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UNITED STATES INTERNATIONAL DEVELOPMENT COOPERATION AGENCY
AGENCY FOR INTERNATIONAL DEVELOPMENT
Washington, D. C. 20523

ECUADOR

PROJECT PAPER

ECONOMIC STABILIZATION AND RECOVERY

AID/LAC/P-569

Project Number: 518-0078
Grant Number: 518-K-603

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CLASSIFICATION:

AGENCY FOR INTERNATIONAL DEVELOPMENT

PROGRAM ASSISTANCE APPROVAL DOCUMENT (PAAD)

1. PAAD Number
518-K-603

2. Country
ECUADOR

3. Category
Cash Transfer

4. Date
September 20, 1989

5. To
AAA/LAC: Frederick W. Schieck

6. OYB Change Number
N/A

7. From
LAC/DR: ~~Terrence J. Brown~~

8. OYB Increase

To be taken from: N/A

9. Approval Requested for Commitment of
$ 9,000,000

10. Appropriation Budget Plan Code
LES989-35518-KG31 72-119/01037

11. Type Funding
☐ Loan ☒ Grant

12. Local Currency Arrangement
☐ Informal ☒ Formal ☐ None

13. Estimated Delivery Period
FY 1989

14. Transaction Eligibility Date

15. Commodities Financed

N/A

16. Permitted Source	17. Estimated Source
U.S. only	U.S. $9,000,000
Limited F.W.	Industrialized Countries
Free World	Local
Cash $9,000,000	Other

18. Summary Description

The purpose of the ESF Program is to provide balance-of-payments assistance in support of the Government of Ecuador's (GOE's) economic stabilization and recovery program. The dollars provided will be used to finance imports of capital goods by the private export sector. The local currency proceeds of the Program will be jointly programmed by A.I.D. and the GOE in selected priority areas to support longer-term, broad based economic growth goals.

The $9.0 million grant will consist of a cash transfer to a separate Central Bank account to be disbursed in one tranche upon compliance with the conditions precedent as described in Section III.E. of the program assistance approval document. The GOE will deposit an equivalent amount in local currency into a special, interest-bearing account in the Central Bank.

"I certify that the methods of payment and audit plan are in compliance with the Payment Verification Policy."

LAC Controller

19. Clearances		Date
LAC/SAM:RQueener		9/20/89
GC/LAC:PBenoit	PBenoit	9/20/89
LAC/DP:BSchouten		9/21/89
PPC/EA:ECostello	Ed Costello	9/21/89
PPC/PB:TBarker		9/20/89
STATE/ARA/ECP:DMarshall		9/21/89
PFM/FM/A:RBonnaffon		

20. Action

☒ APPROVED ☐ DISAPPROVED

Authorized Signature: Frederick W. Schieck
Date: Sept. 25, 1989

Title: Frederick W. Schieck
Acting Assistant Administrator, LAC

AID 1120-1 (5-82)

CLASSIFICATION:

FY-1989 PAAD OUTLINE
ECUADOR

ECONOMIC STABILIZATION AND RECOVERY II PROGRAM
(Program No. 518-0078)

Facesheet

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I. SUMMARY AND CONCLUSIONS

The immediate challenge being faced by the Borja administration, which assumed office on August 10, 1988, is to stabilize an economy racked by unprecedented inflation, a large fiscal deficit, increasing debt arrears and negative foreign exchange reserves. This situation, coupled with stagnation in the non-petroleum sectors, has seriously affected incomes, productive employment opportunities and the extension of basic social services to the majority of Ecuador's population living at the margin. The incidence of poverty is substantial and the cost of stabilization and readjustment, at least during its initial stages, is falling heavily on disadvantaged segments of the population. Such circumstances heighten growing social unrest and undermine the country's ability to deter narcotics trafficking and the related corruption otherwise endemic to the Andean region.

The economic program adopted by the Borja administration projects only 1.0% GDP growth for 1989; however, it holds that slow growth is a necessary price in the short term if stabilization is to be achieved and a strong foundation for sustained growth established. While inflation appears to be coming under control, the fiscal deficit has been more than halved, the foreign exchange regime has been stabilized, and net foreign exchange reserves (excluding arrears) have become less negative, several factors impede a more aggressive stance toward stabilization measures. The breakdown of the fragile coalition at the executive-branch level between Borja's Izquierda Democratica party and the Democracia Popular, heightened labor and student unrest (especially in light of the Caracas rioting), and potentially damaging consequences of the unilateral Citibank action in May 1989 to cancel an $80 million line of credit to the GOE, all place presssure on an embattled economic team. This team of pragmatists has realized the need to gain acceptance for its economic program from the international community, especially the International Monetary Fund (IMF) and the World Bank (IBRD), if Ecuador is to obtain the external financing necessary for new investment and growth and to avoid stagflation.

The announcement on July 20 of a staged increase in domestic petroleum-product prices, a new $80 million loan from Citibank, presently being negotiated, and progress toward negotiations to reschedule the foreign commercial-bank debt have gone a long way towards successfully completing the government's efforts to put together an acceptable economic program. A letter of intent to the IMF, in which the GOE is seeking Fund support for its economic program, has been signed and accepted by the Fund's Management, and the Stand-by Agreement is expected to be approved in mid-September by the IMF Board. The base of political support for the GOE's program, however, is extremely thin.

While ESF financing in FY 1989 is very modest, the Economic Stabilization and Recovery (ESR II) program will provide needed moral support at a critical juncture, as well as financing for capital goods imports for the private export sector in order to facilitate new investments for expanded output and help meet the overall balance of payments financing gap. The local currencies to be provided by the GOE under the terms of the program will help respond to the critical economic and social development needs, especially for Ecuador's poor majority.

II. ECONOMIC SETTING

A. Background

Over its remaining three years in office, the Borja administration faces a severe financial crisis as well as a series of structural, institutional and political impediments to the achievement of broad-based, self-sustaining economic development. Despite Ecuador's strong growth over the past quarter-century (second only to Brazil among the major Latin American countries), due mainly to the oil boom of the 1970s, significant declines in per capita income have been registered in recent years. While real GDP per capita in 1987 exceeded its 1960 level by 76%, the 1980-87 period actually witnessed a decline of 11%. GDP per capita, expressed in constant 1987 U.S. dollars calculated at the 1987 national accounts exchange rate of S/.189.76 = US$1.00, increased from $546 in 1960 to $910 in 1975 and $1,081 in 1980. By 1985 it had declined to $1,040 and by 1987 to $960. Although GDP per capita rose by nearly 10% to $1,053 in 1988, as petroleum production recovered from the effects of the 1987 earthquake, it is likely to decline by about 2% in 1989.

Since the early 1980s, the employment situation has also deteriorated. New opportunities for employment slowed as the growth of petroleum revenues stopped, inflation accelerated, and overall economic growth decreased from an average annual rate of 9.0% during the 1970s to an average of 2.6% between 1980 and 1988. The high population growth rate (2.9% per annum) has thus outpaced economic growth during this decade. The combination of rural-to-urban migration and the increased participation of women and young people in the labor force will continue to place severe pressures for employment generation on Ecuador's urban economies in particular through the turn of the century.

While important efforts have been made in Ecuador to improve the coverage of social services, relatively large segments of the population are still totally or partially uncovered. The last reliable survey in the mid 1970s estimated that about 50% of the urban population and as much as 85% of the rural population fell below the threshold of relative poverty.* Anecdotal data indicate that this situation has not improved significantly, if at all, during the past decade. The recent period of high inflation probably has exacerbated the situation. At the same time, many poor urban families continue to live in communities without water, sewage disposal or electricity. In rural areas, only about 30% of the families have access to potable water and 40% to basic preventive and curative services for women and children. Ecuador's infant mortality rate is about seven times higher than in the United States (based on 1988 data published by the Population Reference Bureau). Malnourishment is common among infants, while more than two-thirds of rural children leave school by the end of the fourth grade.

* The threshold of relative poverty is defined as basic needs income. The degree to which people can afford an adequate diet and other basic necessities can be determined by comparing the level of income necessary to buy basic food and other basic needs (basic needs income).

It is now widely recognized that Ecuador's development strategy during the oil boom contributed directly to the problems of the 1980s by leaving the industrial and agricultural sectors in a poor position to adjust to the significant changes in the world economy during the past decade. Aspects of that strategy which impeded employment generation and structural adjustment include the following:

1) A good part of oil-generated revenues was used to increase public sector employment and consumption subsidies, including those for food and fuel, rather than being channeled into productive investments. Considerable infrastructure was created, but it has not generated direct or indirect output proportionate to its cost.

2) While sharply rising oil revenues enabled the nominal official exchange rate of S/.25.00 = $1.00 to be maintained during the 1970s without causing serious balance-of-payments problems, the real exchange rate appreciated significantly, creating disincentives for production of agricultural and industrial exports.

3) Industrial protectionism was used to foster import-substituting manufacturing for the domestic market. Policies that protected inefficient manufacturing industries oriented to the domestic market have also limited the growth of agriculture and export-oriented manufacturing production. Since other policies encouraged the substitution of imported capital goods for labor, employment generation has suffered.

4) Financial market policies, including controlled low interest rates and selective credit allocations, reduced the cost of capital, encouraged capital-intensive production, and lowered domestic savings generation.

5) Minimum-wage and other labor-protection policies benefitted workers with formal-sector jobs but discouraged job creation, especially for young and unskilled workers and women.

6) Government regulations and restrictions inhibited the development of new exports and impeded growth along a path that would continually shift employment to production activities with higher levels of worker productivity.

The foreign debt was expanded, and borrowing while the <u>sucre</u> was overvalued in real effective terms meant particularly heavy future debt service obligations. Also, public sector finances were allowed to become overly dependent on petroleum. As long as the price of petroleum remained above $25/barrel, the problems were manageable; but at current prices oil revenues are insufficient to sustain all the programs developed in the 1970s without recourse to internal and external borrowing. Each one-dollar drop in the price of a barrel of oil represents a decline of about 0.6% of GDP in public sector revenues, and the prospects for improvements in the oil sector are not good. In the absence of significant new discoveries, Ecuador is expected to become a net importer of oil products by the turn of the century.

While Ecuador's low GDP growth rate in the 1980s has been due primarily to exogenous external and internal events, the ability of the agricultural and industrial sectors to respond to the crisis of the 1980s has also been limited by economic policies beginning in the 1960s which favored import substituting industrialization. These policies helped hold the agricultural sector growth rate to 3.3% in the 1970s, significantly below its potential, especially given the rapid rise in incomes during this decade. Although the average annual sector growth rate in the 1980s has risen to 4.9% -- partly because of a dramatic increase in shrimp production and partly because of improved policies over the last four years -- Ecuador's abundant agricultural resources are not being fully utilized. Yields are low relative to those achieved by neighboring countries, and also to experimental results in Ecuador. Low wages and incomes in rural areas reflect the low productivity of labor in agriculture. Except for shrimp, no major new agricultural sector export has been developed in the last few decades, in part because of exchange-rate and other economic policies and in part because little attention has been given to removing institutional barriers to exporting.

Ill-conceived policies have also left the manufacturing sector unable to adjust well to the changed international economic environment. Although the sector's average growth rate of 0.6% a year during the years 1982-88 can be explained largely by the slow overall growth of the economy (and thus the slow growth of demand for manufactured products), the high cost structure of the Ecuadorian manufacturing sector has prevented firms from shifting their production to external markets.

As the Borja administration took office, Ecuador's economy faced a state of near-crisis, precipitated by a series of setbacks in 1986 and 1987 which were largely of an exogenous nature (a 50% drop in world oil prices in 1986 and the March 1987 earthquakes). However, a principal contributing factor to the 1988 situation was an irresponsible fiscal policy adopted in the last year of the Leon Febres Cordero administration (1984-88). Rapid monetary growth to finance a large fiscal deficit became the primary source of the accelerating inflation during the first half of 1988 and also an important factor in the rapid depreciation of the <u>sucre</u>. The inflation rate (63% for the year ended August 31, 1988 -- very high by historical standards) was accelerating, and the value of the <u>sucre</u> in the free foreign exchange market was falling (the <u>sucre</u> lost more than half its value during the first six months of 1988). Political uncertainties related to the presidential elections had contributed to increased capital flight, and negotiations to reschedule Ecuador's debt to international commercial banks had been suspended by the Febres Cordero government. Excessive government spending and failure to keep prices of products and services supplied by the government (especially energy prices) at realistic levels led to a situation which the IMF estimated would result in a fiscal deficit of more than 10% of GDP.

Real GDP declined by 5.5% in 1987, mainly due to the 54% decline in crude petroleum output resulting from the March 1987 earthquakes, which caused a six-month rupture of the trans-Andean oil pipeline.* The decline of oil

* Despite this 6-month rupture, balance-of-payments data show a decline in the value of petroleum exports of only about 17%. This is due to (1) an increase in the average price of crude exports, from $12.80 in 1986 to $16.30 in 1987, and (2) Ecuador's "borrowing" of $253 million of petroleum and derivatives from Venezuela and Nigeria, of which nearly half was reexported.

exports in 1987, together with a 25% increase in imports (in part to offset petroleum losses), led to a negative merchandise trade balance for the first time since 1978. The overall balance-of-payments deficit of $976 million was financed largely ($900 million) by arrearages on debt-service payments.

In 1988 the GDP grew by an estimated 12.8%, as petroleum exports flowed for the entire year and the mining/petroleum sector expanded by 138% from the earthquake-influenced levels of 1987. Other sectors, however, experienced low or negative growth, with the exception of agriculture, which grew at a satisfactory rate of 4.2%.

