

EBS/83/91
Correction 1

CONFIDENTIAL

May 24, 1983

To: Members of the Executive Board

From: The Acting Secretary

Subject: Ecuador - Staff Report for the 1982 Article IV Consultation
and Request for Stand-By Arrangement

The following corrections have been made in EBS/83/91 (5/11/83):

Page 20, lines 8 and 9: for "review 22 prospects" read "review prospects"

Page 22, para. 2, penultimate line: for "these restrictions. Accordingly,
the"
read "these restrictions. It is recommended...12-month cycle.
Accordingly, the"

Page 24, last consultation and recent contacts, line 3: for "EBM/81/182"
read "SM/81/182"

Page 27, under (In per cent of GDP), column 4, line 9: for "41.8"
read "44.2"

Page 39, Table 19: revised

Corrected pages are attached.

Att: (5)

Table 11. Ecuador: Public Sector Debt Service Projections

(In millions of U.S. dollars)

	1980	1981	Prel. 1982	1983	1984	Projected		
						1985	1986	1987
<u>Public sector debt out-</u> <u>standing (end of period)1/</u>	<u>3,530</u>	<u>4,415</u>	<u>4,699</u> 2/	<u>5,041</u>	<u>5,241</u>	<u>5,541</u>	<u>5,841</u>	<u>6,141</u>
<u>Public sector debt service</u>	<u>731</u>	<u>1,057</u>	<u>1,410</u>	<u>1,696</u>	<u>1,347</u>	<u>1,401</u>	<u>1,465</u>	<u>1,454</u>
Principal paid	417	598	676	137	757	857	908	967
Principal renegotiated	--	--	158	930	--	--	--	--
Interest	314	459	576	629	590	544	557	587
<u>Memorandum items</u>								
Ratio of public sector debt to GDP	31.1	32.9	36.0	44.2	42.2	40.9	39.6	38.1
Debt service ratio after renegotiation of debt 4/	24.6	35.2	45.8	28.0	45.2	43.2	41.4	37.7

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

1/ Assumes a net public sector capital inflow of between US\$200 million and US\$300 million per year after 1983.

2/ Excludes debt arising from oil advances.

3/ Includes amortization of renegotiated debts.

4/ As per cent of exports of goods and services.

review progress made in general on the implementation of the program, this mission will examine specifically the modification of the exchange system, the path of the crawling peg system to ensure that it is consistent with the overall program and that it would lead to a substantial reduction of the spread between the official and the free market rates by the end of the program period; the status of the negotiation for the external debt refinancing, and progress made in the elimination of external arrears and in the fiscal area. The mission also will review prospects for 1984 and will reach understandings with the authorities on the targets for the first half of 1984.

7. Exchange arrangements and restrictions
subject to Fund approval

Ecuador's existing exchange arrangements and restrictions subject to the approval of the Fund under Article VIII of the Fund's Articles of Agreement are: (a) multiple currency practices; (b) external payments arrears; and (c) bilateral payments arrangements with Hungary and Romania.

III. Staff Appraisal

Ecuador's economic and financial performance has weakened substantially in recent years. The growth of real GDP has slackened, domestic inflation has accelerated, and the balance of payments situation has deteriorated sharply. Behind this weakening of economic performance were a combination of expansionary demand policies, an overvalued exchange rate, as well as unfavorable external factors. During 1982 the Government of Ecuador sought to prevent further deterioration of the balance of payments by adopting various measures, including a depreciation of the sucre and increases in domestic prices of gasoline. Notwithstanding these measures, the balance of payments position continued to weaken.

In recent months the Ecuadoran authorities have undertaken a program aimed at strengthening the balance of payments through the adoption of a combination of exchange rate action, interest rate adjustments, and tighter demand management. In support of their adjustment plan they have requested a stand-by arrangement for a period of one year. It is to be noted that the Ecuadoran authorities have already started implementing the program through the adoption of specific corrective measures or by setting the legal basis for certain other actions.

In the external field, Ecuador has adopted a more flexible exchange system. The exchange rate in the official market was depreciated from S/. 33 per U.S. dollar to S/. 42 per U.S. dollar on March 19, 1983 and continues to be depreciated on a daily basis so as to reduce substantially the spread between the official and the free exchange rate by the end of the program period. The scope of the official market has been reduced by transferring transactions from the official to the free

market. A larger and faster shift of transactions has not been feasible because of commitments contracted by the Central Bank in the official market. However, the Monetary Board now has the legal authority to set the exchange rate in the official market and to modify the coverage of the exchange markets.

