rate of growth of GNP in the future might be quite different from what it had been in the 1960s, so that the ratio of imports to GDP could be very different as well.

The Deputy Director of the Exchange and Trade Relations Department said that it might be easier to explain his point by using a hypothetical country that had had no debt in the 1960s but had incurred a large debt by the 1980s. That example should help to answer Mr. Zhang's question about whether a country's interest rate payments to the rest of the world mattered; certainly they mattered, because they represented an accumulation of debt. In other words, the country was consuming at a given point in time the output of the future. Hence, even if many other factors appeared to be the same, growth rates could vary because trading was always going on, not only between countries but across time. Clearly, if a country decided that, in five years, it would undertake a debt equivalent to one year of output, that decision would have an impact on the growth rate in the years thereafter.

The staff representative from the Western Hemisphere Department added that any answer to Mr. Zhang's question had to take account as well of the distinction between stocks and flows. In making the difficult choice of an appropriate period as the basis for assumptions about imports, the staff could have chosen a period in which imports had not been strictly linked to the growth of the economy but had expanded to feed consumption, such as had occurred during the coffee-boom period. The 1960s had seemed to be a more reasonable and stable period; and the choice had been thoroughly discussed with the authorities.

Looking at flows in the scenario, the staff representative noted that a 2 percent real growth rate was called for, which was equivalent to about 6 percent of GDP in nominal dollar terms--assuming an inflation rate of 4 percent--a number that turned out to be the same flow that had been estimated for imports. Under various analyses, it had become clear that anything beyond the level of imports that had been assumed would not be sustainable. In that respect, the staff had to look at the numbers in the context of what was viable in terms of the balance of payments and had to ask whether the chosen level of imports would be sufficient to allow for the growth implicit in the scenario.

Mr. Robalino said that he was certain that his authorities in Ecuador would demonstrate the flexibility necessary to correct the imbalances in the economy, but they would probably need more than one year to do so. On interest rate policy, the members of Congress in Ecuador were attempting to conclude discussions on some financial laws in order to allow more room for maneuver in managing interest rate policies. The authorities had recently decided to change the way in which commercial banks charged their customers interest on commercial credit of 180 days' maturity or less. Before that change, the commercial banks had collected in advance the interest on loans of six months' maturity but, in future, the interest on those specific loans would be collected at the end of every three months. The change, which had been made to simplify the system, did not affect other types of loans on which interest continued to be paid at maturity.

On another matter, Mr. Robalino noted that most of Ecuador's arrears would be paid from loans from the commercial banks. Any remaining balance would be dealt with by using the Central Bank's reserves or by rescheduling some suppliers' credits. On June 8, 1984, net international reserves had stood at $156 million, above the target of $143 million set in the program for end-June. The increase in reserves above the June target had been due to an improvement in the trade balance beyond what had been expected for the present year.

With regard to gasoline prices in 1984, Mr. Robalino noted that the Congress of Ecuador had prevented the Government from increasing gasoline prices; however, prices of other oil derivatives had been increasing quarterly, even during the current year.

On exchange rate policy, Mr. Robalino noted that, from February 1984 until the present, the exchange rate in the free market had stabilized at about S/. 89 per U.S. dollar. He was convinced that his authorities in future would show the necessary flexibility to narrow further the spread between the official and the free-market rates, thus demonstrating that they were working toward unification. As he had observed in the past, it had not been possible for the Government to correct all the economic imbalances that persisted in Ecuador, partly because of the structural characteristics of some of the imbalances and partly because one year was not long enough to deal with them. Finally, as mentioned by Mr. Shaw, the new President of Ecuador--who would take office on August 10--had made a public declaration about Ecuador's intention to seek a new arrangement with the Fund.

The Acting Chairman made the following summing up:

> In summing up the Board's discussion on the 1983 Article IV consultation with Ecuador, I shall begin with general comments by Directors and then turn to specific remarks by subject area. Directors observed, first, that the recent stabilization efforts by the Ecuadoran authorities had resulted in the virtual elimination of the public sector deficit and had brought about a major reduction in the external current account deficit and a significant improvement in the overall balance of payments position. They took note as well of the recent decline in the rate of inflation and the encouraging improvement in activity in agriculture and related sectors, and they commented that these results had been achieved in the face of very difficult circumstances of weak foreign demand, declining per capita incomes, and major natural disasters.
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> Second, a large number of Directors were perplexed and concerned about the reluctance of the authorities to come to grips with structural problems, particularly through more flexible and realistic pricing policies, including those with respect to interest rates, exchange rates, and other domestic prices. Such changes were viewed as necessary for Ecuador to maintain external competitiveness, increase the domestic savings rate, and reduce capital outflows so as to improve investment and, hence, prospects for growth.
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> Commenting on specific areas, beginning with exchange rate policy, Directors commended the authorities on the shift of transactions to the free market made earlier in the year, which should be helpful in further strengthening the balance of payments position. They urged the authorities to continue to move decisively

and in a pragmatic and practical way toward a unified exchange market. Directors also welcomed the marked reduction in import restrictions and the elimination of advanced import deposits. They noted the authorities' reaffirmation of their commitment to dismantle all remaining import restrictions by the end of the program period and encouraged them to eliminate remaining restrictions and multiple currency practices as soon as possible.

It was apparent that the continued existence of external payments arrears was of concern to Directors. While noting that an important portion of the external arrears were being eliminated through the extension granted by foreign banks, Directors stressed the need to eliminate any remaining arrears very promptly.

