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EBS/87/263
Correction 2

CONFIDENTIAL

December 29, 1987

To: Members of the Executive Board

From: The Secretary

Subject: Ecuador - Request for Stand-By Arrangement

The following corrections have been made in EBS/87/263 (12/9/87):

Page 7, footnote 1, last two lines: for "rescheduling agreement...in the other."
read "rescheduling agreement."

Page 10, third para., line 12: for "35" read "37."

Corrected pages are attached.

Att: (2)

all times, while performance on the net international reserves is to be tested at the end of each quarter.

In addition, the program establishes the following performance criteria: (a) no new external arrears are to be permitted to develop during the period of the program; (b) the outstanding arrears at the end of 1987 will be eliminated before requesting the first purchase subject to performance criteria under the arrangement; 1/ (c) the spread between the intervention and the free market exchange rates is to be reduced to 5 percent or less before requesting the first purchase subject to performance criteria, and eliminated before the completion of the mid-term review of the program scheduled for no later than July 31, 1988; and (d) before requesting the first purchase subject to performance criteria, the authorities will eliminate the prior import deposit requirement adopted in October 1987. Also, before consideration by the Executive Board of Ecuador's request for the stand-by arrangement, the authorities intend to reduce the spread between the intervention and the free market exchange rates to 10 percent or less.

The customary performance criteria on overdue financial obligations to the Fund and on exchange restrictions, multiple currency practices, bilateral payments agreements inconsistent with Article VIII, and import restrictions for balance of payments purposes are applicable during the program period. The review with the Fund before July 31, 1988 to assess the progress made in implementing the program also is a performance criterion.

2. Fiscal policy

The fiscal program aims at reducing the public sector deficit from 10.5 percent of GDP in 1987 to 1.3 percent of GDP in 1988, largely on the basis of the normalization of petroleum exports and expenditure restraint (Table 3). The overall deficit is expected to be more than financed by net disbursements of external loans, including a new loan from foreign commercial banks, and the rescheduling of service payments to official creditors and commercial banks, thus allowing for the elimination of all external arrears and a buildup of deposits at the Central Bank.

Total public sector revenue is projected to increase by the equivalent of about 8 percentage points of GDP to 29.6 percent of GDP in

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1/ For the purpose of the program, the outstanding arrears will be considered to have been eliminated upon signature of the agreement with commercial banks, upon finalization of the Agreed Minute with Paris Club creditors, and upon the issuance of foreign currency-denominated bonds to retire all trade arrears. In addition, arrears on suppliers' credits will be considered to have been eliminated upon the conclusion of a rescheduling agreement.

