May 2, 2001
Approval: 5/9/01

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 00/42

10:00 a.m., April 19, 2000

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Decisions Taken Since Previous Board Meeting

Executive Board Attendance

S. Fischer, Acting Chairman
E. Aninat, Deputy Managing Director

Executive Directors	**Alternate Executive Directors**
	A.S. Alosaimi A.R. Ismael, Temporary
T.A. Bernes A.G. Carstens R.F. Cippà	W. Szczuka W.-D. Donecker A.A. Rojas, Temporary H. Vittas C. Harinowo
V. Kelkar W. Kiekens	J. Jonáš, Temporary Å. Törnqvist
K. Lissakers J.-C. Milleron	G. Bauche M.R. Hajian, Temporary J.A.K. Munthali, Temporary A. Lushin L. Palei, Temporary
S. Pickford M. Portugal	R. Junguito S.A. Bakhache, Temporary
G.F. Taylor	Liu Z., Temporary Y.G. Yakusha H. Toyama

A. Mountford, Acting Secretary
N.M. Hairfield, Assistant

Also Present

IBRD: P. Davies, Bank/Fund Conferences Office; A.R. Solimano and D.E. Yuravlivker, Latin America and Caribbean Regional Office: Office of Executive Director: P.L. Rubianes. External Relations Department: T.C. Dawson, Director; G. Hacche, Deputy Director; F. Baker, R. Chote. IMF Institute: R. Garcia-Saltos. Legal Department: H. Elizalde. Monetary and Exchange Affairs Department: F.L. Delgado, E.A. Milne, A. Pancorbo. Policy Development and Review Department: T. Leddy, Deputy Director; C. Brachet, E.A. Gelbard, Z. Murgasova, D.C. Ross, M. Rossi, J. Seade. Secretary's Department: S.J. Anjaria, Secretary; B.A. Sarr, C.L. Sevy. Technology and General Services Department: B.C. Stuart, Director; I.E. Prebensen, Deputy Director; A. Amri, F.P. McLaughlin, T. Villagra R.D. Walker. Treasurer's Department: S.P. Bernhardt. Western Hemisphere Department: C.M. Loser, Director; M.E. Bonangelino, Deputy Director; D. Goldsbrough, Deputy Director; T.M. Ter-Minassian, Deputy Director; M. Alier, P.D. Brenner, M. Cortes, S. Cueva, J.R. Franks, J. Gil-Diaz, O. Gronlie, W.C. Keller, C.-J. Lindgren, O.E. Melhado, E.C. Offerdal, T.M. Reichmann, J. Thornton, M. Villafuerte, E.S. Williams. Office of the Managing Director: D.A. Citrin. Advisors to Executive Directors: J.A. Chelsky, J.A. Costa, J.C. Estrella, O. Himani, E.J.P. Houtman, H. Mori, M. Sobel. Assistants to Executive Directors: J.G. Borpujari, R. Burgess, V. Dhanpaul, E. González-Sánchez, S. Hinata, A. Kapteijn, S.K. Keshava, D.H. Kranen, I. Mateos y Lago, D. Nardelli, J. Nelmes, M. Nemli, K. Ongley, L. Redifer, J. Sigurgeirsson, R.J. Singh, T. Skurzewski, Sugeng, S. Vtyurina, M. Yépez.

1. REPORT BY ACTING MANAGING DIRECTOR

The Acting Managing Director reported on the Spring 2000 Meetings.

The Acting Managing Director made the following statement:

I would like to make a few remarks about our experiences this past weekend regarding the International Monetary and Financial Committee (IMFC) and Development Committee. The prime aim of the security precautions was to make sure that these meetings could take place. They did, and the headlines—which said that the IMF and World Bank meetings took place despite demonstrations—were right.

On Sunday, April 16, 2000 the IMFC met at the appointed time. While the people in the chairs were not in every case the people who were supposed to be there, the great bulk of Ministers or Governors were present. The meeting covered all items on the agenda and the communiqué was posted on the Fund's website at 6:20 p.m. Progress was made because of the work of the Executive Board and the staff before the meetings on the reform agenda and in setting the agenda for the next few months, an agenda which the new Managing Director will certainly put his stamp on when he arrives. I would now like to thank the people who made all this possible.

Executive Directors and their staffs showed forbearance and good grace in putting up with many inconveniences, and I would like to thank you for making the meetings possible. If we had not set up in advance the various communication links, it would not have been possible to get everybody on the buses at 5:00 a.m. It would have been nice to have the press here at 5:30 a.m. on Monday morning when we had a variety of the world's great and famous standing in line with their trays, waiting to pay for their breakfasts. It was a nice sight, and illustrative of the fact that they showed calmness and good humor in handling the situation, and that contributed to the success of the meetings.

We also owe our gratitude to people inside and outside this building, particularly to the police and to all those who were responsible for security. We have all been impressed by the professionalism of the U.S. authorities; namely, the D.C. Police, Secret Service, Coast Guard, Park Police, and police from the surrounding districts. The way they handled the events in the streets and the security arrangements inside the building was exemplary. Obviously, the arrangements could have been more draconian to ensure that everybody made it into the building. As the D.C. Police Chief said, demonstrators have the right to demonstrate, and we had to take that into account and balance their right to demonstrate with our right to have our meetings and to maintain security. I certainly never felt in any danger at any time, and that is testimony to the way the situation was handled. You have seen Ms. Lissakers's letter thanking your authorities for dealing so graciously with the inconveniences. Jim Wolfensohn and I will be sending joint letters to various U.S. authorities, including the U.S. Treasury, to thank them on your behalf for the way they took care of these difficulties. Once we got inside the building, it was surprising to see how normal everything was. The communication systems worked well. That is testimony to the planning, execution, and adaptability of all staff members. While we cannot acknowledge all of them, nor the additional contractual and vendor staff, let me just single out a few for special mention.

Patricia Davies from the Bank-Fund Conferences Office handled the work with exquisite skill and grace both before and during the meetings. We would like to thank her and her small team at the Bank-Fund Conferences Office for organizing the meetings. We would also like to thank Major Frank McLaughlin, the Security Officer for the Fund, and his team for their superb job in coordinating with the local security people and for managing the security arrangements inside the building. They were our contact with the World Bank Security and, of course, with the Secret Service and the D.C. Police.

Thanks to Mr. Amri and his staff from Sodexho Marriott, we all got fed. Between 60 and 90 of them spent several nights in the building to ensure that the cafeteria would be open for breakfast at 5:30 a.m. Next to Mr. Amri is Ms. Villagra, who is one of the cashiers in the cafeteria. She is representing all those who slept at headquarters; I understand that she was in the Fund for four days continuously. Mr. Craig Sevy and the registration staff handled the registration of delegates very effectively. We know how concerned you all were beforehand about that particular aspect of the meetings. I would also mention that this is Mr. Sevy's first meeting in which he had that responsibility, and I thought that was handled quite well.

Mr. Anjaria and his staff in the Secretary's Department organized the meetings and the pre-meeting arrangements. Tom Dawson and the EXR team were quite busy keeping the 1,700 press people happy. I would also like to thank the small army of staff members at the Technology and General Services Department, who are represented here by Brian Stuart and Inger Prebensen. They are here representing not only the entire Department, which includes interpreters and translators, but the engineers, computer staff, audio-visual staff, communications staff, transportation staff, electricians, movers, messengers, janitors, plus others who were all in the building making sure everything worked. Many of them worked behind the scenes, and most of them worked quite extraordinary hours, showing their dedication to making sure that the meetings took place as planned.

Although some of you had to put up with inconveniences, it is remarkable how few glitches there were. Once the meetings started, everything seemed quite normal. Of course, something could have gone wrong at any stage. Thus, we have to be careful as we look ahead to the Prague meetings to try to figure out what lessons to draw. Holding meetings abroad can be difficult, possibly more difficult than in Washington, D.C. We will need to discuss with you in the next months how to coordinate arrangements to reduce the risks in Prague.

The last thing we have to reflect on is that we still have a long way to go in explaining to the outside world what the Fund does and what its objectives are. Our work on improving transparency, on being more accountable, and on being more open to the views of civil society is increasingly being understood, but not yet fully understood. We need to do more in that regard.

I have written a letter to the delegates of the meetings thanking them for coming, for their contributions, and apologizing for the inconveniences. I also suggested that they speak out from time to time in support of the Fund. This is an effort which needs to be made not only by EXR, management, and the staff, but also by the shareholders who support us; they ought to do that in their countries as much as possible. All of us, including the members of the Executive Board, should speak out more. We have a lot to say about what the Fund should be doing.

Finally, let me, once again, thank everyone involved. The dedication that was shown by the staff was remarkable, and we are grateful to them.

Mr. Portugal thanked the Acting Managing Director for his personal effort in organizing the meetings, and all the staff involved for the extensive preparations that had made it possible for the Fund to hold the meetings with the minimum possible disruption. He also thanked the U.S. authorities, especially the local police, for the excellent and professional job that they had done on that occasion. While it was true that there had been inconveniences, the outcome had been remarkable.

Mr. Bernes thanked the staff for their impressive efforts and the security forces for keeping the situation under control. One needed to recognize that the demonstrators had shown a remarkable degree of organization and restraint. One also had to be careful about the messages one put out after the meetings, particularly the question about what had changed in the Fund as a result of the demonstrations. While one might be tempted to say that little has changed, clearly that would be the wrong message to send out. The message should be that the demonstrations had reminded the Fund to do an even better job and to continue with the reform process. He thanked the Acting Managing Director for his admirable job in leading the staff, management, and the Board through the process.

Mr. Pickford agreed with the Acting Managing Director that the Fund's shareholders should rally behind the institution. The enormous efforts made by the staff had allowed the meetings to run smoothly. The tribute was that the meetings had felt like normal meetings. His Ministers were grateful for all the efforts that had gone into arranging the meetings.

Mr. Kelkar conveyed his Ministers' and authorities' gratitude in thanking the staff of the Fund and the U.S. authorities for their efforts in making the meetings successful. He also agreed with Mr. Bernes on the need for the Fund to improve its communications. In one of the television shows, he had been alarmed by the remarks made by a famous American actress on her perceptions of the Fund. The Fund therefore needed to strengthen its communications efforts. Like Mr. Bernes, he was also surprised by the demonstrators' idealism and commitment; the Fund should improve its communications with them as well.

Mr. Milleron pointed out that it had been important that the meetings had taken place as planned, despite the demonstrations.

Mr. Taylor wondered whether the Fund knew what conclusions the NGOs had drawn from the experience.

The Acting Managing Director indicated that one of the newspapers had reported that the demonstrators had claimed victory. In terms of what lessons they had drawn from the experience, that was difficult to determine. Some of the demonstrators had been extremely well informed on policy matters and the Fund should continue to communicate with them. Unfortunately, some other demonstrators had been looking for a confrontation. Nevertheless, the Fund needed to reach out to everybody who was willing to talk, including young people. Perhaps the Fund should also increase its communications with schools.

The Director of the External Relations Department remarked that the groups that had demonstrated on the streets by and large were not the same groups that the Fund has been communicating with. The demonstrators had claimed victory because they had received a great deal of media attention. Although the Fund would continue to be criticized strongly by certain groups, the Fund should continue its dialogue with them. The groups remained civil, despite some attempts by the organizers to boycott contacts with the Fund and the Bank during the course of the meetings. Nevertheless, the Fund would continue to communicate with the groups who wanted to continue communicating with the Fund, particularly with the European-based NGOs. Overall, NGOs felt that their experience had been positive because they had made their cause more visible. Besides the images of the street scenes, from the point of view of the Fund, the degree of media commentary over the past few days had been either broadly supportive or critical in an informed sense of the word. In that regard, the session that the Board had with the four members of the Meltzer Commission was exactly the kind of dialogue that the Fund should be going forward with.

The Acting Managing Director noted that the security arrangements in Prague could be more complicated because of the geography of the city. Certainly, the staff would start focusing on the Prague meetings soon to ensure that everything would run smoothly.

Ms. Lissakers conveyed the complements of the U.S. security authorities to the Fund security staff and the organizers of the meetings for organizing such a complex operation, which required a tremendous amount of coordination.

The Acting Managing Director remarked that a few Ministers had told him that they had been particularly impressed by the quality of the Board papers. The work of the Board and the staff had been exceptional, moving the reform agenda significantly ahead.

2. ECUADOR—STAND-BY ARRANGEMENT; AND EXCHANGE SYSTEM

The Executive Directors considered a staff paper on Ecuador's request for a Stand-By Arrangement in an amount equivalent to SDR 226.73 million (EBS/00/66, 4/5/00; Cor. 1, 4/7/00; and Sup. 1, 4/18/00).

Mr. Portugal and Mr. Yepez submitted the following statement:

The economic and political crisis

In 1999, Ecuador faced the worst economic crisis in its Republican history, resulting in dramatic social consequences for its people. Negative external shocks and political instability were two of the main underlying factors behind the crisis. Ecuador faced serious border problems in 1995, followed by adverse climatic events related to a drought with severe consequences in energy supply, and the floods caused by El Niño, which devastated infrastructure and agricultural fields. The turbulent international financial environment and the collapse in oil and other export prices further complicated the situation by seriously affecting fiscal revenues and undermining confidence.

The effects of adverse external shocks were compounded by the delicate political situation. To illustrate the unusually high level of political instability, during the last five years there have been five different administrations in Ecuador. There are many reasons to explain political instability in Ecuador, but an important one is the electoral system that almost ensures that the elected President lacks a majority in Congress. Box 1 of the staff report shows clearly the difficulties of the government to obtain congressional support for tax increases and other important measures. A consequence of this political instability has been the extremely high turnover of economic and supervisory authorities, with the corresponding lack of continuity in the implementation of policies.

Ecuador's GDP—which in 1997 was about US$20 billion—plummeted to US$14 billion at end 1999, a level that reflects a loss of about 1/3 of total income in the last three years. Cumulative inflation in the last three years amounted to 300 percent. The nominal exchange rate depreciated by 500 percent in the last 24 four months, to a level of 25,000 sucres per dollar compared to 5,000 sucres per dollar at end-1997, and by about 42 percent in real effective terms. Private capital outflows in 1999 were estimated at more that US$2.5 billion, while total public debt rose sharply from 64 percent of GDP in 1997 to 112 percent of GDP in 1999. The external current account shifted from a deficit of 11 percent in 1998 to a surplus of about 7 percent in 1999, reflecting a substantial reduction in imports as a result of the drastic decline in economic activity.

The deterioration in economic performance brought about a significant and painful decline in the welfare of the population. Unemployment increased to 20 percent while underemployment currently affects almost 55 percent of the population. Approximately 43 percent of Ecuador's population lives below the poverty line and around 15 percent of this total live in extreme poverty. During the last two years, the purchasing power of Ecuadorans declined by almost 50 percent, and income distribution deteriorated further, severely affecting the most vulnerable groups in the population.

In this context of political and economic instability, it was extremely difficult for the authorities to implement sound measures in a timely way. As a consequence, public finances deteriorated sharply in 1998 owing to the collapse of international oil prices mentioned above, a decline in domestic petroleum production, and increased current expenditures, mainly on wages. In response, our Ecuadoran authorities did what was politically feasible to do to overcome the situation. In 1998, they eliminated most of the subsidy on the prices of cooking gas and electricity, increased the price of diesel and gasoline by 40 and 12 percent, respectively, and indexed these prices to the U.S. dollar exchange rate. In 1999, a temporary import tariff surcharge of up to 10 percentage points was reintroduced, domestic fuel prices were increased by a further 23-27 percent, controls over expenditures were reinforced, and a fiscal package was approved to reinstate the income tax, broaden the base of the VAT, eliminate some tariff exemptions, introduce a tax on luxury vehicles and a one-time tax on corporate net worth, and give additional powers to the Internal Revenue Service to enforce tax compliance. However, following increased social unrest, the government froze the price of gasoline and cooking gas, a move that led to the re-emergence of large subsidies on domestic fuel prices.

The measures adopted by the Government, helped by the later increase in international oil prices, represented a substantial fiscal effort at a time GDP was falling sharply. The primary result shifted from a deficit of 1.2 percent in 1998 to a surplus of 4.1 percent of GDP last year. However, this 5 percentage point shift in the primary result did not show in the combined public sector result, since accrued interest doubled to 10 percent of GDP and the central bank result deteriorated as an effect of the banking crisis.

The deteriorated macroeconomic conditions and the reduced access to international credit lines accentuated the problems in the banking system. The main problems in the sector stemmed from connected lending practices and the growth of foreign currency credit to borrowers that do not generate earnings in foreign currency. The roots of the banking crisis are numerous and not new. Some of the critical elements were: the quality of supervision and prudential regulation lagged behind the rapid process of financial liberalization; and there was insufficient information, particularly on off-shore financial operations, which escaped supervision for many years and, in the case of some banks, were used to disguise problems or indulge in fraudulent transactions. A broad mandate was given to the new deposit insurance agency (AGD) to restructure the banking system, and a universal guarantee was announced. However, doubts about the fiscal ability to sustain the guarantee contributed to a run on the commercial banks, which made it impossible to manage the crisis without impacting inflation, despite the government's decision to freeze demand and savings deposits for six months and time deposits for one year.

Private banks accounting for more than 75 percent of total assets were absorbed by the government, after being identified as nonviable by special auditing firms. Despite political pressures, the shareholders of all banks lost their equity, and bank administrators were removed. The fiscal cost to the government of such a significant intervention of the banking system was obviously huge, and will be borne for several years. But the cost was not absorbed only by the government. Deposit holders did not get their money back at the end of the freeze period. Instead, they received long-term bonds.

The banking crisis severely undermined monetary policy. Currency issued by the Central Bank increased significantly to provide liquidity to the affected banks and to avoid further systemic risks. In the presence of unstable markets and increasing speculative attacks, the Central Bank had no option but to rediscount the government bonds issued to capitalize the banking system. The liquidity injections by the Central Bank were largely sterilized by losses of international reserves and intensification of open market operations through substantial increases in interest rates. In addition, in the face of sustained exchange rate pressure as well as to preserve the level of international reserves, the Central Bank floated the sucre in February 1999. However, none of these actions helped in recovering confidence. Money demand fell sharply and bank credit to the private sector declined by almost 30 percent in 1999, while capital outflows continued.

The exchange rate depreciation worsened the public finances owing to the fact that higher income from oil exports was effectively eliminated by higher interest expenditures due to the increased cost of servicing the public debt. Approximately 70 percent of loans granted by Ecuadoran banks are expressed in foreign currency as well as most of the public debt. The depreciation of the local currency eroded the private debtors' solvency because their liabilities were in foreign currency and their income in local currency. This explains why the expansionary effects of the exchange rate depreciation did not work in Ecuador since the effects on the solvency of the public and private sectors, created by the exchange rate depreciation, led to a deep economic recession.

The other critical element that must be taken into account is the loss of financial sector credibility that brought a run on the deposits from commercial banks. To prevent the collapse of the payments system and avoid the systemic risk, the Central Bank issued local currency to provide the banks with the liquidity necessary to support the withdrawal of deposits. The exchange rate depreciation in Ecuador was due to an interactive circle of devaluation, insolvency, loss of confidence and the issuance of local currency. The only way to break the circle was through an exogenous decision to stop the run against the sucre by introducing the official dollarization of the economy.

The new economic program

To restore confidence in economic management, stem the decline in economic activity, and lay the basis for renewed economic growth, the new government, which took office in January 2000, is undertaking a broad-based program of economic reform. The legal basis for many of the reforms is the Economic Transformation Law which was enacted on March 9, 2000. This law not only approved the needed changes in the monetary area and the Central Bank functions in order to establish the official dollarization of the economy at a conversion rate of 25,000 sucres per U.S. dollar, but also introduced deep structural reforms in key areas, including the financial sector, labor markets, energy (petroleum and electricity), and public finances.

The general objective of the macroeconomic program for 2000 is to consolidate the process of dollarization of the economy through prudent fiscal management, an orderly, transparent recovery of the private financial system, and the stabilization (convergence) of relative prices in the medium term. The exchange risk elimination associated with the dollarization plan will facilitate the convergence of domestic prices with international prices. The end-of-the-period inflation is expected to be 60 percent for 2000. The rate of inflation will remain high during the first months of dollarization as prices absorb the steep devaluation of the last months, as well as the future increases in wages and in the prices of electricity, gasoline, and gas.

It is expected that once the basic macroeconomic equilibrium is reestablished, economic activity would increase. Although annual GDP growth is targeted at 0 percent to 1 percent for 2000, the trend of its quarterly evolution gives an idea of the major recovery anticipated for year-end. Indeed, while the growth rate for the first quarter is reported to be –2.9 percent, it is now expected that growth by the fourth quarter will be at over 7.0 percent.