It is crucial to the success of the program that under the new exchange system the authorities avoid the emergence of an overvalued sucre as has occurred in the past. Therefore, following an initial stage in which the general public becomes familiar with the workings of the crawling peg system, the system will need to be managed in such a way as to ensure compliance with the net international reserve targets and other criteria of the program. In this context, the rate of minidevaluations of the sucre in the official market will need to be accelerated. It is also critically important that once the Central Bank has discharged its commitments for exchange, transactions be transferred periodically into the free market as an incentive to exporters and a means toward the unification of the exchange markets at an early time. To ensure that the new exchange system works effectively, the Ecuadoran authorities will need over time to dismantle existing restrictions, including external arrears, and import prohibitions.

Another main element of the adjustment program will be the achievement of a substantial reduction of the fiscal deficit. The program seeks to lower that deficit from 7.5 per cent of GDP in 1982 to 4.2 per cent of GDP in 1983 through a combination of revenue measures and restraint over expenditures. Most of the required tax measures are already in place, and the Executive has the legal mechanisms and authority to control the growth of public outlays. Given the importance of the fiscal aspect of the program, a careful monitoring of its performance will be required so that corrective measures are adopted in time in the event that deviations should threaten to emerge during the year.

In the past in Ecuador, a major source of demand pressure has been the expansion of Central Bank credit to commercial banks and the private sector. This year the Central Bank will have to finance a part of the fiscal deficit, so that other credit operations will need to be curtailed drastically to ensure that the Central Bank's credit expansion is consistent with the balance of payments target and the eventual dampening of inflationary pressures. In this context, the Ecuadoran authorities will need to complement their demand management policies with a flexible interest rate policy; clearly, the best approach would be to leave the determination of interest rates to market forces. The authorities have already drastically simplified the interest rate structure, and they are planning to review periodically the interest rates to move them toward positive real levels and to ensure that rates reflect developments in world capital markets.

The authorities have so far maintained a firm stance in regard to wage adjustments, and it is their intention to continue with such a policy. At the same time, subsidies are being eliminated and domestic prices of petroleum derivatives are being revised periodically.

Regarding the proposed renegotiation of Ecuador's external private debt, the staff notes that such a renegotiation is necessary in the light of a realistic appraisal of Ecuador's balance of payments prospects, even on the assumption that the adjustment program described above is implemented as planned. Under the proposed scheme of private debt renegotiation, in the event of a default by the private sector, Ecuador would need to make compensatory adjustments in financial policies to comply with the targets of the program.

In the view of the staff, the set of policies which are being implemented by the Ecuadoran authorities are appropriate to redress the country's balance of payments situation. The task is nevertheless a difficult one. Given the magnitude of the proposed adjustment, the staff would stress the need for a close monitoring of the various aspects of the program, to ensure that problems are identified before the program is put in jeopardy. In this context, the midterm review that has been stipulated will provide an occasion to review the progress made in the implementation of the program. In this regard, successful implementation of policies will enable Ecuador to dispose of the prevailing restrictions and multiple currency practices and to reach an early unification of its exchange rate. The authorities intend to proceed in this manner and, therefore, the staff recommends temporary Board approval for these restrictions. It is recommended that the next Article IV consultation with Ecuador be held on the standard 12-month cycle. Accordingly, the following draft decisions are proposed for adoption by the Executive Board.

I. Article IV Consultation

1. The Fund takes this decision relating to Ecuador's exchange measures subject to Article VIII, Sections 2 and 3, and in concluding the 1982 Article VIII consultation with Ecuador, in the light of the 1982 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 external arrears and bilateral payments arrangements and multiple currency practices, as described in EBS/83/91. The Fund encourages Ecuador to continue the simplification of its multiple currency practices with a view to the early unification of its exchange rate, and approves the restrictions and multiple currency practices, as the latter may be adopted by transfers of transactions from the official to the free market, until the end of the stand-by arrangement, or the next Article VIII consultation, whichever is earlier.

II. Stand-By Arrangement

1. The Government of Ecuador has requested a stand-by arrangement for a period of one year from 1983 in an amount equivalent to SDR 157.5 million.

2. The Fund approves the stand-by arrangement attached to EBS/83/91.

3. The Fund waives the limitation in Article V, Section 3(b)(iii), of the Articles of Agreement.

Fund Relations with Ecuador

Status: Article VIII.

Quota: SDR 105 million.

Fund holdings of sucres:	As of March 31, 1983	Millions of SDRs	Per Cent of Quota
Total		105.03	100.03

Operational budget: --

Designation plan: --

SDR Department:	As of March 31, 1983	Millions of SDRs	Per Cent of Net Cumulative Allocation
Cumulative allocation		32.93	100.00
Of which: holdings		(--)	(--)

Gold distribution: Ecuador has received a total of 28,241.989 troy ounces of fine gold in four distributions.

Direct distribution of profits from gold sales: Ecuador has received a total of US\$5.24 million in the two periods.

