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Minutes of Executive Board Meeting 86/136

3:00 p.m., August 15, 1986

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
	D. Saha, Temporary
	M. K. Bush
	H. G. Schneider
	T. Alhaimus
	M. Sugita
	B. Goos
	Jiang H.
	Jaafar A.
A. Kafka	
	M. Foot
	I. Puro, Temporary
	G. D. Hodgson, Temporary
	P. E. Archibong, Temporary
	C. A. Salinas, Temporary
Y. A. Nimatallah	L. P. Ebrill, Temporary
	J. E. Rodríguez, Temporary
	S. de Forges
	H. van der Burg, Temporary
	G. K. Hodges, Temporary
	O. Kabbaj
	A. S. Jayawardena
	A. Vasudevan, Temporary
	L. Tornetta, Temporary

J. W. Lang, Jr., Acting Secretary
A. Akanda, Assistant

1. Annual Report, 1986 . . . . Page 3
2. Ecuador - Stand-By Arrangement; Exchange System; and Purchase Transaction - Compensatory Financing Facility . . . . Page 3

Also Present

IBRD: R. Kanchuger, Latin American Regional Office. Asian Department: S. P. O. Itam. Exchange and Trade Relations Department: W. A. Beveridge, Deputy Director; M. Guitian, Deputy Director. External Relations Department: H. O. Hartmann, I. S. McDonald, H. P. Puentes. Legal Department: R. H. Munzberg, S. A. Silard. Middle Eastern Department: A. S. Shaalan, Director; D. Hammann. Research Department: N. M. Kaibni, H. C. Kim, A. Mullor-Sebastian, A. Muttardy, R. Pownall, J. J. Soladay. Treasurer's Department: T. Leddy, Deputy Treasurer; D. Williams, Deputy Treasurer; K. Boese, A. G. Chandavarkar. Western Hemisphere Department: E. Wiesner, Director; S. T. Beza, Associate Director; M. Caiola, E. V. Clifton, A. H. Gantt, L. L. Perez. Bureau of Statistics: J. V. Carter. Advisors to Executive Directors: A. A. Agah, J. Hospedales. Assistants to Executive Directors: S. King, M. Lundsager, M. Rasyid, G. Seyler.

1. ANNUAL REPORT, 1986

The Executive Directors continued from the previous meeting (EBM/86/135, 8/15/86) their consideration of proposed amendments to the draft of Chapter 2 of the 1986 Annual Report, together with a draft letter for the transmittal of the 1986 Annual Report to the Board of Governors (EBD/86/229, 8/14/86; and Cor. 1, 8/14/86).

After a further brief drafting discussion, the Executive Directors concluded their consideration of the 1986 Annual Report.

The decision was:

The Executive Board approves the transmittal of Chapters 1, 2, and 3 and Appendices I-IX of the 1986 Annual Report to the Board of Governors under cover of the letter set forth in EBD/86/229 (8/14/86).

Adopted August 15, 1986

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

The Executive Directors considered a staff paper on a request by Ecuador for a one-year stand-by arrangement in an amount equivalent to SDR 75.4 million and a proposed decision on Ecuador's exchange system (EBS/86/148, 7/14/86; Cor. 1, 7/24/86; and Sup. 1, 8/14/86), together with Ecuador's request for a purchase equivalent to SDR 39.7 million under the compensatory financing facility (EBS/86/149, 7/14/86; and Sups. 1 and 2, 7/14/86).

The staff representative from the Western Hemisphere Department stated that the Fund had been informed by the lead bank of Ecuador's oil credit facility that underwriting commitments from 15 banks currently amounted to $221 million. In addition, conditional commitments amounting to $50 million had been made by four other banks. On the basis of those commitments, the lead bank planned to syndicate the oil credit facility for the original amount of $200 million. Ecuador's financial program would utilize $150 million under the facility in 1986.

Mr. Kafka made the following statement:

My authorities are in broad agreement with the staff analysis and recommendations expressed in both papers.

The staff papers tell a story of a hard adjustment made unexpectedly still more difficult by a violent deterioration in the terms of trade and of valiant, courageous, and successful efforts by the Ecuadoran authorities to fulfill their international commitments despite all the difficulties. The present request for a stand-by arrangement is the second stage of the adjustment program undertaken by the Government that assumed office in August 1985. It underlies the rescheduling agreements with both private and official creditors. The multiyear rescheduling of the Paris Club was of course a new departure by that group in recent years, especially as it is not necessarily predicated, for the period July-December of 1987, on the continuation of a stand-by arrangement with the Fund, but rather can subsist with an enhanced surveillance relationship. Adjustment under the stand-by arrangement requested will not be less hard than before, but my authorities are confident that they will be able to carry it out without sacrificing after 1986 reasonable economic growth and the continued pursuit of price stability.

Since April 1985, the world has changed dramatically for Ecuador, a relatively small oil exporting country. As late as December 16, 1985, the World Bank report on public investment in Ecuador called for increased investments in oil exporting activities--oil field rehabilitation and ancillary activities (pipelines, storage)--as the country's best hope of alleviating foreign exchange shortages. The report noted that for every dollar invested in these activities in the next four years Ecuador could expect to increase exports by $13. These recommendations made good sense, when nominal dollar oil prices were expected to increase to $36.90 per barrel by 1990, but they do not make good sense now.

The fiscal effort made by the country has been impressive. Facing a very substantial reduction of revenue compared with original expectations, due to the fall in petroleum prices in 1986, the authorities intensified their tax revenue efforts to collect an additional 3 percent of GDP compared with the original projection. At the same time, significant cuts were made in public expenditures equivalent to about 2 percent of GDP in relation to the level originally expected. These efforts are extraordinary, as in 1985 Ecuador had 52.2 percent it its tax revenues based on petroleum, and average petroleum prices--despite recent increases--are expected to be well below 1985. As a result of the measures adopted by the authorities, the overall deficit of the public sector is likely to remain at (or, perhaps, even below) a relatively comfortable 3.2 percent of GDP.

The Ecuadoran authorities agree that the present tax system is hampered excessively by earmarking, which they are working to reduce. Improvements in the valuation and control procedures on imports and the collection of sale and income taxes are also being made to make the system less dependent on fluctuation of oil prices and more receptive to variations in real income.

Monetary policy will be kept tight in 1986 with a moderate increase in the deposits of the public sector in the banking system in an amount equivalent to nearly 1 percent of GDP and an increase of private sector credit by the banking system of about 12 percent over the 1985 level, which is well below the expected increase in CPI for the year--an average of 23 percent, which is 5 percent less than the 1985 increase. The authorities will maintain their policy of stimulating financial savings through increased flexibility of interest rates as explained by the staff; they have reduced the minimum denomination of special certificates of deposit to S/.500,000 and the complete liberalization of financial markets scheduled to take place by March 31, 1987 was implemented on August 12, 1986. Currently, freedom of interest determination for all kinds of time and savings deposits and in banking loans made with such resources was permitted and the discount rate of the Central Bank was allowed to vary according to market conditions.

Several measures were taken also in early January 1986 to liberalize external trade. However, due to the uncertainty of the foreign balance and fiscal receipts it was necessary to provide forward cover to importers after March 1986 and the authorities imposed an 80 percent prior deposit on certain imports; this scheme was by its nature temporary and was eliminated on August 12, 1986.

Last January, the sucre was devaluated by about 12 percent vis-à-vis the U.S. dollar and as a result of this and previous actions the real effective exchange rate was below the level of the early 1970s, when Ecuador began to export oil. On August 12, 1986, the authorities decided to move to the parallel rate all private current transactions, which is likely to result in a significant depreciation of the exchange rate applicable to these transactions.

Despite all these almost draconian measures the authorities have been able to preserve the basis for the country's future growth through capital expenditures, particularly on human capital. Ecuador is very proud to be one of the few middle-income countries to have attained nine years of universal education in urban areas and is now fighting to achieve the same objective in rural areas.

The close cooperation between Ecuador and the World Bank--as well as IADB--is being intensified. In 1985/86, net lending by the World Bank minus interest was barely positive, an unusual situation, but this is expected to be corrected in the near future since quick-disbursing loans will be stressed by the institutions. They will focus on continued correction of distortions.

Over the medium term, and on present assumptions about oil prices, Ecuador's balance of payments will remain viable if tight. The capacity for quick decisions and courage demonstrated by the Ecuadoran authorities in the present crisis augur well for their ability to take advantage of any improvement in the oil situation to raise growth, as well as for their ability to take additional measures to preserve an appropriate balance of payments if unforeseen events should make such action necessary.

Turning now to the compensatory financing facility, we fully agree with the staff's assessment of the modest request of Ecuador. All the conditions for granting a compensatory financing loan are present. I would draw particular attention to the staff's comment that Ecuador has always been a minor supplier of oil to the world market and has-throughout the entire history of production controls--produced well in excess of their OPEC quota and at levels constrained only by capacity.

Mr. Salinas said that over the past few years, Ecuador had undertaken economic adjustment programs with Fund assistance under two consecutive one-year stand-by arrangements, and a compensatory financing facility drawing, together amounting to less than 60 percent of the country's quota. Performance under both stand-by arrangements had been entirely satisfactory. All performance criteria had been met and Ecuador had been entitled to make all the purchases as scheduled. Moreover, in both cases, the programs had been implemented as scheduled and had achieved most of the objectives pursued, namely, fiscal consolidation, strengthening of the external accounts, increase in domestic price stability, and recovery of economic growth.

The adjustment effort undertaken by the authorities that had led to an improved rate of growth and a lower than anticipated rate of inflation at the end of 1985 was currently at risk, Mr. Salinas observed. The outlook for the economy had changed dramatically owing to the significant deterioration in the terms of trade and the sharp decline in oil prices. For a small economy like Ecuador, the sharp decline of the price of its main export commodity, oil, had the dual effect of adversely affecting the external accounts of the country and weakening its fiscal performance through reduced revenue levels. In that respect, it should be noted that oil exports represented about 70 percent of total export proceeds and that oil revenues had been about 50 percent of total revenues for the public sector over the past few years. Against that background, the request for a stand-by arrangement and compensatory financing were fully justified in the light of the economic program envisaged for the remainder of 1986 and for 1987.

