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UNCLASSIFIED

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

ECUADOR

PROJECT PAPER

ECONOMIC STABILIZATION AND RECOVERY

and

Amendment No. 1

AID/LAC/P-566

Project Number: 518-0058
Grant Number: 518-K-602

UNCLASSIFIED

CLASSIFICATION:

AID 1120-1

PAAD

AGENCY FOR INTERNATIONAL DEVELOPMENT

PROGRAM ASSISTANCE APPROVAL DOCUMENT

1. PAAD NO.: 518-0058 518-K-602

2. COUNTRY: Ecuador

3. CATEGORY: Cash Transfer

4. DATE:

5. TO: AA/LAC, Dwight Ink

6. OYB CHANGE NO.:

7. FROM: LAC/DR, Terrence J. Brown

8. OYB INCREASE:

TO BE TAKEN FROM:

9. APPROVAL REQUESTED FOR COMMITMENT OF: $ 6,250,000

10. APPROPRIATION - BPC LES787-35518-KG31 (770-65-518-00-5071) 72-117/81037

11. TYPE FUNDING: ☐ LOAN ☒ GRANT

12. LOCAL CURRENCY ARRANGEMENT: ☐ INFORMAL ☒ FORMAL ☐ NONE

13. ESTIMATED DELIVERY PERIOD: FY 87

14. TRANSACTION ELIGIBILITY DATE: MAY 4 1987

15. COMMODITIES FINANCED

16. PERMITTED SOURCE		17. ESTIMATED SOURCE	
U.S. only:		U.S.:	6,250,000
Limited F.W.:		Industrialized Countries:	
Free World:		Local:	
Cash:	6,250,000	Other:	

18. SUMMARY DESCRIPTION

The purpose of this Program Assistance is to provide balance of payments support to Ecuador. This program will assist the Government of Ecuador (GOE) to stabilize the economy and continue the structural reform process already initiated.

This $6,250,000 (grant) is the second tranche of a $12,315,000 amendment to the ESF program approved in February 1987. The currently approved level for the program is $36,531,000 of which $30,281,000 has previously been authorized. The tranche will be disbursed as a cash transfer into a separate U.S. Bank account of the GOE. Upon disbursement of the assistance, the GOE will deposit into a special account an equivalent amount of sucres. These funds will be used for mutually agreed development purposes consistent with Sections 103-106 of the Foreign Assistance Act.

19. CLEARANCES	DATE
LAC/SAM, KJohnson (draft)	3/26/87
ARA/ECP, JCrawford (draft)	3/26/87
LAC/DP, WWheeler	5/4/87
LAC/DR, ILevy	5/4/87
GC/LAC, ANewton	5/4/87
PPC/EA, KKaufman (draft)	5/4/87
M/FM/CONT, CChristensen	5/1/87
DAA/LAC, MButler	Date

20. ACTION

☒ APPROVED ☐ DISAPPROVED

AUTHORIZED SIGNATURE: Dwight Ink

DATE: May 11, 87

TITLE: Assistant Administrator (LAC)

CLASSIFICATION:

CLASSIFICATION:

AID 1120-1

PAAD

AGENCY FOR INTERNATIONAL DEVELOPMENT

PROGRAM ASSISTANCE APPROVAL DOCUMENT

1. PAAD NO.: 518-0058 518-K-602

2. COUNTRY: Ecuador

3. CATEGORY: Cash Transfer

4. DATE:

5. TO: A-AA/LAC, Malcolm Butler

6. OYB CHANGE NO.:

7. FROM: ~~LAC/DR, Terrence J. Brown~~

8. OYB INCREASE:

TO BE TAKEN FROM:

9. APPROVAL REQUESTED FOR COMMITMENT OF: $ 6,065,000

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U.S. only:		U.S.:	6,065,000
Limited F.W.:		Industrialized Countries:	
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19. CLEARANCES	DATE
LAC/SAM, KJohnson(draft)	
ARA/ECP, WBarmon	2/10/87
PPC/EA, KKaufman	2/10/87
LAC/DP, RQueener	2/10/87
LAC/DR, ILevy	2/11/87
M/FM/CONT, CChristensen	2/11/87
GC/LAC, MRiedy	2/11/87

20. ACTION

☒ APPROVED ☐ DISAPPROVED

William B. Wheeler 2/11/87

AUTHORIZED SIGNATURE DATE

Acting Assistant Administrator (LAC)

TITLE

CLASSIFICATION:

ECUADOR

ECONOMIC STABILIZATION AND RECOVERY PROGRAM

(A.I.D. Program No. 518-0058)

PROGRAM ASSISTANCE APPROVAL DOCUMENT

Amendment No. 1

DECEMBER, 1986

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ECUADOR
ECONOMIC STABILIZATION AND RECOVERY PROGRAM
Program Assistance Approval Document
Amendment No. 1

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I. SUMMARY AND RECOMMENDATIONS.

A. Recommendation. USAID/Ecuador recommends authorization of an additional Economic Support Fund Grant of $12,315,000 for the on-going Economic Stabilization and Recovery Program of the Government of Ecuador (GOE). This action will bring total funding for this Program to $36,531,000. The additional grant funds will be authorized, obligated and disbursed during FY 87.

B. Grantee. The Grantee will be the Government of Ecuador acting through the Ministry of Finance and Public Credit.

C. Program Summary. Economic conditions in Ecuador worsened in the early 1980s. Real GDP growth decelerated while inflationary pressures increased. At the same time, the balance of payments position deteriorated sharply, the foreign debt burden increased, and the country incurred external payments arrears. The weakening of the country's economic and financial situation reflected in part the impact of external developments and unfavorable weather conditions. However, it was greatly aggravated by an overvalued exchange rate, expansionary demand management practices, and highly protectionist trade and development policies.

Upon taking office in August 1984, the administration of President Leon Febres Cordero Ribadeneyra moved quickly to adopt an economic stabilization program for 1985 aimed at strengthening and accelerating the economic adjustment effort and securing a restructuring of Ecuador's public debt. The program was based on a tight monetary policy and an effort to realign fiscal policies to new realities. The program also envisaged the unification of the official exchange market and the adoption of a flexible exchange rate policy to support the achievement of balance of payments equilibrium in 1985, facilitate economic growth, and permit a gradual liberalization of the trade system.

As a result of the successful implementation of these policies, Ecuador was able to essentially stabilize the economic situation and made considerable progress toward restructuring the economic environment in 1985. The public sector's financial position was reversed from a small overall deficit in 1984 to a surplus of about 2 percent of GDP in 1985. The balance of payments recorded a $25 million net surplus, and external payments arrears were eliminated. Furthermore, the average rate of domestic inflation decreased from a high of 53 percent in 1983, to 31 percent in 1984, to 28 percent in 1985. In addition, the GOE had moved forward with policy reforms which reduced interventionism, realigned exchange rate practices, reduced trade barriers, and opened financial markets to influence by market forces.

The outlook for Ecuador's economy has now changed dramatically with the recent sharp decline in the price of its principal export commodity, petroleum. To face this situation, the GOE has implemented a comprehensive adjustment program based on a strategy for maintaining balance of payments viability over the medium term. The program was initiated when the fall in petroleum prices became evident in January 1986 with the introduction of several revenue generating measures and a series of monetary adjustments.

By the third quarter 1986, faced with the prospect of low petroleum prices for a prolonged period, the GOE recognized the need for more radical, structural measures to combat the rapidly deteriorating situation. On August 11, 1986, the GOE adopted a series of economic reforms which ubruptly ended 16 years of interventionist, protectionist GOE economic practices. The official and parallel exchange rates were unified for all practical purposes. No government entity is to have a role in the allocation of foreign exchange. Most interest rates (both long and short term, savings and lending) will be market determined.

This adjustment program has been designed within the Government's overall strategy to reduce economic regulations and increase the reliance of the economy on market forces. In spite of the sharp deterioration in Ecuador's terms of trade, the Government intends to keep Ecuador's economy open. Demand management and exchange rate policies are designed so as to maintain international competitiveness in order to promote the diversification of the economy's sources of foreign exchange and thus improve the conditions for economic growt.

However, to accomplish its objectives, the GOE needs a significant amount of assistance. While debt reschedulings, two IMF arrangements, an oil facility, and multilateral assistance have helped, more assistance is needed in the short run to help off set the growing balance of payments gap, which is projected at $75 million for 1986. This assumes negative growth in real GDP of -1%, or -3% in per capita GDP growth which, of course, means that real income levels and living standards will decrease this year.

While a proportion of the population can probably absorb a short-term reduction in its living standard, for the X% of the population living below the poverty line, economic adjustment will be a painful process. The anticipated shift in investment patterns will undoubtedly result in labor displacement. Inflation has already moved upward in the form of substantial price increases in the family food basket, higher transportation costs, and more precious imports. In the medium term, urban consumers and the 60% of the economically active population located in urban areas will be the hardest hit.

Recent events have demonstrated that adoption of the new economic measures is politically unpopular. An opposition Congress was elected in June 1986. More recently that Congress has succeeded in impeaching the Minister of Finance because of the new economic program, and social unrest has increased. Essentially, the Febres-Cordero administration has less than two years left in which to prove that implementing its economic philosophy, based on reliance on market forces, reduced regulation, and an open economy, is the best strategy for increasing economic well-being for all of Ecuador's citizens. It behooves those nations and international organizations which have an interest in seeing the Ecuadorean economic experiment succeed to assist in all ways possible to ensure that success.

The Program for which an additional funding authorization is requested herein forms the cornerstone of USG bilateral assistance aimed at ensuring the success of Ecuador's economic policies. It will consist of a $12,315,000 increase to the Mission's Economic Stabilization and Recovery Program (518-0058) to be provided from FY 87 Economic Support Funds. The dollars will be provided on a cash transfer basis and will be attributable to eligible imports from the United States over the six month period following disbursement. Upon disbursement of funds, the GOE will deposit an equivalent amount of local currency (sucres) into a Special Account in the Central Bank of Ecuador, the uses of which will be jointly programmed by A.I.D. and the GOE in support of development activities that meet the general criteria of Sections 103 through 106 of the Foreign Assistance Act of 1961, as amended. In programming the local currency, emphasis will be placed on production and equity oriented development activities. Most of the funds reserved for use by the public sector will be utilized to assist in the completion of development investments already underway.

II. ECONOMIC SETTING.

A. Background. The present structure of the Ecuadorean economy has been shaped by the country's exploitation of petroleum resources. Favorable world markets for petroleum during the 1970's and Ecuador's capacity to steadily increase production levels brought about substantial inflows of foreign exchange. These large earnings essentially allowed the Central Bank to maintain an exchange rate that became increasingly overvalued and to finance the unrestrained growth of the public sector. The overvaluation of the domestic currency combined with high industrial trade barriers and access to artificially cheap credit under the rubric of industrial promotion made investment in import-intensive activities highly profitable and discouraged investment in export development endeavours. Thus, the country entered the 1980s with an economy highly dependent on a single product as a source of foreign and domestic revenues, characterized by an overvalued sucre, high levels of protectionism, a weak financial system, and a bloated public sector.

The economy's dependence on petroleum exports as the main source of foreign exchange and domestic revenues likewise made Ecuador vulnerable to the vagaries of world petroleum prices. The share of petroleum in total exports rose from 48 percent in 1979 to 70 percent in 1983, and whereas petroleum taxes accounted for only 19 percent of budget revenues in 1979, they represented 46 percent of the total in 1983. Then, in 1983, when petroleum prices declined by 15 percent and the country was battered by floods that severely affected agricultural production and destroyed physical infrastructure, the economy was not able to sustain the negative impact of these external events, and aggregate output fell. Particularly affected were the agricultural, construction and commercial sectors.