Total exports in 1988 amounted to $2,203 million, a modest 9% above the 1987 level of $2,021 million. About 87% of the increase was accounted for by crude petroleum and petroleum derivatives. Despite an increase of 52% in the volume of crude petroleum exports, their total value rose by only $137 million because of a 22% decline in the price per barrel. Non-petroleum exports grew by only $23 million, or 2%.

A significant decline in imports, from $2,054 million to $1,614 million, also contributed to a reduction of the trade and current account imbalances in 1988. More than 70% of this decline was accounted for by a sharp drop in the imports of crude petroleum and petroleum derivatives, which were abnormally high in 1987 (including crude and derivatives borrowed from Venezuela and Nigeria) because of the rupture of the pipeline. The decline in other imports partly reflects the aftermath of speculative stockpiling in 1987 and partly is the result of quantitative restrictions on capital goods imports imposed by the incoming Borja administration. Specifically, until recently imports of capital goods could be financed only by external credits and imports of automobiles were prohibited.

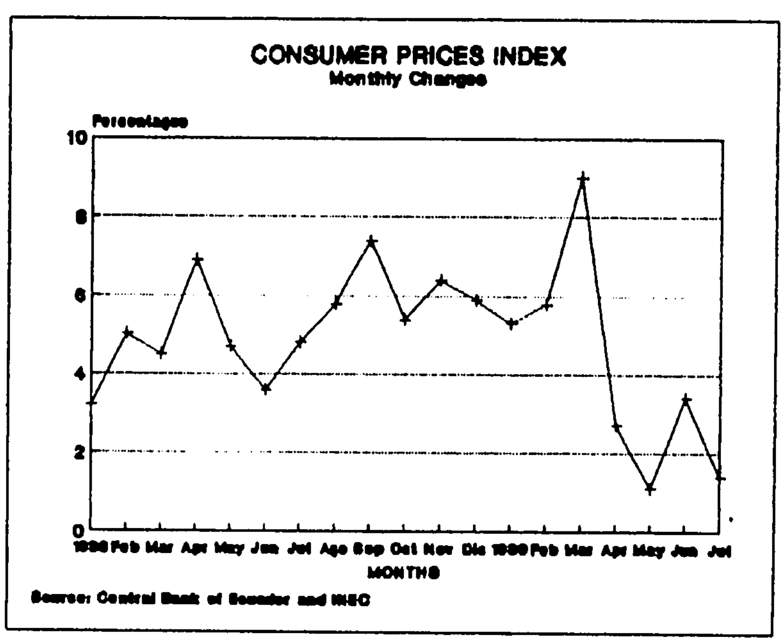
The current account deficit of $597 million was partially financed by net capital inflows of $257 million (an improvement of $102 million over 1987). Of the remaining deficit of $340 million, $315 million was accounted for by an additional accumulation of external arrears.

B. The GOE Economic Stabilization Program

The CDSS's analysis of the environment for development in Ecuador noted that the Borja administration faced both a severe financial crisis over its four-year term as well as structural impediments to broad-based, self-sustaining economic development. The immediate challenge faced by the Borja administration was to stabilize an economy racked by unprecedented inflation, a large fiscal deficit, increasing external debt arrears and negative net foreign exchange reserves. This situation, coupled with modest economic growth in 1988 apart from petroleum and agriculture, and very little overall growth in 1989, has seriously affected incomes, employment opportunities and basic social services for the majority of Ecuador's population living at the margin.

Summary of Measures to Date. To arrest the economic crisis, the new Borja administration adopted on August 30, 1988 a package of emergency economic stabilization measures, including an initial sharp devaluation of the "intervention" exchange rate from S/.249 to the dollar to S/.390 (used for most transactions, including private trade, petroleum export revenues, profit remittances and capital repatriation); further devaluations of S/.2.50 per week through a crawling-peg system; and a devaluation of the official exchange rate (used only for Central Bank accounting purposes) from S/.95 to S/.390. Another key measure adopted at that time was a significant reduction in gasoline and utility subsidies, as the price of gasoline was doubled (to about $0.34 a gallon for the most widely sold grade) and electricity tariffs were increased by 30%. Subsequent measures led to the elimination or significant reduction of wheat, rice, and sugar subsidies. More recently, in April and May of this year, the Monetary Board approved key reforms affecting the foreign exchange rate, interest rates and import controls, as detailed below. A concerted effort to reduce the fiscal deficit through revenue-enhancing measures, as well as by spending reduction, is under way. Further increases in the prices of domestic petroleum products were implemented in July. The commitment to no new Central Bank credit to the public sector is holding firm, with the exception of increased credit to the Banco Nacional de Fomento for the purpose of stimulating agricultural production. Consequently, a continued reduction in the fiscal deficit is taking place. The measures adopted by the Borja administration by late 1988 allowed AID to disburse in December 1988 $6.5 million in FY 1987 funds which had been held up because of deteriorating policy performance under the previous administration.

Inflation. The Borja administration has targeted inflation as public enemy number one. While the roots of the current inflation can be traced to exogenous setbacks in 1986 and 1987 (low world oil prices and the March 1987 earthquakes), another principal factor was an irresponsible fiscal policy adopted in the last year of the previous administration. Rapid monetary growth to finance the fiscal deficit became the primary source of the accelerating inflation, and some observers maintain that inflationary expectations further fueled price increases. The GOE's inflation target was



initially defined as the achievement of a 30% annual inflation rate by the end of the year. Presumably, this meant a 30% increase from December 1988 to December 1989. It soon became evident that this target was unrealistic, and it was revised to 50%. Dramatic declines in the monthly inflation rate to 2.7% in April and 1.1% in May (see Table III) indicate that the new target may indeed be within reach. Even with inflation rising to 3.4% in June, the average monthly inflation rate for the April-June quarter was down to 2.4%. The inflation rate for July declined to 1.4%.

The December-December target of 50% can be reached if this average rate is maintained for the rest of the year. Although current Central Bank projections show the December-December figure to be 59% at best (See Table III), this would still represent significant progress.

Monetary Policy. The current tight-money policy constitutes the centerpiece of the anti-inflation fight. Money supply (M1) is expected to grow by 37.2% between December 1988 and December 1989, whereas inflation is estimated to be 50% for the same period, (this represents a substantial improvement from the 99% inflation registered for the period March 88/March 1989). Additionally, current Central Bank estimates for 1989 indicate a ceiling of 208.3 billion sucres for net domestic assets which, compared to 1988 levels, represents an increase of 0.8% in nominal terms. In real terms, for the same period, the change for this variable is represented by a contraction of 32.8%. As to the net credit of the Central Bank to the non-financial public sector, estimates for 1989 indicate a level of 128.4 billion sucres, higher by 55.9%, in nominal terms, than the December 1988 level; in real terms the change for this variable between 1988 and 1989 is expected to be 3.9%.

The growth of the money supply, which in December and January averaged 59% over the preceding 12 months, was down to 40% over the 12 months ending in June 1989 (see Table II). While monetary growth needs to be controlled, and the GOE's strict adherence to the August 30 program has been applauded by most international observers, there is a danger of stagflation unless significant external resources (including debt rescheduling and/or debt write-downs) are made available. World Bank and International Monetary Fund (IMF) support in the short term is essential. The release of the remaining $50 million from a World Bank financial sector loan, and Japanese co-financing of $100 million ($50 million of which would be available by the end of 1989), conditioned on a sound macroeconomic policy and structural reforms, would enable the GOE to expand credit soon in real terms and keep the economy growing, albeit at a rather modest rate, while still making progress in reducing the rate of inflation. The World Bank funds and the Japanese co-financing resources are expected to be disbursed in 1989. IMF support, based on substantial progress in dealing with Ecuador's internal and external financial imbalances, will also facilitate achievement of the targets of the GOE's program. Based on the signing of the letter of intent, a stand-by arrangement for about $140 million is anticipated to be finalized by mid-September.

Interest Rates. On April 20, 1989, the Monetary Board changed the mechanism used to regulate private bank lending rates. The reference base is now the average of rates paid for 90-day certificates of deposit and for passbook savings accounts. (Until then the reference base was limited to the average rate for passbook accounts). The margin above that base (limiting the allowable lending rate) has been reduced to 15 points from the previous 19. Still the change in the reference base for deposit rates has enabled short-term lending rates to rise from an average of 46.2% to an average of the banking system of 49.32% by July 21, 1989. In a separate move, the Board raised lending rates for official credits (mainly to farmers) from 23% to 32% -- causing a predictable outcry but reducing the effective subsidy and meeting a key condition for disbursement of the IBRD financial sector loan. Also, to meet IBRD Financial Sector loan conditionality, all IFI (IBRD, IDB, CAF and AID) lending for credit to the agribusiness and medium- and large-scale enterprises will now be at market interest rates (currently around 50%), and adjustable interest rates will apply to loans of 360 days or longer. The aim of these measures according to the Monetary Board is "to encourage financial savings geared to productive activities; render credit operations more flexible; avoid rerouting of credit destined for agriculture; incorporate financial companies to the present interest rate system; and rebuild the capital stock of the Banco Nacional de Fomento (BNF)."

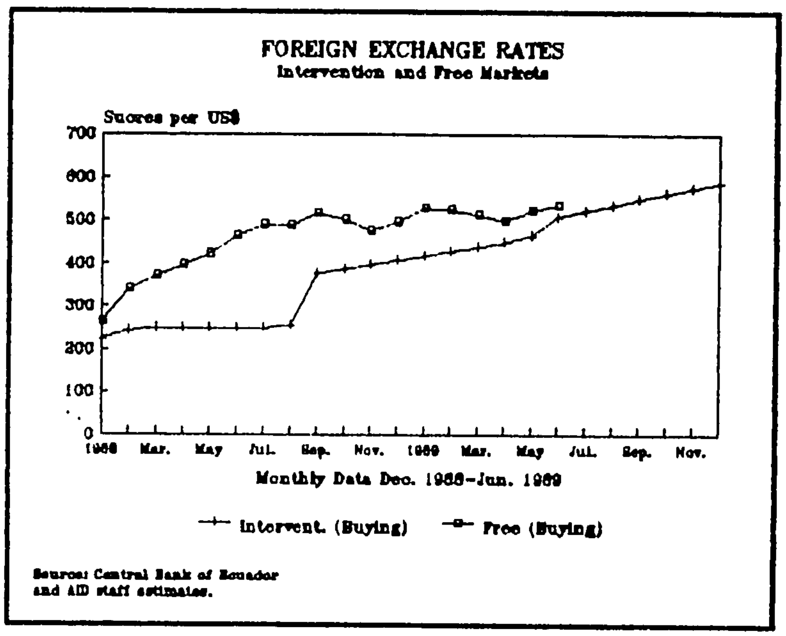
While interest rates have been negative in real terms in recent months if compared with inflation over the previous 12 months, real short-term rates are actually positive if compared with inflation during the second quarter of 1989. However, the 33% annual rate for April-June reflects in part some seasonally low price trends. Still, clear progress is being made in reducing inflation, and current short-term market rates are in line with expected inflation rates through the end of CY 1989. Savings have declined in real terms, having peaked in the last quarter of 1987, but they have not fallen as much as might have been expected, given the negative real return of recent months. Possible explanations for this situation include: 1) the fact that savings in U.S. dollars have been relatively less attractive over the past year given the relatively stable exchange rate; 2) the attraction of savers to high nominal rates in a country not used to steep inflation; and 3) the expectation that Ecuador's traditionally conservative monetary policy would reassert itself and significantly reduce the rate of inflation.

On the other hand, no clear rationale exists for why interest rates have not risen over the past year to positive real levels, despite a reasonably competitive banking system. Among the possible explanations are the following: 1) demand is depressed due to the economic recession; 2) exchange rate stability and hard currency availability through the Central Bank have kept importers' cost increases below inflation; 3) borrowers are not used to high nominal rates and thus do not request credit; 4) bankers are reluctant to compete through rate hikes because they do not want to be blamed for fueling inflation; 5) government-imposed limits on the spread reduce the attractiveness of an interest rate hike; 6) some bankers/borrowers expect a substantial reduction of inflation over the next 12 months, so current rates are close to anticipated inflation; and 7) bankers can substitute increased fees and commissions for higher interest rates.

<u>Exchange Rate</u>. Despite the improvement of $220 million in net official foreign exchange reserves (excluding additions to arrears on external payments obligations) achieved by the Borja administration in its first six months in office, and its plan to eliminate the remaining $110 million in negative reserves (Central Bank definition) by the end of 1989, the World Bank had been seeking a further adjustment in the intervention exchange rate prior to

disbursing key sector loan resources. The government addressed the exchange rate issue by devaluing the intervention rate and by reducing the spread between the buying and selling rates from 10% to 5% on May 15 (the effective date for these measures). The rate for exporters thus moved, beginning on May 23, from S/.458 to S/.497, giving them 8.5% more sucres per dollar, while the rate paid by importers rose from S/.506 to S/.521, an increase of 3.0%. The rate of mini-devaluations was increased from S/.2.50 to S/.3.00 per week, a rate of depreciation of the sucre that remains somewhat slower than the rate of inflation expected by most observers for the balance of 1989. The official exchange rate, used only for Central Bank purposes, was set at S/.497. In addition, the GOE lifted the requirement for external financing of capital goods with an estimated annual value of $40 million, and removed prohibitions on imports amounting to about $35 million annually.

The government appears to have shied away from a larger devaluation and/or a greater weekly adjustment in the exchange rate for fear of adding to inflationary pressures. Its strategy can be defended so long as it takes additional measures -- particularly fiscal actions -- to further stem inflationary pressures. Some observers believe that the sucre is still overvalued by 10-15% in terms of export competitiveness and clearly, any significant further devaluation would enhance Ecuador's competitiveness. However, an examination of real effective exchange rate trends suggests that the sucre may not in fact be overvalued, and other considerations suggest that institutional obstacles to exporting (including excessive paperwork requirements) may be doing more to discourage new exports than the exchange rate. As the chart below shows, the gap between the intervention and free market rates has been closing in 1989, though in May there was a small widening of the gap due to an increase in the free market rate, which could be attributed to the May 15 devaluation. To date, control of inflation has contributed to exchange rate stability and will continue to be a key factor in achieving a greater level of competitiveness for Ecuadorian exports.