The stance of fiscal policy through 1985 had been appropriate, Mr. Salinas continued. Total public sector revenues had increased by more than 3 percent of GDP, while expenditures had increased by less than

1 percent resulting in an overall surplus equivalent to almost 2 percent of GDP, compared with the minor deficit recorded in 1984. The improvement in the fiscal situation in 1985 reflected to a large extent a sizable increase in petroleum receipts resulting from the unification of the exchange rate, the depreciation of the sucre, and the domestic price adjustment of petroleum products. However, public sector outlays also increased instead of declining as originally envisaged and the drastic change in oil prices since the beginning of 1986 had exerted additional pressures on public finances. In the absence of corrective measures, the public sector would have recorded a deficit of about 8 percent of GDP in 1986, after the 2 percent surplus recorded in 1985. In that connection, it was encouraging to note the promptness and determination of the authorities in avoiding such developments and their readiness to adopt necessary measures to achieve a more sustainable fiscal position. The authorities had made commendable efforts to broaden the nonpetroleum revenue base, increase the sales tax rate, and improve both customs procedures and the collection of income and sales taxes.

In contrast to revenue performance, weaknesses still remained on the expenditure side, Mr. Salinas observed. Although in real terms total expenditure in 1986 might remain almost unchanged--slightly below the level observed in 1985--such an outcome in the current circumstances was far from being an ambitious target to pursue, particularly if the real decline in capital expenditures would be virtually offset by the real increase in current expenditures. Moreover, total expenditures as a percentage of GDP would continue to increase in 1986 as in the previous two years--a development to which the authorities should give due consideration. In that context, the authorities' commitment to maintain a realistic pricing policy that would be applied to all state-owned enterprises to end their dependence on central government transfers was welcome. The measures adopted to cut back the amount of central government expenditures for 1986 by 5 percent and the guidelines that had been provided to limit the expansion of outlays on the rest of the public sector were also welcome. Although the authorities' efforts to restore a more balanced fiscal position were commendable, further measures could be undertaken to reduce the level of expenditures in a meaningful way, including the possibility of introducing a restrained wage policy. Avoiding expenditure overruns would not only favor a more sustainable fiscal position, but would also contribute to the achievement of other program objectives such as the intended increase in credit to the private sector without endangering inflationary and external goals.

The authorities' intention to further stimulate financial savings in the economy through increased interest rate flexibility was appropriate in the light of the weak balance of payments situation, Mr. Salinas remarked. The intention of the authorities to accelerate the process of liberalization by allowing interest rates to move more in line with market considerations and abolishing interest rate ceilings on savings deposits and most types of loans was welcome.

There was a clear need for Ecuador to follow a more flexible approach that would ensure a reasonable degree of competitiveness for its non-oil exports, Mr. Salinas noted. The authorities should maintain a flexible exchange rate policy to encourage export diversification and efficient import substitution. In addition, Ecuador's relatively heavy burden of external debt service necessitate the introduction of an exchange rate policy that would be more active than responding simply to developments in the trade balance. To that end, the recent measures to move all private transactions to the free exchange market--which was expected to bring about a significant devaluation of about 60 percent--was a courageous and noteworthy decision that would protect the country's foreign reserves, enhance export promotion, enable the authorities to dismantle nontariff barriers, and promote further liberalization of other areas of the economy. The determination of the authorities to reduce over time the spread between the central bank intervention market and the free exchange market rates was welcome. However, it would be prudent for the authorities to exercise caution in monetary and credit management to allow cost-related and relative price adjustments to inflationary pressures. Under that scenario public finances, in particular expenditure restraint, would become even more important.

Ecuador's modest request for compensatory financing was in line with the guidelines on access limits to special facilities; indeed, the request of SDR 39.7 million was not only modest, but contrasted sharply with the projected total export shortfall of SDR 203.8 million, Mr. Salinas commented. Ecuador could be considered a typical "price taker" producer in the world oil market because the fluctuation in its export earnings were associated mostly with price developments beyond its control rather than with any production or other internal decisions. The staff had drawn its conclusions after Ecuador had agreed to the OPEC production quota agreement, which clearly showed that the agreement tended to reduce rather than increase the size of the previously estimated shortfall on which the request for compensatory financing had been based, thus not affecting any principle of the decision on compensatory financing.

Mr. Hodgson observed that Ecuador had made impressive progress in reducing its internal and external imbalances during the past three years. Although his authorities had hoped that Ecuador would no longer need financial assistance from the Fund, the sharp fall in oil prices had forced the Ecuadorian authorities to reassess and strengthen their policy framework. A number of welcome measures had been implemented, including an exchange rate adjustment, increases in sales taxes, and changes in reserve requirements. If the program under the stand-by arrangement was implemented as planned, the medium-term balance of payments, although tight, might still be viable; however, the authorities would have to continue to be very careful in the conduct of their policies to achieve the appropriate mix of financing and adjustment.

A prudent fiscal stance was an essential element in the program under the stand-by arrangement, Mr. Hodgson continued. With the sharp decline in petroleum revenues, a substantial and rapid improvement in nonpetroleum revenues would have to be achieved by an increase in sales taxes; a significant reduction in the amount of tax credits granted as export subsidies; improved collection of income and sales taxes; and improved customs valuation and control procedures. Although the authorities had committed themselves to exercising tight control over government current expenditures, further measures would be necessary to limit current outlays, including wage restraint. The World Bank's involvement in the review of the public sector investment program and Ecuador's decision to postpone some investments while continuing those which would be necessary to meet Ecuador's medium-term growth targets were welcome.

The recent pricing adjustments and the commitment by the authorities to maintain a realistic pricing policy for public enterprises were positive elements in the program under the stand-by arrangement, Mr. Hodgson said. However, the deterioration in public enterprise operations indicated the need for stronger efforts to control their operating expenditures. Although some progress had recently been made in reducing revenue earmarking, the authorities should take steps to further reduce and eventually eliminate that practice. The attainment of fiscal targets would be crucial if a tight monetary policy was to be implemented as planned. The reduction in the minimum denomination of certificates of deposit and the commitment to free interest rates on term and savings deposits were welcome measures in that direction; those measures would be important in promoting savings and improving efficient credit allocation during the period of overall restraint.

Although the recent large devaluation in the exchange rate was welcome, it was disappointing to note that a multiple exchange rate system had been created, Mr. Hodgson observed. However, since flexibility in the exchange rate system had increased, the devaluation was acceptable and as a second-best option, a review of the multiple exchange rate system should be undertaken during the midterm program review. In recent years, the authorities had made a strong effort to diversify non-oil exports; in 1984/85, nonpetroleum exports had increased by almost 25 percent on average, and a similar rate of increase was projected for 1986. Flexible exchange rate management would be required over the medium term if comparable increases and the desired export diversification were to be achieved. Measures to liberalize trade were welcome, particularly the elimination of the prior import deposit scheme. The stand-by arrangement was consistent with the strong policy framework that the authorities had adopted in the past year.

Ecuador clearly met the compensatory financing requirements of a balance of payments need and cooperation with the Fund, Mr. Hodgson went on. The oil price projections indicating that the export shortfall was temporary are acceptable. Oil prices would have to fall below an average price of $6.87 per barrel in the two postshortfall years for the shortfall to be less than the proposed purchase. Therefore, the principal question was whether the shortfall was in fact beyond the control of the authorities. During the discussion on the use of the compensatory financing facility by oil exporting countries in June 1983 (EBM/83/80, 6/2/83), the

Executive Directors had expressed reservations about providing compensatory financing to oil exporting countries whose export shortfalls were largely related to oil. Over the past decade, OPEC policies promoting higher oil prices had certainly influenced the development of non-OPEC petroleum supplies as well as energy conservation measures, which together had contributed strongly to the present weakness in oil prices. However, decisions on requests for compensatory financing for oil exporters should be made on a case-by-case basis. Although Ecuador was an OPEC member, it had consistently maintained production at close to capacity and had followed flexible pricing policies to maximize sales. Equally important, Ecuador was a small producer holding a small share of world petroleum exports; thus it was essentially a price taker in the international petroleum market. In addition to those considerations, Ecuador had maintained good relations with the Fund and had consistently implemented strong macroeconomic policies in recent years.

Mr. Goos commended the Ecuadorian authorities for their continued adjustment efforts and the successful completion of their last stand-by arrangement with the Fund. He hoped that the authorities would be able to weather successfully the unfortunate setback in their adjustment efforts resulting from recent developments in the oil market. The prompt actions by the authorities in the wake of the oil price decline at the beginning of 1986 were encouraging as were their undertakings under the stand-by arrangement and the decision to further liberalize the foreign exchange market, interest rates, and trade. The acceleration of the liberalization schedule represented a courageous and powerful step that would greatly facilitate the authorities' objective of strengthening the international competitiveness of the non-oil sector and containing the domestic and external imbalances. However, it was clear that those measures would have their full potential effect only if they were supplemented by an appropriate degree of financial restraint and wage moderation, both of which had become even more critical to adjustment because of the likely strong inflationary impulse of the recent exchange rate action and the need to minimize its impact on the entire economy.

In those circumstances, it was not entirely clear that the adjustment program presented by the staff could still be regarded as internally consistent because the recent liberalization measures might have fundamentally altered some of the basic assumptions of the program, Mr. Goos continued. For example, large differences in projected inflation rates would affect savings and investment and they would also have a bearing on policy prescriptions regarding monetary growth targets and the necessary fiscal effort. Unfortunately the staff paper did not address the issue of consistency; it was also puzzling to note that the staff had accepted both an exchange rate policy that was expected to stabilize the real effective exchange rate at the 1971 level and a radical departure from that policy resulting from the devaluation of the currency for the private sector by about 60 percent.