Exchange rate: Official rate (April 5, 1983): S/. 42.28 per U.S. dollar buying rate and S/. 43.13 per U.S. dollar selling rate. The sucre in the official market is being depreciated by S/. 0.04 per U.S. dollar per working day. Ecuador also has a free exchange market in which quotations fluctuate daily. On April 5, 1983, the buying and selling rates in this market were S/. 80.00 and S/. 81.50 per U.S. dollar, respectively.

Last consultation and recent contacts: The 1981 Article IV consultation discussions were completed by the Executive Board on September 11, 1981 (SM/81/182 and SM/81/150). The 1982 Article IV consultations were held in Quito during June 28-July 16, 1982 and were continued in Quito during October 20-November 5, 1982 and in Washington during November 30-December 2, 1982. They were completed during February 10-25, 1983. An expert from the Fiscal Affairs Department is assigned to Quito to assist in implementing a public sector accounting system.

Ecuador: Selected Economic and Financial Indicators, 1980-83

	1980	1981	Prel. 1982	Proj. 1983
(Annual per cent changes, unless otherwise specified)				
National income and prices				
GDP at constant prices	4.8	4.3	2.0	--
GDP deflator	15.0	13.2	14.4	31.0
Consumer prices (average)	12.8	14.7	16.4	35.0
External sector (on the basis of U.S. dollars)				
Exports, f.o.b.	18.3	--	-8.3	--
Petroleum exports	34.6	9.0	-11.6	-3.4
Imports, f.o.b.	6.9	5.4	-7.7	-25.5
Export volume	-11.7	3.5	2.9	15.0
Import volume	-6.4	3.0	-8.0	-26.9
Terms of trade (deterioration -)	17.3	-5.6	-11.2	-14.6
Nominal effective exchange rate (depreciation -)(year average)	1.5	6.3	-12.5	-48.7
Real effective exchange rate (depreciation -)(year average)	1.0	9.8	-5.0	-16.7
Central government budget				
Revenue	41.6	4.1	19.2	...
Total expenditure	33.8	31.6	11.7	...
Money and credit				
Domestic credit ^{1/2/}	14.0	18.2	48.3	24.8
Public sector ^{2/}	(-3.8)	(-7.0)	(8.8)	(5.0)
Private sector	(19.5)	(22.7)	(22.7)	(14.6)
Money and quasi-money (M2)	26.5	11.2	20.2	23.5
Velocity (GDP relative to M2)	5.3	5.6	5.5	5.8
Interest rate (maximum on 1-6 months savings deposits)	6.0	8.0	12.0	15.0
(In per cent of GDP)				
Overall public sector deficit	-4.9	-5.8	-7.5	-4.2
Central government savings	1.5	-0.6	0.3	...
Central government budget deficit (-)	-1.1	-4.8	-3.8	...
Domestic financing	(0.8)	(2.5)	(1.2)	(...)
Foreign financing	(0.3)	(2.3)	(2.6)	(...)
Gross domestic investment	27.9	25.5	24.7	16.0
Gross domestic savings	22.2	17.3	15.6	12.1
Current account deficit	-5.7	-8.2	-9.1	-3.9
External debt ^{3/}				
Inclusive of use of Fund credit (end of year)	31.1	32.9	36.0	44.2
Debt service ^{4/}	16.5	21.6	19.8	9.8
Interest payments ^{4/} (in per cent of exports of goods and nonfactor services)	17.8	23.0	29.2	31.6
(In millions of SDRs, unless otherwise specified)				
Overall balance of payments	174	-249	-417	-91
Gross official reserves (months of imports of the following year) ^{5/}	6.0	4.3	3.4	4.1
External payments arrears	--	--	68.0	--

^{1/} In relation to liabilities to the private sector at the beginning of the period.

^{2/} Includes adjustment for gold revaluation in 1982.

^{3/} Public debt, including short term.

^{4/} Public and private debt, including short term.

^{5/} Gold valued at US\$300/troy oz.

Ecuador: Recent Economic Developments

This appendix updates and supplements the information provided in the staff report on the 1982 Article IV consultation discussion with Ecuador (SM/82/192, 9/21/82) and the report on Recent Economic Developments (SM/82/198, 10/4/82).

1. Economic activity

Economic activity in Ecuador continued to decelerate last year, as real GDP grew by 2 per cent in 1982 compared with about 4-1/2 per cent in 1981 and about 5 per cent in 1980 (Table 12). The estimate for 1982 reflected a marked reduction in the rate of growth of manufacturing, as well as a contraction in construction and stagnation in petroleum output. The slowdown in industrial activity was widespread throughout the sector, but it was particularly pronounced in the case of cereals, sugar, and soft drinks industries. The sluggish performance of manufacturing was attributable to several factors, among which domestic demand conditions, rising costs of production, and financial difficulties of enterprises were the most important. According to official estimates, some two thirds of the installed capacity was utilized during 1982, compared with about 70 per cent in 1981.