Table 3. Ecuador: Summary of Public Sector Operations

	1984	1985	Prel. 1986	Projected 1987	Projected 1988
	(In billions of sucres)				
Total revenue	192.6	309.2	337.4	390.9	730.5
Petroleum revenue	82.2	154.1	115.9	110.8	332.3
Nonpetroleum revenue	92.0	140.0	190.6	255.3	359.5
Operating surplus of public enterprises	18.4	15.0	30.9	24.8	38.7
Total expenditure	197.4	288.0	407.5	579.2	761.7
Current expenditure	142.5	211.4	287.9	407.4	555.9
Capital expenditure	54.9	76.6	119.7	171.8	205.8
Of which: fixed capital formation	42.7	56.2	91.3	141.9	176.1
Overall surplus or deficit (-)	-4.8	21.1	-70.1	-188.3	-31.2
External interest arrears	--	--	--	43.9	-70.4 1/
Overall balance (cash basis)	-4.8	21.1	-70.1	-144.4	-101.6
Financing	4.8	-21.2	70.1	144.4	-112.9
External financing (net) 2/	11.7	15.4	76.0	86.5	-11.9
Disbursements	19.6	23.1	106.0	153.9	206.2
Amortizations	7.9	7.7	30.0	67.4	218.1
External amortization arrears	--	--	--	21.4	-34.4 1/
Domestic financing (net)	-6.9	-36.6	-5.9	36.5	-66.6
Central Bank	-12.3	-35.7	-10.6	52.0	-55.8
Rest of banking system	-0.6	0.3	-1.0	-11.4	-6.0
Other	6.0	-1.2	5.7	-4.1	-4.8
Financing gap	--	--	--	--	214.5
Renewal of oil facility	--	--	--	--	60.8
Commercial bank credit	--	--	--	--	41.5
Rescheduling	--	--	--	--	112.2
Of the 1987 arrears	--	--	--	--	53.0
Of the 1988 payments	--	--	--	--	59.2
	(In percent of GDP)				
Total revenue	23.7	27.8	24.7	21.7	29.6
Petroleum revenue	10.1	13.9	8.5	6.2	13.5
Nonpetroleum revenue	11.3	12.6	14.0	14.2	14.6
Operating surplus of public enterprises	2.3	1.3	2.2	1.3	1.5
Total expenditure	24.3	25.9	29.8	32.2	30.9
Current expenditure	17.5	19.0	21.1	22.6	22.5
Capital expenditure	6.8	6.9	8.7	9.6	8.4
Overall surplus or deficit (-)	-0.6	1.9	-5.1	-10.5	-1.3
External interest arrears	--	--	--	2.5	-2.9 1/
Overall balance (cash basis)	-0.6	1.9	-5.1	-8.0	-4.2
Financing	0.6	-1.9	5.1	8.0	-4.5
External financing (net) 2/	1.4	1.4	5.6	4.8	-0.4
Disbursements	2.4	2.1	7.8	8.5	8.4
Amortizations	1.0	0.7	2.2	3.7	8.8
External amortization arrears	--	--	--	1.2	-1.4 1/
Domestic financing (net)	-0.8	-3.3	-0.5	2.0	-2.7
Central Bank	-1.5	-3.2	-0.8	2.9	-2.3
Rest of banking system	-0.1	--	-0.1	-0.7	-0.2
Other	0.8	-0.1	0.4	-0.2	-0.2
Financing gap	--	--	--	--	8.7
Renewal of oil facility	--	--	--	--	2.5
Commercial bank credit	--	--	--	--	1.7
Rescheduling	--	--	--	--	4.5
Memorandum items					
Current expenditure excluding interest payments	14.7	15.0	16.3	16.7	15.3
Interest payments	2.8	4.0	4.8	5.9	7.2

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

1/ Represents the settlement of external arrears accumulated in 1987 valued at the 1988 exchange rate.
2/ Includes the oil loans extended by Venezuela and Nigeria in 1987, which are amortized in 1987 and 1988.

1988. Most of this improvement comes from the resumption of petroleum exports. Nonpetroleum revenues have strengthened somewhat since 1985 thanks to a broadening of the tax base (involving mainly import duties and excise taxes) and improvement in tax administration (for income and general sales tax) and they are expected to show further gain in 1988.

The authorities aim at reducing total public sector expenditure by the equivalent of 1.3 percentage points of GDP to 30.9 percent of GDP in 1988. Current expenditures are projected to remain basically unchanged in relation to GDP but non-interest current expenditures are estimated to decline by about 1.4 percentage points of GDP. Following an increase in the minimum wage for public sector employees of 20.8 percent in October 1987, no provision is made for a new adjustment in 1988. Should an adjustment be made next year, the authorities would adopt compensating revenue and/or expenditure measures. Capital expenditures are projected to decline by the equivalent of 1.2 percentage points of GDP in 1988, of which 1 percentage point reflects the completion in 1987 of exceptional expenditures on the reconstruction of the oil pipeline and other infrastructure destroyed by the earthquakes.