Nonetheless, he felt that the thrust of the staff's appraisal and recommendations remained broadly appropriate, Mr. Goos observed. In view of the pronounced uncertainties about Ecuador's external accounts and the initially adverse effects on the balance of payments of the devaluation, it was advisable that fiscal and monetary policy should be guided by a significant degree of restraint. It was heartening to note that the authorities were willing to take corrective action when necessary to achieve the program's objectives.

Without passing judgment on the appropriateness of the recommendation to contain the fiscal deficit to exactly 3.2 percent of GDP, he advised the authorities to explore all the avenues proposed by the staff for further strengthening the fiscal position, including additional efforts to reduce earmarking, increase nonpetroleum revenue, and strengthen tax administration and expenditure control, Mr. Goos said. Despite the cuts already effected in the public sector investment program, the substantial increase in the financing gap of public enterprises indicated the possible need for another review of the program with a view to postponing, or at least reducing, the size of future projects without unduly affecting the country's medium-term growth prospects. Although monetary policy might become quite restrictive within the credit ceilings proposed under the program, the authorities should take a cautious policy stance in view of the expected inflationary impact of the recent exchange rate decision. The liberalization of interest rates should greatly facilitate the mobilization of additional savings and improvement of resource allocation. However, the liberalization of interest rates might complicate the conduct of monetary policy--at least for a transitional period--because it might entail some reintermediation of credit transactions into the banking system, thereby increasing the rate of expansion and volatility of monetary aggregates.

At the discussion on the use of the compensatory financing facility by oil producers in June 1983, the Executive Directors had agreed that requests should be examined on a case-by-case basis, Mr. Goos recalled. Nonetheless, given the magnitude of trade in oil and the fluctuations in the oil markets, he was concerned about the impact on the Fund's liquidity of further requests for compensatory financing for oil export shortfalls. That issue would have to be taken up in the coming discussion on the Fund's liquidity and access limits under special facilities.

The size of the export shortfall would depend on the future direction of oil prices, Mr. Goos continued. The staff generally based their projections--for individual countries or in the context of the world economic outlook--on the assumption that oil prices would increase again. If one accepted that working assumption, then the temporary nature of Ecuador's shortfall was established. However, considering the uncertainty in the oil market, one could well envisage a scenario in which oil prices continued to decline for an indeterminate period. Nonetheless, the staff had provided for a large margin of error in its projections. Oil prices would have to fall to very low levels in the postshortfall period--below an average of $7--for the calculated shortfall to become smaller than the proposed purchase.

The criterion that the shortfall should be beyond the control of the authorities was of particular importance in determining the eligibility of a country for compensatory financing, Mr. Goos remarked. He reiterated his authorities' view that developments in the oil markets were determined to a large extent by the pricing decisions of OPEC and other oil producers. Hence, it appeared that the current shortfall experienced by oil exporters as a whole could hardly be seen as being largely beyond their control. Nonetheless, looking at Ecuador's particular circumstances, it appeared that the country had generally avoided production cuts or stockpiling and that the production of oil exports had been close to capacity in recent years. Moreover, the country's ability to influence oil markets appeared to be rather minimal because of its small share in world oil markets; that lack of influence might have been more credible had Ecuador not recently joined other countries in announcing production cuts. The decision by Ecuador to reduce production raised the issue that individual countries, whether small or large, could in fact influence markets by their participation in a joint action, thereby increasing the impact of the production and pricing decision of the group on the market. Despite his reservations about Ecuador's compliance with the criteria that the shortfall be both temporary and beyond the control of the authorities, he supported the request because in recent years Ecuador had made significant adjustment efforts in collaboration with the Fund and appeared to be committed to making serious efforts to continue that course and to overcome its balance of payments problems with assistance under another stand-by arrangement.

Mr. Jaafar said that it was disappointing that the economic stability of Ecuador was once again threatened by factors largely beyond its control, owing mainly to the sharp and substantial fall in the price of oil. The program under the stand-by arrangement was significant in the light of Ecuador's achievements in restoring both external and domestic stability: surpluses had been recorded for the public sector fiscal position for 1985; growth in net domestic credit had been kept below the ceiling; and a deficit in the current account of the balance of payments had narrowed to less than 1 percent of GDP, significantly lower than the 3 percent projected in the midterm review under the previous stand-by arrangement. Ecuador urgently needed to achieve a more diversified economy in the medium term because its dependence on oil made its economic position extremely vulnerable. He wondered how much progress had been made in that direction, particularly with the cooperation of the World Bank.

The significance of the current program was underscored by the need to consolidate the gains made in 1985, Mr. Jaafar continued. Although the fall in the oil price had been expected in such a weak market, the extent of the decline had not been foreseen. The fiscal position could not be sustained with such a dramatic change in circumstances. The program was also essential because of the debt profile of Ecuador; there was not much room for maneuver because the debt service ratio was projected to remain extremely high--at close to 50 percent in the 1987-89 period, deteriorating to nearly 60 percent by 1990. The multiyear rescheduling arrangement for the public sector for maturities falling due in 1985-89 should have eased somewhat the debt burden, but it appeared that new financing would be required if the medium-term balance of payments projections of the staff were to materialize. The increase of the financing gap--which would reach $500 million by 1990--was a disquieting feature of the external position; closing the gap would require a strong commitment by the authorities to implementing the program under Fund assistance. The authorities had already demonstrated that commitment.

It was important that the fiscal targets under the new program be achieved, Mr. Jaafar noted. Rigorous export promotion would be essential in the medium term, and its success would depend both on the international market and domestic prices. It would be important to maintain the flexible exchange rate regime. Ecuador would also need the cooperation of both private and official creditors for a relatively long time.

As to the request for compensatory financing, the criterion of cooperation had been fully met given the excellent performance under the previous two stand-by arrangements, Mr. Jaafar observed. It appeared that the export shortfall had been largely beyond the control of the authorities because Ecuador was a relatively small oil producer with a small portion of the total global oil market. The current oil situation showed that a single country could not influence the international oil price without adversely affecting its share of the market. Since that held true for Ecuador, he wondered whether it was relevant to consider that Ecuador's participation in the recent OPEC agreement would affect the calculation of the shortfall itself or even the extent to which the shortfall had been largely caused by exogenous factors. In his opinion, there was little connection between Ecuador's recent petroleum production policy under OPEC leading to the reduction of the export shortfall and the staff's conclusion that the shortfall was largely attributable to circumstances beyond the control of Ecuador. The degree of external influence would depend on whether Ecuador could significantly influence the international oil market; the evidence provided in the staff paper showed that Ecuador had little such influence.

Mr. Nimatallah said that the authorities were to be commended for the bold adjustment measures that had been taken to remove the imbalances in the economy, particularly their efforts to restore fiscal balance and their decision to devalue and, more recently, float the sucre. He also commended them on their awareness of the need to resume economic growth at stable prices after adjusting to the dramatic decline in oil prices.

The authorities' efforts to reduce the deficit by collecting higher tax revenues in 1986 equivalent to 3 percent of GDP and reducing expenditures by about 2 percent of GDP were understandable, Mr. Nimatallah continued. He wondered whether it would be prudent to continue that approach beyond 1986-87. It would be appropriate to broaden the tax base, since that would be consistent with the authorities' efforts to diversify the export base. However, he found it difficult to understand why the public sector would continue to absorb resources from the private sector in the medium term. He hoped that, while the authorities made significant efforts to enhance the efficiency of the economy over the medium term, they would give particular importance to encouraging the expansion of the private sector and more efficient utilization and allocation of resources. Therefore, in their efforts to restore fiscal balance over the medium term, the authorities should control public expenditure, particularly current expenditure, rather than increase taxation.

It would be prudent to avoid earmarking when there was an improvement in revenues from the export of primary products, since primary product markets were volatile, Mr. Nimatallah observed. The appropriateness of that approach had been borne out by the example of Colombia, which had avoided earmarking when coffee prices were buoyant. The recent decline in coffee prices had demonstrated the wisdom of that approach. It was encouraging that the authorities were examining ways to further limit the use of earmarking.

The increased cooperation between Ecuador and the World Bank was welcome, Mr. Nimatallah said. Ecuador would need to eliminate structural rigidities to sustain economic growth based on a diversified export base and efficient economic sectors, especially as it would face a large debt service burden over the coming years. Many economies that were heavily dependent on oil had suffered greatly owing to the sharp decline in revenues over a short period: large domestic imbalances had emerged; unemployment had increased; and income and living standards had declined. It was important that those countries made significant efforts to bring their economies up to a sustainable level. That would be a difficult and painful task. The authorities had already undertaken a number of courageous and appropriate measures that would facilitate the adjustment process. Finally, the criteria for a purchase under the compensatory financing facility were satisfied. In particular, the stand-by arrangement provided sufficient evidence of Ecuador's commitment to cooperate with the Fund.

Mr. de Forges remarked that the authorities had demonstrated in recent years their willingness to cooperate with the Fund and the international financial community by successfully implementing necessary adjustment policies. Under the previous stand-by arrangement, all the quantitative performance criteria had been fulfilled with sizable margins. In addition, while the rate of growth of real GDP had exceeded 3 percent in 1985, inflation had increased very little. Ecuador was clearly an example of successful adjustment in the context of a Fund-supported program. However, in the past year, the external environment had changed dramatically, especially with regard to the evolution of oil prices. That change--which had been beneficial for some countries--had adversely affected Ecuador's economic situation, since oil exports had accounted for two thirds of total exports and generated about half of public sector revenues in 1985.