The overall deficit of the Non Financial Public Sector (NFPS) for 2000 is expected to be 3.9 percent of GDP, of which the central government budget, with a programmed overall deficit of 2.5 percent of GDP, has the largest share. The fiscal policies geared to narrowing the central government budget deficit are as follows: an increase in domestic fuel selling prices, with the aim of reaching the March 1999 levels through periodic adjustments in 2000 and 2001. For July 2000, an increase of 60 percent is envisaged in the prices of all fuels, except gas, the price of which will be raised by 40 percent. In October 2000, there will be an additional price increase of 60 percent, compared with the March price; the prices of diesel and super gasoline will increase by 30 percent, compared with the March price; and the price of gas will be raised by 29 percent increase.

The wage policy includes, for April, an across-the-board increase of 10 percent on the remuneration of all civil servants covered by the central government budget. In addition, further increases of 10 and 20 percent for specific groups of civil servant are under consideration for July and October 2000. The Solidarity bond - a direct compensation mechanism benefiting approximately 1.1 million persons—will be increased throughout the year if projected financing and fiscal revenues are higher than programmed.

The primary balance of the NFPS is one of the indicators that clearly demonstrates the fiscal effort to which the government is committed. The program envisages a significant improvement, from a surplus of 4.2 percent of GDP in 1999 to a surplus of 6.7 percent of GDP in the year 2000. Preliminary information for February shows a cumulative surplus of 1.9 percent of GDP compared to 0.4 percent estimated in the program. The continued tight control over expenditures, including purchase of goods and services, has been a major factor behind the overall fiscal stance, as was the commitment of the authorities to meet the performance criteria and indicative targets of the economic program supported by the Fund.

In 2000, the external capital account is expected to record a deficit equivalent to 1.2 percent of GDP. Foreign direct investment is expected to reach US$685 million (US$52 million more than in 1999). Disbursements from foreign loans programmed in the 2000 budget are US$641 million. A regular payment of principal (US$777 million) is assumed from the commitments made to the various creditors, which results in a negative flow of US$75 million.

The total financing requirement of the NFPS for 2000 is US$2.5 billion, of which US$435 million is to be earmarked to cover domestic debt repayments and US$559 million for external debt. It must be mentioned that of the domestic debt repayments, about US$304 million relate to restructured debt. In other words, net repayments are expected to reach only US$130.9 million. External debt-service arrears are estimated at US$1,036 billion. Debt-service arrears are expected to continue until March 2000.

Once the stand-by arrangement has been approved, meetings with external creditors (Paris Club, as well as the holders of Brady bonds and Eurobonds), will be held in order to restructure debt-service payments, which would provide both short-term cash-flow relief and medium-term debt reduction.

Ecuador has been in default on its debts owed to private bondholders for more than seven months. This is an unsatisfactory situation both for Ecuador and the creditors. Ecuador now intends to move promptly to regularize its relationship with its private bondholders. This will be done through an offer to exchange the country's existing bonds for new debt instruments whose financial terms will produce a sustainable debt-service profile. Ecuador has retained the services of an international investment bank to assist in designing and executing this transaction, and preparatory work is now under way. Ecuador has kept, and will continue to keep, an open channel of communication with its creditors in an effort to ensure that the transaction will be broadly acceptable to the investor community.

The Central Bank has retained the function of managing systemic liquidity. To this end, it has authority not only to set legal reserve requirements, but also the capacity to borrow short and long term, internally or abroad (particularly from international monetary and financial institutions), to augment international reserves and be in a position to provide liquidity to the banking system. Hence, one of the most urgent and important challenges for the Ecuadoran authorities is to access external funding to enhance the international reserves available to recycle banking system liquidity. The level of international reserves should be large enough to face possible deposit withdrawals associated with the partial deposit unfreeze and, more broadly, to manage the financial effects of the credibility gap likely to characterize the initial months of the dollarization process. Our Ecuadoran authorities have made substantial progress with the multilateral agencies to gain financial support to implement the dollarization program and associated reforms. In this regard, once the Executive Board approves the Stand-By Arrangement that has been requested, disbursements of almost US$300 million would create a further build up in the level of international reserves.

The approval of the Economic Transformation Law has paved the way for important structural reforms in the labor market, the oil sector, and privatization. The labor code has been amended to eliminate rigidities and create conditions to increase employment. Private companies have been allowed to refine, process, and store oil and gas, as well as to build oil pipelines--a provision that will facilitate the planned construction of a new US$600 million oil pipeline from the Amazon region to the northern coast, scheduled to begin later this year. Revenue in 2000 from privatization is tentatively estimated by authorities at US$300 million, including that resulting from the sales of majority shareholdings in the state electricity generation, distribution, and transmission companies, and in the two state telecommunications companies.

Several representatives of the parties that support the government in Congress came to Washington this week to meet with the multilateral organizations including the Fund. During the meeting with the Acting Managing Director of the Fund, the President of the Ecuadoran Congress reiterated that the purpose of the visit was to reaffirm the support of the majority of the Congress to the letter of intent and to the commitments of the economic authorities.

While Ecuador has witnessed a situation where political developments have restricted plans for a faster pace of reform, efforts have continued and will be enhanced to correct imbalances and to set the basis for a sustainable improvement in real growth and poverty alleviation. Success in achieving this objective will help generate the necessary consensus to break the existing rigidities and further advance the far-reaching structural reforms already initiated. Finally, we and our Ecuadoran authorities would like to express our deepest appreciation to Management and staff of the Fund for the excellent working relationship and collaboration during the design of Ecuador's economic program.

Mr. Shaalan and Mrs. Farid submitted the following statement:

A confluence of external shocks in the period 97-99 coupled with persistent domestic policy weaknesses have brought the Ecuadoran economy to a state of acute crisis. Real GDP has contracted sharply, inflation has accelerated, unemployment has doubled, public finances have deteriorated and the banking system is in a poor state. Needless to say, this has resulted in extreme hardship on the population, particularly the poorest and most vulnerable segments.

We are pleased that after a long period of domestic uncertainties and difficult negotiations with the Fund, the Ecuadoran authorities and the staff have come to an agreement on an adjustment and reform program that could be supported by an SBA. While the risks to the agreed program are substantial, and success is by no means assured, the program appears to offer a reasonable chance of easing Ecuador out of the present extremely difficult situation.

Economic recovery will depend on the timely implementation of policy actions on a number of fronts, at the forefront of which is fiscal policy. At the same time, this will need to be supported by adequate debt relief, a reduction of external obligations, and the restoration of banks' credit lines. As noted by staff, neither the short-term viability nor longer-term sustainability of Ecuador's balance of payments can be restored without significant debt reduction. Unless both the adjustment and external financing components of the program are brought together, a lasting return of confidence will be elusive.

The policy measures to be implemented by the authorities are closely interlinked. The strengthened mobilization of public sector resources and the reduction of the fiscal deficit form the core of the program. Success of the dollarization mechanism and the bank resolution strategy, the two other mainstays of the program, are highly dependent on the achievement of the fiscal targets. The key challenges in resource mobilization lie in the required adjustments to fuel prices and public sector wages. The low level of social spending is also likely to cause difficulties. Strong political resolve and the ability to forge and maintain a national consensus on the necessity of these measures will be crucial. Looking further ahead, increasing emphasis will need to be placed on enhancing the flexibility of Ecuador's fiscal system, particularly since with the adoption of dollarization, fiscal policy becomes the single policy instrument available to policymakers.

We are encouraged that the announcement of the intent to adopt an official dollarization regime appears to have restored a measure of confidence to markets. However, it is important to stress that dollarization in and of itself cannot be considered a panacea for Ecuador's problems. Success will hinge on the implementation of the strong supporting policies called for, particularly in the fiscal and banking areas. As the staff note, a major test will come in the period through end-July as the remainder of the frozen time deposits are unfrozen. Hopefully, public confidence in the authorities' program will keep these dollar resources in the country rather than result in capital flight. It is also urgent that the supporting institutional arrangements be put in place without delay. We note in particular the need to build up a stabilization fund to support a liquidity recycling facility for banks. The strengthening of the deposit insurance agency to facilitate the implementation of the bank resolution strategy must also be accorded high priority.

Resolution of the banking crisis is essential to a restoration of confidence and the resumption of private investment and growth. A critical step has been taken in this direction with the passage of the economic transformation law, which provides the legal framework for bank restructuring. Strengthening the solvency of banks should also proceed without delay. Improvements in loan classification and provisioning need to be brought up to international standards, and the on-site examination of banks intensified. A system of prompt corrective action to deal with banks whose CAR fall below the regulatory minimum should also be instituted as soon as possible. Bank recapitalization will require the mobilization of public sector resources, particularly over the short-run since it is not foreseen that sufficient private capital will be available at an early stage of the process.

Private sector involvement in the resolution of the crisis in Ecuador is essential. The financing requirements of the adjustment program are large, and prospects of regaining private market access in the near future are extremely limited. We welcome the resumption of negotiations with private creditors expected before the end of April. Clearly an early resumption of discussions to find a cooperative solution with regard to private sector financing is essential.

Finally, we welcome the close monitoring of the program through bi-monthly program reviews. We support the proposed decision and wish the Ecuadoran authorities every success in the difficult period ahead. .

Mr. Toyama submitted the following statement:

To begin, I want to thank staff for their enormous efforts in assessing the macroeconomy in Ecuador and for designing a comprehensive program. This chair broadly supports the thrust of the staff appraisal, but will comment on a few points.

The initial aim of announcing the Dollarization seems to have been achieved, as the economic crisis has eased. The credibility of the currency system has been restored, and the banking sector crisis has been stemmed. The exchange rate has remained stable and interest rates have declined following that announcement. However, several challenges remain, such as smoothly unfreezing time deposits, something the authorities must address to complete Dollarization. Moreover, it will be necessary to establish a framework of macroeconomic management without monetary autonomy.

With confidence in the currency system restored, I do not expect to see Ecuador experience large-scale capital flight again when the remaining frozen bank deposits are released this year. On the other hand, inflation should be monitored carefully as increased pressure is anticipated as a result of increased liquidity in the economy.

The redemption of sucre banknotes for U.S. dollars is projected to proceed gradually over the next six to twelve months. The demand for U.S. dollar banknotes could increase quickly, followed largely by the unfreezing of bank deposits. I urge the authorities to prepare a sufficient amount of these banknotes to meet any unexpected demand in order to avoid further economic turbulence.

Under the Dollarization framework, interest rates are determined apart from the business cycle. This might make fiscal policy all the more important in response to the business cycle. In this regard, the authorities should firmly implement committed measures to strengthen the fiscal position, so as to take counter-cyclical fiscal expenditures. Increasing the flexibility of the economy, including improvement of flexibility in the labor market, will also be needed to absorb external shocks.

Dollarization has imposed strict limitations on the central bank's function of "lender of last resort". Except for a liquidity support facility, there is no liquidity assistance from the central bank. Restructuring the banking sector and strengthening bank supervisory framework should be addressed. In this regard, I agree that a mechanism to recycle liquidity within the banking system could work for function of liquidity support to weaker banks under the "flight to quality" circumstances. However, it is puzzling to me how a central bank that will not issue banknotes can continue to issue instruments attracting investors. Staff comments would be appreciated.

The success of dollarization will hinge on improvement of the fiscal balance. However, prospects are uncertain for international oil prices and fiscal costs for restructuring the banking sector. Also, the fiscal measures include political controversial issues, such as a gradual increase in the public wage bill and a reduction of subsidiaries in petroleum products. Although this is a step in the right direction, tax reforms for the 2001 budget are expected to take time and hard work in order to meet the consensus. In this context, it would be appropriate to avoid major fiscal contractions in the economy where domestic demand has collapsed. The authorities are also committed to increasing social sector expenditures in the second half of 2000 if oil revenues are higher than projected. These measures would be welcome on one hand, for obtaining a national consensus toward economic reforms. It will be necessary to assess in forthcoming SBA program reviews whether the authorities' fiscal stance discourages domestic demand and momentum for economic reform.

Given that the crisis in Ecuador has deepened more than was projected at the beginning, the international community's calm response to Ecuador's temporary suspension of debt payments is encouraging. This seems to be evidence that market participants are better understanding PSI. In this context, I welcome the authorities' commitment to hold an April meeting with private creditors of Brady and eurobonds through a consultative group. Needless to say, it is important to create an environment in which debtor countries and creditors cooperate and communicate with each other while implementing PSI. Therefore, I hope the authorities will make every effort to find a sufficient solution with creditors.

Finally, without a doubt, adopting the Dollarization regime has contributed to restoring confidence in the banking system and to enhancing momentum for renewed economic growth. The authorities should seize this opportunity to decisively implement measures committed to, and to establish the basis for sustainable economic future growth. This SBA program should also encourage Paris Club and private sector creditors to offer assistance to Ecuador as its catalyst function. Having said that, this SBA program design is adequate for the macroeconomic framework comprising the Dollarization regime. Meanwhile, there are also several risks in timely implementing the program. I therefore urge staff to elaborately monitor and review this program.

With these remarks, I support the proposed decision and wish the authorities every success in their endeavors.

Mr. Bernes submitted the following statement:

Ecuador is trying to recover from an extremely grim economic situation that includes defaulting on Brady bonds and eurobonds, the rise of inflation to insidious levels, an alarming increase in the incidence of poverty, and the simultaneous collapse of the banking system, economic activity, and the exchange rate. The centerpiece of the authorities' policy strategy to emerge from the crisis is dollarization supported by fiscal tightening, banking-sector and structural reforms and debt restructuring.

From a very broad perspective, this strategy could work, and indeed has its merits. However, as the staff notes, the strategy is untried from starting-point conditions similar to those currently in place in Ecuador, and the program is subject to significant risks. In particular, dollarization comes across—to use an American sports expression—as a sort-of "hail mary" of economic policies under current circumstances. Notwithstanding, I support Ecuador's request for a Stand-by arrangement. The degree of financial support incorporated in the proposed arrangement should not risk unduly forestalling or diminishing the involvement of the private sector in resolving Ecuador's external viability problems. Indeed, the program should provide a reasonable basis for approaching private-sector creditors to conclude debt restructuring negotiations.

I agree with the key risks identified in the staff report: the authorities may not have sufficient political and popular support required to implement the program given the difficult political and economic environment; there is limited room to maneuver under dollarization in the event of renewed pressures on the banking system; and it may be difficult to secure the significant degree of debt reduction required to restore external viability.

The report notes that in order to minimize risks, the program includes substantial prior actions and bi-monthly reviews. While these are welcome and appropriate, I think there are a few more steps that could be taken to minimize risks.

As the report points out, the cooperation between the authorities and the staff has been problematic in the past, and there are doubts about the government's ability to deliver on its commitments. In this light, I found it curious that the purchases under the proposed SBA are front-loaded, rather than back-loaded. Back-loading the schedule of purchases would provide a more appropriate incentive to the authorities for continued progress, and I would appreciate hearing from staff about the rationale for front-loading the purchases.

Successful dollarization will depend on a major strengthening of the public finances. However, while tight fiscal policy will help to build investor confidence and reduce financing pressures going forward, such efforts will have to be balanced by efforts to engender widespread popular support for the reform process. The benefits of reform should be shared as equitably as possible, especially given that overall growth prospects are not likely to turn out to be as optimistic as incorporated in the program. Both monetary and fiscal policy are set to remain restrictive, and the soundness of the banking sector will not be restored overnight. My feeling is that confidence and a renewal of credit growth and private investment will similarly take time to regenerate.

Under these circumstances, I am concerned that the envisaged fiscal tightening places a disproportionate, or at the minimum an outsized, burden of adjustment on the most vulnerable segment of society. In addition to raising questions about equity in sharing the burden of adjustment, this could lead to strong public resistance to reform and possibly to social unrest. In the 2000 budget, for example, Congress has eschewed taxing luxury automobiles and capital assets, while spending on social programs will be cut at the same time that the share of the population living below the poverty line is rising to near 50 percent. More broadly, subsidies on domestic fuels are to be decreased in large discrete steps later this year, and experience tells us that such a move can be extremely unpopular and lead to significant social unrest.

It would have been preferable not to cut spending on social programs, and to reduce fuel subsidies either more gradually, or more selectively while protecting the poor. Notwithstanding, I strongly support the staff's recommendation to direct higher-than expected fiscal revenues in the second half of 2000 to increasing social expenditures, and to strengthen and enhance the targeting of the social safety net in the 2001 budget. Moreover, the authorities will have to redouble their efforts at strengthening the collection of electricity tariffs, along with an appropriately targeted reduction in electricity subsidies, given their regressivity in the safety net.

With respect to the banking system, the authorities cannot afford any further delays in implementing the framework that has been designed in collaboration with the IFIs. A strengthening of the banking system is absolutely critical to the process of economic recovery. A key challenge will be the diligent supervision of banks, and prompt action with respect to banks whose capital adequacy ratio falls below the 9 percent minimum level. As well, I would urge the authorities to move swiftly in establishing a program for the disposal of assets acquired in the bank resolution process, along with the corrective action plan to deal with obstacles to effective bankruptcy procedures and corporate debt workouts.

Finally, on debt restructuring, obviously Ecuador's economy will not be able to return to long-term viability without a comprehensive restructuring of domestic and external obligations. I recognize the difficulties in estimating the debt-reduction requirements to achieve fiscal and external sustainability. Nevertheless, on the domestic side, burden sharing considerations suggest that it will probably be necessary for domestic creditors, in particular holders of U.S. dollar denominated time deposits, to shoulder a larger burden of adjustment than the 10 to 18 percent haircut implied by current deposit-to-bond conversion scheme.

Moreover, the need for significant external debt reduction is clearly illustrated in the staff's analysis in appendix 1 of the report. Even assuming a 25 to 33 percent reduction in the overall stock of external debt outstanding, the net present value of debt service ratios would remain above the HIPC sustainability thresholds. The implication is that the authorities will need to ask private creditors for debt reduction in excess of the above illustrative rates. Does the staff have any feeling for the odds the authorities are facing in attempting to successfully negotiate such an outcome?

In any event, I wish the authorities success in reaching an appropriate agreement with private creditors in a timely manner.

Mr. Harinowo and Mr. Sugeng submitted the following statement:

As the staff reported, Ecuador's economy during the past year continued to worsen. Real GDP dropped sharply, inflation rate soared, and the unemployment rate doubled. Adverse external circumstances, particularly international financial turmoil, the drop in oil prices, and a considerable plunge of the sucre, were among the factors behind this development. Meanwhile, the loosening stance of monetary and fiscal policy taken by the authorities complicated the situation and added to the problems. In the coming years, the challenges that lie ahead are daunting ones: the banking system remains fragile, and the external position is vulnerable, while a bulk of external financing is needed.

In the face of the current difficult situation, we praise the Ecuadoran authorities in taking a "valiant" policy measure in the form of a dollarization scheme. With the large depreciation of the sucre since 1997, we see the authorities' merit of undertaking this scheme. The recent development showed that this dollarization has brought about favorable impacts on the market as marked by the somewhat improved confidence in the banking system. However, as the Staff Report notes, significant downside risks to the scheme remain. Much remains to be done in order for this scheme to work effectively, and lays down a firm foundation for economic recovery. While policy actions in some areas, particularly the fiscal and banking sector, and structural reform are called for, we would like to note that, at this stage, it is important that continued socialization of the dollarization scheme be given priority, especially in the areas where most people may be receiving incomplete information about this scheme.

At this juncture, bank restructuring becomes one of the key aspects of Ecuador's economic program. The success of this measure is essential to regain confidence in the banking system, thus helping stem private capital outflows. It is very encouraging to note that the authorities have started to cope with the process of bank recapitalization under the mandate of the Deposit Insurance Agency (AGD). To resolve the problem of non-performing loans that increase sharply, the AGD must exercise pressure on debtors in order to lessen the fiscal burden. Meanwhile, we welcome the authorities' steps to begin to unfreeze the demand and saving deposits. In the long-run, this will help accelerate economic recovery. Given the fragility of the situation, caution needs to be exercised so that this process will not cause unwarranted instability. Considering the current international reserves, however, we are somewhat concerned with the impact on the dollarization scheme. In this regard, we encourage the international financial community to provide support in this program.

Under the fragile banking condition where flight to quality still occurs, setting a maximum legal interest rate is understandable, avoiding banks -- particularly the weak banks-- to raise their deposit rates irrationally. However, as the process of banking restructuring has already started, we think this policy should be gradually eased, and let interest rates be determined by the market. Of course, under the still fragile financial circumstance, prudential regulation and banking supervision needs to be strengthened.

Corporate restructuring is also important and needs to be seriously implemented as the success of bank restructuring will depend heavily on the resolution of corporate debt. To the extent that corporate restructuring continues to lag behind, bank restructuring may be delayed. We are pleased to see that the authorities have set a strategy that includes steps to strengthen bankruptcy and foreclosure procedures as well as to focus on the largest borrowers. Furthermore, taking into account the huge number of NPLs (around 43 percent as of January 2000) and due to the complicated nature of the problem, developing a framework which would facilitate out-of-court corporate restructuring is of similar importance.

