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FINANCIAL MARKETS ASSESSMENT REPORT/ EQUADOR

Bureau for Private Enterprise
U.S. Agency for International Development

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EXECUTIVE SUMMARY

Introduction

The relative financial stability experienced by Ecuador in the 60's and the first half of the 70's gave way to first boom (1975-1981) caused by major oil discoveries and subsequent exports and then bust or, as Ecuadorians term it, "the crisis." The crisis brought about in great part by GOE fiscal and monetary policies designed to prop up an ailing economy began to abate shortly after the inauguration (8/10/84) of President Febres Cordero. Nevertheless, the situation remains delicate with restructuring of the country's financial markets representing one of the necessary steps for insuring future, optimal economic development.

The situation has been examined in some depth in recent years - by the IFC Capital Market Group, the World Bank, and the Mission. Of particular note in the latter regard was a comprehensive study performed by Price Waterhouse in late 1984 which established on-going work in the financial markets field as a high priority for future Mission activities. That study concluded that the most critical problem then (and today) was "how to mobilize sufficient savings to satisfy the country's development aspirations without excessive reliance on foreign debt."

The Febres Cordero administration has taken some notable steps- "sucretization" (conversion of external debt into local currency), establishment of two exchange rates (as opposed to three), reduction in subsidies, introduction of a debt instrument with market determined rates, and, above all, a solid commitment to private sector development. Thus, the time could not be better for a major AID thrust in the financial markets area to complement steps already taken and accelerate progress.

Scope and Objectives

Under the terms of the contract the consultant:

1. Assessed donor groups' activities in the financial markets field.

2. Reviewed with the Mission other PRE companion studies (to its financial markets efforts).

3. Collected a wide variety of germaine published and unpublished secondary data.

4. Conducted a series of interviews with those familiar with or expert in the subject.

5. Prepared this report.

Approach and Methodology

The study was conducted through:

1. The gathering of information and interviews in the United States prior to and following the Ecuadorian visit. Most notable in the process was the interviewing of Dr. James Hanson of the World Bank who had headed a capital markets study group to Ecuador in early 1985.

2. The holding of some 18 interviews in Quito and Guayaquil, 12/15-21, 1985 with AID and Embassy personnel, bankers, GOE officials, businessmen, and others; the collection and review of information available in Ecuador.

3. Additional reviews in the United States with PRE personnel, Coopers & Lybrand staff (re the PEDS study), Robert R. Nathan consultants (re the capital markets workshop), Dr. Hanson, and others.

Findings

The chapter containing the study findings (IV) is divided into seven groupings. The major findings under each may be summarized as follows:

A. Donor Institution Activities/Recent Special Report.

The Hanson report was reviewed in depth. Its recommendations included:

1. Variable interest rate lending must become more widespread.

2. A unified exchange rate should be put in place.

3. The present GOE budgetary surplus policy should continue.

4. The country's banking system requires both study and reform.

5. Capital markets development is inhibited by current laws and regulations.

A special study on industrial development finance was conducted by Robert R. Nathan & Associates in mid 1983. It traced the development of the country's leading development finance institutions (CFN-public and COFIEC-private) and concluded they had in a major sence failed as:

1. They had not been able to mobilize domestic savings.

2. Most of their loans were short or medium term.

3. Equity investments represented a small part of their portfolios.

Price Waterhouse under contract to the Mission during the new president's transition period saw several key issues in the overall Ecuadorian financial situation:

1. The mobilization of domestic savings and their chanelling into productive investment.

2. The effective functioning of the entire financial sector in Ecuador's capital markets development.

The report made a series of recommendations regarding on-going study activities, many of which have been included by the Mission in its scheduled and proposed activities.

B. Current Mission Activities

The Mission's soon to be performed MPAP (Macroeconomic Policy Analysis Project) and its separate but related fiscal sector and capital markets development analyses were discussed in depth. Especially covered was the latter's focus upon the identification and diagnosis of the policy/regulatory/legal constraints which impede the optimum mobilization of domestic savings and the development of capital markets. It was also noted that the completion of the MPAP was to lead to a three year Mission sponsored capital markets development project.

The Mission's proposed amendment to its non-traditional agricultural exports project regarding investment promotion was outlined with specific reference to the notion of the establishment of a venture capital pool. While the Mission had marshalled cogent arguments concerning the pool and had made some excellent preliminary analyse, there were others who thought that the notion needed expanding, perhaps into a merchant banking concept.

C. Sucretization - Debt Refinancing

Facing default, Ecuador converted all external debt owed to private sector financial institutions by local private sector debtors into sucres. Whether a bail out program for the private sector or a calculated risk, the GOE had little choice. As it has turned out the process led in December of last year to the refinancing of that debt with some 400 foreign banking institutions. The process should give the country a breather and allow it to concentrate on financial markets restructuring.

D. Ecuadorian Financial Markets System

With 31 commercial banks (with 340 branches), 12 financieras, 8 S&L's, 27 insurance companies, and a number of other private sector institutions plus a variety of public sector entities, the financial markets infrastructure of the country appears to be relatively developed. The banks, however, are generally quite small and, by developed country standards, undercapitalized (the average ratio of capital and reserves to assets being 5.0 percent for the 31 and 3.9 percent for the top five). The financieras, large or small, face problems relating to a lack of separate identity (vis-a-vis the banks) and liquidity plus a host of portfolio problems. The eight S&L's are considered as being insignificant while the tightly restricted insurance companies' combined assets are less than two percent of Ecuador's GDP.

There are two stock exchanges, in Quito and Guayaquil. Trading in equities, however, is almost non-existent with the bulk of their activities confined to the trading of private sector mortgage notes and certain GOE issued paper.

There is a flourishing though illegal "mercado extra-bancario" matching supply and demand among those willing to break the non-enforced laws for the returns which can be obtained and those who do not have access to conventional and legal institutions. About S30 billion moved through this market in 1984, about 3.8 percent of the country's GDP or 10 percent of the combined assets of the private sector banks. This represents a less of over S1.5 billion in tax revenues to the GOE, about 1.5 percent of the total budgetary revenue.

The Ecuadorian Social Security Institute is severely limited as to the type of investments which it can make and assumed to be considerably underfunded insofar as its future liabilities are concerned. Pension funds are not as yet widespread and consequently have a limited impact on the financial scene.

Other public sector financial institutions (than CFN) include an agricultural oriented development finance bank, a large housing finance institution now directing all of its efforts towards low-income groups, and a development bank involved in public sector loans and investment promotion. Additionally and more importantly is the Central Bank which establishes monetary policies and controls, to a great extent, both credit and interest rates throughout the financial markets spectrum.

E. <u>Financial Instruments</u>

Currently there are some nine public sector and eight private sector issued financial instruments. The former are essentially tax exempt while the latter are generally subject to an eight percent tax on interest excluding common stock dividends which pay a 22.2 percent rate. All are traded on one or both of the stock exchanges. Issuance is either by a GOE entity or a financial institution; direct issuance by a non-financial institution (e.g., a corporation) save for initial stock sales is rare.

The most important financial instrument is the accumulation policy (poliza de acumulacion), short term instruments issued at competitive market rates (as opposed to GOE established rates which had been the norm). Issued initially in late 1984, by mid 1985 the policies has accounted for well over S30 billion or almost half of the combined "notes in circulation and other obligations" of the private banking system. Carrying after tax interest rates slightly in excess of the inflation rate, the policies reportedly were beginning to soak up funds from the illegal market. At the time this report was written, however, corporations had not issued such policies, albeit permitted to do so, and no major way of disintermediating the banks had been seized upon.

F. Taxation

The study focused, because of time constraints, only superficially upon Ecuador's tax system. Yet, the findings revealed that it was a "low tax" country insofar as the region was concerned. Considerable tax evasion was indicated while certain fiscal policies appeared to retard, rather than enhance, economic development.

G. Corporate Results

The study presented the combined 1984 balance sheet and profit and loss results for 10,421 corporate entities as submitted to the Superintendent of Corporations. While "global" and perhaps representative of efforts to minimize taxes, the results nonetheless revealed that on the whole Ecuadorian companies were still suffering the effects of the crisis - net earnings after taxes representing 2.4 percent on sales and net earnings to total equity at 6.9 percent (after 3.0% in 1983 and 4.0% in 1982).

Conclusions

A. Donor Institution Activities/Recent Special Reports.

1. World Bank Activities. The Hanson report was indeed correct: a) in-depth study and resulting reform of the banking system is required; b) legislation is needed to spread variable interest rate lending; c) current laws and regulations inhibit capital markets development; and d) further Bank-AID cooperation in the financial markets field is essential.

2. Special Study. Nathan's major conclusion remains valid today. "Data acquisition, information management systems, computerized evaluation and monitoring audits, and upgraded human skills .... appear to offer a promising area for continuing development assistance."

3. Price Waterhouse. A review of "the current financial and management situation of the private banks and financieras to identify priority financing and operating problems" remains an important task relative to any future financial markets activities.

B. Current Mission Efforts

1. MPAP. While some misgivings were expressed concerning the structure of the study, especially that relating to policy/regulatory/legal matters and needed reforms vis-vis capital markets, its conduct is essential if the required changes in the institutional framework are ever to be effectuated.

2. Investment Promotion. Again, misgivings where expressed concerning the Mission's approach, specifically relating to venture capital. It was concluded that more study and sound expert input were required.

C. Financial Markets Systems

1. Banks. The current system appears overly fragmented, lacking in competition, under capitalized, over-extended, and generally weak. Mergers should be welcome yet they are ruled out by current banking laws and regulations. Nonetheless, there is a foundation present which could be built upon to strengthen and modernize the system.

2. Financieras. There appears little reason under current conditions for the continuation of the financieras as separate financial markets institutions save, perhaps, for CFN and COFIEC.

3. Insurance Companies. As long as the industry remains over regulated, its potential for aiding in the development process cannot be realized.

4. Stock Exchanges. If one were to apply developed country standards relating to the trading of equities and longer term debt instruments in the Ecuadorian context, the two exchanges (probably one too many) are failures. Nevertheless, a foundation is in place and with proper guidance and technical support, an exchange network could have a major impact upon future capital markets development.

5. Mercado Extra-Bancario. Its existence indicates a sub-optimal distribution of credit throughout the economy. Its elimination is virtually impossible; however, its size and impact can, with proper enforcement of existing laws and regulations and legal alternatives, be minimized.

6. Social Security/Pension Funds. Accumulated funds could become a major source of long term financing. A close examination of the situation is required to determine the proper role which they might assume in capital markets development.

7. Public Sector Financial Institutions. Agricultural credit availability is a major problem, one which neither the banks/financieras nor the parastatal BNF appear capable of solving at present. The reorganization and strengthening of that institution is one option which should considered. While beyond the scope at this study, future studies relating to the Ecuadorian financial scene must tackle the housing finance issues, within the content of existing entities, including the parastatal Ecuadorian Housing Bank, and other which might be created.

D. Financial Instruments

There apppears to be nothing out of the ordinary regarding the makeup of public sector instruments. There are, however, some anomalies among their private sector counterparts. One is struck particularly by the fact that while corporations may issue directly certain types, including the new accumulation policies, this is rarely done. While there are structural and risk avoidance reasons behind this, another way for disintermediating the banks is not in use.

Also, the tax situation relating to these instruments is "messy." Reform of appropriate tax codes and regulations is clearly required.

E. Taxation

While a "low tax" counry, Ecuador's codes and regulations have evolved to the extent that they may be inhibiting private sector growth. Given the current pro-business climate, the time is ripe for donor institutions to have a hand in bringing about changes which would have a most beneficial impact on private sector development.

* * * * *

The areas of legal, regulatory, and tax reform relating to corporations and the financial sector must be tackled in any susequent studies and advisory efforts. Nonetheless, the development of capital markets is demand driven and must reflect local economic needs. Insufficient data are currently available, and existing and latent demand must be determined before the supply side of the equation, the long term, optimal structure, can be specified.

Recommendations

The focus of the lengthy process of financial markets development activities should be upon the entire financial system. The approach should not be upon institutional specifics but rather upon bringing about changes in policies, regulations, laws, and other areas. These changes will permit new and improved institutions to emerge and evolve in response to market forces which will determine over time the types of institutions required in development process.

Specific recommendations included:

A. Continued policy dialogue.

B. Inclusion of Ecuador in the PRE-sponsored financial markets study.

C. Short term TA from that study regarding certain aspects of the MPAP, the investment promotion component, and the planning for the FY 1987 capital markets developments study.

D. The development of a capital markets workshop program.

E. Participation by the Mission in the PRE-sponsored Private Enterprise Development Support (PEDS) and Privatization studies.

F. Increased liaison and the development of a complementary "game plan" relative to financial markets with other donor institutions.

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CHAPTER I

INTRODUCTION

Ecuador experienced both relative financial stability and steady economic growth during the 1960's paralleling rising demand in developed country markets for its traditional agricultural exports-bananas, cocoa, and coffee. In the late 60's major oil discoveries were recorded in the east which led to the construction of a lengthy pipeline connecting those fields by 1973 to the seaport of Esmeraldas.

Financial markets development during the period kept pace with Ecuador's economic growth. The mid 60's saw the foundation of both public and private sector development finance corporations, CFN and COFIEC. During the same period two stock exchanges were established, in Guayaguil and in Quito. Other institutions appeared as well including what has become the country's largest savings and loan association started with the assistance of the Peace Corps.

During the 60's and 70's donor group activities in the financial markets field appear to have been of the standard or "normal" variety aimed, as might be expected, at evolutionary growth. These activities combined with limited government intervention in market activities, a stable exchange rate, and a growing agricultural and industrial sector created a reasonably stable financial sector, one which functioned satisfactorily during stable times.

The bonanza of the oil discoveries and that sector's subsequent development (to a point today where Ecuador produces over 300,000 barrels of oil per day marketing almost 200,000 barrels abroad) led the economy to rapid growth during the 1975-1980 period. In doing so, however, it might have been very instrumental in creating the "crisis" from which Ecuador is slowly emerging.

The story of unreasonable expectations concerning ever rising oil prices need not be recounted here. Let it merely be noted that Ecuador did not behave atypically and the eventual results were somewhat calamitous. Obviously, there was some official inertia; for example, by the late 1970's the exchange rate which had stood for over 10 years at 25 success to the dollar had become overvalued. This had a decidedly negative impact on the sale of Ecuador's traditional agricultural exports but no steps were taken to let the market decide a more appropriate rate. The worldwide recession exacerbated the situation, and the natural disasters of 1982 - 1983 (the shifting of the "El Nino" current and resulting heavy floods) were particularly damaging thereby accelerating the decline, along with the oil situation, of export earnings. The small industrial sector which had been in part created by the oil bonanza turned out to be non-competitive externally and very costly (in terms of comparable imports) internally surviving only behind high protective tariff barriers. The GOE, in its efforts to promote "domestic tranquility" continued to maintain a low interest rate policy resulting in increasingly negative real interest rates which quite naturally militated against the mobilization of domestic savings.

By late 1981, early 1982, GOE policies had placed a tremendous burden on the budget - it was reflating while tax revenues from all areas save for petroleum exports were falling. Many public sector enterprises were permitted to operate at steady and/or increasing deficits. The gaps in the current account portion of the balance of payments and the deficit in the public sector budget were being financed by a rapid buildup in the external debt which abruptly halted with the virtual cessation of foreign lending except through donor institutions, thereby bringing about the full scale crisis.

From 1980 to 1984, time and savings deposits fell while demand deposits were stagnant. Commercial banks and financieras had to rely on credit from the Central Bank as their major single source of domestic credit (reportedly up to 40 percent for the banks and 65-75 percent or more for the financieras). Thus, these financial institutions became, in essence, agents of the Central Bank, subject for their survival to the vagaries of that institution's often changing policies. Also, their "agency" role was extended by the fact that often the initial borrower would relend the funds to a second borrower who might relend to yet a third, each time with an increase in the interest rate.

By 1981 the donor groups had begun to examine Ecuador's financial markets framework in some depth. That April, IFC's Capital Market Department sponsored a major conference which was held in Quito on the development of capital markets in Latin America. While not focusing solely on Ecuador, clearly the situation there was sufficiently grave to attract a significant amount of attention leading to more intensive analyses of the environment than had heretofore occurred.

A second major IFC sponsored conference, this time on Latin American securities commissions and similar organizations, was held in Quito in April 1983. Once again while not focusing directly on Ecuador, the donor group attendees were naturally forced to give some specific attention to Ecuador's rapidly growing problems and try to develop an investigatory program which would identify systemic inadequacies which were having a negative impact on the country's economic development.