Strong fiscal adjustment measures would be needed to increase GDP, Mr. de Forges continued. Thus, it was important to continue fiscal restraint, especially with respect to current expenditures. The authorities' commitment to flexibility in the interest and exchange rate policies was welcome. A stand-by arrangement would permit the implementation of the second phase of the multiyear rescheduling agreement on Ecuador's external debt, that had been concluded with the Paris Club in April 1985.

His authorities had reservations about the request for a compensatory financing to cover shortfalls in oil revenues, Mr. de Forges stated. The reservations were of a general nature: thus far, the compensatory financing facility had not been used for shortfalls of oil export revenues, which was a wise principle to follow; the size of the financial amounts involved should be taken into account because in 1983, crude oil represented 12.4 percent of total world trade, compared with 2.8 percent for iron and steel, and 1.8 percent for cereals; the oil market could not be compared to other primary commodity markets for which the compensatory financing facility had been created, and using the facility in the circumstances of a shortfall in oil export revenues would compromise its real purpose and would reduce the funds available for countries that produced primary commodities; Ecuador was only a marginal oil producer, and the proposed compensatory financing represented only the equivalent of one sixth of revenue losses.

Since the first oil crisis, the Fund had substantially changed its means of financial intervention, Mr. de Forges noted. In the opinion of his authorities, the policy of enlarged access under the framework of a stand-by arrangement or an extended arrangement reinforced by structural adjustment efforts represented a more appropriate means than compensatory financing for dealing with the severe difficulties that certain countries might encounter as a result of fluctuating oil prices. In Ecuador's case, it would have been preferable to have increased the amount provided under the stand-by arrangement. In June 1983, the Executive Directors had agreed that each request for a compensatory financing by an oil exporting country should be evaluated on a case-by-case basis. Given Ecuador's unique circumstances, its request conformed to the criteria for drawings under the compensatory financing facility; however, the decision to provide compensatory financing to Ecuador should not be a precedent for future assistance to an oil exporting country. Given the economic outlook and the extremely high sensitivity of the country to developments in the oil markets, the financing gaps that were expected to emerge in 1987 would be closely linked to the fluctuations in oil prices. He wondered whether a contingency financing plan had been developed, and whether there would be quicker reimbursement of debt or less need for borrowing if oil prices increased above the level projected by the staff. The authorities' policy of diversifying production and promoting non-oil exports to reduce Ecuador's dependence on oil was commendable. Increased technical involvement by the World Bank in Ecuador's economic development was welcome.

Mr. Nimatallah observed that there was no established principle for not providing compensatory financing to oil exporting countries.

Mr. de Forges replied that his authorities wondered whether the use of compensatory financing was the most adequate way to cover shortfalls of oil export revenues.

Mr. Foot said that the authorities should be commended for successfully adjusting to the sharp decline in international oil prices. It was encouraging to note the near completion of the sizable new oil credit, which had attracted considerable attention by some banks that had not previously been major lenders to Ecuador.

It was important that the authorities should maintain their flexible exchange rate policy, Mr. Foot continued. The floating of the sucre should be accompanied by a rapid reduction of the spread between the two remaining foreign exchange markets. He asked for further clarification on the effects of the floating of the sucre. In that context, he observed that estimates of Ecuador's financing gap had been revised: oil exports from 1986 to 1987 were currently projected at $98 million lower than the previous estimate, and exports for 1988 were $140 million lower, thereby raising by about 50 percent in each year the new financing to be sought from commercial banks.

It was crucial for the authorities to continue their efforts at fiscal consolidation without jeopardizing the partially successful drive thus far to reduce the rate of inflation or unnecessarily increasing the output pressure on wages, Mr. Foot remarked. Monetary policy would play a key supporting role, and increased flexibility in interest rate policy would encourage inward capital movements. It would be useful to have the staff comment on net capital movements in 1986 and on the general financial position of the commercial banking system; he wondered how policies under the stand-by arrangement would assist banks in difficulty.

The request by Ecuador for compensatory financing should be seen in the light of the Executive Board's discussion in June 1983 on the use of compensatory financing by oil exporters, which had led to the general agreement that individual requests should be evaluated on the basis of a detailed examination of a wide range of relevant factors, Mr. Foot said. The staff's review of Ecuador's production and pricing policy and its association with OPEC were in line with that agreement. Ecuador had met the criterion of cooperation with the Fund through its record of adjustment, its commitment to the new stand-by arrangement, and its continued willingness to find an appropriate solution to its balance of payments difficulties. In evaluating such requests, his authorities placed great emphasis on the importance of cooperation in seeking viable solutions to imbalances in the economy where the causes of those imbalances were clearly not short term in nature. Ecuador had hitherto generally produced oil at levels constrained only by capacity. It had not hesitated to increase its capacity and production and had not followed a policy of deliberately accumulating stocks and increasing storage capacity. While those factors had been helpful in establishing the appropriateness of Ecuador's request, a cloud had been cast on them by developments in recent weeks. In his authorities' view, the staff's assertion that Ecuador was a price taker in the world market was not relevant to an evaluation of its request for assistance; rather Ecuador's insignificant role in price fixing and in the regulation of productive capacity within OPEC was the appropriate--and highly favorable--factor to consider.

He shared Mr. Goos's reservations about the price assumptions used for the calculation of the oil export shortfall in the initial request for compensatory financing, Mr. Foot continued. The calculated shortfall was so large that drastic changes in the price assumptions still produced a significant shortfall to support the request for compensatory financing even if production cuts were taken into account. The staff should provide an analysis of the sensitivity of the size of the shortfalls to the price assumptions, assuming that the production cuts were temporary. It was noteworthy that under the OPEC agreement, Ecuador would undertake to reduce production by 30,000 barrels a day between August and September/October; on the assumption that that reduction would have no impact on world oil prices, it would entail a sacrifice by Ecuador of nearly $400,000 a day, in total nearly the same amount being sought under the compensatory financing facility. Since he had some misgivings about the logical and factual basis of Ecuador's request for compensatory financing, he had reservations about the appropriateness of such assistance in meeting Ecuador's needs.

Should the price of oil rise significantly, Ecuador should accelerate its repayment to the Fund, Mr. Foot remarked. He supported Mr. de Forges's view that it would be unwise to establish general precedents from the discussion on Ecuador's request for compensatory financing.

Mr. Nimatallah said that his authorities considered that requests for compensatory financing by oil exporting countries should be evaluated on a case-by-case basis, and that oil should be treated no differently than any other commodity. He recalled that he had expressed a similar view at the Executive Board discussion on requests for compensatory financing by oil exporters (EBM/83/80, 6/2/83). His authorities rejected any generalization that specific countries were not entitled to use facilities available to them by the Fund.

Mr. Schneider observed that the authorities had successfully implemented the adjustment program supported by the previous one-year stand-by arrangement. Economic indicators--the growth in real GDP, the reduction in the inflation rate, the surplus in the operation of the nonfinancial public sector, the slowing of the growth of central bank credit, and the decrease in the deficit of the current account--suggested that the economy was on the right track toward a viable balance of payments position and sustainable growth over the medium term. However, developments in the oil market at the beginning of 1986 had prevented further progress. Despite the authorities' commendable efforts to diversify the economic base from oil to non-oil sectors, oil exports in 1985 accounted for two thirds of total exports and half of public sector revenues. Therefore, the fall in oil prices continued to play a significant role in the economy. Consequently, diversifying resources to non-oil productive areas should be the authorities' priority; a new stand-by arrangement appeared to be in line with that purpose. In particular, flexible exchange and interest rate policies, structural reforms, tight financial policies, and trade liberalization efforts would help to diversify the economy further.

Ecuador's external debt situation would remain difficult over the medium term, Mr. Schneider remarked. By 1991, the total external debt would be about 70 percent of GDP and the debt service ratio after debt relief would be about 50 percent, which implied that Ecuador would have to keep tight control over financial policies in order to achieve the desired adjustment. The debt management problem could be eased through strong export growth as well as the continuation of structural reforms.

In the Executive Board's discussion on compensatory financing for oil exporters in June 1983, the Chairman had clearly stated in his summing up that uniformity of treatment of members was one of the basic principles governing the Fund, Mr. Schneider said. He had stated that "OPEC membership creates neither a negative nor a positive presumption relating to a member's eligibility. What is important for the purpose of applying the criterion of whether or not an export shortfall is beyond the member's control is an examination of specific conditions and behavior of each country requesting a drawing." He considered that Ecuador's export shortfall had been largely beyond the control of the authorities. In addition, the sequence of stand-by arrangements had clearly demonstrated that the criterion of cooperation with the Fund had been met. Moreover, the purchase of SDR 39.7 million was only one sixth of the total estimated shortfall, which would provide adequate flexibility for unexpected developments regarding the assumptions underlying the projected petroleum export volume and prices in the two postshortfall years.

Mr. Tornetta commended the authorities for their achievements under the 1985 stand-by arrangement and their prompt reaction to the fall in oil prices during the first half of 1986. In 1985, all the performance criteria had been met with comfortable margins. Real GDP had increased at a rate of 3.2 percent, and the strong growth in non-oil exports was encouraging since it indicated increased diversification of the economy. In that context, the continuation of close cooperation between Ecuador and the Fund through the stand-by arrangement was welcome. The program under the stand-by arrangement should be instrumental in allowing the country to reschedule its external obligations on the basis of agreements reached with the commercial banks in 1985. In view of the relatively high credit outstanding to Ecuador, the reduction in access limits for 1986/87 was appropriate.

Under the 1986/87 program, the authorities were implementing measures to offset the negative impact of the decrease in oil prices on the fiscal deficit, Mr. Tornetta continued. Important adjustments had been made on the revenue side, which include raising sales taxes from 6 percent to 10 percent to increase nonpetroleum revenues by over 3 percent of GDP. Efforts to contain expenditures did not seem to be very successful and it appeared essential to continue a prudent wage policy.