Fiscal Policy. Government fiscal policy is an essential component of the fight against inflation. Improvements in both revenue collection and expenditure control in the latter part of 1988 enabled the Borja administration to reduce the deficit of the nonfinancial public sector from a projected 10.3% of GDP to 5.1%. The deficit in 1989 is projected to be 3.4% of GDP, with the improvement due to higher revenues from domestic petroleum products (see below), improved tax administration, and continued expenditure restraint.

There are three broad areas in which additional measures can be taken to improve the fiscal situation: taxation and other central government revenues; a further reduction or elimination of subsidies; and expenditure reductions, particularly through improved efficiency. The following paragraphs discuss possibilities in each of these areas.

Central Government Revenues. Real non-oil revenues per capita in Ecuador actually fell between 1973 and 1986 by about 23%, while real per capita incomes rose by 21%. If nonoil taxes were 50% higher and petroleum consumption subsidies eliminated, Ecuadorians would still be left with average after-tax per capita incomes that had more than kept pace with growth of GDP over 1973-86. Income tax collected (excluding that paid by oil companies) was only 3% of GDP in 1984, compared with a theoretically possible yield of 10-13%. In December 1988, the GOE introduced a tax reform package which (1) broadened the tax base; (2) improved tax collection through a series of administrative reforms (including conversion from a manual to a totally computerized system); and (3) tightened controls on tax evasion. A more far-reaching reform package will be presented to Congress in October and will propose a significant reduction in the highest marginal income tax rate (currently 69%). At the same time, an effort will be made to make the income tax progressive in practice and not just in principle. These reforms are expected to increase income tax collections from 5.4% of GDP in 1988 to 6.0% in 1989.

Subsidies. The most important implicit subsidy in the Ecuadorian economy (as much as 10% of GDP at current prices before the July 20 increases) is that for petroleum. Although most petroleum products are sold domestically at or above cost, there is a subsidy because domestic prices are below world market prices. The Borja administration took a major step to reduce this subsidy by doubling the price of gasoline on August 30, 1988. Still, the subsidy was far from eliminated.

On July 20, the prices of petroleum products were raised again, and further monthly increases were scheduled through December. For the most frequently sold grade of gasoline, the total increase through December will be 50%, while for diesel fuel the increases will total 92%. For kerosense, the principal cooking fuel of the urban poor, prices were increased by 33% in July but no further increases were scheduled. By December, the dollar price of the most frequently sold grade of gasoline will be about $0.44 per gallon, assuming a continuation of present exchange-rate trends. While a substantial subsidy on petroleum products remains, the government felt politically unable to raise prices any higher. Apart from the negative public reaction such measures tend to bring, the government feared that sharper price increases would compromise its inflation target. Nevertheless, the new measures will reduce the 1989 fiscal deficit by an estimated 0.7% of GDP, and the IMF technical staff has found petroleum product price increases not significant but still acceptable in the context of an overall fiscal program to reduce the deficit of the nonfinancial public sector in 1989 to 3.4% of GDP. Both the Embassy and USAID are, nonetheless, disappointed in the low rate of increase and will strongly encourage the GOE to make stronger adjustments in coming years.

In addition to the price of petroleum products, there are numerous other subsidies intended to help the poor; they simultaneously (and mostly) benefit those who do not need them. Included are price subsidies for water, medicines, and a few basic food items. Reduction and, in at least some cases, eventual removal of these subsidies will increase fiscal revenues, lower government expenditures, curtail inflationary pressures, diminish or eliminate distortions in the economy, and increase incentives for production. While the GOE took a major step in the right direction by eliminating wheat subsidies in November, and has now done the same for rice, direct subsidies are still provided to barley and sugar, among others (although the sugar subsidy was reduced on March 14). Huge investments in irrigation projects also are heavily subsidized by the state, and many of these investments are relatively unproductive, with evidence of very low or even negative rates of return on investment. The modest benefits that do result accrue to a relatively limited number of mainly well-to-do farmers.

Public Sector Efficiency. The public sector deficit could be further reduced in the short run by cutting back or eliminating certain low-priority expenditures. The credibility of the anti-inflation program would be greatly enhanced, moreover, if the GOE undertook a major program to improve public sector efficiency over the long run. The bureaucracy is too big and public sector productivity is very low. Most state enterprises (CEPE, INECEL, INERHI, ENAC, ENPROVIT, FERTISA, CEDEGE, etc.) require large, recurring subsidies. There is evidence that the government can neither fully account for nor control expenditures by these enterprises. This suggests waste and inefficiency, vested interests, and opportunities for cutting unproductive expenditures. A thorough review of public enterprises, followed by a program of action to improve efficiency, is needed.

Growth Stimulation. While short-term stabilization is clearly the GOE's top priority, anti-inflation policies will choke off investment and growth if they are not supplemented by structural reforms and the external resources needed to implement them. The low official projection for the overall GDP growth rate in 1989 of 1.0% is a cause for concern, although it is doubtful that a higher growth rate would be consistent with the GOE's economic program for 1989 in the absence of favorable exogenous events.

For the medium term, Ecuador must look beyond the stabilization process and begin now to respond to fundamental development problems in macroeconomic as well as sector policy formulation so as to stimulate self-sustaining growth and greater employment opportunities. There are basic structural problems in the economy associated with 30 years of import-substitution industrialization. In essence, industry, services and the government sectors have been subsidized at the expense of agriculture. The total economic pie is smaller than it would have been with market-oriented policies. Moreover, development policy still is largely internally-focused.

A substantial reduction or removal of trade barriers, movement toward market prices, and unification of the exchange rates and its periodic adjustment to maintain external competitiveness will help considerably in encouraging investment and production. A more flexible labor market would also facilitate growth. Current labor laws, and the interpretation given to them, benefit those who currently hold jobs but strongly discourage firms from adding to their labor force, especially when overall economic conditions are poor and prospects for economic recovery are uncertain. Suitable policy changes will result in painful adjustments for inefficient parts of the economy, but will lay the foundation for much more rapid economic growth in the 1990s and beyond.

C. Prospects for the Balance of Payments in 1989 and Policy Dialogue with AID and International Organizations

The outlook for the balance of payments in 1989 has been clouded by uncertainties relating to a number of key items, including exports, imports, prospects for assistance from the IMF and the World Bank, and the terms of an agreement (if any) between the GOE and its commercial bank creditors. The balance-of-payments projection for 1989 presented in Table IV is based on the following key assumptions:

-- Commodity export earnings will be $2,333 million, an increase of 5.9% over 1988.

-- The value of imports will be $1,680 million, an increase of 4.1%.

-- A stand-by agreement with the IMF will be concluded for a period of 18 months beginning on September 15. The total amount of the stand-by will be approximately $140 million, of which $40 million will be drawn during 1989. Approximately 25% of the total will be reserved for support of a debt-rescheduling agreement with commercial banks within the Brady initiative framework.

-- The remaining $50 million tranche of the World Bank Financial Sector loan, plus $50 million (half) of the Japanese co-financing, will be disbursed during the remainder of 1989. As described below, most of the specific conditionality for this loan has already been met. However, a major condition still pending is the adoption by the GOE of an adequate macroeconomic program that is consistent with the Financial Sector loan. A major Industrial/Export Sector loan is being developed but will most likely not initiate disbursements this year. Total IBRD disbursements, including those for the Financial Sector loan, are expected to be $114 million in 1989. GOE amortization and interest payments, however, will total $110 million.

-- An agreement with commercial banks is expected to be reached this year. We assume that the decline in amortization payments shown in the balance of payments for 1989, reflects the effects of external debt rescheduling.

The following paragraphs look at each of these in more detail and examine the conditionality associated with the major resource flows.

Exports. Exports (FOB) in the first 5 months of 1989 showed a 4% drop to $950 million as compared with the same period last year. While the GOE projects a 15% increase in non-oil exports for 1989, non-oil sales dipped 9% to $485 million for the first 5 months due mainly to declines in shrimp and fishmeal exports. During the first quarter, oil output was 8.3% less than for the same period in 1988 (286,449 bpd); however, the export price was up 24% to $16.90/barrel.

Together with petroleum, five commodities (bananas, coffee, shrimp, cacao and fish) make up about 95% of all exports. Of these, only bananas (barely) and coffee experienced increases during the first 5 months of 1989 compared with the same period in 1988. Banana export sales, at $129 million, were up by less than 1%, but coffee sales rose 42% to $63 million. Still, coffee exports are well below the average of recent years and the recent collapse of the International Coffee Agreement has resulted in a sharp price decline. Shrimp exports plummeted 23% due to the lack of larvae supply, falling prices due to increased competition from the Chinese, and increased local costs. Exports of cacao beans declined by 20%. Export performance will have to improve significantly in the rest of the year for the target annual increase of 5.9% to be met. The recent fall in coffee prices is a serious blow, although this might be offset to some extent by sales of stocks. The target for petroleum exports (see Table V) could be exceeded if prices continue to average more than what is assumed in the balance-of-payments projection.

Imports. Imports expanded by 19% to $705 million during the first 5 months of 1989, perhaps reflecting restocking (especially of raw materials) after a significant decline in imports in 1988. Import growth could well slow significantly in the rest of the year, reflecting the relatively flat trend of economic growth, but they may not slow enough to meet the target annual growth rate of only 4%.

In summary, the projected trade balance for 1989 appears somewhat optimistic. Achieving it will require some luck on export prices and volumes and possibly tighter credit restrictions to restrain import growth.

World Bank. In addition to the April 20 interest rate measures described above, the GOE has taken a series of additional measures in recent months designed to meet IBRD conditionality for its Financial Sector loan. Listed below are a number of key conditions and the measures which have been taken to address them. The IBRD recommended that:

1. Cash dividends to shareholders be reduced so as to increase bad loan reserves. In response, the GOE empowered the Superintendent of Banks to bar a bank from distributing profits when it has not set aside adequate reserves to cover risks (Resolution 88-146, dated December 7, 1988).

2. Adequate debt/equity ratios be established. The GOE has introduced several reforms designed to encourage increased equity positions. For example, a) the surplus from asset reappraisal may be converted into capital stock only if the amount converted is matched with fresh subscribed capital; b) new branch office openings will be approved only if minimum equity standards are met; and c) ceilings were established for overdraft/equity-legal reserve and risk assets/equity-legal reserve ratios.

3. Insider lending limits be established. The Superintendent of Banks was given the responsibility for supervising bank holding companies or other groups possessing 20% or more of the shares in a financial institution. Conflict of interest rules now apply to borrowers who comprise more than 20% of lenders' stock, as opposed to 50% previously.

4. Independent, external auditors should be contracted to supervise portfolios and submit their findings to the Superintendent of Banks. Audit regulations have been issued and audits have been made mandatory for all credit institutions. The Superintendent of Banks is empowered to require that a bank change its external auditors.

5. A rehabilitation process should be initiated for those banking institutions which do not meet adequate equity and liquidity levels. In response, the Monetary Board may now deny access to Central Bank operations for any institution which refuses to undertake a stabilization program. Other legal reforms also enhanced the Superintendent of Banks' leverage, leading to the liquidation of one bank and three financial companies in recent months.

6. The Superintendent of Banks should improve its capacity to undertake credit risk policy evaluations. Regulations have been revised to enhance the Superintendent of Banks' power to review risk assets and bad loan provisions.

7. A deposit insurance instrument should be proposed. The GOE has made little progress on this point.

8. The Central Bank should reduce credit to the private sector by 25% with respect to December 31, 1986 levels (adjusted for inflation). By the time the Borja administration took office, real credit to the private sector had been reduced by 26.4%. The present monetary authorities, through their tight credit policies, have reduced real credit levels to the private sector (as for June 30, 1989) by 49.4% with respect to the 1986 year-end totals.

9. The lowest Central Bank interest rate for its credit programs should be several points lower than the rate for certificates of deposit. The lowest Central Bank interest rate is 20% for government lending whereas the 30-day CD rate is 37%. The Central Bank has, however, restricted the amount of its lending at subsidized rates, which now constitute no more that 25% of total credits.

10. Public sector securities should be sold through an auction mechanism. The Central Bank was authorized on April 21 to sell stabilization bonds through auctions or through the stock exchange, but it may also make direct sales. According to Central Bank information, the auction mechanism is not likely to be implemented this year.

11. Not more than half of total stabilization loans (derived from the Central Bank's assumption of the private foreign debt) should be refinanced, and the interest rate should be equal to that for certificates of deposit. The Borja government has prohibited such refinancing and automatically debits the accounts of banks when <u>sucretization</u> loans come due.

12. Credits financed through IFI loans must be at an interest rate equal to or higher than that for certificates of deposit. The initial rate for IDB, IBRD, CAF and AID loans for agribusiness and medium- and large-scale industry is to be the top rate allowed by the banking system.

13. No interest rate ceilings should be applied to adjustable-rate loans. Legislation has been approved which permits adjustable interest rates. The Monetary Board will determine which credit lines may apply adjustable rates and the terms for such lending. The Monetary Board has since allowed financial institutions to contract readjustable rates for long-term lending operations, and all lending of one year or longer (not financed with the issue of fixed-rate securities) must be at fluctuating rates.