Preliminary work within the Mission, the IFC Capital Markets Group, the World Bank, and the IDB was conducted later that year and early in 1984. All realized, however, that the investigations were taking place within the context of a "lame duck" administration and that significant progress could only take place after the elections and the inauguration of the new president, an event which took place on August 10, 1984.

With the elections and the selection of a new president, the Mission swung into action by retaining Price Waterhouse & Company to perform an extensive analysis of the AID program, current and projected, as it might tie in with the goals and objectives of the new Febres Cordero administration. Conducted during the transition period and issued shortly after the inauguration, the report, entitled "Report on Economic Advisory Services to USAID Ecuador," provided an excellent overview of the entire AID program. Further, it specified the critical areas for in-depth future examination, including, as a high priority, financial markets. The final report stated that other than the day to day handling of monetary and credit policy in the (inadequate to the task) Central Bank, the most critical problem within the Ecuadorian financial framework was "how to mobilize sufficient savings to satisfy the country's developmental aspirations without excessive reliance on foreign debt."

The Price Waterhouse study identified a number of problem areas and outlined a comprehensive capital markets development study approach for early implementation by the Mission following Febres Cordero's assumption of the presidency. Shortly after that event, the World Bank recognizing the gravity of the situation (and the IMF's conditions relative to future loans), sent a team to Ecuador to do a thorough examination of the financial scene. Their preliminary report was issued in April 1985 and is discussed in some depth elsewhere in this report.

Obviously, the guns are now being brought to bear on the Ecuadorian financial market situation and the time appears highly appropriate for the commissioning of substantive work by AID on the subject. Since August 10, 1984, a number of events have strengthened this scenario, viz:

1. The "sucretization" process (registration and conversion of private sector foreign debt into local currency through the Central Bank) begun in the former administration has been completed. Ecuador's foreign debt owed to non-governmental financial entities, some $4.5 billion, has been renegotiated.

2. The three tiered exchange rate system has been reduced to two, a free market rate and a Central Bank intervention rate. Movement, albeit slowly, is leading towards a unified, somewhat floating rate of exchange.

3. Subsidies have been reduced, increases in the minimum wage have been restrained, and tariff and non-tariff barriers lessened.

4. A short-term debt instrument with a floating, non-government determined interest rate ("Polizas de Accumulation") has been introduced, the popularity of which has grown rapidly.

5. Several laws and regulations have been introduced into the National Congress or are in the process of preparation which could have a most salutary impact on the country's financial market framework.

6. The Mission is in the final stages of contracting for a macroeconomic policy analysis project (MPAP) aimed at both fiscal analysis and policies and capital markets development (especially from the regulatory and legal standpoint), following, in great part, the recommendations made by Price Waterhouse.

7. Lastly, and most importantly, the GOE under President Febres Cordero has made a solid commitment to private sector development. In doing so, it has placed a high priority on financial markets structural reform and considers development of this sector into a strong, modern institutional framework as an absolute necessity for accelerated economic growth.

The time could not, in my estimation, be better for a major AID thrust in this area. It has in fact begun with the MPAP and this limited survey. It should continue with some sort of PRE sponsored effort followed by a capital markets development program which would be devoted in part to recommendations' implementation and institutional design and construction. This report, the author trusts, will aid in the process.

The remainder of this paper is devoted to a description of the scope and objectives of the study; details concerning the approach and methodology utilized to perform the required tasks; the study findings; the conclusions which can logically be drawn from those findings; and the consultant's recommendations concerning tactics, strategies, and ongoing financial markets development activities.

CHAPTER II

SCOPE AND OBJECTIVES

As outlined in the contractor agreement between Arthur Young & Company and the contractor dated December 11, 1985 and the general terms of reference of the contract between Arthur Young & Company and the Agency for International Development, No. DPE-2005-C-00-5060-00 dated September 30, 1985, the scope of the work to be performed included:

1. An assessment of Mission and other donor groups' activities in Ecuador in the area of financial markets assessment and development over the last few years to date. Included was an examination of activities which had already been scheduled for performance within the near term and those which were under consideration for conduct as a result of both the undertakings to date and those for which contracts were scheduled to be let.

2. A review with the Mission of the two PRE sponsored companion studies (to the financial markets effort); i.e., the Private Enterprise Development Support (PEDS) and Privatization studies.

3. The collection of background materials at the Mission, from AID/Washington, and from other donor organizations (e.g., the World Bank, IFC, IDB, and the IMF) relative to Ecuadorian financial markets.

4. The conduct of in-depth personal interviews in both Quito and Guayaquil of Mission and Embassy staff, GOE officials, local bankers, financial consultants, businessmen, and others on the general subject of Ecuadorian financial markets with specific reference to the current situation and short term outlook in terms of evolutionary development.

The objectives of the study were to:

1. Critique the current Ecuadorian financial markets institutional framework in and of itself and in terms of the past, current, and projected donor groups' study activities.

2. Specify, as a result of 1, those features of that framework which when applied against both the current Ecuadorian socio-economic-political context and that of a developed financial markets situation, could be said to be actually or have the potential for inhibiting private sector development.

3. Collect sufficient information to allow the contractors (i.e., Arthur Young _et al._)to make recommendations to PRE and the Mission as to future AID strategies in the area of

Ecuadorian private sector financial markets stimulation/-development in light of: a) 1 and 2; and b) current and potential Mission programs (e.g., the Macroeconomic Policy Analysis Program or MPAP and the FY 1987 capital markets project).

4. Examine, with Mission personnel, the activities which are contemplated in the PRE sponsored PEDS and Privatization studies: a) as they might be applied within the Ecuadorian context; and b) as they relate to current and possible future Mission activities.

CHAPTER III

APPROACH AND METHODOLOGY

The approach and methodology to be utilized in the conduct of this study were detailed in my proposed scope of work and budget submitted to you on December 10, 1985. At the request of PRE, with your concurrence, they were modified slightly - see "Statement of Work" in the contractor agreement dated December 11. They were further refined in several lengthy telephone conversations held between the consultant, PRE, and Arthur Young personnel in Washington and the director of the Mission's private sector office (PSO) in Quito.

As a result, the study proceeded as follows:

1. Activities Conducted Prior to the Ecuadorian Visit

Immediately prior to departure on December 15, an interview was conducted with Dr. James Hanson of the Industry Department of the World Bank who had headed a Bank study group to Ecuador relative to capital markets in early 1985. While Dr. Hanson could not provide a copy of the group's report, since its contents were still under review by the GOE, he was willing to share its major findings, conclusions, and recommendations which are incorporated within this report. Also, discussions were held with Coopers & Lybrand personnel relative to the PEDS study, with Robert R. Nathan & Associates staff concerning their capital markets workshop program, and with the Arthur Young project manager regarding various aspects of the field investigations. As noted previously, several lengthy telephone conversations were also conducted with the Mission's PSO director on the same subject.

2. Ecuadorian Visit

The field visit, including both Quito and Guayaquil, was conducted during the period December 15-21, 1985. Prior to my departure, the PSO had prepared an extensive list of persons/organizations to be interviewed and had arranged a comprehensive daily schedule for the conduct of those interviews. As a result of this prior scheduling, it was possible to interview 18 persons; a complete listing of names, titles, and organizations is contained as Appendix A to this report.

As is the case in virtually all field investigations of a short duration, especially those which occur immediately prior to a holiday season, there were several gaps in the interview coverage. On the other hand, an unexpectedly large amount of timely published and unpublished secondary data concerning the subjects under investigation was available and was collected (see "Bibliography" - Appendix B). Thus, the combination of the interviews and the collected data provided sufficient information upon which the findings, conclusions, and recommendations contained within this report could be developed.

3. Subsequent Events

Following the field interviews, approximately one week was spent in reviewing and assimilating the collected reports and data. The weeks of January 6 and January 13 were devoted to the preparation of the draft report and additional interviews in Washington with IDB, World Bank, and IFC personnel plus detailed discussions with Arthur Young staff, the director of the Mission's PSO, and PRE staff. Following these discussions the initial draft report was revised, as required, and issued during the week of January 27 to Arthur Young & Company for review and comment.

CHAPTER IV

FINDINGS

Introduction

This chapter consists of the findings uncovered during the field and desk research portions of the study. As such it is divided into seven groupings:

A. Donor Institution Activities and Recent Special Reports
   1. World Bank Activities
   2. Special Study - Industrial Development Finance
   3. Price Waterhouse Study

B. Current Mission Efforts
   1. The Macroeconomic Policy Analysis Program (MPAP)
   2. Investment Promotion and Venture Capital

C. Sucretization-Debt Refinancing

D. The Ecuadorian Financial Markets System
   1. Commercial Banks
   2. Financieras
   3. Savings & Loan Associations
   4. Insurance Companies
   5. Stock Exchanges
   6. Other Private Sector Financial Institutions
   7. The Mercado Extra-Bancario
   8. Social Security and Pension Funds
   9. The National Development Bank
   10. Other Public Sector Financial Institutions

E. Financial Instruments
   1. Public Sector
   2. Private Sector
   3. Accumulation Policies/Special Financial Certificates

F. Taxation

G. Corporate Results

A. Donor Institution Activities and Recent Special Reports

World Bank Activities

In April 1985, a World Bank study team headed by Dr. James Hanson, a macroeconomist of the Bank's Industry Department, completed a draft study relative to Ecuador's financial sector. The "gray cover" or final report has, at this writing, not been issued since there are, according to Dr. Hanson, some as of yet unresolved differences between members of the study team on one hand and senior GOE officials on the other as to various aspects of the projected (by the Bank) implementation program.

Dr. Hanson, while not willing to release a copy of the draft report outside the Bank, did provide considerable information relative to its contents. In terms of major findings, the Bank team found:

1. The GOE's interest rate policy in the period of 1975-1982 had been ineffective. By allowing the nominal lending rates to remain constant over a long period in the face of growing inflation, real interest rates for savers became negative and the mobilization of capital except through forced means slowed dramatically. Schemes such as attracting mortgage capital by requiring potential borrowers to place savings into S&L's as a prerequisite for a loan quickly fell apart after the time spent waiting to get a loan, except for the first lottery chosen borrowers, destroyed the real value of money.

2. The lack of domestic funds led to an over dependency on foreign borrowings which became a contributing factor in the financial crisis which began in 1981, continued through 1984, and is only now beginning, finally, to work its way through the nation's economy. (The rapid buildup in the foreign debt, albeit primarily public sector debt, precipitated the economic crisis which left Ecuador by 1982 technically bankrupt and unable to borrow abroad save from donor institutions. A combination of "sucretization" -- see elsewhere in this report -- and the renegotiation of that portion of the total debt owed to foreign financial institutions concluded last month have eased the international financial problems somewhat, at least for the time being.)

3. Government credit allocation policies made the situation very "messy" -- the commercial banks and financieras, which relied upon the Central Bank's rediscount window for a significant portion of their loanable funds (in excess of 40 percent for the former and 65 percent or more for the latter) were directed as to their loan policies to either invest in certain areas or purchase government bonds.

These factors, combined with others, led to significant capital flight, disinterest in capital markets development, limited mobilization of financial resources, and other calamaties. When combined with "bad short run macroeconomic policies" of reflation (as oil prices dropped) which led to a public sector deficit of 6-8 percent of GNP 1981-1983, the new administration of President Febres Cordero inherited a difficult financial situation when it assumed power in 1984.

The Bank's paper makes several recommendations:

1. Variable interest rate lending, now underway with Polizas de Accumulation, must become more widespread -- perhaps tied in some way to LIBOR with more frequent adjustments in smaller increments. A law to this effect is currently before the National Congress which would give the banks more latitude in establishing lending rates, something they are currently denied, except, to a limited extent, with the polizas.

2. The GOE should continue its efforts to reach a unified exchange rate.

3. The new, present policy of running a budgetary surplus (1-2 percent excess of revenues vis-a-vis expenditures) should continue.

4. The structure of the Ecuadorian banking system requires in-depth study and resulting reform. In the Bank's estimation, the system with 31 private and mixed ownership commercial banks, 13 finance companies (including a parastatal DFC), and 8 savings and loan associations is far too fragmented, non-competitive, and currently incapable of playing a significant rate in optimal financial markets, let alone capital markets, development in the country.

5. Capital markets development is inhibited by current laws and regulations. The Bank believes a highly qualified team should be put in place to assist the GOE in drafting laws on such matters as regulation of corporations/disclosure, auditing standards, underwritings, and associated matters.

6. The Bank realizes that the Corporacion de Fomento Nacional (CFN), the parastatal DFC which has served primarily as a conduit for donor organization funds, is under financial stress. Whether or not it can survive and prosper, however, is apparently not a subject of the report. For it to receive additional World Bank funds, in any case, will require it to build its debt to equity ratio from 12 or 13:1, as it currently stands, to the Bank recommended figure of 10:1. (N.B. Recent Bank actions required CFN to write off some loans with a resulting drop in the equity position. While this had the opposite effect insofar as the eventual attainment of the 10:1 ratio was concerned, the Bank believed that its pressure was necessary if CFN were to continue in any form.)

From the Bank's standpoint, Dr. Hanson said that Mission's current and prospective activities in the area of capital markets development, with or without PRE participation, were most welcome and could be highly beneficial to the country's economic development. He noted favorably that the MPAP project was being coordinated with the Bank's forthcoming project in public administration which will be targeted, in great part, at the Ministry of Finance. He believed that subsequent AID activities would also be coordinated with that and other Bank projects and that there was little likelihood of conflict or overlap.

Special Study-Industrial Development Finance

In mid-1983, the Mission commissioned the above cited study by Robert R. Nathan and Associates, a Washington, D.C. based management consulting firm. The study, completed and submitted to the Mission on September 27, 1983, had as its stated purpose the determination of "what set of circumstances led to the relative success of two AID industrial development credit projects implemented in Ecuador in the mid-1960s."

In essence, the study traces the foundation, growth, and current (1983) situation and outlook for two Ecuadorian development finance institutions (financieras), the parastatal Compania de Fomento Nacional (CFN) and the private sector Compania Financiera Ecuatoriana de Desarrollo (COFIEC). They were provided loans ($5.0 MM to CFN and $3.0 MM to COFIEC) by AID for "seed money" purposes shortly after their foundation in 1964 and 1966, respectively. It also discusses at some length the relationships of those loans to a more comprehensive GOE program, "significantly assisted by USAID," of institutional development of policy reform aimed at increasing industrial growth in the country.

A substantial amount of information is provided concerning the two institutions' performances over the years in financing medium and larger firms in Ecuador (their activities in financing what AID terms SMSEs having been almost nil). The authors considered that, on balance, both institutions had been reasonably successful in promoting industrial development within the county, both were financially sound, and both were positioned to continue their important promotional roles in the future.

On the other hand, the authors noted that the economic functions of a financial intermediary could be defined as performing the mobilization of domestic "savings in the form of financial resources" and allocating those savings "towards the most productive investment opportunities available." Against that definition or yardstick was added the simple and correct statement that the optimum allocation was not merely "directed" but directed in terms of duration and type. That is, the optimum allocation and, therefore, a "developed" capital market required: a) the issuance of long term debt instruments; and b) the creation, continuance, and growth of functioning equity markets.

Thus, the authors concluded that CFN and COFIEC, as development finance institutions, had in one major sense failed since: a) domestic savings had not been mobilized to any significant extent; financial resources for both institutions were primarily external resources funneled through them by the public sector; b) a significant portion of their loans (especially those of COFIEC which had not had full access as had CFN to long term public and external resources) were made on a three year basis or less; and c) a small part of their loan portfolios consisted of equity investments.

This partial failure, however, was not ascribed to the two institutions themselves, which the authors viewed as having been a) relatively successful insofar as they could be; and b) reasonably well managed. The blame was, in fact, placed on GOE macroeconomic policy measured in the areas of interest rates and taxation and in various other legal and regulatory fields which did not allow truly free market forces to enter into play. Also, it was noted that CFN's efficiency and effectiveness as a development finance organization have been limited by officially imposed obligations to support, through its loans, problem industries and firms judged to be of strategic importance by the GOE (or, of course, those of political importance to a given administration).

This report is of fairly recent vintage and the authors have made some general observations concerning possible future AID sponsored programs in the area of financial intermediation. Thus, for general background material for those who will read this report and might became involved in future studies, the three page annex containing those observations is attached as Appendix C to this report. Comments on them and other aspects of that report are contained within the conclusions and recommendations presented in this study.