The increase in the reserve requirement on demand deposits and the introduction of reserve requirements on certificates of deposit--which had been taken to absorb the liquidity in the economy--were welcome measures, Mr. Tornetta said. In that respect, the 1985 monetary policy had not been as stringent as expected, since M2 had grown at a rate of about 35 percent. Greater efforts should be made in 1986 to contain the growth of M2 within the projected limit of about 10 percent to facilitate a reduction in the relatively high level of inflation. The recent liberalization of interest rates should facilitate a return to positive real interest rates that, in turn, should reduce capital outflows. Furthermore, greater flexibility in interest rates should enhance the effectiveness of monetary policy by improving its transmission mechanisms.

The recent elimination of the import deposit scheme and the removal of some trade restrictions were welcome measures, Mr. Tornetta remarked. A major reform in the exchange rate system had been implemented in August 1986, causing a depreciation of 60 percent in the exchange rate for some transactions. The staff should comment on the effects of that measure. Under the medium-term balance of payments projections made prior to the implementation of the exchange rate reform, non-oil exports were expected to increase at an annual rate of about 8 percent during 1987-91. The staff should explain the initial assumptions made on the underlying real exchange rate during that period and to comment on the expected repercussions of the depreciation. Furthermore, it was debatable whether such a sharp depreciation was advisable in the light of the favorable non-oil export performance and its possible repercussions on the rate of inflation. He expressed disappointment that the staff had not been able to make a more extensive analysis of the consequences of the exchange rate reform.

In the context of the request for compensatory financing, his authorities were satisfied that a balance of payments need existed and that the country continued to cooperate with the Fund, Mr. Tornetta stated. For the first time, the export shortfall had been caused by a decline in oil prices, thereby presenting two problems: first, the difficulty of determining the value of exports in the postshortfall years; second, the difficulty of determining whether the shortfall had been caused by circumstances beyond the authorities' control. With respect to the first problem, since oil prices had been very volatile in recent years, decisions on production levels might be subject to considerations not related to productive capacity. Therefore, it would be very difficult to predict with reasonable certainty the value of oil exports in the postshortfall years. Although Ecuador's potential shortfall would have to be calculated very carefully, it was reassuring to note that the price of petroleum in the postshortfall period would have to fall below an average of $6.87 for Ecuador's shortfall to be lower than the proposed purchase and below $5.68 for its shortfall to be totally eliminated.

With respect to the requirement that the shortfall be largely beyond the country's control, the principles approved by the Executive Board on requests for compensatory financing by oil exporting countries in June 1983 called for a careful examination of production and pricing policies in each request, Mr. Tornetta recalled. If Ecuador--together with other countries--had taken an active role in trying to influence world oil prices by adjusting its production levels, that could have been viewed as a constraint on the use of the compensatory financing facility. Although that would appear not to have been the case in recent years, some doubts about Ecuador's role had arisen because of its recent agreement with OPEC to prop up oil prices by reducing production--exports would be reduced from the May-July 1986 level of 204,000 barrels a day to 167,000 barrels a day during August-October. That concern had only partly been mitigated by the argument that Ecuador had a modest share in the oil market and, therefore, was simply a price taker. While his remarks should not be interpreted to mean that the Fund should not provide financial assistance to countries that had been put into difficulties by the recent decline in oil prices, the compensatory financing facility did not appear to be the best instrument to address those problems. In that context, his authorities would be willing to examine the possibility of having more ad hoc mechanisms similar to those devised during the 1970s under the oil facility. Those mechanisms could provide more resources and more flexible use of access limits under Fund programs.

The shortfall in export earnings had been calculated with respect to the year ending October 1986, Mr Tornetta noted. Since the decision on compensatory financing of export fluctuations (Decision No. 6224-(79/135)) specified that the decision on the drawing should be determined with respect to the 12 months preceding the request or to a shortfall year in which not more than 6 months' data on merchandise exports were estimated, the staff should clarify the method of choosing the shortfall period and the constraints imposed by those guidelines.

Mr. Alhaimus said that the requests by Ecuador for a stand-by arrangement and compensatory financing were well justified in the light of the sharp deterioration of the economy after the collapse of the oil market in 1985 and its satisfactory record in fully adhering to strong adjustment programs over the past few years.

Since the early 1980s, Ecuador had reoriented policies in response to worsening economic conditions caused by adverse external factors and inadequate domestic policies, Mr. Alhaimus remarked. Adjustment measures had been initiated in 1982, and more comprehensive measures had been taken under Fund-supported arrangements in 1983 and 1985. The 1983 program had resulted in the elimination of the public sector deficit and the creation of a small surplus in the overall balance of payments. The targets under the 1985 program had been observed by substantial margins, although some delay had occurred in unifying the exchange rate. Substantial improvement had taken place in the fiscal and external situation, which included encouraging signs such as the strong growth in the private sector financial savings and the better than anticipated reflow of capital from abroad. Another significant achievement had been the agreement on the multiyear rescheduling arrangement, reflecting the growing confidence in Ecuador of its commercial bank creditors. However, those achievements had been seriously jeopardized by the drastic fall in oil prices, currently projected to reduce oil revenues in 1986 from over 10 percent to 6 percent of GDP. Unless strong measures were taken, the deterioration in the fiscal balance would be unsustainable given the uncertain oil situation and Ecuador's heavy debt burden. Hence, it was understandable that the program did not aim at improving the current situation, but instead at limiting the significant economic deterioration which might occur in the absence of corrective measures.

The new program appropriately emphasized containing of the public deficit to no more than 32 percent of GDP, while stipulating a set of monetary and exchange rate policies which would be needed to achieve the program's objectives, Mr. Alhaimus observed. Careful attention should be paid to public expenditure, since total government outlays were projected to rise slightly, with higher operating expenditures for public enterprises as well as high investment outlays. Although a higher level of expenditure might be unavoidable, it appeared that the staff considered it necessary for the authorities to implement further cuts to offset greater deterioration in oil revenues. Under the medium-term scenario, the external position of Ecuador would be tight but viable only under certain assumptions, including the continuation of adequate policies and the expectation of a small but steady rise in oil prices in the coming years.

Over the medium and long term, the appropriate strategy would be to emphasize the development of the non-oil sectors, Mr. Alhaimus considered. The authorities had stressed that ongoing investments were essential for Ecuador's medium-term growth prospects. And although a major part of those projects were directed at developing essential oil-related activities, it was encouraging to note the extensive involvement of the World Bank in a wider field of activities, including agriculture. The agricultural sector should provide significant potential for the expansion of non-oil activities and increase the share of non-oil exports; apparently, only 40 percent of cultivable land was being utilized.

Regarding Ecuador's request for a compensatory financing drawing, Mr. Alhaimus indicated full support for the request as it met all the requirements of the compensatory financing decision. In fact, Ecuador's recent policy governing petroleum production exports had reduced rather than increased the shortfall on which the request for compensatory financing was based. As the supplement to the staff paper had shown, recent developments had not changed the staff's findings that the shortfall appeared largely attributable to circumstances beyond the control of the authorities. Therefore, it would be counterproductive to make the case for Ecuador's request for compensatory financing on the grounds that the country had produced oil at levels constrained in effect by capacity only and well in excess of the OPEC quota. If it became an accepted principle that countries requesting compensatory financing for shortfalls in primary exports would have to demonstrate that their production was constrained only by capacity, irrespective of the impact on revenues, then the compensatory financing facility would become a mechanism that would promote overproduction of primary commodities, thereby leading to falling prices and to steeper shortfalls and imbalances--precisely what the facility was designed to ameliorate. Furthermore, the production of oil at full capacity by all oil producers would play havoc with the market, given the extremely large spare capacity available in many oil producing countries, estimated at over 10 million barrels per day. The impact on Ecuador of such an eventuality would not be difficult to imagine.

From a global perspective, the request by Ecuador for compensatory financing was particularly significant because the decline in export earnings in the shortfall year had been due almost entirely to the sharp drop in the price of petroleum, Mr. Alhaimus observed. As such, providing compensatory financing to Ecuador would be the first instance that the Fund had actually responded to the recent staggering shortfall in the earnings of oil exporting countries, a shortfall which had resulted in a massive transfer of income from the developing countries, as noted by the Interim Committee at its most recent meeting (April 9-10, 1986). Although the response by the Fund to the shortfalls was very small in global terms, he hoped there would be more extensive use of the compensatory financing facility in addressing the enormous imbalances faced by many oil exporting countries. He recalled that the G-24 Ministers at their meeting in Buenos Aires (March 6, 1986) had called upon the Fund to use the compensatory financing facility to address the kind of difficulties faced by petroleum exporters. The remarks of some Executive Directors at the present Board meeting were disappointing since they went in the opposite direction to the expectation of support for the use of the compensatory financing facility and the spirit of the consensus expressed at the meeting of the Executive Board in June 1983. In associating himself with the comments of Mr. Nimatallah and Mr. Jaafar on that issue, he wondered, regarding a comment made during the discussion, about how the use of the compensatory financing facility by oil exporting countries would affect the Fund's liquidity, given the existing low access limit and the unlikely event that the compensatory financing facility would be used by all oil exporters.

Finally, a separate annex in the staff report on the oil policies of members requesting compensatory financing was almost exclusively devoted to oil exporting countries, Mr. Alhaimus remarked. If that practice were continued, it would convey the impression that the policies of some Fund members were examined more carefully than others. He wondered if the annex could be incorporated into the text of the staff report, as was usual in other cases.

Mr. Sugita observed that there had been significant progress in Ecuador's economic adjustments prior to the sharp decline in oil prices, which had considerably changed the outlook for the economy. Fiscal deficit had declined, external imbalances had been reduced, and trade and exchange restrictions had been largely dismantled. By January 1986 unification of the exchange rate system and the subsequent depreciation of the currency had brought the real effective exchange rate to the level that had prevailed in the early 1970s. The authorities' strong adjustment efforts had been evidenced by the fact that all the performance criteria had been observed with ample margins and all drawings had been effected under the 1985 program.

