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Statement by Mr. Portugal and Mr. Yépez on Ecuador
Executive Board Meeting
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1. Six months after the introduction of formal dollarization, Ecuador shows clear signs of the beginning of a broad-based economic recovery. Initial surveys and anecdotal evidence indicate that sales are picking up significantly, not only for export, but also for the domestic market. Construction activity has resumed. Household consumption is rebounding from the very depressed levels registered in 1999 at a faster-than-expected pace. Firms--whose inventories were depleted throughout the crisis--are hiring new employees to increase production which, together with a massive out-migration of laborers, has begun to create shortages for unskilled workers in a few places, such as Otavalo (in northern Ecuador) and Cuenca (the third largest Ecuadoran city). In all, there are indications that the outflow of capital has considerably slowed down and that the external current account, which reached a surplus of almost 7 percent of GDP in 1999 after an 11 percent deficit in 1998, may be returning closer to balance faster than anticipated.

2. Business confidence is returning and a new sense of hope appears to be emerging among entrepreneurs. With the reduction of the uncertainties that used to fuel opportunities for financial arbitrage and speculation, entrepreneurs are extending their planning horizons and redirecting energy towards reducing costs and enhancing productivity in their firms. The voluntary schemes of corporate debt restructuring have improved the solvency of debtor enterprises, thereby aiding the economic rebound. Our Ecuadoran authorities are committed to maintain the rescheduling schemes under the principle of voluntary basis participation. While bank credit has not been restored yet, firms are financing themselves out of their own resources and, in the case of the larger ones, with increased recourse to external suppliers' credit. Moreover, it appears that continuing political impasses are less of a concern for business people, who perceive that politicians, due to dollarization, are less able than in the past to interfere with economic variables. The recent announcement of the successful external debt exchange and the continuous support of the IMF and other multilateral organizations, have added to this process of confidence rebuilding.

3. Economic agents have adapted smoothly and at a faster pace than expected to the full dollarization of the financial system and the use of US dollar bills for transaction purposes. To date, almost ninety percent of the total amount of local currency has been withdrawn from circulation in exchange for US dollar bills. Even in the informal sector, which has been benefiting from a visible increase in incomes due in part to dollarization-induced rounding up of prices, people have found effective ways to deal with the transitional shortage of coins, the demand for which is expected to be fully satisfied by end-September as the new minted coins arrive in the country.

4. Nevertheless, there are major obstacles and unsolved problems that Ecuador will have to confront in order to consolidate the recovery process, reduce poverty, and improve equity. Ecuador has a long way to go in improving legal security--a necessary ingredient of a favorable investment climate. The reconstruction of a sound financial system, including the reprivatization of publicly controlled banks, is a major challenge, fraught with political complications. Our Ecuadoran authorities are involved in a sound program to strengthen the financial system through the introduction of international standards and the improvement of banking supervision. Some positive results are observed since deposits in the financial system have increased by about US$500 million in the last seven months.

5. The enduring restoration of fiscal viability will necessarily require a major tax reform (as outlined in the program) and discipline in avoiding expenditure slippage, so as to protect the oil windfall gains of the recent past, until legal reforms establish a well-functioning oil stabilization fund. The very important steps already taken for a comprehensive restructuring of the public sector liabilities including the deposit unfreeze, the reprogramming of the domestic public debt, and the recent international bond exchange need to be completed with the rescheduling of the Paris Club debt and the establishment of a modern, prudent system of public debt management in the future. Against this background, the continued support of the international community, especially the IMF, will be crucial to improve the chances of success.

6. The well-written, accurate, and candid staff report raises some important issues. In particular, we would like to touch on three areas: the debt exchange, the legal reform under the Trole II, and fiscal matters.

7. As regards the debt exchange, we are very pleased to report that on August 23, 2000, the Republic of Ecuador closed a debt exchange transaction with its Brady Bond and Eurobond holders. Holders of more than 98 percent of the eligible debt elected to participate in this transaction. The financial effects of this transaction will be important. The Brady and Eurobond debt stock has been reduced by approximately 40 percent of their face value.

8. The external financing gap for 2000 would be eliminated, provided that the Paris Club agrees with a rescheduling. According to the staff's medium-term external projections, the debt exchange would make a sizable contribution to closing the projected external financing gaps over the medium term. Further assistance from official creditors will likely be needed during 2001-2003, but beyond that the remaining external financing gaps should be manageable, especially if the bond buybacks scheduled to begin in 2006 take the form of debt equity swaps.