The Price Waterhouse Report

As discussed in the introduction to this report, Price Waterhouse undertook a fairly detailed assessment of the USAID/Ecuador assistance program in the period following the 1984 election to just slightly beyond the date of the inauguration of President Febres Cordero on August 10 of that year. While the "Report on Economic Advisory Services to USAID/Ecuador" covered all areas of the existing and planned program, it dwelled in some length on the financial market area.

The report pointed out that in all traditional donor areas, including financial markets, AID in the past had been a relatively minor player, leaving the bulk of the donor effort to the World Bank and the Inter-American Development Bank. In view of the lingering effects of the crisis situation and the obvious need to mobilize domestic savings to stimulate investment (gross domestic investment having fallen on the average of 8.5 percent per year for the period 1978-1983), Price Waterhouse recommended a much more active approach by the Mission in the financial markets arena.

The key in that approach was the design and conduct of a capital markets development study with the following objectives:

1. The improvement of monetary policy in ways conducive to mobilizing domestic savings to finance development.

2. The fostering of the institutional development of the entire financial sector, both public and private, so it could perform more effectively its roles of financial intermediation and the mobilization of savings

3. The improvement of the institutional structure and operational functioning of the Central Bank and the Superintendency of Banks to enhance their capability to perform their respective regulatory functions for the financial system.

As Price Waterhouse saw it, the key issues in the situation were:

1. The mobilization of domestic savings and their channelling into productive investment.

2. The effective functioning of the financial sector, public and private, in the country's capital markets development.

It suggested that any study in the area of financial markets focus upon:

1. Government monetary policy - interest rates, exchange rates, and credit policies. Price Waterhouse believed that a rationalization of this policy could result in the strengthening of all types of financial intermediaries -

banks, financieras, insurance companies, stock exchanges, the bond market, savings and loan associations, and exchange houses.

2. An institutional analysis of the Ecuadorian financial sector including the following reviews of:

   a. The organic laws, regulations, and decrees of the Central Bank and the Superintendency of Banking.

   b. The organizational structure, financial management and control practices, management information systems, roles and responsibilities of organizational units, personnel staffing and training, and operational performance of the two GOE entities.

   c. The relationships between the Central Bank and the banks and financieras relating to terms and conditions for financing, reserves, and other regulatory requirements and the influence which the Central Bank exerts over private banks' credit policies.

   d. The current financial and management situation of the private banks and financieras to identify priority financing and operating problems as well as to pinpoint their relationship with the Central Bank and the Superintendency of Banking.

Price Waterhouse further recommended that any subsequent study include:

a. Alternative approaches for improving the monetary policy framework for the mobilization of domestic savings.

b. Alternative policies and institutional requirements for establishing an efficient local capital market capable of mobilizing domestic savings and channelling them into productive investments.

c. Requirements for improving the organization, management, staffing, and functioning of the Central Bank and the Superintendency of Banking.

Price Waterhouse did not specify the Mission as the originator of the study but rather suggested that the World Bank might be interested in the financing of such a study as part of its preparation for a forthcoming structural adjustment loan (SAL). The firm estimated that the study program could be performed by five experts over a period of three months for approximately $270,000.

A copy of this report was not available for the World Bank group headed by Dr. James Hanson which investigated the Ecuadorian financial sector (see specific section related thereto). Nonetheless, that group did cover several of the areas which had been highlighted for investigation by Price Waterhouse, an event which might have been logically expected. Additionally, the Mission utilized some of the general concepts which Price Waterhouse had expressed in both the preparation of the scope of work for the MPAP and the preliminary outline of the projected FY 1987 capital markets development study.

B. Current Mission Activities

The MPAP

The Mission is in the final stages of negotiating a consulting contract with a firm to perform a "Macroeconomic Policy Analysis Project (MPAP)." As stated in the contract scope of work, the objective of the MPAP "is to provide the technical assistance required to analyze the policy-related and institutional constraints which impede the effectiveness and efficiency of fiscal expenditures and the development of capital markets in Ecuador..."

Contemplated to require about 60 person months of technical assistance, the MPAP will result in two separate but closely related studies conducted simultaneously: a) a fiscal sector analysis to be completed within six months of contract signing (presumably to take place in February of this year); and b) a capital markets development analysis to be completed within four months of the signing. Additionally, the contract will be expanded for two months following completion of the fiscal sector analysis in order that the contractor can "be available to the Ecuadorian implementation team to initiate policy implementation on an ad-hoc basis."

The purpose of the MPAP will be to strengthen the GOE's capabilities in the process of structural adjustment and develop a capital markets scenario which will "encourage increased investment, employment, and productivity in the private sector. The ultimate goal of the project is a restructuring of the country's economy whereby it could promote and fortify a private sector-led, market oriented development strategy, leading to long-term economic growth and stability."

The study will be conducted under the joint auspices of the Mission and the Ministry of Finance. The Mission will fund the 60 person months of technical assistance component while the Ministry will contract for a long-term, locally based consulting team to perform the required assistance in follow-up activities and in implementing the recommendations made by the MPAP consultants.

MPAP oversight by the Mission will be provided by both the Program Development and Private Sector offices. The former will focus primarily upon the fiscal policy area while the latter will concentrate its efforts in the capital markets portion of the MPAP.

The capital markets analyses apparently will be aimed at the constraints which exist in the current governmental policy and regulatory/legal framework. That is, they will identify and diagnose the constraints which exist within that framework which impede the optimum: a) mobilization of domestic savings; and b) development of domestic capital markets. As a result of this identification and diagnostic process, the MPAP consulting team will design a short to medium term program to implement the policy/regulatory/legal reforms necessary to bring about the required changes in the Ecuadorian capital markets institutional framework.

The satisfactory completion of the MPAP is currently scheduled to lead to two major Mission programs in FY 1987: a) a three year capital markets development project with a proposed obligation of $6.0MM ($2.0 MM in grants, $4.0 MM in loans); and b) a two year fiscal administration development project.

The stated purpose of the former will be "to strengthen the capacity of (Ecuadorian) private capital markets to mobilize domestic savings for reinvestment in productive sectors of the economy." Technical and financial assistance will be provided to the GOE and the private sector "to expand and deepen capital markets in Ecuador." Training and technical assistance will be provided to existing private sector financial institutions "to upgrade their capabilities and bring them more in line with the savings and investment needs of the economy." If the examinations warrant, the study team will recommend the development of new institutions "to mobilize private capital for purposes of productive investment..." Subsequently, it would work with the "implementing organizations" (e.g., the Association of Private Banks, the Financiera Association, and individual private sector banks and firms) to establish such institutions.

Investment Promotion and Venture Capital

The Mission has recently developed a project paper amendment to its already underway non-traditional agricultural exports project entitled "investment promotion component." This project, which commenced in September 1984 shortly after the inauguration of President Febres Cordero, did not initially contain a major component of that type as the decision was made to wait for a clearer indication of the new administration's stance on foreign investment before making a much larger commitment, in monetary terms, to the project.

In the Mission's estimation that stance has been clearly positive. It has therefore recommended the inclusion of the component into the project comprised of three separate, but closely related, activities:

1. Investment Promotion and Support Services.

2. Foreign Investor Identification

3. Venture Capital Pool

The component envisioned initially that development grant funding would be made available to FEDEXPOR, the private sector Federation of Ecuadorian Exporters. Part of the amount would be used to retain the services of a professional promoter for the venture capital pool. The Mission expected that about $2.0 MM in local currency will be made available through "the form of non-voting shares held by FEDEXPOR or other non-profit group which would allow the group to participate in the pool's earnings" ($1.0MM) and through an "addition to the Investment Credit Facility already established in the Central Bank for this project" ($1.0MM). An additional $4.0MM in local currency was expected to be generated for the pool from private Ecuadorian capital sources (e.g., commercial banks and financieras).

The pool would be for investments in agri-business projects "which fully comply with the purposes of the Project and the specific parameters (e.g., firm size, products, loan limits, degree of labor intensity, and local value added) set out for investment projects financed under the Investment Credit Facility." As stated within the amendment, the pool could not make an investment equivalent to more than 15 percent of the equity in one single project. The absolute limit on the value of participation per investment had yet to be established.

While the program may go forward with the first two activities, the venture capital pool is currently being examined thoroughly by the Mission with no decision thus far as to whether or not it will proceed, either in its current or a modified form. If it were to proceed, it would be the only capital markets insitution of its type in the country and probably second only to CFN in providing any type of long term financing to Ecuadorian firms. It would bear some resemblance to the Private Investment Corporation (PIC) which AID is helping to establish in Costa Rica. Albeit since it would be quite differently funded, it would be more along the line of AID/Tequcigalpa's recently suggested model which would place the non-voting stock in the hands of the Catholic University of San Pedro Sula or any one of several other not-for-profit corporations.

The Mission anticipated questions concerning the possible involvement of the GOE in a private sector effort. The GOE could, for example, insist upon participating in the equity decisions of a venture capital pool to the extent that local currency proceeds were used to capitalize the pool. The Mission believes that: a) the current private sector posture of the GOE and officials' support for the pool mitigate against such a decision and; b) any future possible GOE participation could be deflected by shifting local currency costs to grant funding and/or direct loans.

Other observers of the Ecuadorian financial scene were less sanguine, however, about various aspects of the venture capital pool notion and other aspects of the entire program and suggested significant modifications. A detailed critique of the investment promotion component submitted by two Guayaquil based American financial experts argued quite persuasively that the concept needed substantial realtering. The authors contended that: a) the scope of the proposed investment company and the attendant venture capital pool was too limited; b) there were significant disadvantages in affiliation with an existing bank or financiera as would be the case in both the investment promotion company and a venture capital pool organization; c) additional long term capital beyond the initial capitalization would be difficult to secure; and d) the program was unnecessarily limited to non-traditional exports and agri-business projects. They concluded by requesting that they be permitted to develop their alternative concepts, perhaps in the form of a de novo merchant banking operation, into a more detailed proposal.

In a subsequent conversation with the authors of the alternative concepts, the venture capital pool funding question was discussed in some depth. The notion arose of what was termed a "Baker Company" (after Secretary of the Treasury James Baker) whereby, through a yet to be developed system of AID guarantees (rather than grants or direct loans), a portion of the annual interest payments in the now renegotiated foreign debt could be diverted to funding a venture capital/investment banking/merchant banking operation. The funds would be invested through the purchase of preferred or convertible preferred stock providing the foreign bank investors with a return at least equal to that which would have been secured by the investment of the interest payments which were to have been received.

Quite obviously, a notion of this type requires much further analysis and study. The authors and others will be looking at the concept in some depth over the next few months to determine if it has any degree of feasibility. Also, the examination may well be extended to other countries than Ecuador where debt renegotiation may offer similar opportunities for the creation of several or more "Baker Companies."

Another group of Ecuadorian economists and financiers have made a proposal to the International Finance Corporation concerning the establishment of a rather complex investment banking operation which would include venture capital, financial consulting, and the creation of a series of innovative financial "products." The initial response by the IFC was favorable with the request that a detailed feasibility study be conducted in order that the viability of the project within the Ecuadorian context could be determined.

The latter project was not presented as a substitute for the AID project discussed above, but rather as a means by which another form of capital markets institution could be established. At last report, the promoters of the concept had met with IFC officials in Washington to discuss progress on the feasibility study and to determine future steps which might be taken to create the institution with or without IFC support.

A seminar entitled "The Baker Plan as Instrument for the Development of International Commerce" will be held in Quito February 17-18, 1986. Sponsored by the Ecuadorian Banking Practices Institute (an AID grantee), an affiliate of the Ecuadorian Association of Private Banks, and the AID Mission the meeting will reportedly draw bankers and government finance officials from throughout the hemisphere.

C. Sucretization - Debt Refinancing

Ecuador, facing a virtual default situation in regards to its international debt in late 1983, decided to follow, with distinct modifications, the earlier example established by Chile. It converted all external debt owed to international private financial institutions by local private sector debtors into success, the Eucadorian currency, in exchange for the debtors' assumption of sucre obligations to the Central Bank. The process began as a type of a term loan over a three year period where all such foreign debt was to be registered with the Central Bank at certain exchange rates: a) immediate registration at S62.00= US$1.00 plus a "risk commission" or S100 in total; b) registration with "delay" at S110; c) registration of commercial credits (e.g., open L/Cs 180 to 360 days) at S100 to S105; and d) non-registration with the Central Bank but with commercial bank guarantees at S135. By mid-1984 when sucretization had been for the most part completed, the loans negotiated through the process were equivalent to some 32 percent of all bank credit to the private sector, according to the World Bank.

Viewed by many, including the US Embassy, as a bail out program for the private sector, sucretization had no impact on the money supply - no fresh money was injected into the system. The impact, however, was quite naturally on monetary aggregates and as of September 30, 1985 the amount of funds in so-called stabilization credits including the effects of sucretization had reached S72 billion or approximately $654.4 million (at S110=US$1.00).

Initially, the fixed conversion of the dollar debt was to have been paid back in three years - interest, principal, and risk commission. Shortly after the inauguration of President Febres Cordero, the term was extended to seven years with a 3 1/4 years grace period in which interest only was required. With the recent renegotiation of Eucadorian total (public and private sector) foreign debt owed to international private sector financial institutions, signed in New York last December, considerable thought was being given to extending the sucretization period to coincide with the agreement at 12 years with a three year grace period.

While the corporate and financial sector debtors were registering their foreign debt with the Central Bank and converting their liabilities to the stated rates (thereby adding considerably to their balance sheet liabilities and raising their debt/equity ratios and in some instances, among firms with large foreign debts, creating negative net worth situations), the same registrants were required to sell their foreign exchange holdings to the Central Bank. These sales were made at the more favorable (than the then existing official rate) Central Bank intervention rate thereby providing the debtors with a bit of a break. On the other hand, the sucre denominated debt carried initial interest rates of 16-17 percent plus an annual fee of one-half percent and a two percent commission for the financial institution holding the liability and have subsequently been raised to 23 percent. (Taking into account the original source debt, the "risk commissions," the interest rate itself, and the other fees and commissions, the World Bank in late 1984 estimated that the implicit interest rate being charged by the Central Bank at that time was about 39 percent on an annual basis. Since the initial rate has been raised, the implicit rate is now well over 40 percent per year.)

Those contacted during the course of the interviews queried on the subject believed that the GOE had little choice in the matter - sucretization or default. As such, the process was viewed as a time buying exercise. If the GOE did not get its financial house in order or if foreign capital did not begin to flow back into Ecuador (from other than donor insti'utions), sucretization was merely postponing the inevitable. They viewed it as certainly a gamble; after all by assuming the entire exchange risk above the so-called "risk commission," the GOE and, for that matter, the entire financial system were betting that inflation could be brought under control and that some resulting stability in the sucre could be attained. There was also a bet that subsequent indebtedness not covered by the sucretization could be kept commensurate with the debtors' and the country's ability to repay - that it would not have a major negative impact on the experiment.

D. Ecuadorian Financial Markets System

As of the end of 1985, according to the Executive Director of the Ecuadorian Association of Private Banks, the Ecuadorian financial markets system consented of:

Private Sector

Number	
31	Commercial banks with 340 branches
12	Financieras with 26 agencies
8	Mutualistas or savings & loan associations
?	Savings & credit cooperatives (credit unions)
?	Financiadoras (consumer credit organizations)
5	Leasing companies (all owned by banks)
?	Factoring companies
?	"Loan Sharks" and relenders
27	Insurance companies (19 national, 8 foreign)
2	Stock exchanges (Quito and Guayaquil)

Public Sector

Banco Central - Ecuador's Central Bank
IESS - Ecuadorian Social Security Institute
Banco Ecuatoriana de la Vivienda - housing finance
Banco National de Fomento
Corporacion Financeria Nacional (the parastatal financiera)
Banco de Desarrollo

The number of private sector institutions marked with question marks is not known as they are not registered with the Superintendent of Banks. They, in part, constitute the "mercado extra-bancario", an important aspect of the Ecuadorian financial system which is discussed elsewhere in this report.