The overwhelming importance of petroleum exports as a source of both foreign exchange and government revenues combined with the high oil prices of the 1970's also led the GOE to implement overambitious government spending and investment policies. When spending surpassed even the bloated revenue levels generated by petroleum, the GOE did not hesitate to finance its investment programs with ever increasing levels of debt. At the same time, the Ecuadorean private sector found the international banking community only too eager to lend to a nation which had as collateral the kind of wealth and stability that "large, untapped, commercially-viable petroleum reserves" implied during the 1970's and early 1980's. The result was the contracting of an unprecedented level of foreign debt (especially short-term commercial debt) which soon turned into a crushing debt burden as payments came due.

In August 1984, the new administration of President Febres Cordero inherited an economy which was experiencing serious economic difficulties. Over the period 1979-83, real GDP growth dropped from a positive rate of over 5 percent in 1979, to a negative one of 3.3 percent in 1983. The rate of price increases had accelerated sharply from 10 percent in 1979 to 53 percent in 1983. Even though merchandise imports in 1983 were 67 percent lower than in 1979, the balance of payments position had gone from an overall surplus of US$ 30 million in 1979 to an overall deficit of US$ 58 million in 1983, and net international reserves had fallen from US$ 631 million to US$ 152 million during the same time period. Total external indebtedness had risen from US$ 3.6 billion (38 percent of GDP) at the end of 1979 to US$ 6.9 billion (53 percent of GDP) at the end of 1983, and external payments arrears stood at slightly over US$ 100 million.

Upon taking office in August 1984, the administration moved quickly to forestall further financial deterioration. Measures implemented before the end of 1984 included a devaluation of the sucre, an upward adjustment in interest rates, an increase in reserve requirements on commercial banks' demand deposits, and large increases in the domestic prices of petroleum products.

Ecuador's economic program for 1985, which was supported by a one-year stand-by arrangement with the IMF, aimed at consolidating the gains achieved in 1983-84 and at creating conditions for sustained economic growth through a further reduction of inflation and a strengthening of the country's external position. The program's objectives were pursued mainly through a flexible exchange rate policy in the context of a unified exchange market, a liberalization of the trade system, a significant strengthening of public sector finances, and prudent monetary management. The authorities met all quantitative performance criteria under the stand-by arrangement. Moreover, output and prices performed somewhat better than projected. The rate of growth of real GDP reached 3.8 percent in 1985, while the year end increase in the consumer price index was reduced to 24.4 percent.

The overall operations of the nonfinancial public sector shifted from a small deficit in 1984 to a surplus of 1.9 percent of GDP in 1985. Public sector revenues rose from 26 percent of GDP in 1984 to 29 percent in 1985, mainly because of a sizable increase in petroleum receipts resulting from the unification of the official exchange rates, the depreciation of the sucre, and the 65% average increase in the domestic price of petroleum products. This improvement in the fiscal situation in 1985 allowed the GOE to slow the growth of net domestic credit to the Central Bank; bank credit to the private sector also expanded somewhat more slowly than projected.

In 1985 Ecuador reached agreement with its external commercial bank creditors on a multiyear refinancing arrangement of public sector debt covering all new and previously refinanced principal maturities falling due in the period 1985-89. By that time, the "sucretization" program had resulted in the public sector's having assumed nearly all of the private sector's foreign exchange denominated debt. In addition, Ecuador reached an unprecedented multi-year agreement with its Paris Club official creditors to reschedule maturities falling due in the period 1985-87, as well as the unpaid principal which fell due after June 1, 1984.

After the highly successful foreign debt renegotiations brought relief, the overall 1985 balance of payments situation was such that an increase of US$25 million could be registered in the net official international reserves. The deficit on the current account of the balance of payments narrowed from 2.5 percent of GDP in 1984 to less than 1 percent of GDP in 1985. Oil and non-oil exports were higher than expected and offset both increased import levels and a slightly weaker-than-expected services account. Oil shipments reached nearly 71 million barrels, substantially higher than the projected 65 million barrels, and the average export price of crude oil was US$25.85 per barrel in 1985 vs. a US$25 projection.

Over the past twenty-four months, the authorities have taken a number of steps to liberalize imports. Within a month of coming into office, the new administration lowered certain import duties and reduced the minimum financing requirements for imports. In early 1985, import prohibitions were lifted and the advance import deposit requirement was abolished. In January 1986, the tariff schedule was revised. The overall effect was to lower protection and reduce the dispersion of import duty rates.

The economic policies applied in order to promote economic growth with stability also generated foreign confidence in the Ecuadorean economy. This manifests itself in an unprecedent interest on the part of foreign investors to start new business ventures, particularly in the oil, fishing, and gold sectors.

In sum, at the end of 1985, the economic future looked bright. Economic stabilization had been achieved, and recovery targets for 1986 had been identified: a robust growth performance of 6 percent in real terms, inflation declining to 15 percent, a comfortable position in the balance of payments with anticipated gains of US$ 250 to US$ 300 million in exchange reserves, and the completion of a good number of the public works that had been initiated in 1984-85.

B. The Crisis. While there had been rumblings about a softening up of the world petroleum market, the GOE economic strategy had not taken into account any kind of disastrous drop in world petroleum prices. As a matter of fact, the GOE's initial expectations were that the price of petroleum would drop to about US$ 23 per barrel, and its worst case scenario had it coming down to US$ 21 per barrel. No scenarios had been drawn up for prices lower than US$ 18 per barrel. It was thought, justifiably from the perspective of oil economics, that there were too many factors at work against a protracted and chaotic price collapse.

World petroleum prices, however, plummeted after the New Year and have not substantially recovered throughout 1986. Crude oil prices fell from an average of US$25.85 per barrel in 1985 to US$13.85 per barrel during the first half of 1986, and are expected to reach an average of US$ 11.90 per barrel for all of 1986. Due to this sharp decline in oil prices, Ecuador will lose close to US$ 800 million in foreign exchange from petroleum exports, and the public sector will lose about S/. 70 billion in revenues. It has been estimated that, in the absence of corrective measures, the operations of the public sector would move from a surplus of nearly 2 percent of GDP in 1985 to a deficit of about 8 percent by the end of 1986. This of course has had the practical effect of rendering almost useless the planned recovery strategy developed by the GOE in 1984-85 and forcing a return to a stabilization strategy.

The Ecuadorean authorities took immediate steps to face the unexpected financial crisis. An all-out effort has been made to increase public revenues from non-petroleum sources and to slash expenditures. A 25 percent import surcharge was introduced; the sales tax was increased from 6 to 10 percent; automobile imports were practically encouraged so as to increase central government revenues from the high import taxes; and rates on public utilities (including water, electricity, telephone service and air transportation) have been subject to major increases. At the same time, the GOE's big push to increase compliance with income and sales tax laws began to result in large increases in tax revenues. Combined, these revenue measures are expected to yield between S/. 25 to 30 billion.

On the expenditure side, budget cuts will result in a 5% - 15% savings. This has been, and will continue to be effected by tightening up approval of new outlays, postponing a number of projects, and delaying the administrative handling of spending authorizations. In addition, wage policy throughout the public sector is targeted at increases which are not to exceed 20 to 24 percent. In total, it is officially estimated that S/. 10.7 billion will be saved through budget slashing measures. Still, the combined public sector deficit will climb to about 3.2% of GDP by the end of 1986.

In the external sector, the GOE's initial actions were to immediately seek further debt relief, speed disbursements under international donor projects, request higher assistance levels from the international financial community, and to increase its efforts to attract more foreign investment.

C. <u>The GOE Stabilization and Recovery Strategy</u>. By mid-1986, it was apparent that gradual modifications in monetary and fiscal policies were going to be insufficient to solve the major problems created by a protracted loss of oil revenues. By August petroleum prices had not recovered enough to offset the losses already sustained. The President had already been handed a resounding defeat at the mid-term elections, and even the most optimistic GOE analyst grudgingly recognized that the days of US$25.00 per barrel oil were probably over for the foreseeable future. In that environment the Febres Cordero administration made a momentous decision to recognize that the problems caused by the loss of petroleum revenues had to be addressed quickly and structurally and not with a series of minor revenue generating (band-aid) measures. The economic cabinet believed that the severe and protracted nature of the drop of oil prices required the adoption of a series of fundamental policy reforms the combined result of which would be a large and rapid expansion of exports and a dramatic increase in private domestic savings.

At the same time, the public's lack of confidence in the GOE's ability to deal with the deteriorating economic situation had resulted in an ever-widening gap between the official sucre and the free market sucre (S/.110 vs. S/.175 = US$ 1.00). Large disbursements under multilateral programs and a 1986 IMF Stand-By arrangements also were being held up on the issues of GOE interest rate controls and preferential interest rate practices in some sectors in addition to the GOE's maintenance of an overvalued sucre. Thus, on August 11, 1986, a far reaching program of reforms of the exchange policy, the financial system, and the structure of protection was put in place.

The new program totally dismantled the import substitution model of the 1960's and 1970's. In one massive reform, 56 years of monetary and financial practices in Ecuador were erased. Under the new system the exchange rate will be determined by the market. All savings rates have been untied from administrative restrictions, and will be essentially market determined. Most lending rates, including the rediscount rate of the Central Bank, have been allowed to float.

There are essentially two objectives of the program. One is to provide clear market signals to exporters that their activities are favored, and that export diversification can and should take place. Exporters will be required to repatriate their foreign exchange and trade it through the open exchange market. Importers will likewise buy their foreign exchange on the private sector exchange market.

The other objective of the program is to stimulate financial savings and thereby create new sources of funding for private investment. The freeing of interest rates builds on the GOE's successful experiment with the introduction of Certificates of Deposits free of interest rate ceilings in 1985 which generated an estimated S/.______________ in additional savings. The freeing of interest rates on savings and lending operations is being done at a time when the nominal return on sucre financial assets is on the order of 36 percent (an expected 10-14 percent real rate). This should make sucre holdings attractive enough to limit currency speculation, and to reinforce the trend toward a return of flight capital begun with the introduction of CD's.

Henceforth the Central Bank will attend only to the servicing of the external debt and the financing of public sector imports. It will receive the dollars from petroleum exports as well as most disbursements of external assistance. The key point of economic management has essentially become the control of liquidity in the system. Foreign trade transactions in the private sector will no longer create new money; i.e., there will be no monetary emission by the Central Bank. Sucres will be traded for dollars through the private financial system, and new money will be created primarily by the Central Bank through its credit programs, and secondarily by the banking system through the accumulation of M^1, current account deposits plus currency in circulation, and M^2, savings and deposits. The monetary authority has lowered the limits on credit expansion through its rediscount programs. As a result, the interest rate on the sucre will be kept high, and the dollar rate should be kept in check. The exchange rate, it should be noted, has come down from a high of 175 sucres before the regulations were passed to a low of 141 sucres.

D. Outlook.

1. 1986. The package of economic measures adopted on August 11, 1986, will probably have little affect on Ecuador's economic performance for the rest of 1986. Tha major variable in projecting 1986 performance thus becomes the positive impact of revenue generating, budget slashing measures adopted during the year, the performance of non-petroleum exports, disbursements under international loans, and the all-important world price of petroleum.

Table 1 presents what the Mission believes is a reasonable projection for 1986 economic performance. The balance of payments projections for 1986 point to an increase in the current account deficit to 7.3 percent of GDP from a deficit of less than 1 percent of GDP in 1985. The dollar value of total exports is projected to decline by about 28 percent, reflecting a reduction of over 50 percent in the value of petroleum exports which would be partially offset by an increase in the value of other exports. The estimate of petroleum exports is based on an average price of US$11.90 per barrel and 2 percent increase in export volume. To the extent that the average price falls below $11.90, revenues will decrease by $76 million for every $1.00 drop in the per barrel price.