Commercial Banks. The Borja administration has been moving slowly but steadily toward completing negotiations with the foreign commercial banks concerning resumption of partial service on its $6.5 billion debt. These negotiations had led to acceptance by the bank steering committee of procedures for partial resumption of regular debt service payments pending formal renegotiation of the debt. However, on May 5 (and before debt service was actually resumed), Citibank unilaterally debited $81 million in principal and interest from a bilateral 90-day revolving trade-credit account, using GOE resources on deposit which included $33 million earmarked for the resumption of debt service to all commercial bank creditors. Despite this setback, even while continuing negotiations with Citibank, the GOE has communicated its continued commitment to addressing its debt service obligations to foreign commercial banks. A $16 million interest payment was made in early July. The GOE has announced its intention to continue such payments even while debt negotiations continue. Further, the just signed Letter of Intent commits the GOE to not incure additional arrears. The GOE and Citibank are presently negotiating a new loan of $80 million, and the agreement is expected to be signed imminently. The GOE met with the commercial banks' steering committee in early August to describe its economic program for 1989 and 1990 and indicated its capacity to make payments under an envisioned debt restructuring agreement under the framework of the Brady initiative.

AID Policy Dialogue. As outlined in the FY 1990-1994 CDSS, helping the GOE move toward a proper set of policies is the central focus of the Mission's strategy. The Mission is in a unique position within the donor community in that its significant in-country presence allows a greater sense of partnership to develop. Relying less on large sums of ESF resources and the "leverage" such funds may offer, USAID's programs and influence at the sector level have opened many doors and served to deepen the dialogue independent of the ideological plane.

The Borja administration is clearly preocuppied with short-term stabilization measures to control inflation and the fiscal deficit, on the one hand, and with social programs directed at minimizing the consequences of adjustment on the more disadvantaged segments of the population and fulfilling the GOE's political agenda, on the other. USAID's strategy is supportive of this dual approach, but it also recognizes the more basic need for, and places great emphasis on, structural reform leading to self-sustaining economic growth and a more equitable distribution of the benefits of growth.

USAID's macroeconomic policy reform strategy addresses both the stabilization and the structural reform goals included in the CDSS (see policy dialogue matrix in Annex F). The Mission is optimistic that economic stabilization is attainable over the short term, i.e., by the end of CY 1990. While stabilization is a necessary prerequisite for longer-term, broad-based growth, basic structural reforms must be made as well. As discussed below, several of these structural reforms will require further analysis, dialogue and consensus-building before adoption is likely. Thus, the Mission strategy for FY 1989 has been to pursue policy dialogue and conditionality principally on those policy measures necessary for achieving stabilization. Thus our discussions leading up to FY 1989 ESF assistance has focussed on support for immediate and pressing measures in order to bring the fiscal deficit and inflation under control. Adoption of a foreign-exchange regime conducive to an outward-oriented investment strategy is the single growth-oriented structural reform to be targeted by the Mission in the context of the FY 1989 ESF program. In FY 1990, the Mission will incorporate certain other key elements relating to structural reform in its ESF conditionality for that year, including steps conducive to privatization; however, the principal focus will continue to be on short-term stabilization through the end of CY 1990. Our current projections show that the GOE's stabilization program is basically on track, with significant reductions predicted for both inflation and the fiscal deficit if the thrust of its August 1988 and subsequent measures can be maintained.

The Mission's strategy must also take into account current Ecuadorian political reality and the need to support the Borja government's pragmatic team of top economic advisors. The economic team (composed of the Ministers of Finance, Industry, Energy, and Agriculture; the Managers of the Central Bank and the National Development Bank; and the President of the Monetary Board), with responsibility for defining and implementing economic policy, is perceived as a highly competent, prestigious group. This team includes a mix of political leanings and non-insiders from the President's Izquierda Democratica (ID), Democracia Popular (DP) (until recently) and independents. While the group has high legitimacy with the political center and with international donors and actors, those farther to the left are less sanguine about policies instigated by the economic team which do little toward short-run improvement of the living standards of the working and less privileged classes. At the same time, privileged groups on the right will oppose policies designed to reduce their traditional subsidies. During the week of January 14, 1989, the economic team was called before the ID/DP-dominated Congress to justify its actions regarding price hikes of essential goods promulgated at the end of December 1988. Some political observers regard the economic team as disposable should the economic measures designed by it not bear the appropriate fruit. Further, the continued presence of non-ID elements on the economic team makes Borja vulnerable to his constituents on the left.

As examples, for two key areas requiring policy reform the Borja economic team is holding the line against serious opposition. With respect to price controls and subsidies, Borja's party is ideologically committed to price fixing, just as Febres Cordero presumably was to price freedom. Paradoxically, the Borja government has proceeded to authorize price increases where its predecessor maintained them fixed at below cost. Congress, public opinion and many business leaders all support price controls. The need to reduce the fiscal deficit has required domestic price hikes for petroleum products and will require subsequent price hikes (already programmed through December) which may likely lead to more debilitating labor and student unrest.

With respect to the need to abandon its import-substitution development model, a recent survey carried out among legislators found that 87% of them believe that exports should be submitted to more strict controls; 9% found present controls adequate and 5% found them excessive. Clearly there is no national consensus on the need for an export-oriented growth policy. This notwithstanding, key policy-makers are indeed committed to this policy direction as evidenced by the GOE's announcement of a major export promotion initiative.

The Borja administration came into office at a time when inflation was accelerating to unprecedented rates and the fiscal deficit was headed for double digits as a percentage of GDP when it could have been brought down to the low single digits. The new administration recognized the need to undertake stabilization measures, but the lack of an outright ID majority in the legislature and sharp divisions within ID itself required a delicate balancing act for the government to move forward with economic reform measures. While the administration has rejected a "shock treatment" approach, presumably because its base of support is insufficiently broad, it needs to continue making strong, steady progress in policy reforms; Costa Rica in 1982-83 provides a good example of how much can be accomplished under such an approach. Half-hearted mesures will not succeed, as Argentina (under its previous government) most recently has demonstrated. While strong measures carry political risks, weak measures are almost guaranteed to cause political turmoil.

In recognition of this difficult political situation and the necessity of maintaining continuity in the GOE's economic decision-making process, USAID and the Embassy strongly believe that support for the current economic team is warranted and essential to keep the GOE's stabilization program on track until needed IBRD and IMF resources are made available.

The FY 1989 ESF Program is being conditioned upon the adoption by the GOE of an economic program which is credible by international standards. At this time, that program essentially has been completed. Specific targets of the GOE's 1989 program include (1) a reduction in the deficit of the consolidated non-financial public sector to 3.4% of GDP; (2) the reduction of US$100 million in the negative net international reserves; (3) a sublimit of S/.128.4 million sucres on Central Bank credit to the non-financial public sector; (4) no increase in real terms in the public sector payroll; and (5) the maintenance of a foreign exchange regime which encourages exports. Measures affecting international reserves, the Central Bank's credit allocation, the public sector payroll, the fiscal deficit, and the foreign exchange regime are in place and deemed acceptable. Covenants regarding the maintenance of these targets will be incorporated in the ESF Program Agreement.

As part of its ongoing policy dialogue, USAID will urge the GOE to monitor carefully the trade balance and other key assumptions regarding foreign exchange inflows and outflows. If the balance of payments comes under more pressure than expected, the GOE will be urged to tighten credit controls further and to take additional fiscal actions, especially on the expenditure side, to reduce the fiscal deficit by more than the targeted amount.

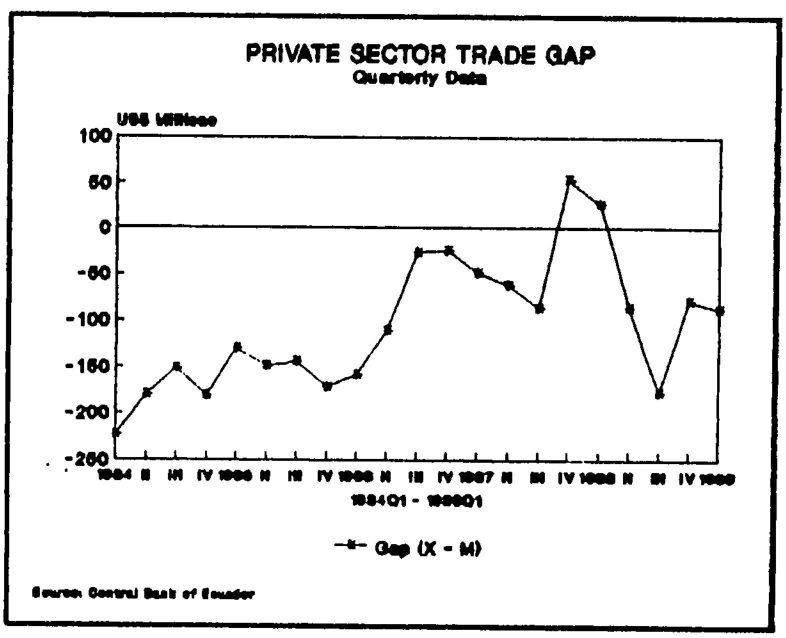
III. Program Description

A. Program Overview

The basic rationale for the proposed ESF assistance program for FY 1989 is to provide support to the Borja administration's stabilization program through the contribution of needed foreign exchange for capital goods imports by the private export sector. In the face of a projected 1989 current account deficit of 5.5% of GDP, USAID seeks in the short term to help finance the private sector's trade deficit and in the long run to support the GOE's efforts to eliminate it by helping to strengthen export capacity.

Private sector imports have exceeded private sector exports almost every year since the petroleum boom began in the early 1970s. Even in 1988, when private sector imports slowed substantially during the second half, they were still approximately $1.5 billion -- or $300 million more than private sector exports. The Borja administration's stabilization program has attempted to reduce this imbalance through a variety of temporary mechanisms, including capital goods import prohibitions (except those financed by international organizations) and incentives for seeking 120-day foreign financing of imports. As a result of these measures, capital goods imports showed a contraction of 3.6% during the first 5 months of 1989 as compared with the same period in 1988. Nevertheless, since September 1, 1988, a gap averaging $22 million per month remains between private sector imports and exports.

On May 10 the Monetary Board reduced restrictions applying to some capital goods imports; however, restrictions or prohibitions remain in force for capital goods imports worth $250-300 million annually. The lifting of these restrictions probably will have to await the approval of substantial balance-of-payments support from the IMF and IBRD.



While USAID's FY 1989 ESF level is modest compared to the import gap, by focussing on the private export sector's needs, the Mission hopes to encourage new investment essential to bolstering the country's export potential. This situation is dramatized by the disappointing export figures, reviewed above, for the first 5 months of 1989. The ESR II program's support for imports of private exporters' capital goods will also help reduce the GOE's unfinanced balance of payments gap.

B. Dollar Financing

1. Justification for Cash Transfer

As was the case in the first Economic Stabilization and Recovery Program (518-0058), the use of a cash transfer (rather than a Commodity Import Program) is proposed for the ESR II program. A cash transfer program will allow a more flexible and responsive disbursement capability than a CIP. Given previous Mission experience with credit funds in the Central Bank, including a modified CIP, it would require between six and nine months to set up the procedures for operating a CIP in Ecuador. Also, the CIP would require Mission staff time to administer, an additional burden which is not merited given the level of ESF resources programmed.

The Mission has also considered using the ESR II resources in a sector program approach, including utilization for debt-for-development schemes. A concept paper describing alternative sector program approaches was submitted to LAC for consideration in August 1988. Given initial uncertainties surrounding Agency debt-for-development guidelines and limitations included in the guidelines as they are currently drafted, the Mission has decided to forego development of a specific proposal for FY 1989, although it continues to encourage local and international PVOs to pursue options which are consistent with priority sector concerns.

2. Utilization and Management of Dollar Resources

As with the final tranche of FY 1987 ESF Resources, dollar funds in the Separate Account (to be disbursed in a single tranche) will be available to facilitate the importation of U.S. capital goods for the private export sector. The Ministry of Finance (MOF) will be responsible for verifying that clear linkages exist between ESF dollars and the specific payment transactions, and that the Central Bank maintains complete and consistent documentation. This documentation will be submitted to USAID on a quarterly basis and, at a minimum, include the following: import license number; the name of the supplier; the name of the importer; a brief description of the goods, including quantity; the cost of the goods (including insurance and freight, if applicable); date of shipment; and the name of the correspondent bank through which the letter of credit was advised and paid. The Central Bank will also be responsible for ensuring that no more than reasonable prices are paid for the goods and related delivery services financed, in whole or in part, with the funds in the Separate Account. USAID will review the documentation provided and formally notify the MOF and the Central Bank of its concurrence or non-concurrence with each disbursement made. In the case of non-concurrence, the Agreement will provide for reimbursement to the Separate Account of the amount in question.

Prior to the disbursement of the US dollar funds, the MOF will be required to provide the Mission the procedures by which dollars are made available to the commercial banks and financial institutions which, in turn, will issue letters of credit to finance import transactions. The requirements for these procedures will be set out in the Program Agreement and more fully detailed in Program Implementation Letter No. 1. USAID does not anticipate any difficulties with this mechanism given its experience with the $6.5 million disbursement under Amendment No. 6 to the ESR Program Agreement.

C. Local Currency Uses and Procedures

1. Programming

While the rationale for the ESR II Program and the use of ESF dollars is focussed on attaining economic stabilization over the short term, the use of local currencies will be principally directed toward financing activities supportive of the Mission's longer-term, broad-based economic growth goal. Activities to be targeted include small and microenterprise (SME) development and non-traditional agricultural exports (NTAE) promotion. Funding for these activities will be directly supportive of policy dialogue and program innovations being pursued or already achieved through DA-funded projects, including advances negotiated with the banking community concerning market interest rates, assumption of credit risk and financial participation in SME credit programs; market interest rates and administrative improvements for the Central Bank's NTAE discount line; and legislative reform and administrative streamlining of tax and procedural limitations impeding export growth. Tentative agreement has also been reached with the MOF concerning the possible support of the design and/or implementation of directed subsidy programs (e.g. transport or food stamp subsidies) and discrete GOE drug awareness and control activities. A 10% AID operating expense trust fund will also be funded out of local currency resources.

