0404

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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 88/1

10:00 a.m., January 4, 1988

R. D. Erb, Acting Chairman

| Executive Directors | Alternate Executive Directors |
|---|---|
| | E. T. El Kogali |
| | Song G., Temporary |
| C. H. Dallara | |
| | J. Prader |
| | E. V. Feldman |
| | S. K. Fayyad, Temporary |
| G. Grosche | |
| | Hon C.-W., Temporary |
| A. Kafka | J. Hospedales |
| | C. Enoch |
| | G. D. Hodgson, Temporary |
| | D. Saha, Temporary |
| | P. D. Péroz, Temporary |
| G. Ortiz | |
| | M. Fogelholm |
| | D. Marcel |
| G. A. Posthumus | |
| | G. K. Hodges, Temporary |
| G. Salehkhou | O. Kabbaj |
| | V. K. Malhotra, Temporary |
| K. Yamazaki | |
| | F. Di Mauro, Temporary |

L. Van Houtven, Secretary and Counsellor
R. Gaster, Assistant

Also Present

IBRD: K. Sierra, Latin America and the Caribbean Regional Office. Exchange and Trade Relations Department: E. Brau, A. Leipold, P. J. Quirk. Legal Department: A. O. Liuksila, J. V. Surr. Research Department: N. M. Kaibni, A. Muttardy, B. E. Rourke. Western Hemisphere Department: S. T. Beza, Director; M. Caiola, Deputy Director; J. Ferrán, Deputy Director; M. E. Bonangelino, L. L. Pérez, G. L. Terrier. Advisors to Executive Directors: G. Pineau, D. C. Templeman, J. E. Zeas. Assistants to Executive Directors: E. C. Demaestri, S. Guribye, T. Morita, J. A. K. Munthali, L. M. Piantini, S. Rouai, C. C. A. van den Berg, E. L. Walker, R. Wenzel, D. A. Woodward.

1. ECUADOR - STAND-BY ARRANGEMENT, EXCHANGE SYSTEM; AND PURCHASE TRANSACTION - COMPENSATORY FINANCING FACILITY

The Executive Directors considered a staff paper on Ecuador's request for a 15-month stand-by arrangement in an amount equivalent to SDR 75.35 million (EBS/87/263, 9/12/87; Sups. 1 and 2, 12/31/87; and Cors. 1 and 2, 12/19/87), together with a staff paper on Ecuador's request for a purchase under the compensatory financing facility (EBS/87/264, 12/9/87; and Sup. 1, 12/30/87).

The Acting Chairman said that the case of Ecuador was a difficult one, particularly as the decline in world oil prices had altered an important parameter of the proposed program. Preliminary estimates indicated that the financial situation in Ecuador was tight but manageable, provided that the adjustment program was adhered to and the fiscal measures were implemented early in the program.

The previous week, management had been faced with two possible courses of action in Ecuador's case: to withdraw the proposed arrangement and negotiate a new one; or--the alternative before the Board--to adjust the timing and phasing of the arrangement already negotiated, the Acting Chairman continued. Withdrawing the proposed stand-by arrangement would have had some negative repercussions--inter alia, jeopardizing the conclusion of financing arrangements with the commercial banking community and official creditors.

Insufficient external support would make it more difficult for Ecuador to maintain its adjustment effort, the Acting Chairman remarked. Even with the proposed changes in timing and phasing, the program would involve risks and would be tight. Approval of the requested stand-by arrangement--as modified by the proposed advancement of the midterm review--was a way to deal with those risks. Ecuador and the Fund had had a good working relationship for a long time, including in the context of the country's major adjustment efforts since 1983. The authorities had made considerable progress, and the present difficulties stemmed in part from the recent decline in the price of oil and the severe consequences of the earthquakes of March 1987. Ecuador had maintained a very good relationship with external creditors and had always been current on its obligations to the Fund--even in difficult circumstances. Commercial banks representing over 85 percent of Ecuador's debt to commercial banks had accepted the renegotiated terms, and an indication of a positive reaction had been received concerning the likely outcome of the Paris Club meeting to be held three weeks hence.

The staff representative from the Western Hemisphere Department said that the chairman of the steering committee of the commercial banks had indicated that as of January 4, 1988, he had received confirmed participation in the proposed financing package for Ecuador of 86.4 percent of the total of $350 million. Additional confirmations were expected shortly.

The staff representative from the Research Department commented that the recent decline in the price of oil would have implications for the shortfall calculations supporting the proposed purchase under the compensatory financing facility. The shortfall calculated in EBS/87/264 was based on a projected price of about $17 per barrel for the two years ending September 1989. With that projection, the shortfall in total exports for the 12 months ending September 1987 amounted to SDR 646 million, roughly 15 times the amount of the proposed purchase; although most of the shortfall was attributable to oil exports, the non-oil shortfall amounted to SDR 50 million, which itself exceeded the proposed purchase. The decline in oil prices in recent weeks had obviously cast some doubt on the plausibility of the price of $17 assumed for the two postshortfall years. Prices had declined from over $18 in November 1987 to under $14 by mid-December 1987, and had recently recovered to $15.50. However, a price significantly lower than $17 for the two postshortfall years would still yield a shortfall significantly larger than the proposed purchase; indeed, because of the very large decline in earnings in the shortfall year, even if earnings from oil exports for the two postshortfall years were zero, the shortfall in total exports would still amount to SDR 132 million, about three times the proposed purchase.

Mr. Zeas made the following statement:

> My authorities would like to thank the staff for the speed with which they have prepared the reports related to Ecuador's requests for a stand-by arrangement equivalent to SDR 75.4 million and for a drawing under the compensatory financing facility for SDR 42.7 million (equivalent to 50 percent and 28.5 percent of quota, respectively). After taking into account Ecuador's scheduled repurchases, full use of the proposed purchases would reduce the Fund's holdings of sucres from 341 to 329 percent of quota, equivalent to SDR 495.8 million.
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> The years 1984-85 were a period of successful economic recuperation, when Ecuador's annual real growth reached 4.5 percent with external and internal equilibrium. By contrast, in 1986 the country faced, with relative success, a very serious deterioration in the prices of several of her export commodities; particularly, Ecuador faced a sharp drop in her main export product, oil, which fell to $12.80 a barrel, compared to $25.80 in the previous year, and to $34.40 per barrel in 1981. Ecuador, with a population of 9.5 million, is a small supplier of crude oil. It exports approximately 70 million barrels of oil per annum equivalent to under 1 percent of world production and exports. The sharp decline in oil prices alone represented a loss of export revenue in 1986 of approximately $925 million (equivalent to 31 percent of 1985 exports); and, fiscal revenue equivalent to 25 percent of that realized in 1985 was lost. Nevertheless, through expenditure control and other measures, the overall deficit of the balance of payments that year was only $50 million, excluding a loan from the Andean Reserve Fund

for $175 million which carries a five-year maturity. The estimated overall deficit of the nonfinancial public sector was S/. 70 billion, equivalent to $570 million or about 5 percent of GDP. The serious financial difficulties of 1986 were faced without engaging in excessive new net foreign borrowing. The stock of foreign debt increased by 12 percent, equivalent to 6 percent of 1985 GDP, an 11 percent increase excluding borrowing from the Fund. In particular, new borrowing from foreign commercial banks was kept to a minimum increase of only 4.7 percent net. The growth of real GDP equaled the growth of the population, 2.9 percent.

The most important policy actions implemented in 1986 were explained to the Board on the occasion of the June 1987 request for emergency assistance. Therefore, we will not repeat them here, except to mention that strong market-oriented policies were adopted aiming at increasing the flexibility of prices, including the exchange and interest rates.

During the first few days of March 1987, the country was seriously ravaged by a series of strong earthquakes. The epicenter of these quakes was in the Orient, a sparsely inhabited area of the country and, therefore, fortunately the loss of human lives was small. However, there was substantial destruction to the oil pipeline and its related infrastructure. Oil production forgone in 1987 is estimated at about $730 million--five months of production. Physical damages surpassed $80 million in public works and $25 million in private losses. The financial community came promptly to Ecuador's rescue, and my authorities wish to record their sincere thanks and appreciation to all of those donor countries that responded very generously. We wish to make special mention of Venezuela, Colombia, Mexico, Nigeria, and the United States. Two of these countries granted Ecuador oil loans free of interest charges. Also very helpful were the emergency loans granted by the Fund and the World Bank.

In addition to the oil revenue loss, because of a sharp drop in coffee prices--from an unusually high level to an unusually low level--coffee exports dropped in 1987 by $140 million compared to 1986.

Despite these very serious blows to the heart of the country's finances, it is now estimated that non-oil GDP increased by 2.6 percent and the overall deficit of the balance of payments was contained at $740 million--significantly less than the loss in oil and coffee revenue. The deficit was largely financed by an accumulation of arrears, mainly on foreign debt, and to a minor extent with trade arrears. As expected, the overall deficit of the public sector is estimated to have widened to S/. 188 billion, on an accrual basis, equivalent to $1,092 million, or 10 percent of GDP.

Despite all of the difficulties caused by the earthquakes, the authorities proceeded to increase gasoline and other oil derivative prices by 70 percent in 1987, which made a total 500 percent increase in five years, compared to an inflation rate of 292 percent in the same period.

When it was perceived that there was excessive domestic liquidity, the Monetary Board proceeded to adjust reserve requirements which were increased in five instances during the year, reaching 37 percent for monetary deposits in November 1987 compared to 27 percent at the end of 1986. These adjustments and the rapid drop of the sucre in the free market led lending interest rates to rise sharply to levels much higher than inflation. Depite the positive role that these policies played in helping to cope with the situation, the unusually high interest rates continue to be a matter of concern to the authorities due to their potentially disruptive effect on productive investment.

Under these very difficult circumstances, the authorities continued to eliminate prior import authorizations and to reduce import tariffs, with the backing of certain World Bank loans. As a result, in 1987, imports increased by 7 percent after discounting $300 million for the nonrecurring emergency imports of construction materials and oil.

Perhaps the most disturbing factor for the authorities, during 1987, particularly during the last quarter of the year, was the exaggerated increase of the sucre/U.S. dollar exchange rate in the free market. This rate increased from S/. 146 per $1 in February to S/. 300 at the end of November, a 105 percent depreciation. By December 15, however, the sucre free market exchange rate had fallen to S/. 247 per $1, which still represented a very high rate of depreciation--near 68 percent--compared to an inflation rate which bordered 30 percent. The 1987 depreciation took place after the real effective exchange rate had depreciated by a cumulative 40.3 percent during 1982-86, a percentage which was about equal to the appreciation which had taken place in the previous 12 years ending 1981. It is the authorities' view that once the decision was taken not to service amortization and interest on foreign commercial debt--to offset the loss of oil revenues--a nominal devaluation of 68 percent against the U.S. dollar was sufficient, particularly since the non-oil economy was performing well. Non-oil and non-coffee exports, for example, increased by almost 16 percent in U.S. dollar terms in 1987, after a similar increase in 1986 and almost twice that percentage in 1984-85. Despite the authorities' commitment to a flexible exchange rate, they were concerned in the second half of 1987 about the potentially disruptive side effects of an excessive depreciation in the areas of investment and inflation, and about the negative expectations that might be exacerbated and which could lead, inter alia, to higher wage demands, and adjustments in the prices and tariffs of public utilities.