Fiscal policy continued to be an important instrument in stimulating the economy. For the time being, external resources are an essential component, and needs to be sought to fill the financing gap. To this end, seeking an agreement to restructure debt-service payment on its Brady and Eurobonds is essential in propping up the supply of the dollar. From the internal side, we welcome efforts to strengthen the revenue side through increasing the VAT rate, and maximizing marginal rate of tax on personal income and corporate profit. The tax reform agenda that will be sent to congress next September is welcomed. However, we were puzzled by the government's action to abolish taxes on luxury vehicles. Furthermore, in order to make the fiscal position viable in the long-run, we basically support the government's intention to increase domestic oil prices. However, to be effective, this policy should be carried out cautiously. With an increase in the population living under the poverty line, a gradual adjustment in the price increase seems to be more appropriate, particularly in anticipating the possible re-emergence of social unrest that could deteriorate confidence.

The economic and financial crisis facing Ecuador exacerbated the already poor poverty condition. Therefore, one main area of concern is poverty reduction that needs to be addressed in a more decisive and systematic manner. The social safety net program (SSN) need to be strengthened, and targeted more effectively; this is an extremely important element in enhancing social cohesion. In this context, the privatization program will play a critical role in backing the SSN program. Therefore, the privatization program needs to be implemented further to provide a vital cushion in supporting the program, especially since the government will make a significant increase in domestic fuel prices this year.

Finally, we support the proposed decision, and wish the authorities every success in facing the challenges.

Mr. Milleron and Mrs. Mateos y Lago submitted the following statement:

Ecuador finally seems closer than it has ever been to seeing the end of the tunnel. But there is still a long and winding road to go before growth and prosperity can be restored. Indeed, it will take time, as well as perseverance and determination from the Ecuadoran authorities. Against this background, the program agreed between Staff and the Government of Ecuador provides solid building ground. It is not a perfect program - if there is such a thing - and it is unquestionably a risky one for the Fund.

Before supporting it, there are a few issues which call for clarification.

Private sector involvement

PSI has been a pivotal issue since the very beginning of Ecuador's negotiations with the Fund, with stakes reaching far beyond Ecuador itself, to the international financial community as a whole. Now that a program has finally been agreed upon, it is important that we get it right.

First, I would like to urge Staff to be extremely cautious, when writing about this issue, not to send misleading signals. In this respect, I believe the wording of paragraph 49, page 30 could seem to suggest that the IMF actually encouraged the authorities to default on their Brady and Eurobonds, as a way to cover their financing gap. Even if this report is not expected to have a wide circulation, it would be preferable to avoid any language which could fuel such allegations.

Second, I would appreciate it if Staff could provide us with detailed balance of payment projections for the next three years, as for some reason it was the time horizon retained by multilateral donors to make their pledges of exceptional financing. Indeed, based only upon the projections presented on page 57, the total financing gap for the next three years would seem to be in the order of $2 billion, against pledges by the IDB, the World Bank and the Andean Development Corporation (CAF) of $2 billion for the same time frame. That would seem to leave little to be provided by the private sector.

Third, and more substantially, focusing on the time horizon of this program, I regret to note that only a relatively small amount of private sector involvement is envisaged, whereas a maximum effort is expected to be made by Paris Club creditors. This is not consistent with the principle of burden-sharing, as set by the IMFC no later than last Sunday. Private sector involvement should be the rule, not the exception summoned if and when there remains a financing gap after the intervention of official creditors.

Here, the total financing gap is estimated by the Staff at $1.45 million, of which only about $300 million would be provided by the private sector. If one takes into account the contribution of the IMF, the official sector ends up supplying $1.42 million out of $1.72 million, i.e., 83 percent of the financing needed. Bearing in mind that the stocks of debt owned respectively by official and private creditors are about the same size, this does not strike me as being a fair burden sharing. Furthermore, as far as bilateral creditors are concerned, payments falling due in 2000 (including arrears) are of the same order of magnitude as payments due to the private sector. Nevertheless, according to the data supplied in the report, it would seem that private creditors will receive almost twice as many payments as Paris Club creditors. This would be all the more surprising as it would result from capital outflows following the unfreezing of deposits. Staff's comments on this point would be appreciated.

In the same vein, I would like to thank the Staff for their sustainability analysis, which does indicate that the debt to export ratio will remain extremely high for the foreseeable future. Let me just point out that most of this indebtedness is with private and multilateral creditors. On the contrary, bilateral creditors' share is relatively small, indeed only 19 percent of the total, of which 5 percentage points stem from the accumulation of arrears.

Finally, it appears that serious negotiations with bondholders have yet to begin, and that the IMF has dropped all prior actions in this regard, except for the announcement of a meeting with private creditors. But, in the absence of any substantial plan to actually make these talks go forward, we have serious doubts that these negotiations will make more headway than the previous encounters. In this regard, we feel it would probably have been more effective to ask the authorities to present to the board an overview of the rescheduling proposals they intend to discuss with their private creditors, if only as background information. In this connection, I would like to recall that it is necessary to effectively involve all private creditors, including domestic holders of dollar-denominated bonds. The initial strategy of selective default has rapidly showed its limitations. I would welcome Staff's comments on whether foreign bondholders are likely to be offered restructuring terms similar to those offered to domestic bondholders.

The economic program

We fear the program does not put enough emphasis on the responsibilities of the authorities

This problem appears in the very first pages of the report, where the recapitulation of the recent crisis wrongly puts the stress on external factors. This approach suggests that domestic economic mismanagement did not cause the crisis, but only made it worse. We do not share this view and fear it might send the message that, as the external environment gets better, Ecuador's economic situation will improve spontaneously, regardless of what the government does, which, to us, would be both misleading and counterproductive.

In particular, we fear Staff might have somewhat downplayed the magnitude of unfinished business regarding two very crucial areas, namely banking sector restructuring and fiscal reform.

As far as the banking sector is concerned, arguably, the situation is so dreadful it could hardly get worse. And Staff have done a great job establishing the diagnosis and drafting the prescriptions needed by the patient, as shown in the financial sector reform matrix. But we have some doubts that the same AGD, central bank and superintendancy of banks that let the financial sector dive into such a severe crisis will know how to rescue them now that they have been given appropriate guidelines by the IMF. Somehow, it has to take something else to put the banking sector back on a sound footing and minimize the cost to public finances, and I am not sure this something else is present here. On a related issue, it would be interesting to hear the Staff's views on the potential effects of a toughening of US monetary policy on the recovery of the banking sector and the fiscal cost of its crisis.

Turning to the latter, I was concerned to see that the improvement in fiscal balance is achieved primarily through temporary measures, which are essentially not sustainable and may not even be politically practicable, such as the two-waved 60 percent hike in petroleum prices. Incidentally, there is no indication in the report as to what contingency measures the authorities have, should revenues fall short of expectations, for whatever reason. Moreover, Staff contends that an overhaul of the fiscal system is due to be passed at the time of the next budget. But, I would like to ask what makes them so confident that, next fall, the Ecuadoran Congress will agree to do something it has consistently refused to do over the last decade, including in the face of such pressing emergency as during the last 6 months. Yet, short of a thorough fiscal reform, which should in particular raise the tax pressure way above the current level, the government will remain unable to deliver what both the population and the markets expect it to.

Dollarization

We regret the Staff report did not dwell more on the dollarization process

The risk that the population opposes the process seems to be controlled, even though many Ecuadorans are not nearly enthusiastic about it. Nevertheless, in the absence of many details about that in the report, one may wonder if the authorities undertook all the necessary preparations. In particular, reports already point at an inflationary effect of the transition, due to the lack of divisional money, which leads sellers to round off prices upwards. There are also concerns that the dollarization scheme might prove a great opportunity to money-launder narcodollars from neighboring countries on a very large scale. Staff comments on whether the authorities have designed plans to address these issues would be welcome. Also, it would have been interesting to read about seigniorage and the cost of losing it for Ecuador.

Moreover, given that the liquidity situation of the central bank is going to remain very tight until after the end of the program, even without any further crisis in the banking sector, one may wonder what would happen in case the disbursement of one or several IMF program tranches is postponed, because performance criteria are not met. Clearly, in case that happens, there will be extraordinary pressure on the Board to grant Ecuador whatever waivers it requests, because otherwise the consequences would be too dreadful. This is dangerous for the viability of the program and for the credibility of the Fund. Staff's comments would be welcome.

Finally, this is a unique opportunity for us to learn how the economy reacts to such a process, and insofar as it is agreeable to the authorities, Staff should closely monitor how it impacts economic developments, particularly in the monetary sector.

To conclude, we wait for management clarifications, but we stand ready to support Ecuador's program with the understanding that private sector involvement will be treated in a sufficient and expeditious manner.

Mr. Pickford and Mr. Burgess submitted the following statement:

I am grateful to the staff for these papers, and in particular for the analysis of the medium term sustainability of Ecuador's external and fiscal positions in appendix one. This kind of analysis should become a required feature in all programs in which the private sector needs to be involved the resolution of a crisis.

I agree with others, and with staff, that this is a high risk program. The prospects of success are at best uncertain. It is not clear, however, that there is a viable alternative to going ahead with the program. Let me say at the outset therefore that I can, with some sense of trepidation, support the authorities request for a Stand-By Arrangement. I would, however, be interested to hear whether consideration has been given to additional contingency measures which may be necessary should some of the risks highlighted in the staff paper materialize. I will focus my remarks on: (i) the policy reforms necessary to ensure the success of dollarization; and (ii) issues surrounding external finance and private sector involvement.

The key challenge in the short term is to secure confidence. The program should go some way towards doing that with its emphasis on bringing the public finances back towards balance, and on strengthening the liquidity of the banking sector. It is moderately encouraging that the majority of bank deposits which were unfrozen in March have remained within the banking system.

I do, however, have some concerns about the slippage which has occurred in issuing US dollar-denominated central bank instruments. It is important that these instruments are issued efficiently. I agree with staff that the authorities must remove the ceiling which they have placed on domestic interest rates. I also have some concerns about whether there is sufficient technical expertise within the central bank and within the Superintendency of Banks to manage the transition to dollarization and address complicated banking sector reforms. Some technical assistance may be necessary.

As others have noted, dollarization will only succeed over the longer term if the authorities make a sustained effort to improve the fiscal position. Ecuador's recent record on implementing fiscal measures as set out in Box 1 is not encouraging. The possibility of further slippages and policy reversals is one of the main risks to the program. Bi-monthly monitoring is therefore appropriate. Further fiscal performance criteria may be needed in subsequent reviews to ensure that fiscal consolidation remains on track.

I welcome the efforts to base the fiscal projections on prudent assumptions about economic growth and oil prices. The assumption of zero growth does indeed look conservative. The Consensus forecast is for growth of 1.1 per cent this year, given the competitive exchange rate, the improving external environment, stronger commodity prices, and lower domestic interest rates. The oil price assumption, however, looks a little less prudent following the recent fall in prices.

I can understand the dilemma in which the authorities find themselves regarding the need to preserve support for the most vulnerable sections of society, in part to ensure continuing support for an agenda of difficult reforms, while at the same time pressing ahead with fiscal consolidation. I agree that the authorities' priority must be to ensure that economic stabilization take hold before additional resources can safely be released to buttress social spending programs. That said, I agree with Mr. Bernes that the balance of consolidation measures could have been targeted better, to protect the poor, from the outset. I also think that, given concerns about the sustainability of the public finances and the need to restore confidence, some consideration should be given to allowing privatization proceeds to be used to reduce government debt as a more efficient way (than the current social solidarity fund arrangements) of releasing resources for social expenditure over the medium to longer term.

The program contains relatively few details about the structural reforms which will, in the context of dollarization, be necessary to enhance the economy's flexibility and boost productivity. The labour market reforms which have been announced are welcome, but the authorities will, over time, need to turn their attention to deepening the process of structural reform.

Ecuador's external financing requirements into the medium term are substantial. The authorities' position is, if anything, made even more difficult by dollarization. Clearly, Ecuador needs significant assistance both in the short and in the medium term if dollarization is to succeed. The key message I

> take from the staff's analysis is that any debt restructuring package will need to include a substantial element of debt reduction if Ecuador's external financing position is to return to a sustainable level in the medium term. It would be useful to hear from staff whether, and how, this message will be delivered to private creditors at the meeting scheduled for early next month.

Mr. Milleron stressed that it was necessary to be clear on the way to proceed on the issue of private sector involvement. While the staff paper had documented the issue well, it could have been more explicit. Moreover, there was a new element in the debate as a result of the most recent IMFC communiqué, which had defined the appropriate involvement of the private sector in the overall funding of a country and had set out a new requirement with regard to the principle of fair burden sharing. Those were important considerations for Paris Club creditors. He therefore asked the staff how they would proceed on that difficult issue.

The Deputy Director of the Western Hemisphere Department, in response to questions and comments, made the following remarks:

> The Fund-supported program will require substantial private sector involvement in the form of cash flow relief and debt service reduction. Private creditors had earlier indicated to the authorities that they were not prepared to enter into serious negotiations with Ecuador until there was a Fund-supported adjustment program in place. Now that a program is in place, the authorities have convened a meeting with a group of private creditors in early May 2000, at which time they will present their economic program, the cash flow financing needs for 2000, and an assessment of the needed debt reduction to restore medium-term sustainability. The authorities will essentially present a framework for what they see as their medium-term capacity to pay, broadly along the lines shown in the annex to the staff report.
>
> In terms of measuring the amount of burden sharing with other creditors, that is always complicated because, in the case of the private sector in particular, the debt relief takes the form of a combination of both cash flow relief and debt reduction over the medium term. How one balances that and how one measures that vis-à-vis other creditors is a difficult matter. To fill the cash flow needs of the program, the staff's projections suggest that a substantial proportion of existing arrears and debt service falling due in 2000 to Brady bond and eurobond holders amounts to about US$540 million through end-2000. The balance of payments projections that underlie the program suggest that a large proportion of the debt will need to be restructured, although the exact amount depends on exactly how much the Paris Club creditors will come up with. In addition, the analysis of the medium-term sustainability presented in the staff report also points to the need for significant debt reduction, although any estimates on the required magnitude of debt reduction are going to be approximate and preliminary, particularly at this moment in time because these projections are being made at the deepest part of the crisis and it is not known exactly how the economy is

going to evolve. In the discussions that will begin in May, our understanding is that the authorities will present detailed projections and detailed proposals to the consultative group of private creditors.

It is difficult to say with any certainty what the outcome of the negotiations will be. Clearly, the negotiations are going to be difficult since it is likely that the private creditors are not going to accept any solution easily. Of course, at the moment, no payments are being made on those bonds, and that does affect the leverage of the negotiations. In the program, there are bi-monthly reviews on the financing assurances aspect of the program. During those reviews, the staff will come back to the Board to report on the status of the negotiations.

The Acting Chairman remarked that some Directors had perhaps received letters from a variety of private sector creditors urging Directors not to support the program for Ecuador. He had also received a letter from a private creditor which indicated that they had not received payments for several months. Clearly, private sector creditors were not pleased with the fact that Ecuador was not making payments.

Ms. Lissakers remarked that one of the letters she had received had objected to the fact that the Fund was lending into arrears. The letter had pointed out that the program made no allowance for any servicing of bonds. What was the staff's advice on how to respond to such a question?

The Deputy Director of the Western Hemisphere Department replied that one could respond by saying that the program made no specific assumptions as to what the terms and what the payments to bondholders should be. However, the reality of the balance of payments position in 2000 was such that the cash flow position was tight. Moreover, it was difficult to see how a debt restructuring would achieve the necessary cash flow relief in 2000 that would result in substantial cash payments to bondholders.

Mr. Donecker also felt that the paper did not properly address the issue of private sector involvement. At the IMFC meeting, Ministers had stressed the need for more concrete involvement of the staff in that area, including an assessment of possible scenarios. It was easy to point to the Paris Club for assistance without giving indications that a strong involvement of the private sector was required to make the program viable. That message could have been stronger in the staff report. He asked the staff working on that issue to keep the Board informed of the next steps with private creditors and also to provide a more concrete assessment of the situation.

Mr. Pickford thought that Appendix I properly examined Ecuador's medium-term sustainability. There was a fine line that had to be drawn with regard to the amount of staff involvement in the negotiations. What role would the staff play in the meeting of the group of private creditors scheduled for early May?

Mr. Milleron asked for more information on the overall timing of the exercise. For instance, immediately after the meeting with the private creditors, there should be a new meeting to ensure that the situation was under control. While it was difficult to provide an absolute amount, it would be useful to have an idea of how large the contribution from the private sector would be.

The Acting Chairman recalled that the IMF Communiqué had stated that the IMF should review the country's efforts to secure needed contributions from private creditors. The responsibility for the negotiation with private creditors was placed squarely with debtor countries. The international financial community should not micromanage the details of any debt restructuring or debt reduction negotiation. The IMFC communiqué stated that the IMF should consider whether the amount of private sector involvement was appropriate in programs supported by the Fund. In that regard, the IMFC also agreed on the need to provide greater clarity to countries about the terms and conditions of their programs. Furthermore, in those cases where debt restructuring or debt reduction might be necessary, the IMFC agreed that Fund-supported programs should put strong emphasis on medium-term sustainability and should strike an appropriate balance between the contributions of private external creditors and official external creditors, in light of the financing provided by IFIs. While the assumption about private sector involvement in the communiqué was perhaps too drastic, specifying the exact amount to be paid to the private sector at a time of maximum uncertainty about a program was not consistent with the spirit or the wording of the IMFC communiqué.

Mr. Milleron agreed with the Acting Chairman that the Fund needed to find the proper way to proceed on the issue of private sector involvement. The IMFC communiqué also stated that the IMF should consider whether private sector involvement was appropriate in programs supported by the Fund. Thus, some general information on the order of magnitude of private sector involvement with respect to bilateral creditors would be useful as that was a matter of fair burden sharing. He was, however, not asking for a precise number.

Mr. Carstens said that his interpretation of the IMFC communiqué was different than Mr. Milleron's. The reference on the appropriate participation of the private sector did not necessarily imply the principle of fair burden sharing as it applied to other types of transactions. What was more relevant was that the whole context needed to be taken into account, including the prospects for returning to medium-term sustainability, and the issue of payments capacity and payments scheduling. In the case of Ecuador, it was crucial to induce the rapid augmentation of credit lines to commercial banks from foreign banks. That was the key issue for the sustainability of the program, and that implied private sector involvement. However, deciding on the exact amount of private sector involvement was not crucial. Moreover, one should not try to interpret the IMFC communiqué in a way that was not shared by all. Everybody agreed that more involvement by the private sector would be desirable. Certainly, the involvement of the private sector could also be catalyzed by the measures that the Fund took through, for example, a Fund-supported program and how the private sector was treated. He therefore strongly supported the views expressed by the staff and its recommendations in that area.

Mr. Yakusha pointed out that the Board was supposed to assess whether or not there were sufficient financing assurances following the debt renegotiation. Even though there were a number of uncertainties, it would be useful to have more information on that, as well as a clear understanding of what the level of sustainable debt was.

Mr. Szczuka noted that, given a financing gap of US$1.4 billion—equivalent to 13 percent of GDP—the program was considered risky. In such a situation, the issue was not whether the Fund could play a catalytic role, but rather whether there needed to be a concerted involvement by the private sector to ensure that the financing gap would be covered. It was therefore not clear whether the leverage that the Fund had would be enhanced when its resources were made available to Ecuador after approval of the program. He wondered whether it would be possible to have a reference to the possibility of private sector involvement in the program. Without such a signal, the private sector would not be keen on getting involved. He was therefore worried about the degree of financing assurances under the program.

Mr. Donecker said that he agreed with Mr. Szczuka, Mr. Yakusha, and Mr. Milleron. The debt rescheduling strategy had started out with the concept of fair burden sharing and, following Mr. Carstens' line of thinking, one would end up with the public sector taking all the burden. In a situation as grave as Ecuador's, one needed to be more concerned about giving some indication about what was expected from the private sector. He therefore agreed with Mr. Milleron that there should be some mention in the program, not only about the amount of rescheduling by the Paris Club and the public sector, but that the program was based on the firm expectation that the private sector would also provide cash flow relief and rescheduling.

Mr. Vittas said that, while he shared the concerns about the lack of a clear message in the report on the amount of financing that was expected from the private sector, at the same time, he understood the difficulty of being precise at present. One way out of that dilemma would be to convey a strong message about the large amount of private sector involvement that one was expecting in the Acting Chairman's summing up of today's meeting and in the press release.

The Acting Chairman pointed out that, since Ecuador had stopped making payments to all creditors since August 1999, the notion that the public sector was bearing the entire burden of financing was strange.

Mr. Carstens reminded colleagues that the purpose of today's discussion was to approve a program for Ecuador and not to have a discussion on how to involve the private sector. The main issue was to help Ecuador. Certainly, that did not imply that one should just expect official debt relief. At the same time, a Fund program would clearly be a catalyst for more private sector involvement and more money for Ecuador. An important part of private sector involvement was how to induce further access of Ecuador to the markets as soon as possible. That would also minimize the participation of the official sector over the medium to long term.