Through greater focus on priority areas, local currency programming will avoid the proliferation of activities which has occurred to date. Over 30 activities have been approved in a broad range of areas, including AIDS control, rural water and sanitation systems, nature tourism, higher education, and municipal development, as well as support to SME and NTAE activities. While concern exists that MOF and USAID management is rapidly being spread too thin, the development impact of limited resources must also be taken into account. In addition to agreeing on a reduced number of priority areas, the MOF and USAID have established criteria for future programming which include sustainability (e.g., the funding of counterpart requirements for AID and IFI projects has been discontinued so as to avoid creating an illusion that GOE/private sector commitment exists and that activities will be continued once external funding ends), clear commitment on the part of implementing agencies, and MOF/USAID technical oversight capabilities.

2. Procedures

Procedures governing the programming, use and control of local currencies generated under the Program will be in accordance with those established in the Spring and Summer of 1987 (as described in Section III.D. below), which are consistent with LAC guidance. The Program Agreement will include a covenant to the effect that within seven days from the date on which the initial U.S. dollar deposit of the grant is made to the Special Account, the Central Bank will deposit the sucre equivalent (calculated at the highest rate of exchange not unlawful in Ecuador in effect on the day the U.S. dollar deposit is made) into an interest-bearing Program Account established in the Central Bank.

The Mission will jointly approve, with the MOF, the general programming and specific uses of host country-owned local currency through the issuance of Implementation Letters. The MOF will initially screen the proposals to ensure their consistency with the development priorities of the GOE and with the terms and conditions of the Program Agreement. In consultation with AID technical staff, the MOF will also carefully review the proposals for clarity, feasibility, ease of implementation, application of host country environmental protection and mitigation procedures, and reasonableness of costs. If approved based on this review, the MOF will transmit the proposal to AID, which, if it concurs, will prepare an Implementation Letter. Prior to approving funds for program activities, AID and the GOE will assure that projects have been designed in accordance with acceptable technical, financial, accounting, administrative, and environmental standards, and that the interested entity has technical, financial, accounting and administrative capacity to carry out its programming, design, implementation, monitoring and evaluation responsibilities.

The MOF's Subsecretariat for Public Credit will be responsible for all administrative functions, except for disbursements and other cash management functions, which are the responsibility of the Treasury Subsecretariat. The Program Agreement will require that the GOE provide the Mission with quarterly reports which reflect the overall status of the Program account (generations, deposits, interest earned, commitments, approved withdrawals, and balance uncommitted), as well as individual reports for each project/activity showing the financial status and other required information necessary to meet the Mission's needs.

Evaluations and audits will also be responsibilities of the MOF. Copies of all evaluations will be kept on file and be made available to the Mission for its review. Through the Controller General of the Nation, or through an independent accounting firm contracted and supervised by the Controller General, annual audits will be conducted.

The Office of Program and Project Development (PPD) will be assigned primary responsibility for monitoring the Program's local currency activities. This monitoring responsibility includes maintaining the financial reporting on local currency uses; recommending approval to the Director of the proposed uses of the local currency (based on close collaboration with the Mission's technical offices); monitoring the use of the local currency on a regular basis; and preparing all Program documentation. The Controller's Office will maintain the normal accounting records for the OE Trust Fund.

3. AID Operating Expense Trust Fund

Pursuant to AID/W guidance on the review of the FY 1989 ESF Concepts Paper (STATE 133624), the Mission will negotiate with the GOE for trust funds at the historical level of 10% of ESF-related local currency. The FY 1991 Annual

Budget Submission projects the use of these trust funds to begin the second half of FY 1990 and running through the end of FY 1991. Given ABS OE levels, it will not be possible to meet funding requirements without accessing local currencies generated under this Program prior to the eighteen-month lag period recommended by AID/W.

D. <u>Experience to Date Under the Economic Stabilization and Recovery Program (518-0058)</u>

1. <u>U.S. Dollars</u>

In response to an economic recession which started in Ecuador in 1982, USAID/Ecuador solicited $50 million of Economic Support Funds for balance of payments support to promote financial stabilization and economic recovery. The initial program agreement (Economic Stabilization and Recovery Project No. 518-0058) was signed on September 29, 1985 and granted $4 million to the Government of Ecuador for balance of payments support. Subsequent amendments between January 1986 and September 1987 raised total grants to $43,031,000.

The overall objective of this program was to assist the Febres Cordero government to stabilize the country's economic situation and to continue with structural reforms leading to economic recovery in the medium term and providing a firm foundation for long-term economic growth. The specific purpose of this program was to provide immediate balance of payments and budgetary support to Ecuador, thereby ensuring that adequate funding was provided for the continuation of important public sector development investments without substantial negative impact on the availability of foreign exchange for private sector productive needs.

The initial Program Assistance Approval Document (PAAD), which was approved in September 1985 at a $24.0 million funding level, identified the freeing up of interest rates and the reduction of import tariffs and of gasoline subsidies as areas where corrective measures were needed. In each of these areas significant progress was achieved, although some of that progress was subsequently reversed.

Interest rates were liberalized with the purposes of encouraging the growth of domestic savings, weaning the commercial banking system from its dependence on the Central Bank, rationalizing the costs of financial resources to achieve higher efficiency in productive activities, and avoiding credit diversion. To achieve this, the monetary authorities first allowed the financial system to issue certificates of deposit bearing market-determined interest rates. Later, the authorities also approved regulations designed to put in place a system of adjustable rates in long-term operations. The structure of interest rates was streamlined, and four basic rates were put into effect: a CD rate, commercial bank asset and liability rate, rediscount rates of the Central Bank, and preferred rates for production loans in agriculture and low-income housing projects. In addition, the level of the simplified structure was brought closer in line with anticipated inflation. Finally, the reforms of August 1986 further untied savings and most lending rates from administrative restrictions.

Protectionist sentiments run strong in Ecuador, and coalitions have formed against opening the economy to outside competition. Labor unions and industrialists have joined forces to oppose measures that will force domestic industry to compete with foreign entities. In spite of this, the GOE took strong steps to liberalize imports by reducing overall protectionism and simplifying the tariff structure. Except for automobiles and computers, the effect of this liberalization was to reduce overall protection from about 120% to about 70 percent.

The GOE took a major step in December 1984 to reduce the implied subsidy on petroleum prices by increasing them by an average of 78 percent. In 1986, the sharp decline in world petroleum prices lowered the implied subsidy even more.

In January 1987, PAAD Amendment No. 1 was submitted to AID/W for review and approval. This amendment requested $25 million in FY 1987 ESF resources and argued that an initial disbursement of $15 million be granted as an ex post recognition of the comprehensive exchange and interest-rate reforms of August 11, 1986, and of the progress made in January 1986 by the GOE in reducing trade barriers. Due to budget constraints, only $12.3 million were programmed for Ecuador in FY 1987, and this amount was disbursed under Amendment No. 5. When year-end ESF funds became available, an additional $6.5 million were obligated on the rationale of continued USG support for the Febres Cordero administration's maintenance of a firm stance vis-a-vis its policy agenda, despite two devastating shocks to the economy (the 1986 oil price decline and the March 1987 earthquakes) and strong political pressure to reverse many of its market-oriented policy reforms.

In April 1988, the Mission cabled Washington to explain that while several matters related to the implementation of the program had been resolved, emergency measures adopted on March 3, 1988 required the Mission to reexamine the rationale upon which this last tranche of $6.5 million in ESF funds was authorized. Discussions in the last months of the Febres Cordero government on various priority macroeconomic policy measures proved inconclusive. However, based on the emergency stabilization measures adopted by the Borja government on August 10, 1988 and subsequent commitments made by the Borja economic team concerning the exchange rate and domestic petroleum prices, the Mission obtained LAC concurrence for proceeding with the disbursement of the $6.5 million, which occurred on December 1, 1988. While the progress described earlier with regard to exchange rates has been satisfactory and consistent with the commitments received, domestic petroleum prices were not adjusted in a timely fashion to keep up with inflation. The price increases announced on July 20, 1989 addressed this shortcoming, and while not ideal they constitute a satisfactory response given the current political environment.

2. Local Currency

The GOE was required to establish a special account in the Central Bank of Ecuador and deposit therein an amount of sucres equivalent to the amount of the dollars disbursed. The funds deposited into the special account have been used for a series of specific activities, mutually agreed upon by USAID/Ecuador and the Ministry of Finance (MOF). A total of 30 subprojects have been approved to date.

The office of the Regional Inspector General for Audit/Tegucigalpa made a financial/compliance and efficiency audit of the local currency program in July 1987. The audit, which covered the period from September 29, 1985 to May 13, 1987 and included local currency equivalent to $24,216,000, found that adequate disbursement and audit controls had not been established to ensure that local currency funds were used for intended purposes. Also, the efficiency of program operations was impeded because local currency was not made available at the highest rate of exchange and placed in interest-bearing accounts. Finally, compliance with some program requirements was lacking.

The situation was remedied during the summer of 1987 through negotiations with the Ministry of Finance (MOF), leading to the following arrangements:

- The MOF, through the Subsecretariat of Public Credit and the Treasury Subsecretariat, is now responsible for implementing the various aspects of the Program. The Ministry provides facilities and personnel, and contracts additional staff, services and commodities, as required. The Subsecretariat for Public Credit is responsible for all administrative functions, except for disbursements and other cash management functions, which are the responsibility of the Treasury Subsecretariat.

- A Special Account was opened in the Central Bank into which all local currency associated with the Program is initially deposited. The undisbursed balance of the Special Account is invested in interest-bearing instruments, which in practice have been Central Bank-issued Stabilization Bonds invested at varying maturities in accordance with Program disbursement schedules.

- The MOF and AID agree upon general categories of uses for local currency as well as specific activities to be financed.

- The MOF monitors the approved local currency activities to ensure that they are being properly implemented and that the local currency funds are being used for the approved purposes.

- Each activity is to be audited at least once a year by the Controller General of the Nation or by an independent accounting firm contracted and supervised by the Controller General. In addition, the Program Account is to be similarly audited at least once a year.

E. Conditions and Covenants

USAID's macroeconomic policy dialogue strategy with the GOE was described in Section II.C. above. The ESR II Program Agreement will be signed by USAID and the GOE following PAAD authorization, likely in September.

1. Conditions Precedent. Prior to disbursement of the Assistance, the GOE will comply with the standard Conditions Precedent (legal opinion and authorized representatives), as well as the following conditions: (a) establishment of a Separate Account and a Special Account for the deposit of the US dollar and *sucre* proceeds of the grant, respectively; (b) provision of

the procedures governing how the dollars and sucres will be administered under these accounts; and (c) an amendment to the AID Operating Expense Trust Account Agreement signed under the ESR I program, providing the equivalent of $900,000 in sucres for USAID's operating expense budget.

2. Covenants. In addition to the above conditions, the Program Agreement will include the following covenants related to program implementation:

(a) that, within seven working days of the disbursement of the dollar resources, the GOE deposit in a Special Account in the Central Bank of Ecuador the amount of sucres equivalent to the dollar disbursement, the uses of which will support development activities that meet the criteria for funding as outlined in Section 103 through 106 of the Foreign Assistance Act of 1961, as amended (to be jointly accorded by USAID and the GOE) as well as support USAID's operating expense budget;

(b) that the GOE maintain, at a minimum, the May 17, 1989 foreign exchange rate (in real effective terms) so as to encourage exports; and

(c) that the GOE maintain steady progress in the implementation of its economic stabilization program, especially with respect to (i) the reduction of the 1989 fiscal deficit to 3.4% of GDP; (ii) the reduction of negative net international reserves by $100.0 million from the end of CY 1988 to the end of CY 1989; (iii) the maintenance of a sublimit on Central Bank credit to the non-financial public sector; (iv) the continued adjustment of domestic petroleum product prices at levels which are consistent with sound fiscal policy; (v) not allowing any increase in real terms in the public sector payroll; (vi) the achievement of significant progress towards the signing of a foreign commercial bank debt rescheduling agreement (consistent with the terms of the IMF letter of Intent); and (vii) the adherence to an overall economic program which is acceptable to the principal international financial institutions.

MINISTERIO DE FINANZAS
SUBSECRETARIA DE CREDITO PUBLICO

Oficio No. SCP-89- 1601

Quito, a 18 AGO 1989

Señor
Frank Almaguer
DIRECTOR DE LA MISION AID
Ciudad.-

Señor Director:

Como es de su conocimiento, el 29 de septiembre de 1985, el Gobierno de los Estados Unidos, a través de la Agencia para el Desarrollo Internacional A.I.D. y el Estado Ecuatoriano suscribieron un convenio de asistencia de fondos no reembolsables como apoyo a la balanza de pagos, por la cantidad de US$4'000.000,oo, con el fin de promover la estabilización y recuperación económica en el Ecuador. Dicha asistencia, se ha ampliado al monto total de US$43'031.000,oo, a través de seis Enmienda, siendo la última Enmienda (No. 6) suscrita el 30 de septiembre de 1987 por el monto de US$6.5 millones.

El destino de los recursos, a más de cumplir con los objetivos previstos, ha permitido impulsar al sector privado con el establecimiento de líneas de crédito a sectores marginados del sistema bancario, impulsando la generación de mano de obra e incorporando nuevos sectores al sistema productivo como el agroexportador.

Con los fondos del Programa y las políticas del Gobierno Nacional han coadyuvado para una recuperación de la gestión del sector público, permitiéndole desarrollar programas de beneficio social orientados hacia la salud, la niñez y el mejoramiento de las condiciones de salubridad del sector rural.

