EBS/83/91
Supplement 3

CONFIDENTIAL

July 27, 1983

To: Members of the Executive Board

From: The Secretary

Subject: Ecuador - Stand-By Arrangement

Attached for the records of the Executive Directors is the text of the stand-by arrangement for Ecuador agreed at Executive Board Meeting 83/77, June 1, 1983 to become effective by the decision taken on July 25, 1983 (EBS/83/91, Supplement 2, 7/25/83).

Att: (1)

Ecuador--Stand-by Arrangement

Attached hereto is a letter dated March 24, 1983, from the General Manager of the Central Bank of Ecuador and the Minister of Finance of Ecuador requesting a stand-by arrangement and setting forth the objectives and policies that the Government of Ecuador intends to pursue for the period of this stand-by arrangement. To support these objectives and policies, the International Monetary Fund grants this stand-by arrangement in accordance with the following provisions:

1. For the period of one year from July 25, 1983, Ecuador will have the right to make purchases from the Fund in an amount equivalent to SDR 157.5 million, subject to paragraphs 2, 3, 4, and 5 below, without further review by the Fund.

2.(a) Purchases under this stand-by arrangement shall not, without the consent of the Fund, exceed the equivalent of SDR 39,375,000 until July 31, 1983, the equivalent of SDR 78,750,000 until October 31, 1983, and the equivalent of SDR 118,125,000 until January 31, 1984.

(b) None of the limits in (a) above shall apply to a purchase under the stand-by arrangement that would not increase the Fund's holdings of Ecuador currency in the credit tranches beyond 25 per cent of quota, or increase the Fund's holdings of that currency resulting from purchases of borrowed resources beyond 12.5 per cent of quota.

3. Purchases under this stand-by arrangement shall be made from ordinary and borrowed resources in the ratio of two to one until purchases under this arrangement reach the equivalent of SDR 39,375,000 and then each purchase shall be made from ordinary and borrowed resources in the ratio of 1 to 1.2, provided that any modification by the Fund of the proportions of ordinary and borrowed resources shall apply to amounts that may be purchased after the date of modification.

4. Ecuador will not make purchases under this stand-by arrangement that would increase the Fund's holdings of Ecuador currency in the credit tranches beyond 25 per cent of quota or increase the Fund's holdings of that currency resulting from purchases of borrowed resources beyond 12.5 per cent of quota:

(a) during any period in which

(i) the limit on the net domestic indebtedness of the nonfinancial public sector set forth in Table 1 annexed to the attached letter is not observed, or

(ii) the limit on the net domestic assets of the Central Bank of Ecuador set forth in Table 2 annexed to the attached letter is not observed, or

(iii) the data at the end of the preceding period indicate that the target for the net international reserve position of the Central Bank of Ecuador set forth in Table 3 annexed to the attached letter has not been observed, or

(b) the limits on the outstanding external debt of the public sector or guaranteed by the public sector with original maturities of up to and including 12 years and up to and including one year set forth in Table 4 annexed to the attached letter are exceeded without including the proceeds from such borrowing in gross international reserves; or

(c) after November 30, 1983 until the elimination of all external arrears referred to in paragraph 11 of the attached letter has been completed; or

(d) during any period after October 18, 1983 if the review contemplated in paragraph 15 of the attached letter has not been completed or, if further understandings have been reached pursuant to the review, while such understandings are not being observed; or

(e) during the entire period of the stand-by arrangement, if Ecuador:

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

(ii) introduces or modifies multiple currency practices other than as described in paragraph 10 of the attached letter, or

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

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

When Ecuador is prevented from purchasing under this stand-by arrangement because of this paragraph 4, purchases will be resumed only after consultation has taken place between the Fund and Ecuador and understandings have been reached regarding the circumstances in which such purchases can be resumed.

5. Ecuador's right to engage in the transactions covered by this stand-by arrangement can be suspended only with respect to requests received by the Fund after (a) a formal ineligibility, or (b) a decision of the Executive Board to suspend transactions, either generally or in order to consider a proposal, made by an Executive Director or the Managing Director, formally to suppress or to limit the eligibility of Ecuador. When notice of a decision of formal ineligibility or of a

decision to consider a proposal is given pursuant to this paragraph 5, purchases under this arrangement will be resumed only after consultation has taken place between the Fund and Ecuador and understandings have been reached regarding the circumstances in which such purchases can be resumed.