At the same time, the dollar value of imports is expected to decline by about 6 percent in 1986. The trade surplus would thus be reduced from 9 percent of GDP in 1985 to about 4 percent of GDP in 1986, while the deficit on the service account would rise from 10 (1985) to 12 (1986) percent of GDP. An increase in net capital inflows in 1986 mainly reflects the expanded use of trade credit lines by the Ecuadorean banking sector and larger external borrowing by the public sector. Projected disbursements on external loans to the public sector include an optimistic US$340 million from multilateral organizations (principally the World Bank and IDB), and US$150 million under an oil credit facility negotiated with foreign commercial banks. In sum, under this optimistically conservative scenario, the Ecuadorean economy could end CY 1986 with a balance of payments gap of as little as US$75 million, which would have to be financed by a drawdown of Ecuador's dwindling international reserves.

The most significant single point of impact of the drop in oil prices will be on the public sector budget. Central government operations are programmed to

TABLE 1

CENTRAL GOVERNMENT BUDGET
(In Percent of GDP)

	1983	1984	1985	Proj. 1986
Total Revenue	12.1	13.8	17.9	16.8
Petroleum Revenue	5.5	6.3	10.3	6.1
Nonpetroleum Revenue	6.6	7.5	7.6	10.7
Tax Revenue	6.3	6.8	7.6	9.6
Taxes on Income and Profits	1.7	[illegible]	1.8	1.7
Property Taxes	0.1	0.0	0.0	0.0
Taxes on Goods and Services	2.4	2.7	[illegible]	4.3
General Sales Tax	1.3	1.5	1.7	3.0
Selective Excise Tax	1.1	1.2	[illegible]	1.3
Taxes on International Trade	2.4	2.6	[illegible]	[illegible]
Import Duties	2.2	2.4	1.5	[illegible]
Export Duties	0.0	0.0	0.0	0.0
Exchange Profits Tax	0.2	0.2	0.2	0.0
Other Taxes	0.2	0.2	0.3	0.3
[illegible] (-)	[illegible]	[illegible]	[illegible]	-0.1
Nontax Revenue	0.2	0.4	0.4	0.4
Transfers	0.1	0.3	0.2	0.7
Total Expenditure	15.1	14.6	[illegible]	17.7
Current Expenditure	12.5	12.3	14.1	14.7
Wages and Salaries	3.0	2.5	2.4	2.5
Purchases of Goods and Services	0.5	0.5	0.4	0.3
Interest Payments	2.6	2.4	2.9	3.3
Current Transfers	5.2	5.2	6.1	6.3
Other Current Expenditures	1.2	1.7	2.3	2.3
Capital Expenditure	2.6	2.3	3.2	3.0
Fixed Capital Formation	1.3	1.5	2.2	1.0
Capital Transfers	1.3	0.8	0.8	1.2
Other Capital Expenditures	0.0	0.0	0.2	0.8
Overall Surplus or Deficit (-)	-3.0	-0.8	0.6	-0.9

Sources: Central Bank of Ecuador, Ministry of Finance, U.S.AID Mission estimates.

TABLE 2
BALANCE OF PAYMENTS: 1982 - 1986

(In millions of U.S. dollars)

	1982	1983	1984	1985	Proj. 1986
CURRENT ACCOUNT	(1,195)	(126)	(249)	(100)	(745)
Trade Account	146	940	1,054	1,147	455
Exports, f.o.b.	2,327	2,348	2,621	2,870	2,080
Petroleum	1,508	1,733	1,835	1,926	900
Other	819	615	786	944	1,18[illegible]
Imports	(2,181)	(1,408)	(1,567)	(1,723)	(1,625)
Service Account	(1,361)	(1,090)	(1,323)	(1,272)	(1,22[illegible])
Service Credits	407	340	350	390	[illegible]
Service Debits	(1,7[illegible])	(1,430)	(1,673)	(1,662)	(1,65[illegible])
Interest Payments	(767)	(711)	(836)	(737)	(7[illegible])
Other Service Debits	(1,00[illegible])	(719)	(837)	(775)	([illegible])
Transfers	20	24	20	25	25
CAPITAL ACCOUNT	524	176	308	185	670
Public Sector	660	[illegible]	231	227	
Drawings	8[illegible]	694	402	408	
Interest Rescheduled	[illegible]	43	15	0	
Amortization	(7[illegible])	(121)	(187)	(181)	
Other	477	(12)	0	0	
Private Sector	(136)	(430)	77	(42)	
Direct Investment	40	50	50	60	
Drawings	806	12	0	3	
Interest Rescheduled	0	5	3	0	
Amortization	(630)	(117)	(42)	(52)	
Other	(352)	(380)	66	(53)	
OVERALL BALANCE	(671)	52	59	85	(75)
Net International Reserves (increase ())	460	58	(20)	(25)	
Arrears (decrease ())	211	(110)	(39)	(60)	
Financing Gap	0	0	0	0	(75)

Sources: Central Bank of Ecuador, U.S.AID Mission estimates.

shift froma surplus equivalent to 0.5 percent of GDP in 1985 to a deficit of about 1 percent in 1986. Central government revenue is projected to decline from 17.9 percent of GDP in 1985 to 16.8 percent in 1986. Central government outlays are projected to rise from 17.5 percent of GDP in 1985 to 17.7 percent in 1986.

The overall public sector balance is much worse, moving from a fiscal surplus of nearly 2% of GDP in 1985 to a deficit of 3.2% of GDP by the end of 1986. The effects of the budget crunch are being felt all over the public sector. Many major investment projects have ground to a halt. Hardest hit have been social infrastructure projects (housing, health, education) as the GOE finds itself short of funds to finance many of its priority, income-generating foreign exchange producing investments.

2. Beyond 1986. The ultimate success and impact of the program of policy measures recently adopted is still hard to predict. Undeniably a turnabout has been accomplished and the import-substitution model has been totally abandoned. Export promotion and preservation of an open economy are undoubtedly the GOE's policy priorities. However, the key variable in calculating impact is how quickly behaviour will change.

As long as foreign exchange earnings from petroleum exports account for a large percentage of total earnings, the country's economic outlook will continue to be determined by the world market price of petroluem. The level of export earnings of petroleum products will, in turn, determine the country's capacity to meet the high import levels needed to fuel the productive sectors of the economy.

The analysis, below, examines Ecuador's external requirements in terms of import levels that allow for negligible and moderate per capita income growth. Tables 2 and 3 present both scenarios, and the following assumptions are applicable to both:

a. Petroleum export earnings are projected to recover gradually from their sharp decline in 1986. The price of oil is projected to increase by about one U.S. dollar a barrel a year on average, and the volume of crude petroleum exports is assumed to increase at an annual rate of 2 percent.

b. Assuming normal weather conditions and that the system of export incentives remains in place, non-oil exports are projected to grow at an average annual rate of 7 percent per year in the period 1987-1990.

c. Interest payments projections are based on a three-month LIBOR of 7.5 percent and a U.S. prime rate of 8.5 percent. Based on this, interest payments would average around US$ 830 million per year for the next four years. As a percentage of exports, interest payments would decline from 31 percent in 1986 to 26 percent in 1990.

d. Noninterest service payments are projected to remain slightly over 8 percent of GDP throughout the period, while service income would be around 4 percent of GDP.

e. Gross annual disbursements from the World Bank are projected to increase from US $156 million in 1986 to about US $204 million in 1987-90, while disbursements on IDB loans would increase from US $150 million to about US $216 million in the same period.

f. As amortization payments to foreign commercial banks increase, net capital inflows are projected to fall from US $670 million in 1986 to US $254 million in 1989, and to become negative in 1990, the first year not covered by the multiyear rescheduling arrangement (MYRA) with foreign commercial banks.

Assuming an economic growth scenario in which real GDP remains stragnant, imports would have to grow at an average annual rate of about 6 percent between 1987-1190. On this basis, the current account deficit would decline from US $443 million or 3.5 percent of GDP in 1990. Under these assumptions, the overall balance of payments deficit would increase from US$ 75 million in 1986 to US$ 500 million in 1990. Allowing for the modest increase in net international reserves required to maintain one month of imports, the financing gap would average US $285 million a year in the period 1987-90, as presented in Table 2.

Table 3 assumes the level of imports needed to achieve an economic growth scenario in which real GDP would grow at an average annual rate of 2 percent between 1987-90. During that period, imports would have to grow at an average annual rate of 11.7 percent. Under this scenario, the current account deficit would increase from US $745 million in 1986 to US $915 million in 1990, but it would fall as a percentage of GDP from 7.1 percent in 1986 to 6.2 percent in 1990. The overall balance of payments deficit would increase from US $75 million in 1986 to US $972 million in 1990, and assuming a level of international reserves equal to one month of imports, the financing gap would average US $554.5 million a year in the period 1987-90.

TABLE 3

BALANCE OF PAYMENTS PROJECTIONS: 1986 - 1990
NO GROWTH SCENARIO
(In millions of U.S. dollars)

	1986	1987	1988	1989	1990
CURRENT ACCOUNT	(745)	(591)	(506)	(490)	(443)
Trade Account	455	657	744	798	859
Exports, f.o.b.	[illegible]	2,307	2,533	2,715	2,912
Petroleum	[illegible]	1,084	1,230	1,295	1,363
Other	[illegible]	1,223	1,303	1,420	1,549
Imports	(1,625)	(1,709)	(1,789)	(1,917)	(2,053)
Service Account	(1,155)	(1,22[illegible])	(1,285)	(1,3[illegible])	(1,347)
Service Credits	[illegible]	[illegible]	471	50[illegible]	547
Service Debits	[illegible]	(1,67[illegible])	(1,756)	(1,832)	([illegible]894)
Interest Payments	[illegible]	[illegible]	(831)	(842)	([illegible]32)
Other Service Debits	(865)	(864)	(925)	(990)	(1,062)
Transfers	25	30	35	40	45
CAPITAL ACCOUNT	670	[illegible]	355	254	(57)
Direct Investments	70	90	105	115	125
Medium & Long-Term Debt	420	297	210	94	(232)
Drawings	726	687	758	782	838
Amortization	(306)	(390)	(548)	(688)	(1,070)
Other	180	35	40	45	50
OVERALL BALANCE	(75)	(169)	(151)	(236)	(500)
Net International Reserves (increase ())			(56)	(18)	(11)
Arrears (decrease ())					
Financing Gap	(75)	(169)	(207)	(254)	(511)

Sources: Central Bank of Ecuador and U.S.AID Mission estimates

TABLE 4

BALANCE OF PAYMENTS PROJECTIONS: 1986 - 1990
TWO PERCENT GDP GROWTH SCENARIO
(In millions of U.S. dollars)

	1986	1987	1988	1989	1990
CURRENT ACCOUNT	(745)	(679)	(730)	(828)	(915)
Trade Account	455	519	520	460	387
Exports, f.o.b.	[illegible]	2,307	2,533	2,715	2,912
Petroleum	900	1,084	1,230	1,295	1,363
Other	1,186	1,223	1,303	1,420	1,549
Imports	[illegible]	(1,788)	(2,013)	(2,255)	(2,525)
Service Account	[illegible]	(1,228)	(1,283)	(1,328)	(1,347)
Service Credits	[illegible]	[illegible]	471	504	547
Service Debits	[illegible]	(1,673)	(1,756)	(1,832)	(1,894)
Interest Payments	[illegible]	[illegible]	[illegible]	(842)	(832)
Other Service Debits	(865)	[illegible]	[illegible]	(990)	(1,062)
Transfers	25	37	35	40	45
CAPITAL ACCOUNT	670	422	355	254	(57)
Direct Investments	70	90	100	115	125
Medium & Long-Term Debt	420	297	210	94	(232)
Drawings	726	687	758	782	838
Amortization	(306)	(390)	(548)	(688)	(1,070)
Other	180	35	40	45	50
OVERALL BALANCE	(75)	(257)	(375)	(574)	(972)
Net International Reserves (increase ())			(89)	(20)	(22)
Arrears (decrease ())					
Financing Gap	(75)	(257)	(464)	(594)	(994)

Sources: Central Bank of Ecuador and U.S.AID Mission estimates

III. JUSTIFICATION FOR THE PROPOSED PROGRAM.

A. Economic Justification.

1. Balance of Payments and International Reserves. The Febres Cordero administration came to office commited to carrying out a thorough restructuring of the Ecuadorean economy along free-market, price-directed lines, minimizing public sector interference, and encouraging private and foreign investment. The GOE has turned this commitment into an action program that it has been successfully implementing over the first half of the current Presidential term. The reforms of August 11, 1986, in fact, turned the economic development strategy being follwed by Ecuador around, completely substituting an import-substitution model for an export promotion one.