Los logros alcanzados con la asistencia del programa, han sido satisfactorios y han permitido la recuperación de la economía, reflejado en la reducción del déficit fiscal presentado en los años 1986, 1987 y 1988. Adicionalmente el Gobierno del Ecuador, ha desarrollado políticas fiscales y monetarias, que se ajustan a la realidad económica del país, permitiendo el mejoramiento de sistemas tributarios, mediantes mecanismos modernos que serán perfeccionados oportunamente. Ello demuestra la seriedad y capacidad del actual gobierno para lograr una recuperación sólida que permita mantener una estabilidad en los diferentes sistemas económicos, para posteriormente impulsarlos dentro del sistema productivo.

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MINISTERIO DE FINANZAS
SUBSECRETARIA DE CREDITO PUBLICO

Sr. Frank Almaguer. 1601
Pág. No. 2.

Los objetivos y los esfuerzos del actual gobierno son grandes y han sido reconocidos por organismos internacionales y países amigos. Sin embargo, frente a las necesidades que cada día son mayores, se requiere de asistencias foráneas que permitan mantener los logros alcanzados y desarrollar nuevas políticas hacia otros sectores. Es por ello que me permito a nombre del Gobierno de la República del Ecuador, solicitarle se gestione ante su Ilustrado Gobierno la continuación de la asistencia que permitirá complementar el ajuste financiero fijado por el Gobierno y el impulso de nuevas actividades dirigidas al bienestar del pueblo Ecuatoriano.

Atentamente,

Ing. Com. Jorge Gallardo Zavala,
MINISTRO DE FINANZAS Y CREDITO PUBLICO.

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3(A)2 - NONPROJECT ASSISTANCE CHECKLIST

The criteria listed in Part A are applicable generally to FAA funds. and should be used irrespective of the program's funding source. In Part B a distinction is made between the criteria applicable to Economic Support Fund assistance and the criteria applicable to Development Assistance. Selection of the criteria will depend on the funding source for the program.

CROSS REFERENCES: IS COUNTRY CHECKLIST UP TO DATE? HAS STANDARD ITEM CHECKLIST BEEN REVIEWED?

A. GENERAL CRITERIA FOR NONPROJECT ASSISTANCE

1. FY 1988 Continuing Resolution Sec. 523; FAA Sec. 634A. Describe how authorization and appropriations committees of Senate and House have been or will be notified concerning the project.

   Congress was notified by normal Congressional Notification procedures.

2. FAA Sec. 611(a)(2). If further legislative action is required within recipient country, what is basis for reasonable expectation that such action will be completed in time to permit orderly accomplishment of purpose of the assistance?

   No further pre-conditions for obligation are necessary.

3. FAA Sec. 209. Is assistance more efficiently and effectively provided through regional or multilateral organizations? If so, why is assistance not so provided? Information and conclusions on whether assistance will encourage developing countries to cooperate in regional development programs.

   No

4.	<u>FAA Sec. 601(a)</u>. Information and conclusions on whether assistance will encourage efforts of the country to: (a) increase the flow of international trade; (b) foster private initiative and competition; (c) encourage development and use of cooperatives, credit unions, and savings and loan associations; (d) discourage monopolistic practices; (e) improve technical efficiency of industry, agriculture, and commerce; and (f) strengthen free labor unions.	The assistance will increase international trade, foster private initiative and competition, and improve the efficiency of industry, agriculture and commerce.
5.	<u>FAA Sec. 601(b)</u>. Information and conclusions on how assistance will encourage U.S. private trade and investment abroad and encourage private U.S. participation in foreign assistance programs (including use of private trade channels and the services of U.S. private enterprise).	Via this balance of payments assistance, U.S. markets for Ecuadorian products will be enhanced.
6.	<u>FAA Secs. 612(b), 636(h); FY 1988 Continuing Resolution Secs. 507, 509</u>. Describe steps taken to assure that, to the maximum extent possible, foreign currencies owned by the U.S. are utilized in lieu of dollars to meet the cost of contractual and other services.	Agreements with the GOE encourage use of local currencies for local needs.
7.	<u>FAA Sec. 612(d)</u>. Does the U.S. own excess foreign currency of the country and, if so, what arrangements have been made for its release?	No
8.	<u>FAA Sec. 601(e)</u>. Will the assistance utilize competitive selection procedures for the awarding of contracts, except where applicable procurement rules allow otherwise?	N/A
9.	<u>FAA 121(d)</u>. If assistance is being furnished under the Sahel Development Program, has a determination been made that the host government has an adequate system for accounting for and controlling receipt and expenditure of A.I.D. funds?	N/A

B. <u>FUNDING CRITERIA FOR NONPROJECT ASSISTANCE</u>

1. <u>Nonproject Criteria for Economic Support Fund</u>

a. <u>FAA Sec. 531(a)</u>. Will this assistance promote economic and political stability? To the maximum extent feasible, is this assistance consistent with the policy directions, purposes, and programs of Part I of the FAA? — Yes/Yes

b. <u>FAA Sec. 531(e)</u>. Will assistance under this chapter be used for military or paramilitary activities? — No

c. <u>FAA Sec. 531(d)</u>. Will ESF funds made available for commodity import programs or other program assistance be used to generate local currencies? If so, will at least 50 percent of such local currencies be available to support activities consistent with the objectives of FAA sections 103 through 106? — Yes/Yes

d. <u>FAA Sec. 609.</u> If commodities are to be granted so that sale proceeds will accrue to the recipient country, have Special Account (counterpart) arrangements been made? — N/A

e. <u>FY 1988 Continuing Resolution</u>. If assistance is in the form of a cash transfer: (a) are all such cash payments to be maintained by the country in a separate account and not to be commingled with any other funds? — Yes (b) will all local currences that may be generated with funds provided as a cash transfer to such a country also be deposited in a special account to be used in accordance with FAA Section 609 (which requires such local currencies to be made available to the U.S. governnent as the U.S. determines necessary for the requirements of the U.S. Government, and which requires the remainder to be used for programs agreed to by the U.S. Government to carry out the purposes for which new funds authorized by the FAA — Yes would themselves be available)? (c) Has Congress received prior notification providing in detail how the funds will be used, including the U.S. interests that will be served by the assistance, and, as appropriate, the economic policy reforms that will be promoted by the cash transfer assistance? — Yes

f. FY 1988 Continuing Resolution. Have local currencies generated by the sale of imports or foreign exchange by the government of a country in Sub-Saharan Africa from funds appropriated under Sub-Saharan Africa, DA been deposited in a special account established by that government, and are these local currencies available only for use, in accordance with an agreement with the United States, for development activities which are consistent with the policy directions of Section 102 of the FAA and for necessary administrative requirements of the U. S. Government? — N/A

2. Nonproject Criteria for Development Assistance

a. FAA Secs. 102(a), 111, 113, 281(a). Extent to which activity will (a) effectively involve the poor in development, by expanding access to economy at local level, increasing labor-intensive production and the use of appropriate technology, spreading investment out from cities to small towns and rural areas, and insuring wide participation of the poor in the benefits of development on a sustained basis, using the appropriate U.S. institutions; (b) help develop cooperatives, especially by technical assistance, to assist rural and urban poor to help themselves toward better life, and otherwise encourage democratic private and local governmental institutions; (c) support the self-help efforts of developing countries; (d) promote the participation of women in the national economies of developing countries and the improvement of women's status; and (e) utilize and encourage regional cooperation by developing countries? — N/A

b. FAA Secs. 103, 103A, 104, 105, 106, 120-21. Is assistance being made available (include only applicable paragraph which corresponds to source of funds used; if more than one fund source is used for assistance, include relevant paragraph for each fund source):

N/A

(1) [103] for agriculture, rural development or nutrition; if so (a) extent to which activity is specifically designed to increase productivity and income of rural poor; [103A] if for agricultural research, account shall be taken of the needs of small farmers, and extensive use of field testing to adapt basic research to local conditions shall be made; (b) extent to which assistance is used in coordination with efforts carried out under Sec. 104 to help improve nutrition of the people of developing countries through encouragement of increased production of crops with greater nutritional value; improvement of planning, research, and education with respect to nutrition, particularly with reference to improvement and expanded use of indigenously produced foodstuffs; and the undertaking of pilot or demonstration programs explicitly addressing the problem of malnutrition of poor and vulnerable people; and (c) extent to which activity increases national food security by improving food policies and management and by strengthening national food reserves, with particular concern for the needs of the poor, through measures encouraging domestic production, building national food reserves, expanding available storage facilities, reducing post harvest food losses, and improving food distribution.

(2) [104] for population planning under Sec. 104(b) or health under Sec. 104(c); if so, extent to which activity emphasizes low-cost, integrated delivery systems for health, nutrition and family planning for the poorest people, with particular attention to the needs of mothers and young children, using paramedical and auxiliary medical personnel, clinics and health posts, commercial distribution systems, and other modes of community outreach.

(3) [105] for education, public administration, or human resources development; if so, (a) extent to which activity strengthens nonformal education, makes formal education more relevant, especially for rural families and urban poor, and strengthens management capability of institutions enabling the poor to participate in development; and (b) extent to which assistance provides advanced education and training of people of developing countries in such disciplines as are required for planning and implementation of public and private development activities.

(4) [106] for technical assistance, energy, research, reconstruction, and selected development problems; if so, extent activity is:

(i)(a) concerned with data collection and analysis, the training of skilled personnel, research on and development of suitable energy sources, and pilot projects to test new methods of energy production; and (b) facilitative of research on and development and use of small-scale, decentralized, renewable energy sources for rural areas, emphasizing development of energy resources which are environmentally acceptable and require minimum capital investment;

(ii) concerned with technical cooperation and development, especially with U.S. private and voluntary, or regional and international development, organizations;

(iii) research into, and evaluation of, economic development processes and techniques;

(iv) reconstruction after natural or manmade disaster and programs of disaster preparedness;

(v) for special development problems, and to enable proper utilization of infrastructure and related projects funded with earlier U.S. assistance;

(vi) for urban development, especially small, labor-intensive enterprises, marketing systems for small producers, and financial or other institutions to help urban poor participate in economic and social development.

(5) [120-21] for the Sahelian region; if so, (a) extent to which there is international coordination in planning and implementation; participation and support by African countries and organizations in determining development priorities; and a long-term, multi-donor development plan which calls for equitable burden-sharing with other donors; (b) has a determination been made that the host government has an adequate system for accounting for and controlling receipt and expenditure of projects funds (dollars or local currency generated therefrom)?

c. FAA Sec. 107. Is special emphasis placed on use of appropriate technology (defined as relatively smaller, cost-saving, labor using technologies that are generally most appropriate for the small farms, small businesses, and small incomes of the poor)? N/A

d. FAA Sec. 281(b). Describe extent to which the activity recognizes the particular needs, desires, and capacities of the people of the country; utilizes the country's intellectual resources to encourage institutional development; and supports civic education and training in skills required for effective participation in governmental and political processes essential to self-government. N/A

e. FAA Sec. 101(a). Does the activity give reasonable promise of contributing to the development of economic resources, or to the increase of productive capacities and self-sustaining economic growth? N/A

EXCHANGE RATES, 1985-1989
(Sucres per US$)

Annual Average	Official Market (Buying)	Intervention Market (Buying)	Intervention Market (Selling)	Free Market (Buying)
1985	70.38	95.00	96.50	115.52
1986	95.00	122.05	123.42	148.08
1987	95.00	169.97	170.97	193.23
1988	194.45	294.34	308.88	435.03
1989 (Est.)	457.31	502.88	537.00	
Monthly Average				
1988 Jan.	95.00	224.00	225.00	262.05
Feb	95.00	242.95	243.95	340.32
Mar.	95.00	248.57	249.57	370.28
Apr.	95.00	249.00	250.00	394.44
May	95.00	249.00	250.00	422.20
Jun.	95.00	249.00	250.00	463.63
Jul.	95.00	249.00	250.00	488.94
Aug.	108.41	254.52	257.25	487.89
Sep.	390.00	375.90	415.47	516.14
Oct.	390.00	386.30	426.96	501.57
Nov.	390.00	396.87	438.64	475.90
Dec.	390.00	406.92	449.75	496.95
1989 Jan. 1/	390.00	417.36	461.29	528.78
Feb 1/	390.00	427.51	472.51	524.97
Mar. 1/	390.00	437.33	483.36	512.53
Apr. 1/	390.00	447.69	494.82	499.14
May 1/	448.68	465.52	500.83	522.42
Jun. 1/	497.00	509.20	534.66	534.71
Jul. (Est.)	497.00	522.26	548.37	
Aug. (Est.)	497.00	535.61	562.39	
Sep. (Est.)	497.00	548.60	576.03	
Oct. (Est.)	497.00	561.74	589.83	
Nov. (Est.)	497.00	574.40	603.12	
Dec. (Est.)	497.00	587.39	616.76	

1/ Free market rates for January-May 1989 are provisional.

Sources: Central Bank of Ecuador and USAID staff estimates.