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

7. The value date of a purchase under this stand-by arrangement involving borrowed resources will be normally either the 15th day or the last day of the month, or the next business day if the selected day is not a business day. Ecuador will consult the Fund on the timing of purchases involving borrowed resources.

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

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

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

(c) The value date of a repurchase in respect of a purchase financed with borrowed resources under this stand-by arrangement will be normally either the 6th day or the 22nd day of the month, or the next business day if the selected day is not a business day, provided that repurchase will be completed not later than seven years from the date of purchase.

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

11. In accordance with paragraph 15 of the attached letter, Ecuador will consult the Fund on the adoption of any measures that may be appropriate at the initiative of the Government or whenever the Managing

Director requests consultations because any of the criteria in paragraph 4 above have not been observed or because he considers that consultation on the program is desirable. In addition, after the period of the arrangement and while Ecuador has outstanding purchases in the upper credit tranches, the Government will consult with the Fund from time to time, at the initiative of the Government or at the request of the Managing Director, concerning Ecuador's balance of payments policies.

ATTACHMENT

Quito, Ecuador
March 24, 1983

Mr. Jacques de Larosière
Managing Director
International Monetary Fund
700 19th St., N.W.
Washington, D.C. 20431

Dear Mr. de Larosière:

1. Over the past five years, Ecuador's rate of economic growth has been progressively decelerating, while inflationary pressures rose. Further, Ecuador's economy remained basically open, and the current account of the balance of payments deteriorated sharply. The widening public sector deficit and the sluggish growth of exports contributed strongly to this deterioration. Yet, the level of international reserves was kept more or less constant in spite of these adverse conditions due to Ecuador's easy access to international capital markets. However, in recent years, the sharp rise in interest rates in the world market and the world economic recession added further burdens to Ecuador's balance of payments. As a result, in 1981 the net international reserves of the Central Bank of Ecuador declined by almost US$300 million, the first overall balance of payments deficit in five years.

2. The Government of Ecuador sought to prevent further deterioration of the balance of payments by adopting several measures. The sucre in the official market was depreciated from S/. 25 per U.S. dollar to S/. 33 per U.S. dollar (by 32 per cent in sucre terms) in May 1982, domestic prices of gasoline were doubled during the year, subsidies on wheat were eliminated, and a number of tax measures were submitted to Congress, and some were approved. Interest rates were raised and credit creation by the Central Bank was sharply curtailed. In October, Ecuador requested a refinancing of public debt amortizations due to foreign commercial banks during the period November 1982-December 1983, and in November, importation of a large list of commodities was prohibited. Notwithstanding these measures, the spread between the official and the free market rate averaged about 70 per cent during 1982, compared with about 20 per cent during 1981. Moreover, due to the worsening of the international financial situation, Ecuador's access to foreign borrowing became extremely difficult and was at less favorable terms. The decline in the net international reserves (excluding a revaluation of Central Bank gold holdings) reached US$460 million in 1982, while external payments arrears emerged toward the end of the year.

3. The Government of Ecuador has recognized the need to frame further adjustment policies within the context of a medium-term objective of maintaining international competitiveness and promoting economic growth. The program for 1983 is aimed at setting the basis for sustained economic growth over the next few years, in the context of improved international conditions. Thus, during 1983 the Government is

in the process of reforming the exchange system, overhauling public finances and the utilization of monetary instruments, and establishing adequate rules and controls on public sector external indebtedness. To achieve the above-mentioned objective, the Government has formulated a program, which is described in the following paragraphs, and it wishes to count on the International Monetary Fund's support. Accordingly, it hereby requests a one-year stand-by arrangement in an amount equivalent to SDR 157.5 million from ordinary and borrowed resources. The Government believes that its request for enlarged access to the Fund's resources is justified in the light of Ecuador's difficult circumstances, and particularly the large balance of payments need relative to quota.