1. Commercial Banks

In 1985 32 commercial banks operated in Ecuador.* All were of the private sector variety although several were classified as "mixed," having partial (minority) ownership in the hands of the GOE or local government entities. Of the 32, four were foreign controlled -- Banco Citibank, S.A. and the Bank of America (U.S.), Banco Holandes Unido (Holland), and Banco de Londres y America del Sud (U.K.). Additionally, Chase-Manhattan maintained a representative office while the Bank of Boston was reported to be considering a similar move or the acquisition of an existing bank. As of June 30, 1985, combined the banks had according to data published in November by the Ecuadorian Association of Private Banks:

	Success	Dollars
Assets	S 311.0B..........	$ 2.83B
Paid In Capital	10.4B..........	94.8 MM
Capital & Reserves	15.4B..........	139.8 MM
Ratio of Capital & Reserves to Assets	5.0%..............	

The five largest banks (Pacifico, Filanbanco Pichincha, Citibank, and Popular, in that order) had:

	Success	Percent of Total
Assets	S 150.2B..........	48.3%
Paid-In-Capital	4.1B..........	39.5
Capital & Reserves	5.8B..........	37.5
Ratio of Capital & Reserves to Assets	3.9%..............	

* By year end two small banks had failed. One, the Banco de Descuento, is in receivership while the other, Banco La Previsora, is being run by the GOE. Combined all banks have 340 branches throughout the country with the five largest having about 70 percent of the total.

On the liability side, the commercial banking system's liabilities as of June 30 were as follows:

	Billions of Success	Percent of Total
Demand Deposits	S 71.1	24.2
Inter-Bank Funds	1.2	0.4
Other Immediate Obligations	14.9	5.1
Term Deposits	33.0	11.2
Acceptances	14.2	4.8
Accounts Payable	5.2	1.8
Notes Outstanding**	45.3	15.4
Owed to Banks	81.0	27.6
Banco Central	(71.8)	(24.5)
Other Liabilities	27.7	9.4
Total Liabilities	S 293.6	100.0

** As of June 30, 1985, the recently introduced Polizas de Accumulation, short term (30-360 day) notes with free or floating interest rates, totalled S 20.6 B or 45.5 percent of this category.

2. Financieras

As noted elsewhere in this report, Ecuador currently has 12 private sector financieras or development finance institutions with 26 agencies and one large parastatal, the National Finance Corporation (CFN). Dating from the mid 1960's, the financieras were envisioned as an institutional body which could provide longer term debt and equity financing to spur the country's economic development, as opposed to the country's banks which were far more short term oriented.

At the end of 1984, CFN had assets of S19.1 billion, short term liabilities of S6.7 billion, long term liabilities of S8.9 billion and capital and retained earnings of S3.5 billion. Net income for the year totaled S56.8 million or a return on revenues of 2.4 percent and on equity of 1.6 percent. Loan disbursements that year totaled S6.5 billion of which S2.5 billion were made through its FOPEX (Fund for the Promotion of Exports) and FOPINAR (Fund for the Promotion of Small Industry and Artisans) mechanisms. The bulk of the remaining funds were disbursed as direct industrial credits and stabilization credits to firms in economic distress.

CFN, as a public institution, has been required to enter into a variety of government sponsored projects with little or no return. As an example, at the end of 1984 it had an equity position of from 2 to 96 percent in over 30 entities. Approximately 42 percent of those holdings in sucre terms were experiencing technical and/or financial difficulties. About 11 percent of its assets are currently invested is equity (versus 17 percent is 1982), while the bulk of its lending, over 50 percent, is for longer term (two to 10 years, but generally five) fixed assets financing purposes.

The largest single private sector financiera is the country is COFIEC - Compania Financiera Ecuatoriana de Desarrollo. Founded in 1966, two years after CFN, COFIEC as of the end of 1984 had assets of about S8.5 billion, liabilities of S7.4 billion, and capital and retained earnings of S1.1 billion. Net income figures for that year have not been received as of this writing; however, they have generally averaged as a return on equity of from 12-15 percent indicating perhaps S130 million that year.

COFIEC generally directs its financing towards short term (less than two years, usually one year without a roll-over provision) working capital loans for the industrial, commercial, and agri-business sectors of the economy, over 70 percent of its activity in 1984. About 8 percent of its assets have traditionally been invested in equities, and it reportedly is experiencing no significant problems with these holdings.

As opposed to CFN and the other financerias, COFIEC had until recently been quite successful in mobilizing domestic resources from the private sector. CFN is and has been almost totally dependent for its loanable funds from the GOE and international donor institutions while COFIEC obtained through 1982 about 90 percent of its funds from the private sector.

Two other large financieras were contacted during the interview portion of the study - the Financiera Iberoamericana (FINIBER) with about S6.0 billion in assets headquartered in Quito and Financiera de Guayaquil headquartered in that city with over S7.0 billion in assets.

The former, some 55 percent of which is owned directly or indirectly by the country's largest commercial bank, the Banco Popular, is reportedly the best managed financiera in the county. Its current problem loans account for only 2.2 percent of its portfolio versus a national average of private sector financiera of 6 percent (to a maximum of 15 percent). About 75 percent of its loans have maturities of less than two years and its equity position is almost nil.

The later's ownership is spread among 345 stockholders, the largest of which controls only six percent. Its current problem loans account for about 3.0 percent of its portfolio. It has a direct equity investment in six Ecuadorian companies, holding about 30 percent of the common shares in one instance and averaging about 12 percent among the the six. Some 20 percent of its loans are for over five years, averaging seven, while about 60 percent are of a short term mature, under two years but averaging one. Long-term loans currently outstanding are on a fixed basis; however, the rates are adjusted every six months under the law for monetary reform which requires the Ecuadorian Monetary Board to authorize the banks and financieras to change the rates. As of December 1985, the "fixed" rate stood at 23 percent.

Those interviewed agreed that Ecuador's financieras faced the following problems:

1. Lack of Separate Identity. The financieras had been created to marshall and loan long term funds for various types of investment projects. Because of a lack of funds, exacerbated by the fact that they were (and are) prohibited by law from receiving sight, demand, and term deposits, they became more and more in terms of their loan and other, ancillary activities like the commercial banks. Observers commented that there was really no unique purpose for their continued existence and that the existing financieras, save perhaps for COFIEC, should be merged into the banks.

2. Liquidity. Since the late 1970s, except for COFIEC, the financieras have been quite dependent upon the Central Bank for their loanable funds. One executive interviewed stated that as of June 30, 1985, 78.9 percent of their combined liabilities consisted of monies owed to the Central Bank and other GOE entities. Inflation and sucretization have resulted in a substantial erosion of

equity against the assets portfolio and companion major increases in the debt/equity ratios of the institutions.

3. Portfolio Problems. With, reportedly, 100 or more of the leading 200 firms in the country facing moderate to severe financial problems as a result of the "crisis" and succeeding events, it should come as no surprise that portfolio problems among the financieras are rife. Problem loans account for 15 percent or more of the portfolios in two financieras and perhaps 10 percent in several more. In all, industry participants stated that six of the private sector organizations were in trouble to the extent that their survival was threatened in the near term.

In sum there was general agreement that Ecuador's financieras as a financial institution subset faced many problems. With CFN, according to World Bank sources, experiencing problems (although another loan for specified relending purposes is currently under consideration) and six of the remaining ones in various stages of disarray, something of a more short term nature, as opposed to institutional reform, was needed now to allow the luxury of the latter over time.

3. Savings & Loan Associations (Mutualistas)

Ecuador has eight somewhat small "mutualistas" or savings and loan associations which are involved principally in mortgage lending to all those save for the poorest strata of society which must depend on the government's own housing institution (Ecuadorian Housing Bank) for mortgage support. Typically, a mutualista receives deposits from individuals of a time or passbook nature, paying an interest rate somewhat below that of financial instruments issued by the government, the banks, and the financieras. These savings, however, are intended to accumulate in order that the saver at some future time will have the necessary funds for the equivalent of the down payment on a dwelling unit, the purchase of which will be financed by the mutualista to which the borrower "belongs."

Mutualistas are not permitted to issue their own financial paper raising their funds from deposits and from (as a small percentage of total deposits) banks and financieras, several of which own part or a controlling interest in three or four of the S&Ls, themselves. Excess funds are invested in various financial instruments traded on the stock exchanges without restrictions as to type. The S&Ls are rather loosely regulated by the Superintendent of Banks - they are not required to issue semi-annual reports and are rarely subject to "snap" audits as are the larger financial institutions. They are considered as being somewhat insignificant at present within the country's institutional framework with assets (in 1983) totalling S10.6 billion or slightly more than 5 percent of the combined assets of the banks and financieras.

4. Insurance Companies

Currently, there are 27 private sector insurance firms licensed by the Superintendency of Banks and Insurance to write insurance of various types in the country, 19 domestic and seven foreign. In 1983, the last year for which information was available at the time of this study, the net premiums written by these companies on all types of policies totalled S34.2 billion (U.S.$95 million at the average official exchange rate). At the end of 1983, some 17,300 individual life and 410 group life policies were in effect representing coverage for slightly less than 0.3 percent of the country's population, probably one of the lowest percentage figures in Latin America (outside of Haiti and Bolivia).

Additionally, there is the mixed firm (partial government ownership), the Compania Nacional de Seguros Agropecuarios (CONASA) which has as its objective "the writing of insurance to protect and stimulate agricultural and livestock activities." The firm provides certain types of crop and livestock insurance and has been a recipient since its inception in 1981 of AID grant funds.

Insurance companies are tightly restricted by the Superintendency as to the type of investments which they can make with their funds. Currently, these investments are limited to, by regulation, the purchase of fixed term bonds issued by governmental entities and commercial banks. They were not permitted to trade in other types of financial instruments nor are they allowed to make direct investments (e.g., in commercial real estate). Consequently, the impact of insurance companies on the Ecuadorian financial scene is extremely limited as their bond investments represent only a small portion of the total credit available and outstanding in the country, none are members of either of the two stock exchanges, and their combined assets are probably less than 2 percent of the country's GDP.

5. Stock Exchanges

Ecuador currently has two separate "bolsas de valores" or stock exchanges, one in Quito and the other in Guayaquil. Trading operations of the two during the last two years were:

	Nominal Values-Millions of Sucres			
	1983	%	1984	%
Quito				
Mortgage Notes	2,437.5	30.0	2,313.1	33.8
Stabilization Bonds	2,746.6	33.8	2,734.2	40.0
Financial Certificates	78.6	1.0	409.8	6.0
Collateral Bonds	52.6	0.7	352.3	5.2
Bankers' Acceptance	2,287.9	28.2	246.9	3.6
Guarantee Bonds	358.6	4.4	282.8	4.1
Bonds of the State	71.4	0.9	258.3	3.8
Stocks	28.1	0.4	40.3	0.6
All Other	56.0	0.6	197.5	2.9
Total	8,117.3	100.0	6,835.2	100.0
Guayaquil				
Mortgage Notes	2,003.4	39.7	1.991.0	42.5
Stabilization Bonds	1,351.6	26.8	947.9	20.2
Financial Certificates	0	0	155.0	3.3
Collateral Bonds	36.0	0.7	359.6	7.7
Bankers' Acceptances	803.4	15.9	475.0	10.1
Guarantee Bonds	259.9	5.2	270.6	5.8
Bonds of the State	120.3	2.4	216.3	4.6
Stocks	13.0	0.3	0	0
All Other	450.6	8.9	273.8	5.8
Total	5,038.1	100.0	4,689.2	100.0

Thus, combined trading operations of the two exchange in 1984 totaled slightly more than S11.5 billion (US $183.2 million at the average official exchange rate for 1984) or about 1.5 percent of the country's GDP versus S13.2 billion in 1983 ($297.6 million) or 2.4 percent of GDP.

As can be noted from the above chart, the stock exchange trades primarily in two types of financial instruments, mortgage notes issued by commercial banks and financieras and monetary stabilization bonds issued by the Central Bank. There has been and continues to be little activity in the trading of common and preferred stock.

Structurally, each of the two has 25 members from the private and public sectors which own seats on the exchanges. Currently, eight organizations (CFN, COFIEC, Desarrollo Empresarial, Filanbanco, INFISA, Banco Central, National Treasury, and Social Security) have seats on both exchanges. There are 150 registered stockbrokers with the two exchanges, 85 in Quito and 65 in Guayaquil (including those registered at both locations). A seat trades nominally in Quito for S25,000 and in Guayaquil for S200,000, although actual prices paid in 1985 were S1.5 million for the former and S2.5 million for the latter.

At the end of 1984 the capital and reserves of the Quito exchange totalled S43.3 million while that of Guayaquil totalled S28.5 million ($ 689M and $453M respectively at the average official exchange rate). Both are members of the Iberoamerican Federation of Stock Exchanges, and the current president of the Guayaquil exchange heads that organization this year.

The exchanges operate under what are termed by knowledgeable local observers as "tradition," regulatory, and legal handicaps. As an example, the Quito stock exchange has 27 banks, 21 companies, 2 municipalities, and 13 financieras listed on the exchange relative to the trading of various types of financial instruments. Insofar as stocks are concerned, only 8 banks, 17 companies, and 2 financieras are listed. Of these 27 entities, only 6 stock issues were traded in 1985. The Guyaquil exchange recorded no trades for the last year among the 5 banks, 7 companies, 3 financieras, and one warehousing firm listed.

The reasons behind this lack of equity activity are reasonably clear. There is no mass market; perhaps 500 businessmen in the country understand stock trading principles and no more than 100 have actually been involved in trades. There is no tradition of stock trading, either new issues initially or secondary trading. Laws concerning disclosure are virtually non-existent, and minority shareholders have no way of knowing the actual circumstances of the firms in which they have an equity interest.

Taxes on dividends are high relative to other taxes, 22.2 percent paid in total by the company on distributed (and on, for that matter, undistributed) earnings. This means that for a dividend yield to be competitive with the yield on, for example, a poliza de acumulacion, the gross dividend would have to equate to almost 32 percent in relation to the investor's original outlay. Secondly, while the investor receives a tax credit for the taxes paid to offset what is in effect ordinary income, his ultimate marginal tax bracket is usually much higher than 22.2 percent forcing an additional tax payment. (N.B. The only provision for the small investor whose marginal bracket is less than 22 percent appears to lie in credit notes rather than a cash refund - see section of report on financial instruments). While capital gains are taxed at only 8 percent, the combined yield on stocks from dividends and stock appreciation in what is currently an inflationary economy is not sufficiently attractive, according to those interviewed on the subject, to generate much enthusiasm for equities.

Other obstacles exist as well. Bearer shares are not permitted, only the nominative variety. Neither the stock exchanges (as an ancillary activity) nor any of the brokers or members are permitted to be involved by law in underwriting activities. Some three years ago a study was conducted for the Superintendency of Companies by a local firm which recommended that CFN's equity holdings be sold eventually through the two bolsas. When the first six sets of holdings for sale were finally decided upon, in December 1985, they were advertised in the local press. Reportedly the only bidders were those with detailed knowledge concerning the financials of the companies involved. (Whether or not the successful bidders will seek to have their companies and respective shares listed on either or both of the exchanges remains to be seen.) Prohibition against secondary trading of polizas de acumulacion, as noted elsewhere, has thus far eliminated the possibility of an overnight market. Pressure by bank and financiera members on the exchange has generally tended to eliminate the possibility of significant bank disintermediation by companies going directly to the market with debt issues (e.g., obligaciones and polizas de acumulacion). Even if the pressure were lifted, the investor public might tend to remain with government and bank issued paper since, as noted previously, the information available to them relative to corporate financial status is extremely limited.

The bolsas, to strengthen their activities and allow them to become a larger force within the financial institutional framework, have made a number of suggestions relative to reform to the Superintendency of Companies, which, in the absence of anything resembling an Ecuadorian SEC, provides exchange oversight. Various elements of tax reform have been high on the list. Also, the trading in gold and precious metals and certain other commodities plus the formation of investment clubs and mutual funds have been recommended. Many of these recommendations have, in fact, been included in a "pre" law which the Superintendency submitted to the National Congress in August 1984. Paramount in this "anti-proyecto" was the recommended establishment of a new classification of corporation - "the open capital company." To be so qualified, the company would have to have at least 50 common shareholders representing no less than 40 percent of the paid-in capital which would have to be at least 5,000 times the annual minimum salary (due to be raised to S100,000, a total of S50.0 MM, or roughly $400,000 at today's free rate of exchange). Firm disclosure standards would be established and maintained, and certain tax incentives for both the company and its shareholders would be put in place.