MONEY SUPPLY, 1985-1989

	M1		Time and Savings Deposits		M2	
	Millions of Sucres	% Change	Millions of Sucres	% Change	Millions of Sucres	% Change
Dec. 1985	137,846	23.6	71,887	33.1	209,733	56.0
Dec. 1986	166,000	20.4	96,855	34.7	262,855	25.3
Dec. 1987	219,575	32.3	146,385	51.1	365,960	39.2
Dec. 1988	337,667	53.8	208,701	42.6	546,368	49.3
Dec. 1989 (Est.)	463,300	37.2	281,000	34.6	744,300	
?88 Jan.	198,667	-9.5	146,782	-5.6	345,449	0.3
Feb	228,040	14.8	148,819	1.4	376,859	9.1
Mar.	224,893	-1.4	158,265	6.3	383,158	1.7
Apr.	228,200	1.5	159,435	0.7	387,635	1.2
May	240,438	5.4	165,179	3.6	405,617	4.6
Jun.	261,351	8.7	180,227	9.1	441,578	8.9
Jul.	269,585	3.2	174,884	-3.0	444,469	0.7
Aug.	270,570	0.4	176,198	0.8	446,768	0.5
Sep.	279,037	3.1	186,380	5.8	465,417	4.2
Oct.	277,976	-0.4	189,154	1.5	467,130	0.4
Nov.	286,129	2.9	189,020	-0.1	475,149	1.7
Dec.	337,667	18.0	208,701	10.4	546,368	15.0
1989 Jan.	324,996	-3.8	205,508	-1.5	530,504	-2.9
Feb	331,238	1.9	205,363	-0.1	536,601	1.1
Mar.	334,935	1.1	218,292	6.3	553,227	3.1
Apr.	333,407	-0.5	222,137	1.8	555,544	0.4
May	343,554	3.0	225,371	1.5	568,925	2.4
Jun.	366,206	6.6	247,120	9.7	613,326	7.8

Source: Central Bank of Ecuador.

CONSUMER PRICES, 1985-1989
(May 1978-April 1979 = 100)

	Index	Annual Change 1/ (%)	Monthly Change (%)
Annual Average			
1985	394.0	28.0	
1986	484.7	23.0	
1987	627.7	29.5	
1988	993.1	58.2	
1989 (Est.)	1,728.7	74.1	
December-December			
1985	423.1	24.4	
1986	538.8	27.3	
1987	713.8	32.5	
1988	1,325.6	85.7	
1989 (Est.)	1,988.6	50.0	
Monthly, 1988-1989			
1988 Jan.	736.9	34.3	3.2
Feb.	773.7	37.6	5.0
Mar.	808.4	36.7	4.5
Apr.	864.2	43.3	6.9
May	904.8	48.0	4.7
Jun.	937.1	49.9	3.6
Jul.	982.2	55.7	4.8
Aug.	1,039.3	62.9	5.8
Sep.	1,116.2	71.5	7.4
Oct.	1,177.0	77.4	5.4
Nov.	1,251.8	80.5	6.4
Dec.	1,325.6	85.7	5.9
1989 Jan.	1,395.8	89.4	5.3
Feb.	1,477.2	90.9	5.8
Mar.	1,609.7	99.1	9.0
Apr.	1,652.9	91.3	2.7
May	1,670.3	84.6	1.1
Jun.	1,727.5	84.3	3.4
Jul.	1,752.5	78.4	1.4
Aug.	1,797.4	72.9	2.6
Sep.	1,843.4	65.1	2.6
Oct.	1,890.6	60.6	2.6
Nov.	1,939.0	54.9	2.6
Dec.	1,988.6	50.0	2.6

1/ For the monthly data, annual percentage figures refer to changes over the preceding 12 months.

Source: Central Bank of Ecuador.

ECUADOR: BALANCE OF PAYMENTS, 1985-1989
(US$ 000)

		1985	1986	1987	1988	1989
1 . Exports, (FOB)		2905	2186	2021	2203	2333
2 . Imports, (FOB)		-1611	-1631	-2054	-1614	-1680
I . TRADE BALANCE	(1+2)	1294	555	-33	589	653
3 . Travel (Net)		-63	14	-3	6	22
4 . Interests Medium and Long Term Debt		-775	-704	-708	-782	-845
5 . Interests Short Term Debt		-73	-77	-83	-93	-87
6 . Other (Net)		-349	-374	-436	-377	-388
II . GOODS AND SERVICES BALANCE	(3+4+5+6)	-1260	-1141	-1230	-1246	-1298
III . TRANSFERS		80	45	132	60	60
IV . CURRENT ACCOUNT BALANCE	(I+II+III)	114	-541	-1131	-597	-585
7 . Public Sector	(a+b)	519	684	287	-193	487
a . Disbursements		1804	1964	1708	1501	1669
b . Amortization		-1285	-1280	-1421	-1694	-1182
8 . Private Sector	(a+b+c)	-10	0	88	101	80
a . Investment		62	70	75	80	80
b . Disbursements		38	13	20	57	21
c . Amortization		-110	-83	-7	-36	-21
9 . Other 1/		-347	-397	-220	349	-258
V . CAPITAL ACCOUNT BALANCE	(7+8+9)	162	287	155	257	309
10 . Arrears 2/		-251	-17	900	315	376
11 . Net Official International Reserves 3/		-25	271	76	25	-100
VI . NET INTERNATIONAL RESERVES 3/ [-(IV+V)]=(10+11)		-276	254	976	340	276

1/ Includes errors and omissions and valuation adjustment
2/ Positive sign indicates accumulation; negative sign indicates payment.
3/ Negative sign indicates increase.

Source: Central Bank of Ecuador

NATIONAL ACCOUNTS, 1985-1989

	1985	1986	1987	Prov. 1988	Proj. 1989
Population (Thousands)	9,377.9	9,647.1	9,922.5	10,203.7	10,490.2
GDP in Market Prices					
Current Sucres (Billions)	1,109.9	1,383.2	1,807.5	3,113.0	5,416.6
1975 Sucres (Billions)	164.1	169.1	159.8	180.3	182.1
Real GDP Growth Rate	4.3	3.1	-5.5	12.8	1.0
Real Per Capita GDP (1975 Sucres)	17,494	17,532	16,109	17,672	17,378
Real Per Capita GDP Growth Rate	1.4	0.2	-8.1	9.7	-1.7
Real Sectoral Growth Rates					
Agriculture	9.9	10.2	4.2	9.1	3.5
Mining and Petroleum	9.1	5.4	-54.3	138.2	-3.2
Manufacturing	0.2	-1.7	3.3	3.9	0.6
Construction	2.4	-3.4	1.7	-8.5	1.5
Services	2.8	2.9	2.3	2.5	
Other	9.3	0.5	0.3	-3.5	
Savings and Investment (% of GDP) (Current Prices)					
Gross Domestic Investment	18.2	20.9	22.9	23.3	21.6
Private	11.4	11.4	13.5	14.6	
Public	6.8	9.5	9.4	8.7	
Gross National Savings	16.9	13.1	9.1	15.0	0.0
Private	5.5	6.0	5.4	9.0	
Public	11.4	7.1	3.7	6.0	
Net Foreign Savings	1.3	7.8	13.8	8.3	21.6

Source: Central Bank of Ecuador.

PRINCIPAL EXPORTS, 1985-1989 1/

PRODUCT	1985	1986	1987	1988	Proj. 1989
CRUDE OIL	1,824.7	912.4	739.4	876.3	948.6
Volume	70.6	71.3	45.4	69.0	61.2
Unit Price	25.8	12.8	16.3	12.7	15.5
OIL DERIVATIVES	101.9	70.1	78.2	99.8	134.4
Volume	4.8	6.7	5.7	9.5	11.2
Unit Price	21.2	10.5	13.7	10.5	12.0
BANANAS	220.0	263.4	266.9	301.4	316.2
Volume	1,278.2	1,399.6	1,406.2	1,570.0	1,550.0
Unit Price	172.1	188.2	189.8	192.0	204.0
COFFEE (Unprocessed)	190.0	298.9	192.3	152.3	190.8
Volume	78.3	102.7	98.8	74.2	90.0
Unit Price	2,426.6	2,910.4	1,946.4	2,052.6	2,120.0
COCOA (Unprocessed)	138.4	71.1	82.8	77.7	72.9
Volume	70.4	38.3	45.4	52.9	53.0
Unit Price	1,965.9	1,856.4	1,823.8	1,468.8	1,375.5
COCOA (Processed)	78.8	77.2	57.1	54.8	62.4
Volume	34.1	35.4	24.2	30.7	35.0
Unit Price	2,310.9	2,180.8	2,359.5	1,785.0	1,782.9
SHRIMP	156.5	287.9	383.1	387.0	347.8
Volume	20.0	31.1	48.7	56.2	46.0
Unit Price	7,825.0	9,257.2	7,866.5	6,886.1	7,560.9
OTHER FISH AND SEAFOOD	109.2	99.7	96.6	123.0	123.0
OTHER	84.6	105.2	124.9	130.4	137.0
TOTAL	2,904.1	2,185.9	2,021.3	2,202.7	2,333.1
PETROLEUM	1,926.6	982.5	817.6	976.1	1,083.0
NON-PETROLEUM	977.5	1,203.4	1,203.7	1,226.6	1,250.1

1/ Value in Millions of dollars.
Volume in millions of barrels for oil and derivatives exports.
Volume in thousands of metric tons for non-oil exports.
Unit value in dollars per barrel and per metric ton.

Source: Central Bank of Ecuador.

BANKING SYSTEM OPERATIONS, 1985-1989
(Millions of Sucres as of December 31)

	1985	1986	1987	1988	1989
NET INTERNATIONAL RESERVES	18607	-7171	-14328	-68540	-39600
OTHER FOREIGN ASSETS	139	642	-4982	-6426	14400
NET DOMESTIC CREDIT	652047	757094	960406	2300352	2509400
Public Sector (net)	-77090	-80047	-64105	-85491	-132900
Private Sector 1/	326407	378118	467122	529813	705900
Net unclassified	402730	459023	557389	1856030	1936400
INTERBANK FLOAT	17018	17505	16601	10339	48100
ALLOCATION OF SDRs	4308	4657	4916	20416	23200
MEDIUM- AND LONG-TERM FOREIGN LIABILITIES	346354	347122	369099	1376486	1405000
LIABILITIES TO PRIVATE SECTOR	302342	374194	530772	765971	1029000
Currency in circulation	41697	53346	73494	122470	168700
Demand Deposits	96150	112654	146081	215197	294600
Time and savings deposits	45652	64472	105573	162189	386700
Bonds	77424	96015	125978	151429	49000
Other sucre liabilities	34918	37048	64549	87974	91500
Liabilities in foreign currency	6501	10659	15097	26712	38500
CAPITAL AND RESERVES	34807	41537	52910	72852	75000

Source: Central Bank of Ecuador.

CENTRAL BANK OPERATIONS, 1985-1989
(Millions of Sucres as of December 31)

	1985	1986	1987	1988	1989
NET INTERNATIONAL RESERVES	15895	-10176	-17439	-84190	-39600
NET DOMESTIC ASSETS	25802	63522	90933	206660	208300
Non Financial Public Sector	-72164	-82007	-58275	-82373	-128400
Central Government (net)	-21831	-34440	-8714	3882	
Other (net)	-50333	-47567	-49561	-86255	
Financial Institutions (net)	108494	109414	94632	28940	33900
Banking System (net)	69516	66075	49831	-7714	
Private	53565	44937	33886	-33964	
Banco Nacional de Fomento	15951	21138	15945	26250	
Other Financial Intermediaries (net)	38978	43339	44801	36654	
Private Sector (net)	-898	-5462	-33989	-53237	-21900
Unclassified Assets (net)	339923	350202	427102	1628316	1625100
Medium- and Long-Term Foreign Liabilities	-341947	-330506	-329613	-1289627	-1277200
Other Liabilities	-4308	-4657	-4916	-20416	-23200
Capital and Reserves	-3298	-3466	-4015	-4943	
CURRENCY ISSUE	41697	53346	73494	122470	168700

Source: Central Bank of Ecuador.

EXTERNAL DEBT INDICATORS, 1985-1989
(Millions of US$)

	1985	1986	Prov. 1987	Prov. 1988	Proj. 1989
DEBT OUTSTANDING, end of period	8,111	9,076	9,828 1/	9,714 1/	9,753
Public	7,956	8,991	9,730	9,595	9,655
(of which IMF)	(351)	(471)	(438)	(403)	(292)
Private	155	85	98	119	98
INTEREST ARREARS OUTSTANDING, end of period	--	--	456	836	1,343 2/
DEBT SERVICE (paid and unpaid) 3/					
Principal:					
(Before renegotiation)	1,496	2,281	1,565	1,932	1,468
(After renegotiation)	323	437	911	1,293	973
Interest	840	763	772	861	919
RATIOS					
Debt to GDP	65.4	80.7	92.8	94.5	
Debt Service to Exports (goods only)					
Before Rescheduling	70.2	114.7	94.8	105.5	
After Rescheduling	35	45.2	68.3	78.6	
Interest to exports (goods only)	29.2	35.6	39.1	39.7	

1/ Excludes interest arrears.
2/ End of March 1989.
3/ Includes Balance of Payments financing.

Source: IMF and Central Bank of Ecuador

CONSOLIDATED ACCOUNTS OF THE NONFINANCIAL PUBLIC SECTOR, 1985-1989
(Billions of Sucres)

	1985	1986	Prov. 1987	Prov. 1988	Proj. 1989
TOTAL REVENUES	309.1	340.3	393.1	650.8	1279.7
Petroleum	154.1	115.5	107.0	233.2	473.5
Non-Petroleum	140.0	191.4	257.2	385.9	673.7
Operating Surplus of Public Enterprises	15.0	33.4	28.9	31.7	132.5
CURRENT EXPENDITURES	220.1	397.9	439.3	625.1	969.2
CURRENT SURPLUS OR DEFICIT (-)	89.0	-57.6	-46.2	25.7	310.5
CAPITAL EXPENDITURES	67.9	112.3	126.7	181.4	494.0
OVERALL SURPLUS OR DEFICIT (-)	21.1	-169.9	-172.9	-155.7	-183.5
EXTERNAL INTEREST ARREARS	--	--	49.6	63.7	
OVERALL BALANCE (Cash basis)	21.1	-169.9	-123.3	-92.0	
FINANCING	-21.1	169.9	123.3	92.0	
External (net)	15.4	76.0	65.0		
Disbursements	23.1	106.0	126.0		
Amortization	7.7	30.0	61.0		
External Amortization Arrears	--	--	26.2		
Domestic (net)	-36.6	-6.1	32.1		
Central Bank	-35.7	-10.6	44.0		
Rest of Banking System	0.3	-1.0	-7.8		
Other	-1.2	5.5	-4.1		

Source: Central Bank of Ecuador.