The fall in petroleum prices had adversely affected the external and internal balances of the economy and was likely to undermine the gains that had been achieved, Mr. Sugita continued. Therefore, it was reassuring to note that the authorities had taken prompt action and drawn up a comprehensive adjustment program with medium-term balance of payments viability. The program aimed at reducing the public sector deficit and containing the overall deficit of the balance of payments within a reasonable limit. While those objectives--and the strong fiscal restraint that would reduce the fiscal deficit from 8 percent to 3.2 percent--were welcome, the fiscal adjustment effort would fall heavily on the revenue rather than on the expenditure side. Given the importance of fiscal adjustment in the program, there might be a need for a contingency plan to reduce expenditures in the event that revenues fell short of expectations. In that connection, the World Bank might be able to provide useful advice to the authorities with respect to the priorities of public sector investment projects.

The monetary targets set for 1986 that sought to limit the loss of net foreign reserves and provide additional credit to the private sector were appropriate, Mr. Sugita remarked. However, the inflation target--particularly that relating to consumer prices--might not be ambitious enough; the staff should comment on that aspect. Significant progress had been made in liberalizing the interest rate structure and the recent measures for further liberalization were welcome.

The flexible exchange rate policy had been a key feature of previous adjustment programs and it was reassuring that it had been incorporated in the new program with the status of a performance criterion, Mr. Sugita commented. The authorities' recent decision to transfer private sector transactions to a free exchange market was a step toward more flexibility in the exchange rate system. The authorities' elimination of the prior import deposit scheme that had been in operation since early 1986 was welcome.

Despite the deterioration in the current account position, the medium-term outlook was "tight but viable", Mr. Sugita observed. A financial gap of $200-300 million was projected to continue until 1989, increasing further in 1990 owing to the amortization schedule under the current multiyear rescheduling arrangement. Among other things, the projection was based on an assumption of a mild recovery in oil prices. However, the relatively high growth rate of non-oil exports would not be possible unless the exchange rate was maintained at a realistic level. The difficulty of assembling syndicated loans on commercial terms should not be underrated. In sum, the balance of payments prospects over the medium term might be viable, but would be very tight; additional financing would be available only if the authorities succeeded in demonstrating to the international financial community their achievements under the adjustment programs.

The criterion that the use of Fund resources under the compensatory financing facility would be dependent on the existence of a situation beyond the control of a country was particularly relevant in cases related to the shortfall of oil revenues, Mr. Sugita commented. He emphasized the importance of intensive, case-by-case examinations of the conditions and behavior of each country requesting compensatory financing; those analyses would cover such areas as output, export, and pricing policies. A relevant criterion could be whether the country had been producing oil at full capacity for some time prior to the shortfall year. Although Ecuador had met the criterion of having a shortfall beyond its control, its recent decision to limit oil production had cast some doubt on the appropriateness of the estimates for oil exports during the postshortfall years.

Mr. Nimatallah said that it was not appropriate that the Executive Directors discuss cases other than Ecuador's request for compensatory financing. All requests for compensatory financing should be evaluated according to the guidelines of the compensatory financing facility. With respect to oil production, it was not necessary to state whether a country requesting assistance was producing below or above its productive capacity. Ecuador's request for compensatory financing should be evaluated on its own merits; the same principle should apply to any other country requesting assistance, regardless of the commodity produced. With respect to productive capacity, although Saudi Arabia did not need to request compensatory financing, it should be remembered that the tremendous productive capacity of the country had been built up for the purpose of helping industrial countries--and the rest of the world--to acquire more oil at times when other countries were trying to limit oil production. Generalizations about the level of productive capacity might alienate countries such as Saudi Arabia and affect its relations with the Fund.

Mr. Rodríguez noted that under the previous stand-by arrangement all quantitative performance criteria had been observed with ample margins and that macroeconomic targets for output and prices had been met. The current account deficit for 1980-82 had been twice as large as the public sector balance, reflecting excess spending by the private sector financed from external sources. The relationship of that expenditure to nearly completed oil development projects would explain the relative ease shown by the economy in adjusting to a substantial low level of imports, as well as the effectiveness of demand management measures in reducing the macroeconomic disequilibria without fueling inflation in the short term or causing an excessive contraction in economic activity. Like other oil exporting countries, Ecuador had been severely affected by the oil shock of early 1986. However, it was clear that the nature and magnitude of the initial disequilibrium and progress made over the past two years had placed the economy in a relatively more favorable position to contain the deterioration in public finances and external accounts, as well as the negative macroeconomic repercussions of the shock.

The fiscal target for 1986 appeared to be quite ambitious, since the authorities aimed at absorbing about half the fiscal impact of the estimated 1986 oil shock, Mr. Rodríguez continued. He considered that the fiscal adjustment being contemplated might turn out to be more rigorous than indicated in the staff report, since the underlying assumptions about prices and output might be too optimistic because of the magnitude of the oil shock. The staff had assumed that inflation--as measured by the consumer price index--would be slightly lower than in 1985, and that GDP would rise by 1 percent, despite the oil price decline. However, such an outcome seemed unlikely. From the balance of payments figures, the estimated fall in petroleum revenues would be about $1 billion, equivalent to about 10 percent of GDP, while the current account deficit would increase by 6 percent of GDP--4 percentage points short of the effects of the shock. Moreover, since the real exchange rate was assumed to remain relatively constant--although that assumption might have changed in view of the recent depreciation of the sucre--the discrepancies between the balance of payments figures and the national accounts were not likely to be very significant. As such, the source of the modest growth was unclear. Unless there was a surge in private sector activity--not reflected in the staff report--output would probably contract significantly and/or inflationary pressures would probably reappear. The trade-off between additional inflation and a more severe recession would depend upon the effects of the fiscal retrenchment on aggregate demand and on the behavior of monetary and credit variables. It would be helpful if the staff provided information on Ecuador's recent economic performance.

Although most of the fiscal adjustment on the revenue side was projected to originate from additional indirect taxes, the pricing policies that would be undertaken by public enterprises might induce some upward pressure on prices, Mr. Rodríguez commented. Those policies were appropriate both from the viewpoint of resource allocation and for financial reasons, especially as the authorities considered that the continuation of investment projects carried out by state enterprises was crucial for attaining the medium-term growth targets of the economy. However, despite planned price increases, the operating positions of state enterprises were expected to remain generally balanced, implying that investment projects would have to be financed through budget transfers. Given that the World Bank had substantially increased new commitments, it appeared particularly relevant to ensure the availability of the domestic counterpart of the investment program. To the extent that inflation would turn out to be higher than envisaged and given the fact that all fiscal and monetary performance criteria were fixed in nominal terms, compliance with those targets might endanger the implementation of the investment program unless current expenditures could be further cut and/or additional revenue measures were put in place.

The proposed monetary and credit policies were broadly appropriate and the exchange rate policy had been designed to promote export diversification and reduce the country's excessive dependence on oil imports, Mr. Rodríguez continued. Trade liberalization had proceeded according to plan and in a manner consistent with the objectives of increasing the efficiency in resource allocation and expanding the export base.

Mr. van der Burg remarked that under the previous stand-by arrangement, all performance criteria had been met--some by a considerable margin. The public sector's finances had been in surplus, real GDP had increased by about 3 percent, and the current account deficit had been reduced substantially--all development accompanied by substantial increases in non-oil exports. However, inflation--which had remained virtually unchanged at about 25 percent as measured by the consumer price index--remained a black spot on Ecuador's record. It was encouraging to note that the authorities had reacted to the recent decline in oil prices with strong determination and were intensifying their adjustment efforts, including the recent decision to move all private transactions to the free parallel exchange rate, which would have nearly the same effect as a devaluation.

The measures taken to lower the 1986 deficit were impressive, Mr. van der Burg continued. However, he stressed the importance of containing that deficit to a level that could be financed from available resources without resorting to domestic bank borrowing. Expenditure overruns should be avoided. In that context, the spending overruns of 1985 were a source of concern, since they had caused an increase of current expenditure from 18 percent of GDP to 19.9 percent of GDP; therefore, it seemed that the authorities should tighten expenditure control. The authorities should also eliminate the practice of earmarking. The increase in the overall deficit of public enterprises--from 0.5 percent of GDP in 1985 to 2.6 percent of GDP in 1986--would be caused by an increase in investments, which appeared warranted in order to stimulate non-oil exports and contribute to economic growth in the medium term. Nevertheless, a stronger effort to increase revenues or contain costs might be warranted, to offset both the weakening in operational income and the increase in investments.

That the consumer price inflation rate had remained at over 20 percent was a source of concern, especially as the recent devaluation could contribute significantly to inflationary pressures, Mr. van der Burg observed. In that respect, he stressed the importance of a tight monetary policy and welcomed the recent measures following the devaluation to raise reserve requirements. The recent liberalization of interest rates was also welcome since it would contribute to an increase in domestic savings with a more efficient allocation of resources. Such liberalization might present possibilities for the introduction of a more market-oriented monetary policy, which would further strengthen the liberalization process.

The World Bank loans to Ecuador in 1985 were appealing since they had been used for small-scale enterprises, urban development, and agriculture, Mr. van der Burg remarked. The World Bank expected to emphasize quick disbursing loans in the future, which was an important positive feature.

The medium-term outlook for Ecuador would remain tight, Mr. van der Burg noted. Reserves were expected to remain at a very low level and the country would have little room for maneuver. The authorities should continue to demonstrate the courage they had shown in the past and to take additional measures to preserve an appropriate balance of payments in the event of unforeseen developments. Such further action might well be needed in order to counter the inflationary consequences of the recent devaluation.