Accompanying the pre-law described above was a companion piece entitled "Pre-Project of the Law for Investment Companies and Investment Funds." Initial sales of stock for the former would be handled by licensed stockbrokers and the two exchanges. Administrative companies, however, established to administer the resulting investment companies and investment funds could have no relationship with brokers or the exchanges because of potential conflicts of interest.

The two resulting detailed draft laws were presented to the National Congress just over a year ago. Thus far, Congress has taken no action on the matter. Observers of the situation believe action is highly unlikely until studies detailing the impact of the laws on the country's economy and fiscal situation are undertaken and completed.

6. Other Private Sector Financial Institutions

Other private sector financial institutions involve financiadoras (consumer credit organizations patterned on the Argentinian model), some five leasing companies (owned separately by the large private sector banks), and several factoring companies. To this list might be added loan sharks and relenders (described in more detail below in the section entitled "Mercado Extra-Bancario") and the exchange houses.

The first grouping, financiadoras, leasing companies, and factoring companies, is reportedly quite small and currently has, combined, no appreciable impact on the Ecuadorian financial scene. Financiadors provide short term consumer credit for the purchase of "large ticket items," generally for less than two years at interest rates at the 35 percent or higher level. The leasing companies, without any special tax incentives favoring such activities and in the midst of a construction slump, are relatively inactive. Factoring companies aim their efforts at medium and smaller sized companies unable to secure credit from other, more traditional sources. With so many of their actual and potential clients in economic distress, their current activities are reportedly very limited.

The exchange houses play of course, a paramount role in the free market rate for success letting demand and supply establish that exchange rate. There was some suggestion, however, that they had manipulated the rate at times to insure that the two-tiered system remained in effect as they feared, apparently, that unification, if the GOE were to have a hand in setting the rates of exchange, might lead to their ultimate demise.

Other than the buying and selling of currencies, no evidence was uncovered about other roles by the exchange houses - overnight or very short term lending, purchase of commercial paper, etc. One might suspect, however that they might at least be geared up for other activities such as hedging, futures, etc.

While their impact may be slight, the mere existence of these other types of financial institutions is significant. Local observers believe that they could play an important, even if highly secondary, role in the Ecuadorian financial scene if taxation and regulatory policies and regulations supported their efforts.

7. Mercado Extra-Bancario

As in many developing countries which have experienced shocks to their financial systems, Ecuador has a "mercado extra-bancario" an unofficial and, under the the law, illegal banking system. Unlike others, however, where foreign exchange trading plays a major role, Ecuador's system is of the domestic variety since a currency black market does not exist.

According to a member of the U.S. Embassy's economic staff, some S30 billion (US $478 million at the average official rate of exchange) flowed through this market in 1984, about 3.8 percent of the country's GDP or about 10 percent of the combined assets of the private banks. Local observers believed that the 1985 figure could have been lower, in part because of the successful introduction of the polizas de acumulacion (see below).

The illegality of the market stems from the fact that stamp and interest taxes ($2\frac{1}{4}$ percent on transactions and 8 percent on interest received, respectively) are not collected by the government on the transactions which occur. Thus, the GOE may have lost over S1.5 billion (US $24.0 million) in revenues in 1984, a figure representing almost 1.5 percent of the government's total budgetary revenue in that year.

The players in the market are numerous. On the demand side are a host of small businessmen and farmers who have limited or no access to the formal financial markets. Paying annualized interest rates of 35 percent or more for short term loans, the illegal system often provides their only alternative. On the supply side are, first, the obvious-the small corner money lenders or loan sharks, especially in the smaller cities and towns. Then there are borrowers who have arranged normal loans at regular financial institutions. According to a prominent Ecuadorian banker, there have been many instances when a person will borrow funds solely for relending purposes or will secure a loan for more than his immediate requirements, utilizing the excess for personal loan purposes. Reportedly, there have been cases where loans will be relent several times with a higher interest rate being charged at each separate lending stage.

Lastly, the supply side includes some of the private banks and financieras which have established "oficinas de mandato" borrowing from their associated institutions at 24-26 percent and relending at 36-38 percent to relatively low risk borrowers. The practice, as mentioned previously is illegal; however, since banking regulations are both out of date and somewhat lax, there are institutions which are known to be involved in such practices since the returns are high (higher interest rates, no taxes) and the chances of being prosecuted are currently almost nil.

The GOE, obviously, wishes to eliminate this market and associated practices. It believes that the issuance of polizas de acumulacion and certificados financieros especiales at market determined rates will be a first step and should, over time, steer money out of the mercado extra-bancario and into the regular banking system (as well as bringing back some of the flight capital which has left the country since 1979). Thus far, it is a bit too early to tell if this is indeed happening, although there were signs by year end that the volume being handled by the mercado was leveling out if not actually dropping. Some observers commented that the substantial inflow of funds into polizas was being diverted from other types of financial instruments which carried fixed rates. Others thought that at least some money was coming from those who had been engaged in the illegal mercado.

8. Social Security and Pension Funds

This portion of the overall Ecuadorian financial markets framework was not subjected to intensive investigation during the course of the field interviews. The time available was far too limited to cover adequately a somewhat complicated subject. Also, those interviewed expressed the opinion that both groupings currently played an almost insignificant role in Ecuadorian financial markets activities. The following information was secured, however:

1. The Ecuadorian Social Security Institute (IESS) has seats on both the Quito and Guayaquil stock exchanges. It channels its funds through the exchanges primarily into government bonds of the fixed term, fixed interest variety.

2. The funds arise from mandatory payments by both the employer (10.5 percent of total remuneration excluding mandatory fringe benefits) and the employee (9.0 percent). It should be noted, however, that the government reportedly has not made the employers' contributions to the fund for over 25 years.

3. IESS, though the nature of its investments, has generally received a lower return than other organizations which could purchase other types of financial instruments or could invest in equities or real estate. Consequently, it is assumed by many that the system is considerably underfunded insofar as its future liabilities are concerned, a certainty if one takes into account the government's lack of contributions.

4. Some of the larger banks and financieras and several corporations have established private pension funds to supplement social security payments. They are reportedly not managed as pension funds _per se_ but rather the collected funds are invested in various types of financial instruments. Over the last year or so, many of these funds have been placed or switched into polizas de acumulacion because of their relative safety and higher yields.

5. The Ecuadorian Supreme Court made a ruling in 1983 which required employers to make pension payments to all retirees who have at least 25 years of service with the firm. No provisions were made in that decision, however, nor in subsequent laws and regulations, in respect to these payments (e.g., how funded, tax implications, etc.).

6. Information concerning the nature and extent of private pension funds, relative newcomers to the Ecuadorian scene, is apparently not available at any one governmental agency although IESS may have some more detailed information. Consequently, the impact of these pension plans in the financial markets framework is currently not known (and probably quite small in any event).

9. National Development Bank (Banco Nacional de Fomento - BNF)

As the CFN serves as the public sector development bank for the commercial and industrial sectors of the economy, the BNF serves the same purpose for the agricultural sector. Unlike the CFN, however, the BNF is not considered by Ecuadorians as a parastatal financiera but rather as a type of a banking institution (for reasons which are unknown to the author of this report).

Its institutional importance has dropped considerably since 1975. In that year it provided 68.5 percent of the then official agricultural credit utilized in the country - S3.2B of the total S4.7 billion which then represented 24.1 percent of the country's agricultural GDP. By 1982, the latest year for which data are available, the BNF's percentage had dropped to 28.3 percent while total credit generated constituted 42.2 percent of agricultural GDP. In fact, by 1978 the commercial banks had become the chief source of official or legal agricultural credit in the nation. (The World Bank which provided the above numbers in an October 1984 report stated that BNF had estimated that over 60 percent of the total agricultural credit or roughly S11.0 billion in 1982 emanated from the "Mercado Extra-Bancario." A large number of small scale producers receive funds from money lenders and loan sharks, intermediaries, and larger commercial farmers. Interest rates for these short term loans are far higher than commercial rates, probably ranging from a low at 35 to a high of 60 percent today.)

Since 1974, BNF has received at least 70 percent of its resources from the Central Bank with the remainder from other public sector institutions and until 1982 from some direct foreign borrowings. Its resources have been dropping in real terms since 1976, except for 1978, indicating a diminution of its role in the agriculture sector insofar as the GOE is concerned, perhaps because the commercial banks were willing and able to take up the stock.

10. Other Public Sector Financial Institutions

Given the nature and duration of this study, virtually no time was spent examining the activities of the other public sector financial (or "quasi-financial") institutions including the all-important Banco Central, the Banco Ecuatoriana de la Vivienda, and the Banco de Desarrollo. Since, however, no report or the Ecuadorian financial scene would be complete without at least mentioning them and their functions, there follows a brief outline of their activities.

1. Banco Central. Ecuador's Central Bank performs the traditional functions of establishing monetary policies, creating and diminishing the money supply, and others which are similar or identical to those performed in those developing countries which are not centrally planned. Its impact or Ecuadorian financial markets is more of the indirect variety and its effect on those markets is described implicitly throughout this report, primarily in terms of its policy of rapidly expanding credit in the late 1970s and maintaining with other government agencies and its own Monetary Board a policy of low (negative real) interest rates.

2. Banco Ecuatoriana de la Vivienda (BEV). During Ecuador's rapid growth period the BEV was involved in both middle and low income housing finance. In recent years, facing a housing deficit of over 500,000 units, it has directed all of its (limited due to public finance constraints) efforts toward shelter solutions for low-income groups.

   In 1983, the last year for which data were available, BEV had assets of S10.6 billion (or about US$220 million) almost exactly the same as the combined assets of the eight mutualistas. Reportedly, it was operating near the break-even mark, although as a public sector organization it was not expected to be profitable.

3. Banco de Desarrollo. None of the literature reviewed nor any of the interviews produced information concerning this governmental development institution. It is believed that the bulk of its activities are in investment promotion and development and it has little activities currently in the lending field. Until several years ago, however, it reportedly receiving funding from several interational donor institutions (World Bank, IDB) which it combined with equal amounts in sucre terms for on-lending purposes. Local funds were apparently secured from the Central Bank while lending projects were in the commercial and industrial areas.

E. Financial Instruments

The following types of financial instruments currently exist in Ecuador:

I. Public Sector

A. Bonds of the State (Bonos del Estado). Issued by the Ministry of Finance. Guaranteed by the GOE. Medium (3-5 years) and long (over 5) term. Fixed interest rates (17 & 20 percent).* Traded on the stock exchanges. Tax exempt.

B. Dollar Bonds (Bonos Dolares). Issued by the GOE where possible to capture external resources to finance the general budget. 10 years. 8 and 9.5% interest. Not issued since 1984. Traded. Tax exempt.

C. Bonds for Monetary Stabilization (Bonos de Estabilizacion Monetaria). Issued by the Central Bank. Objective to reduce or increase money in circulation. Short term (30-360 days). No interest, discounted. Traded. Tax exempt.

D. Tax Certificates ("CATS") (Certificados de Abono Tributario). Issued by Central Bank as tax rebates to exporters of non-traditional products. Utilized for credit against income and other taxes due. No interest. Discounted. Traded. Tax exempt.

E. Treasury Certificates (Certificados de Tesoreria). Issued by the Ministry of Finance to "capture internal resources to finance the necessary cycles of the fiscal system." 181 and 360 days (although provisions exist for emission for up to five years). Fixed interest at 17%. Traded. Interest only is tax exempt, gain on sale subject to capital gains treatment (8 percent).

F. Credit Notes (Notas de Credito). Issued by the Ministry of Finance for overpayment of taxes (tax refunds). Utilized against income tax obligations. No interest, discounted. Traded. Tax exempt.

G. Municipal and Provincial Bonds (Bonos Municipales). Issued by political entities. Similar to Bonds of the State in all respects. Tax exempt.

H. Development Bonds (Bonos de Fomento). Issued by the National Development Bank "or by financial and banking institutions of the country which deal with the agro-livestock, forestry, and fishery sectors." Can be issued for up to 100 percent of the institutions' capital and reserves for five years or more. Purchased by the Central Bank at par and resold on the stock exchanges and to others at a discount (to bring yield to "market" rates). Fixed interest rates (13 percent). Traded. Interest and discounts tax exempt.

I. Housing Bonds (Bonos de Vivienda). Issued by the Ecuadorian Housing Bank. For medium and low cost housing finance. Cannot exceed five times the capital and reserves of the bank or be issued for less than 10 or more than 20 years. Obligatory purchase by the private banks - at least 10 percent of savings deposits. Fixed interest rates (up to 20 percent depending upon the maturity). Traded. Tax exempt.

Issues which carry fixed interest rates are sold initially at discounts (predetermined by the Central Bank) in order that the yield to maturity might approximate what the Bank considers to be "market" rates. Those which carry no interest are sold at "deep" discounts.

II. Private Sector

A. Stock (Acciones) - Ordinary or Preferred. May be issued by corporations or by "mixed economy" companies. Can only be nominative, fully paid. Company pays dividend tax of 20 percent (plus 2.2% university tax, total 22.2%) relative to shares held by residents. 40 percent on overseas remittances. Local residents utilize corporate tax payments as a tax credit (and may pay more taxes depending upon their incremental tax bracket).

B. Obligations (Obligaciones). Issued by a "mercantile" corporation. Secured by fixed assets. Cannot exceed 60 percent of paid in capital and reserves nor more than 60 percent of value of the security. Fixed interest rates (17 to 20 percent depending upon maturity). Traded "below nominal, par value." Rarely utilized. Interest taxed at 8 percent.

C. Mortgage Notes (Cedulas Hipotecarias). Issued by mortgage banks (government) or mortgage departments of commercial banks. Purpose - to "capture resources to finance construction activities." Fixed interest rates (17 percent five years or less, 20 percent, over five years). Traded. Interest taxed at 8 percent.

D. Bankers' Acceptances (Aceptaciones Bancarias). Letters of credit or promissory notes. Issued by clients of commercial banks and accepted by those banks for negotiation to other credit institutions, generally the Central Bank, which discounts or rediscounts the document to provide the funds back to the clients. Must be collateralized. Three classes: agri-livestock, fishing, mining, and for artesans; industrial; commercial. Sold by Central Bank on the stock markets at a discount to derive "acceptable" yields - non interest bearing. Issued for 30 to 270 days. Not taxed.

E. Ordinary Financial Certificates (Certificados Financieros Ordinarios). Issued by Financieras. Authorized by the Monetary Council up to five times the capital and reserves of the issuing financeria. Council also establishes interest rate (currently fixed at 17-20 percent). May be issued for no less than 270 days or more than three years. Traded (at discounts). First interest slab of 7.5 percent tax free. Remainder taxed at 8 percent. (N.B. "Special" Financial Certificates issued at "market" rates have been authorized and are discussed elsewhere in this report.)

F. Collateral Bonds (Bonos de Prenda). Issued by commercial banks and savings institutions to finance specific agricultural, livestock, industrial, or fisheries projects. A given loan may not exceed 60 percent of the value of the assets comprising the collateral. Assets acquired must be paid for within five years. Fixed interest rates (16 to 17 percent). Traded. Interest taxed at 8 percent.

G. Guarantee Bonds (Bonos de Garantia). Issued by financieras in two classes - general and specific. General guarantee bonds may be issued for up to 80 percent of the value of the individual mortgage or collateral loans made from the proceeds; however, the grand total or all such bonds issued may not exceed 60 percent of the combined value. Specific guarantee bonds are tied to a given, identified project and can be issued for up to 100 percent of the mortgage or collateral. May be issued for any length of time. Fixed interest rates (16% for five years or less, 17% for over five years). Traded. Interest taxed at 8 percent.

H. Accumulation Policies (Polizas de Acumulacion). Described in detail in the following section of this report.

The source of the foregoing information was "The Market for (Financial) Instruments in Ecuador" published by the Superintendency of Companies, Quito, August 1984.

Polizas de Acumulacion/Certificados Financieros Especiales

In late 1984, the Febres Cordero Administration authorized the banks and financieras to issue a new type of financial instrument - polizas de accumulacion (by banks) and certificados financieras especiales (by financieras). With 30 day to one year maturities for the former and 90 days to 3 years maturities for the latter, these instruments issued at competitive market rates established by the institutions themselves became overnight successes. By the end of June 1985 the polizas had accounted for well over S30 billion or almost half of the combined "notes in circulation and other obligations" of the 30 banks within the system. Paying currently between 23 and 28.5 percent interest rates, the after tax (8 percent) yield on the instruments averages roughly 24 percent or a small, positive, real interest rate, given the current rate of inflation in the country.