The financial program for 1988 is very strong and courageous. In addition to reducing the public sector's deficit from approximately 10 to 1 percent of GDP, it aims at an accumulation of deposits by the public sector in the Central Bank of S/. 55 billion--approximately $200 million--a total elimination of $668 million of arrears and a gain of net international reserves of $30 million.

Foreign debt service in 1988, after the refinancing agreements, will reach 52 percent of exports of goods and services, excluding the repayment of arrears. Including the repayment of foreign debt arrears, which will not be refinanced, debt service will be over 69 percent of exports of goods and services; or, 16 percent of GDP in 1988, compared to 7 percent in 1986.

The exchange rate policy is to remain flexible so as to maintain the competitiveness achieved by October 1987; and, additional efforts are to be made on foreign trade liberalization and reduction of import tariffs. Imports in 1988 are expected to increase by 6 percent with respect to the previous year, after accounting for nonrecurring emergency imports of $300 million in 1987. The goal set for the growth of non-oil real GDP is 2.6 percent.

A significant part of the 1988 improvement will be contributed by the normalization of oil exports to a full year level. This will mean an additional $565 million equivalent to 6 percentage points of GDP, assuming that oil prices reach an average of $17.25 per barrel during 1988. A significant effort is expected in the acceleration of net disbursements from the multilateral banks; and the new loan from commercial banks is estimated at $350 million.

Based on more recent developments in the oil market, however, it is now estimated that the average price of oil in 1988 could be as low as $15 per barrel. This is, of course, a tentative estimate given the high degree of uncertainty in the oil market at the present time. For this reason, the authorities have requested that the midterm review of the program be advanced. Adjustments to the program's objectives would be made, if necessary, at the time of the review mission of 1988.

To fulfill this ambitious program, the authorities will depend heavily on expenditure control. Even capital expenditure will be reduced. Using the average exchange rates on page 11 of the staff paper, the public sector's fixed capital formation will decline, in 1988, by $106 million--or by 14 percent--with respect to 1987's nonemergency fixed capital formation. In terms of GDP, fixed capital formation would be reduced by 0.4 percent after allowing for nonrecurrent emergency reconstruction expenditure of $80 million in 1987.

In addition, the authorities expect to finalize a refinancing agreement with the commercial banks and with the Paris Club members, which will postpone the repayment of principal to the commercial banks and of principal and interest to Paris Club members. The authorities have agreed with the steering committee of the commercial banks on the terms of the refinancing package. The agreement is of a "carve out" nature, not being serial; it will save additional interest payments per year--via a further reduction on the spread--and the banks will obtain relending, currency options, exit bonds, and debt-equity swaps, as new features granted by the authorities for the first time.

The success of this strong financial program depends heavily on a good, healthy external environment, particularly with respect to oil and other export commodity prices, foreign interest rates, and open markets. Ecuador is not a CONTRACTING PARTY to the GATT; it maintains, however, a relatively open foreign trade policy stance, and it expects and needs equal treatment from all member countries of the Fund.

We believe that the Ecuadoran authorities should be supported on their requests for stand-by and compensatory financing arrangements.

Mr. Yamazaki made the following statement:

The damage caused by the earthquake aggravated Ecuador's difficult economic situation. However, I also note and regret that the economic program related to the latest stand-by arrangement beginning in August 1986 was already off track before the earthquake. As a consequence of the earthquake, the balance of payments imbalance has become huge, and--according to the midterm scenario outlined in the staff paper--a large financing gap will emerge, even when the adjustment measures to be implemented under the proposed stand-by arrangement achieve the expected results. There is no room for slippage under this program, and I hope that the Ecuadoran authorities initiate the corrective measures with firm and renewed determination. Timely accomplishment of the adjustment measures and steady implementation of the related structural reforms are essential to regain a viable balance of payments position. In addition, if need be, the authorities should take additional measures to secure the expected adjustment. This program should also be considered only a first step in a continuous medium-term adjustment process.

The 1988 economic program is generally appropriate, and I broadly support it. Four points are of particular interest.

First, the unification of the exchange rate is the key feature of the adjustment toward a sound balance of payments position in the future. Therefore, I welcome the inclusion of this target as a performance criterion in the program with a specific timetable for implementation.

Second, the proposed fiscal policy does not seem adequate, as the efforts to reduce the overall public sector deficit fall rather heavily on the revenue area, particularly on increased revenue from the recovery of oil production. The ratio of current expenditures to GNP is projected to be largely unchanged from the 1987 level, which was even higher than that of 1986, when the slippage in the fiscal deficit target occurred. Considerable effort will be required to control current public outlays; and if revenue falls short of expectations, a contingency plan for cutting expenditure may be needed.

Third, in the face of uncertainty concerning future oil prices, it is increasingly necessary that the expected reduction of imports in 1988 be secured. To ensure that reduction, the public sector deficit must be kept below the program level, especially through the close monitoring of investment outlays. A sufficiently flexible exchange rate policy can also play a vital role in this area.

Fourth, the flexible interest rate policy is a step in the right direction. Nevertheless, the inflation rate is still high, and the monetary indicators will need to be monitored carefully, given the impact of the flexible exchange rate policy and the debt/equity swaps in the monetary area. Control of credit expansion needs to be exercised in a timely and flexible manner.

Ecuador meets all the criteria for the proposed compensatory financing, and I support the proposed decision.

There is also a procedural issue involved here. The staff is proposing approval of a stand-by arrangement on the basis of the term sheet and before the critical mass is achieved. This procedure is not desirable, and although I support the decision in this case, Ecuador should be treated as an exception, and similar cases should be considered on a case-by-case basis in the future.

Mr. Ortiz made the following statement:

For some time, Ecuador was one of the Fund's success stories used as evidence of the appropriateness of the debt strategy. Indeed, the record of adjustment and the achievements under the stand-by arrangements of 1983 and 1985 were impressive: the current account deficit of the balance of payments was eliminated and even turned into a surplus in 1985; the fiscal deficit was reversed and also turned into a surplus; inflation was brought down despite the pronounced depreciation of the real exchange rate; and positive economic growth was even restored.

Ecuador's good performance was disrupted by two severe external shocks: the collapse of the oil market in 1986, and the 1987 earthquakes. As Mr. Zeas noted, the impact on the balance of payments and the fiscal accounts was limited by the adoption of containing measures, despite the very large losses of exports and fiscal revenues brought about by the oil shock. To put the magnitude of the external shocks in perspective, the cumulative losses attributable to these shocks in 1986 and 1987 amounted to some 19 percent of GDP, according to the information provided by the staff and Mr. Zeas, who notes that the 1988 program is strong and ambitious. It seems a bit too much so, as the objectives of the program may have been put at risk. The program seems to ignore the extent of the damage caused by the external shocks, and to be based on some optimistic assumptions regarding the behavior of key external variables. It also appears to be constructed too rigidly to accommodate any deviations from these assumptions.

The program assumes a projected average export price of oil on the order of $17.25 per barrel--a price that most observers would agree seems optimistic. This, of course, is not a trivial matter for Ecuador, since oil will still account for about half of total exports in 1988, despite the encouraging recent performance of non-oil exports which, incidentally, are expected to continue growing at a very rapid pace despite a slowdown in world economic activity. The assumptions regarding oil prices are crucial, both for meeting the balance of payments targets and for achieving the drastic fiscal correction contemplated under the program. The recovery of oil revenue in the public sector is projected at more than 7 percent of GDP.

A second optimistic assumption concerns the financing of the balance of payments gap. From previous experience, it is well known that the timing of the completion of financial arrangements with commercial banks is highly uncertain, and the timing of disbursements is even more so. In addition to a full Paris Club rescheduling--which does seem likely--the program contemplates a rescheduling of arrears on suppliers' credits, including the favorable conclusion of a legal dispute.

It is surprising that the program has been constructed as if those uncertainties were not present. One of the performance criteria is that the arrears outstanding at the end of 1987 will be eliminated before Ecuador requests the first purchase under the stand-by arrangement. This condition will increase the pressure on the Ecuadoran authorities to accede to creditors' terms. Under the present program, the clearing of arrears with commercial banks is a prerequisite for drawings on the Fund which in turn are a prerequisite for drawings under the arrangements made with commercial banks. Therefore, it appears that we have gone full circle in tightening and circumscribing the financial package.

The adjustment program appears to be extremely ambitious, and the credit policy seems inconsistent with the growth projected. There are too many performance criteria, and insistence that the spread between the intervention and the free market exchange rates be first reduced and then totally eliminated by certain dates seems to constrain excessively the authorities' ability to manage the foreign exchange market.

The staff and the authorities have made a preliminary assessment of the effect of the revised outlook for oil prices on the program's objectives. Since this price is such a crucial assumption for the program, the staff has advanced the midterm review of the program by some months in order to determine which "complementary fiscal measures" should be avoided, rather than undertaking a complete revision. This response validates my fears and reservations. Instead of arranging an oil price contingency mechanism along the lines of that for Mexico in 1986, the staff now calls for the adoption of further adjustment measures in a program which is already extremely tight. This response greatly increases the probability of failure, endangering the position of Ecuador vis-à-vis the international financial community--and increases the risks to Fund resources--thereby threatening to damage the considerable degree of adjustment that has already taken place.

It seems odd that the first program to be considered in 1988 should belong to the 1982-83 vintage. As the medium-term scenarios show, the debt/GDP ratio will peak at 117 percent in 1988, and even under optimistic assumptions and continuous adjustment it will still be above 80 percent in 1993; the debt/service ratio, including debt relief, will remain between 44 percent and 53 percent of total exports. In these circumstances, and given the extent of the Fund's exposure in Ecuador, the proposed terms of the agreement with commercial banks provide little comfort, leaving a financing gap that will emerge in the early 1990s. In view of the country's debt burden and past record of adjustment, this agreement does not seem to meet Ecuador's requirements appropriately. Perhaps the Fund should have been somewhat more candid with the authorities in this regard, especially considering the large exposure of the Fund and the progress that Ecuador has made to date.

Mr. Feldman made the following statement:

Ecuador has suffered a series of economic setbacks in recent years. In 1986, the authorities implemented an adjustment program just as a sharp decline in oil prices negatively affected the economy. Some progress was made, but in the end this program was not completely successful. In 1987, Ecuador's economic situation has grown even worse; the balance of payments has deteriorated significantly--owing mainly to lower export earnings caused by a five-month suspension of oil exports, caused in turn by severe earthquakes in early March. In 1988, the authorities are implementing a program that, together with an increase in oil exports, should finally result in a significant improvement in the external economic situation. In conjunction with the program, the authorities are requesting a stand-by arrangement and a purchase under the compensatory financing facility, and I support the proposed decisions concerning those requests.