In commending the virtual elimination of the public sector deficit in 1983--following a deficit equivalent to nearly 7 percent of GDP in 1982--Directors welcomed the tax measures that had been adopted and the policy of expenditure restraint that had been pursued, particularly in wage policy. They stressed the importance of maintaining control over the growth of public sector outlays--to ensure that the overall public sector equilibrium envisaged for 1984 would be attained--while still permitting the Government to increase its investment expenditures. In particular, Directors encouraged the authorities to resist wage and salary increases in the future.

Directors expressed disappointment about the recent actions with regard to interest rates and stressed the need to make further adjustments with a view to establishing positive real interest rates in order to reduce external capital outflows, and to promote growth in domestic savings and a more rational flow of domestic credit. Directors also urged the authorities to maintain a relatively tight credit policy in 1984; in that regard, they cautioned against the assumption of private sector debt by the public sector, noting that such an action would not work to solve the overall debt problem and would subject the public sector to an additional burden. Executive Directors also expressed the hope that domestic prices would remain flexible and would reflect underlying economic realities; in that connection, however, they noted with concern the decline in the real price of gasoline to a level that was below world market levels.

On the external side, Directors noted the positive effects of the recent rescheduling agreements with foreign commercial banks and the Paris Club. They observed, however, that the medium-term projections indicated a very high debt-service burden for the foreseeable future and stressed that the problem of debt management over the medium term could be solved only through a combination of factors, including reduced recourse to foreign commercial borrowing together with further debt restructuring, additional strong adjustments designed to lay the foundation for economic growth, and sustained export growth, which would be a necessary complement to efforts to deal with the medium-term debt problem.

In conclusion, it is expected that the next Article IV consultation with Ecuador will be held on the standard 12-month cycle.

The Executive Board then turned to the proposed decisions, which it adopted.

The decisions were:

Exchange Measures Subject to Article VIII

1. The Fund takes this decision relating to Ecuador's exchange measures subject to Article VIII, Sections 2 and 3, in the light of the 1983 Article IV consultation with Ecuador conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. Ecuador maintains restrictions on the making of payments and transfers for current international transactions in the form of bilateral payments agreements, minimum financing or barter requirements for imports, and as evidenced by external payments arrears, as well as a multiple currency practice, as described in EBS/84/92. The Fund encourages Ecuador to continue the simplification of its exchange system by an early unification of the exchange rate and removal of the restrictions on payments and transfers for current international transactions. In the meantime, the Fund approves the multiple currency practice, including reclassification of transactions from the official to the free market, as they may occur, and the exchange restrictions in the form of minimum financing or barter requirements for imports and as evidenced by external payments arrears, through the end of the stand-by arrangement.

Decision No. 7735-(84/96), adopted
June 20, 1984

Review Under Stand-By Arrangement

1. Ecuador has consulted with the Fund in accordance with paragraph 4(d) of the stand-by arrangement for Ecuador (EBS/83/91, Sup. 3, 7/27/83) and paragraph 15 of the letter of March 24, 1983 attached to the stand-by arrangement for Ecuador, as supplemented and modified by the letter of October 25, 1983, in order to reach understandings with the Fund regarding the policies and measures that Ecuador will pursue during the remaining period of the stand-by arrangement.

2. The letter of April 19, 1984 from the Minister of Finance of Ecuador and the General Manager of the Central Bank, together with the attached Memorandum on the Economic Policies of Ecuador, shall be attached to the stand-by arrangement for Ecuador, and the letter of March 24, 1983 shall be read as supplemented by the letter of April 19, 1984, together with the attached Memorandum on the Economic Policies.

3. Accordingly, and pursuant to paragraph 4(d) of the stand-by arrangement, Ecuador will not make purchases under the stand-by arrangement during any period in which:

(a) the limit on the net domestic indebtedness of the nonfinancial public sector referred to in paragraph 7 of the Memorandum of Economic Policies attached to the letter of April 19, 1984, and set forth in Table 1 thereof, is not observed, or

(b) the limit on the net domestic assets of the Central Bank of Ecuador referred to in paragraph 7 of the Memorandum of Economic Policies attached to the letter of April 19, 1984, and set forth in Table 2 thereof, is not observed, or

(c) the data at the end of the preceding period indicate that the target for the net international reserve position of the Central Bank referred to in paragraph 7 of the Memorandum of Economic Policies attached to the letter of April 19, 1984, and set forth in Table 3 thereof, has not been observed, or

(d) the data at the end of the preceding period indicate that the limit on the outstanding external debt of the public sector or guaranteed by the public sector referred to in paragraph 13 of the Memorandum of Economic Policies attached to the letter of April 19, 1984, and set forth in Table 4 thereof, has not been observed.

Decision No. 7736-(84/96), adopted
June 20, 1984

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/84/95 (6/18/84) and EBM/84/96 (6/20/84).

3. ECUADOR - 1983 ARTICLE IV CONSULTATION - POSTPONEMENT

Notwithstanding the period of three months specified in Procedure II of the document entitled "Surveillance over Exchange Rate Policies" attached to Decision No. 5392-(77/63), adopted April 29, 1977, the Executive Board agrees to extend the period for concluding the 1983 Article IV consultation with Ecuador to not later than June 25, 1984. (EBD/84/170, 6/15/84; and Cor. 1, 6/19/84)

Decision No. 7737-(84/96), adopted
June 19, 1984

4. EXECUTIVE BOARD TRAVEL

Travel by an Executive Director as set forth in EBAP/84/131 (6/18/84) is approved.

APPROVED: February 1, 1985

LEO VAN HOUTVEN
Secretary