4. A key element of the adjustment program will be a substantial reduction of the public sector deficit. On March 14, 1983 the Congress approved a law regulating public expenditure, which will have a far-reaching impact on public finances, inasmuch as this law has imposed severe limitations on the operations of the Central Government and of the autonomous entities. Regarding the former, budgetary appropriations cannot be revised by more than 5 per cent during the year, except in the case of exceptional circumstances. During 1983 and 1984, the increase in current outlays of the rest of the public sector will be limited to no more than 5 per cent of the previous year's budget, except for contractual salary adjustments. Investment expenditures could be increased only if the required financing is available. The law also modifies the system of revenue earmarking, limits the increase in public sector employment, regulates public wage structures, and subjects all future foreign borrowing by the public sector to prior approval of the Minister of Finance.

5. The Government plans to lower the overall public sector deficit from 7.5 per cent of GDP in 1982 to about 4 per cent of GDP in 1983, through a combination of revenue measures and tight control on expenditure. A number of revenue-generating measures have already been approved, including increases in domestic gasoline prices and placement of new taxes on beer, cigarettes, and other selected consumption items. Furthermore, an average surcharge of 9 per cent has been applied to imports. The system of earmarking of petroleum revenues is being simplified. In addition, prices charged for public goods and services will be increased in line with policies followed by the Government in order to meet domestic production costs. Other tax measures are being considered and will be implemented if necessary. Tax evasion will be reduced through the computarization of income tax rolls, the tightening of controls on sales tax collection, and the strengthening of other tax legislation. Moreover, the number of individuals and enterprises subject to taxation will be widened. Public sector expenditures have been limited on the basis of the Law on Public Expenditure. Additional savings will be sought by further limiting the expenditures of public institutions to only a marginal increase over 1982 levels. This restriction will be made in spite of some wage increases granted during the year and the emergency aid required to repair damage to infrastructure and the productive apparatus in the coastal region following heavy flooding in

late 1982 and early 1983. To monitor the public sector deficit, the Government presently is improving the expenditure control machinery. The implementation of these policies will make it possible to limit the overall public sector deficit to the level indicated above. To assure that the financing of the public sector deficit would not unduly limit credit to the private sector, the net indebtedness of the nonfinancial public sector to the Central Bank of Ecuador will be limited to the amounts specified in the annexed Table 1.

6. Monetary and credit policies will continue to be conducted so as to advance the economic and social development contemplated in the programs of the Government, without producing excessive demand on foreign exchange resources or pressures on the domestic price level. Considering the experience of past years, it would appear that an expansion of the banks' liabilities to the private sector by approximately 23.5 per cent might meet these requirements. The effectiveness of the policies in this field will be judged by reference to the maximum levels for the net domestic assets of the Central Bank of Ecuador set forth in annexed Table 2, for the periods defined in this table.

7. In 1982 the Monetary Board sharply increased domestic interest rates on deposits and loans of commercial banks and savings and loan associations. The Government recognizes that such adjustment is necessary due to the openness of Ecuador's economy, if the medium-term objective of increasing domestic savings is to be realized. Accordingly, the Monetary Board will continue to adjust interest rates in order to move toward positive real interest rates in the domestic financial markets and to reflect developments in world capital markets. On March 18, 1983 the Monetary Board restructured the interest rate system, increasing deposit and loan rates. In order to bring interest rates closer to a level attractive enough to help generate additional internal savings, the Monetary Board decided to increase the maximum short-term loan rate to 16 per cent and to unify the rates for several operations.

8. An important element in improving the cost-price relationship and Ecuador's international competitiveness is the area of wage determination. The authorities will continue to implement a controlled wage adjustment policy, and across-the-board wage increases will be considered only if they would not create economic imbalances. Wage adjustments will be consistent with the monetary and fiscal policies described in this letter. The Government believes that labor and management are likely to understand that excessive wage increases will not lead to real wage gains.

9. The Government will continue to implement a rational pricing policy enabling the economy to take full advantage of the natural resources and productive capacity of the country. In this respect, prices and tariffs for nontraded goods and services marketed by the public sector will be adjusted toward their domestic costs. Also, producer prices

of internationally traded goods will be reviewed to eliminate price subsidies if any and ensure the efficient use of Ecuador's natural resources. This is of particular importance now that international prices are changing rapidly. Already the average domestic price of gasoline has been doubled to S/. 30 per gallon in 1982.