Central government operations are projected to shift from a deficit of 4.7 percent of GDP in 1987 to a surplus of 3.9 percent of GDP in 1988 (Statistical Appendix Table 11). About three fourths of this improvement is attributable to the increase in oil revenues, while increases in nonpetroleum revenues and reductions in capital outlays account for the remainder of the improvement. Petroleum revenues of the Central Government are estimated to increase by the equivalent of 6.4 percentage points of GDP, which corresponds to almost 90 percent of the rise in total public sector oil revenue. The distribution of petroleum revenues will change in favor of the Central Government in 1988 because of the impact of the estimated depreciation of the sucre in the intervention market (almost the entire oil revenue in sucres that results from an exchange rate higher than S/. 66.50 per U.S. dollar goes to the Central Government), and because of a transitory change in the method of distributing royalty revenues. Nonpetroleum revenues are projected to increase by the equivalent of 1.1 percent of GDP, mainly because of a strong performance of taxes on international trade and the phasing out of export rebates. Revenue from taxes on international trade and from the import component of the sales tax will increase mainly as a result of the depreciation of the sucre in the intervention market.

Total central government outlays are projected to fall by the equivalent of 1.1 percent of GDP in 1988. Noninterest current expenditures are projected to decline by 1.3 percentage points of GDP; this reduction hinges on the authorities' intention to refrain from new hirings and from granting salary increases during 1988. Capital outlays, which almost doubled in 1987, are projected to decline by 1 percentage point of GDP reflecting a reduction in investment and in capital transfers to the rest of the public sector. A large share of these transfers is allocated to both municipal and provincial governments to finance construction projects.

The overall position of the rest of the general government is projected to improve in 1988 with a decline in its deficit from 3.2 percent of GDP in 1987 to 2.4 percent of GDP in 1988 (Statistical Appendix Table 12). Higher petroleum revenues will offset an expected reduction in nonpetroleum revenue so that most of the adjustment will fall on the expenditure side. A cutback in the amount of net lending by the Social Security Institute (IESS) will be an important element behind the reduction in expenditure by the rest of the general government.

With respect to the public enterprises, their operating surplus is expected to improve marginally in 1988, to 1.5 percent of GDP, reflecting the normalization of petroleum exports by the Ecuadoran Oil Corporation (CEPE) and a recovery in the revenues of the state electricity company (INECEL) (Statistical Appendix Table 13). The electricity company is expected to continue its policy of increasing electricity rates by 3 percent a month while strengthening the collection of overdue electricity bills. While capital outlays by the public enterprises as a group are to be kept roughly constant relative to GDP in 1988, investments by CEPE and INECEL are projected to increase significantly if emergency related outlays during 1987 are excluded. Investment by INECEL will concentrate on the completion of the third phase of the Paute hydroelectric dam, the drainage of the Amaluza canal in Paute, and the conclusion of the Ecuadoran interconnected electricity transmission system. CEPE's investment will be mainly on exploration and development of oil fields and the construction of another oil pipeline to transport refined products for domestic consumption.

3. Monetary policy

The monetary program for 1988 aims at achieving an increase in net official international reserves of US$739 million, some US$30 million over and above the elimination of external arrears. The program contemplates a buildup of public sector deposits with the Central Bank of nearly S/. 56 billion (2.3 percent of GDP) and would allow for an expansion of about 25 percent in banking system credit to the private sector (Tables 4 and 5). The program assumes that banking system liabilities to the private sector would rise by about 31 percent, somewhat less than the projected increase in nominal GDP. In order to control credit expansion, the authorities increased reserve requirements in several steps in 1987, including an adjustment in the reserve requirement on demand deposits from 27 percent at the beginning of the year to 37 percent in November 1987. The authorities intend to adjust reserve requirements and to conduct open market operations as needed to ensure that the objectives of the program are achieved.

With a view to fostering the growth of financial savings in the domestic banking system, the authorities have adopted in recent years measures designed to bring about more flexibility to interest rates. On August 11, 1986 the minimum denomination of certificates of deposit