Nonetheless, the success of the restructuring is now seriously threatened by adverse external developments beyond Ecuador's control. The drop in world petroleum prices that was feared a year ago has since turned into a reality that has resulted in a tremendous shock to the Ecuadorean economy which, in turn, has thrown the successful economic management practices of the GOE into crisis. The prospect for sustaining any real economic growth in 1986 has been all but eliminated, and future prospects are in doubt unless the measures recently adopted can be shown to have a very positive effect in the very short term. The GOE now faces a balance of payments gap of $75 million in 1986 and $169 million in 1987. Unless performance in the export sector can be significantly improved in the short term and the foreign debt once again renegotiated, that gap will continue to grow to over $500 million by 1990, obviously an unsustainable level. Growth of international reserves, already at minimal levels, will have to be foregone in 1986 and 1987. The consequences of this gap are negative growth in 1986 and zero growth for the foreseeable future, something that may ultimately result in public rejection of the free-enterprise, market oriented economic model itself. The short term answer to the crisis which the GOE is attempting to implement with some success is the moblization of increased levels of external resources largely from the international banking and donor communities to enable it to buy some time for the recently introduced export promotion policies to produce positive financial results.

2. Fiscal Deficit. Another of the major results of the economic crisis facing Ecuador has been the return of a large fiscal deficit not experienced since the year prior to the Febres-Cordero administration's coming to office. This deficit has already resulted in a near halt to public investment efforts that are viewed by the populace as tangible evidence of economic progress. It has also resulted in the administration having to develop a policy position against real wage increases, another anti-popular position given that the crisis is resulting in significant increases in the cost of living. Again, the GOE needs an increased level of financial and budget resources, combined with the serious expenditure slashing program currently underway, to gain time. The GOE is doing all it can to generate those resources domestically, but it is not going to be enough in the short-term and sooner, rather than later, external resources will have to be applied to this purpose.

3. Economic Restructuring. The provision of ESF assistance should not be justified on the basis of a balance of payments gap or fiscal deficit alone. Its major purpose must be to allow a recipient country enough time to take corrective measures to deal with its basic economic disequilibria, and to make the process of structural adjustment less politically and economically destabilizing than it would be without such assistance. The task of persuading governments of ESF-recipient countries to undertake essential economic reforms necessary to put their houses in order is thus a key part of the USG strategy, particularly for countries receiving substantial amounts of balance of payments assistance.

Ecuador represents almost a unique case in this regard. The GOE began implementing the necessary policy and institutional reforms long before the USG initiated an ESF program. The most recent reforms leave only a few adjustments to be made before the market-oriented economic model is fully in place. Thus, the "carrot-and-stick" approach to ESF assistance so often seen in other countries is not, nor has it been appropriate in Ecuador to date. That, however, does not negate the need nor the justification for ESF assistance if the real purpose of such assistance is to allow recipient governments the time required for adjustment measures to take effect, to allow for a restructuring process that is as stable as possible. It does mean that the level of resources and the time period over which ESF may be required are significantly less in Ecuador than in other nations.

B. US Interests and Response.

1. U.S. Interests.

a. Background. The election of President Leon Febres Cordero represented the first successful transition from one democratically elected administration to another in the past twenty-five (25) years of Ecuadorean history. The new President set out to stabilize a rapidly deteriorating economy and to effect a radical restructuring of the economy he inherited. He embraced the concept of an open economy where market forces determine allocation of scarce resources, foreign investment is welcomed, exports are promoted and free trade is encouraged. During the first twenty-four months of the Febres-Cordero administration, the GOE has effected an impressive list of accomplishments on the economic front including major debt renegotiations and economic adjustments. By the close of 1985, the economy had largely been stabilized and the GOE's economic recovery strategy was clearly working. Then in January 1986, petroleum prices plummeted and the economy was thrown into crisis, forcing a return to stabilization measures.

The crisis has also had a significant destabilizing effect on the political situation. President Febres-Cordero and his economic policies are viewed as one and the same by the Ecuadorean populace. Hence, as the economic crisis worsened, support for the President dwindled. An opposition Congress was elected and, in its short two-month life, two constitutional crisises have been provoked, one of which was over the economic reform package implemented by the Monetary Board on August 11, 1986.

b. The Political Environment. The combination of support from medium to lower income groups for the popular political promises of the Christian Social Party platform and from private enterprise and business groups succeeded in electing President Leon Febres Cordero in May 1984. The majority of this constituency remained loyal and supportive of the President during his first year in office while his administration focused largely on economic issues, especially on the debt renegotiations and attracting needed international support from the international commercial banks, the IMF, and the Paris Club. At the same time, it must be recognized that even then some of the economic measures adopted eroded the President's political support in some sectors. For example, as one its first actions, and in support of its promise to reduce government interventionism, the GOE reduced the number of commodities subject to prices controls from 55 to 7, which had a direct and immediate impact on the purchasing power of most consumers. In support of his commitment to economic austerity, in December 1984 the President faced down labor unions and stern Congressional opposition, vetoing a salary increase for wage earners which he considered excessive and inflationary. At virtually the same moment, the administreation reduced subsidies on domestic petroleum prices, thereby increasing the price of gasoline to the consumer by an average of 65%. This initiated a price spiral that included increases in all forms of transportation, in turn sparking increases in food prices, etc.; all of which fueled inflation, which spurted to 38%, on an annualized basis, during the first quarter of 1985.

While adoption of earlier measures reduced the popular image of the Febres-Cordero administration, the effects of the 1986 deterioration in world oil prices has had a profoundly deliterious effect on his popularity, and a destabilizing effect on the overall political situation. As oil revenues fell precipitously the GOE began to slash the 1986 GOE budget. As a result many of the most visible signs of government investment and support for municipalities (roads, bridges, sewers, street repairs) were halted or slowed down.

Another effect of the oil crisis was the dramatic devaluation of the freemarket sucre. One of the major causes of this devaluation was the public's increasing lack of confidence in the ability of the administration to pull the economy out of the tailspin caused by the drop in petroleum revenues. This, of course, became a self-fulfilling prophecy as the sucre plummeted to new, all-time lows. In response, prices began to rise. Urban transport unions once again began pressuring for rate increases and food prices rose overnight.

At the same time that the country was reeling from the devaluation and revenue losses, the GOE continued to move away from economic controls. For example, in April 1986 the GOE announced the creation and opening of the Agriculture Commodity Exchange through which most agricultural commodities bought by the GOE (ENAC) and for which minimum prices were set would be transacted in the future. Producers began to speak out against the policy. Such events, combined with other challenges to the President's authority, could not have converged at a worse time politically for the Febres-Cordero administration, and were recorded in the defeat of the administration's party in the June, 1986 elections.

In short, the effects of the fall in GOE revenues at the same time that the GOE has been restructuring the economy has been profoundly negative on this administration's popularity. With the election of a unicameral Congress controlled by the opposition, it will be much more difficult for the administration to continue with needed economic reforms. This sense of the political environment which will face future reform measures was confirmed and discussed by ex-Minister of Finance, Francisco Swett Morales, in a recent speech before the OAS. He stated that, in fact, the major challenge facing the Febres-Cordero administration during its last two years would be to garner sufficient political support for continued economic restructuring. The new Congress has already demonstrated how difficult it will be to acquire that support. As one of its first official acts, the Congress succeeded in impeaching President Febres-Cordero's second Minister of Finance because he was a member of the Monetary Board that reformed the exchange and interest rate regimes on August 11, 1986.

Finally, it is also important to remember that in addition to an economic philosophy, there are many other areas where GOE and USG policies are mutually supportive. With regard to foreign investment, the GOE has created a climate where U.S. investors are welcomed. To do this, Ecuador was one of the first nations to break rank on Decision 24 of the Andean Pact, which led to the signature of an OPIC Agreement early in President Febres-Cordero's term of office. The GOE later followed this with a liberalization of its policy on profit remittances, broadened the legal rights of foreign investors in cases of investment disputes, recognized the legal right of foreign investors to majority ownership in local companies, and began to allow foreign investors access to long-term domestic credit.

In the area of foreign policy, the policies of the USG and the Febres-Cordero administration also have been mutually supportive on a number of issues. With regard to Central America, Ecuador is supportive of USG policy. It is neither a member of the Contadora Group which has pursued a peace through dialog strategy for resolving differences in Central America, nor is it a member of the Lima group which has, in the past, been critical of U.S. involvement in Central America. Ecuador has been highly supportive of U.S. anti-terrorism policicies and positions in international fora, and conducts a domestic terrorism policy that is similar to that of the United States' own international policy. Finally, in the area of U.S. narcotics policy, the GOE has been one of the most supportive of USG efforts to attack the drug problem on the supply side. The GOE has been working closely with the USG for several years with sustained success to reduce the production and processing of narcotics in and through Ecuador.

In sum, US interests in Ecuador support the movement toward a free-enterprise, market-oriented, open economy that is the policy of the current GOE administration. As such, it is in the USG's best interests to support that policy to help ensure that it succeeds, thereby providing demonstrable support for a friendly ally. If the economic strategy pursued by the Febres-Cordero administration does not succeed, it is highly unlikely that a future GOE administration that supports free markets and an open economy will be elected.

2. USG Assistance Strategy. To respond to the current economic crisis will require three types of support from the USG: assurance of a reasonable level of bilateral financial resources, coordination of assistance efforts within the USG itself and between the USG and the multilateral financial community, and some exceptional efforts at providing non-financial assistance in areas where Ecuador may not be exploiting its full potential.

The GOE fully understands the budgetary situation facing the USG at the present time. As such, it realizes that significant increases in bilateral assistance levels to Ecuador are probably not possible in spite of the crisis it is facing. Still, even the level of resources requested can play an important economic and political role in assisting the GOE to weather the storm. The US Mission in Ecuador firmly believes that because of the economic crisis the GOE is facing and the political difficulties it is having in trying to implement an open, market-oriented economic model, now is not the time to significantly reduce assistance levels to Ecuador. The USG strategy is based, therefore, on the assumption of assistance levels that are equal to (ESF), or slightly reduced (DA) from last year's levels. The preservation of an ESF program at the same funding level is the only bilateral instrument the USG has to provide to Ecuador the type of assistance that has enough immediate impact to enable the GOE to address its short-term crisis and quiet domestic criticism. In light of the comprehensive economic policy reforms being implemented by the GOE, it is all the more important that the USG provide tangible evidence of its support and approval of the economic model being pursued.

At the same time, the USG recognizes that the economic crisis currently being faced by Ecuador is of such a magnitude that ESF and DA programs alone are not, and cannot be designed to fill the ever increasing gaps. As such, coordination among the different arms of the US government that play a role in formulating and executing US foreign assistance policy will become even more important than they have been in the past. Assistance to the GOE in facing its current crisis may be provided in many forms. The Baker Plan, agricultural commodity assistance, assistance through the Department of Commerce, OPIC, and the Trade and Development Program in foreign investment are all examples of areas where assistance has been provided in the past and will continue to be requested in the future. Given the economic crisis facing the GOE and the USG's desire to help, and given that ESF and DA financing alone will be insufficient to meet the GOE's needs, assistance from other USG entitites will play an important role in achieving US objectives in Ecuador. In short, the ESF program requested herein should be evaluated as only a part, albeit an important part, of total USG efforts to assist the GOE.