10. Adjustment of the effective exchange rate and reform of the exchange system are key elements in the program. The aims of a flexible exchange system should be to stimulate the competitiveness of exports, to reduce imports of nonessential goods, to discourage capital flight, and to rebuild in the medium term international reserves. For legal reasons, the dual exchange market system will be retained for the time being, but the monetary authorities have been authorized to transfer transactions from the official to the free market. Modifications have been introduced in the exchange system. The exchange rate of the sucre in the official market has depreciated from S/. 33 per U.S. dollars to S/. 42 per U.S. dollar as of March 19, 1983. A crawling peg system is being implemented during the program period which, together with other measures, would result in a substantial reduction of the spread between the free and official exchange market rates by the end of the program period. To regulate the flow of imports, commercial credit requirements have been introduced. Targets for changes in the net international reserves of the Central Bank of Ecuador are set out in the annexed Table 3.

11. In line with the establishment of a more flexible exchange system, the Government will disband by the end of the program period the prohibition placed on imports toward the end of 1982. Similarly, arrears on current international payments will be liquidated by November 30, 1983. The Government of Ecuador does not intend to introduce any new multiple currency practice other than as described in paragraph 10 above, impose restrictions on payments or transfers for current international transactions, conclude bilateral payments agreements which are inconsistent with Article VIII of the Articles of Agreement, or impose or intensify restrictions on imports for balance of payments reasons.

12. During the last ten years, Ecuador made an extensive use of foreign loans to finance its economic activity. Besides international agencies, private foreign banks lent considerable amounts in a rather liberal fashion. However, the terms of this lending became less favorable in recent years, thus resulting in a heavy accumulation of amortizations during the period 1983-85. At the end of 1982, the outstanding external public debt (excluding advances) amounted to US$4.6 billion, and the outstanding registered private debt to about US$1.6 billion. In the light of the continuing balance of payments deterioration, in January 1983 the Government of Ecuador reached an agreement with a group of foreign commercial banks for a refinancing of public debt amortizations falling due during the period November 1, 1982 to December 31, 1983. Also some suppliers' credits to the public sector are being renegotiated. To lessen further the pressure on the balance of payments,

negotiations are proceeding with foreign commercial banks for a refinancing of outstanding foreign private debts. The refinancing scheme would entail that creditor foreign banks would extend lines of credit to the Central Bank of Ecuador in order to cancel the outstanding foreign private debt. No exchange losses will be assumed by the public sector or the Central Bank of Ecuador, while the private sector would still benefit from the refinancing of its debts. We believe that the refinancing of these external debts is necessary, otherwise, the total payment of debt amortization through the official market would have been equivalent to 85 per cent of Ecuador's exports in 1983; a ratio that would have been unsustainable.

13. The servicing of the external public debt will entail a considerable burden on Ecuador's balance of payments for the next few years. The Government, therefore, plans to bring about an improvement in Ecuador's external public debt structure. This objective will be sought by limiting the net use of public external debt with a final maturity of up to 12 years as set forth in the annexed Table 4.

14. Once the basis for sustained economic growth has been achieved due to the successful implementation of the program described in this letter, the thrust of the policy actions of the Government of Ecuador will be aimed at the resumption of strong economic growth within the context of a balance of payments equilibrium over the medium term. We are aware that balance of payments constraints will still exist in 1984 due to the large debt service burden of the public sector and to the limited prospects for rapid increases in our exports in the context of the weak world demand for our major export product.

15. During the period of the requested stand-by arrangement, the authorities of Ecuador will periodically consult with the Fund, in accordance with the Fund's policies on such consultations, about the progress being made in the implementation of the program described in this letter and any policy adaptations judged to be appropriate for the achievement of its objectives. In this context, progress made in the implementation of the program, taking into account balance of payments developments, including the envisaged debt refinancing, the modification of the exchange system, and those policy statements indicated in paragraph 11 above, will be reviewed with the Fund before October 18, 1983. Since this letter establishes the economic goals for calendar year 1983, upon the occasion of this review of the requested stand-by arrangement, policy targets and ceilings will be defined for the remaining period of the stand-by arrangement.