The conclusions reached at the Executive Board meeting in June 1983 were relevant to Ecuador's request for compensatory financing, Mr. van der Burg stated. Each request for compensatory financing from an OPEC member should be examined on its own merits. Although fully agreeing that Ecuador had pursued an independent production policy and was a price taker on the world market, he said that some doubts had been raised in view of Ecuador's recently introduced production caps in line with the OPEC agreement. Nevertheless, the export shortfall could still be viewed as being beyond Ecuador's control.

Mr. Puro noted that Ecuador was the first OPEC member to request compensatory financing to meet a shortfall that had been caused by falling oil prices. With respect to requests by members of different price cartel arrangements, his chair endorsed a case-by-case approach in judging whether a shortfall was largely beyond the control of the member. Taking into account Ecuador's role as a minor oil supplier, its petroleum policies, and its role as a price taker, he found sufficient evidence to conclude that the shortfall in its export earnings was largely beyond its control. Furthermore, despite the difficulties in making oil price forecasts, the shortfall was expected to be temporary. Hence, a drawing by Ecuador would be in compliance with the principles for drawing under the compensatory financing facility.

Ms. Bush said that Ecuador was a good example of a country that had pursued an economic strategy consistent with the strengthened international debt strategy. The involvement and interest of the commercial banks was welcome. The Fund support for Ecuador's new economic program and its request for a stand-by arrangement was justified because of the country's record of good performance under stand-by arrangement. The new adjustment measures outlined in the staff report were welcomed. However, since those measures had been taken only recently, a more careful assessment of their impact would be needed at the time of the midterm review.

The aims of the new stand-by arrangement were to a considerable extent focused on ways of adjusting to the impact on the budget and the balance of payments of lost revenues, while continuing some very important longer-term structural reform efforts, Ms. Bush continued. In the balance of payments, the loss of more than $1 billion in oil-export revenues, ceteris paribus, would have led to a current account deficit of 16.7 percent of GDP. The objective of the program to limit the deficit to 6.9 percent of GDP was welcomed. Without adjustment efforts, the public sector deficit would have shifted from a surplus of nearly 2 percent of GDP in 1985 to a deficit of 8 percent of GDP in 1986. The fiscal deficit ceiling now set at 3.2 percent of GDP was appropriate. Such a degree of adjustment in the external fiscal accounts would be impressive if it were achieved. As the economy adapted to the immediate effects of the oil price decline, more attention should be devoted to the structural aspects of the program.

Ecuador's adjustment to the debt problem had not involved a dramatic decline in real economic activity, Ms. Bush observed. After a fall of 3 percent in 1983, GDP had grown at 4 percent and 3 percent in 1984 and 1985, respectively. The anticipated growth of about 1 percent in 1986 was certainly inadequate for the longer term. However, it would probably be difficult for the economy to perform any better in the light of the large loss of income from the worsening in the terms of trade. Recent private savings and investment figures were a source of concern. The private savings rate of 8-11 percent of GDP in the period 1981-86 did not look very good in terms of the long-term outlook. The persistence of real interest rates over the period 1981-86 might have had some influence on the private savings rate. The private investment rate of 14-15 percent of GDP would also decline in the long term.

The apparently constant inflation rate of 20-25 percent was a source of concern, Ms. Bush remarked. It would be useful if staff commented on future inflation trends, including the effects that the new exchange rate measure might have on the inflation rate. It was heartening to note the Government's prudence in setting minimum wage and public wage rates for 1987; the authorities' resistance to excessive wage pressures in the past was commendable.

The balance of payments performance in 1986 had been favorable, Ms. Bush commented. Real export growth of nearly 10 percent and real import growth of 11 percent, together with other external developments, had contributed to a current account deficit of less than 1 percent of GDP, which was a favorable base for absorbing the impact of the oil price fall. The ceilings on the loss of international reserves in 1986 of no more than $50 million and on the current account deficit ratio of 6.9 percent were very ambitious, given the low level of reserves in terms of imports and the high deficit ratio. A key element under the adjustment program would be the continuation of Ecuador's competitive position; the shift of private sector transactions to a floating rate market and continued flexibility in the official market should go a long way in achieving that goal.

Ecuador's foreign creditors had shown an exceptionally cooperative attitude in support of the country's adjustment efforts and its responsible approach to its foreign debt obligations, Ms. Bush observed. Both the banks and official creditors had been engaged in multiyear debt relief operations. The commercial banks were providing new credits and the multinational development banks were expanding their advisory and financial support in a manner consistent with the international debt strategy. It should be pointed out that the oil facility currently being syndicated by the banks will be the first new money of an essentially voluntary nature since the emergence of Ecuador's debt problem.

It was appropriate to describe Ecuador's medium-term external outlook as tight but viable, Ms. Bush said. The estimated loss in the oil export revenues of $4.6 billion over the period 1987-91 and continued uncertainty about oil price prospects indicated that achieving an acceptable balance in the external accounts would continue to be a matter of concern. A flexible exchange rate policy, prudent financial policies, and structural reforms could all play an important role in achieving that balance. However, a debt ratio of 68 percent and a debt service ratio of 52 percent by 1991 indicated the seriousness of the continuing debt problem.

The authorities had already begun measures to liberalize the trade and foreign investment regimes, Ms. Bush noted. In the wake of some measures in 1984-85, there had been further lowering and reduction in the dispersal of the customs rates in 1986--some pre-1983 import prohibitions had been eliminated. The prior import deposit scheme and most of the prior import licensing requirements that had been introduced in 1986 had also been removed, which was a very welcome development. A modest improvement in the climate for foreign direct investment might be expected as a result of the recent liberalization of profit remittances, strengthened rights for foreign investors in the settlement of disputes, freedom to purchase stocks in local companies, and access to long-term local credit for foreign investors. Although such actions were welcome, further liberalization needed to be undertaken; it would be useful to have more information on the authorities' plans for further liberalization of trade and investment.

Success in limiting the public sector deficit to the 3.2 percent ceiling for 1986 would depend partly on containing the overspending that had occurred in 1985, Ms. Bush remarked. It was worrisome that the public sector spending ratio to GDP had risen steadily--by 4 percentage points between 1983 and 1986. There had been a corresponding rise in the ratio of current expenditures. Apart from rising interest payments, there appeared to have been an increase in current transfers. The current surplus of public enterprises had been declining and their overall deficit increasing, despite adjustment in public tariff rates. There also appeared to be a tendency for an increase in the revenue ratio; revenue earmarking continued to be a source of concern. The staff should comment on the increase in current expenditures and current transfers, and an assessment of the adequacy of Ecuador's tax system.

The growth of credit and money aggregates in recent years might have been excessive, Ms. Bush continued. In 1985, credit to the private sector had grown at a rate of nearly 26 percent and M2 had increased at a rate of nearly 35 percent. Nonetheless, credit to the private sector was important. It would be useful if staff provided some clarification about the overall expansion of credit. She supported the stand-by arrangement.

The request by Ecuador for a drawing under the compensatory financing facility was the first request based solely on a shortfall in oil exports, which raised very serious issues, Ms. Bush remarked. In June 1983, the Executive Board had conducted a thorough review of the basic issue of providing compensatory financing for oil export shortfalls and had concluded that a case-by-case approach to individual requests should be taken. At that time, her authorities had stressed the need for a thorough evaluation of each case. Both the detailed evaluation and the case-by-case approach conformed to the principle of equitable treatment for all Fund members. Ecuador's request for compensatory financing had met two general criteria: the balance of payments need was clear; and Ecuador had a good record of cooperation with the Fund, having recently successfully completed two stand-by arrangements, with the current compensatory financing request being accompanied by a new stand-by arrangement. The test of cooperation for compensatory financing was of fundamental importance, regardless of the extent of compensatory financing being requested.

The third criterion for compensatory financing--whether the shortfall was largely outside Ecuador's control--was more difficult to judge, Ms. Bush observed. The recent volatility in the oil market made such evaluation even more difficult, because of problems associated with projected data and the calculation of shortfalls involving five-year periods. It might be argued that Ecuador's active participation in a collective decisionmaking process over the years had contributed importantly to the significant influence of such a process on world oil prices and production levels. It was likely that participation in that process had influenced the market. Such considerations had led her authorities to question, and review with care, the issue of whether the shortfall was largely outside Ecuador's control.

However, Ecuador's actual behavior with regard to its own pricing, production, and export of oil could not be ignored, Ms. Bush continued. Looking closely at its performance in recent years, including the two preshortfall years used in the calculation of the shortfall, Ecuador's pricing production policies did not appear to have been very constrained. For example, it had consistently maintained production levels at close to capacity--about 93-95 percent of capacity in 1983-85. It had exceeded its quota range of 183,000-200,000 barrels per day--average production had been 260,000-270,000 barrels per day. Indeed, at various times Ecuador had exceeded its output by as much as 152 percent. In addition, the country had maintained negligible oil stocks and had actively encouraged energy exploration and investment. It had also followed a pricing policy which had closely tracked, or even led, the spot market price. However, in the past few days, the authorities had agreed to return, at least temporarily, to the 1984 production quota. It was not clear what would happen after the two-month production quota period--September-October 1986--would expire. Thus, the situation created complications in Ecuador's policy regarding quotas and production. However, the country was a small producer, accounting for only 0.5 percent of global oil production, and its ability to affect the global oil price might be negligible. Ecuador's small-producer status, together with its actual performance in producing near capacity and well in excess of quotas lent credence to the argument that the shortfall was beyond Ecuador's control. Conformity with the other two general criteria for the use of the compensatory financing facility strongly strengthened the argument. Thus, despite her authorities' concerns and reservations, Ecuador's actual performance with respect to oil price, exploration, production, and exports, conformed to the guidelines for providing assistance under the compensatory financing facility.