After taking into account Ecuador's scheduled repurchases, full use of the resources to be made available under the proposed decisions before the Board would in fact reduce the Fund's net financing to Ecuador. Thus, Ecuador will actually receive only enough financing to compensate for the repurchases to the Fund due in 1988. At best, the Fund's financing can only serve as a catalyst for obtaining other sources of finance, mainly from the banking community, as the Fund is not actually contributing to the closure of Ecuador's financial gap. This is worrying, as Ecuador's external position is very delicate, and the country deserves help from the Fund in improving its economic performance.

The difference between the export shortfall and the requested compensatory financing is dramatic: the estimated export shortfall amounts to SDR 646 million and the proposed purchase to about SDR 43 million. The requested financing is clearly insufficient in the light of the external difficulties implied by the export shortfall--it is merely symbolic. The authorities are requesting minimal financing because that is the maximum amount allowable under the current mode of operation of the compensatory financing facility. In fact, Ecuador's new requested financing and the repurchases due in 1988 under the compensatory financing facility are exactly the same--SDR 42.8 million.

Perhaps an alternative should be considered, namely, allowing Ecuador to cancel the balance due on its 1983 compensatory financing drawing--SDR 42.8 million--and approving a new compensatory financing purchase of SDR 85.4 million. That would maintain Ecuador's utilization of Fund resources at 83 percent of quota during 1988, and would imply some relief to Ecuador's external position, since the country would not need to effect repurchases of its compensatory drawings until 1989.

I welcome the staff's belief that approval of the requested stand-by arrangement is justified, even though the critical mass of commercial bank financing has not yet been reached. I am, however, concerned about the excessive conditionality attached to the stand-by arrangement--particularly the proliferation of performance criteria--and I am particularly concerned about the rigidity of the limits imposed on the relationship between the intervention and the free market exchange rates.

All these conditions are being imposed just to permit Ecuador to make purchases of SDR 75.4 million until March 1989--purchases that simply match projected repurchases related to previous financing under the credit tranche policies. Since no new net financing is involved, the revolving character of Fund resources is obviously not in danger.

The implementation of the economic program supported by the stand-by arrangement will require a great effort by Ecuadoran authorities, and the fiscal adjustment in particular seems difficult and too fast. The program plans imply that adjustment--a reduction of the fiscal deficit by about 8-9 percentage points of GDP--has to be completed in one year. About 5 percentage points will come from the recovery in oil production, and with this part there is no problem. It is not at all clear, however, why the remaining reduction has to be completed within one year; a more gradual fiscal effort might be feasible. A contingency clause should also be included in Ecuador's program, to allow for the uncertainties derived from the volatility in oil prices.

The depreciation during the last six years has been very important, as the real effective exchange rate has declined by 50 percent--yet this change has not resulted in a stronger response from exporters and, particularly, greater export diversification. The staff, however, continues to recommend a flexible exchange rate policy and argues that a lasting solution to debt management problems will require the continued implementation of adjustment policies in future years.

The financial side of Ecuador's economic situation is extensively considered in the staff papers, but the real side of the economy is also important--particularly the interrelated analysis of prices, wages, and productivity. The labor market, income distribution, and the level of GDP per capita also deserve a fuller consideration.

Finally, I wonder whether the target rate of 2.6 percent of GDP growth in the non-oil sector is likely to be reached in 1988 under the present program, and whether this rate is considered satisfactory, given Ecuador's present economic situation--especially as the rate of population growth is close to 3 percent a year.

Mr. Hon said that he was satisfied with the 1988 economic program prepared jointly by the staff and the Ecuadoran authorities, and supported approval of the one-year stand-by arrangement. He agreed that the shortfall in export receipts in 1986 was mainly due to a natural disaster and other factors beyond the control of the authorities, and, therefore, he supported the authorities' request for compensatory financing.

The authorities had adopted remarkably stringent adjustment policies under the stand-by arrangements of 1983 and 1985, resulting in a significant strengthening of public finances and the balance of payments, as well as the elimination of external payments arrears, Mr. Hon continued. However, the authorities had not done well under the previous stand-by arrangement approved in August 1986. After making an initial purchase, the economic program had fallen apart only a few months after the stand-by arrangement had been finalized. While the program had envisaged tight control of current expenditure, the authorities had granted an unprogrammed 17 percent wage increase in October 1986, on top of the 18 percent increase allowed by the program at the beginning of 1986. In addition, existing investment projects had been accelerated even though the program called for a postponement of new investment projects. While he fully understood the pressure for such actions while the exchange rate was falling, he regretted the use of such soft options when government revenues were falling rapidly as a result of the decline in oil prices.

The authorities had successfully negotiated with the commercial banks' steering committee a new loan of $350 million and a rescheduling of $4.7 billion of public sector debt due between 1987 and 1996, Mr. Hon remarked. Positive indications had also been received from the Paris Club creditors on a rescheduling of official debts. Together with the forthcoming financial assistance from the Fund and the continued support from the World Bank and the Inter-American Development Bank, it seemed that all the necessary conditions were largely in place for Ecuador to find a lasting solution to its debt management problems. A firm footing could then be established for sustained growth of the economy--if prudent fiscal and monetary policies, and flexible exchange rate policies were pursued.

Mr. Enoch made the following statement:

> The country is recovering impressively from the devastation of the March 1987 earthquakes. The authorities should be commended for this achievement. The fiscal targets in the program for 1988 look ambitious, and will require firm commitment from the authorities if they are to be achieved. Wage restraint is clearly going to be important, given the significance of wages in overall public spending and the program assumption of no further increase in minimum wages in 1988. Minimum wages were, however, increased in October 1987, and the overall public sector deficit--estimated at 10.5 percent of GDP--was larger than that projected in July's request for emergency assistance. Any further increase in minimum wages this year will need to be offset by compensatory measures elsewhere.

The external projections in the program appear to be optimistic. The nominal value of imports is projected to fall this year, while real GDP rises by 8 percent. Not all of this can be explained by the rundown of imports associated with the completion of earthquake repairs, or by the buildup of inventories in 1987. On the export side, oil revenue projections--prior to those issued in the supplement--are predicated on a price somewhat higher than that prevailing today. It is worrying that even in the supplementary paper no revised projections are given for future years, and we must wait for the first review to see what additional fiscal measures will be adopted.

Leaving aside the oil sector, little recovery is envisaged in much of the rest of the traditional export sector. In particular, the production of coffee and cocoa has fallen dramatically following the decline in prices, which suggests an extremely high price elasticity of supply. This adds force to recommendations that Ecuador must intensify its attempts to diversify exports away from both oil and from some traditional agricultural crops as well.

I particularly commend the authorities' stated intention of continuing to pursue a flexible exchange rate policy. The report in the supplement to EBS/87/263 that the authorities have used a significant proportion of their foreign exchange to achieve an appreciation of the domestic currency is very worrying, and I welcome the authorities' commitment to recovering as much as possible in that area. The authorities must also adhere to their timetable for eliminating the existing exchange rate differential, and they should end the multiple currency practice resulting from their import deposit scheme.

Overall, I endorse the staff view that the program seems to leave Ecuador in a difficult but viable position. The debt service ratio remains high through the next few years, and the appearance of a financing gap from 1990 on is worrying. The program relies on continued strong export growth and is particularly sensitive to changes in oil prices. Nevertheless, by the end of the projection period, in 1993, the Ecuadoran economy could be in a much stronger position than it is today, if the program is carried out firmly.

A wider issue relates to the fact that we are discussing the Ecuadoran program before the overall financing gap has been filled. In particular, while the commercial banks have agreed to an exceptionally generous rescheduling for Ecuador, the critical mass of confirmed bank support has not yet been achieved. As the staff has informed us, commitments for the required new money element have been received from banks representing about 85 percent of total exposure. I hope that the remaining amount can be put together very rapidly. There have been significant slippages in other cases between 85 percent commitment and full commitment, and there can be no certainty that they will be avoided in this case.

Indeed, a fundamental point raised by the proposed decision on exchange restrictions and multiple currency practices is the approval under Article VIII of a restriction evidenced by arrears, an issue which also arose when we discussed the program for Costa Rica in October 1987. In that discussion a number of Directors, including myself, indicated that we would be very unhappy if a similar case were brought to the Board before we had seen a full legal analysis of the issue. My authorities therefore have some hesitation in going along with approval under Article VIII of the proposed decision. There are a number of factors that we have borne in mind. First, a substantial paper by the Legal Department is in preparation and should be available soon; while I would have preferred to postpone consideration of Ecuador's request until after the discussion of the legal paper, I recognize the need to move more quickly. Second, prospects for early elimination of the financing gap appear very much better for Ecuador than they did for Costa Rica. Third, with hindsight, I am most unhappy with the procedure adopted for Costa Rica, which allowed disbursement with arrears and without waiver; this seems irregular, and not a precedent to be followed.

A related but somewhat distinct issue concerns the prospect of disbursement before the financing gap is filled. I am not convinced of the need for disbursement at this stage. For the Paris Club meeting later this month, only approval in principle by the Fund is required--a signal that should also satisfy the commercial banks. An immediate disbursement may be perceived as a clear change from our earlier practice; in time, the Paris Club--and perhaps even the banks--may seek disbursements under a Fund-supported program, rather than approval in principle, before their own packages come into effect. Our present practice is recognized and accepted, and it would be very unfortunate if that recognition were challenged by the granting of an exception in this case.

The established practice suggests that today we should approve both proposed decisions only in principle, and this would have been my preference.

Mr. Pineau made the following statement:

Since the Board last reviewed Ecuador's situation at the end of June 1987, economic prospects have improved. Now that operations in the oil sector are back to normal, it seems reasonable to judge that the authorities will be able to correct existing imbalances in an orderly way. The formulation of a new

Fund-supported program is a major step in this direction, even if the program does contain an element of uncertainty. Moreover, approving an arrangement at a time when Ecuador has not yet begun to eliminate its external arrears and is still in the process of assembling foreign financing raises some questions of principle.

I hope that the authorities display the determination needed to avoid repeating the slippages that marred the previous program at the beginning of 1986. Obviously, satisactory implementation will hinge largely on the level of oil earnings, a fact effectively reflected in the fiscal projections. Much of the improvement over the poor results recorded in 1987 will stem from the restoration of normal oil revenues; but if the price for oil assumed in the program does not materialize, the authorities should be prepared to take remedial action--a point made very clear in the supplement to EBS/87/263. That supplement concludes that the viability of the program would not be jeopardized by a moderate decline in oil prices, so long as corrective actions are taken. The timing of such additional measures may be crucially important, and the date of the midyear review should indeed be brought forward.

