**IMMEDIATE ATTENTION**

EBD/09/38

April 16, 2009

To: Members of the Executive Board

From: The Acting Secretary

Subject: **Ecuador—Consultation with the World Trade Organization on Balance of Payments Restrictions**

The Fund has accepted an invitation to consult with the World Trade Organization (WTO) in connection with the forthcoming consultation of the WTO Committee on Balance of Payments Restrictions with Ecuador during April 22–24, 2009. The Fund will be represented at the meeting by Mr. Abrego, WHD and Mr. McDonald, SPR.

As this is to be a full consultation, it is expected that the WTO will request the Fund's view on recent developments in Ecuador. The staff recommends that, in response to such a request, the Fund representative should be guided by the attached statement.

In the absence of an objection by an Executive Director, or a request for discussion of the proposed statement, by **the close of business on Monday, April 20, 2009**, the recommendation will be deemed approved by the Executive Board and it will be so recorded in the minutes of the next meeting thereafter.

Questions relating to the guidance statement may be referred to Mr. Abrego, WHD (ext. 38754).

This document will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities.

Att: (1)

Other Distribution:
Department Heads

**Ecuador—Statement by the IMF Representative at the 2009 Consultation of the WTO Committee on Balance of Payments Restrictions April 22–24, 2009**

1. **In the context of a very favorable external environment, domestic demand grew strongly during 2005–08, boosting economic growth.** Oil prices for the Ecuadoran mix rose from an average of US$24 a barrel in 2000–04 to US$83 in 2008.[1] Oil export receipts almost doubled during 2005–08, accounting for about 40 percent of central government revenue and 60 percent of exports. With large increases in public spending and domestic credit, the economy grew at an average of 4¾ percent a year during 2005–08. The external current account recorded surpluses averaging about 2½ percent of GDP a year during this period. CPI inflation was low through 2007 but rose to 8¾ percent last year, owing to demand pressures and the global shock to food prices (domestic fuel prices are regulated by the government and have remained unchanged in recent years).

2. **In the fiscal accounts, the surge in revenue was accompanied by a sharp increase in expenditure.** Nonfinancial public sector (NFPS) revenue rose by 10⅓ percentage points of GDP during 2005–08, with oil revenue accounting for about 40 percent of the increase. Primary spending grew by 12⅓ percentage points of GDP over the same period, with about two-thirds of this increase explained by higher capital outlays. The NFPS registered surpluses averaging 1½ percent of GDP during 2005–08. These surpluses, together with strong GDP growth, helped lower the public debt-to-GDP ratio from 39 percent of GDP in 2005 to around 28 percent in 2008. Public sector deposits at the central bank rose to close to 8 percent of GDP at end-2008, a level similar to that of official net foreign assets (NFAs).

3. **Since August 2008, Ecuador's external environment has deteriorated sharply.** Oil export prices (Ecuadoran mix) fell from US$97 a barrel in the first seven months of 2008 to US$54 a barrel in the seven-month period through February 2009. Nonoil exports and worker remittances have also been adversely affected, mainly because of the global downturn. Ecuador's monetary (dollarization) regime constraints policy options to respond to ongoing external shocks. In this context, and with a substantial weakening in the public finances, official NFAs have declined from a peak of US$6.5 billion (4¾ months of imports) at end-September 2008 to US$3.0 billion (2.2 months of imports) in early April 2009.

4. **Staff projects that the economy will contract in 2009, before initiating a slow recovery in 2010.** Consistent with the Spring 2009 WEO forecast, staff projections are based on an oil price of US$41 a barrel for the Ecuadoran mix in 2009 and US$54 a barrel in 2010.[2] Real GDP would contract by 2 percent in 2009, reflecting the difficult global

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[1] Ecuadoran oil trades at a discount relative to the WTI, due to its lower quality.

[2] The terms of trade are projected to decline by 6½ percent in 2009, and improve by 4 percent in 2010.

environment, expected fiscal retrenchment, and lower domestic credit growth. In 2010 growth is projected at 1 percent, consistent with the expected recovery in the world economy. CPI inflation is projected to decline to 2–2½ percent in 2009–10, as global inflation falls and weaker activity eases domestic demand pressures.