One of the most important areas where the USG can be supportive of GOE efforts to address the current economic crisis is by utilizing the influence it has with the major multilateral donors; specifically, the World Bank, the IDB, and the IMF. Conditions have been cleared for a 1986 IMF stand-by arrangement to be implemented. However, disbursements under on-going World Bank and IDB projects and approvals of new projects remain problematical. As can be seen from the economic analysis, dramatic and sustainable increases in those disbursements are extremely important to the success of the GOE's economic strategy.

Finally, it is important to note that in implementing its strategy of diversifying the sources of its foreign exchange, the GOE is carefully analyzing the constraints to investment or to increasing foreign exchange earnings in a variety of sectors. Because of the USG's demonstrated desire to assist and because the GOE often prefers USG assistance, the GOE sometimes makes what appear to be nontraditional or unconventional assistance requests. Many of these requests are for a very limited amount of assistance to examine a certain constraint to the development of an entire sector; i.e., with a small investment of US expertise, the GOE can often then provide the resources necessary to alleviate the problem and stimulate earnings. Responding positively when possible and when it appears reasonable to do so, is another way the USG can support GOE efforts to address the current economic crisis and foster insitutional changes that will help the economic restructuring effort.

IV. PROGRAM DESCRIPTION.

A. Program Overview. The overall objective of this program is to assist the Government of Ecuador to stabilize the current economic situation and to continue with economic structural reforms which will lead to economic recovery in the medium term and provide firm foundations for long term economic growth. The specific purpose of this program is to provide immediate balance of payments and budgetary support to Ecuador, thereby ensuring that adequate funding is 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 proposed $12,315,000 program amendment will be authorized and disbursed in tranches during FY 1987. The first tranche of $6,157,000 will be disbursed as soon as possible after commitment of FY 1987 funds as a cash transfer into the account of the Government of Ecuador in the Federal Reserve Bank of New York. A subsequent increment will be authorized and disbursed in FY 1987 subject to compliance with certification requirements set forth in the Anti-Drug Abuse Act of 1986. The specific timing of disbursements of funds approved under this Program will be responsive to the GOE's needs for balance of payment support and budget financing. To the extent practical, they will also be supportive of the overall stabilization program and economic restructuring program put in place by the GOE, although formal tying the timing of disbursements to specific accomplishments is not proposed.

Given the notable progress of the GOE to date in implementing a major restructuring program and the urgency of the balance of payments and budget financing requirement, the Mission proposes to disburse the assistance as soon as possible after authorization and obligation of funds without additional conditionality. As a covenant to the Program, the GOE will make a commitment to continue to take actions which will further institutionalize the GOE's policy reforms, as outlined in its letter of application for ESF assistance. Specific targets for compliance will be set forth in a subsequent letter from the GOE.

Upon each disbursement, the GOE will deposit an equivalent amount of sucres into a Special Account in the Central Bank of Ecuador. These sucres will be used for mutually agreed upon economic and social development purposes which are consistent with Sections 103 through 106 of the Foreign Assistance Act. The amount of sucres to be thus deposited will be calculated at the free market exchange rate or the Central Bank rate, whichever is higher on the date of the dollar disbursement.

B. Conditionality Strategy.

1. Progress in achieving conditions to date. In spite of encountering strong political opposition, the Febres Cordero administration has continued to reorient the economy toward a free market system. To that effect, the government has instituted far reaching and coherent liberalization measures in both foreign and domestic trade and finance.

Last year's PAAD identified the freeing up interest rates, and the reduction of import tariffs and of gasoline subsidies as areas where corrective measures were needed. In each of these areas the GOE has made significant progress.

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, interest rates have been liberalized. 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 social housing development). In addition, the level of the simplified structure was brought closer in line with anticipated inflation. Finally, the recent reforms of August 11th, further untied savings and most lending rates from administrative restrictions.

Protectionist sentiments run strong in Ecuador and unusual partnerships are found 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 government has taken courageous steps to liberalize imports and recently prepared a new struture of protection which will further lower the level of tariffs. Government officials have stated that the list of products whose tariffs have either been eliminated or reduced is to be announced soon.

The depreciation of the sucre and the fall of petroleum prices have substantially reduced the subsidy element of gasoline prices in Ecuador. The absence of adequate data prevent the use of international parity prices or calculating the opportunity cost of petroleum exports to determine the size of the subsidy of gasoline prices in Ecuador. It is, however, possible to compare consumer prices for similar types of gasoline in the United States and Ecuador. As Table 4 shows, the net subsidy per gallon of unleaded gasoline has fallen from 74.44 sucres in 1985 to 43.80 sucres in 1986, and the burden of this subsidy on the government budget has been reduced from 29 billion sucres to 17 billion sucres.

TABLE 4
Gasoline Subsidy Estimates: 1985 and 1986*
Comparison of Gasoline Prices in the U.S. and Ecuador

	1985	1986
Average Free Market Exchange Rate (Sucres/U.S.$)	116.3	140.0
Unleaded Gasoline Price in the United States		
- In U.S. dollars per gallon	1.10	.70
- In Sucres per gallon	127.93	98.00
Unleaded Gasoline Price in Ecuador		
- In U.S. dollars per gallon	.43	.36
- In Sucres per gallon	50.00	50.00
Price Difference Between the U.S. and Ecuador		
- In U.S. dollars per gallon	.67	.34
- In Sucres per gallon	77.93	48.00
Transportation Cost Ecuador to U.S. Port		
- In U.S. dollars per gallon	.03	.03
- In Sucres per gallon	4.39	4.20
Net Subsidy to Ecuadorean Consumer		
- In U.S. dollars per gallon	.64	.31
- In Sucres per gallon	74.44	43.80
Cost of Subsidy to Ecuadorean Economy**		
- In U.S. dollars million	250	118
- In Sucres billion	29	17

* Comparison of prices of 80 octane leaded "regular" gasoline in the U.S. and "extra" gasoline in Ecuador.

** Estimated on the basis of domestic petroleum consumption of 390.6 million gallons in 1985 and 382.2 million in 1986.

2. Conditions of additional assistance. The GOE has surpassed the conditionality of last year's ESF program in all areas. In addition, it has gone farther in implementing exchange rate reform than envisioned. As stated above, the GOE has already instituted a comprehensive set of economic reforms that implement the GOE's commitment to a market-oriented, open economy. This commitment has repeatedly been tested politically, and it has not waivered.

Given that the policy reforms have been implemented, the Mission believes that Ecuador is a case where an ex-post conditionality strategy is warranted, as discussed in the A.I.D. Policy Paper on "Approaches to the Policy Dialogue." Given that the purpose of this program is to provide Ecuador financial resources for the economic adjustment process to be a stable one until the measures begin to produce the desired results, and to demonstrate USG support for those measures, additional conditionality is not proposed for the follow-on program at the proposed level of funding.

C. Dollar Financing.

1. Justification for cash transfer. In its original design of this Program, the Mission carefully weighed the advantages and disadvantages of the cash transfer versus the commodity import program (CIP) as the dollar financing mechanism. Based on a careful analysis of LAC experience with both mechanisms and the appropriateness of each mechanism in light of the objectives of this Program, the Mission concluded that only by utlizing the cash transfer mechanism could the overall objectives and the specific purposes of the Program be achieved. AID/W concurred in its review of the program, and the program authorizations reflect this approval.

2. Utilization and management of dollar resources. A $12.315 million cash transfer to the Central Bank of Ecuador (BCE) is proposed. Disbursements will be made into a separate BCE bank account in the U.S., in accordance with its instructions contained in the financing request. It is anticipated that an electronic transfer of funds to its account in the Federal Reserve Bank of New York will be employed.

3. Justification for grant financing. The level of ESF assistance proposed for Ecuador is quite small given the size of the economy and the magnitude of the 1986 balance of payments gap and budget deficit. Therefore, if the USG is to make a demonstrable contribution and achieve maximum political impact with a limited amount of assistance, it is essential that funds continue to be provided on the most concessional terms. It was determined in the 1985 AID/W review of this program that given the size of the proposed program vis-a-vis the magnitude of Ecuador's economic problems, grant financing was justified. Since the magnitude of Ecuador's economic problems have surpassed even the worst case estimates of 1985 and given that USG funding for this program is likely to be even more restricted in 1986, the justification for grant financing, originally approved, is further strengthened. Hence, the Mission recommends grant financing of this Program amendment.

D. Local currency uses and procedures. In addition to its promise of strengthening a market-oriented approach to development that emphasizes the role of the private sector, the Febres Cordero government was elected on a populist platform of "Bread, Housing, and Employment." While the policy reforms enacted thus far during the four-year life of this administration have emphasized the first promise, the development investments have been oriented toward both structural reform of the economy and the more populist platform. As noted in the PAAD for the FY 1985-1986 program, progress on the more populist oriented development investments was unacceptably low at the end of 1985. With the economic crisis of 1986 and the resulting efforts to reduce the size of the GOE budget, progress has been even slower over the past year. In fact, the problem has grown to such a proportion that for some projects, donors have threatened to cut off foreign exchange financing for major projects until GOE budgeted counterpart is made available. In other cases, major infrastructure works already nearly completed and for which other donors have disbursed the foreign exchange sit idle for lack of the local counterpart required to finish the final details.

Because of the budget crisis and the commitment of the USG to the comprehensive policy reforms being implemented under the Febres Cordero government, the Mission has determined it imperative that a significant amount of local currency be utilized to finance GOE budgeted counterpart. Financing will be focused on the increasingly difficult problem of funding on-going GOE investment projects in need of local counterpart. In all cases, local currency will continue to be used to finance activities consistent with Sections 103-106 of the Foreign Assistance Act.

The following summarizes use of funds to date and proposed uses of addi onal funding.

1. Public Sector Uses. Local currency utilized by the public sector falls into three major categories: public investment projects, counterpart to AID and IFI projects, and local cost extensions of on-going AID/GOE projects.

During 1986, ESF generated local currency has been financing a series of small, largely rural infrastructure projects throughout Ecuador. Typical activities include bridges, road repair, school repair, water system construction and repair, and medical infrastructure. These activities will continue into 1987 without additional funding.

In 1986, A.I.D. authorized the first use of local currency for budgeted counterpart for A.I.D. and other donor projects. In addition to A.I.D. projects, IBRD, IDB, and other bilateral donor projects received financing. Given the magnitude of the budget crisis, additional financing will be required for this purpose in 1987.

In 1985 the Mission and the GOE agreed to set aside a portion of ESF generated local currency to finance extensions or additional activities under on-going AID/GOE projects. This practice essentially allowed the Mission to avoid using precious dollar resources to finance certain project activities, thereby accomplishing more under projects than originally anticipated. In 1986, the Macroeconomic Policy Analysis and Agriculture Sector Reorientation Projects received this support. For the FY 1987 ESF program, the Mission proposes to provide the local currency equivalent of US $2.3 million to continue this effort. We anticipate dedicating most, if not all, of the funds available to an extension of A.I.D. efforts in rural water supply and sanitation.

2. Private Sector Uses. ESF local currency programmed for private sector activities will continue to finance the general activities originally approved: investment credit for productive activities complementary to A.I.D. programs and the Mission's PVO program.

3. A.I.D. Trust Fund. Ten percent of each disbursement of local currency into the Special Account shall be programmed for transfer to the A.I.D. operating expense trust fund.