The staff correctly stresses the importance of a stringent wage policy for controlling current expenditures, as wages seem less affected by the program than investment outlays. Another way to offset possible shortfalls in revenue would be to adjust the domestic price of oil products, as roughly one third of total oil output is used to cover internal needs.

The disruptive effects of the March 1987 earthquakes did not cause a marked deterioration in price performance. However, the inflationary pressures which emerged in 1986 should be kept strictly under control, and some price adjustments might be envisaged in the public sector. The relative easing of credit policy toward the private sector--expected to follow the consolidation of the fiscal position--should then be conducted in a prudent manner.

As the present severe payments difficulties should be overcome by the resumption of normal oil exports, they appear to be reversible, and an exceptional debt relief exercise seems warranted on the part of Ecuador's main creditors. Nevertheless, a prolonged adjustment effort will be needed if the country is to secure a viable external position in the longer term. The staff's medium-term scenarios make it clear that oil production will level off in the years to come, thus increasing the sensitivity of external receipts to price developments in the non-oil sector. Ecuador's reliance on commodities such as coffee and cocoa also makes it vulnerable, as market prospects are not promising in these sectors.

Given its present level of indebtedness--particularly to the Fund--Ecuador should follow prudent financial policies with a view to addressing any unexpected external developments, and the authorities should engage in structural reforms that will strengthen the production base. In this respect, the staff rightly stresses the crucial importance of a flexible exchange rate policy in promoting a more competitive and diversified export sector. A fully unified exchange rate appears to be a decisive step toward this end. The authorities are committed to unification, and their intention to unify the exchange rate before the midyear review has been translated into intermediate targets designed to gradually narrow the spread between the intervention and free market rates. The best way for the authorities to stabilize expectations will be for them to adhere to their intended course of action, while husbanding their limited external reserves.

My authorities would have preferred not to be asked to approve the exchange restrictions so as to allow Ecuador to use Fund resources. During the recent discussion on Costa Rica, it was agreed that no similar cases involving arrears would be submitted to the Board before a general debate on the issue had taken place. A document on this matter is under preparation by the staff but the issue has not yet been examined. Ecuador does urgently need external support, and given the exceptional circumstances, my authorities can go along with the proposed decisions while looking forward to a discussion of the principles involved.

With respect to the financing gap, my authorities support outright approval of the stand-by arrangement. As a rule, I would be inclined to limit approval in principle to a few exceptional cases--among which Ecuador does not belong; the fairly rapid assembling of the needed financial resources seems to confirm this judgment.

The factors which caused the deterioration of the external position were clearly outside the authorities' control if one considers only the disruptive effects of last March's earthquake. In addition, the compensatory financing will cover only a small portion of the actual shortfall, because of the constraint imposed by access limits. I support the proposed decision.

Mr. Hodgson made the following statement:

The past few years have been difficult for Ecuador, and the proposals before us for a stand-by arrangement and compensatory financing are welcome, as the economic program they support should help to reduce Ecuador's internal and external imbalances in 1988. However, the medium-term outlook remains very tight, even if the proposed policies are fully implemented and the oil price assumptions in the staff paper are correct. Debt service ratios after rescheduling may remain in excess of 40 percent well into the 1990s. In these circumstances, there is no room for slippage, and modifications may be required if external events are less favorable than projected.

My authorities are not comfortable with outright approval of the stand-by arrangement, instead of the usual procedure of approval in principle in cases in which a critical mass of bank financing has not been obtained. I had hoped that a general discussion on the relationship between commercial bank financing and Fund-supported programs would take place before new specific cases were addressed. However, it is reassuring that banks representing 86 percent of the financing have already committed themselves to participation in the refinancing package. Given the strong likelihood that the necessary financing will soon be finalized, I am prepared--with some reluctance--to support outright approval of the proposed stand-by arrangement. However, a Board discussion of procedures with respect to approval in principle is needed early in 1988. I also look forward to a discussion on the legal issues noted by Mr. Enoch and Mr. Pineau.

I agree with the thrust of the program, which centers on a strengthening of public finances and a continuation of flexible interest and exchange rate policies. The improved fiscal balance projected for 1988 is due largely to a recovery in oil revenues. However, further improvements in tax administration are important in order to achieve the projected increase of non-oil revenues and to reduce the current heavy reliance on the oil sector. The authorities will have to control current expenditures tightly, and the intended introduction of additional revenue and expenditure measures--to compensate for any wage adjustments in 1988--is especially welcome. However, the overall deficit of the public sector enterprises is expected to deteriorate in 1988, even though the operating surplus should increase slightly. In fact, there has been a significant deterioration in the overall deficit of the parastatals in recent years. Further adjustments to public sector prices should be considered, so that these companies can generate the resources needed to finance their investment program internally.

I welcome the measures adopted to increase interest rate flexibility to promote increased growth of domestic financial savings. The proposed financial sector loan from the World Bank should give significant support to further structural reforms in the financial sector.

The Ecuadoran authorities have followed a commendable and relatively flexible exchange rate policy over the past year. Official intervention in the free market should be kept to a minimum, and should be guided by the balance of payments test outlined in the program. I agree with the staff that early unification of the exchange rates as envisaged in the program, and continued flexibility in exchange rate management, are crucial if Ecuador's competitiveness is to be maintained. However, even if the proposed program is fully implemented, the medium-term balance of payments position will remain very tight and sensitive to external factors, particularly oil prices and interest rates. Given these uncertainties, as well as the remaining uncertainty about external financing, I welcome the new midterm review deadline of May 31, 1988.

I support the proposed purchase under the compensatory financing facility, since it meets the criteria for use of the resources of that facility.

Mr. Grosche made the following statement:

The year 1987 was an extremely difficult one for Ecuador. The decline in oil prices and the devastating earthquake in early 1987 severely afflicted the economy, offsetting nearly all the previous progress made in adjustment. Ecuador now faces severe external and internal imbalances, and the path to recovery seems further away than ever before. Against this background, I am pleased that Ecuador is ready to resume comprehensive reform measures in the context of a Fund-supported program. Cooperation with the Fund is all the more important as Ecuador's relations with its creditors have been strained over the past year, while the country urgently requires external assistance in addressing its economic difficulties more effectively.

Nevertheless, I have a number of doubts and concerns about the adequacy of economic policies, given the uncertainties about the medium-term viability of the balance of payments highlighted by the Acting Chairman's introductory statement. I am satisfied with the proposed course of action, in particular the advancement of the midterm review, and major improvements may be necessary at that occasion. Clearly, the main objective of Fund-supported programs--restoring balance of payments viability over the medium-term--can be achieved under this program only if the authorities demonstrate their continued commitment to stabilizing the economy; only that demonstration can help to generate the additional external resources so urgently needed to close the external financing gap.

Despite my concerns about the adequacy of economic policy and, in this context, the adequacy of external resources, I can approve the proposed compensatory financing, and I support the main features of the economic program to be supported by the stand-by arrangement. However, an outright approval of the stand-by arrangement may not be the most appropriate decision to take at this time. As the staff has clearly explained in its paper on financing assurances in Fund-supported programs (EBS/87/266; 12/14/87)--which will soon be discussed in the Board--the main principle that has guided Fund practice in this area has been to seek formal confirmation of the availability of financing at the outset of a program in those cases in which significant uncertainty attaches to financing from particular creditors. With respect to commercial banks, a critical mass of commitments would thus normally be required before the Fund-supported program enters into effect. The paper still to be discussed does not seem to suggest a deviation from this practice in cases such as Ecuador's. We should, therefore, not embark on new avenues before we have had a chance to discuss the issue thoroughly.

I am certainly glad that there are strong expectations that the critical mass of commitments will soon be assembled. But as long as that mass has not been reached, I am skeptical about giving outright approval. I would suggest, therefore, that the stand-by arrangement be approved only in principle today, with the provision that the program would enter into effect as soon as the financing is assured--in which event, a decision on a lapse of time basis might still be necessary. If the critical mass has not been reached in about 25 days, the case can be reconsidered. In the meantime, we will, I hope, have had the opportunity to discuss the staff paper on financing assurances, and may have obtained a better understanding of future policy in this area--particularly in relation to the concept of critical mass.

Turning now to the proposed decision on exchange restrictions and multiple currency practices, the recent discussion on Costa Rica has substantially raised the level of awareness on problems associated with the approval of restrictions evidenced by the existence of external arrears. Like Mr. Enoch and others, I am looking forward to a thorough discussion of this issue--before we embark on new avenues--on the basis of the paper being prepared by the Legal Department. I am reluctant to embark on innovative approaches before having had a chance to look at this issue very thoroughly, and I would have problems with approving the proposed decision at this time. But I would be interested to learn more about the background which led the staff to propose this wording and I would be particularly interested in any deviations from current Fund practice entailed in approval of the proposed decision.

Mr. Hodges made the following statement:

The rapid deterioration in Ecuador's economic performance in 1986 and 1987 largely reflected the economic aftershocks of the sharp fall in oil prices and the major earthquakes that struck in March 1987.

The 1988 economic program is an important first step in restoring medium-term balance of payments viability and sustained economic growth, and it deserves our support. Although much of the projected economic improvement in 1988--including the significant reduction in the current account and budget deficits--can be attributed to a return to normal levels of oil production and oil exports, the program nonetheless contains a number of very important measures that will provide the basis for continuing adjustment over the medium term. In particular, eliminating the spread between the intervention and free market exchange rates by the time of the conclusion of the first review and the authorities' commitment to maintaining external competitiveness will further encourage the development of non-oil exports--which, in 1988, are expected to account for about half of total exports. The flexible use of interest rates and the ongoing financial sector adjustments to be supported by the World Bank will be important in fostering domestic savings and in strengthening the performance of Ecuador's financial system. Wage restraint in 1988 will be important to contain inflationary pressures and maintain external competitiveness.

Although considerable improvement in economic performance is expected in 1988, and to a lesser extent in 1989, the medium-term balance of payments projections show only a fairly slow, albeit steady, reduction in the current account deficit from 1989 to 1992. The question is whether more should be done now to achieve faster improvement in the external accounts in that period, with the aim--at a minimum--of eliminating the financing gaps projected from 1990 onward. The need for more rapid progress in reducing the current account deficit over the medium term is reinforced by the downward adjustment of the oil price assumption for 1988--and presumably thereafter--and the vulnerability of Ecuador's external sector and budgetary revenues to small changes in international interest rates and oil prices. The midterm review will permit the authorities to assess performance under the program, and to implement additional measures to strengthen medium-term economic performance.