9. Our Ecuadoran authorities are scheduled to meet with Paris Club creditors on September 14-15. At this meeting, Ecuador will be seeking as much cash-flow relief as possible during the program period.

10. The target for reduction in domestic arrears was not met, in part because of the need to accumulate sufficient deposits to pay the cash component of the external debt

restructuring. However, our Ecuadoran authorities are committed to reduce domestic arrears over the coming months. A waiver for this performance criterion is, therefore, requested.

11. The Ecuadoran authorities intend to deepen the structural reform process through the "Ley para la Promoción de la Inversión y la Participación Ciudadana" (Trole II), which expands the scope of private sector activity, permitting the privatization of public utilities, roads, seaports, airports, postal services, and the extraction of nonrenewable natural resources. The regulatory frameworks for the petroleum, mining, electricity, telecommunications sectors have been reformed in order to facilitate privatization and/or joint ventures. The law also increases labor market flexibility, including longer probation periods for workers, use of part time labor, and greater functional mobility for workers within firms.

12. The Trole II clarifies that a financial institution with a capital adequacy ratio below the minimum established can be administrated by the shareholders as long as there is a plan agreed with the Superintendency of Banks to fulfill the requirements. The framework for recapitalizing banks below the minimum capital adequacy ratio of 9 percent should be approved within a few weeks by the Junta Bancaria. A waiver for this performance criterion is, therefore, also requested.

13. On August 23, the Central Bank issued a new regulation, which liberalizes the interest rate and defines usury rate as 50 percent above the average lending rate. This was a major step in the implementation of the structural reform agenda agreed with the Fund.

14. As regards recent fiscal performance, the overall surplus in the Non-Financial Public Sector at the end of June was 0.7 percent of GDP, with a primary surplus of 4.2 percent of GDP vis-à-vis an overall deficit of 2.5 percent of GDP and a primary surplus of 2.0 percent of GDP contemplated in the program. The positive results during the first half of the year are attributed to an efficient fiscal policy, which has been aimed at reducing expenditures by almost 1.6 percent of GDP and increasing tax collection by 1.2 percent of GDP. Hence, public sector spending is not a major contributor to the current recovery in economic activity.

15. Ecuador made substantial progress with the fiscal package announced by the Government last May. The package aims at setting the basis for an increase in social spending. It included a significant increase in domestic fuel prices aimed at reducing subsidies. The estimated revenue gain from the increase would be 1 percent of GDP (US$ 106 million). Increases of about 66 percent in the price of high octane gasoline, 72 percent in the price of low octane gasoline, 91 percent in the price of diesel, 160 percent in the price of jet fuel, 310 percent in the price of fuel oil, 276 percent in the price of solvents, and 337 percent in the price of aviation gasoline were implemented. To help alleviate the social impact of the fuel price increases, many of which were larger than envisaged in the program, the increases in the price of cooking gas were delayed and will be determined at the time of the second review. Since the increases in domestic fuel prices are a performance criterion under the program, a waiver on the price of cooking gas has been requested.

16. As the fiscal revenues are higher than programmed, special consideration has been given in the package to an increase in social expenditures in the second half of the year. The value of the cash transfer to the poor (bono solidario) was increased. In addition, special attention has been given to social programs in the education, health, and welfare sectors and the Fund for Indigenous People. Total spending on these programs would be increased by US$ 27 million.

17. The fiscal package also provided for a nominal wage increase between 48 percent and 70 percent for all categories of central government employees. This increase has been paid beginning last June. The adjustment in the wage bill will be financed with the revenue gain generated by the increase in domestic prices of the most important consumer fuels. The estimated cost of this measure is US$ 90 million (0.8 percent of GDP).

18. Available information suggests that the fiscal package would be completely financed and will not change the programmed fiscal deficit. If there are indications of a revenue shortfall, the authorities intend to move quickly to contain other current expenditures.

19. Preliminary data for end-June indicate that the performance criteria for the combined public sector borrowing requirement and the nonfinancial public sector borrowing requirement were met with substantial margins. However, since these data are not yet final, our Ecuadoran authorities request a waiver of applicability for these two performance criteria.

20. We would like to thank the staff, Management, and the Executive Board for the support that the Fund has shown to Ecuador. Our Ecuadoran authorities remain fully committed to the implementation of the economic program and are confident that they will continue to be able to count on the indispensable support from the international community for this endeavor.