INITIAL ENVIRONMENTAL EXAMINATION

Project Location: Ecuador

Project Title: Economic Stabilization and Recovery II

Funding: $9,000,000.00

Project Description: The project consists of a cash transfer to provide balance of payments assistance to support economic stabilization and recovery in Ecuador during CY 1989

Action: Handbook 3, Chapter 2, Appendix 20, Section 216.2.(c) (2) (vi) states that "contributions to --- National Organizations by the United States which are not for the purpose of carrying out a specifically identifiable project or projects" are not subject to AID's environmental procedures.

The USAID/Ecuador FY 1989 PAAD provides for cash transfers to the Ecuadorian Central Bank for balance of payments support. The foreign exchange provided under the cash transfer is used by the Central Bank to finance capital goods imports for use by Ecuador's private sector in manufacturing and other productive activities. Pesticides will not be procured with these funds without first doing an Environmental Assessment and having it approved by AID/W. Also, an amount of local currency equivalent to the cash transfer will be deposited by the Central Bank in a special account to be used for mutually agreed-upon development purposes specified in the PAAD. The PAAD does not authorize AID funds for identifiable projects, rather it provides funds for an economic stabilization and recovery program.

Based on AID regulations in Handbook 3, Chapter 2, the AID Mission to Ecuador recommends that no further environmental study be undertaken for this PAAD and that a "categorical exclusion" be approved.

IEE prepared by: J. Michael Deal
J. Michael Deal
Program and Project
Development Officer

Concurrence: Frank Almaguer
Frank Almaguer
Mission Director
USAID/Ecuador

(2496M)

AGENCY FOR INTERNATIONAL DEVELOPMENT
WASHINGTON D C 20523

LAC-IEE-89-62

ENVIRONMENTAL THRESHOLD DECISION

Project Location	:	Ecuador
Project Title	:	Economic Stabilization and Recovery II
Project Number	:	518-0078
Funding	:	$ 9 million
Life of Project	:	1 year
IEE Prepared by	:	J. Michael Deal USAID/Ecuador
Recommended Threshold Decision	:	Categorical Exclusion
Bureau Threshold Decision	:	Concur with Recommendation
Comments	:	Concurrence subject to condition stated in IEE and placed in approval documents that no pesticides will be procured without first doing an Environmental Assessment and having it approved by AID/W.
Copy to	:	Frank Almaguer, Director USAID/Ecuador
Copy to	:	J. Michael Deal, USAID/Ecuador
Copy to	:	Howard Clark, REMS/SA
Copy to	:	Eugene Rauch, LAC/DR/SA
Copy to	:	IEE File

John O Wilson Date AUG 25 1989

John O. Wilson
Deputy Environmental Officer
Bureau for Latin America
and the Caribbean

ACTION AID2 INFO DCM/3

VZCZCQTO833
RR RUEHQT
DE RUEHC #3624/01 1180837
ZNR UUUUU ZZH
R 280836Z APR 89
FM SECSTATE WASHDC
TO AMEMBASSY QUITO 5169
BT
UNCLAS STATE 133624

LOC: 022 798
28 APR 89 0838
CN: 21418
CHRG: AID
DIST: AID

REPLY DUE 5.5.89

☒ NO REPLY NEEDED
☐ REPLY BY
ON 5/3/89
DATE INITIALS
FILE

AIDAC

E.O. 12356: N/A
TAGS:
SUBJECT: ECUADOR FY 89 ESF CONCEPTS PAPER

1. THE REVIEW OF THE ECUADOR FY 89 ESF CONCEPTS PAPER WAS CHAIRED BY ACTING AA/LAC, F. SCHIECK ON APRIL 7, 1989. THE MISSION WAS REPRESENTED BY DIRECTOR, F. ALMAGUER AND PROGRAM OFFICER, P. MALDONADO. THE PROGRAM PRESENTED IS VERY COMPREHENSIVE AND IN LINE WITH A.I.D. POLICY AND GOE NEEDS. THE RESULTS OF THE REVIEW ARE SUMMARIZED BELOW.

2. ISSUE: SHOULD NARCOTICS CONDITIONALITY BE A PART OF THE GRANT AGREEMENT?
DECISION: AS A MATTER OF PRINCIPLE, A.I..D. BELIEVES THAT WE SHOULD CONSIDER HOW WE CAN BEST USE ALL USG RESOURCES TO ACHIEVE OUR FUNDAMENTAL NARCOTICS CONTROL OBJECTIVE. IN THE SPECIFIC CASE OF ECUADOR, CONDITIONING ESF ON PROGRESS IN NARCOTICS COULD CONTRIBUTE TO BROADER U.S. FOREIGN POLICY OBJECTIVES IF THERE WERE DISCRETE AREAS IN WHICH WE BELIEVED THAT GOE PERFORMANCE COULD BE IMPROVED AND THAT ESF WERE THE MOST APPROPRIATE INSTRUMENT TO ACHIEVE THE CHANGE. WE DO NOT BELIEVE, HOWEVER, THAT SUCH CONDITIONING AT THE PRESENT TIME WOULD BE PARTICULARLY HELPFUL GIVEN CURRENT ECUADORIAN EFFORTS TO COOPERATE WITH THE U.S. IN STEMMING THE PRODUCTION AND TRAFFICKING OF NARCOTICS. ECUADOR HAS TAKEN POSITIVE STEPS TO STOP THE PRODUCTION AND TRANSPORT OF NARCOTICS AS STATED IN THE PRESIDENT'S MARCH 1ST CERTIFICATION TO CONGRESS. IN THE ABSENCE OF A DEMONSTRATED NEED FOR NARCOTICS CONDITIONALITY TO ACHIEVE SPECIFIC OBJECTIVES, THE DAEC CONCLUDED THAT, UNLESS THE SITUATION WERE TO CHANGE RADICALLY, NARCOTICS CONDITIONALITY SHOULD NOT BE INCLUDED IN THE ESF GRANT AGREEMENT.

ACTION: PPD
DIR
D/D
RLA
RCO
EXO
CONT
PPD
GDO/PSD
ARDO
FHD
RHUDO
HUDO
RF
M/R
EMB
WASH

28

3. ISSUE: CAN THE MISSION EFFECTIVELY IMPLEMENT THE PROPOSED POLICY DIALOGUE WITH AVAILABLE PERSONNEL RESOURCES?
DECISION: ALTHOUGH THE MISSION HAS A LARGE MENU OF ITEMS IN ITS POLICY DIALOGUE AT THIS TIME, IT WAS CONCLUDED THAT THE MISSION COULD ACCOMPLISH ITS

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OBJECTIVES. IN ADDITION TO ITS CURRENT STAFF, THE MISSION IS PLANNING TO ENGAGE A SENIOR LEVEL ECONOMIC CONSULTANT TO ASSIST WITH IMPLEMENTATION OF THE POLICY DIALOGUE. PER RESULTS OF THE ECUADOR FY 90/91 ACTION PLAN REVIEW, A SENIOR ECONOMIST IN LAC/DP WILL ALSO PLAN ON QUARTERLY TRIPS TO ECUADOR.

4. ISSUE: SHOULD THE MISSION ESTABLISH A LOCAL CURRENCY TRUST FUND UNDER THE ESF AGREEMENT?
DECISION: THE LAC BUREAU UNDERSTANDS THE RELUCTANCE OF THE MISSION TO BE DEPENDENT ON UNCERTAIN LOCAL CURRENCY TRUST FUNDS, BUT GIVEN THE DECREASING LEVEL OF BUREAU OE FUNDS, THE MISSION SHOULD NEGOTIATE WITH THE GOE FOR TRUST FUNDS AT THE HISTORICAL LEVEL, PREFERABLY UP TO THE MAXIMUM TEN PERCENT OF ESF GENERATED LOCAL CURRENCY. IN KEEPING WITH THE UNCERTAINTY OF THE AVAILABILITY OF LOCAL CURRENCY TRUST FUNDS, THE MISSION SHOULD TRY NOT TO BUDGET FOR TRUST FUND USE FOR AT LEAST EIGHTEEN MONTHS AFTER PROPOSED RELEASE OF ESF FUNDS. THE MISSION SHOULD REFRAIN FROM PROGRAMMING TRUST FUNDS FOR COSTS WHICH WOULD BE DIFFICULT TO COVER IF TRUST FUNDS WERE NOT AVAILABLE.

5. ISSUE: ARE PROPOSED GOALS ADEQUATE MEASURES ON WHICH TO BASE RELEASE OF ESF FUNDS?
DECISION: THE MISSION WAS CONGRATULATED FOR ITS EFFECTIVENESS IN ENGAGING THE GOE IN AN AMBITIOUS MACROECONOMIC AND SECTORAL POLICY DIALOGUE. ALTHOUGH THE GENERAL TARGETS ESTABLISHED IN THE CONCEPT PAPER ARE ADEQUATE, IT IS NECESSARY TO INCREASE THEIR OPERATIONAL

SIGNIFICANCE. IN ORDER TO STRENGTHEN THE PRACTICAL APPLICABILITY OF THE TARGETS, THE MISSION WAS ASKED TO DEVELOP JOINTLY WITH THE GOE AN ECONOMIC PROGRAM CREDIBLE BY INTERNATIONAL STANDARDS THAT WOULD INCLUDE SPECIFIC TARGETS FOR NET INTERNATIONAL RESERVES, FOR THE DEFICIT OF THE CONSOLIDATED NON-FINANCIAL PUBLIC SECTOR, AND FOR CHANGES IN CENTRAL BANK CREDIT (INCLUDING A SUBLIMIT ON CENTRAL BANK CREDIT TO THE NON-FINANCIAL PUBLIC SECTOR). THE ACCEPTANCE OF THIS PROGRAM BY USAID/E WOULD CONSTITUTE A CONDITION PRECEDENT FOR THE DISBURSEMENT OF THE ESF; THE TARGETS ESTABLISHED IN THE PROGRAM WOULD BECOME COVENANTS UNDER THE GRANT AGREEMENT. IF A PUBLIC SECTOR PAYROLL TARGET IS ESTABLISHED, IT WOULD BE USEFUL TO RECONSIDER THE PROPOSAL MADE IN THE CONCEPT PAPER AND PERHAPS ESTABLISH AN ALTERNATE TARGET OF NO INCREASE IN REAL TERMS IN THE PUBLIC SECTOR PAYROLL.

6. GUIDANCE COMING FROM THE ISSUES MEETING.

A. THE MISSION WILL PROVIDE A DETAILED BALANCE OF

PAYMENTS ANALYSIS IN THE PAAD THAT SUPPORTS THE USE OF A CASH TRANSFER. THE ESF DOLLAR RESOURCES WILL BE USED TO FINANCE PRIVATE SECTOR IMPORTATION OF CAPITAL GOODS.

B. THE MISSION WILL PROVIDE IN THE PAAD, A COMPLETE EXPLANATION OF HOW THE DOLLARS AND LOCAL CURRENCY WILL BE UTILIZED AND MONITORED. MONITORING OF ESF DOLLARS AND HOST COUNTRY LOCAL CURRENCY WILL BE IN ACCORDANCE WITH A.I.D. POLICY GUIDANCE FOR CASH TRANSFERS AND PROGRAMMING OF HOST COUNTRY OWNED LOCAL CURRENCY. BAKER
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USAID/ECUADOR POLICY DIALOGUE AGENDA MATRIX

	FY 89	FY 90	FY 91-94
Goal 1: Economic Stabilization			
A) Reduce fiscal deficit (of the consolidated non-financial public sector) through a combination of the following measures:	3.4% of GDP	2% of GDP	0
- Domestic petroleum product price adjustment	Major price hike made and/or adjustment mechanism defined by 6/89 (completed in 7/89)	Price adjustment mechanism in place which covers production and investment costs plus a reasonable margin	Pricing policy maintained
- Commitment maintained that BCE will not finance any government deficits	X	X	X
- Balance of payments will be positive without incurring additional arrearages	X	X	X
- No increase in real terms in the public sector payroll	X	X	X
B) Foreign comercial bank debt Rescheduled	By 6/89, serious negotiations will have begun and service resumed	By end of CY 89, arrangements will have been negotiated	Debt servicing maintained
C) IMF standby	Agreement signed	GOE continues to be in compliance with IMF program	GOE continues to be in compliance with IMF program

	FY 89	FY 90	FY 91-94
Goal 2: Structural Reform/Growth			
TARGETS:			
A) Increase Ag. productivity;			4.5% average real growth of value added (GDP) in agriculture, including a greater participation of small and medium-sized farmers.
B) Increase exports; and			Non-traditional agricultural exports supported by USAID programs expanded by $40 million a year and result in 11,000 new jobs by 1994
C) Lower underemployment			Minimum wage and labor stability laws revised so as to promote labor-intensive production
through a combination of the following measures:			
- FX rate which encourages exports	Maxi-devaluation or more aggresive crawling peg system adopted by 6/89	FX rate which encourages exports maintained	FX rate which encourages exports maintained
- Positive real interest rate	---	X	X
- Elimination of subsidies	X	X	X
- Reduce protective tariffs	---	---	X
- Liberalize labor legislation	---	---	X
- Eliminate state-run ag. marketing organizations	---	---	X

(2497M)