I agree with the staff that Ecuador meets all the requirements for compensatory financing, but I have some reservations about the recommended procedure. In accordance with usual practice, I would have preferred the arrears to be eliminated prior to approval of the stand-by arrangement. The current procedure for approval of arrangements involving new money is clearly set out in the recent staff paper on financing assurances in Fund-supported programs. As Mr. Grosche noted, one of the principal conclusions of that paper is that "the main principle that has guided Fund practice...has been to seek formal confirmation on the availability of financing at the outset of the program...With commercial banks, when new money was requested, a critical mass of commitments (which we have taken as 90 percent of total bank financing) would normally be required before the Fund program enters into effect...If confirmation of such a commitment (i.e., the critical mass) was likely to be delayed by a brief period, approval in principle of the program could be appropriate; if the uncertainties were greater, a delay in Board consideration should be considered."

That procedure has played an important role in helping to protect the Fund's resources, and it should be applied consistently in all cases. Ecuador's program and the drawing under the compensatory financing facility clearly deserve our support. The authorities have faced serious and unavoidable difficulties and are now undertaking substantial measures to correct the resulting domestic and external imbalances. Moreover, the staff has noted that the required 90 percent critical mass should soon be achieved. I therefore support approval of the stand-by arrangement and the drawing under the compensatory financing facility; however, I prefer approval in principle at this time, and hope that the critical mass will quickly be confirmed, so that outright approval of both can then follow automatically.

Mr. Posthumus said that the medium-term balance of payments projections showed a financing gap averaging about $300 million per year in 1990-93, a figure that did not seem to present a large problem. The scenario also showed a difficult but viable external position to manage, as the debt service ratio was about 50 percent, and interest payments were approximately 23 percent of exports each year until 1991. While specific details on the negotiations between Ecuador and its creditors were not yet available, some innovation in the debt strategy as it applied to Ecuador might be helpful, thereby making the situation more manageable. The authorities' major medium-term contributions to an improved debt profile were their macroeconomic and structural adjustment policies. While the reduction of the public sector deficit by 7 percentage points of GDP--from 10.5 percent to 1 percent of GDP--looked impressive, 6 percentage points represented estimates, and only 1 percentage point was due to changes in policies--and that 1 percentage point itself was mainly the result of the completion of special projects necessitated by the earthquake. The budget's sensitivity to oil revenues-supported by the figures in the supplementary paper--was unsurprising. However, the strength of the fiscal effort could be questioned, and an explicit performance criterion for the fiscal deficit, or a subceiling on the expansion of credit to the public sector, would have been warranted. If the estimate of increasing oil revenues proved wrong, it was clear that fiscal policy would have to be reviewed. In addition, the decline in the inflation rate was to be rather slow and the real interest rates on credit funded by the Central Bank were apparently negative.

In the final analysis, however, he supported the staff appraisal and the proposed stand-by arrangement and compensatory financing, Mr. Posthumus remarked. The Fund could assist Ecuador more effectively by approving the decisions forthwith, rather than waiting until the debt negotiations with the creditors had been fully completed; approval would indeed be a case-by-case decision, as Mr. Yamazaki had noted, and the risk run by the Fund might not be unreasonable in Ecuador's case. In any event, Ecuador's case should not constitute a precedent.

Mr. Péroz made the following statement:

The last two years have been particularly difficult for Ecuador. The authorities' efforts have so far been frustrated by circumstances essentially beyond their control, as illustrated by the five-month interruption of oil exports last year. International support is essential for the success of the authorities' adjustment efforts, and I support the proposed decisions.

I have no specific comments on the request for compensatory financing, as Ecuador's case illustrates the usefulness of this facility. The compensatory drawing will clearly provide additional support to the adjustment process and will reinforce the effects of the stand-by arrangement.

The projected reduction in the budget deficit--even modified to reflect a lowering of expected revenues--is the most significant feature of the program. This improvement will be made possible, in large part, by the resumption of oil production and the corresponding increase in the availability of tax resources. Additional adjustment measures will be required to cover the revenue shortfall now being projected on account of lower oil exports, and I urge the authorities to implement the necessary fiscal measures on a priority basis. Meanwhile, current expenditures should be contained, and I support advancing the midterm review to May 31. The new fiscal situation makes the original intention of monthly monitoring of the central government budget even more appropriate. The authorities should also be prepared to take all necessary actions to correct any slippages as they occur.

The conduct of monetary policy will be directly affected by developments in fiscal policy. The authorities might conceivably be tempted, at times, to increase their borrowing, but the inflationary implications of a relaxation of monetary policy should not be overlooked. In any event, a flexible use of all tools of monetary policy seems called for.

The complete elimination of arrears in 1988 is still considered feasible, as originally envisaged. Any further weakening of the external situation, however, would require corrective action. In any event, balance of payments developments, like fiscal developments, should be closely examined in the context of the midyear review.

I commend the authorities for pursuing a flexible exchange rate policy in the face of the recent adverse economic circumstances, and I support the planned unification of the two rates--an appropriate performance criterion under the program. Like the staff, however, I feel that a shift toward a market-determined exchange rate implies only minimal Central Bank intervention. Any significant departure from this policy would unavoidably affect the goal of a full unification of the exchange rate and the pace of further liberalization of the trade system.

Mr. Dallara made the following statement:

As Executive Directors have already pointed out, the Ecuadoran authorities have faced serious adverse external developments over the past two years. The appropriate response to these exogenous events must be a combination of adjustment and financing, and I am pleased that the authorities have now negotiated a stand-by arrangement with the Fund that embodies both elements, although the authorities must stand ready to strengthen the program during the course of the year, should that prove necessary. The financial community has recently demonstrated its willingness to cooperate with Ecuador: the Fund and the World Bank have extended emergency assistance; the Venezuelan and Nigerian authorities have provided temporary assistance; the U.S. authorities have provided bridging financing; and the commercial banks have been patient in the face of payment delays, have now reached agreement on a term sheet, and are relatively close to reaching the critical mass for the new financing package.

My authorities are, however, concerned about the adequacy of the financing of this program, and have considerable sympathy for the views on that matter expressed by many Directors, particularly Mr. Enoch and Mr. Grosche. Even before the recent oil price decline, we are concerned about granting definitive approval of the arrangement today before reaching the critical mass. With the oil price decline, this concern has increased. There are likely to be some offsetting elements in the balance of payments as well as in the fiscal area, but I understand and welcome the decision of the authorities and the Fund management to accelerate the program review--a helpful step. Nevertheless, uncertainties on the financing clearly remain, and it is not clear whether the estimates in the staff supplement--which appear to be based on the views of the authorities on potential ways of closing the external and domestic financing gaps--are thought to be reasonable by the staff. The estimates are described as tentative, as they must be at this stage, but they conclude that recent developments will cause no net increase in the external financing gap, and that the latter will not exceed approximately 0.5 percent of GDP. My concerns are heightened by the medium-term outlook, which is rather uncertain, and also by the large proposed drawing under the compensatory financing facility.

A cautious approach is therefore important. Had there not been such a large initial drawing under the compensatory financing facility, my concerns would be somewhat smaller. Indeed, my view differs from those of Mr. Péroz and others; while the compensatory financing facility has helped to close the initial financing gap, if it had not been available, and if instead an external contingency facility had been in place, perhaps the Ecuadoran authorities might have been better off over the medium term. Without that initial compensatory financing, the financing gap would, at least hypothetically, have been closed by some other means. That could, of course, have put pressure on the Fund to increase modestly the size of the stand-by arrangement, but it is likely--ceteris paribus--that the additional financing gap created by the absence of compensatory financing might have been closed--perhaps by the World Bank, Ecuadoran adjustment efforts, or some additional effort by the Fund. If the initial financing gap had been closed by means other than compensatory financing, and some access had been preserved for contingency financing to meet the additional gap created by the oil price declines, the prospects for successful adjustment would have been enhanced. In that particular and rather narrow sense, I somewhat regret that the Ecuadoran authorities have apparently not chosen to support the creation of an external contingency facility, and I would hope that they could reconsider their position.

The program does represent a sound economic policy approach. Indeed, if the objectives are achieved, growth would resume in the oil and mining sectors and growth of roughly 2 1/2 percent is expected in other sectors of the economy. Inflation would be cut by 8 percentage points, and both the external and fiscal deficits would be reduced sigificantly.

Considerable progress has already been made in restoring balance in the fiscal accounts. Unless the revenue losses due to the oil price decline severely undermine this effort, the expected recovery of revenue in 1988 should, by itself, go a long way toward correcting immediate fiscal problems. I also recognize the expenditure restraint effort embodied in the program. However, I would encourage the authorities to undertake a fundamental review of the tax system, with a view especially to reducing dependency on taxation of energy. It is also important that the authorities and the staff closely monitor certain areas of expenditure which are inevitably subject to particular pressure--the assumption of no increase in government wages in 1988 is a case in point. The rising parastatal deficit appears to reflect considerable growth in investment expenditures, and this too will need to be constrained.

The pressure of fiscal deficit financing should be relieved in 1988, and credit to the private sector should be adequate for maintaining a reasonable rate of economic activity--perhaps credit policy could be employed more forcefully over the next year or so, to squeeze out inflation.

Over the last few years, the sucre has depreciated sharply in real effective terms, and the encouraging performance of nontraditional exports and the containment of import growth--other than for earthquake reconstruction--suggest that this depreciation has been an effective policy tool. Nonetheless, continued flexibility will be needed as long as the domestic inflation rate remains at its current high level. Like the staff and other Directors, I was concerned about the recent foreign exchange intervention by the Central Bank--especially its scale--but I welcome the authorities' recent assurances regarding exchange rate policy.

Trade liberalization can play an increasingly important role in ensuring that the tradable goods sector is disciplined by external competition. Some progress has been made since 1985 in reducing the extent of import licensing and customs tariff rates, and I also welcome the pending IBRD loan in support of reductions in quantitative restrictions and in duty exemptions and the consideration being given by the Ecuadoran authorities to accession to the GATT. However, if commitments on trade liberalization are not to be specifically included in the Fund-supported programs, I would welcome more information in Fund documents regarding steps being supported by the World Bank.

I share other Directors' reservations concerning the approach being taken in this case. Despite the Acting Chairman's statement, it is not clear that there is a persuasive case against a short delay to obtain the critical mass of bank support. Nor is it clear why additional commitment to fiscal policy adjustment could not have been sought from the authorities during the recent consultation. I am, however, willing to support both the approach adopted and the requests before us, primarily on the basis of Ecuador's record of cooperation with the Fund, and the authorities' strong commitment to sound economic policies in the face of serious adverse external developments. I encourage the authorities to remain alert to the need to strengthen this program as it evolves.

Mr. Salehkhou made the following statement:

I support the proposed decisions and generally agree with the staff appraisal. The authorities' economic program for 1988 is aimed at restoring GDP growth, which was adversely affected by the sharp decline in oil prices in early 1986 and the devastating March 1987 earthquakes which disrupted oil exports for five months. The authorities will continue to center their efforts on strengthening public finances, relying on tight fiscal and monetary policies while pursuing the implementation of a flexible exchange rate policy to improve the balance of payments, eliminate external payments arrears, and achieve a substantial reduction in the inflation rate.