The apparent goals of the administration included:

1. A means by which IMF and World Bank concerns regarding the freeing of the interest rates structure could be met, at least partially.

2. A way of bringing money into the official, legal financial system from the "mercado extra bancario" through which, according to the Embassy some S30 billion of untaxed funds flowed in 1984.

3. An attempt to bring back some of the dollars which had earlier left the country under flight conditions.

Funds obtained from the issuance of these instruments have been used to a great extent in financing international trade and, more limitedly, in working capital support. While financieras have been permitted to issue them for up to three years, none have had, according to a financiera senior executive, terms of more than one year. The average has been 180 days, and there have been no provisions for roll-overs.

Corporations have been granted permission to issue polizas de acumulacion directly thereby disintermediating the banks. The idea is reportedly picking up slowly, and by the end of this year corporate issued paper could be outstanding. (N.B. Generally speaking, the Ecuadorian buying public appears to favor banks and financieras which have reasonably complete disclosure requirements as opposed to corporations which have none. Corporations, except for the very best known and financially sound, may well find that the "risk premium" expected by the investor may be equal to or exceed the spread charged by the financial institutions thereby making direct issuance impossible.)

Various comments concerning these instruments include:

1. With after tax yields currently of 24-25 percent and reasonable safety, why would an individual or corporate investor invest in anything else?

2. The market rates notion for both investors and borrowers is an excellent first step in freeing up Ecuadorian financial markets. With borrowing rates in excess of 30 percent, however (25-26 percent plus a 4 percent spread and a 2 1/4 percent stamp tax), and the short term nature of the instruments, they are hardly a way of promoting longer term investment.

3. The GOE prohibited secondary trading in the instruments thereby eliminating the possibility of using them in an overnight market situation. This was cited (by a US Embassy official) as an counter example to deregulation and the opening of capital/financial markets.

F. Taxation

Obviously, the fiscal policies of any country will have an impact, both directly and indirectly, on that country's financial markets. By, for example, imposing relatively high tax rates on one type of instrument and low rates on another, equilibrium in yields, risk considerations aside, will only occur at an "expense" to the former and a "benefit" to the latter. This is certainly true in Ecuador where, as noted in the discussion of financial instruments, dividends under the current law (dating from 1971) are taxed at a much higher rate than polizas de acumulacion (8 percent on interest), state bonds (tax exempt), etc.

This brief study could only focus on Ecuador's tax system as it related to financial markets in a highly superficial way. It will be up to the group performing the MPAP to draw detailed findings, conclusions, and recommendations from its fiscal administration and capital markets study segments as to how tax policies inhibit, if that is indeed the case, the orderly growth and development of a "modern" institutional framework. Nonetheless, some information in terms of limited findings should be presented in this study to allow those who review it to make at least preliminary judgments as to taxation area and financial markets relationships as they currently stand and possible avenues for eventual change.

Of major note currently is a study being performed for the Mission entitled "Ecuador Fiscal Administration Project" by the Maxwell School of Syracuse University. In an interim report issued in December of last year, the consultants presented substantial statistical data relative to Ecuador's tax structure. Excerpts from one table, as an example, revealed the following:

1982 Data

	Total Taxes / GNP	Total Taxes / Capita	Individual Income Tax (IIT) / Total Taxes	IIT / GNP	IIT / Capita
Ecuador	11.3%	US$128.72	6.7%	0.8%	US$8.69
15 LA Country & Caribbean Average	18.0	384.39	8.9	1.8	38.31

Ecuador	
Taxes on International Trade Transactions/ Total Tax Revenue	35.8%
Tax on Income, Profits, Capital Gains/Total Tax Revenue	40.5
Tax Revenue	
(Individual)	(6.7)
(Corporate including all taxes)	(21.7)

The authors found that Ecuador was a "low tax" country with limited reliance on individual and corporate taxes, except for oil, as a revenue source. A much heavier reliance was placed on those areas which might be said to be more readily collectable (and, conversely, less avoidable or evadable) such as duties on imports and a VAT. From an individual income tax basis, the study team found that while collections arising from income from employment and capital income (dividends, interest, and royalties, generally withheld at the source) were reasonably straight forward, collections from professional and independent work income and personal work in connection with business profits (partnerships, sole proprietors, etc), were much lower than could be reasonably expected, indicating considerable tax evasion. (N.B. No reference was found in the report relating to capital gains arising from the sale or transfer of stocks and bonds. Capital gains under Ecuadorian law do not form part of income subject to the usual personal income and are subject only to a single tax of 8 percent of the total gain.)

Detailed information on Ecuador's tax structure can be found in the Price Waterhouse Information Guide Series in a publication entitled "Doing Business in Ecuador." While published in February 1981 and not subsequently revised, it presents a reasonably accurate picture of that structure as it exists today. Updated information, especially that relating to revised individual income tax rates (inflation having been factored in) can be found in Business International's FFO and ILT series which contain specific chapters on Ecuador.

G. Corporate Results

The Ecuadorian Superintendent of Corporations received 1984 annual reports from 10,421 corporate entities (S.A., C.A., excluding financial organizations). Combined results were as follows:

	Billions 1984	%	
Balance Sheet			
Current Assets	S 331.2	52.1	
Other Assets	303.9	47.9	
Total Assets	S 635.1	100.0	
Current Liabilities	278.2	61.5	
Non-Current Liabilities	174.0	38.5	
Total Liabilities	S 452.2	100.0	71.2
Paid in Capital	86.0	47.0	
Capital Surplus	68.0	37.1	
Reserves	28.4	15.6	
Undistributed Earnings	0.5	0.4	
Total Equity	S 182.9	100.0	28.8
Total Liabilities and Equity	S 635.1		
Profit & Loss			
Net Sales	S 529.1	100.0	
Inventory Reduction	153.0		
Production Costs	227.0		
Cost of Sales	380.0	71.8	
Gross Margin	149.1	28.2	
GS&A Expense	88.0	16.6	
Operating Earnings	61.1	11.6	
Finance Charges	33.4	6.3	
Net Operating Earnings	27.7	5.3	
Non-Operating (Earnings) & Expense	(12.9)		
Net Earnings before Taxes	40.6	7.7	
Mandatory Profit Sharing	5.0	0.9	
Taxes	22.8	4.3	
Net Earnings After Tax	S 12.8	2.4	

The ratio of net earnings to "patrimonio" or total equity was 6.9% in 1984 after approximately 3.0% in 1983 and 4.0% in 1982.

In 1984, 247 companies of the 10,421 had sales in excess of S 100.0 MM and 50 or more employees. According to a December 1985 conference held by CEDATOS (The Ecuadorian Center for Economic Studies and Data), these companies had 20 percent of the total corporate liabilities (S 91.0B), had combined losses of over S 16.0B 1982-1984, and had seen their total equity reduced by almost 50 percent over that period. Among 26 leading construction companies, liabilities increased by 50 percent in both 1982 and 1983 and by 15 percent in 1984. Return on total equity was negative in all three years -- (10%) in 1982, (26%) in 1983, and (10%) in 1984.

CHAPTER V

CONCLUSIONS

Introduction

The conclusions contained within this chapter are necessarily drawn from the findings presented in the previous chapter applied against the author's knowledge of financial markets in both developed and developing countries. As such, the conclusions stated are designed to provide the reader with information concerning both problem areas and opportunities which should be subject to detailed examination in any future institutional design and building process. They are not, however, clear cut prescriptions for change or for specific alternatives; that portion of the report, insofar as these matters are concerned, is contained in the following chapter, recommendations.

Following the pattern established in the previous chapter, the conclusions are divided into groupings. Since several of the previous ones were provided for informational or background purposes and require little, if anything, in the way of conclusions this chapter will consist of five (rather than seven) groupings.

A. Donor Institution Activities and Recent Special Reports

B. Current Mission Efforts

C. The Ecuadorian Financial Markets System

D. Financial Instruments

E. Taxation

A. Donor Institution Activities and Recent Special Reports

World Bank Activities

It is unfortunate that the Hanson report is currently not available to this consultant, those who will be performing the MPAP, and the PRE-Arthur Young consulting team. While from his comments and their review, it can safely be assumed that the report is somewhat macro in nature, specific bank approved findings, conclusions, and recommendations concerning the entire financial markets framework in its entirety would be most useful in this and future efforts to reshape that framework.

The major points made are well taken and have been verified through the medium of this study:

1. The banking system requires in-depth study and resulting reform.

2. Variable interest rate lending must become more widespread; appropriate legislation is needed.

3. Current laws and regulations affecting capital markets development are inadequate and are inhibiting the growth process.

4. Further Bank-AID cooperation is not only desirable but essential.

The foregoing conclusions are obvious; however, the successful implementation of the associated activities will be difficult. Bankers, for example, are known for their conservatism and reluctance to accent change, especially in those areas which will impact upon their own activities. Ecuador is no exception, and a selling job to convert the current mentality will be required. Reform legislation, historically and currently, is difficult to accomplish in the National Congress; perhaps a strong chief executive with a decidedly pro-private sector stance will be able to bring appropriate pressure to bear. Nonetheless, in Ecuador, as in many other countries, one can expect evolutionary rather than revolutionary change, and the change which does come about can only occur, at least in part, through an educational process. Certain recommendations in that regard will be made in the following chapter.

Special Study-Industrial Development Finance

The Nathan study conclusions, which I support, are contained within Appendix C to this report. One area which it touches upon which has not been subject to intensive scruitiny in this study is the question of technology transfer. Since their study was done strides have been made toward improving the "electronic" and human resources elements of the Ecuadorian financial institutions environment, particularly through, in part, AID sponsored support for the Ecuadorian Banking Practices Institute of the Ecuadorian Association of Private Banks and the graduate business/finance program at one of the local universities. Yet the Nathan 1983 conclusion remains valid today - "Data acquisition, information management systems, computerized evaluation and monitoring aids, and upgraded human skills remain critical factors in determining the financial operating costs and economic efficiency (of LDC financial institutions) and appear to offer a promising area for continuing development assistance." This conclusion is particularly true if more sophisticated capital markets mechanisms such as venture capital, merchant banking, and investment banking are to take root and flourish within the country. Without them, these mechanisms are probably doomed to failure.

The Price Waterhouse Report

The Price Waterhouse report, completed in late 1984, served as an excellent guide to the Mission concerning all aspects of its program, including financial/capital markets development activities. It had a decided impact upon the development of the related scope of work for the MPAP and found its way into the pre-planning exercise for the proposed FY 1987 capital markets development project. Yet, some of its overall impact may have been blunted by the (often unavoidable) delays in getting projects underway. The MPAP has taken a substantial amount of time, through the necessary documentation preparation and the competitive bidding process in this regard, and will not be completed until midway through the Febres Cordero administration's tenure (presidents being not able to stand for reelection). Much of the usefulness of its recommendations regarding policy and regulatory reform will be lost if a "lame duck" syndrome enters into play. Considering the fact that the National Congress is very slow moving under the best of circumstances, the likelihood of the syndrome occuring is even increased.

There is an area mentioned by Price Waterhouse which deserves immediate attention from a financial market's development standpoint and will only be superficially covered in the MPAP awaiting the FY 1987 study for more exhaustive coverage. That is a review of "the current financial and management situation of the private banks and financieras to identify priority financing and operating problems." Given the findings provided above, one can only conclude that the failure of review and corrective action in this area could lead to a situation whereby rebuilding efforts relating to the current institutional framework would be required before: a) the resulting MPAP recommendations could be placed into affect; and b) the projected FY 1987 study could proceed.

B. Current Mission Efforts

1. MPAP

The capital markets analyses portion of the overall scope of work for the MPAP, focusing upon the constraints which exist to capital markets development within the current governmental policy and regulatory/legal framework, appears to be well designed. Assuming that the group ultimately chosen to perform these analyses: a) has the requisite technical knowledge; b) is well aware of the Ecuadorian socio-economic-political environment; and c) has easy access to the key political decision makers in the Ministry of Finance and other governmental agencies which play a role in the entire scenario, the desired results should be attained. There are, however, several factors which must be taken into consideration and monitored closely during the course of the MPAP. First, Mission oversight of the project is divided among two offices - Project Development and the PSO. They will have to coordinate their activities closely to insure that the project's outcome becomes a "whole" rather than two separate parts. Second, the GOE's primary interest and priority lies with the fiscal administration portion of the MPAP. The Mission and the selected consulting group will have to insure that appropriate and sufficient GOE resources are brought to bear on the capital markets analyses portion.

Nonetheless, the findings certainly support the conclusion that the capital markets analyses portion of the MPAP is badly needed and that policy/regulatory/legal reforms are essential if the required changes in the institutional framework are ever to be effectuated. Additional study planning and strategy development are required, however, and are discussed in the recommendations chapter which follows.

2. Investment Promotion and Venture Capital

The findings relating to the "investment promotion component" lead to the conclusion that while the Mission's efforts are laudable and well reasoned, the mechanisms chosen, at least insofar as their proposed configuration is concerned, may require further examination. In the apparent conflict of views between the Mission and the Guayaquil based financial experts, as an example, one might tend to agree more with the latter. Nonetheless, the Mission has marshalled its arguments well regarding agri-business sector concentration and has apparently identified the safeguards required to eliminate any GOE interference in what is essentially a private sector project.

The venture capital pool concept or, for that matter, any proposed venture capital operations require, I would conclude, more study and sound expert input. As an example, venture capitalists in the United States contacted (TA Associates and their international subsidiary Advent International and the Ohio State Venture Capital Association) concluded that the hiring of a professional manager from abroad without sound local knowledge and backup, the lack of a requirement for management financial commitment to the pool, and a 15 percent limitation on equity participation in a given company would place formidable road blocks in the way of the pool's possible success.

The notion of the "Baker Company" described in the findings, while a bit revolutionary at first glance, deserves expert study as well. If it proved possible, with the requisite institutional design, to implement such a concept in Ecuador, the ultimate ramifications would be considerable. I can only conclude that this concept should be explored in depth independently and in concert with the February 17-18 Quito Conference.

C. The Ecuadorian Financial Markets System

The Commercial Banking System

As I wrote in my report on Honduran Financial Markets, "a sound and efficient commercial banking system (whether it be in Honduras, Ecuador, or elsewhere) requires a balance of full competition and government regulation. Competition among banks for investors' savings improves the return to depositors thereby encouraging the monetization of domestic savings. Competition among banks for lending opportunities tends to limit lenders' margins and keep borrowing costs as low as possible. On the other hand, capital adequacy requirements and regulatory scrutiny of portfolio quality serves to forestall bank failures, diminishes the risk to depositors, and, thereby, reduces the risk premium implied in the deposit rates. To monitize fully the savings of small, risk adverse investors, moreover, a system of deposit insurance would also be required."

The findings indicate a bit of a paradox within the Ecuadorian banking system. To be sure, there are 30 (or 31) commercial banks indicating, on the surface at least, a rather substantial amount of competition. Over the last few years, however, they have been competing more for GOE funds rather than those from depositors. The rules of the game have been stacked against them as the government, until fairly recently, maintained interest rate policies which forced investor/depositors who had any funds available into the mercado extra-bancario, moving funds offshore, real estate, or almost anything else besides deposits or, more importantly, into financial instruments issued by the banks directly or through the stock exchanges.

The GOE's decision in late 1984 to allow the banks to issue market determined, variable rate instruments, polizas de acumulacion, plus its policies relating to discounts and increasing interest rates at more frequent intervals on fixed rate instruments are highly important events. While these actions have not gone far enough, they should reduce over time the banks' dependence on the Central Bank for loanable funds.

Whether or not those actions will make the system more competitive remains to be seen. On balance, they might since polizas de acumulacion have become a rather rapid success and obviously the money will flow to those institutions, all other things considered, which offer the best "deals." On the other hand, the commercial bank structural system is very weak; two banks have recently gone under and at least six more are in poor shape. The largest single bank has a net worth and reserves picture equivalent to a U.S. bank headquartered in a city having a population at about 50,000. Its ratio of net worth and reserves to assets, of about 4.0 percent would automatically put in on, if it were that small U.S. bank, the Comptroller of the Currency's watch list.

One can probably conclude that overall the Ecuadorian commercial banking system is not very competitive, yet it is far too fragmented. After all, reportedly several banks have been started in recent years merely to secure government funds for relending purposes utilizing the easily attainable spread for profit generation. Competition might better be served if the commercial banking system were comprised of five to ten larger, better capitalized, and highly competitive banks.