Table 12. Ecuador: Selected Economic Indicators

(Annual percentage changes)

	1978	1979	1980	1981	Prel. 1982
Real GDP	6.6	5.1	4.8	4.3	2.0
Real GDP, excluding petroleum	4.9	4.4	6.5	3.7	2.3
Manufacturing	8.2	8.4	6.4	5.9	3.7
Agriculture, including fishery	-3.9	3.6	5.2	4.0	4.8
Construction	5.0	-1.1	1.7	1.1	-4.4
Petroleum	16.2	6.2	-14.5	6.4	--
Consumer price index					
End of period	10.8	10.0	13.5	17.3	24.4
Yearly average	13.1	10.1	12.8	14.7	16.4

Source: Central Bank of Ecuador.

Table 19. Ecuador: Balance of Payments by Markets, 1981-82

(In millions of U.S. dollars)

	1981				1982 (Prel.)			
	Total	Official Market	Free Market	Self-financed Transactions	Total	Official Market	Free Market	Self-financed Transactions
<u>Goods, services, and transfers</u>	-1,002	-202	-490	-310	-1,050	-539	-195	-316
Exports, f.o.b.	2,544	2,544	--	--	2,334	2,108	--	226
Imports, f.o.b.	-2,362	-2,052	--	-310	-2,181	-1,639	--	-542
Interest payments	-670	-471	-199	--	-835	-679	-156	--
Other services (net)	-539	-238	-301	--	-388	-329	-59	--
Transfers	25	15	10	--	20	--	20	--
<u>Capital movements</u>	708	298	100	310	590	152	122	316
Public sector	608	245	53	310	874	644	-16	246
Drawings on loans	(1,522)	(1,150)	(62)	(310)	(1,117)	(698)	(15)	(404)
Amortizations	(-598)	(-589)	(-9)	(--)	(-834)	(-645)	(-31)	(-158)
Other	(-316)	(-316)	(--)	(--)	(591)	(591)	(--)	(--)
Private sector	101	44	57	(--)	-284	-492	138	70
Drawings on loans	(1,087)	(111)	(976)	(--)	(1,293)	(227)	(516)	(550)
Amortizations	(-788)	(-111)	(-677)	(--)	(-1,133)	(-165)	(-418)	(-550)
Other 1/	(-198)	(44)	(-242)	(--)	(-444)	(-554)	(40)	(70)
Banking system (net)	-1	9	-10	--
<u>Intramarket operations</u>	--	-390	390	--	--	-73	73	--
Central Bank intervention	--	-167	167	--	--) -248) 248	--
Other	--	-223	223	--	--))	--
Arrears	--	--	--	--	--	175	-175	--
<u>Net international reserves</u> (increase -)	294	294	--	--	460	460	--	--

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

1/ Includes net errors and omissions.

Table 20. Ecuador: National Accounts

(In millions of sucres)

	1978	1979	1980	1981	Prel. 1982
(At current prices)					
<u>Consumption</u>	149,085	183,179	208,525	257,639	301,492
Private sector	122,635	153,095	168,472	207,194	242,577
Public sector	26,450	30,084	40,053	50,445	58,915
<u>Gross domestic investment</u>	54,432	60,193	79,353	85,631	96,903
<u>Fixed capital formation</u>	50,085	55,790	69,716	79,977	89,927
Private sector	(33,236)	(36,810)	(46,235)	(51,994)	(...)
Public sector	(16,849)	(18,980)	(23,481)	(27,983)	(...)
Increase in stocks	4,347	4,403	9,637	5,654	6,976
<u>Gross domestic expenditure</u>	203,517	243,372	287,878	343,270	398,395
<u>External sector</u>	-12,172	-7,472	-3,680	-7,607	-6,717
Exports of goods and nonfactor services	42,588	60,268	71,663	72,838	85,128
Minus: imports of goods and nonfactor services	-54,760	-67,740	-75,343	-80,445	-91,845
<u>Gross domestic product at market prices</u>	191,345	235,900	284,198	335,663	391,678
Minus: net factor payments abroad	-6,383	-8,893	-13,118	-18,058	-28,722
<u>Gross national product at market prices</u>	184,962	227,007	271,080	317,605	362,956
Plus: subsidies	1,073	1,472	2,473	2,755	...
Minus: indirect taxes	-17,554	-19,889	-24,346	-31,132	...
<u>Gross national product at factor cost</u>	168,481	208,590	249,207	289,228	...
Minus: depreciation	-10,774	-12,610	-14,221	-18,075	...
<u>National income</u>	157,707	185,980	234,986	271,153	...
(At 1975 prices)					
<u>Gross domestic product at market prices</u>	133,632	140,420	147,202	153,521	156,560

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