Ms. Lissakers, pointing out that if one took into account the fact that Ecuador was not servicing its private debt and also the fact that the private sector's share of total indebtedness was relatively small, wondered why some Directors were worried about a lack of burden sharing. That being said, investors were worried that their leverage was actually declining because the Fund was lending into arrears. In the past, the Fund would stand behind private creditors and encourage countries to cut a deal with them before suggesting that the official sector put up any money. The new approach was allowing lending into arrears, provided that the Ecuadorans were negotiating in good faith with their creditors, which they appeared to be.

Mr. Szczuka remarked that the Fund's catalytic role vis-à-vis the involvement of the private sector might not be sufficient in the case of Ecuador. More was needed to have a sufficient degree of assurance that there would be financing provided. With regard to the debt figures, the private sector share of the total debt was larger than what Ms. Lissakers thought. Also, in case there was no agreement or an agreement was not reached early with the creditors, the continuation of lending into arrears was considered a contingency measure.

Mr. Törnqvist agreed with Mr. Carstens that the focus of today's discussion should be on the special circumstances of Ecuador. However, the involvement of the private sector was crucial in that particular case. In that connection, the proposal made by Mr. Vittas was constructive and should be reflected on.

Mr. Yakusha said that he was concerned about the feasibility of the program. Moreover, there were some signs that burden sharing might not be equal. Ecuador's attempt to restructure part of its domestic bonds had implied a small haircut, and the private sector would be asked to do more. Thus, he supported the suggestion by Mr. Vittas. Without a strong message from the Fund on the involvement of the private sector, there was the likelihood that the situation would worsen.

Ms. Lissakers pointed out that Table 13 of the staff paper was confusing. Did that table refer to private sector claims on Ecuador or private sector obligations of Ecuador?

The staff representative from the Western Hemisphere Department explained that the table indicated Ecuador's foreign claims on Ecuador's domestic public sector.

Ms. Lissakers said that the shares in percent of totals in Table 13 were confusing. The top of the column indicated 100 percent, while the numbers below it added to more than 100 percent. The table indicated that foreign public claims on Ecuador's public sector was 80 percent in 2000. Where did the commercial banks fit in under that? Were they part of the 80 percent?

The staff representative from the Western Hemisphere Department explained that in 2000 Ecuador's total public and private sector debt was US$19.5 billion, of which, the domestic private sector owed US$3.7 billion to foreign creditors and the public sector owed US$15.8 billion to foreign creditors. Those foreign creditors were multilaterals, bilaterals, commercial banks, suppliers, and some others.

Ms. Lissakers pointed out that Table 13 should include the term "of which" in the subtotals, under the public sector. Also, why were bonds a subset of commercial banks? Would it be possible to have a number on the total amount of the foreign private sector's claims on Ecuador's public sector?

The staff representative from the Western Hemisphere Department clarified that the bonds were essentially Brady bonds, the majority of which were held by commercial banks.

Ms. Lissakers said that the letter that she had received from the investors suggested that others besides the commercial banks were holding those bonds.

The Deputy Director of the Western Hemisphere Department agreed that Table 13 was confusing. The staff would correct that table and issue a supplement.

Ms. Lissakers asked what was Ecuador's public sector's total obligations to foreign private creditors.

The Deputy Director of the Western Hemisphere Department replied that that amount was US$7.4 billion.

Ms. Lissakers added that about 40 percent of what the government owed was owed to private foreign creditors.

Mr. Szczuka asked what the financing gap in Table 13 represented. Was that arrears?

The staff representative from the Western Hemisphere Department explained that the financing gap was essentially unidentified financing for 2000, but within that gap there were assumptions about arrears.

The Acting Chairman added that the confusion arose because normally the financing gap was represented as a flow and in Table 13 it was a stock. The staff had assumed that the entire financing gap would eventually amount to arrears.

The staff representative from the Western Hemisphere Department explained that if the government filled the gap through additional loans, then that additional new money would add to the stock of debt.

The Acting Chairman agreed that that would add to the debt, thus increasing arrears and claims. However, that financing gap should not be in that table; it should be in next year's outstanding debt. The question was whether one was looking at December 2000 or today. If one wanted to calculate the total for the end of the year, it should include the financing gap. However, the table should include the present stock of debt.

Mr. Portugal informed the Board that the Ecuadoran authorities had decided to publish the Letter of Intent and the Technical Memorandum of Understanding, without the tables, immediately after the conclusion of the Board discussion.

On the issue of private sector involvement, Mr. Portugal stressed that the Fund-supported program required substantial private sector involvement. While it was true that that was already occurring, it was, unfortunately, occurring through a default on Ecuador's obligations to bondholders and other creditors. The authorities would continue to keep an open channel of communication with all creditors, and continue to engage in good faith negotiations with all creditors to achieve a solution that would be broadly acceptable to all. The Finance Minister had confirmed that he was coming to New York on May 2, 2000 to present Ecuador's economic program and the figures for Ecuador's medium-term payment capacity. The aim was to present an agreement to restructure the debt service in a way that provided both short-term cash relief as well as medium-term debt reduction. The Finance Minister would also continue the discussions with the banks and ask them to maintain their exposure and interbank trade-related lines. The authorities had already requested meetings with the Paris Club to seek the rescheduling of arrears, principal, and interest that had fallen due to those creditors. Thus, the authorities were taking several precautions to ensure that no class of creditor would be considered inherently privileged or be left out.

The authorities were also conscious of the need to maintain an appropriate balance between the contributions of the private external creditors and the official external creditors, and they would certainly aim for that, Mr. Portugal remarked. The authorities also understood the need for aiming for fairness of treatment in different classes of private creditors, as was mentioned in the IMFC communiqué. They planned to involve and to try engage with the private sector in an expeditious plan, and it was the hope of the Ministers that they could come to an initial agreement with private creditor participants as soon as possible. He agreed with the Acting Chairman's reading of the communiqué, that it was difficult at present to be precise about what the appropriate balance or fairness of treatment would mean. He also agreed with the Acting Chairman that the Fund's responsibility was not to micromanage the details of the debt restructuring or the debt negotiation itself. Although it was certainly difficult to achieve the aim of appropriate balance and fairness of treatment for a number of technical reasons, he reaffirmed that the firm purpose of the authorities was to aim for that.

Clearly, the program contained numerous risks, Mr. Portugal stated. However, considering what the government had already accomplished under difficult circumstances, the commitment that they had recently shown, and what the alternative for the absence of a program would be, the Fund program was the lowest risk alternative among all that were available. Much had been endured by the Ecuadoran people in the past year—a fall of GDP of 8 percent, a rate of unemployment of 20 percent, and an increase in the share of the poor in the population from 13 percent to 43 percent. Accepting the risks involved with such a program was consistent with the Fund's mission of helping members to adjust their balance of payments by means that were not destructive to national prosperity. He thus hoped that the Board would be able to support the program, despite the difficulties.

Mr. Milleron said that he was reassured by what Mr. Portugal had just said. The fact that there were no privileged classes of creditors was a positive indication. Certainly, one should not micromanage those negotiations. As Mr. Carstens said, the Fund needed to take into account the fact that it had to help Ecuador get out of such a difficulty. That being said, he asked for a clearer assessment by the staff on the appropriateness of the balance between the contribution of the private external creditors and the official external creditors.

The Acting Chairman pointed out that such an assessment would have to be consistent with the Fund's evolving policy on private sector involvement. The IMFC communiqué had asked the Fund to consider methods to further involve the private sector. However, asking the Fund to tell private creditors to come up with an exact amount was unenforceable. That had been tried in the case of Romania, and that did not get very far. The Fund should not get involved in the negotiations between Ecuador and its creditors.

Mr. Rojas made the following statement:

> The major economic and financial crisis that has affected Ecuador over the past three years, led to the adoption of a comprehensive package of stabilization and structural measures, which has at its center a dollarization plan. In this regard, it is worth noting that the stabilization properties of dollarization have not been put to test in a context such as the one Ecuador was experiencing. A successful dollarization plan presumes the existence of certain requirements such as a high level of dollar reserves, a sound banking system, strong fiscal position, and flexible wages, conditions largely absent in Ecuador. The main advantage of dollarization in Ecuador is that it can help create a credible policy environment. Given the recent history of high and accelerating inflation, and a widening of the public sector deficit, importing monetary stability through dollarization could work, provided the authorities keep up the momentum of the reforms required to lay out the underpinnings necessary for dollarization to work. These reforms need to result in a substantial strengthening of savings, public and private, so as to reduce financing requirements and, together with debt restructuring, ease the burden of public debt to sustainable levels over the medium term.
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> As stated in the staff report there are many risks that could derail a successful implementation of the program. A main concern arises from the size of the financing needs and financing gap envisaged for 2000 and by the fact that these gaps not only persist through 2016, but also widen in the baseline scenario. In this respect, could the staff clarify why private sector savings are projected to decrease significantly after 2000 and through 2016, more than offsetting the expected strengthening in public savings over that period? Also, the staff report indicates that a substantial debt restructuring, including from the private sector, will be required to close the financing gaps, and that even after this restructuring, debt indicators will remain well above the HIPC-style sustainability thresholds. Then, it is of utmost importance that the stand-by arrangement serves the purpose of restoring confidence of international investors in Ecuador, a loss due in part to the default on Brady and eurobonds last year.

Regarding the tightening of fiscal policy, we share Mr. Bernes' concern regarding the risk posed by the inadequacy of the social safety net and the reduction in social expenditure in 2000. In this connection, we support also the staff's recommendation to use higher-than-budgeted fiscal revenues to increase social expenditure in 2000 and strengthen and enhance the targeting of the social safety net in 2001.

One crucial requirement for a successful dollarization is a sound and well-supervised banking system. In Ecuador, the banking system collapsed in part due to the large depreciation of the sucre and the reversal in capital inflows. The solution to the crisis of the banking system will take time. To reduce the risk posed to the program associated with this factor, the authorities should not falter in carrying through all the necessary steps to strengthen the financial system. These include the creation of a fully operational mechanism to recycle liquidity and a liquidity support facility, which are essential in the absence of an inter-bank market, and the flight to quality of deposits. It should be emphasized that the purpose of these facilities is to assist banks facing liquidity problems, and not to resolve solvency problems. A key development in the money market will be the unfreezing of US$250 million time deposits in July, which could reduce liquidity of the banking system as a whole, if it results in capital flight. To repeat the success experienced with the unfreezing of US$100 million deposits in March, the authorities must reaffirm their commitment to implement all structural reforms specified in the Economic Transformation Law (Box 4).

The major drawback of dollarization is that it is not possible to respond to external shocks with changes in the exchange rate or in the stance of monetary policy. Output and employment are likely to bear the brunt of additional adjustment. This is of significant concern and risk, because of the substantial decline already experienced by GDP over the past three years, which would put Ecuador's per capita GDP below the PRGF threshold in 2000 as noted by Mr. Bernes.

We welcome the substantial prior actions and bi-monthly reviews that have been put in place by the staff to reduce risks, but remain concerned about the vulnerability stemming from the uncertainty introduced by the substantial debt restructuring to be secured from the private sector; the low level of private savings over the long-term, and the fragility of the social fabric, which needs to be strengthened through an adequate social safety net.

With these remarks, I support the proposed decision, and wish the authorities success in the implementation of the program.

Mr. Jonas made the following statement:

We are pleased that Ecuador has finally reached agreement with the Fund on a program that can be supported by a stand-by arrangement. Like other Directors, we think that this program is very risky, but given the situation in Ecuador, there is no riskless way out. I see al least three reasons why the program is very risky. First, economic situation in country is very serious, second, past record of policy implementation is not very reassuring, and third, conditions for successful dollarization are not in place. Let me address in more detail this last point.

In October 1999, at a conference sponsored by the Federal Reserve Bank of Boston, Argentine Central Bank President Pedro Pou suggested several minimum conditions that a country considering dollarization should meet. These conditions include a period of price and exchange rate stability, strong fiscal institutions, an open, privatized, and deregulated economy, a sound financial system, price and wage flexibility, and a large ratio of international reserves to currency-in-circulation. It is evident that Ecuador does not meet most of these conditions. But Ecuador's situation is desperate, and its policy making paralyzed to an extent that makes it nearly impossible to put these conditions for successful dollarization in place before starting. The only hope is now that dollarization and the program will mobilize enough political support to make the implementation of these conditions possible ex post.

The easiest part—relatively speaking—should be establishing price and exchange rate stability, since they should be automatic results of dollarization. On the other conditions, there is much work to be done. Ecuador is not an altogether open and liberalized economy, and the announced plans to privatize major state shareholdings in 2000 are therefore welcome. Tying its fate to the U.S. economy means that Ecuador cannot afford to lag in productivity growth, but must keep up with the fast-growing U.S. economy. It was thus surprising to see that the staff still projects relatively low GDP growth of around 2-3 percent in the medium-term. On the use of privatization revenues, I think it reasonable to ensure that privatization proceeds are used to assist the poorest members of a society. But like Mr. Pickford, I wonder if it would not have been better to use part of the privatization proceeds to retire existing public debt, instead of putting them all into the Solidarity Fund. The Solidarity Fund will invest them in high quality instruments yielding as much as 5-6 percent. Using the proceeds to retire part of the public debt would save much more in interest costs.

Probably the greatest challenge for the authorities will be restructuring the banking sector and achieving the goals of fiscal policy. A very ambitious fiscal adjustment is planned for this year, and will probably cause some economic contraction. But given the small amount of nonmonetary financing available, the authorities do not have much room for maneuver. I particularly urge them to make all necessary efforts to increase fiscal revenues, and I find it disturbing that the Congress is not cooperating very well in this area. Dollarization's success depends crucially on popular support, and the authorities must take great care to avoid public spending cuts that would undermine this support. On this point I fully share Mr. Bernes's concern. A 33 percent cut in cash transfers to the poor seems very large. I wonder whether if it would not be better to use at least some of the higher than expected fiscal revenues to fund these transfers as early as the first half of the year. The planned sharp rise in subsidized prices could also trigger strong protests at a time when the authorities have to preserve popular support for the program. As we have seen during previous increase in prices of subsidized commodities, public reaction could be quite strong.

I note that Mr. Pickford and Mr. Milleron have also mentioned the desirability of putting additional fiscal conditionality or fiscal prior actions in place. I likewise wondered, in light of the authorities' problems with Congress, whether we should not make Congressional actions a part of our conditionality. This is an issue which has already come up several times before. I know that it is difficult to tell legislators what they should do, but I think Congress needs to be aware that it, too, is responsible for the success of the program. And since the president of Congress has declared that a congressional majority supports the program, it should not be impossible to commit Congress more formally to take the actions needed to implement it.

In the banking sector things are equally difficult. Weak and illiquid banks are the weakest point of any dollarization program. With government resources so scarce, it is up to private resources to provide the necessary recapitalization. The staff notes that in the short run there is little hope for recapitalization from private funds. I wonder whether this bleak view applies to both domestic and foreign sources of private capital. Could the staff tell us more about foreign participation in Ecuador's banking sector, and the chances that foreign investors might provide more capital? Strong foreign participation in the banking sector of a dollarized economy can give strong support to increased stability. Banks with foreign participation often receive liquidity support from their foreign headquarters, and this could boost domestic confidence and head off a run on deposits.

With these comments, I support the request for the arrangement.

Ms. Lissakers made the following statement:

We would like to thank staff and management for their intensive efforts to stay engaged with Ecuador throughout the past year. The program we are considering today contains important reforms, whose implementation should help lay the basis for restored stabilization and growth. We strongly support the program and the proposed decision as the best way to move forward.

There have been several positive developments that have improved the environment for implementing the program. For example, the announcement and ongoing implementation of dollarization has helped stabilize the situation, and the passage of the trolleybus legislation and achievement of the other priors for the program indicate that the Noboa Administration and Congress are finally working together to put an end to the crisis.

However, the program also contains significant risks that leave no room for missteps. The authorities must continually bear in mind that Ecuador's road out of their current predicament will be long and difficult and will require continued cooperation between the Noboa Administration and Congress, including on forthcoming Trolleybus II legislation. Likewise, authorities will need to cooperate fully with IMF staff and management, including keeping them aware of significant policy decisions that arise, and work closely with private creditors.

While dollarization is not a substitute for reform and would not be the first choice strategy of many for this situation, it was the course chosen by the Ecuadoran authorities, and it has helped stabilize the situation and provides a firm monetary and foreign exchange rate framework for moving forward.

It will be important that the authorities make every effort to educate the population about using dollars, including identification of counterfeit dollars and prevention of money laundering.

Central to the success of the reform program (and dollarization) will be a strong fiscal adjustment effort. The program envisages reducing the combined fiscal deficit as a percentage of GDP from 7.2 percent to 3.2 percent this year, through: higher revenues from oil exports, a reduction in domestic fuel price subsidies; extension of the temporary import tariff, tight expenditure controls (including wages) and further improvements in tax administration.

Our main concern here is the rising poverty indicators and the lack of recourse to more traditional social safety net mechanisms. Box 6 on page 23 of the staff report indicates that expenditures are falling as a share of GDP, which has also fallen strongly, indicating substantial real drop offs in expenditure. Staff notes that oil price assumptions in the program are conservative, and that any windfalls in the first half of this year will be applied to reducing the deficit. The second review will examine the scope for devoting excess revenues to additional social spending by relaxing the ceiling on central government expenditures. Perhaps staff can comment on why the scope cannot be examined sooner.

Similarly, it is unfortunate the authorities could not agree to a more gradual, but sooner implemented, schedule for increasing domestic fuel prices and eliminating subsidies. Fuel subsidies are a blunt instrument for providing social sector protection. While the current plan for eliminating subsidies is calibrated to blunt the impact on the poorest, if the schedule were spread out and moved up, resources would be freed sooner that could be used for social spending and/or deficit reduction. In our view, keeping these unproductive broad subsidies a day longer than necessary is hardly defensible in light of broader trade offs, and attempts to reduce the burden of external liabilities.

Bank reform is a core part of this program. A viable banking system is key to maintaining confidence and allowing the economy to function and grow in the medium term. The fact that most deposits unfrozen last month have remained in the system bodes well for the authorities' efforts so far. However, the threat of capital flight still exists, and any missteps in reform efforts could lead to a loss of confidence with potentially large additional fiscal costs for the government.

An important issue is rechanneling and provision of liquidity to still-open banks, as the central bank's lender of last resort function no longer exists. We understand the central bank recycling mechanism is now functioning, but the question remains whether there will be adequate demand for central bank issued dollar denominated bonds at acceptably low interest rates from a fiscal perspective.

Also, it is not clear what progress is being made in selling the assets of closed banks. Perhaps staff can comment on these issues, as well as affirm whether the bonds issued to large deposit holders are fully backed by official guarantees, or just up to a certain threshold? Also, in paragraph 11 of the staff report, can staff confirm that acceptance by banks of bonds from third banks for repayment of debt owed by individuals is purely voluntary, or is there some compulsory element to this mechanism? Finally, we would like to join staff in urging that temporary provisioning measures on loan operations which carry higher interest rates be abandoned as soon as possible. This, in effect, provides an interest rate ceiling that was deemed undesirable in negotiation of the trolleybus legislation.

The main issue we have to face today in approving this program is the tension between adequate financing and medium-term BOP sustainability. In the short term, there is still a financing gap despite the combined IFI financing. We continue to believe that if some augmentation of the program can improve or accelerate its overall chances of success, we should be open to considering it.

In cases where debt reduction or debt rescheduling is clearly necessary, we believe, consistent with statements we have issued in the G-7 context, the country and Fund staff should agree on a financing plan that is compatible with a medium-term payments profile. We are prepared to support a generous Paris Club rescheduling to help Ecuador finance the program.

The technical MOU confirms that Ecuador will seek an orderly resolution with private creditors to fill its large short-term financing gap and provide for broad comparability between the contributions of official and private external creditors. It is important that the arrangement with private creditors results in a sustainable financial position over the medium term. We appreciate the Fund staff's initial efforts to analyze the medium-term sustainability of Ecuador's fiscal and balance of payments positions, and urge them to develop further their capacity to assess medium-term sustainability going forward.

Finally, it should be noted that, under the staff's baseline scenario, Ecuador does not return to pre-crisis debt-to-GDP levels of around 70 percent until 2010-2015, meaning that its finances will remain extremely vulnerable to adverse external shocks. Can staff comment on any plans the authorities may have for staving off further declines in trade lines?

Corporate debt restructuring will be important to restore the intermediation function of the banking system and get the economy moving again. Now that the Presidential decree has been issued that distinguishes between classes of large debtors and whether or not they need restructuring, can staff comment on supporting mechanisms the authorities are designing to help hasten the restructurings? Are there controls in the mechanism to ensure that debt restructurings themselves do not become politicized?

We look forward to progress on the privatization agenda as set out in the economic transformation law. We urge authorities to conduct privatization in consultation with affected workers and in a fashion that fully protects labor rights under Ecuadoran labor law, including rights for workers to select union representation, should they wish. The new oil pipeline holds particularly good potential for improving Ecuador's economic situation. We encourage the authorities to conclude the pipeline deal in a manner that is both speedy, yet fair and transparent, and in a manner that makes every effort to minimize the potential environmental impact of the pipeline and its construction.