4. Local Currency Programming and Disbursement Procedures. Upon disbursement of the dollar resources, the GOE will deposit an equivalent amount of local currency into a Special Account in the Central Bank. Mission experience over the past year has indicated that given the erratic availability of funds to AID/W for this program, it is not always possible to officially program the local currency prior to a dollar disbursement. However, it is preferible and will continue to be done whenever feasible. When it is not possible, local currency will be programmed jointly by AID and the GOE prior to authorizing any disbursements of local currency from the Special Account. Subsequent changes in the local currency programming are subject to joint agreement of A.I.D. and the GOE, as are all disbursements of funds.

5. Summary of Programming. To summarize, local currency uses are oriented toward production and equity-oriented development investments. A summary table of actual and anticipated local currency uses is presented in Table 5, below.

TABLE 5

ESR LOCAL CURRENCY PROGRAMMING
ACTUAL AND PROPOSED
(S/. and US$ 000)

		TO DATE $	TO DATE S/.	UNPROGRAMMED	FY 87 ILLUSTRATIVE PROGRAMMING
I.	Public Sector Development Investments	6,590	626,000		
II.	Extensions of On-Going AID/GOE Activities	2,105	200,000		2,300
III.	Private Sector Development Activities	8,695	826,000	97.2	4,400
IV.	AID OE Trust Fund	2,400	228,000	21.6	1,200
V.	GOE Budget Counterpart AID and IFI Projects	4,210	400,000	97.2	4,415
TOTAL		24,000	2,280,000	216	12,315

ANNEX A

REPUBLICA DEL ECUADOR
MINISTERIO DE FINANZAS

OFICIO No. **6314**

Quito, 9 de diciembre de 1986

Señor
Frank Almaguer
Director de la Agencia para
el Desarrollo Internacional
En su Despacho

Estimado señor Almaguer:

A nombre del Gobierno del Ecuador, tengo a bien solicitar financiamiento por la cantidad de 25.000.000 dólares para continuar el Programa de Estabilización y Recuperación Económica que ha permitido llevar adelante el Programa de Ajuste Económico del Ecuador en que se encuentra empeñado este Gobierno.

Al asumir el mando en Agosto de 1984, el actual Gobierno adoptó rápidamente un programa de estabilización económica para 1985 diseñado para fortalecer los esfuerzos de ajuste y asegurar la reestructuración de la deuda pública externa del Ecuador. Este programa, que fue apoyado con recursos del Fondo de Estabilización Económica del Gobierno de los Estados Unidos, contempló una política monetaria estricta y el fortalecimiento de las políticas del sector público. El programa también preveía la unificación del mercado de cambios oficial y la adopción de una política flexible de tasas de cambio que apoye el logro del equilibrio de la balanza de pagos en 1985, que facilite el crecimiento económico, y permita una liberalización gradual del sistema arancelario.

Como resultado de la ejecución de estas políticas, el Ecuador ha hecho considerable progreso en el mejoramiento de la situación financiera y económica. La situación financiera del sector público cambió de un pequeño déficit total a un superávit en 1985, y la balanza de pagos registró un ligero superávit, incluyendo la eliminación de todas las moras en pago de la deuda externa. Más aún, el promedio de la tasa interna de inflación decreció. Al final de 1985, la presente Administración había esencialmente estabilizado la economía ecuatoriana.

Los esfuerzos del Gobierno para poner en efecto un programa económico que conducirá a un equilibrio interno y externo y a la consecución de la estabilidad financiera del país, a través de las políticas económicas ejecutadas

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REPUBLICA DEL ECUADOR
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OFICIO No. **6314**

se han visto, en 1986, refrenadas por la brusca caída de los precios del petróleo en el mercado mundial. Mientras en 1985, se logró un superávit fiscal, en 1986 se ha acumulado un déficit, debido a la disminución de los ingresos fiscales. La brecha de la balanza de pagos, también crecerá en 1986.

En esta situación, el Gobierno del Ecuador ha delineado un programa completo de ajustes, en el contexto de una estrategia para mantener la viabilidad de la balanza de pagos a un mediano plazo. El programa se inició en Enero de 1986, cuando la caída de los precios del petróleo fueron evidentes, a través de un ajuste de la tasa de cambio del Banco Central en el mercado de intervención de S/.96.50 por dólar a S/.110 por dólar, de un aumento del requisito de reserva legal aplicable para los bancos comerciales, y a través de un incremento en los impuestos a las ventas. Más tarde, el Gobierno introdujo una comisión de riesgo cambiario que también ajustó el tipo de cambio aplicable a las importaciones. En Agosto de 1986, este Gobierno complementó estas medidas con una reestructuración completa de las políticas de tasas de interés y tasas de cambio. El programa de ajuste ha sido diseñado dentro de la estrategia global del Gobierno para reducir regulaciones económicas e incrementar la influencia de las fuerzas del libre mercado en la economía.

A pesar del claro deterioro de los términos de intercambio del Ecuador, el Gobierno tiene la intención de mantener la economía del Ecuador abierta, y las políticas monetarias, así como las políticas sobre tasas de cambio, se dirigirán a mantener un nivel adecuado de competitividad internacional, a fin de promover la diversificación de las fuentes de la economía que originan divisas y consecuentemente mejoran las condiciones del crecimiento económico. Si bien las reformas de Agosto de 1986 en gran parte han sentado las bases para lograr este objetivo, el Gobierno está consciente de la necesidad de más modificaciones en la estructura arancelaria para el próximo año.

Las consideraciones en las cuales se basa esta solicitud de asistencia económica son las siguientes:

a. Las proyecciones de la balanza de pagos para el período 1986-1989 muestran claramente la necesidad de aportes financieros de todas las fuentes;

b. El Gobierno actual ha adelantado reformas económicas globales consistentes con la política del Gobierno de los Estados Unidos demostrando serios intentos para abrir y reestructurar sus economías hacia la influencia del mercado;

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REPUBLICA DEL ECUADOR
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c. El Gobierno ha realizado y continuará realizando sus mejores esfuerzos para la normalización de las actividades de intercambio y de inversión, sobre todo internacionalmente; y,

d. Durante los últimos dos años, Ecuador ha asumido una posición como un miembro respetado y responsable en la comunidad financiera internacional.

El Gobierno del Ecuador desearía contar con el apoyo de los Estados Unidos de América para su programa económico, y consecuentemente, solicita por medio del presente un programa de apoyo económico por un año, por un monto de 25 millones de dólares. En vista de la incertidumbre existente con relación a los precios del petróleo y en vista de las reformas ya implementadas para enfrentar la crisis de 1986, quisiéramos proponer que una primera cuota de 15 millones de dólares sea desembolsada en este año calendario, sin ninguna condición económica adicional. Condiciones para una segunda cuota de 10 millones de dólares serán desarrolladas conjuntamente a principios de 1987 y podrían enfocar otras áreas de mutuo interés para el Ecuador y los Estados Unidos como políticas arancelarias, políticas sobre el tráfico de drogas, etc.

A nombre de la República del Ecuador, espero que esta solicitud recibirá el apoyo total del Gobierno de los Estados Unidos, con el cual mi país mantiene importantes relaciones políticas, financieras y comerciales de beneficio mutuo.

Atentamente,

DIOS, PATRIA Y LIBERTAD

Domingo Cordovez
MINISTRO DE FINANZAS Y
CREDITO PUBLICO

REPUBLICA DEL ECUADOR
Ministro de Finanzas

SECTORAL VALUE AND DISTRIBUTION OF GDP

	1982	1983	1984	1985	Proj. 1986
GDP at market prices	155.2	150.5	150.6	161.6	[illegible]
Agriculture & Livestock					
S./ billion at 1975 prices	23.1	19.7	21.0	[illegible]	[illegible]
As percent of total GDP	14.8	13.1	13.4	13.4	[illegible]
Petroleum and Mining					
S./ billion at 1975 prices	15.5	19.7	22.1	22.4	24.[illegible]
As percent of total GDP	10.0	13.1	14.1	14.[illegible]	14.9
Manufacturing					
S./ billion at 1975 prices	29.6	29.5	28.9	28.[illegible]	[illegible]
As percent of total GDP	19.1	19.6	18.5	18.4	18.4
Construction					
S./ billion at 1975 prices	7.3	6.6	6.6	6.7	6.1
As percent of total GDP	4.7	4.4	4.1	4.1	3.8
Commerce					
S./ billion at 1975 prices	25.6	22.3	23.7	24.[illegible]	24.3
As percent of total GDP	[illegible]	14.9	15.0	15.1	14.9
Transport & Communications					
S./ billion at 1975 prices	[illegible]	10.5	10.9	11.2	11.4
As percent of total GDP	[illegible]	7.0	6.9	6.9	7.0
Electricity, Gas & Water					
S./ billion at 1975 prices	1.3	1.4	1.7	1.8	1.9
As percent of total GDP	0.8	1.0	1.1	1.2	1.2
Real Estate					
S./ billion at 1975 prices	7.0	7.2	7.4	7.6	7.6
As percent of total GDP	4.5	4.7	4.7	4.7	4.7
Public Administration					
S./ billion at 1975 prices	14.2	14.4	14.6	14.9	14.2
As percent of total GDP	9.2	9.6	9.3	9.2	8.7
Other					
S./ billion at 1975 prices	21.1	18.9	19.8	20.3	20.8
As percent of total GDP	13.6	12.6	12.7	12.6	12.7

Sources: Central Bank of Ecuador, U.S.AID Mission estimates

Best Available Document

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CENTRAL GOVERNMENT OPERATIONS
(In billions of Sucres)

	1983	1984	1985	Proj. 1986
Total Revenue	67.1	108.8	167.5	[illegible]
Petroleum Revenue	30.3	49.2	107.6	[illegible]
Nonpetroleum Revenue	[illegible]	59.5	[illegible]	127.2
Tax Revenue	34.9	54.0	[illegible]	[illegible]
Taxes on Income and Profits	[illegible]	[illegible]	[illegible]	[illegible]
Property Taxes	0.4	0.1	[illegible]	[illegible]
Taxes on Goods and Services	13.7	21.0	[illegible]	[illegible]
General Sales Tax	7.4	11.4	[illegible]	[illegible]
Selective Excise Tax	[illegible]	9.6	[illegible]	[illegible]
Taxes on International Trade	[illegible]	[illegible]	[illegible]	[illegible]
Import Duties	12.1	[illegible]	[illegible]	[illegible]
Export Duties	[illegible]	[illegible]	[illegible]	0.0
Exchange Profits Tax	[illegible]	[illegible]	[illegible]	[illegible]
Other Taxes	[illegible]	[illegible]	[illegible]	[illegible]
CATs and IERAC (-)	[illegible]	[illegible]	[illegible]	[illegible]
Nontax Revenue	[illegible]	[illegible]	[illegible]	[illegible]
Transfers	[illegible]	[illegible]	[illegible]	8.4
Total Expenditure	[illegible]	[illegible]	[illegible]	[illegible]
Current Expenditure	[illegible]	[illegible]	[illegible]	[illegible]
Wages and Salaries	10.5	[illegible]	[illegible]	[illegible]
Purchases of Goods and Services	2.8	[illegible]	4.4	3.6
Interest Payments	14.4	15.8	30.7	39.8
Current Transfers	28.9	40.7	63.6	75.0
Other Current Expenditures	6.7	13.3	[illegible]	27.1
Capital Expenditure	14.4	18.2	34.9	36.1
Fixed Capital Formation	7.2	11.9	23.5	12.3
Capital Transfers	7.2	6.3	8.8	14.5
Other Capital Expenditures	0.0	0.0	2.6	9.3
Overall Surplus or Deficit (-)	-16.6	-5.4	4.8	-11.5

Sources: Central Bank of Ecuador, Ministry of Finance, U.S.AID Mission estimates.