The resumption of oil exports and the completion of capital expenditures related to the repair of earthquake damages should help the authorities to reduce the overall public sector deficit from 10.5 percent of GDP in 1987 to 1.3 percent in 1988. To this end, the authorities are committed to further pursuit of tight expenditure control, avoidance of cost overruns, and further improvements in public enterprises' operating surpluses. These efforts will be accompanied by continuous adjustments of public sector tariffs, especially electricity charges. The authorities also intend to refrain from new hirings of public sector employees, and envisage no provisions for public sector salary increases in 1988.

Along with the right fiscal policy, the 1988 program provides for continuing interest and exchange rate flexibility so as to increase domestic savings, promote a more efficient allocation of credit, and strengthen external competitiveness and export diversification. In addition, the spread between the intervention and free market exchange rates will be gradually eliminated. These measures should permit a substantial reduction of the inflation rate from 28.5 percent in 1987 to 20.5 percent in 1988.

While the 1988 program will go a long way toward reducing the current account deficit to 5 percent of GDP from its peak of 13.2 percent in 1987, and toward eliminating external arrears, I am somewhat concerned by the medium-term outlook for the balance of payments and by the country's heavy debt burden. Despite the substantial progress made by the authorities in negotiating a refinancing package with commercial banks, the debt service ratio, even after debt relief, is expected to remain relatively high--averaging 50 percent of exports in 1988-93--thus placing a considerable burden on the balance of payments.

The proposed compensatory financing equals only 6.6 percent of the estimated shortfall--which reinforces my position that the size of the shortfall, rather than of the quota, should be used for determining access under this facility, to provide adequate and meaningful financing to help members pursue their adjustment program in an orderly manner.

Mr. Fogelholm said that, as previous speakers had noted, Ecuador had experienced extraordinary economic difficulties in recent years. Thus it was appropriate that the authorities' present efforts were supported by the Fund. However, in view of the large uncertainties involved, he welcomed the staff's proposal that the midterm review be advanced to before the end of May 1988.

Although he could accept the proposed stand-by arrangement, some procedural comments were warranted, Mr. Fogelholm considered. An agreement with the steering committee of creditor banks had been successfully concluded, but the Board was again being invited to approve a stand-by arrangement before that agreement had gained the support of all the creditor banks. It could certainly be argued that a decision in principle would have been a more appropriate procedure, and one more in line with the procedures followed in similar cases in the past. He, too, regretted that the matter had been brought to the Board before the general discussion of the relevant staff paper. Approval of the proposed arrangement for Ecuador should, therefore, not constitute a precedent.

Mr. Prader said that as most other speakers had agreed, the proposal for a stand-by arrangement was seriously flawed. Doubts arose from both the legal procedure--which closely resembled the recent, ambivalent decision on Costa Rica--and the overoptimistic assumptions about key variables underlying the Fund-supported program. However, given Ecuador's urgent need for external finance, and in recognition of the authorities' strong adjustment efforts, he supported the proposed decisions. As the Board had often adopted decisions approving arrangements for countries with a much weaker commitment to adjustment than Ecuador's, it would have been unfair for the Ecuadoran authorities to be denied support at a critical moment.

Mr. Fayyad noted that Ecuador's economic performance had been adversely affected in 1986 by the sharp decline in the export price of oil, as both the fiscal and external imbalances had turned out to be larger than envisaged under the 1986 economic program, which had been supported by a one-year stand-by arrangement with the Fund. As might have been expected, the substantial decline in its foreign exchange earnings in 1986, caused largely by a decline of about 50 percent in oil export receipts, had greatly strained Ecuador's ability to service its debt, and had led to delays in meeting obligations to commercial and official creditors.

In 1987, Ecuador's economic situation had deteriorated further, following the March earthquakes which had resulted in significant damage to the country's infrastructure and a substantial decline in the country's oil export earnings from their already depressed 1986 level, Mr. Fayyad continued. The associated deterioration in public sector finances, together with the decline in export earnings, had exacerbated pressures on the external payments position, and the deficit in the overall balance of payments was projected to have tripled in 1987.

The 1988 economic program to be supported by a stand-by arrangement, concurrent with which the authorities were requesting a purchase under the compensatory financing facility, was indeed strong, Mr. Fayyad considered. The program was designed to improve the overall balance of payments, eliminate external payments arrears, and reduce the rate of inflation. It placed special emphasis on the need for expenditure control and continuation of flexible interest and exchange rate policies, and it envisaged a substantial reduction in the public sector deficit as well as a significant acceleration in real GDP growth.

A large part of the projected improvement in Ecuador's economic performance in 1988 depended significantly on normalization of oil export earnings, Mr. Fayyad remarked. However, as was noted in the supplement, the recent decline in international prices for oil had led the authorities to estimate that the price of Ecuador's crude oil exports would stabilize at about $15 a barrel on average in 1988, compared with the $17.25 average price initially assumed in the proposed stand-by arrangement. Should that turn out to be the case, then, as the staff had indicated, a fiscal gap would likely emerge notwithstanding the number of favorable developments since the formulation of the program. Given the tentative nature of the estimates for the likely economic outturn for 1988--entailed by the continuing uncertainty in the international oil markets--he could see the importance of advancing and enhancing the midterm review. He could also see the potential advantages of integrating a contingency mechanism in Fund-supported programs in cases like Ecuador's, which involved vulnerability to adverse exogenous developments.

Ecuador's request for a purchase under the compensatory financing facility represented only about 6.6 percent of the shortfall in export earnings predominantly accounted for by the substantial decline in oil export earnings, Mr. Fayyad commented. As the staff had noted, that decline had been due not only to the damage to the oil transportation facilities, but also to the weakness of petroleum prices that had persisted into the shortfall year. He fully endorsed the proposed compensatory financing drawing, which met all the required criteria and supported the proposed decisions.

The staff representative from the Western Hemisphere Department said that the original oil price assumption had indeed turned out to be optimistic. However, the oil price assumed in the program was the same as the actual price at the time of the negotiations. The market had been stable, and there were strong expectations that the assumption was realistic. The subsequent sharp drop could not have been predicted.

The assumptions concerning financing from commercial banks were based fully on the agreement that had almost been concluded at the time of the negotiations on the program being supported by the Fund, the staff representative continued. The financing arrangement provided for a rescheduling of amortization payments both in 1988 and those that remained unpaid from 1987, new money of $350 million, together with the new oil facility that would replace the existing oil facility when the latter expired. That was a firm basis from which to assume bank financing under the program.

The program included an assumption of rescheduling of both principal and interest payments to official creditors, for both 1987 and 1988, in accordance with the proposal that the authorities would make to Paris Club members, the staff representative noted. The staff had contacted other creditors--including the World Bank and the IDB--in seeking to establish a realistic level of foreign loan disbursements. In fact, the amount of disbursements projected to 1988 was fairly large, and there was always a risk that it might not fully materialize. It was, however, based on ongoing projects that had been approved and on others that were going to be approved in the near future. The financing assumptions had been reconsidered in discussions with the authorities during the past week, and the authorities now believed that there would be more financing from bilateral creditors than had previously been assumed. The staff had accepted the new estimates but had noted that some of the financing had yet to be obtained.

A mechanism for contingency financing had not been contemplated primarily because at the time of negotiations the oil market seemed to be quite stable, the staff representative remarked. In addition, the authorities had made substantial progress in negotiating an arrangement with commercial banks, and the authorities were concerned that delays be avoided. Consideration of contingencies would, of course, have implied possible delays in those negotiations.

Both the rescheduling from commercial banks and the new disbursement of $350 million were subject to the first purchase from the Fund, the staff representative said. All the money from the commercial banks, except for one part of the $350 million that was linked to the World Bank financial sector loan as cofinancing, would be disbursed almost immediately after the Fund purchase--and the loan from the World Bank had already been approved. The arrears with the commercial banks would be basically eliminated when the arrangements came into effect, because the rescheduling would provide for the rescheduling of all the arrears on principal that were accumulated in 1987, while the new money would be equivalent to the interest payment arrears accumulated in 1987. Thus, once the arrangements with the commercial banks and with the World Bank became effective, arrears with commercial banks would be eliminated, and if matters proceeded without much delay, those arrears could be eliminated before the time set out in the stand-by arrangement. Arrears with official creditors would be eliminated as soon as an agreement was reached with the Paris Club members, and the trade arrears were currently being eliminated as described in the staff paper, through the issuance of U.S. dollar-denominated bonds that would pay obligations to domestic importers that had arisen as a result of requests for exchange to pay for imports. The staff therefore believed that the condition that arrears be eliminated before the first purchase could be made from the Fund should not cause problems for the authorities, and was consistent with the timetable for arrangements with the country's external creditors.

The staff shared the concerns expressed by many Directors about the tight situation in the medium term, which would become even tighter if oil prices fell, the staff representative remarked. The staff intended to undertake a complete re-examination of the medium-term outlook at the time of the midyear review.

Based on the oil prices assumed in the staff paper, the financing gap that emerged beginning in 1989 and 1990 was significant, but it did not appear to call for an increase in the exposure of banks during that period, the staff representative noted. Thus, while the financing situation was tight, it did not seem totally unfeasible. A lower average oil export price would indicate a need for further adjustments to the economy than were implied in the medium-term outlook. While some Directors felt that the degree of adjustment implicit in the program for 1988 was already too ambitious, the staff noted that the large improvement both in the current account and in the fiscal balance reflected to a large extent a normalization of oil exports.

Although the adjustment in the real exchange rate had been impressive in 1986 and in 1987, only toward the end of 1987 had the real exchange rate reached a level comparable with that existing before the start of oil exports in the early 1970s, the staff representative remarked. The balance of payments had been essentially in equilibrium, and at that time the real exchange rate was at a level which the authorities judged adequate. Given the high level of debt, a further real depreciation could now be considered necessary. Further progress had however been made in 1987 and the real exchange rate was currently at a level sufficient to provide a good level of external competitiveness. While the aggregate data on exports did not indicate an impressive growth of non-oil/noncoffee exports, that data included also several other commodities. If those were excluded, and attention was focused on the nontraditional items, the rate of growth was much more significant, showing that the lower exchange rates were beginning to generate some favorable responses. There tended to be a lag between changes in the exchange rate and the response of exports, so both the staff and the authorities believed that clearer results would materialize in that area in the near future.

The compensatory financing would mainly provide liquidity, because the target for reserves--excluding the elimination of arrears--was for a very small increase, the staff representative commented. Thus, neither the compensatory financing nor the purchases under the stand-by arrangement would be used to finance current account transactions of the balance of payments. Those Fund resources were, however, very important, particularly in the first quarter of 1988, because of the seasonality involved in Ecuador's balance of payments. For instance, the authorities would have to repay practically the entire present oil facility during the first half of 1988; the new oil facility would come into effect perhaps in the second or third quarter of the year. Thus, an imbalance would emerge in the first two quarters, which meant that while the annual target was for a small increase of reserves excluding arrears, those reserves would decline during the first two quarters of 1988. The compensatory financing and purchases under the stand-by arrangement would be very helpful in meeting those financing needs.