We also would like to encourage staff to work with the authorities, in conjunction with the World Bank, to push for more progress on judicial reform and strengthen anti-corruption efforts.

We are encouraged by the progress Ecuador has made in clearing its wage arrears to public sector workers. We encourage the GOE to consult with labor and employers about the country's reform efforts, in order to increase ownership in the program and avoid possible serious labor-management

> confrontations that can slow progress. Consultative efforts in Korea during that country's crisis (through the Tripartite Commission) have been credited with the absence of serious labor-management confrontations that could have exacerbated the crisis and slowed the recovery. Similarly, government consultations with indigenous people concerning relevant aspects of the program are important to broaden ownership. Finally, we encourage authorities to spare, to the maximum extent possible, cuts to programs that fund or facilitate the protection of forests and biological diversity.

The Acting Chairman pointed out that insisting that everything be published would create problems. Frequently, there were things about future legislation that were of deep concern to congress. How would Directors feel if the Fund insisted on the publication of all that information in all countries? Governments might want to inform their public that they planned to undertake certain measures without publishing detailed information. While he was in favor of publishing as much as possible, there were limits. If one required that everything be published, then one had to accept programs with a lot less conditionality.

Ms. Lissakers disagreed with the Acting Chairman's point. Certainly, she would accept some omissions from the published version of the Letter of Intent that dealt with dates and specific sensitivities. However, in a couple of recent cases, the withholding of information had gone too far, particularly with regard to the omission of crucial information on performance criteria. There were cases where the deletion of sensitive information was acceptable.

Mr. Donecker agreed with Ms. Lissakers's assessment. In particular, when it came to prior actions, parliament should be informed, but such prior actions should be worded in a way that it was the responsibility of the government to find the proper parliamentary approval for such measures. At the same time, the public and parliament should be aware that the program needed the ownership of the country, and the country was also represented by parliament. Therefore, he did not object to requiring that prior actions or performance criteria be published.

Mr. Carstens made the following statement:

> After a long and painful wait, finally conditions were met that allowed the Ecuadoran Government to agree with the Fund on a consistent—although risky—stabilization program. It is clear from staff's paper and Mr. Portugal and Yepez useful buff that exogenous shocks have played an important role in determining the path that the Ecuadoran economy took. But it is also remarkably clear that the main responsibility lies in Ecuador's past inability to establish strong governments, with constructive relations with Congress, that would have allowed them to tackle the extreme difficulties that the Ecuadoran economy faced. Fortunately, in recent months, developments in the political front seem to indicate that conditions are there for Ecuador to be in a position to deliver its part in a stabilization program. Fund's staff have been working

very hard with authorities in this regard, and the result has been the economic program that is presented for our consideration today.

This chair is prepared to support the program, being aware of its risks, under the expectation that the necessary policy measures will be carried through. This will require a lot of determination by the government and comprehension by the population, but they have to realize that there is not an easier way out.

The main building block of the program is the adoption of dollarization, which by itself cannot solve the problems of the country, unless such a regime is credible. This will happen, in turn, only if three issues are dealt with in a convincing and effective way: (a) the banking system crisis; (b) the fiscal imbalance; and (c) the overindebtedness situation of the country. Therefore the package as a whole is what matters, not the individual features.

It is urgent to stabilize the situation in the banking system. The main implication of dollarizing the economy is that the government cannot perform as lender of last result. Thus it is essential that the need of a lender of last resort to address a generalized run against the banks does not present itself anytime soon. For this to be the case, the banking sector problems need to be dealt with. The agreed working program to basically induce a major overhaul in the Ecuadoran banking system seems appropriate. Certainly many complex issues in the financial system must be tackled at the same time, and I have serious doubts that from a technical stand point both the government and Congress will be able to deal with this load in a compressed period of time. I would suggest that IFIs should not spare resources in sending a team of experts not only to help in the design of the policies, but also in their implementation. This would be a worthwhile investment for all the parties involved in this demanding operation.

The mechanisms adopted to provide liquidity to weak banks seem appropriate for the short run. Nevertheless, it would be strongly advisable for the authorities to keep track of which banks are the ones that depend on these facilities for their funding, and take appropriate and timely corrective actions, including the intervention of these banks. This contingent policy is required since if the market realizes that a bank depends on authorities' financing, the institution would be ostracized progressively, increasing its dependency on the facilities and making the solution of its problem more difficult and expensive. Therefore an "exit strategy" from these liquidity mechanisms should be thought. An obvious step would be to attract foreign banks participation, a prospect that does not seem feasible in the near future. In another topic, I agree with staff that the legal provision for interest rates ceilings should be eliminated as soon as possible.

If the banking system is not stabilized, the fiscal imbalances will not be manageable any time soon. With respect to fiscal issues, I agree in general terms with the proposed strategy for the present year. There is no doubt that a tax reform is dearly needed, and hopefully it will be approved by Congress towards the end of this quarter. The correction in fuel prices, and in general in public sector prices, is essential, although I question the strategy of preannouncing huge increases in energy prices for future dates. From past experiences, it would be expected that massive political and social pressures will concentrate on those dates, trying to derail the application of such measures. Hopefully the government will have the strength to support such forces. Other public prices should be adjusted gradually, but on a sustainable basis, so as to correct their relative stance with respect to other prices. If this is not done, the privatization efforts in the oil, electricity, infrastructure and utilities will not prosper. The hardships that private investors ran into in the electricity sector due to lags in price adjustments are a good example of the difficulties generated by misaligned prices.

In addition, as soon as possible substitute income sources for the financial transactions tax have to be found. It just does not make any sense to depend on a tax that affects directly the weakest sector in the economy. My last comment on fiscal aspects is on the inappropriateness of social expenditure. I agree with the staff's recommendation that as soon as conditions allow it, such expenditure should be enhanced.

Needles to say, the key fiscal problem is generated by the huge overindebtedness of the Ecuadoran government. The debt burden is not manageable, as staff exercises clearly show. Debt relief is of the essence. Both private and official bilateral creditors will have to get involved and provide debt relief, and I welcome Ecuador's strategy in this regard as described by Mr. Portugal. I agree with the Chairman's indication that we cannot come with a specific number for PSI. In any case, I reiterate my position that the required PSI should be pursued in a prudent way, given that in the immediate future it is essential for Ecuador (in particular for the banking system) to preserve and increase access to credit lines from foreign banks and also trade lines.

The suggestion for Paris Club debt relief presented in the paper seem appropriate. Contrary to the interpretation of Mr. Milleron and Ms. Mateos y Lagos, the message in the IMFC communiqué calling for "an appropriate balance between the contributions of private and official external creditors" does not necessarily imply the principle of burden sharing. Other considerations need to be taken into account when planning PSI in the context of an insolvent country, for example medium term sustainability, the importance of regaining market access and the immediate payment needs. In light of these, the strategy prescribed by staff seems appropriate to me.

All in all, I support the program, given that it is consistent and achievable if authorities and Congress deliver their part. The risks are high for the Fund, but it would be riskier for the institution to let a member country sink into oblivion.

I welcome staff's close involvement in Ecuador and commend them for an excellent job done so far. In closing, I would like to wish the best to the people of Ecuador.

Mr. Alosaimi made the following statement:

Ecuador continues to face daunting economic challenges. Although partly a result of factors beyond the authorities control, the steep decline in output and jump in inflation since 1997 also reflect policy shortfalls. While strong policy correction is critical for the economy to perform better, dollarization at this juncture is a particularly bold and demanding initiative. By ceding monetary and exchange rate independence, the authorities have in effect opted for a more exclusive reliance on fiscal and structural policy flexibility. It is encouraging that the market response so far is positive. The task now is to build on that gain for a sustained recovery.

I broadly agree with the proposed program. Improvements in the fiscal and external positions, and effective reform of the banking system are key priorities. Wider structural reforms for greater flexibility of product and labor markets are also essential for lasting reversal of the current economic decline.

On the fiscal front, the envisaged reduction of the deficit is ambitious but necessary. The authorities face a difficult task of walking the very thin line between reducing the deficit and avoiding an excessive aggravation of the economic contraction. Here, I welcome the program's conservative revenue assumptions, which provide a margin for achievement of fiscal targets. On the spending side, restraining the public wage bill will be critical. Given the still high inflation, it is important to also have a suitably flexible approach to social spending. The provisions for such spending to rise later this year on an easing of the financial constraints is, therefore, appropriate.

Staff is right to stress the challenges that dollarization poses as a policy choice during a crisis situation. In particular, given the banking system's very difficult condition, effective liquidity recycling within the banking system is important to help offset the loss of the central bank's traditional role as provider of liquidity. Here, I am encouraged by the progress reported in the staff update on progress regarding the recycling facility and the supplementary liquidity fund. The news that recent liquidity developments in the banking sector are better than expected is also welcome.

Continued close monitoring and assessment of the liquidity needs is essential in view of the uncertainties that still remain. Improved supervision of banks, greater resource mobilization, and an orderly curtailment of deposit guarantees are priorities. Success of the ongoing broad-based restructuring of the household and corporate debt to banks is vital for restoration of the banking system's health. The detailed review that staff promises of progress in banking reform will be important for the program's prospects.

Structural reforms have now assumed a new urgency in view of dollarization. Here, I welcome the steps already taken toward increased labor and product market flexibility as part of the economic transformation law. Further progress in this regard is essential. I also fully endorse staff's emphasis on debt reduction as an essential element to ensure viability of Ecuador's external payments position. As emphasized by the previous speakers, this requires active efforts for an early agreement with private sector creditors. The forthcoming meeting in May in that regard is therefore welcome.

In conclusion, let me stress that avoidance of any further policy slippage is critical for success of the challenging program that the authorities have embarked on. Indeed, the program has substantial risks that can only be faced in close and sustained cooperation of all concerned parties. Here, I am encouraged by the authorities' policy commitment and improved cooperation to consult with the Fund prior to any significant policy change.

With these comments, I support the proposed decision and wish the authorities success in meeting the difficult challenges ahead.

Mr. Donecker made the following statement:

I share most of the serious concerns already voiced by Mr. Milleron, Mr. Bernes, Mr. Pickford, Mr. Shaalan, and others. This is a very high-risk program indeed. For it to succeed, the authorities will have to prove strong ownership by implementing it rapidly and decisively. They must not allow major slippages to happen, and will also need to succeed in reaching substantial private sector participation in the much-needed reduction and rescheduling of Ecuador's debt. In this case, the need to ensure appropriate private sector involvement in crisis resolution is particularly important. I share several colleagues' concerns that this issue is not adequately addressed in the staff paper. Given the Fund's past experience with lack of political consensus and support for appropriate stabilization measures within past Ecuadoran governments and parliament, I see a great risk for the success of the now agreed program, and possibly continuing insufficient ownership of this program by the authorities and the people of Ecuador. For this reason, we would have preferred to see more emphasis being given to the protection of the poor to enhance its chances of acceptance by the majority of the people. I take note of, and I welcome, the authorities' intention to strengthen the social safety net as soon as the fiscal situation allows.

These concerns notwithstanding, we broadly support the staff appraisal, and we are prepared, albeit with considerable trepidation, to give the new government the benefit of the doubt and to support their credit request. Allow me to stress once more, though, that the key to success will be strong national ownership entailing decisively credible and, thus, confidence-enhancing actions by the authorities. Apart from this, our other main concerns are related to the timing of the new program, and to the appropriateness of program design.

On the timing of the program, the approval of the proposed program just one month after the introduction of dollarization in Ecuador could be perceived as a signal that the Fund advocates dollarization as a panacea and answer to Ecuador's economic woes. We should not forget, however, that the decision to dollarize the Ecuadoran economy was taken by the government against IMF recommendations. Dollarization requires tremendous adjustment efforts, including strict monetary and fiscal discipline, and comprehensive structural reforms. Up to now, it has been common sense that dollarization should be adopted at the end rather than at the beginning of the stabilization of an economy. Although there are encouraging signs that dollarization has already helped to stabilize the Ecuadoran economy, it is much too early from our point of view to assess the outcome. Moreover, the report clearly states that the program needs roughly 12 months to be fully implemented, so we are still at the beginning. If dollarization fails, not only the government, but also the Fund will be blamed.

Since the success of this untried dollarization strategy is not only crucial for Ecuador but is of great importance for the IMF, the program has to meet high expectations. On fiscal policy, a one-side effect of dollarization is that the stabilization burden on fiscal policy will increase further. With the dollar as a common currency, high inflation will no longer alleviate the negative effects of high public debt. Against this background, it is crucial that the government stick to its plans to increase revenues and cut subsidies, particularly in the fuel sector, although I am also worried with the approach of two big jumps rather than a more gradual progress, but this is a government decision and I just hope it will not backfire.

Regarding VAT, we support the staff's recommendation to increase this tax. We welcome the fact that Ecuador is focusing on improved targeting of social expenditures. However, against the background of increasing poverty, like Mr. Bernes and others, we would have also expected the share of social expenditures in the budget to be raised. As I mentioned already, we too are worried about this aspect of the program. I agree with Ms. Lissakers that we need to intensify our efforts to redistribute at least some of this burden at the next review.

On the financial sector, the main concerns are concentrated in the area of bank restructuring. Progress in this area has been sluggish, further increasing the need for rapid restructuring. The introduced limitations on the central bank's ability to extend liquidity assistance has created additional pressures, which have led to flight to quality. In this regard, we welcome the economic transformation law, which creates the needed institutional basis for further actions. The revitalization of the interbank market is also crucial. One major challenge to this program, when a quarter of U.S. dollars of frozen deposits becomes available for withdrawal in cash if this money does not remain in the banking system and this unfreezing turns out to trigger a run on the banks, is that the whole program will be imperiled. This obvious major risk underscores the need for government actions to bolster the credibility of the government's strategy, as well as the need for timely contingency planning. We therefore welcome the envisaged close monitoring of the program and bi-monthly reviews.

On external indebtedness, public debt and related debt risk is extremely high. Indicators of public debt in relation to exports have already exceeded the HIPC Initiative thresholds. Under the proposed program, Ecuador will have access to Fund resources. Over the next two years, total support of the IMF, World Bank Group, the IDB, and the Andean Development Corporation will amount to roughly US$2 billion. Against this background, it is crucial that the overall outstanding stock of debt be substantially reduced. In this context, we stress the need for the envisaged private sector involvement in fair burden sharing, which is intended to be achieved in the coming meetings with private creditors.

In concluding, we wish the authorities much success in their stabilization efforts to lead Ecuador's economy back on to the path of sustainable growth and poverty reduction.

The Acting Chairman asked Directors to reflect on how to publicize the fact that the Board recognized that the program for Ecuador was unusually risky. Saying that the program was unusually risky would not strengthen confidence in Ecuador. On the other hand, if in a year from now the program failed, the IMF would be blamed for it.

Ms. Lissakers pointed out that most of the risk was for Ecuador, not for the Fund. Although the Fund was putting US$300 million on the line, Ecuador was taking the risk. It certainly would not hurt if the Fund emphasized in any public statement the damage that any missteps by the authorities would do to the prospects for the program.

The Acting Chairman indicated that the public did not care about the US$300 million that the Fund would provide, but rather the risk of the program failing.

Mr. Carstens suggested that, instead of speaking of risk, it would be preferable to state that the conditions for the program to succeed were demanding and that it encouraged the authorities to perform well.

Mr. Donecker agreed with Mr. Carstens. Furthermore, it would be important to mention in the Acting Chairman's summing up that the Fund would come in and help Ecuador overcome a difficult situation.

Mr. Kelkar added that, given that the program was risky, it was important for the staff to discuss alternative scenarios with the authorities, including what policies would be required and how much would be Fund be able to provide.

The Acting Chairman remarked that if the information on alternative scenarios became public, that would create additional problems.

The Deputy Director of the Western Hemisphere Department remarked that there were enormous risks in the program. The largest fundamental risk was related to the political structure in Ecuador. In the past, it had been difficult for the government to pass through congress some of its policy measures. Although there were no absolute guarantees that that would not be a problem in the future, there were some signs that the situation has changed. During the program negotiations, the discussions that had taken place with congress and with certain groups of congressional leaders had been more open than in any other program. In fact, a congressional delegation had come to the Fund the previous week. The President of the congress had even remarked at one point that Ecuador was responsible for where it was now in terms of the policy failures that had been largely responsible for the crisis. He had also emphasized that there was a majority coalition—albeit a thin majority—in favor of the reforms under the program. That was certainly one cause for some confidence.

With regard to prior actions, the Deputy Director pointed out that a number of prior actions had been achieved over the past 6 to 12 months. However, those prior actions had not been adequate. The fact that it had taken so long to put in place an adequate framework on both the fiscal and banking restructuring side had clearly increased the ultimate cost of the crisis. Nevertheless, a number of measures were in place now. For example, the economic transformation law contained many important measures, not only on the financial sector side. Also, that law was considerably stronger owing to the involvement of the Fund and other IFIs. Despite all the risks, the program was justified. Relatedly, the cooperation with the present administration had been, on the whole, good, although there had been some problems.

Mr. Szczuka asked the staff to comment on the social support for the program. Some public opinion polls had reported that 23 percent of the population supported the dollarization plan. However, given the planned fuel increases, decrease in minimum wages, and the reduction in social spending, was there a risk of a major social disturbance?

The Deputy Director of the Western Hemisphere Department replied that that was difficult to predict. Certainly, there would be some tensions when some of those actions were taken, particularly when the domestic fuel prices would be increased. The fact that various opinion polls had indicated support for the dollarization plan was not the critical issue, as the situation could change rapidly. What was more important was the resumption of growth and the stabilization of the situation over the coming months, which would help broaden support in the country for the policy measures. Nevertheless, there were risks with regard to the domestic fuel price increases and the staff shared the concerns that had been expressed by Directors. Thus, the staff would recommend a more gradual phased increase. The sequencing of those increases had already been decided by the President. Ecuador was the ultimate judge of what they saw was the politically best way to implement such increases.

On why the access under the program was so front loaded, the Deputy Director explained that that was because Ecuador had no access to Fund resources. For that reason, the first purchase had to be slightly over 25 percent of quota to put that on the upper credit tranche conditionality.

On whether the timing of the program would be seen as an endorsement of dollarization as a cure for all ills, the Deputy Director remarked that he would be surprised if that was the way that was viewed by the outside world. It was fairly well-known that the Fund was not in favor of dollarization in those particular circumstances. However, given the fact that the government had made that choice and had put in place a set of policies that were beginning to support it, it would make no sense to have waited, as that would have increased the risks. In terms of what that meant for the Fund, if the program failed, obviously there would be consequences for the Ecuadoran people, but the Fund would also receive a large part of the blame. However, if the program succeeded, the public would say that it succeeded because of dollarization and despite the Fund.

The Acting Chairman added that if the program succeeded, the Fund would have to rethink some of the things it had said about the necessary conditions for dollarization to succeed. If the program failed, then the Fund would reaffirm its faith in the necessary conditions.

Mr. Donecker pointed out that the Fund was in a dilemma. It was supporting a program where its major components were the decision of the government and the Fund was reluctantly willing to go along with such a program by putting its credibility and name behind it. An alternative course of action would be to say to the country to go ahead, but without the Fund. That would most certainly mean that the country's adjustment program would fail immediately. The authorities should be given the benefit of the doubt. The Fund would support them in their endeavors and hoped that they would be successful.

Ms. Lissakers said that one could make the case that the program was in some ways less risky than many other programs precisely because the broad outlines of the Ecuadoran program had been adopted somewhat against the advice of the Fund, but were very much the government's own initiatives. It was better for the Fund to support a program that was adopted by the government than the Fund supporting a program that it had forced a country to accept.

Mr. Szczuka was surprised that Ecuador was the first case in the history of the Fund where the Fund could have offered its opinion on the dollarization decision, but the staff had decided not to offer any comments on that in the staff paper. Anyone who looked at the history of the Fund should not know whether the Fund supported that decision. He would therefore want to see some comments on the correctness of the decision and why, for instance, a currency board would not have been a better option. Even if the dollarization decision had been a sovereign decision that the Fund would have had to accept, why did the staff not comment on the decision to fix the conversion rate at 25,000 sucres per U.S. dollar?

Mr. Carstens remarked that, although what Ecuador had done in the specific case of dollarization might seem new to the Fund, it was not such a new thing in the discussion of exchange rate regimes. The Fund had discussed similar issues in the context of the European Union; specifically, whether a country should comply first with conditions and then adopt a currency union, or first adopt the currency to attain the right incentives prior to undertaking the required conditions. There seemed to be a consensus that it was probably safer to go in the way that Europe had gone, which had been to establish Maastricht conditions first and then adopt the single currency. However, in the discussion of exchange rate regimes, it had not been unheard of that a country had decided to go with an exchange rate regime that would have provided all the incentives for the rest of the pieces to fall in place, which seemed to be the case in Ecuador. In the absence of dollarization, the measures that were necessary would not have taken place, and certainly history had shown that in Ecuador policy measures that were being undertaking had not been undertaken before. Certainly, for historical purposes, one should leave some trace about that discussion. However, that was not such a unique or extraordinary issue.