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CENTRAL GOVERNMENT OPERATIONS
(In percent of GDP)

	1983	1984	1985	Proj. 1986
Total Revenue	12.1	13.8	17.9	16.8
Petroleum Revenue	5.5	6.3	10.3	6.1
Nonpetroleum Revenue	6.6	7.5	7.6	10.7
Tax Revenue	6.3	6.8	7.0	9.6
Taxes on Income and Profits	1.3	1.1	1.5	1.7
Property Taxes	0.1	0.0	0.0	0.0
Taxes on Goods and Services	2.4	2.7	2.8	4.3
General Sales Tax	1.3	1.5	1.7	2.0
Selective Excise Tax	1.1	1.2	1.1	1.3
Taxes on International Trade	2.4	2.6	[illegible]	2.4
Import Duties	2.2	2.4	[illegible]	2.4
Export Duties	0.0	0.0	0.0	0.0
Exchange Profits Tax	0.2	0.2	0.2	0.0
Other Taxes	0.2	0.0	0.3	0.3
CATs and IERAC (-)	-0.1	[illegible]	-0.1	-0.1
Nontax Revenue	0.2	0.4	0.4	0.4
Transfers	0.1	0.3	0.2	0.7
Total Expenditure	15.1	14.6	17.3	17.7
Current Expenditure	12.5	12.3	14.1	14.7
Wages and Salaries	3.0	2.5	2.4	2.5
Purchases of Goods and Services	0.5	0.5	0.4	0.3
Interest Payments	2.6	2.4	2.9	3.3
Current Transfers	5.2	5.2	6.1	6.3
Other Current Expenditures	1.2	1.7	2.3	2.3
Capital Expenditure	2.6	2.3	3.2	3.0
Fixed Capital Formation	1.3	1.5	2.2	1.0
Capital Transfers	1.3	0.8	0.9	1.2
Other Capital Expenditures	0.0	0.0	0.2	0.9
Overall Surplus or Deficit (-)	-3.0	-0.8	0.6	-0.9

Sources: Central Bank of Ecuador, Ministry of Finance, U.S.AID Mission estimates.

[illegible]

CONSOLIDATED BANKING SYSTEM, 1984-85

(In billions of Sucres)

	December 1984 Central Bank	Other Banks	Total	December 1985 Central Bank	Other Banks	Total
Net International Reserves	10.6	0.0	10.6	18.6	0.0	18.6
Other Foreign Assets, net	0.0	-7.4	-7.4	0.0	3.3	3.3
Net Domest. Assets	143.8	245.0	388.8	155.3	[illegible]	457.6
Public Sector, net*	-31.4	-4.1	-35.5	-67.0	[illegible]	[illegible]
Private Sector	23.1	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Unclassified, net	152.1	43.0	195.1	[illegible]	42.7	241.7
Interbank Transactions, net	70.0	-53.9	16.1	65.5	[illegible]	[illegible]
Credit	92.7	33.4	[illegible]	101.0	[illegible]	[illegible]
Deposits**	-22.7	-89.3	[illegible]	-35.5	[illegible]	-127.1
Intersystem Transactions, net	38.9	-0.7	38.2	42.4	-1.2	41.2
Allocation of SDRs	-3.1	0.0	-3.1	-3.4	0.0	-3.4
Medium & Long-Term Foreign Liabilities*	-216.3	-2.9	-219.2	-225.4	-4.4	-229.8
Liabilities to Private Sector	-41.9	-180.2	-222.1	-52.9	-250.6	-303.5
Currency in Circulation	-34.8	0.0	-34.8	-41.8	0.0	-41.8
Demand Deposits	-0.7	-76.2	-76.9	-1.2	-95.2	-96.4
Time and Savings Deposits	0.0	-28.5	-28.5	0.0	-45.6	-45.6
Special Certificates of Deposits	0.0	0.0	0.0	0.0	-33.8	-33.8
Other Sucre Deposits	-5.8	-53.8	-59.6	-9.0	-54.9	-63.9
Liabilities in Foreign Currency	-0.8	-6.2	-7.0	-0.9	-5.6	-6.5
Private Capital and Reserve	0.0	-15.5	-15.5	0.0	-15.5	-15.5

Source: Central Bank of Ecuador.

Notes : * Public sector for 1984 and 1985 excludes deposits for oil facility, which are included in Medium and Long-Term Foreign

** In Central Bank accounts, includes currency held by

BALANCE OF PAYMENTS - AGGREGATED PRESENTATION, 1984-85
(In millions of SDRs)

	1984	1985
A. CURRENT ACCOUNT	(242.0)	(83.8)
Merchandise Exports, f.o.b.	2,558.0	2,820.6
Bananas	132.7	187.1
Coffee	170.7	181.2
Crude Petroleum	1,638.0	1,737.4
Other	616.6	660.9
Merchandise Imports, f.o.b.	(1,529.8)	(1,697.0)
Trade Balance	1,028.2	1,123.6
Other Goods, Services, and Income: Credit	341.5	314.1
Other Goods, Services, and Income: Debit	(1,632.2)	(1,622.1)
Shipment	(147.3)	(118.2)
Investment Income	(935.6)	(877.0)
Other	(549.3)	(626.9)
Total Goods, Services and Income	(261.5)	(108.4)
Private Unrequited Transfers	0.0	0.0
Total, Exc. Official Unrequited Transfers	(261.5)	(108.4)
Official Unrequited Transfers	19.5	24.6
B. DIRECT INVESTMENT AND OTHER LONG-TERM CAPITAL	(827.3)	(674.6)
Direct Investment	46.8	59.1
Portfolio Investment	0.0	0.0
Other Long-Term Capital		
Resident Official Sector	(319.0)	(636.2)
Loans Received	(310.2)	(636.2)
Other	(8.8)	0.0
Deposits Money Banks	(6.8)	0.0
Other Sectors	(548.3)	(97.5)
Total Groups A and B	(1,069.3)	(758.4)
C. OTHER SHORT-TERM CAPITAL	(242.9)	0.0
Resident Official Sector	(22.4)	0.0
Deposit Money Banks	33.2	0.0
Other Sectors	(253.7)	0.0
D. NET ERRORS AND OMISSIONS	9.1	(83.3)
Total Groups A thru D	(1,303.1)	(841.7)

BALANCE OF PAYMENTS - AGGREGATED PRESENTATION, 1984-85
(In millions of SDRs) (Cont.)

	1984	1985
E. COUNTERPART ITEMS	47.3	(80.1)
Monetization/Demonetization of Gold	0.0	0.0
Allocation/Cancellation of SDRs	0.0	0.0
Valuation Changes in Reserves	47.3	(80.1)
Total Groups A thru E	(1,255.8)	(921.8)
F. EXCEPTIONAL FINANCING	1,294.6	867.7
Debt Rescheduling		
Resident Official Sector	1,176.6	1,127.7
Other Sectors	0.0	18.7
Long-Term Loans Rec. from Comm. Banks	0.0	0.0
Payments Arrears	118.0	(278.7)
Total Groups A thru F	38.8	(54.1)
G. LIABILITIES CONSTITUTING FOREIGN AUTHORITIES' RESERVES	(70.2)	0.0
Total Groups A thru G	(31.4)	(54.1)
H. TOTAL CHANGE IN RESERVES	31.4	54.1
Monetary Gold	0.0	0.0
SDRs	(0.4)	(25.7)
Reserve Position in the Fund	11.4	0.0
Foreign Exchange Assets	(19.0)	(4.6)
Other Claims	0.0	0.0
Use of Fund Credit	39.4	84.4
CONVERSION RATES: SUCRES PER SDR	64.1	70.6

Source: Balance of Payments Statistics, IMF.

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COMPOSITION OF MERCHANDISE EXPORTS

(U.S.$ Million)

	1983	1984	1985	1st Semester 1986
TOTAL EXPORTS	2,349	2,620	2,905	1,104
Primary Goods	2,149	2,277	2,506	936
- Petroleum	1,639	1,678	1,825	530
- Bananas	153	135	220	133
- Coffee	149	175	181	109
- Shrimp	175	160	150	104
- Cocoa	8	96	135	38
- Abaca	9	12	9	4
- Wood	7	8	[illegible]	5
- Tuna	2	3	[illegible]	4
- Other Fish Products	2	3	[illegible]	4
- Other Exports	5	7	[illegible]	5
Manufactured Goods	199	344	399	168
- Metal Manufactures	[illegible]	3	2	2
- Sugar & Molasses	0	17	6	1
- Petroleum Derivatives	94	150	102	35
- Chemicals & Pharmaceutics	5	8	9	3
- Processed Coffee	19	22	18	15
- Fish Meal	10	36	59	34
- Cocoa Products	26	50	79	44
- Panama Hats	3	4	4	[illegible]
- Electrodomestics	0	0	0	0
- Other Processed Marine Products	17	28	34	15
- Fish Oil	0	0	4	2
- Other Processed Exports	21	20	20	11

Sources: Central Bank of Ecuador, U.S. AID Mission.

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COMPOSITION OF MERCHANDISE IMPORTS

(U.S.$ 000's)

	1983	1984	1985	Proj. 1986
Consumer Goods	114,121	142,868	152,486	155,110
As % of Total	7.7	8.8	8.6	8.8
- Durables	51,646	59,988	58,246	57,990
As % of Total	3.5	3.7	3.3	3.3
- Nondurables	62,475	82,880	94,240	97,120
As % of Total	4.2	5.1	5.3	5.5
Fuels & Lubricants	300,922	172,949	195,922	141,198
As % of Total	20.4	10.7	11.1	8.1
Raw Materials	666,731	859,629	890,411	815,096
As % of Total	45.2	53.2	50.5	46.4
- Agricultural	42,271	62,799	71,672	74,416
As % of Total	2.9	3.9	4.1	4.2
- Industrial	583,057	749,976	768,928	689,302
As % of Total	39.5	46.4	43.6	39.2
- Construction	41,403	46,854	49,810	51,378
As % of Total	2.8	2.9	2.8	2.9
Capital Goods	392,943	440,237	525,523	641,036
As % of Total	26.6	27.2	29.8	36.5
- Agricultural	10,876	17,592	34,101	40,120
As % of Total	0.7	1.1	1.9	2.3
- Industrial	271,371	274,136	338,694	392,346
As % of Total	18.4	17.0	19.2	22.3
- Transport Equip.	110,696	148,509	152,728	208,570
As % of Total	7.5	9.2	8.7	11.9
Other Imports	0	57	0	3,566
As % of Total	0.0	0.0	0.0	0.2
Total Imports	1,474,617	1,615,739	1,764,342	1,757,982

Source: Central Bank of Ecuador, U.S. AID Mission estimates.