The authorities considered that outright approval of the compensatory financing and stand-by arrangement was extremely important, the staff representative continued. The authorities wished to make purchases as soon as possible, precisely because of the tight liquidity situation in the first quarter--particularly in January. In addition, proceeding with the drawings from the Fund would make it possible for arrangements with commercial banks to become effective.

Directors had varied views on fiscal policy, the staff representative noted. Some Directors had said that the program targets were too ambitious; others that they were too modest. The large adjustment in the fiscal deficit mainly represented the normalization of oil exports and the increase in revenue from oil. However, there was also a genuine fiscal adjustment. While total current expenditure was projected to remain constant in terms of GDP, noninterest current expenditures were expected to decline by about 1.3 percent of GDP. Total current expenditures would thus remain stable, because the decline in noninterest expenditures would be offset by an increase in interest payments. Capital expenditure was programmed to decline by 1.2 percent of GDP; while that seemed a large reduction, over 80 percent of it was the result of the nonrecurrence of 1987 emergency expenditures. Excluding those expenditures, the degree of adjustment in the capital expenditure budget was very modest. Taking both current and capital expenditures into account, the adjustment--in addition to that produced by the normalization of exports--was approximately 1 1/2 percent of GDP, a reasonable effort that could be continued in future years so as to gradually reduce further the deficit of the public sector. The level of the deficit had also been determined by the need to provide the margin for a reasonable expansion of credit to the private sector, consistent with the overall balance of payments and price targets of the program.

The authorities needed more time to consider the measures to be taken should the oil price remain lower than projected, the staff representative observed. Advancing the midterm review would allow for comprehensive re-examination of the program, and it was hoped that the authorities and staff would then have a better basis for determining the new oil price assumption.

The World Bank had approved a financial sector loan predicated on a reduction of subsidized credit to the private sector, which was to be accomplished by reducing the amounts allocated to credits by the central bank and by increasing the applied interest rates, the staff representative said. The loan from the World Bank and the associated reform program were very important for Ecuador and supported objectives similar to those of the stand-by arrangement. The interest rates for credit granted by commercial banks--funded by the issuance of certificates of deposit, term deposits, and time deposits placed at market-determined interest rates--were positive in real terms--currently 30-35 percent as against an inflation rate of approximately 30 percent. The rate given in the selective economic indicators table of the staff paper--27 percent--referred only to term deposits of a certain maturity. Term deposits of over 90 days attracted an interest rate of more than 28 percent, and interest on certificates of deposits varied between 28 percent and 33 percent.

Inflation for the year ending December 1987 might turn out to be approximately 1 percentage point higher than originally anticipated, the staff representative continued. The policies for 1988 were intended to achieve a reduction of 4-5 percentage points in the rate of inflation.

The staff did not believe that there had been a proliferation of conditionality in Ecuador's case, the staff representative went on. The targets and ceilings included in the program basically concerned credit, external debt, and net international reserves. Some other performance criteria related to the elimination of the spread between the intervention exchange rate of the central bank and the free market rate, but those were very important aspects of policy for the program, and it was appropriate to have criteria that would ensure that exchange-related commitments would be met. The authorities fully agreed that the exchange rate should be unified and arrears eliminated, and they were anxious to normalize relationships with foreign creditors so as to pursue those goals.

A 2.6 percent increase in non-oil GDP might be possible if increased private sector investment compensated for the projected reduction in public sector investment in 1988, the staff representative commented. In addition, growth in the oil sector might have indirect effects that would help Ecuador to attain the projected non-oil GDP growth rate. While a higher rate of growth was desirable given the population increase of approximately 3 percent annually, it might not be feasible given existing financing constraints.

Imports had grown quite substantially in 1987, but the increase would be less than originally anticipated, the staff representative from the Western Hemisphere Department went on. That would imply a lower level of imports than originally projected. Non-oil and nonemergency imports were estimated to decline marginally in 1988. That decline could still be consistent with the growth projected for non-oil GDP, because there had been some anticipatory imports and some buildup of inventories in 1987.

The staff representative from the Exchange and Trade Relations Department said that the paper on financing assurances in Fund-supported programs had been circulated in December 1987 for discussion in the near future. The paper described a wide variety of cases and circumstances that had arisen with respect to financing assurances, and the nature of the assurances had in general depended on the type of financing sought. There had been cases in which a rescheduling of principal payments due during the program period was sufficient to close an ex ante financing gap. In many of those cases, provided that active negotiations had been in progress with bank steering committees, the Board had approved the stand-by arrangement outright.

In some cases, in which there were known to be contentious issues concerning the rescheduling of amortization payments falling due, the Board had wished for an assurance that--at a minimum--the steering committee had reached an agreement in principle, the staff representative continued. In still other cases, in addition to the rescheduling of amortization payments falling due, the closing of the ex ante financing gap required that existing arrears had had to be refinanced or financed. In some cases, the Board had approved a stand-by arrangement outright on the basis of the recommendation of the steering committee to the banking community at large that the refinancing be undertaken.

The critical mass procedure was addressed to the cases where new concerted lending from banks was required to meet an ex ante financing gap, the staff representative noted. The norm in such cases had indeed been that the critical mass commitment of the banks should be reached before the Board approved the stand-by arrangement outright. In some cases, in which the critical mass commitment had not been reached at the time of a Board discussion, the procedure of approval in principle had been adopted, a procedure that reflected the Fund's understanding that approval would encourage the banks, thereby helping in reaching the critical mass.

In the case of Ecuador, debt-servicing arrears had arisen in 1987, largely as a result of the earthquakes, the staff representative from the Exchange and Trade Relations Department said. Ecuador had resumed interest payments to banks in mid-November 1987 and was current in its interest payments to banks as of that date. The staff had suggested that, in conformity with similar cases in the past, the Board might wish to approve the stand-by arrangement for Ecuador outright on the basis that there was agreement at the level of the steering committee on the term sheet which included the elimination of arrears, and 85 percent of total commitments had already been received from the banks. In addition, Ecuador had cooperated closely with the Fund in the past.

The staff representative from the Research Department said that it was possible that Ecuador could have advanced the compensatory financing repurchase that was to fall due in 1988, which would have enabled Ecuador to augment its present purchases. Obligations in respect of two purchases were currently outstanding: a purchase of SDR 44 million made in 1983, and another, for SDR 40 million, made in 1986. Ecuador was to complete the repayment of the SDR 44 million in the course of 1988. Had that repurchase been advanced, Ecuador could have qualified for a larger purchase, which would have the effect of extending the maturity structure of Fund credit extended to Ecuador. The result would have been a trade-off: a larger purchase now, but at the expense of no access under the compensatory financing facility while the maximum access remained outstanding--which would have been the case for at least the next three years. Such a decision was, of course, essentially a matter for the authorities.

The staff representative from the Legal Department commented that the procedure to be followed by the Board in approving exchange restrictions at the same time as granting a stand-by arrangement had been stated in the Board's decision reviewing the Fund's policy with respect to payments arrears (Decision No. 3153-(70/95), adopted October 26, 1970). The approval of exchange restrictions was granted for balance of payments reasons, upon completion of an Article IV consultation discussion, stand-by arrangement, or on an ad hoc basis when requested by a member, provided that the member's program for the elimination of arrears was satisfactory to the Fund. The requirement--in accordance with the 1970 decision--was not that there had to be a full and complete rescheduling or refinancing agreement with each creditor, but that the Board should exercise judgment as regards the point at which to grant an approval, in view of the ongoing negotiations between a member and its creditors. Under the 1970 decision, the point of time chosen in the current case was the point at which the Board approved the stand-by arrangement for Ecuador, and the decision itself provided for that linkage. In Ecuador's case, there were four categories of arrears, and different procedures applied for the rescheduling of the four different categories.

From the perspective of the member's program for the elimination of arrears, in the case of Costa Rica the steering committee had not yet issued a recommendation at the time of the Board discussion, although the committee had mentioned that it would have no objection to the Fund granting a stand-by arrangement, the staff representative continued. No new terms for rescheduling had been established. In Ecuador's case, the steering committee had reached a decision, one accepted by at least 85 percent of the creditors. The Fund's regular procedures had therefore been followed, in that the approval of the arrangement had been accompanied by approval of the needed restrictions. The approval related to restrictions evidenced by payments arrears, and--until midyear--to restrictions that remained pending with the actual contractual rescheduling of each claim to take place, after the elimination of payments arrears for program purposes.

The staff representative from the Western Hemisphere Department said that the new financing from the banks was linked only to the first disbursement by the Fund. A precondition for both rescheduling arrangements and the disbursement of the $350 million in new money was that the first purchase from the Fund be made.

Mr. Grosche commented that, as he understood it, the arrangement with the banks did not provide for any fresh money; the arrangement aimed at regularizing past interest arrears, and if Ecuador continued to pay the banks on time, the country would perhaps face liquidity constraints in the near future that would have to be overcome by the use of Fund resources. Although that arrangement was very positive for the banks, they were still slow to accept the package. He was, therefore, disappointed that the banks were not yet fully committed to the financing package.

The staff representative from the Legal Department, responding to a question by Mr. Grosche, said that there had been cases in which the approval of exchange restrictions--evidenced by payments arrears--had taken place at the same point of the negotiation procedure as was proposed in the current case. No cases were completely comparable; for instance, in Ecuador's case there were four distinct types of creditors for the member to deal with.

The Acting Chairman remarked that the lack of a critical mass of bank support for the financing arrangement--which was for a two-year period, from the end of 1986 to the end of 1988--was indeed a modification of past procedures. However, from the point of view of the debt strategy, that was not the fundamental difference in Ecuador's case; it was the problem of interest arrears that bothered Directors, from a variety of perspectives, and in Ecuador's case, that problem was differentiated by the use of new money to eliminate those arrears to finance the program during the first year of the two-year financing period. Such financing resulted from the Board's consideration of Ecuador's request in the middle of a financing period, rather than in the context of obtaining new money for a prospective future period.

The increase in bank exposure from the end of 1986 until the end of 1988 was on the order of 8 percent, the Acting Chairman noted, a large increase in the context of the Baker initiative and in comparison with other cases. Exposure had increased partly because the debt had grown from $9.1 billion at the end of 1986 to $10.3 billion at the end of 1988, an increase of 14 percent in total debt. During that period, Fund exposure would decline from SDR 398 million to SDR 345 million. The increase in multilateral lending and in government lending during the period was also large.

Another difference in Ecuador's case, in contrast to earlier cases in which the critical mass played a central role, was the high exposure of the Fund and the large repurchases that Ecuador would have to make in the near future, the Acting Chairman remarked. Delay in disbursement under the stand-by arrangement might make it more difficult to put together the financing package, in turn making it more difficult for Ecuador to service its debts, which would put the Fund at greater risk.