Mr. Donecker agreed with Mr. Carstens that sometimes the choice of exchange rate regime forced other things to fall into place. However, he would not exactly compare the situation of Ecuador with the EU and its history, because the EU had 10 years to prepare for such a move. In Ecuador's dollarization approach, there was a political risk and that was why ownership was important. The government and the Fund should do whatever possible to strengthen that initial support.

The Acting Chairman pointed out that the Fund could not advise governments to embark on extremely risky courses of action. The fact that the dollarization decision turned out better than expected was fortunate. If it had turned out worse than expected, it would have been difficult to advise on the proper course of action.

The staff representative from the Western Hemisphere Department acknowledged that the report did not sufficiently address the issue of dollarization. The discussion in the report—in paragraphs 59 and 62—indicated that the staff had discussed with the authorities a move to a currency board, but the staff had urged against it for precisely the same reasons it would have urged against dollarization. In particular, the staff was concerned about the state of the public finances, the state of the banking system, the susceptibility of the country to external shocks, and the lack of credibility in the dollarization announcement in a country in the state at which Ecuador was in at the present time. In addition, since the staff did not have discussions on dollarization per se with the authorities, it did not have discussions on the rate at which the dollarization would take place.

Once the announcement on the conversion rate had been made, and once the staff had discussed the implications of the conversion rate with the authorities, the staff representative recalled that, noting that an overshoot of the exchange rate would have had severe implications for inflation throughout the course of the year, the rate had stabilized at 25,000 sucres per U.S. dollar immediately after the announcement. Moreover, the rate had remained stable, even during the coup, which had provided a basis for stabilizing expectations. It would have been risky for the new government to start talking about a different exchange rate. There also had not been sufficient reserve coverage to cover a more appreciated exchange rate than 25,000 sucres per U.S. dollar. For those set of reasons, the staff felt that the 25,000 sucre rate was appropriate.

Private sector savings were not expected to decline as much, the staff representative remarked. They were expected to return to their medium-term average of around 11 to 11½ percent of GDP, which was where they had been in the late 1980s and early 1990s. In fact, in 1999 there had been a significant increase in private sector savings related to the external position. The growth assumption was not low, given that Ecuador was a low growth economy. Even prior to the crisis, the growth rates had averaged around 2½ to 3 percent in the 1980s and not much better in the early 1990s. Thus, it did not seem reasonable to expect vast improvements in the growth rate over the next 10 to 15 years, given the external public debt position and the fiscal adjustment that would be imposed on the economy.

The staff had discussed with the authorities the possibility of using privatization proceeds to reduce external public debt, the staff representative stated. The provision in the Constitution which required that all revenues from privatization be turned over to the Social Solidarity Fund created a problem. Those revenues would be invested in high quality debt instruments, which, under the present circumstances, meant foreign instruments. The revenues from those investments could be used for social projects. There was a short-term trade-off, however. Using those proceeds for debt reduction would require a change in the Constitution. While that could be desirable over the medium term, in the short run, there was a trade-off between debt reduction and the immediate use of funds for social spending. Thus, that provision in the Constitution might not actually be a bad thing over the short term.

The mission had tried to involve the congress in the program negotiations, the staff representative indicated. Moreover, the mission had held discussions with members of society, including the Chamber of Commerce, trade unions, and indigenous groups. The staff had been heavily involved with congress in the passage of the economic transformation law and the subsequent amendments. In addition, the staff was fortunate to have a Fund resident representative in the country, which facilitated regular contacts through those groups.

The key foreign banks that had credit lines had told the mission that they did not have much interest in discussing with the authorities how to preserve those credit lines until the authorities had in place a Stand-By Arrangement with the Fund, the staff representative noted. That being said, there has been some progress in that area. The authorities, through one of the major British banks, had restructured about US$65 million of trade credit lines on intervened banks that had fallen into arrears. Certainly, if the SBA were to be approved, the authorities would be in a much stronger position to have further discussions with foreign commercial banks.

After adjourning at 1:00 p.m., the meeting reconvened at 2:30 p.m.

The staff representative from the Western Hemisphere Department reported that social expenditures had declined under the program. That was, of course, not an ideal situation. Social expenditures had declined because of a lack of tax revenues and therefore other expenditures had to be drastically reduced. There was, however, a contingency for social spending. Any excess revenues from petroleum prices being higher than programmed could be used to boost social spending in the second half of 2000. The staff welcomed the support from many Directors for putting that contingency into play as soon as circumstances allowed.

Fuel price increases and social expenditures were directly linked, the staff representative explained. An increase in fuel prices was needed to secure the level of social spending under the program. Those adjustments would be timed to coincide with increases in public sector wage payments and increases in cash payments to the poor. Actually, fuel price adjustments did not directly hurt the poor as much as it hurt the middle and upper classes because typically the poor did not buy large amounts of gasoline. In fact, the poor did not buy large amounts of most of the products that were subsidized. They were most directly hurt by increases in cooking gas prices, which would have the smallest price increases through the program period.

The staff representative from the Monetary and Exchange Affairs Department, in response to questions and comments, made the following remarks:

> The bank restructuring strategy has been developed over a long period. It has been a discussion with many twists and turns. In fact, there have been many surprises and many departures from best practices. However, in the end, a major restructuring has actually taken place, even though there is still a need for liquidity support and there will be additional costs.
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> The bank restructuring strategy contains all the key elements. It includes major legal and regulatory reforms, a strengthening of banking supervision, recapitalization and restructuring of the remaining banks, intervention in weak banks, and the resolution of bad assets. A number of these measures remain to be implemented, and there are many problems with this implementation. The Fund has been providing technical assistance on a massive scale to Ecuador. The authorities'awareness and knowledge of how to deal with these issues has substantially improved from only a year ago. The Fund has brought in expertise whenever there have been crucial stages to support in this process, and other organizations have been doing the same. For example, the Fund has provided a resident advisor in Quito to support this

process. The World Bank is in the process of approving a technical assistance loan, and other organizations are also going to put in major resources to support the reform efforts. Every organization has a component in its work program focused on the financial sector.

The liquidity recycling and support facilities are key issues now that the interbank market is not working and the traditional lender of last resort facility in the central bank has been outlawed. The staff has been discussing the mechanisms for these facilities with the authorities over the past few weeks. Although they have not been implemented as expected, there have been improvements. The liquidity situation, after the unfreezing that started on May 13, has been much better than we had even dared to dream, and this is clearly the result of the change of government, the dollarization decision, the timing of the announcement of the Fund program, and the support from all the international financial agencies on the eve of the unfreezing. Concerning an exit strategy from this liquidity facility, that is part of the so called prompt corrective action. The moment a bank falls below certain minimum ratios, it would be intervened. It is, of course, always difficult to distinguish when an institution is becoming insolvent, but the rules are being tightened, and the human capacity is being put in place, so this could be done much better than in the past.

Another crucial area of weakness is the corporate debt restructuring, without which the bank restructuring will not work. Certainly, there are risks that this will be politicized. We have agreed upon principles on how this strategy should be working, and we are now in the process of developing detailed regulations on how it is to be implemented. The World Bank has taken the lead in the corporate debt restructuring area, and is in the process of putting in place technical assistance to support this. In the meanwhile, we put in a Fund-sponsored advisor for one month to ensure that the momentum is not lost on this crucial area.

The next issue raised was bank recapitalization and the prospects for foreign capital. At present, there are four foreign banks in Ecuador. We have no knowledge of any other banks wanting to get in. Some of the existing ones, reportedly, want to get out. Therefore, the strategy has been not to rely on foreign capital for bank recapitalization, but rather to make sure that there are arrangements in place to give incentive for the domestic private sector to provide the necessary capital. A scheme has been denied under which new private capital contributions are matched with capital from the government. These seems to be more more scope immediately for private participation in the resolution of the assets taken over by the deposit insurance fund, i.e., portfolios of assets to be auctioned off toward the end of 2000. Whatever foreign capital will come in will probably come in that way first, and then, as confidence builds, there will be scope for more direct investment in banks. So far, no banks have expressed any particular interest.

> Another point that was raised was the status of the asset management by the deposit insurance fund. In this case, as is in all cases, progress is much slower than we would like to see it. This is also an extremely complex situation on account of the new rules. But there are some positive signs. For example, the last intervention two weeks ago by the deposit insurance agency already included the sale of a substantial part of the portfolio to another private bank. The agency is now within a few weeks from starting with the sale of the easiest assets to sell, which are teller machines, vehicles, art objects, and physical assets. The loans are still in the process of being categorized and packaged for sale. We do not expect that there will be much movement until the second half of the year. This is also an area that has been hampered by the fact that the agency has suffered from many management changes and major staffing shortages, which have tended to slow down the process. But this is another area where there is a plan for substantial technical assistance, mainly from the World Bank, but also from the IDB. We expect to see progress before the end of the year.

Ms. Redifer asked the staff to address the question about the demand for central bank dollar bonds at low interest rates from a fiscal perspective.

The staff representative from the Western Hemisphere Department reported that, based on the results of the two auctions that had taken place so far, the central bank had auctioned US $5 million of central bank funds on April 14, 2000. It had received offers for US$12 million at a maximum interest rate of 13.5 percent and had sold a minimum amount at an interest rate of 6.5 percent. There had been another auction on April 18, 2000 where the central bank had offered to gain US$5 million. It had received bids for $11 million, and placed US$4 million at an interest rate of 6.5. The lowest bid it received had been 10 percent.

Mr. Kapteijn reported that there had been a meeting at the Inter-American Development Bank where the Ecuadoran authorities had made a presentation. In their handout, it had stated that 45 percent of the oil revenues above what had been programmed would go into an oil stabilization fund. Could the staff clarify what that oil stabilization fund was and what was its intended use? If 45 percent of oil revenues were supposed to go into that fund, did that mean that the remaining 55 percent would go to social expenditure?

The staff representative from the Western Hemisphere Department replied that an oil stabilization fund had been created last year. At present, it had no resources and it was not expected to have significant resources over the course of 2000, even though programmed oil prices were higher than budgeted. As a practical matter, the staff expected that all excess revenues above those programmed would go to social expenditures in 2000. That meant that at the end of 2000, the stabilization fund would again have no funds.

Mr. Szczuka pointed out that the first auction had not been encouraging.

The Acting Chairman said that he was surprised at the low bids, given the low interest rates.

Mr. Milleron asked for some clarification on the amount of payments the private creditors would receive compared to Paris Club creditors.

The staff representative from the Western Hemisphere Department pointed out that the financing gap for 2000 was about US$1.5 billion. The only identified financing was disbursements from the multilaterals of US$435 million. Thus, for 2000 the gap was US$1.1 billion. The authorities would then ask for a rescheduling in the amount of US$600 million. Therefore, the unfinanced gap would be about US$500 million. Payments to private creditors in 2000, including arrears from last year, were about US$514 million. That was the size of the gap and how it was expected to be filled over the short term. The authorities hoped to reschedule their debt in the short term through Paris Club arrears and payments to nonprivate sector creditors until some kind of exchange offer was agreed. Even if an exchange offer were to take place, the authorities would have to make substantial payments to private creditors in 2000, and they would need additional financing from somewhere.

The Deputy Director of the Western Hemisphere Department stated that it was very difficult to compare private sector involvement with that of bilateral creditors because one was essentially adding up cash flow relief with debt reduction. For instance, in the case of the Brady bonds, some of them had an escalation of the interest rate built in. When the Brady bonds had first been set up, the interest rate had started low and had built up in later years. For example, in 2000, under the cash flow, the debt service on the Brady and eurobonds was not large. It was in the order of US$420 million, in addition to the arrears from 1999. When one was thinking about burden sharing, was one thinking about the proportion that was paid of the debt service in relation to the total debt? In that case one would get a small number. Or was one thinking in terms of the debt reduction component of the private sector involvement that would need to be incorporated? That was why it was difficult to making the comparisons that Mr. Milleron had referred to. The program did not have specific numbers built in for a particular deal with private creditors, so the staff could not give a precise answer. However, in the way in which the balance of payments underlying the program was set up, there would be no significant payments to private creditors. It was difficult to conclude that there was unequal burden sharing and that somehow the private sector was getting too much if the program did not assume significant payments to them.

The staff representative from the Western Hemisphere Department explained that there was a misunderstanding about the US$2 billion financial package that had been announced two weeks ago. Over the next three years, the financing gaps would amount to US$1.9 billion the largest in 2000, and smaller ones for the next two years. The misunderstanding associated with the US$2 billion package might have contributed to stabilizing the exchange rate. A small part of that additional financing would in fact fill the financing gap. Of the US$2 billion, US$300 million was the IMF disbursement which went into reserves, not the financing gap. The US$435 million from the emergency program lending from the World Bank would fill the gap, as well as a further US$120 million in 2001 of emergency lending. The rest of the regular disbursements from the World Bank and the Inter-American Development Bank—amounting to $1.1 billion—would not fill the financing gap. It appeared essentially above the line in the balance of payments. While there was US$2 billion of financing, only US$550 would actually fill the financing gap.

Mr. Milleron thanked the staff for that clarification. After the consultative meeting in May 2000, he asked the staff for an update on the negotiations.

Mr. Palei made the following statement:

> After a long period of negotiations with Ecuadoran authorities, the staff have decided to recommend to the Board a long-awaited Stand-by program. It is fair to say that in the recent two or three years, Ecuador had to face unfavorable exogenous pressures, however, the authorities' response to these challenges was inadequate. On several occasions Ecuador failed to adopt measures aimed at fiscal consolidation and, in fact, aggravated the fiscal situation by freezing the domestic fuel prices. By providing large liquidity support to a weakening banking system, the authorities provoked high inflation and sharp depreciation of the Sucre. As a result, the combination of unfavorable exogenous shocks coupled with deficient economic policies led to the destruction of the banking sector and to the default on the debt.
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> The proposed program aims at rebuilding of investors' confidence through drastic reduction in the authorities' discretionary power to implement monetary policy. However, as many previous speakers have already pointed out, dollarization has to be complemented by many other confidence building measures, especially in the area of bank restructuring, fiscal area and corporate governance. In my view, adoption of the rigid exchange rate regime and the presence of an excessive debt burden impose unusually tight time constraints on the implementation of many structural measures. Therefore, I have to disagree with those directors who call for gradualism in Ecuador, even if this call is justified by their concerns about social pain. I believe that social costs will be much higher if the necessary reforms are delayed.
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> Unfortunately, doubts remain about the authorities' commitment to the required agenda. Among the burning issues is the ability of the superintendency of banks and of the AGD to carry out bank restructuring. I would urge the authorities to proceed expeditiously, even if the extra speed leads to somewhat higher fiscal costs in the short-run. The goal of creating a healthy banking system, in Ecuador's situation, should have a priority over the goal of value recovery. As Mr. Jonas and Mr. Carstens have already mentioned, foreign banks should play a major role in the restructuring. Despite somewhat pessimistic comments by Mr. Lindgren, I still think that the introduction of foreign banks should be assigned an explicit priority in the program, firstly, on the grounds of efficiency and competitive pressures associated with the presence of foreign international institutions and, secondly, in order to substitute for the curtailed central bank's lender of last

resort function. I did not find any references to the role of the foreign banks in the otherwise comprehensive program to tackle the banking sector problems.

To attract foreign investors to Ecuador, the issues of corporate governance have to be addressed. It seems to me that reliance on the changes in domestic legislation and subsequent lengthy process of learning and institution building may not be sufficient in Ecuador. Again, the authorities should look for more drastic solutions. For example, some of the observers proposed to allow for the international arbitration of contracts, as it was recently done in Turkey, when this country was facing similar problem of confidence building. I wonder if the staff and the Ecuadoran authorities have discussed such proposals.

Like the staff and many previous speakers, I believe that the envisaged modalities of fuel price increases in two discrete steps, one in July and another in October, are a serious mistake. In Ecuador, the price increases are not constrained by the structure of the economy as in my country and some other transitional economies. According to the staff, in March of 1999, the fuel prices, in Ecuador, already were at the international level. Current large disparity is the result of the collapse in the real exchange rates. According to the staff, the real exchange rate will be corrected through a large adjustment in dollar prices after the nominal exchange rate has been fixed. Apparently, disparity in price levels is a temporary phenomenon. Hence, in the interim period, the fuel prices should at least cover the domestic costs of production and distribution and provide some profit margin. It seems to me that delays in adjustments in fuel prices and the discrete nature of the price hikes will probably hamper price realignment for the economy as a whole.

Yet, another concern that I share is about delay until the end of this year of the introduction of a comprehensive fiscal reform.

Overall, it seems to me that more clarity in the authorities' commitment to reforms could pay off with faster return of confidence in economic recovery and could pave the way for faster progress in relations with private creditors. The latter is essential for the success of the program, and here I agree with other speakers. Apparently, some of the private creditors still distrust the authorities to the extent that they wrote a letter to the executive directors. I believe that we cannot simply dismiss accusation by the authors of this letter. They seem to be genuinely concerned about the authorities' commitment to the program, as are many of today's speakers highlighting the risks to the program. It would be useful to hear the staff's comments on the credibility of the authors. Is it known, for example, how large is their share of claims on Ecuador, or what is their role, if any, on the Creditors' committee.

On a more general note, the staff intend to conduct financing assurances reviews concurrently with the program reviews. Given the importance of private sector involvement, I would call on the staff to inform the Board about any significant developments in debt negotiations without waiting for the program review. It would be in line with already established practice of periodic informal meetings on the issues of this type.

As for the Fund's strategy of private sector involvement in the particular case of Ecuador, similar to Mr. Carstens, Mr. Portugal, and Ms. Lissakers, I support the current approach. With today's endorsement of the proposed program, the Fund steps forward with lending into arrears to private creditors while making it clear that the scale of Fund's financing is limited. I note also that it is up to the authorities to persuade other creditors that Ecuador is, indeed, committed to the implementation of the program. In full accordance with the governors' communiqué, the Fund's approach places responsibility for negotiation with creditors squarely with debtor country. The staff made it clear that the program could later be adjusted to take into account the results of the coming negotiations.

To conclude, Mr. Chairman, I believe that the staff did their best in highlighting to the authorities great risks associated with possible slippages in this program's implementation. Despite some reservations about the envisaged pace of the reforms, I endorse the proposed decision and wish the authorities success in facing challenges ahead. I also welcome the authorities' decision to publish their program.

Mr. Yakusha made the following statement:

I want to compliment the staff for their candid paper. They have had to work with many constraints; namely, the economic situation combined with weak political support for many of the needed measures. I share the points raised by previous speakers. The debt situation is clearly unsustainable, a run on bank deposits could immediately close down the banking system, and the needed fiscal adjustments will be difficult to achieve. Dollarization, if not entirely successful, could become an additional complication. The Fund will also be lending to arrears, given that the financing assurances are not that certain.

Ecuador's balance of payments problem could almost entirely be solved if it were to charge international market prices to domestic residents for fuel and gas. These subsidies have three main downsides. First, they misallocate public resources in the sense they are not targeted to the most needy. This benefits high income households. Moreover, the subsidies are twice as high as social payments designed to benefit the poor. Second, the subsidies have resulted in fuel prices that are significantly lower in than neighboring countries. Therefore, chances are that a significant part of the subsidy does not benefit Ecuadorans at all, but neighboring countries' migrant workers. Certainly, the main drawback of the subsidy is that it distorts incentives, which leads to waste. What is clear is that the subsidies need to be eliminated, although it is not clear how to do it quickly. I hope that the authorities stick to the schedule of the program, which is crucial for the credibility of the efforts that the authorities have chosen.

On private sector involvement, it is more clear now after the staff's explanation what needs to be done, but it is not known how to do it. The debt is, by any standard, unsustainable. Incidentally, the paper could have been more clear in this area. I am still uncomfortable about the different numbers for the financing of the gap. In Table 7 it is US$1.7 million, while in Table 10 it is US$1.5 million. Staff seem to use the US$1.5 million figure. It is also not clear if we are expecting debt rescheduling and/or a debt reduction from the Paris Club. This portion of domestic debt, and how the authorities are going to address that is not at all clear. A creditor committee is quite upset over the fact that Ecuador has gone ahead and restructured part of its domestic bonds with an implied haircut of 9 percent. I hope the authorities keep the debt on the table in order to facilitate agreement with creditors. Staff seems to calculate a 25 percent reduction for private creditors, but the private sector itself seems to be expecting a much higher haircut. In September, Lehman Brothers issued a report which indicated a 60 percent reduction in the principal, while Goldman Sacks in March indicated a 70 percent haircut on bonded external debt.