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SOURCES OF IMPORTS AND DESTINATION OF EXPORTS

(In U.S.$ Million)

	1984			1985		
	Exports to	Imports from	Trade Balance	Exports to	Imports from	Trade Balance
Industrial Countries	1,823	1,237	585	2,095	1,381	714
U.S.A.	1,601	591	1,011	1,796	650	1,140
Canada	17	32	(15)	52	40	12
Japan	18	236	(218)	44	193	(149)
New Zealand	5	15	(9)	10	4	6
Belgium	8	16	(8)	7	[illegible]	(2)
France	4	23	(19)	16	30	(14)
Germany	37	111	(74)	84	148	(64)
Italy	21	37	(17)	23	40	(17)
Netherlands	18	15	3	15	39	(24)
Spain	9	30	(21)	6	39	(33)
U.K.	11	32	(21)	22	83	(61)
Other Industrial	73	100	(27)	20	106	(86)
Developing Countries						
Africa	1	5	(4)	0	3	(3)
Asia	135	7	128	294	64	230
Hong Kong	1	1	(1)	1	2	(1)
Korea	129	1	128	289	48	241
Other Asia	5	4	1	4	14	(10)
Other Western Europe	3	7	(4)	6	6	0
Middle East	1	16	(16)	5	35	(30)
Americas	364	311	53	24	59	(35)
Argentina	4	21	(17)	0	0	0
Brazil	2	133	(131)	0	39	(39)
Chile	40	31	9	6	20	(14)
Colombia	66	40	26	0	0	0
Panama	179	3	175	0	0	18
Other Americas	73	82	(9)	18	0	18
Eastern Bloc	15	33	(18)	13	2	11
Hungary	7	11	(4)	13	2	11
Czechoslovakia	2	7	(5)	0	0	0
U.S.S.R	6	1	5	0	0	0
Other Eastern Bloc	1	15	(14)	0	0	0

Sources: Direction of Trade Statistics, IMF, U.S.AID Mission

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INTERNATIONAL MONETARY RESERVES: 1981-86

(In U.S.$ Million)

	Dec. 1981	Dec. 1982	Dec. 1983	Dec. 1984	Dec. 1985	July 1986
Assets:						
Gold	17.5	124.3	124.3	124.3	124.3	124.3
Foreign Exchange	423.7	167.3	544.5	481.2	[illegible]	280.4
SDRs	60.6	--	0.1	1.3	35.1	31.2
Other Assets	176.0	165.5	118.7	149.5	164.6	167.5
Gross International Reserves	677.8	457.0	787.6	756.3	880.2	807.4
Liabilities:						
Short-Term	104.3	235.2	402.5	331.5	320.0	226.6
Medium-Term	10.6	11.9	233.9	254.1	368.4	429.5
Total Liabilities	115.0	247.0	636.3	585.6	684.3	656.2
Net International Reserves	562.9	210.0	151.3	170.7	195.9	151.3

Source: Central Bank of Ecuador

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U.S. DOLLAR EXCHANGE RATES: 1980-86
ANNUAL AND MONTHLY AVERAGES

(In Sucres)

	Official Market		Free Intervention Market		Free Private Market	
	Buying	Selling	Buying	Selling	Buying	Selling
1980	24.80	24.95	26.75	27.15	27.68	27.78
1981	24.80	24.95	27.56	27.86	30.59	30.76
1982	30.00	30.25	30.00	34.11	49.78	49.81
1983	44.20	45.01	82.37	83.22	[illegible]	83.47
1984	62.30	63.55	91.55	92.65	95.43	96.09
1985	70.36	71.75	95.00	98.50	115.52	116.29
1986						
January	95.00	96.50	106.76	108.26	130.39	130.74
February	95.00	96.50	96.31	97.81	145.36	146.20
March	95.00	96.50	108.50	110.00	140.92	141.60
April	95.00	96.50	108.50	110.00	156.60	157.23
May	95.00	96.50	108.50	110.00	162.56	163.69
June	95.00	96.50	108.50	110.00	165.40	165.55
July	95.00	96.50	108.50	110.00	167.30	168.20
Up to August 11	95.00	96.50	108.50	110.00	172.40	175.00
September	apply the free market rates				163.50	164.40
October					141.30	143.50

Sources: Central Bank of Ecuador, U.S.AID Mission estimates.

MEDIUM-TERM EXTERNAL DEBT PROJECTIONS: 1985 - 1990

(In US$ Million)

	Actual	Projected				
	1985	1986	1987	1988	1989	1990
Total Debt Outstanding	7,754	8,401	8,695	9,197	9,466	9,080
of which:						
IMF	313	412	361	243	164	62
Financing Gap	--	--	--	--	--	--
Debt Service	2,120	2,095	2,[illegible]	2,227	2,310	1,[illegible]
Principal paid, of which:						
Banks	54	64	90	195	295	[illegible]
IMF	..	8	103	102	69	[illegible]
Financing Gap	--	--	--	--	--	17
Principal renegotiated	1,101	996	924	748	711	--
of which:						
Banks	987	911	860	748	711	--
Interest paid, of which:	787	787	609	601	642	632
Banks	602	542	582	559	546	493
IMF	25	33	24	30	23	16
Financing Gap	--	--	2	21	38	68
Interest renegotiated	--	--	--	--	--	--
of which:						
Banks	--	--	--	--	--	--
Memorandum Items						
Debt/GDP						
Including IMF	69.0	81.7	80.9	78.1	75.1	71.5
Excluding IMF	66.2	77.7	77.7	76.1	73.8	71.1
Debt Service/Exports of Goods & Nonfactor Serv.						
Before Relief	65.0	83.6	80.8	74.1	71.8	57.6
After Relief	31.3	43.8	47.3	49.3	49.7	57.6
Interest Payments/ Exports of Goods & Nonfactor Services						
Before Interest Relief	24.1	31.4	29.4	27.7	26.2	24.1
After Interest Relief	24.1	31.4	29.4	27.7	26.2	24.1

Source: Central Bank of Ecuador

EXTERNAL DEBT BY CREDITOR: 1984 - 1985

(U.S.$ Million)

	World Bank	IDB	Other Int. Org.	Govern-ments	Banks	Sup-pliers	Bonds	Total
Beginning Year								
1984	201	455	53	591	4,890	481	14	6,690
1985	247	504	54	745	4,902	495	2	6,949
Disbursements								
1984	67	73	4	235	1,136	93	--	1,610
1985	41	129	10	261	1,231 **	82	--	1,753
Amortizations								
1984	20	18	3	68	1,118	69	12	1,308
1985	28	32	10	124	1,021	117	2	1,334
Interest								
1984	19	26	3	26	725	32	1	834
1985	21	28	2	59	602	49	0	762
Adjustments*								
1984	--	(6)	--	(13)	(14)	(10)	--	(42)
1985	--	5	--	32	14	20	--	71
End of Year								
1984	247	504	54	745	4,902	495	2	6,949
1985	260	606	53	914	5,127	480	0	7,440

Sources: Central Bank of Ecuador, U.S.AID Mission
Notes : * Foreign exchange rate adjustment
** Non-refinanced disbursements total US$ 90 million

Economic Policy Reforms
Accomplishments of the Febres Cordero Administration

The administration of President Leon Febres Cordero has organized an exceptionally well-qualified team of private enterprise-oriented economists. This group, with limited assistance from A.I.D., has put together a package of economic measures that are designed to stabilize and reorient the economy in the immediate to short term, and lead to recovery in the medium term. Among those steps already taken are the following:

1. August 1984: To reduce energy subsides, the GOE resolved to continue the 2% per month increase in electricity rates.

2. September 4, 1984: To align exchange rates, the GOE:

   a. created the official intervention market;
   b. moved all transactions except public sector transactions, selected imports, and debt servicing on external loans contracted prior to 9/4/84 to the intervention and parallel markets;
   c. reduced the minimum financing period from 360 days and 180 days to 120 days for the majority of imports;
   d. lowered certain import duties; and,
   e. removed most import prohibitions.

3. September 11, 1984: To free the market, the GOE eliminated price controls on 48 of the 55 commodities subject to control.

4. November 6, 1984: To slow the rate of growth of Central Bank credit, the GOE raised the reserve requirement on sight deposits by 2 percentage points to 22 percent.

5. November 1984: To foster foreign investment, the GOE successfully negotiated and signed an OPIC Agreement.

6. December 1984: To stabilize the economy, the GOE successfully completed negotiations for a MYRA (1985-1989) debt rescheduling with foreign commercial banks.

7. December 28, 1984: To increase government revenues and decrease petroleum subsidies, the GOE:

   a. increased domestic gasoline prices by about 65 percent (regular and high octane);
   b. increased the domestic diesel price by 100 percent; and
   c. intends to further adjust prices in the future.

8. January 1985: To make interest rates more flexible, the GOE:

   a. raised the interest rates on commercial lending to 23 percent;
   b. raised the interest on deposits to 20 percent; and,
   c. allowed the banking system to issue term deposit certificates at market-determined interest rates and to determine freely the interest rate applied on loans funded with the proceeds from the placement of such certificates ("polizas de acumulacion").

   By August 31, 1985, this mechanism had generated approximately $270 million, about $135 million of which is estimated to be capital returned from abroad. Of the amount generated, approximately $200 million had been relent. Since their institution, interest rates on the certificates have fallen steadily, underlining their popularity. Rates on 90 to 119-day certificates fell from 26% in April 1985 to 24% at the end of August. Rates on the 270-day certificates have fallen from 28% in April 1985 to 26% at the end of August.

9. January 1985: To stabilize the economy in the immediate term and restore economic growth over the medium term, the GOE successfully completed negotiations with the IMF for an SDR 105.5 million Stand-by Agreement. The following measures were identified for implementation during 1985 as part of the IMF Stand-by Agreement:

   a. unification of the official and Central Bank intervention exchange rates;
   b. transfer of foreign exchange transactions for services from the parallel market to the unified market;
   c. ultimate implementation of a flexible exchange rate policy;
   d. achievement of an official fiscal surplus through increased revenues from domestic petroleum sales and traditional taxes and expenditure constraints;
   e. limitation of wage increases to the rate of inflation;
   f. elimination of the requirement for advance payments for imports;
   g. ceilings on external debt; and,
   h. limits on expansion of domestic credit.

10. April 1985: To further open the economy, the GOE officially eliminated all remaining import prohibitions.

11. April 1985: To stabilize the economy, the GOE successfully completed negotiations for a MYRA for official debt at the Paris Club.

12. August 28, 1985: To unify exchange rates, all import/export transactions were moved to the Central Bank intervention exchange rate. Prior to this date, the GOE had been gradually transferring specific tranactions from the official to the Central Bank rate. On August 28, the only transactions which continued to take place at the official rate were pharmaceutical imports, Texaco exports, and payment of previously contracted and disbursed foreign debt. With the transfer of the first two of these transactions to the Central Bank rate, the official market has been virtually eliminated. Tight monetary policy has resulted in strengthening the free market sucre from a low of S/125:$1.00 in February 1985 to S/100:$1.00 at the first of August 1985. Since the Central Bank intervention rate has remained constant at S/97:$1.00 and the official rate has been virtually abolished, a de facto exchange rate unification is taking place.

13. November 13, 1985: To further unify exchange rates, the Monetary Board officially abolished the official rate of exchange on this date (S/67:$1.00). No further transactions will take place at this rate of exchange. This complies with the conditions of the IMF Stand-by Agreement, and further closes the gap exchange rates. Political opposition forces characterized the move as a serious devaluation. In fact, as mentioned above, the GOE has been gradually moving transactions from the official rate to the Central Bank Free Market Intervention rate over the past year.

14. January 28, 1986: To further rationalize exchange rates, the GOE devalued the Central Bank Intervention Rate of Exchange from S/. 95/96.5:$1.00 to S/. 108.5/110:$1.00. This was a further 14% devaluation of the sucre.

15. January 28, 1986: To reduce trade barriers to further open the economy, the GOE revised the tariff code to begin the process of reducing protectionism.

16. March 6, 1986: To control inflation and financial liquidity, the GOE increased the minimum legal reserve requirement a total of 4 points.

17. March - April, 1986: The GOE adopted several measures geared to increase treasury revenues and at the same time rationalize imports. These measures included:

   a. establishment of a mandatory exchange rate fluctuation insurance.
   b. requirement that importers pay the BCE the full sucre value of imports before leaving the ports.

18. April 24, 1986: In an effort to increase foreign investment the GOE amended Decision 24 of the Andean Pact, to abandon the fade-out rule for foreign investment except when exports are intended to the Andean Common Market.

19. April 25, 1986: The Agricultural Commodity Exchange was established to provide a price directed marketing mechanism for agricultural products, decrease the role of middle men and enable small producers to sell their products easier.

20. August 11, 1986: To further rationalize foreign exchange allocations, the GOE effected several far-reaching monetary and foreign exchange measures:

    a. liberalization of exchange rates: All private sector exporters and importers must sell and buy their foreign exchange in the free market. Central Bank Intervention rate will fluctuate with the free market.

    b. the ceiling on interest rates for savings accounts and Certificates of Deposits was allowed to fluctuate with the market. Most lending rates are freed from controls.

DATED: December 8, 1986
(2697G)

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