The staff representative from the Western Hemisphere Department noted that under the stand-by arrangement maintaining the real effective exchange rate of the early 1970s was viewed more as a minimum objective; the understanding with the authorities had been that more drastic actions might have to be taken. Exchange rate policy was to be kept under constant review during 1986, particularly in view of uncertainty about oil prices, the high debt service burden, and developments in the balance of payments. The authorities' decision to take the measure of passing private sector transactions to the free exchange market should be seen in the light of oil price developments in mid-1986. The devaluation that had occurred as a result of the transfer of private sector transactions to the free exchange market might not be sustained for 1986 as a whole. After the initial devaluation one could expect the sucre to increase in value in foreign exchange markets. It was too early to predict either the impact of the exchange rate action on foreign exchange markets or how the oil situation would affect the exchange rate during the last months of 1986. With respect to the effects of the program on inflation, it had to be noted that some progress had already been made in meeting the 1986 target of 22 percent since the inflation rate from July 1985 to July 1986 as measured by the consumer price index had been 19 percent. Although the exchange rate measure would have an impact on prices, the overall impact would depend also on the monetary and fiscal policies that would be implemented during the remainder of 1986.

The authorities were aware of the need to closely monitor monetary policy, the staff representative continued. The change in the discount rate mechanism was an indication that they intended to follow an active monetary policy and would adjust it as warranted by the circumstances. The very sharp increase in interest rates had also increased the savings rate. The minimum wage had been increased in January 1986 by 18 percent, partly as a result of the wage negotiations undertaken in 1985. The level was lower than the average increase in prices during 1985 as a whole, and no additional wage modifications were currently envisaged for the remainder of 1986.

Some improvement had been made in monitoring the Government's expenditure programs, the staff representative noted. During the forthcoming mission in October 1986, the staff intended to discuss further with the authorities the measures being implemented to control expenditures. The authorities were also interested in exploring tax reform possibilities; reforms had been undertaken in customs administration and international trade taxes, which required significant administrative effort by the authorities. In the past, the authorities had relied largely on petroleum revenues since the nonpetroleum revenue base had not been very buoyant. The authorities' decision to increase private sector transactions indicated more clearly the need to dismantle the remaining earmarking arrangements with respect to petroleum revenue; the authorities would be examining the earmarking mechanism in the coming months as part of their efforts to develop a more flexible and modern tax system.

The revised medium-term scenario showed that production and export of petroleum would be lower than previously envisaged, which would have a negative impact on the balance of payments prospects, the staff representative observed. However, the authorities' attempts to follow a more realistic exchange rate policy should have a favorable impact on nonpetroleum exports, thus offsetting to some extent the negative impact of the decline in petroleum earnings. The new exchange rate policy would be effective in that sense if appropriate demand policies were implemented at the same time.

Since a very ambitious borrowing program from the multilateral development banks was envisaged under the medium-term scenario, the size of the remaining financing gap could be determined only approximately, even if it was assumed that the gap would be financed by commercial banks, the staff representative from the Western Hemisphere Department continued. The financing contribution required from commercial banks could be equivalent to an increase in the banks' exposure of 4 percent instead of 2 percent. However, there were other factors which would have to be taken into account to determine the size of the gap. In that connection, there was some evidence that a certain amount of capital repatriation would take place in 1986. Certificates of deposits increased from S/. 37 billion in December 1985 to S/. 85 billion in May 1986; part of that increase in financial savings was associated with capital reflows into Ecuador. Thus, the policies of interest rate flexibility and financial savings promotion appeared to have had a favorable impact on the balance of payments. The general financial position of the banking system had improved; they were providing significant trade financing.

The Deputy Director of the Exchange and Trade Relations Department said that the elimination of the surrender requirement for private foreign exchange under the prior import deposit scheme, as well as the elimination of the related minimum import financing requirement and of most prior import authorizations all followed logically from the authorities' decision to transfer private sector transactions to the free exchange rate market. Since the market for those transactions was allowed to operate freely, there was no a priori way of determining the level at which the exchange rate in such a market would finally settle. The exchange rate would depend on the behavior of the private economy as well as on policies implemented by the authorities under the adjustment program. It was important, however, to stress that the move to transfer private sector transactions to a free exchange market was the correct one. Furthermore, the exchange rate adjustment that had taken place was in the right direction and in a sense compensated for the liberalization measures. The adequacy of the exchange rate would be assessed during the review of the program and at that time, it would also be possible to evaluate how the process of unification could be achieved. With respect to a contingency scheme for possible fluctuations in oil prices, no such plans had been contemplated at this time, other than the use of the compensatory financing facility; it was understood, however, that at the time of the review the authorities would determine whether additional policy measures would be required.

The staff representative from the Research Department said that the export data used in the calculations of the compensatory financing referred to aggregate merchandise exports, including oil. Since 1975, there had been more than 200 requests for compensatory financing, and in 52 cases oil as an export commodity had featured in calculating the export shortfall; two cases, including Ecuador's request in 1983, had involved OPEC countries. Oil shortfalls had contributed to 10 drawings under the compensatory financing facility and reduced drawings in 8 other cases; oil exports had had no effect on the remaining 34 drawings because of quota constraints.

Although the question of the coverage of the compensatory financing facility had been examined from time to time, there had not been a systematic review by the Executive Board of the coverage since 1979, the staff representative said. In 1979, the Board had decided to increase the coverage of the facility by including certain services in the calculation of the earnings shortfalls.

The decision to provide the member requesting compensatory financing the option of basing calculations on estimated data for up to six months of the shortfall year had been intended to facilitate the processing of requests for compensatory financing where the evidence indicated strongly that the country would experience an export shortfall but did not yet have actual data to support a request, the staff representative remarked. If Ecuador's request had been based on the latest actual data available--through April 1986--there would be no shortfall; however, because of the sharp decline of oil prices, it was estimated with a fair degree of certainty that oil export earnings would drop sharply in the six months to October 1986. The fall in export earnings for those six months would establish the condition for use of the compensatory financing facility. However, use of the early drawing procedure would be subject to a later review on the basis of actual data, and if that review indicated that Ecuador had been overcompensated in its drawing, the country would be expected to make a prompt repurchase of the amount of overcompensation.

The annex in the staff report dealing with the oil policies of members requesting compensatory financing had been included because of special and complex factors relating to the oil sector in various countries coming before the Board, the staff representative continued. The annex had been prepared in response to a request made by the Executive Directors in June 1983, at the time of their discussion on the issue of access to compensatory financing by the oil countries. The possibility of incorporating the information contained in the annex into the main text of the staff report would need further consideration.

Ecuador's export earnings shortfall resulted from falling prices and was not related to the volume of exports, the staff representative from the Research Department went on. To the extent that Ecuador's petroleum policy had not contributed to the fluctuation in world oil prices, the export earnings shortfall could be attributed to factors outside the country's control. In general, if a country requesting compensatory financing was a small exporter, like Ecuador, it would be reasonable to conclude that the shortfall relating to price variations would be due to circumstances outside its control. In Ecuador's case, although there had been a higher volume of exports, prices had fallen sharply; hence, the shortfall in earnings. The current shortfall in Ecuador had existed before the recent OPEC announcement of production cutbacks and, indeed, the cutbacks by Ecuador had contributed to reducing the shortfall; it was possible that the cutbacks could lead to a shortfall relating to a later period. If such a shortfall was established and determined to be the consequence of cutbacks in production, then the situation would be examined very carefully to determine whether the volume variations were within the control of the member or whether exogenous factors had contributed to the change in volume.

Mr. Nimatallah agreed that if prices declined, then demand would decline and consequently the supplier would suffer revenue losses. Thus, the shortfall would be beyond its control. However, if production were reduced, prices might go up and revenues might increase, implying that compensatory financing for the shortfall could be reduced. He wondered whether factors other than prices were affected by demand in analyzing the criterion of export shortfalls caused by circumstances beyond the control of a country. In that context, OPEC production cuts had encouraged a country like Canada to undertake more extensive oil exploration and produce greater amounts of oil because the price established by the production levels had made its oil fields economically more viable.

The staff representative from the Research Department replied that it was difficult to determine which factors would contribute to export shortfalls in oil exporting countries. However, the policies of the member requesting compensatory financing for export shortfalls in a particular year would be examined in relation to two preshortfall and two postshortfall years to establish whether the country's actions had been responsible for the variation in export earnings. With respect to price variations, it would be necessary to establish whether the country had influenced prices during the five-year trend period, in particular whether it had contributed to declining prices in the shortfall year. However, the ability of a small producer such as Ecuador to influence prices through volume changes was relatively limited.

Mr. Kafka said that any departure from providing compensatory financing under the guidelines established in 1983, such as introducing new rules that would distinguish between commodities, would be in violation of the principle of equal treatment for Fund members and not be compatible with the objectives of the Fund.

The Executive Board then took the following decisions:

a. Stand-By Arrangement

1. The Government of Ecuador has requested a stand-by arrangement for a period of one year from August 15, 1986 in an amount equivalent to SDR 75.4 million.

2. The Fund approves the stand-by arrangement set forth in EBS/86/148, Supplement 2.

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

Decision No. 8366-(86/136), adopted
August 15, 1986

b. Exchange System

Ecuador maintains an exchange restriction and a multiple currency practice as described in EBS/86/148 and Supplement 1. The Fund encourages Ecuador to remove these practices. In the meantime, the Fund approves the multiple currency practice until completion of the midterm review contemplated under paragraph 4(c) of the stand-by arrangement for Ecuador or December 31, 1986, whichever is earlier.

Decision No. 8367-(86/136), adopted
August 15, 1986

c. Purchase Transaction - Compensatory Financing Facility

1. The Fund has received a request by Ecuador for a purchase of SDR 39.7 million under the Decision on Compensatory Financing of Export Fluctuations (Executive Board Decision No. 6224-(79/135), adopted August 2, 1979, as amended).

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

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

Decision No. 8368-(86/136), adopted
August 15, 1986

APPROVED: April 30, 1987

LEO VAN HOUTVEN
Secretary