Like other Directors, I do not see where growth is supposed to come from. The program projects a decline to 4 percent growth rate in second half of 2000. This is a 12 percent turnaround, despite a fiscal contraction of 4 percent GDP relative to 1999, tight monetary conditions, and a liquidity crunch. The presumption seems to be that the engine of growth will be exports, which could start to benefit from a large depreciation. This growth, however, seems to be completely dependent on the oil price, while non-oil exports are projected to decline by over 10 percent in 2000. The dependence on oil revenue is evident in the primary surplus and in the stable primary expenditure.

I am also somewhat concerned that most of the fiscal adjustment took place in 1999 before the program started. It would therefore be important for Ecuador to apprise its managers of upcoming fiscal measures. There are some doubts that this will help and some private sector institutions are skeptical about Ecuador's ability to implement fiscal reform. The average length of time it took commercial banks to reach an agreement with debtor countries in the fall of 1989 was 24 months, and therefore the road ahead will likely be long and difficult. It is also clear that the current 12-month program will not be the end of the Fund's involvement in Ecuador, but if history is anything to go by, Ecuador will in the end succeed in overcoming its problems.

We wish the authorities success and good luck.

Mr. Vittas made the following statement:

Given the severity of the economic and financial crisis that Ecuador is experiencing and the hardship the crisis has inflicted on the population, one cannot but welcome the program of economic adjustment and reform that the authorities have begun to put in place, after difficult and protracted negotiations with the Fund staff.

As the staff candidly points out, the program is subject to considerable risks. Its success is therefore by no means assured. However, the program, which is off to a good start, offers a reasonable chance of restoring confidence in economic management, thereby laying the basis for a gradual recovery in economic activity. Moreover, the program is likely to help mobilize substantial amounts of external finance and debt relief, including through a restructuring of debt owed to the private sector. This would be crucial if a more sustainable fiscal and external position is to be achieved.

Thus, despite the risks involved, the program deserves to be endorsed by the Fund and I would like to indicate that this chair is prepared to support the authorities' request for an SBA.

I will focus the remainder of my comments on a few selected aspects of the program.

The initial steps taken towards the adoption of an official dollarization regime appear to have been well received by the markets. They have contributed to the restoration of some stability in the foreign exchange market and a significant decline in interest rates. They also seem to have succeeded for the time being in stemming the run on bank deposits. These developments are a good omen for the future. They may be interpreted as signaling a perception among market participants that dollarization will impose greater discipline in economic policies than Ecuador has been accustomed to over the past several years. Be that as it may, it would be foolish to assume that dollarization will in itself address all the problems that Ecuador is confronting at present. Indeed, dollarization is likely to increase the vulnerability of the banking sector to future adverse developments, such as a substantial increase in US interest rates. Moreover, because of the loss of monetary autonomy that it entails, it would make it more difficult for Ecuador to adjust to shocks in the future. This is a significant drawback for a country that remains vulnerable to exogenous shocks. On balance, I am inclined to accept the authorities' judgment that in the current difficult circumstances the benefits of dollarization outweigh its potential costs. However, I would urge them to move as swiftly as possible to implement the strong fiscal and structural adjustment policies that are essential to ensure the success of their stabilization program, as well as the longer-term viability of the new monetary regime.

The fiscal adjustment effort that has been built into the program can be viewed as reasonable, given the need to strengthen investor confidence and absorb the costs of bank restructuring while at the same time avoiding an overly restrictive impact on economic activity. However, I share the misgivings that many speakers have expressed about the composition of the fiscal package. In particular, I share the concern that an unduly large part of the adjustment effort may have been placed on the most vulnerable segments of society. This imbalance in the burden of adjustment is not only inequitable; it also risks undercutting popular support for the program, which is as crucial to its success as the political resolve of the government. Thus, I would strongly encourage the authorities to take advantage of any opportunity that may arise to restore a better distribution of the burden of adjustment. In this context, I agree with the view that if revenues turn out to be higher-than-expected a substantial part of the excess should be used to increase spending on social programs during the second half of the year. Looking beyond the current year, I agree with the staff that an important priority should be to implement a reform of the tax system so as to raise the tax yield, reduce its dependence on the oil sector and increase the efficiency of the tax structure. Apart from contributing to the required strengthening of the public finances, this could provide some room for raising spending on social programs and infrastructure.

While the strategy that the authorities have designed, with the assistance of the IFIs, in order to restructure the banking system appears comprehensive, putting it fully into effect will be a formidable task. This said, I welcome the actions that have so far been implemented, including in particular the steps taken to establish a mechanism for recycling liquidity within the banking system. This is especially important given that under the dollarization regime the ability of monetary authorities to offer lender of last resort facilities is limited. I note, however, that the recycling mechanism is still not fully effective and that in other areas implementation of the strategy is lagging somewhat behind schedule. I hope that these problems will be addressed before the conclusion of the first program review.

Finally, in order to help ensure that the program is adequately financed, it would be useful to convey to private creditors a clear message that the program relies heavily on substantial PSI both to ease the cash flow constraint that Ecuador is facing in the short term and to help achieve a more sustainable external and fiscal position over the medium term.

With these comments I reiterate this chair's willingness to support the proposed decision and I wish the authorities success in the implementation of their program.

Mr. Taylor made the following statement:

If one came to the Ecuadoran case for the first time through reading Mr. Portugal's statement, I think you'd find it a more exciting story than watching a James Bond movie - although the script is no better: Ecuador is a very tragic case.

The question of effectiveness and ownership of this program is being raised on all sides. Real ownership, as somebody said this morning, depends on the strength of the framework, and this framework is relatively weak; and the adherence of the government is relatively brief. A stronger and more secure program would have been desirable, and in that regard I associate myself with, for example, everything Mr. Palei had to say this afternoon.

The fiscal position seems to me to be particularly problematic. It's quite astonishing how small the social expenditures appear to be in this country (particularly compared with Uganda, the country that we were agonizing over yesterday), and the burden of the program seems to fall to a noticeable extent on the poor. That must increase the possibility (or probability) that the huge one-off increases in fuel prices on which the program depends won't, in fact, occur.

I have two technical questions that staff might comment on. On page 23, a good deal of doubt is thrown on the equity of the Bono Solidario. That being the case, I wonder whether it wouldn't have been better to have maintained at least some level of fuel subsidy directly for the poorest in the community. And secondly, if I understand the paper correctly, the sensitivity analysis for changes in fuel prices assumes corresponding adjustments to domestic subsidies. The better assumption – given the political realities - would be no adjustment to domestic subsidies. If there were no adjustment, what would be the effect on the fiscal position of a change in fuel prices?

On the monetary side, I don't understand paragraph 35. I don't understand the system there described; and I don't understand how you can run a dollarized system with interest rate ceilings.

On private sector involvement, there have been a number of references to the recent IMFC communiqué, about what's appropriate in the management of a crisis. As Mr. Goldsbrough said, in this case there will be no significant payments from the private creditors: thus the catalytic role of the Fund doesn't seem to me to be very relevant here. To an extent, we are not so much managing a crisis as dealing with the aftermath of a crisis.

Chair, I was very happy to hear what you said about the complexity of publication. We do quite urgently need to discuss this in the Board. As you said, I think any government, in certain circumstances, can need some leeway in relation to its public--in the timing with which things are announced. I don't know exactly how to cater for that, but I think we would benefit from a discussion as soon as we get the time.

Finally, looking at other programs in other parts of the world, I think this program raises some questions of equality of treatment. There have been much less problematic cases brought to the Board where stronger prior actions are required, where drawings have been back-loaded not front-loaded, and where a smaller proportion of quota has been granted. So this program establishes a benchmark which I expect to see met in future such cases.

The Acting Chairman remarked that it was difficult to decide how long to let things go before the Fund got involved. Many had felt that in the case of Ecuador the Fund had waited too long to get involved. The Fund had to make a judgment and it had to inform the Board of what was happening. The program was not an ideal program and it therefore should not set a precedent for how other countries should be treated. Otherwise, the Fund would treat countries as if they were going through the most difficult political situation imaginable. He understood Mr. Taylor's point that the Fund sometimes was too hard on the countries that could do more. However, in the case of Ecuador, the program had not been as strong as the Fund would have liked and could have negotiated longer.

Mr. Taylor pointed out that that introduced an element of moral hazard.

The Acting Chairman, noting that that might be true at some abstract level, the Fund waited about a year for some remarkable events in Ecuador to run their course. Certainly, the Fund would have preferred for more measures to be undertaken, it was a question of how far the country should go.

Mr. Portugal said that, while he was not sure whether the program raised the question of equality of treatment in the benchmarks under the program as pointed out by Mr. Taylor, the program contained a number of prior actions. While it was true that in the last Letter of Intent there were not too many prior actions, the current Letter of Intent included a number of measures. The situation in Ecuador had been stretched to the point that the government had been overthrown. That being said, if there was moral hazard, the participants had already been severely punished.

Mr. Szczuka made the following statement:

This is clearly a very critical time for Ecuador. With the enactment of the economic transformation law, authorities have made a first step in their efforts to deal with the consequences of adverse external developments and past policy slippages. I agree with the staff and other speakers that the proposed program underpinning the SBA may provide a framework to stabilize the economy and bring Ecuador onto a path of recovery. I thus support the proposed arrangement but, like Messrs. Pickford and Burgess, I do so with a lot of trepidation.

My less than enthusiastic approach can be mainly explained by the presence of very substantial risks that were only partially addressed in the program. The ever-present political risk has slightly abated, but by no means disappeared as the main political structures remain unchanged. Given the less than satisfactory track record and the fragility of the political balance, the probability of yet another failure in implementing the necessary fiscal adjustment and tax reform is still quite far from zero. The design of the program, with decreasing social spending, steep price adjustments and decline in real wages may result in aggravating the social tensions, in particular at the time of fast rising unemployment and very high underemployment.

As admitted by the staff, the program provides safeguards and contingencies only against some of the existing risks. Introducing official dollarization in the midst of an economic and financial crisis, and in the face of sizable fiscal imbalances, means entering uncharted waters. Dollarization will of course eliminate the currency risk and should play a critical role in restoring confidence and avoiding further capital outflows. It is, however, still an open question whether dollarization was the only available option and the right strategy to choose. In any case, dollarization should not be seen as a panacea for all of Ecuador's problems and by no means it eliminates the risk of future economic difficulties. After all, Panama, the very seasoned "dollarizer," has been a frequent client of this institution.

On the face of things, introducing a currency board may have been a more viable measure to stabilize the currency. While serving the same short-term objectives as the dollarization scheme, it would have allowed more room for maneuver in the long run. In particular, a currency board would have permitted to retain at least a limited ability to provide liquidity support to the banking system. Acknowledging that the authorities have their sovereign right to choose any currency system, I would expect the staff to present their view on the appropriateness of this decision when proposing substantial Fund support. I also find it rather surprising that the staff offer no comment on the fundamental decision of selecting the sucre/dollar conversion rate. Was this rate set at an appropriate level to secure export competitiveness and sustainability of Ecuador's balance of payments position in the medium term? What explains the very poor performance of Ecuador's non-traditional exports despite the 42 percent real depreciation of the sucre?

Sound domestic banking sector may be considered a prerequisite for enjoying any long-term benefit of full dollarization. Efforts to restructure and reform the banking system should thus be undertaken without the least delay. It is of crucial importance that the authorities stick to the timetable agreed under the arrangement, and that measures to strengthen the solvency of banks, to improve their transparency and liquidity management, and to facilitate the restructuring of private sector bank debt are introduced as rapidly as possible. It will be equally important to strengthen banking regulation and supervision.

Also, the entrance of foreign banks should be actively encouraged. This should contribute to strengthening the system and could help in seeking the augmentation of foreign credit lines. Securing such credit lines will be important to partly substitute for the loss of central banks' lender of last resort role.

A further necessary condition for the success of the dollarization scheme is the flexibility of goods and factor markets. This calls for efforts to remove structural rigidities, in particular in the labor market. The increase in wage flexibility brought about by the economic transformation law is a first step. But we agree with staff that the current labor market regime warrants further review. I wonder whether the staff and authorities are considering any additional measures that could help to improve the situation on the labor market.

We welcome the liberalization of the oil sector as envisaged in the Transformation program, and we see merit in the privatization schemes for the electricity and telecommunications sectors. In addition, we take note of the authorities' commitment to abolish the import tariff surcharge and urge them to do so without undue delay.

Turning to the fiscal side, we agree with staff that it will be important to avoid a major contraction of public spending. While we see merit in the programmed reduction of the combined deficit for the current year, we would consider it very important to preserve an adequate level of social spending. Like Mr. Bernes and many other Directors, I am very concerned that the program puts too much burden on the poorer segment of the society. To safeguard the social peace and support for the program it will also be critical to avoid a further widening in the incidence of poverty. We therefore welcome the provision under the program for a moderate increase in public capital expenditure, and we agree that the ceiling on central government expenditure should be lowered by the time of the August review, in order to allow for the allocation of any excess revenue to social and other priority expenditures.

I take note of the authorities' intention to submit a tax reform package to Parliament along with next year's budget. We concur with staff that authorities should seek to include measures to increase the value-added tax rate and to reduce the financial transactions tax in the reform proposal. However, given Ecuador's very uneven record in implementing the tax reforms, I would prefer having included in the program more contingency measures in case the congress were yet again to reject the proposed tax changes. Furthermore, to compensate for the loss of seigniorage revenue, it would in our view be expedient to seek a revenue-sharing arrangement with the US authorities. Given the importance of fiscal flexibility, I think that more efforts should be made to reduce the excessive earmarking of fiscal revenues.

I would also appreciate it if the staff could provide some information on the current status of the pension reform proposal that was submitted to congress.

I already commented earlier on the question of PSI and I would like to reiterate that this is an issue to which this Chair attaches great importance. In particular, I think that we should not shy away from providing both the authorities and the private creditors with some guidance concerning what might be an acceptable restructuring deal to the Fund. While this may be very difficult for the medium term, it should have been done at least for the program duration. I would also appreciate some comments by the staff with regard to the risk that the deal might fall short of being acceptable to the Fund. How would we react in such a case?

To conclude, I urge the authorities to implement the envisaged reforms in a timely fashion. Otherwise, dollarization of the economy could easily turn out not to remove, but to increase, financial instability and to compound the problems currently faced by the Ecuadoran authorities. However, the near irreversibility of the dollarization scheme should provide strong incentives for the authorities to move ahead swiftly. In any case, we wish the authorities every success in their difficult endeavor.

Mr. Liu made the following statement:

Ecuador's economy has been hit badly by the current crisis. I sympathize with the Ecuadoran authorities and the people for the difficulties and hardships they have encountered over the past two years. The crisis has vividly demonstrated how the interaction between a natural disaster, a negative external environment, and weak policy response can easily damage an economy, particularly so in the absence of timely international assistance. Although the some encouraging signs of stabilizing movement have been seen since March, the economy as a whole is still fragile.

It is encouraging to note that some initial stabilization effects of dollarization have recently emerged. However, the authorities should be aware that dollarization, especially the phasing in at an unusual time, is not a panacea, and that genuine stabilization relies critically on solid economic fundamentals and balanced structures. I welcome the authorities' policy initiatives summarized in the program which is ambitious and far-reaching. Dollarization is like a double-edged sword, on the one side it offers a stabilizing anchor, while on the other, it imposes constraints on government discretionary action and the ability to create the needed financing source. In view of time consuming nature of confidence rebuilding, fiscal consolidation, and financial resource constraints, the adjustments scheduled in the fiscal, banking and structural areas, in the dollarization environment, need to be well sequenced and tailored. In this context, the technical assistance provided by the Fund and other competent parties is helpful.

While supporting fiscal tightening and deficit reduction in general, I am, like Mr. Bernes and others, also concerned about the disproportionate burden sharing of the adjustment on the most vulnerable segment of society. A major measure of fiscal deficit reduction comes in the substantial upward adjustment in fuel prices while relevant subsidies are to be cut. We must bear in mind that the share of the population living below the poverty line and in extreme poverty reached 43 percent and 15 percent, respectively by 1999. Although the staff has explained the link between price adjustment and social spending, I still wonder how large a proportion of such fiscal measures will be borne by the vulnerable group; it should be carefully estimated at the first review of the program and well targeted compensation for the badly hit group needs to be worked out.

In addition to the authorities' efforts, like many previous speakers, I am of the view that private sector involvement in the resolution of the current crisis in Ecuador is essential. There has been intensive discussion on this subject, and a balance between voluntary and compulsory involvement has to be made. It should be stressed that the expected international financial assistance rendered by multilateral institutions should not be a substitute for the efforts of the private sector. We welcome the authorities' intention to resume consultations with their external creditors. The external creditors are urged to give special consideration to Ecuador's debt issue, and a flexible and cooperative attitude is desirable.

This chair fully supports the proposed SBA-supported program. With these remarks, I wish the authorities success in their challenging mission.

Mr. Munthali made the following statement:

We all agree that the economy of Ecuador is facing some serious difficulties that reflect the convergence of a number of exogenous shocks, which occurred in the period 1997–98. The sharp decline in output, the acceleration of inflation and rising unemployment has brought into sharper focus the deep-seated structural bottlenecks that the economy is facing. Thus far the Ecuadoran authorities have found it difficult to build a political consensus in order to focus on measures to decisively address the fundamental causes of the crisis. Indeed, weakness in policy formulation was reflected in the widening fiscal deficits and accommodating monetary policies which also precipitated the crisis in 1999.

Mr. Chairman, we are in broad agreement with the staff appraisal and can support Ecuador's request for the use of Fund resources under the proposed Stand-By arrangement. We believe that the program which began with the announcement of the dollarization of the economy is only a first step in the process of restoring confidence, halting the decline in economic activity and laying the basis for sustainable growth in the medium term. Given the difficult circumstances under which the program was formulated, we concur with previous speakers who have emphasized that the program is appropriately focused on substantial fiscal consolidation, the introduction of key structural reforms and the securing of private sector involvement in debt relief and restructuring.

Many previous speakers have highlighted the need for the full implementation of the measures agreed under the program for successful dollarization which has significantly reduced the degrees of freedom for monetary policy. I will therefore offer only brief comments on fiscal policy which has been identified as the core of Ecuador's program. The tightening of policy is necessary and appropriate, given the need to reestablish sustainable financial conditions. However, the problem for the authorities is to find an appropriate balance between further fiscal restraint and the need to halt further contraction of the economy. Mr. Toyama and others have alluded to this point in his gray while Mr. Bernes has stressed the danger of the burden of adjustment falling disproportionately on the poor. Here, we would agree with many of those who have called for the protection of social spending. In particular, we would like to add our voice to that of Mr. Bernes in calling for a strengthening of social safety net while reducing the fuel subsidy gradually.

The program has rightly stressed the introduction of reforms to underpin this announcement of successful dollarization. This has rightly started with the legal framework for bank restructuring being put in place as provided by the passage of the economic transformation law. We would therefore urge the authorities to move decisively on the other aspects of the reform agenda in the financial sector, including in particular, strengthening the solvency of banks, improving loan classification and provisioning.

This program and the support by the Fund should be viewed as being catalytic to the prospective debt relief and the involvement of the private sector in debt restructuring if Ecuador is to achieve external sustainability. While we recognize that the financing requirements are large and that the prospects for regaining access of private capital markets are limited, we believe that a systematic and cooperative solution to the high debt ratios will be essential.

With these remarks, we wish the authorities success with their adjustment program.

Mr. Ismael made the following statement:

Given the deterioration in the economy of Ecuador, we welcome this program. We note that it is off to a good start, despite the many misgivings, and that it has contributed to a restoration of confidence. However, as most Directors have noted, this program involves major risks, not only for Ecuador but for the Fund as well. While the risks to the Fund are in regard to its credibility, the risks for Ecuador are much higher. If the Fund does not provide the needed assistance, then the program will surely fail and will be followed by social and economic chaos. The Fund, therefore, has a major responsibility in helping Ecuador, and all our efforts should be towards ensuring the success of the program. In this context, we are reassured by Mr. Portugal's statement regarding his authorities determination to address the issues, and also by the many difficult measures that have already been taken.

But as noted, by previous speakers, much more needs to be done, and the Government and the Congress will need to work closely to ensure the success of the program. The centerpiece of the authorities' strategy is the dollarization program. As other have commented, many of the conditions for a successful dollarization are still missing, but we are hopeful that having successfully introduced the dollarization measure and having a Fund program will give the authorities the support necessary to proceed quickly with the other measures which are of critical importance to the success of the stabilization efforts.

As Mr. Shaalan and Ms Farid note in their statement, the measures envisaged in the program are interlinked, and the authorities do not have the luxury of a gradual approach, and the sooner the authorities can implement the other measures the better the chance of success. However, we would add that success will also depend to a large extent on additional financial assistance, the involvement of the private sector and a fair solution to the debt problem.

On the fiscal side, bringing the deficit down will be an important objective. We welcome the revenue measures being introduced, especially as regard oil prices. However, like Mr. Bernes we are concerned that this may be done at the expense of the more vulnerable social group. While we welcome the intention to use oil revenue in excess of that programmed to boost social expenditure, we would join others in urging the authorities to ensure that fiscal measures are socially equitable. The program is ambitious and the risks of failure are significant. Therefore, it is important that the authorities try to get as much support for the program as possible. As Mr. Donecker noted, the key to success is strong national ownership and in this regard measures to protect the poor are of critical importance.