Many Ecuadorians in and outside the banking community agree with the above conclusion. They see the system as under capitalized, in many instances over extended, and generally weak, especially in regards to the smaller and new banks. Mergers or "fusion" would be welcome; however, current banking laws and regulations dating from the early 70s while promoting the establishment of new commercial banking institutions rule out mergers. Unless and until the now antiquated banking control system is modernized, as has been recommended by many (including the World Bank), the commercial banking system is likely to remain somewhat weak, non-competitive, and unable to marshall from non-governmental sources the volume of savings required to accelerate the country's economic development.

Insofar as the breadth and extent of the types of financial instruments issued by the banks are concerned, the general framework, even if not utilized optimally, appears to be in place to both foster banking competition and marshall savings. Perhaps the only "negative" conclusion that might be reached is that there may be too many types of instruments with several of those being too targeted or specific. A simpler system based, for example, on three or four more general types might be preferable.

No matter how it might be configured, the framework cannot operate properly until the bulk, if not all, of the instruments carry market determined interest rates. The issuance of the polizas de acumulacion is a good start in that direction; however, it should be continued through the application of free market rates to other instruments. Also, attention must be given to indexing (as recommended by the World Bank) to insure the issuance of more medium term instruments under conditions agreeable to the banks and borrowers alike.

Another sign of the lack of competition is the infrequent disintermediation of the banks by borrowers through direct debt or equity placement. Obviously, with more limited investor confidence in Ecuador's industrial and commercial firms than in the banks, disintermediation is unlikely to occur to any great extent until that confidence is restored. If and when that event occurs, the mechanisms are in place - obligations, bankers' acceptances, accumulation policies, facturing, etc. Additionally, liquid markets for these instruments could exist through the two Ecuadorian exchanges; however, in the absence of merchant banks specializing in the purchase and placement of a wide range of securities, such a system is unlikely to develop.

Finally, it should be noted that the commercial banking system, to protect its own interests and reduce the possibility of competition, has tacitly supported many aspects of the current structure which make disintermediation, the creation of merchant banks, and other alternatives difficult, if not impossible. Again, revision and modernization of the banking laws and regulations to diminish the banks' favored position is clearly called for if competitive pressures are to be brought to bear on the banks.

In sum, we can conclude that a basic, market oriented framework exists which can be built upon to accelerate economic development. Yet, the word "basic" must be stressed since significant changes are required in order that the commercial banking system can play a major role in the process.

Financieras

There indeed appears little reason under current conditions for the continuation of the financieras as separate financial markets institutions save, perhaps, for CFN and COFIEC. While CFN has proven the off-quoted observation that parastatal development banks are often dominated by politics and their investments are more than occasionally aimed at often non-financially viable "showcase" projects, its overall record does not appear as poor as many similar institutions in other LDCs. Perhaps through better management, additional portfolio shedding, improved project selection, etc. (and additional World Bank financing), CFN could play a useful role in the long-term developmental process.

COFIEC, as a large (by Ecuadorian standards) private sector development bank with a rather good track record, at least until 1982, deserves special attention. Insofar as longer term debt and equity financing is inhibited by the regulatory process, these barriers should be identified with the assistance of COFIEC and targeted for elimination by any subsequent capital markets study - MPAP, PRE, and/or capital markets development. Insofar as donor activity aimed at the private sector is concerned, COFIEC should, I would conclude, continue to receive the concentration of effort. (This presupposes, of course, a fairly extensive analysis of the institution, appropriate remedial recommendations, and implementation.)

If the remaining financieras are to serve no other purpose than emulating the commercial banks and confining their lending activities, for the most part, to the near and medium terms, their merger into or fusion with those banks which are viable and growth oriented appears desirable. Granted, this conclusion is based in the "ideal world" context which does not exist. Also, it can be logically assumed that at least the profitable financieras might take exception. Yet, if a regulatory/legal framework could be put in place which would support such mergers rather than almost ruling them out (remembering the fact, of course, that some of the financieras are controlled by private sector banks), the economy and development could be well served.

In sum, presently most of the financieras are redundant. While a case might be made that under different conditions they could flourish, a system with one or two large private sector development institutions concentrating on medium and longer term lending and one public sector institution, in some instances competing while still taking into account other than strict bottom line considerations, could be a sensible solution for the Ecuadorian developmental context.

Savings and Loan Associations (Mutualistas)

Because of their relative smallness and current lack of significance in the Ecuadorian financial scene, the functioning of the eight mutualistas was not examined in any depth during the course of this study. Nonetheless, in a more middle income country (among the ranks of the LDCs) with a small, but growing middle class, the importance of a strong cadre of S&Ls for the provision of mortgage funds to all save for the (much larger group of) urban and rural poor is substantial. It can be surmised that some elements of regulatory reform are required to stimulate this portion of the financial markets sector; however, the overriding issue at present is continued inflation and high interest rates. Unless and until these are brought under control, the demand for the S&Ls' services in terms of mortgage funds will remain very limited. Likewise, until the S&Ls can attract deposits and investments at real, positive interest rates the supply of funds will also be very limited.

Insurance Companies

Insurance companies, particularly those which write life insurance where actuarial requirements make them potentially a major source of long-term investment funds, especially for commercial construction purposes, account for a significant portion of the world's financial assets. In some developed countries, their combined loanable funds can account for as much as 30 percent of those countries' financial wealth. In Ecuador, because of tight restrictions, limited interest in or ability to pay for life insurance, and other factors, the portion is extremely small. It is evident, however, that the Ecuadorian insurance industry has some unrealized potential for aiding in the developmental process, but as long as that industry remains "over" regulated, this potential cannot be realized.

Stock Exchanges

If one were to conclude that the primary function of a stock exchange is to trade in equities and longer term debt instruments, as is the case in most developed countries, the Quito and Guayaquil Stock exchanges are failures. As was noted in the findings, the bulk of their trades occur in mortgage notes and stabilization bonds.

Several informed observers have suggested that the stock exchanges are merely clubs where paper is shuffled with little or no impact on the country's economic and financial development. One even thought that "both of them should be blown up and we should start all over from scratch." This appears to be somewhat of an extreme conclusion in this writer's mind, however, since their mere existence is significant from an infrastructural standpoint.

Nonetheless, one can conclude that under current and foreseeable circumstances, two exchanges are probably one too many. Separately, neither has the resources, technical capabilities, overall skills, "clout," or much of anything else to play a role in the developmental picture. Amalgamation and on-going technical assistance could be a necessary step in creating that role.

But, for an Ecuadorian "super" exchange to be successful, many other elements are needed. Tax reform to reduce or eliminate the structural bias against equities is an obvious requirement (although without accompanying disclosure laws tax reform in and of itself would have little or no impact). Underwriting through member brokerage firms would be highly desirable. The exchanges' own recommendations relating to precious metals and commodity trading and to the formation of investment clubs and mutual funds appear sound. The "open capital" company as described in the findings might have substantial merit.

Quite obviously, the Ecuadorian stock market situation and the role which the bolsas (or one bolsa) might play within an optimal capital markets framework could well be the subject of a rather large study onto itself. In fact, this writer would not be surprised if a number of studies in this regard have not already been done. It would seem, however, with the "anti-proyecto," the present pro-private sector atmosphere, the beginning of economic recovery, and other factors that the time for studies is, in effect, past and what is needed is action. I must conclude that with a foundation in place, no matter how ill-developed it may be, with guidance and technical support of a "hands on" or "let's do it" nature could have a major impact upon future capital markets development.

Other Private Sector Financial Institutions

Other, more specialized, financial institutions are necessary in order that a "complete" financial markets institutional framework can be in place. In this regard, Ecuador, as mentioned in the findings, has several consumer credit organizations, five leasing companies, and several factoring companies. From a capital markets standpoint or at least the provision of other than short-term credit, the leasing companies have, of course, an important role. By raising short-term funds and converting them to secured medium-term loans, these companies provide an alternative to the long-term capital market in developed and advanced developing countries as well.

Problems relating to high inflation rates, scarcity of short-term funds, the lack of fiscal incentives, etc. have inhibited the development of this particular type of institution in Ecuador. Yet, as in the case of the bolsas, some semblance of a foundation is in place which, given the right atmosphere, could be built upon resulting in perhaps still small but highly effective institutions capable of assuming their rightful place in the entire developmental process.

Certainly, the results of the MPAP should indicate where changes in the regulatory/legal/fiscal system are required to stimulate the growth of leasing companies and other, more modern forms of financial institutions. The capital markets study should examine the MPAP recommendations, review the existing and likely development patterns evidenced by these companies, and describe fairly precise future development.

Clearly, the findings indicate the eventual need for merchant and investment banking operations as well as something which may resemble the developed country version of a venture capital firm. These institutions, however, cannot be planned nor developed under the current regulatory/legal/fiscal framework, assuming that the longer term demand for these services is present, and serious thinking concerning their formation must await, at the very least, the results at the MPAP study plus other activities in which the Mission is engaged (e.g., the final version of the non-traditional agricultural products program amendment).

The Mercado Extra-Bancario

If one assumes that the availability of some credit to those who need it is better than none at all, one can conclude that the mercado plays a necessary role in the Ecuadorian institutional framework. After all, its activities are not unlike those which transpire in a host of developing and highly developed nations as well. And, as efforts to eliminate loan sharking in various areas, as an example in the United States, have failed, surely the GOE's desire to eliminate this market and associated practices is probably not attainable.

Nonetheless, some aspects of the mercado, probably the least desirable from an overall equity standpoint, could disappear virtually overnight giver the proper impetus. If all interest rates were market determined, the incentives would exist for borrowers and lenders alike to treat the mercado as the ultimate court of last resort. If existing banking regulations were enforced and appropriate penalties levied, the "oficinas de mandato" would quickly be closed. If tax laws were enforced, the fiscal advantages to the lender secured from tax evasion would be entirely reversed.

The existence of such a market, *per se*, indicates a sub-optimal distribution of credit throughout the economy. Usurious interest rates inhibit economic growth by placing a crushing burden on those who might otherwise be in the vanguard of job creation, the small businessman and agriculturist.

While the mercado can never be eliminated, its size and impact on the economy can be minimized. The first steps to do this have been taken and it is hoped that additional steps will follow.

Social Security and Pension Funds

As with the bolsas, a rather large study could be devoted entirely to the subject of the Ecuadorian social security system and pension funds. In fact, in light of the work currently being done in Indonesia on precisely the same subject, those results might be closely examined to determine if any of the techniques or lessons learned might have applicability in Ecuador.

Along with life insurance, pension funds offer a tremendous source of long term finance in a developed country. Ecuador, having emerged as a middle income developing country, having built a bit of an industrial/commercial base with resulting longer term employment opportunities, and having increased the life span of its citizenry, may soon find itself in a position where its accumulated pension funds, while limited by developed nation standards, could become a source for such finance. (N.B. Under the Supreme Court ruling mentioned in the findings, if it were to be enforced, the process might be accelerated.)

While the pension fund situation, if properly directed, is promising, the IESS situation does not seem equally so. A recent (1984) World Bank study stated that over the 1979 - 1983 period. IESS had accumulated about 15 percent less monetary assets than it otherwise should have because of poor investment policies and government mandated investments. Additionally, as it was pointed out earlier, the largest single employer in the country, the GOE, has not made employers' contributions to the fund for over 25 years. Thus, all the positive factors which lead to more pension funds for long term development purposes may lead the IESS to a tremendous under funded position over time. One should conclude from all this that a very close examination of the IESS - pension funds situation is required to determine the possible impact which it might have on capital markets development.

Public Sector Financial Institutions

Ecuador's agricultural sector is second only to oil in terms of its importance to the economy. The traditional product portion - bananas, coffee, and cocoa - have suffered considerably over recent years because of natural disasters (El Nino and the resulting flooding which dropped Ecuador from its number one banana exporting position to number two) and falling worldwide commodity prices (with coffee now reversing because of the Brazilian droughts.) Non-traditional products such as flowers, winter vegetables, citrus, jojoba, palm oil, etc. are in various stages of development, generally the early ones, and have yet to be major contributors to Ecuador's export earnings.

Agriculture is obviously a crucial element in Ecuador's development process. The findings, however, indicate that agricultural financing is possibly the weakest link in the entire financial system. The BNF's importance has been dropping almost steadily since 1976 to the point that it now provides probably less than 25 percent of the official agricultural credit and around 10 percent of total agricultural credit. Some 50-60 percent of the total has been supplied in recent years by the "mercado extra-bancario" while the remainder has been provided by the country's banks and financieras. Most of the short-term credit available is at very high interest rates, 35 to 60 percent on mercado funds and 28-32 percent on bank and financiera funds. BNF's rates are less than the latter; however, the point becomes academic when one realizes the fact that BNF has very little money to lend.

Credit at "reasonable" rates is required, and there must be institutional entities of a regular, non-mercado nature able to satisfy the demand. We can conclude that this portion of the credit picture needs complete revamping - perhaps with the reorganization and strengthening of the BNF thereby providing means by which it can bid successfully for at least a fair proportion of its loanable funds from other than government sources. Alternatively, perhaps the parastatal should be allowed or encouraged to die with the private sector banking system, adequately prepared for its expanded role, stepping in to take up the slack. In any event, attention must be given at an early date to this issue.

The strong demand for low cost housing in Ecuador reflects an accumulation of past shortages plus a rapid rate of population growth. The age structure of that population with large cohorts of young adults forming families each year has placed a tremendous additional strain on the housing demand situation. The supply side has been stymied by a lack of mortgage funds and high interest rates, and thus the needs of the country's urban and rural poor has resulted in a shortfall estimated at over 500,000 units.

It is highly unlikely that the Banco Ecuatoriana de la Vivienda (BEV) can marshall anything like the US $1.0 billion (500,000 x $2,000 per unit) required to satisfy current needs, let alone the normal, annual requirements for mortgage funds which would exist when the deficit had been eliminated. It is well beyond the scope of this paper to diagnose this situation in depth and make recommendations on the basis of this obvious conclusion. Future studies, however, relating to the Ecuadorian financial scene must tackle this problem and see if there is any feasible way out of this difficult situation.

D. Financial Instruments

There is, as indicated by the findings, a wide variety of both public and private sector financial instruments available in Ecuador. They may be, in fact, too wide of a variety relative to those which currently exist and a lack in the form of other instruments.

To list conclusions regarding every form, existing or non-existing, would probably not be a useful exercise in terms of this report. Some specific conclusions, however, can be drawn regarding them from the overall findings which have been made.

There appears to be nothing out of the ordinary regarding the makeup of the public sector financial instruments. They seem to be adequate in both number and type to finance governmental expenditures at acceptable levels (albeit Housing Bonds are by no means sufficient to eliminate or reduce markedly the housing gap, their obligatory purchase element notwithstanding). Whether or not their usage has a positive or negative impact on private sector development, however, was not a subject addressed during the course of this brief study. Obviously, this would be a subject for close examination in any future, substantive work on the Ecuadorian financial system.

There are, however, some anomalies among the private sector instruments. One is struck, for instance, by the fact that obligations (obligaciones) which can be directly issued by a corporation are rarely utilized. On the other hand, a similarly secured instrument (collateral bonds) issued to finance, among other things, corporate "projects," by the banks and financieras is relatively popular as well as are general and specific guarantee bonds issued by financieras. There is obviously a bias against financial institution disintermediation within the system (a subject discussed elsewhere).

The accumulation policies, representing a major step forward in terms of market determined interest rates, also are notable by the fact that while they can be issued directly by a corporation, none have done so leaving the entire field to the banks. While there are currently structural or risk avoidance reasons behind this, another way for disintermediating the banks is not in use.

There can be no doubt that the tax situation relating to financial instruments is "messy." It can probably be understood, however, in the context that it was designed to foster certain overall economic development goals of the GOE while reducing tax evasion possibilities on those instruments which would be taxed to the maximum possible. Ecuador is a "low tax" country - 8 percent rates or even 22.2 percent rates with a credit to the individual investor receiving the dividends are hardly onerous. But, in a world where maximizing returns is the name of the game, there are those who are favored and those who are penalized no matter what the rates, as long as they exist, may be. This certainly seems to be the case in Ecuador. Reform of the tax codes and regulations are clearly required to foster growth in the private sector. Yet, in saying this, it is realized that reform must take place, if the present slight budgetary surplus situation is to be continued or even improve, at the very least on a revenue neutral basis. Thus, if there are "breaks" relative to private sector development, someone has got to pay.