5. **In the fiscal accounts, the authorities face a challenge because of the sharp drop in revenue.** They have indicated that they plan to adjust capital spending as needed in response to lower revenues. Under current WEO oil prices, staff projects an overall NFPS deficit of 4 percent of GDP in 2009.[3] The nonoil primary deficit—a better measure of the underlying fiscal position—would, however, decline from 9¾ percent of GDP in 2008 to 5 percent of GDP this year. These projections assume full implementation of the authorities' planned cuts in capital spending of about 3½ percent of GDP in 2009. Staff projects the overall NFPS deficit to decline to 1¾ percent of GDP in 2010, reflecting mainly an expected recovery of oil prices.

6. **Gross NFPS financing needs are projected at about 6½ percent of GDP in 2009 and 3½ percent in 2010**. The government has requested financing from regional multilateral institutions for 2009, including program-related loans totaling around US$1.2 billion (2⅓ percent of GDP).[4] Additional budget support is envisaged for 2010, although on a smaller scale. The authorities would also need to draw down on NFPS deposits at the central bank. In November 2008, a report prepared by a presidential debt-auditing committee concluded that part of the government's external debt was either "illegal" or "illegitimate". In December, the government announced that that it would discontinue servicing its debt on two global bonds with a face value of US$3.2 billion. A third global bond (US$0.7 billion) has continued to be serviced. The debt moratorium has reduced external financing options, including for the private sector. The authorities have announced that they will present a debt restructuring proposal to bondholders in late April.

7. **The external accounts are projected to deteriorate sharply in 2009, before improving moderately in 2010.** In addition to the drop in export receipts and worker remittances, the current account would be affected by the appreciation of the currency in real terms. In large part, this appreciation reflects the strengthening of the U.S. dollar, including against the currencies of some of Ecuador's regional trading partners. Ecuador's trade-weighted real exchange rate appreciated by 16 percent in the 12-month period through February 2009. Staff projects the external current account to shift from a surplus of 2½ percent of GDP in 2008 to a deficit of 3½ percent of GDP in 2009. This deficit would be financed through foreign direct investment, borrowing from regional multilateral institutions, and use of NFAs. Assuming that the government fully secures the multilateral program financing that it is seeking for 2009, official NFAs would decline

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[3] For every US$10/barrel drop in oil prices, the NFPS deficit increases by about 1¾ percent of GDP and net export receipts decline by a similar magnitude.

[4] The authorities have requested program-related support from the Inter-American Development Bank, the Andean Investment Corporation, and the Latin American Reserve Fund. The authorities expect that these disbursements will take place in the remainder of this year.

from 3¼ months of imports at end-2008 to under 2 months of imports at end-2009. In 2010, the current account deficit would fall to 2¼ of GDP, consistent with an expected improvement in the terms of trade.[5] However, official NFAs would decline further.

8. **The authorities have adopted administrative measures to limit imports and other payments abroad.** In November, Ecuador introduced changes to its tariff structure consisting mainly of increases in the duties on consumer goods, with some tariff reductions for a more limited number of intermediate and capital goods. Citing the risks of large balance of payments pressures for the functioning of the economy and the financial system under the dollarization regime, in January 2009 the authorities adopted more stringent restrictions on imports of consumer goods comprising about 30 percent of 2008 nonoil imports. These measures included hikes in *ad-valorem* tariffs, specific import duties, and quantitative restrictions. The authorities expect these measures to lower total imports by about 3 percent of GDP in 2009, and have indicated that the restrictions will be removed after one year. In addition, to limit external outflows, the authorities have increased the tax on payments abroad (from ½ percent to 1 percent) and broadened its coverage. They have also imposed a tax (1 percent) on liquid assets held abroad by financial institutions.

9. **In the financial system, the authorities have taken a number of welcome steps recently.** Financial soundness indicators appear generally good, although some small institutions show weaknesses. In this context, legislation to upgrade the financial safety net and strengthen prudential regulation and supervision was enacted in late 2008. The norms and regulations to implement this legislation have been put in place, and include: (i) introduction of new, improved methods of supervision; (ii) creation of a new liquidity fund and establishing the guiding principles for its operation; (iii) introduction of norms for bank resolution procedures based on international standards; and (iv) creation of a new deposit insurance agency. Steps have also been taken to increase capital cushions by limiting dividend payments, strengthen the independence of financial supervisors, and increase the resources available to the new liquidity fund.

10. **Some progress has been made in structural fiscal reforms.** Over the past two years, the authorities have taken steps to deal with budget rigidities—including by reducing non-constitutionally mandated earmarking of tax revenues—and to improve tax administration. However, budget rigidities persist, while energy subsidies continue to be poorly targeted.

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[5] This projection also assumes that the bulk of import restrictions introduced recently (paragraph 8) are removed in 2010, as envisaged by the authorities.