Among the other measures, we agree that the strengthening of the banking sector remains a priority and we associate ourselves with the comments made on this issue by previous speakers. Similarly, we are of the view that the authorities should move decisively as regards the privatization program.

In conclusion, and in view of the risks involved, we would encourage the staff to work closely with the authorities to develop a set of contingency measures.

We support the proposed decision.

Mr. Hajian said that he also supported the proposed decision and wished the authorities success.

The Deputy Director of the Western Hemisphere Department said that the share of debt held by the signatories of the ad hoc creditor committee was not known because Brady bonds were essentially held in a trust by a trustee. The staff would certainly look into that. The staff viewed the letter that was sent to Executive Directors as part of the negotiating tactics that were now under way in connection with burden sharing.

The staff agreed with Mr. Taylor that the rationale for interest rate ceilings in a dollarized regime was not clear, the Deputy Director remarked. Moreover, the staff had urged the authorities to phase them out as quickly as possible. The particular language used in the economic transformation law linked an interest rate ceiling to LIBOR plus 4 percent plus a country risk premium. That measure did not make economic sense; it had been a political agreement.

Mr. Taylor asked for a definition of country risk. Did that mean default by the country?

The Acting Chairman replied in the affirmative. Ecuador could be incapable of paying its debt in dollars or in any other currency.

The Deputy Director of the Western Hemisphere Department added that the central bank had announced an interest rate ceiling of 24 percent, which was supposed to be set on a month-by-month basis. The staff had urged the authorities to raise it substantially with a view to eliminating the interest rate ceiling as soon as possible by legislative action.

If the staff felt that the deal with the private creditors was not consistent with the balance of payments contributions underlying the program, the staff would make its views clear, the Deputy Director continued. The Board would also have many opportunities to make its views known during the financing assurances reviews under the program. Those negotiations would not be concluded quickly.

The dates for when the fuel prices were going to be raised were no secret, the Deputy Director indicated. The reason for why the present administration did not want to increase fuel prices earlier was because there was a presidential decree that had been issued by the previous administration freezing prices. That decree would expire at end-June 2000. Because of that decree, the public knew that prices would increase on July 1. In fact, the government had already indicated that there would be substantial price increases; the amounts had been specified in the Letter of Intent.

The Acting Chairman added that the price freeze had not been a good decision. Many Directors had strongly supported a more gradual increase in prices, but the present administration did not want to violate that decree.

The staff representative from the Western Hemisphere Department remarked that competitiveness was not an issue at the moment as there had been no change in the real exchange rate of any significance. Over the past three years there has been a cumulative depreciation of around 28 percent (end period to end period), even though there has been some real appreciation in 2000. The main problem for the export sector was what was happening in the banking sector with respect to the supply of credit to the private sector, and with respect to internal credit lines. Non-oil exports had been hit hard by a series of unfortunate events. Shrimp exports, for instance, have been virtually obliterated by disease problems. Moreover, other countries were having problems at the present time and not providing much in terms of export demand. The export sector was affected by the combination of financing availability, supply, and demand factors rather than the exchange rate.

The authorities have not elaborated on the pension reform they intend to introduce, even though it was clear that something fairly dramatic was needed, the staff representative continued. Pensions were paid through the Social Security Institute. The Institute has not published any accounts for the last four or five years. It was desperately short of finances and was unable to meet its obligations to members through pension payments and through medical services. Clearly, any reform would have to look at the coverage of pensions, the Social Security Institute, and the contribution rates, which at the present time were minimal.

In terms of additional labor market reforms, the reforms that had been introduced by the trolleybus law had applied to the unemployed, the staff representative noted. Under the new law, the unemployed were allowed to work on hourly contracts at wages to be agreed by the contracting parties; the minimum wage did not apply. Also, a number of nonwage costs were not included in those contracts. As a first step, the authorities should broaden those reforms so that they applied not only to those coming from the unemployed labor force, but also to those who were currently unemployed and were renegotiating their contracts.

The fuel subsidy would be maintained for a while longer to help the poorest groups in society, the staff representative indicated. Fuel prices, in absolute terms, would not be increased to world market levels over the program period. Moreover, the largest increases were in those products that were used by the middle and upper classes rather than by the poorest groups. The largest increases were in high octane fuels and the lowest increases were in cooking gas and kerosene. In terms of the impact on the fiscal revenue, a dollar increase in the oil price generated about 0.6 percent of GDP in fiscal revenue. If there were to be no adjustment in domestic fuel prices, that would have to be offset by about a 0.3 percent of GDP reduction in revenue from domestic fuels.

In response to a question from Mr. Kelkar, the staff representative explained that the real effective exchange rate reflected the real appreciation of the sucre at 25,000 sucres per U.S. dollar, which was the inflation differential between Ecuador and the United States on the sucre exchange rate. Over the next two to three year, there would be a substantial real appreciation of the sucre as inflation in Ecuador converged to the U.S. level.

The Acting Chairman added that that was a reflection of the fact that the authorities had fixed the exchange rate at a greatly undervalued level. That issue had also come up in the Baltic cases as well, where those countries had not wanted to start with an overvalued exchange rate. However, if the exchange rate was too undervalued, the result would then be inflation.

Mr. Szczuka noted that there had been a pension reform bill which had been submitted to congress in May 2000, but which was struggling owing to political reasons. He saw that, however, as an indication of the authorities' willingness to engage in a serious reform effort.

The Deputy Director of the Western Hemisphere Department agreed with Mr. Szczuka's view. The President of the congress had also indicated that he would be willing to support a pension reform bill once the government could come up with the details of its proposal. Clearly, any reform would have to include contribution increases and perhaps a change in the retirement age.

The staff representative from the Monetary and Exchange Affairs Department said that the government was certainly eager to receive foreign investment in the banking sector. The Fund as well as other international financial institutions would be supportive of foreign involvement in the banking sector as much as possible. At the moment, however, there were no foreign banks exploring entry into Ecuador. It seemed that the situation in Ecuador was still too unsettled. The four foreign banks had been in increasing their market share substantially—from about 5 percent of assets to about 10 percent of assets. The domestic private banking sector accounted for 20 percent of assets. Foreign banks might be interested in investing in Ecuador when the deposit insurance agency starts to sell assets.

The Deputy Director of the Western Hemisphere Department, in response to a question from Mr. Kelkar, remarked that it would be premature to start talking about what facility would follow the SBA. There were still a number of structural reforms that needed to be undertaken. In terms of the economic policies themselves, the SBA was only the beginning of the process. Given the nature of the crisis and the decision to dollarize the economy, the authorities needed to move rapidly to put the SBA framework in place. Otherwise, the initial successes that they had achieved in terms of restoring confidence would not last, and they would be in a much worse situation.

Ms. Lissakers said that she hoped that the shareholders of the Fund, Bank, and the IDB would actively encourage MDBs to be proactive in helping Ecuador with its long-term structural problems.

The Acting Chairman pointed out that the IDB had been exceptionally supportive of the Ecuadoran effort by being involved in the overall strategy and by not trying to move ahead of the Fund. Also, cooperation with the IDB has been extremely good. Certainly, the next stage of the program would require shareholder support.

Ms. Lissakers agreed that the IDB has been active in Ecuador from the beginning, which has played a large part in getting the Ecuadoran authorities on track. While one should not rule out a continuation of Fund involvement beyond 12 months, the first response to the recognition that Ecuador faced long-term structural problems should not be the EFF. The first response should be to go to the Bank and the IDB, unless the required measures were in the Fund's core areas.

Just today, Ms. Lissakers indicated that she had had a meeting with a group of private investors, including some holders of Ecuadoran bonds. They had two messages which were important for Ecuador's next steps, in addition to the domestic political and legislative agenda. First, it was important that Ecuador have a successful meeting with the private creditors. Such a meeting should start with a coherent presentation of a game plan by the Ecuadoran side on how they plan to deal with private creditors in the context of what they were doing vis-à-vis the Fund and other official creditors. Investors were anxious because they did not see where they fit in the picture financially or in the structure of the Fund program. Also, they hoped that the Ecuadorans would come up with a plan for restructuring and dealing with their private obligations. That was a perfectly reasonable and understandable position for them to take. Second, it would also be useful for the Fund to validate the authorities' economic analysis. In addition, it had been pointed out that some investors who appeared to be substantial bondholders had not been invited to the consultative group meeting scheduled for May 2000.

Mr. Bauche agreed that the organizers of the meeting should be clear about what was expected from the private sector. In that regard, it would have been useful if the debt had been clearer. Moreover, it would have been helpful if the staff could have commented on the appropriateness of the balance between the contributions expected from the private creditors and those expected from the official creditors. It was hoped that the summing up would contain a reference to the principle of fair burden sharing.

The Acting Chairman pointed out that the Board did not support having a precise number, although they did support that there should be appropriate burden sharing.

Ms. Lissakers added that the group that she had met with had asked for a coherent presentation of how Ecuador saw its own payment capacity and how it planned to treat all classes of creditors. They indicated that is was not up to the Fund to propose a restructuring plan. The Ecuadorans have to take the first step.

Mr. Donecker agreed that that was a fair demand of the creditors. The public sector should not be treated as a residual, and the private sector should be expected to make a major contribution.

Mr. Portugal made the following concluding remarks:

I would like to start by thanking the Acting Chairman for the large amount of time and effort that he has personally put into this negotiation, including his visit to Ecuador last year. I would also like to thank the staff for their hard work and the many hours that have been put into this program, and the Board for their approval of this program and for the support and trust that it was willing to show in approving this program, despite the reservations that many have expressed here.

A number of valid and important points have been raised today. Unfortunately, there were other constraints to having a better program. For instance, there could have been a better mix between tax revenues and expenditure cuts. The authorities would have agreed to that, but they have proposed to congress several measures in terms of tax increases that unfortunately were rejected, which caused social expenditures to decline because of a lack of tax revenue. There is nothing else to cut, and there is not enough financing for the large deficit. I do hope that as a result of the negotiations that are going on now between the Ecuadoran authorities and the World Bank, a tax reform package can be sent to congress next July, which would allow this to be somehow redressed.

I would also certainly agree with the point that has been made about the undesirability of having a cap on interest rates. It was not a government proposal. Again, it was an inclusion by congress, and had to be accepted as part of the negotiations. All this points to the point that Mr. Jonas has mentioned in his statement about the importance of the legislature parties, although negotiating more with the congress might not solve that. My experience is that this is a tough business and I do not know what the solution for that is.

I would also agree with those that have pointed out the issue of the oil price increases. This has been a difficult issue in Ecuador. The authorities, in September 1998, almost completely eliminated the price subsidies. There was a 40 percent increase in diesel prices and a 12 percent increase in gasoline prices. Then there was another increase in April 1999 in the 23 to 27 percent range. And then there was indexation of these prices to the exchange rate. Unfortunately, there were massive demonstrations and disruptions in the country, and the government had to freeze the price of gasoline. I found the decision unfortunate because it has led to the re-emergence of large subsidies. I do not know whether it is better to remove the subsidies all at once or gradually.

There was a lot of discussion about private sector involvement. I took good notes of the points that Ms. Lissakers has just informed us about her meeting with the private creditors. I am sure that the intention of the authorities is to keep a constructive dialogue. I do not know if they will come to the meeting with a full-fledged plan. Of course, it is a difficult issue because as Mr. Donecker said, the private sector does not want to be treated as a residual. Therefore, it is a question of how simultaneously one will approach these negotiations that do not all happen in the same day. And if you eventually present the plan to one group and then later it is not accepted by the others, that might create more difficulties in the negotiations. So, it is not an easy issue to deal with, but the purpose is to maintain a constructive dialogue, with the spirit of coming to a quick resolution on this issue, taking into consideration the importance of maintaining an appropriate balance between the contributions from both the private external creditors and the official external creditors. Certainly, fairness of treatment among the different classes of private creditors is also important. That being said, it is difficult to treat all private creditors equally because individual investors make their decisions at different points in time and with different sets of information, different incentives, and different macroeconomic conditions. Perhaps we would have to think in terms of net present value and in terms of a longer period of time in which the restructuring takes place to come up with equal burden sharing. These are issues that would have to be dealt with by the Ecuadorans. They are difficult ones, and they will be consulting with the Fund staff. I just wish to reaffirm the authorities' intentions that they are conscious of these issues, and that their intentions are to move expeditiously ahead in a way that takes into account all of these considerations.

The Acting Chairman made the following summing up:

Executive Directors welcomed the agreement reached with the Ecuadoran authorities on an adjustment and reform program, and approved their request for a Stand-By Arrangement. They noted that the authorities' program had already achieved some initial success in halting the run on banks and was beginning to restore confidence. Nevertheless, Directors stressed that, if these policies are to be sustained, a broad national consensus will be required to implement decisively the policies envisaged under the program, and the program will need to be supported by adequate external financing, including debt relief and reduction and the restoration of banks' external credit lines.

While the decision to dollarize the economy has achieved initial successes, its continued success poses major challenges: structural reforms—particularly with respect to the labor market—would need to be implemented vigorously to make the economy more flexible and thus better able to withstand external shocks; and public finances need to be strengthened to reduce pressures coming from the financing needs of the public sector. The authorities would also need to move ahead quickly with the bank resolution strategy, including by developing an effective liquidity recycling facility and building up a stabilization fund as a source of liquidity to troubled banks.

Directors also stressed that it is critical to improve bank supervision and prudential regulation, provide adequate incentives for the recapitalization of banks, strengthen the deposit insurance corporation, move to a more limited deposit guarantee scheme, and speed up the restructuring of household and corporate debt. They placed particular stress on the importance of maintaining a voluntary debt restructuring framework for larger debts, since any across-the-board restructuring would further weaken the banking system and increase the ultimate fiscal costs of the banking crisis. Directors stressed that caps on interest rates were inconsistent with the dollarization framework and the goal of strengthening the banking system, and called for their early removal. They encouraged the authorities to move forward rapidly in these areas and noted that progress will be assessed at the time of the first review.

Directors noted that the degree of wage restraint and the increase in domestic fuel prices envisaged in the program were likely to prove controversial and difficult to implement. They welcomed the increase in cash payments to the poor under the program but were concerned, nevertheless, about the low level of budgeted social spending. They stressed the importance of increasing this spending at the earliest opportunity, in particular by using some of the proceeds of privatization, while monitoring the targeted fiscal adjustment. Nonessential expenditures will also need to be strictly controlled to allow any revenue excess to be devoted to increased social expenditure. Directors encouraged the authorities to formulate contingency measures that could be implemented, as needed, to address any unforeseen events.

Many Directors emphasized the importance of putting more permanent fiscal measures in place in the context of the budget for 2001 to mobilize additional revenue, diversify the tax base away from oil, reduce tax earmarking, and create a more equitable and efficient tax structure, including with regard to consumption taxes. These measures would be complemented by legislation aimed at liberalizing the production, distribution, and pricing of domestic fuels. The 2001 budget would also need to give priority to strengthening the social safety net and upgrading the country's infrastructure.

Directors noted that even with the maintenance of a substantial fiscal effort over the medium term, the ratio of public debt to GDP would not reach conventional benchmarks for sustainability. Moreover, the financing needs of the program were large and the prospects for Ecuador's regaining market access in the near future were poor. Therefore, private sector involvement is needed, including through both cash flow relief and debt reduction, if a sustainable external and fiscal position is to be restored over the medium and longer term. Directors stressed the need for the authorities to make every effort to reach an early cooperative solution with private creditors to secure the financing needs of the program, and achieve fiscal and external sustainability over the medium term. They welcomed the authorities' announcement of a meeting with private sector creditors to be held in

May 2000 and stressed the importance of appropriate participation in providing financing by private creditors. Directors looked forward to the staff's providing further details on needed private sector involvement at the first review, including an analysis of the medium-term external situation. They also requested the staff to keep them informed of developments in negotiations between the Ecuadoran authorities and their private creditors.

Directors emphasized that achievement of the program's objectives will be demanding. In particular, strong political resolve—including from the Congress—will be needed to implement the program. The overall liquidity position of the banking system remains fragile and—given the limited lender of last resort facility—the banks could not survive a substantial run on their deposits.

Notwithstanding the risks, Directors believed that there were strong arguments for supporting the program. They welcomed the improved cooperation with the Fund under the new government. Dollarization has been accompanied by a turnaround in confidence, which support from the international community can be expected to sustain and strengthen. Directors noted that substantial adjustment had already taken place (albeit in a disorderly and costly way) and both the external current account and the primary balance of the nonfinancial public sector have shifted to sizable surpluses. The authorities have also demonstrated their commitment to the program through the implementation of several important actions, including enactment of the economic transformation law.

Directors encouraged the authorities to move forward rapidly in the implementation of their program. They looked forward to the bimonthly review of the program, which will regularly update the Board on the medium-term fiscal and external debt sustainability scenario, and on the progress the country is making to secure the needed contributions by the private sector.

The Executive Board took the following decision:

Ecuador—Stand-By Arrangement

1. Ecuador has requested a Stand-By Arrangement in an amount equivalent to SDR 226.73 million for a period of 12 months from April 19, 2000.

2. The Fund approves the Stand-By Arrangement set forth in EBS/00/66.

Decision No. 12179-(00/42), adopted
April 19, 2000

Ecuador—Exchange System

The freeze on demand and saving deposits with the banking system imposed by Ecuador gives rise to an exchange restriction subject to Fund approval under Article VIII, Section 2(b). The Fund approves the retention by Ecuador of the restriction until June 30, 2000, or the conclusion of the next Article IV consultation with Ecuador, whichever is first. (EBS/00/66, 4/5/00)

Decision No. 12180-(00/42), adopted
April 19, 2000

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/00/41 (4/11/00) and EBM/00/42 (4/19/00).

3. BOLIVIA—ENHANCED INITIATIVE FOR HEAVILY INDEBTED POOR COUNTRIES—REVISION TO DECISION POINT DECISION

In the decision point decision for Bolivia, adopted on February 4, 2000 (EBS/00/4, Sup. 2), the final paragraph is hereby revised to read:

"(v)that, in accordance with Section III, paragraph 3(e) of the Instrument, the Trustee shall disburse the assistance committed to Bolivia under paragraph (iv) of this decision at the completion point, together with interest on the amount committed, calculated at the average rate of return per annum on investment of the resources held by or for the benefit of the Trust." (EBS/00/71, 4/7/00)

Decision No. 12181-(00/42), adopted
April 13, 2000

4. MAURITANIA—ENHANCED INITIATIVE FOR HEAVILY INDEBTED POOR COUNTRIES—REVISION TO DECISION POINT DECISION

In the decision point decision for Mauritania, adopted on February 2, 2000 (EBS/00/5, Sup. 1), the final paragraph is hereby revised to read:

"(v) that, in accordance with Section III, paragraph 3(e) of the Instrument, the Trustee shall disburse the assistance committed to Mauritania under paragraph (iv) of this decision at the completion point, together with interest on the amount committed, calculated at the average rate of return per annum on investment of the resources held by or for the benefit of the Trust." (EBS/00/71, 4/7/00)

Decision No. 12182-(00/42), adopted
April 13, 2000

5. UGANDA—ENHANCED INITIATIVE FOR HEAVILY INDEBTED POOR COUNTRIES—REVISION TO DECISION POINT DECISION

In the decision point decision for Uganda, adopted on February 4, 2000 (EBS/00/6, Sup. 1), the final paragraph is hereby revised to read:

"(vi) that, in accordance with Section III, paragraph 3(e) of the Instrument, the Trustee shall disburse the remainder of the assistance committed to Uganda under paragraph (iv) of this decision at the completion point, together with interest on amounts committed but not disbursed during the interim period, calculated at the average rate of return per annum on investment of the resources held by or for the benefit of the Trust."

Decision No. 12183-(00/42), adopted
April 13, 2000

6. TERMINATION OF POLICY ON CURRENCY STABILIZATION FUNDS

The Fund hereby terminates its policy on currency stabilization funds as described in the Acting Chairman's summing up at the conclusion of the Discussion on Fund Support for Currency Stabilization Funds (EBM/95/86, 9/13/95). (EBS/00/74, 4/10/00)

Decision No. 12184-(00/42), adopted
April 13, 2000

7. TERMINATION OF POLICY ON FINANCING OF DEBT- AND DEBT-SERVICE-REDUCTION OPERATIONS

The Fund hereby terminates its policy on the provision of financial assistance for debt- and debt-service-reduction operations as described in the Chairman's summing up on Fund Involvement in the Debt Strategy (EBM/89/61, 5/23/89). (EBS/00/74, 4/10/00)

Decision No. 12185-(00/42), adopted
April 13, 2000

8. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors, by Advisors to Executive Directors, and by Assistants to Executive Directors as set forth in EBAM/00/54 (4/11/00) and EBAM/00/55 (4/14/00) is approved.

APPROVAL: May 9, 2001

SHAILENDRA J. ANJARIA
Secretary