E. Taxation

The story in terms of conclusions, has been said above. Since the author of this study is by no means a tax expert and the Ecuadorian fiscal structure is massive study in itself, no other major conclusions can be drawn at this point. It is, however, incumbant upon the Syracuse University and MPAP studies to come up with some viable alternatives relating to the Ecuadorian tax situation. A global study on the impact of tax structures in developing countries now being conducted by Keene-Monk & Associates of Middleburg, Virginia has concluded, in a macro sense, that: a) the tax climate in a given country must at least be favorable for private sector development and at no worse neutral; and b) many structures have been so designed or at least have evolved into structures which inhibit desired private sector growth. This certainly seems to be the case in Ecuador. With the commitment which President Febres Cordero and his administration has made to private sector stimulation, the time is entirely ripe for donor institutions such as AID and perhaps others (e.g., IFC and the IDB) to have a substantial hand in righting the taxation course.

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While further studies and advisory efforts must establish priorities, the areas of legal, regulatory, and tax reform relating to corporations and the financial sector are absolutely essential in the overall scheme of financial markets institution building in Ecuador. The author trusts that this report will help point the way for those future efforts.

One major word of caution, however, is required. The development of capital markets, especially, is demand driven. The success or failure in the institutionalization of capital markets in an LDC such as Ecuador reflect local economic needs. The operating parameters of optimal Ecuadorian capital institutions must be developed in the context of the country's own particular socio-economic - political environment's calculated demand. I have concluded during the course of this study that insufficient data have been developed concerning this all important demand side of the equation. Intensive study and analysis must be made of existing and latent demand before the supply side of the equation and the optimal structure can be specified with any certainty whatsoever.

CHAPTER VII

RECOMMENDATIONS

This section of the report contains my recommendations, based on the study findings and the conclusions drawn from them, relative to the current situation and outlook vis-a-vis financial markets development in Ecuador. As such, they are focused upon efforts which may be undertaken by the Mission and USAID over both the near and longer term. It should be remembered that this effort is a fairly broad survey and that on-going work is required to develop a set of optimal tactics and strategies which can be effective in stimulating the longer-term growth and efficiency of private sector financial markets in Ecuador. This will be a continuing and perhaps lengthy process involving considerable learning by doing and the adaptation of general principals and findings to the specific circumstances of the Ecuadorian environment.

The focus of these efforts should be upon the long-term development of the entire financial system. The approach should not be based on any preconceptions as to the need for any specific type of institution, but rather upon working, in great part, to bring about changes in policy, regulations, and other areas (many of which are identified in this report). These changes are required to permit new and improved institutions to emerge and evolve in response to market forces which will determine the types of institutions required during the course of an evolutionary process.

1. Continued Policy Dialogue

With a receptive administration and a highly perceptive Mission staff, the opportunities for continued policy dialogue relative to all aspects of private sector financial markets development are substantial, and such dialogue should continue as a matter of course. There is a natural tendency among Mission staff, wherever they are posted, to concentrate upon their project portfolios thereby limiting the on-going but far less structured activities associated with informal discussions and meetings, occasional symposia, etc. These activities, however, are extremely important as they provide the forum for the exchange of views, the "trial-balloons," opinion molding, etc., an informal approach which may have far more impact than a dry report.

As has been noted, the Ecuadorian legal and regulatory framework relative to the financial markets system requires modernization. Such areas as the banking laws, corporation codes, and stock market regulations must be changed and updated if an adequate infrastructure is to be put in place to foster financial markets development. Additionally, the far more complex issue of tax code revision and modernization must be tackled in conjunction with the other activities for as the findings indicate, there are elements of the tax structure which impede optimal financial markets development. While these are logical areas for in-depth study and analysis, and considerable study work is proceeding, the policy dialogue mechanism is clearly in order. Cooperative efforts between the Mission and such organizations as the Ecuadorian Private Sector Banking Association, its affiliated Institute for Banking Practices, the two stock exchanges, the brokers' associations, the Financiera Association, and others on the one hand, and the GOE policy makers on the other in the policy dialogue effort should continue and perhaps even accelerate. Much of the dialogue can be based upon work that has already been done (e.g. the Superintendency of Companies "anti-proyecto") and which is described in this report

Such an effort is particularly timely now and for the next 20 months or so. After that period, in the late summer of 1987, the current administration will assume "lame duck" status inasmuch as the elections will be held in 1988, and dialogue efforts are bound to have limited effect.

2. The Pre-Sponsored Financial Markets Study

I recommend that Ecuador, given the current, positive private sector climate and the state of its financial markets institutional framework, be chosen for inclusion within this study. Specific areas of study, investigation, and implementation activities are spelled out in more detail below.

3. The Macroeconomic Policy Analysis Program (MPAP)

The MPAP has been well designed and can have a major impact on financial/capital markets development in Ecuador, particularly from the legal/regulatory standpoint. I have recommended to Arthur Young & Company, the prime contractor for the PRE sponsored study that, assuming Ecuador is included in the study, certain technical assistance of a short term nature be offered to the Mission in February relative to the MPAP. Specifically, in light of this study's findings and conclusions and other efforts, short term TA could be provided by a consultant with extensive experience in the regulatory aspects of financial markets to provide advice as needed in the preparation of the detailed MPAP work program, particularly that portion of the program dealing with capital markets.

4. Investment Promotion Component

There are, I have concluded, a number of venture capital alternatives from a structural and operational standpoint which should be examined closely before any decision to proceed is taken. I have therefore recommended to Arthur Young & Company that short term TA, in the form of an individual highly qualified in venture capital fund development and investment banking, be made available to the Mission, if it so wishes, as soon as possible under the terms of its contract with PRE.

Specifically, the consultant would review thoroughly the project paper amendment (the "component"), alternative proposals or concept papers already submitted, and other alternatives within his/her store of knowledge in order that firm recommendations could be made and an implementation program developed.

5. Capital Markets Workshop

The study findings and the conclusions which may be drawn from them indicate that the time is absolutely ripe for the holding in Ecuador at an early date of a capital markets workshop. Described initially in the PRE originated cable on the financial markets study, the Ecuadorian workshop would be designed as a two or three day forum to bring together key Mission personnel who would be working on this effort over the next several years and a highly representative selection from both the private and public financial sectors - a total grouping of perhaps 25 to 30 individuals. The workshop would augment the policy dialogue efforts, acquaint participants further with the MPAP and investment promotion component projects, stimulate thinking about alternative institutional entities and frameworks, provide the nucleus for on-going financial markets developmental efforts, and establish an informal, but highly important, policy study and development group. Further, it would constitute an important bridge between this study and near term activities (MPAP, PRE study, investment promotion component) and the later capital markets development study, providing, in fact, somewhat of a platform for the conduct of that study.

Investigations in Ecuador evidenced considerable local interest in the workshop concept with offers of support and co-sponsorship being made by the Institute of Banking Practices and the management institute of the graduate business school of the local university. Assuming that it is in favor of the program, the Mission should proceed with these two groups and with Robert R. Nathan & Associates of Washington which has developed the workshop format to complete the negotiations and establish a target date for presentation during the early stages of the MPAP, presumably during the month of March.

6. Demand Study

It should be reiterated that the development of capital markets is essentially demand driven. This issue must be examined carefully, within both the context of the capital markets development project, assuming it is performed, and independently. To the latter end it may be possible to get those groups providing export and investment promotion assistance within the country to review their files and assistance portfolios and conduct interviews with their present clientele and others (e.g., potential entrepreneurs). The information thus gathered could thereby be provided to the

Mission, PRE consultants, and those submitting proposals relative to the capital markets development project in the hope of developing some preliminary picture as to the quantity and quality of potential demand (amounts and types of financing required preferred and alternatives).

7. Other PRE Activities

The Arthur Young/PRE study team will meet with Mission personnel in Quito in March to review this study and the results of the short term TA provided in February (if indeed provided). The purpose would be, as a result of the review, to make specific suggestions to the Mission concerning its financial markets program and outline future assistance which might be rendered to the Mission under the umbrella of the PRE Sponsored program. This consultant has already recommended that such assistance include the provision of short term TA, presumably in August, to: a) review progress to date in the investment promotion component with specific recommendations concerning current and future efforts; b) discuss the results of the MPAP and make suggestions concerning the direction of any possible implementation program; and c) assist in the preparation of the PID for the FY 1987 capital markets development project.

8. PEDS & Privatization

The statement of work in the contractor agreement required the consultant to "review PRE (PEDS) and privatization studies with Mission re their applicability in Ecuadorian context and their linkages with financial markets activities." This review was conducted with the Mission's PSO during the course of the field visit. Follow-up consisted of arranging meetings between the head of the PSO and the Arthur Young & Company privatization project manager and with representatives of the newly established privatization center. Unfortunately, time did not permit discussions with the Coopers & Lybrand PEDS project director.

PEDS, as a study, requires the close examination of all private sector activities conducted by AID since 1981, especially those "mechanisms" which have been utilized by PRE in its private sector development work. This includes not only activities in export promotion, feasibility studies for potential investment purposes, private health care development, etc., but also financial markets and privatization thereby creating very close linkages with the two separate PRE sponsored studies. It is my understanding that Coopers & Lybrand representatives will be in Quito in the next several months to discuss how the PEDS study might be brought to bear on various Mission projects and programs. I recommend that appropriate priorities be attached to the non-traditional agricultural export promotion program in general and to the investment promotion and support services and the foreign investment identification portions specifically. As a corollary to the financial markets efforts, TA might be considered in the areas of secondary institution building (e.g., pension funds, S&Ls, insurance companies), the mercado extra-bancario, and in such new potential mechanisms as the Baker Company notion. (In the latter regard, attendance of appropriate Mission personal and perhaps the consultant providing the initial TA under the PRE financial markets study at the February Baker Plan conference is strongly recommended if said attendance is in order). Additionally, discussions should be held to determine where PEDS assistance can be provided as a result of the recent Ecuadorian-US businessmen's conference held in Washington during the course of President Febres Cordero's visit.

From the privatization study side, it seems logical that TA might be provided, if acceptable to the GOE, in the CFN divestiture program. This program, mentioned in the study findings, has already drawn some criticism from certain representatives of the private sector and may require outside assistance if it is to be brought back on track.

9. <u>Liaison with Other Donors</u>

Financial market activities are not proceeding in Ecuador within an AID vacuum; other organizations including the World Bank (e.g., the Hanson study), the IFC, and the Inter-American Development Bank are actively involved. In the immediate future, I recommend that the Mission and the Arthur Young study team secure and study thoroughly the Hanson report as soon as it is available and determine, strategically, which of its recommendations and proposed programs call for joint efforts. Secondly, I recommend that the Arthur Young team liaise as soon as possible with appropriate representatives of the aforementioned international institutions to develop some semblance of a joint or at least complementary "game plan" relative to financial markets. The resources available to each group separately are far too thin in relation to the problems involved in this area making overlapping or conflicting efforts unacceptable.

APPENDIX A

INTERVIEWEES

During the week in Ecuador (December 15-21), interviews were held with the following:

1. Raul Daza M., President,Financiera Iberoamericana, S. A. (FINIBER), Quito.

2. Bolivar Chiriboga, President, Bolsa de Valores, Quito.

3. Marco Antonio Guzman, Attorney (and former high level government official), Quito.

4. Gonzalo Chiriboga, Stockbroker and Executive Director, Asociacion de agentes de Bolsa, Quito.

5. Rolf Stern, Partner, Stern & Naranjo (CPA and consulting firm), Quito.

6. Nicolas Landes, former Citibank Executive, now an independent financier, Quito.

7. Jose Iturralde A., Executive Secretary, Asociacion de Companias Financieras, Quito.

8. Ramon Espinal M., Manager, Financiera de Guayaquil S.A., Guayaquil.

9. Dennis Sheets, First Manager, Banco de Credito e Hipotecario, Guayequil.

10. Thomas C. Trauger, Manager, Latin American Finance Company (LAFAFICO), Guyaquil.

11. Modesto Correa, President, Boisa de Valores Guayaquil, Guayaquil.

12. Jose Morillo B., Executive President, Banco de la Produccion, Quito.

13. Alberto Kury A., Assistant General Manager, Corporacion Financiera Nacional, Quito.

14. Ernesto Chiriboga, Executive Sectetary, Asociacion de Bancos Privados, Quito.

15. Fabian Albuja C., Director of Economic Research, Superintendency of Companies, Quito.

16. James Finucane, Private Sector Officer, USAID.

17. Cynthia Giusti, office of Program Development, USAID/Quito.

18. Zachary Teich, Economic Section, U.S. Embassy, Quito.

APPENDIX B

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APPENDIX C

Annex to Robert R. Nathan & Associates "Special Study - Ecuador Industrial Development Finance," September 27, 1983

In speculating on the possibility of new A.I.D. programs in the area of financial intermediation in the developing countries, we have sought to extract from the experiences of CFN and COFIEC a few general observations for the consideration of project designers.

These remarks may perhaps best be framed in the context of a simply stated definition of the economic functions of a financial intermediary; namely, to mobilize savings in the form of financial resources and to allocate these towards the most productive investment opportunities available.

Judged in the light of this definition, the most serious failing of the broader development initative implemented in part through CFN and COFIEC was the failure of the financial system to adequately mobilize and capture domestic savings.

Both institutions -- indeed, the financial sector of Ecuador as a whole -- have been too dependent on external savings, foreign borrowing, to finance domestic investment.

The dangers of excessive reliance on external resources and the need to develop policies, legislation and institutional mechanisms to more effectively mobilize domestic savings in support of investment were clearly recognized in all of the major documents produced twenty years ago in the course of preparing for CFN and COFIEC. The first 10 year Development Plan, the Checchi study, the CENDES study, the A.I.D. loan documents, each emphasize the savings mobilization aspects of the functioning of CFN and COFIEC within the reformed industrial development finance system -- not only through the further development of a domestic market in long-term debt instruments but, especially, through the development of functioning equity markets.

In this crucial aspect, the projects have failed as have similar attempts in other LDC's around the world. Yet, if the current worldwide debt-service crisis of the LDC's tells us anything, it is that development finance cannot be allowed to rely so heavily in the future on foreign borrowings as it has in the past. The problems of more effectively mobilizing domestic savings for financing development -- long ago recognized but largely neglected in practice -- must now be seriously addressed by LDC governments and development institutions alike.

The problems are many, beginning with poverty itself. There isn't that much domestic savings available. Nonetheless, in a vast majority of developing countries, including Ecuador, a significant portion of the savings that do exist is, for a variety of reasons, eluding the financial system and being diverted into speculative and scarcely productive uses. Instability and lack of confidence, punitive fiscal legislation, inadequate enforcement of tax law in general, short-sighted monetary policies are among the intractable obstacles which will need to be dealt with. And though we must rather lamely admit to a shortage of specific solutions at this time, the experience of Ecuador clearly points to a need and a new direction in assistance to the LDC's in the area of financial sector development.

A second observation which can be made on the basis of the Ecuadorean experience is that both public and private institutions can function effectively in the allocation of long-term financial resources for development. Both CFN and COFIEC have done so, but mainly on the basis of external resources funneled through them by the public sector. The problem which both share is the capacity to mobilize domestic savings as has been discussed above.

In considering policy, legislative, and institutional reforms facilitating the mobilization of resources, however, care should be taken not to discriminate between one institutional form over the other. Both can be effective, and both will likely be more effective in the presence of potential competition from the other.

Finally, in the area of allocation of financial resources, two brief observations are in order. First, regarding policy, it must be remembered that demand for financial resources is as important as supply. If credit is to flow towards the most productive potential uses in society, the financial returns to entrepreneurs from engaging in these activities must be in line with socio-economic cost-benefit criteria. To the extent that government policies distort financial returns away from the most economically productive uses, the demand for funds within these sectors will simply not materialize and the development finance institutions will remain helpless to effectively perform their economic function regardless of the quality of their project analysts and administrative procedures. Neither the evaluation nor the future programming of financial sector development projects can afford to neglect the policy framework that determines the demand for development funds.

Secondly, and lastly, management systems and know-how to support more cost-effective operation of development finance institutions in allocating the resources at their disposal remains an area -- in Ecuador as, we suspect, elsewhere -- which remains open for programs oriented towards technology transfer. Data acquisition, information management systems, computerized evaluation and monitoring aids, and upgraded human skills remain critical factors in determining the financial operating costs, and economic efficiency of such institutions in LDC's, and appear to offer a promising area for continuing development assistance.