The delay in reaching a critical mass was difficult to understand, given that the money would be used to eliminate past interest arrears, but he considered that it reflected the difficulty of generating new money from the commercial banks, the Acting Chairman said. Reluctance by banks to become involved in a financial package even when it was so clearly in their interests to do so, marked a more fundamental change in attitude that had to be faced in the context of the debt strategy.

Given Ecuador's fragile financial position, the Acting Chairman commented, without a contingency arrangement, low or falling oil prices would prevent Ecuador from servicing all its debt; it would again fall into arrears with the commercial banks, and the Fund would again be forced to deal with that financing problem. However, the difficulty in putting together a new money package to clear up past arrears meant that the inclusion of a contingency arrangement involving commercial banks would probably have been an added difficulty. Thus, while he agreed with the concerns of many Directors about the absence of a critical mass, other elements, concerning possible financing gaps in the future, were more central in Ecuador's case.

Mr. Dallara said that one implication of the rationale underlying the proposed handling of Ecuador's case was that there might be an inverse correlation between the level of a member's obligations to the Fund and the level of assurances with respect to financing that the Fund might seek in connection with a decision to permit the member to use Fund resources. However, both the difficulties surrounding Ecuador's case and the unique circumstances prevailing with respect to the commercial banks should be taken into account.

On the matter of new financing, he wondered whether he had understood the staff correctly to mean that the entire $350 million was to be disbursed only in relation to the first disbursement by the Fund, Mr. Dallara remarked. If that was to be the case, Ecuador's case seemed to be somewhat different from arrangements which involved disbursement in tranches.

In sum, the difference between Ecuador's case and the recent case of Costa Rica was the judgment that, while it was not yet fully in place, Ecuador had a satisfactory program that would lead to the elimination of its arrears, Mr. Dallara observed. In Costa Rica's case, it had not been at all clear that there was a satisfactory program for the elimination of the arrears.

The staff representative from the Western Hemisphere Department said that the banks would proceed to disburse the $350 million and would make the rescheduling effective only after Ecuador made its first purchase under the stand-by arrangement. That course of events, however, had also been followed in the case of earlier arrangements with Ecuador, when some disbursements by banks had been phased in line with purchases under a stand-by arrangement.

Mr. Ortiz commented that he had mentioned the appropriateness of contingent financing arrangements for Ecuador, because the Fund was supporting a program that essentially ignored the extent of the deterioration in Ecuador's economy that had been caused by both the earthquakes and the fall in oil prices. At the end of 1985, the debt/GDP ratio was

68 percent, down from 72 percent in 1984; it was expected to jump to 117 percent in 1988--a very large deterioration in Ecuador's payment capacity. Yet the proposed stand-by arrangement essentially merely reproduced previous packages that had been offered in the past, as though nothing extraordinary had happened in Ecuador; hence, his doubts about the realism of the program and the proposed combination of financing and adjustment. While the staff considered the proposed reduction in non-interest current expenditure--approximately 1.5 percent of GDP--to be feasible, that was predicated on no wage increases for the public sector in 1988. However, the expected inflation rate was on the order of 20 percent, and the last wage increase had been in October 1987; the substantial deterioration in average real wages would therefore continue. In addition, the effect of real exchange rate depreciations seemed to have been ignored; someone had to pay for real changes in the economy and for the real exchange rate depreciation if that change was to become permanent. Exchange rate adjustments might indeed be necessary, but the implications for real wages would have to be recognized, allowing in turn an understanding of its feasibility in the light of assurances from the authorities that they fully understood the implications of the program and were willing to go ahead with it.

The staff representative from the Western Hemisphere Department said that while there had been a large increase in the stock of debt in U.S. dollars and an increase in the debt service ratio--to some extent caused by the decline in export earnings coupled with the increase in debt--those figures were perhaps misleading, because there was always the problem of converting GDP from local currency to U.S. dollars. Therefore, it was possible that the jump to 117 percent in the debt ratio was slightly exaggerated. However, there was no doubt that there would be an increase in debt and in the debt service ratio.

The authorities had negotiated the financing package with the banks on their own, and the Fund staff had had very little opportunity to influence or even participate in those negotiations, the staff representative continued. The authorities had made substantial progress in their dealings with the banks before the start of negotiations on the program under the stand-by arrangement. Thus, while the authorities could perhaps have extracted something more from the banks, the staff had no way of influencing developments. The financing package did, however, include a full rescheduling of obligations falling due between 1987 and 1996, including amounts previously rescheduled. The rescheduling maturity was 19 years with a 7-year grace period.

The situation of real wages had not been overlooked, the staff representative from the Western Hemisphere Department noted. While it might, in the end, be difficult for the authorities to completely avoid some increase in salaries, their intention was to accompany any such increase with additional compensating fiscal measures.

Mr. Saha asked the staff whether there was a parallel between Ecuador's case and the recent case of Côte d'Ivoire, as the situations of the two countries seemed very similar.

The staff representative from the Exchange and Trade Relations Department said that at the time that the Board was considering the request for a stand-by arrangement from the Côte d'Ivoire, no agreement of any kind existed at the level of the steering committee. In the case of Ecuador, agreement at the level of the steering committee had been accepted by banks representing 85 percent of the refinancing.

Mr. Zeas remarked that although interest rates had increased sharply recently, the authorities remained committed to a flexible interest rate policy. In November and December 1987, the freely fluctuating interest rate on loans by the banks to the private sector had been as high as 70 percent, and that was a matter of concern for the authorities. Similarly, although the authorities were committed to flexibility in the exchange rate, they believed that permitting the exchange rate to move to unusually high levels in 1987 would have been disruptive. They had therefore intervened. However, net interventions of the central bank during 1987 were zero.

The program deserved Fund backing because it was a very strong and difficult one, Mr. Zeas continued. In the context of Ecuador's past relationship with the Fund, the track record of policy implementation was good, and under normal circumstances, the country had managed its macroeconomic policy correctly. Even under the very difficult circumstances of 1986 and 1987--the sharp drop in oil prices and earthquakes--the authorities had waited for an opportune moment to initiate negotiations with the staff and setting up a program for 1988.

He was very confident that the banks would in the end agree to the refinancing package, Mr. Zeas commented. It was in their self-interest to follow the recommendation of the steering committee, but, as in the past, they were waiting for a lead from the Fund. While he had not been involved in the recent negotiations, he had taken part in the previous two negotiations, and the banks had been very cautious and had waited for the Fund's lead. Thus, the Fund's failure to approve the stand-by arrangement outright would have very negative consequences for Ecuador. The banks were watching the Board's actions, and any indications of doubt or hesitation would seriously compound the difficult short-term liquidity problem, with highly negative consequences. Therefore he requested the Board's full support for the Ecuadoran authorities.

The Executive Directors then turned to the proposed decisions, which they approved.

The decisions were:

Stand-By Arrangement

1. The Government of Ecuador has requested a stand-by arrangement for the period from January 4, 1988 through February 28, 1989, in an amount equivalent to SDR 75.35 million.

2. The Fund approves the stand-by arrangement set forth in EBS/87/263, Supplement 3.

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

Decision No. 8767-(88/1), adopted
January 4, 1988

Exchange System

The exchange measures maintained by Ecuador are subject to approval under Article VIII, Sections 2(a) and 3, as described in EBS/87/263. The Fund encourages Ecuador to remove these restrictions and multiple currency practices as soon as possible. In the meantime, the Fund approves the restriction evidenced by the existence of external payments arrears, the restrictions remaining pending agreement with each creditor, and the multiple currency practices arising from the prior import deposit requirement and from the differential between the intervention and free exchange rates, until July 31, 1988.

Decision No. 8768-(88/1), adopted
January 4, 1988

Purchase Transaction - Compensatory Financing Facility

1. The Fund has received a request by the Government of Ecuador for a purchase of SDR 42.7 million under the Decision on Compensatory Financing of Export Fluctuations (Executive Board Decision No. 6224-(79/135), adopted August 2, 1979, as amended).

2. The Fund notes the representation of Ecuador and approves the purchase in accordance with the request.

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

Decision No. 8769-(88/1), adopted
January 4, 1988

## DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/87/179 (12/23/87) and EBM/88/1 (1/4/88).

### 2. EL SALVADOR - 1987 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, as amended, the Executive Board agrees to extend the period for completing the 1987 Article IV consultation with El Salvador to not later than January 20, 1988. (EBD/87/336, 12/23/87; and Cor. 1, 12/28/87)

Decision No. 8770-(88/1), adopted
December 29, 1987

### 3. MALAYSIA - TECHNICAL ASSISTANCE

In response to the Malaysian authorities' request for technical assistance to review the liberalization of government securities markets and to develop the operational framework for a secondary market, the Executive Board approves the proposal set forth in EBD/87/333 (12/22/87).

Adopted December 29, 1987

### 4. MAURITIUS - TECHNICAL ASSISTANCE

In response to a request from the authorities of Mauritius for technical assistance in connection with revising the Customs Act and the Excise Act of Mauritius, the Executive Board approves the proposal set forth in EBD/87/334 (12/23/87).

Adopted December 29, 1987

### 5. AUDIT COMMITTEE, FY 1988 - COMPOSITION AND NOMINATIONS

The Executive Board approves the Managing Director's recommendation that the United Kingdom, Burma, and Chile be invited to submit nominations of persons to serve on the External Audit Committee for financial year 1988 and confirms the nominations set forth in EBAP/87/274 (12/17/87).

Adopted December 28, 1987

6. ANNUAL REPORT ON EXCHANGE ARRANGEMENTS AND EXCHANGE RESTRICTIONS, 1988 - OUTLINE

The Executive Board approves the proposed outline of the Annual Report on Exchange Arrangements and Exchange Restrictions, 1988, as set forth in EBD/87/321 (12/10/87).

Adopted December 24, 1987

7. EDUCATION ALLOWANCE - EXTENSION OF ADJUSTMENTS TO EXECUTIVE DIRECTORS AND ALTERNATES

The Executive Board approves the proposal relating to the extension of adjustments in the education allowance to Executive Directors and Alternates, as set forth in EBAP/87/285 (12/28/87).

Adopted December 30, 1987

8. STAFF TRAVEL ALLOWANCES

The Executive Board approves the proposal relating to staff travel allowances, as set forth in EBAP/87/283 (12/23/87) and Correction 1 (12/28/87).

Adopted December 30, 1987

9. APPROVAL OF MINUTES

The minutes of Executive Board Meeting 87/96 are approved. (EBD/87/328, 12/17/87)

10. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/87/282 (12/22/87) and by an Assistant to Executive Director as set forth in EBAP/87/284 (12/28/87) is approved.

APPROVED: August 26, 1988

C. BRACHET
Acting Secretary