Sincerely yours,

Abelardo Pachano B.
General Manager
Central Bank of Ecuador

Pedro Pinto R.
Minister of Finance

Attachments

Table 1. Ecuador: Limits on the Net Domestic Indebtedness of the Nonfinancial Public Sector 1/

(In billions of sucres)

Time Period	Limits
Up to June 30, 1983	-16.5
July 1, 1983-September 30, 1983	-13.5
October 1, 1983-December 31, 1983	-10.5

1/ For purposes of this limit, the net domestic indebtedness of the nonfinancial public sector is defined as the net claims of the Central Bank on the nonfinancial public sector. All accounts denominated in foreign exchange will be converted at the accounting rate of S/. 45 per U.S. dollar.

Table 2. Ecuador: Limits on the Net Domestic Assets of the Central Bank of Ecuador 1/

(In billions of sucres)

Time Period	Limits
Up to June 30, 1983	17.5
July 1, 1983-September 30, 1983	20.0
October 1, 1983-December 31, 1983	21.0

1/ Defined as the difference between (1) currency issue (Especies Monetarias en Circulacion) and (2) net international reserves of the Central Bank. The definition of the net international reserves of the Central Bank is indicated in Table 3. For the purpose of these ceilings, the net international reserves of the Central Bank of Ecuador will be converted into sucres at the accounting rate of S/. 45 per U.S. dollar.

Table 3. Ecuador: Targets on Net International Reserves of the Central Bank 1/

(In millions of U.S. dollars)

Dates	Targets
June 30, 1983	104
September 30, 1983	84
December 31, 1983	110

1/ Defined as the difference between the foreign assets of the Central Bank of Ecuador and its external liabilities. For the purpose of this ceiling, the net international reserves exclude the deposits of international nonmonetary organizations in the Central Bank of Ecuador, the allocations of SDRs, all foreign loans with a final maturity of more than 12 years, but will include all net foreign borrowing by the public sector in excess of the limits indicated in Table 4. The gold holdings of the Central Bank will be valued at US$300 per ounce; and the holdings of SDRs will be converted at the rate of US$1.09 per SDR.

Table 4. Ecuador: Limits on the Outstanding External Debt of the Public Sector or Guaranteed by the Public Sector with Original Maturity of Up to and Including 12 Years 1/2/3/

(In millions of U.S. dollars)

Maturity Ranges	Up to December 31, 1983
Up to and including one year	950
Up to and including 12 years	4,400

1/ These ceilings will be lowered for any reduction in external debt via shifts in maturity structure occasioned by the renegotiation of external debts.
2/ Ceilings will not be affected by the refinancing of private sector debt outstanding.
3/ Excludes debt of the Central Bank of Ecuador, with exception that the ceiling includes external debt arising from oil advances.

Ecuador: Proposed Domestic Measures to Reduce the Projected Financing Requirements of the Public Sector, 1983

		(In billions of sucres)
A.	Revenue measures 1/	
	1. Increase in diesel price	0.90
	2. Increase in kerosene price	0.20
	3. Increase in turbo fuel price	0.10
	4. Increase in bunker fuel price	0.40
	5. Leyes de Fomento 2/	2.50
	6. Electricity rate increase of 3 per cent (compared with 1 to 1.5 per cent) by INECEL, April-November 1983	0.30
	7. Widening of coverage of tax surcharge	0.50
	8. Establishment of highway tolls and reduction of export tax certificates (CATs)	1.30
	Subtotal	6.20
B.	Expenditure measures	
	1. Restriction of expenditures of the budget to levels approved by Congress	2.70
	2. Limitation of FONAPAR's expenditure to a 5 per cent increase over 1982 levels	0.10
	3. Limitation of BEDE's expenditure (excluding emergency aid) to a 5 per cent increase over 1982 levels	1.10
	4. Limitation of CEPE's expenditure to a 5 per cent increase over 1982 levels	2.60
	5. Limitation of INECEL's expenditure to a 5 per cent increase over 1982 levels	0.80
	Subtotal	7.30
	Total	13.50

1/ Over 10 months. If implemented after March 1, 1983, the percentage increase will be raised in order to provide the projected revenues for the public sector.

2/ If the Leyes de Fomento are not passed by Congress, the Government will increase domestic gasoline prices sufficiently to generate S/. 2.5 billion in public sector revenue (estimated at a 21 per cent increase over 10 months).