March 2006
IMF Country Report No. 06/98

Ecuador: 2005 Article IV Consultation—Staff Report; Staff Statement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Ecuador

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2005 Article IV consultation with Ecuador, the following documents have been released and are included in this package:

- the staff report for the 2005 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on November 16, 2005, with the officials of Ecuador on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on January 4, 2006. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a staff statement of January 25, 2006 updating information on recent developments.

- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its January 25, 2006 discussion of the staff report that concluded the Article IV consultation.

- a statement by the Executive Director for Ecuador.

The document listed below has been or will be separately released.

Selected Issues Paper

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.

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INTERNATIONAL MONETARY FUND

ECUADOR

Staff Report for the 2005 Article IV Consultation

Prepared by the Staff Representatives for the 2005 Consultation with Ecuador

Approved by Charles Collyns and Adnan Mazarei

January 4, 2006

Discussions. A staff team held discussions in Quito and Guayaquil during November 7–16, 2005. The team met with Mr. Alfredo Palacio (President of the Republic); Mr. Wilfrido Lucero (President of Congress); Ms. Magdalena Barreiro (former Minister of Finance), Mr. Alejandro Maldonado (former Superintendent of Banks); other senior government officials; and representatives of the industrial, banking, and export sectors, political leaders, leading economic analysts, and NGOs.

Team. The staff team comprised Trevor Alleyne (Head), Lisandro Abrego, Enrique Flores (both WHD); Bjoern Rother (PDR), and Alexander Pivovarsky (FAD), and was assisted by Jorge Guzman (Resident Representative).

The authorities' response to recent Fund policy advice*.* In the 2004 Article IV consultation, Directors noted the important role of the Fiscal Responsibility and Transparency Law (FRL) and stressed the importance of controlling government spending, in particular on pensions and wages. However, the authorities have had great difficulty in restraining spending growth, which far exceeded the FRL targets in both 2004 and 2005. Moreover, changes to the FRL and the pension system in 2005 have weakened the overall macroeconomic framework. Directors also urged the authorities to advance on key structural reforms, in particular phasing out revenue earmarking and subsidies, taking measures to improve the soundness of the pension system, strengthening the performance of public enterprises, and implementing the recommendations of the 2004 FSAP. Only in the last case was any progress made.

Exchange Regime and Relations with the Fund. The U.S. dollar is the legal tender in Ecuador. Outstanding Fund credit is SDR 58.52 million (19.4 percent of quota). Ecuador has accepted the obligations of Article VIII, sections 2, 3, and 4, and maintains an exchange restriction subject to Fund approval under Article VIII, Section 2 (a) in the form of a freeze on demand and savings deposits held in closed banks managed by the Deposit Guarantee Agency. Staff is monitoring the authorities' economic program at their request, including via quarterly quantitative targets.

Data. Ecuador has subscribed to the SDDS. While data provision for surveillance purposes is adequate overall, the statistical base remains uneven, with shortcomings in the balance of payments (e.g., oil imports, non-oil foreign direct investment, and private capital flows); public finances (e.g., lack of coverage of key public enterprises); and labor market (e.g., unreliability of employment data).

Selected Issues Papers. The companion Selected Issues paper comprises four chapters: (i) economic performance under dollarization, (ii) an assessment of competitiveness, (iii) performance and sustainability of fiscal policy, and (iv) developments in banking sector intermediation.

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EXECUTIVE SUMMARY

Background

- **Aided by high international oil prices, macroeconomic performance in 2005 was generally positive**. Output growth is expected to exceed 3 percent and external sector performance has been strong. Inflation remains low but has picked up in recent months and is now expected to end the year at 4 percent, driven by a strong growth in bank credit and public spending.

- **Financial market conditions have been favorable.** Robust deposit growth signaled continued improvement in confidence in the banking system. Ecuador's successful international bond issue—its first voluntary placement in 8 years—reflected improved investor sentiment, even though Ecuador's EMBI spread remains the widest among Latin American countries.

- **The public sector primary surplus narrowed in 2005, notwithstanding rising oil revenues.** Spending on wages, pensions, and fuel subsidies has risen rapidly. Nevertheless, public debt has continued to decline relative to GDP.

- **With the political environment highly unsettled, there was no progress on most of the critical issues discussed in the 2004 Article IV consultation.** The elimination of the oil stabilization fund and changes to the fiscal responsibility law and pension system have weakened the macroeconomic policy framework.

Key Issues and Staff Recommendations

Ecuador should be doing more to take advantage of the favorable external conditions to strengthen the macroeconomic policy framework and advance structural reform. Stronger long-run growth and the sustainability of dollarization depend crucially on improved fiscal policies and advancing with structural reforms to strengthen the public finances and the financial system and improve the investment climate.

- **Fiscal policy in 2006.** In light of recent inflationary pressures and the need to save a higher share of the oil windfall, the authorities should aim for a higher primary surplus than currently programmed and firmly resist spending pressures from powerful interest groups.

- **Fiscal reforms.** The authorities need to strengthen the institutional framework for fiscal policy to (i) strengthen the budget's resilience to shocks, including through further improvements in debt sustainability; (ii) increase budget flexibility by reducing earmarking and subsidies; and (iii) ensure appropriate use of the country's limited oil wealth.

- **Banking system**. The authorities should strengthen efforts to implement the 2004 FSAP recommendations. Staff strongly supports the authorities' stand against the dangerous banking system law currently being discussed in Congress.

- **The investment climate.** Staff emphasizes the need to address many deficiencies in the environment for doing business, including the labor market and regulatory issues in key sectors such as oil, energy, and telecommunications.

I. BACKGROUND

A. Political Context

1. **Political conditions have been turbulent in 2005.** Congress dismissed President Gutierrez in April. His successor, President Palacio, became Ecuador's sixth president in the last 8 years.

- For much of his time in office, President Palacio has been locked in a dispute with Congress over his desire to set up a constituent assembly that would have powers to design and implement wide-ranging political reforms.

- After initially encouraging expectations for a broad expansion in government spending, the new government has shown a greater concern for fiscal discipline and for advancing much needed structural reforms, while continuing its strong emphasis on addressing the country's social needs.

- However, because of the government's weak political base—it has no party affiliation or representation in Congress—and the population's increasing focus on the October 2006 presidential and congressional elections, it has had difficulties in withstanding pressures for more public spending and in resisting inappropriate policy initiatives from powerful interest groups and local governments.

B. Recent Economic Developments

2. **The economy has been largely resilient to the difficult political environment and, aided by high international oil prices, macroeconomic performance in 2005 was generally positive**.

- Overall GDP growth is estimated to have exceeded 3 percent, with the non-oil sector expanding by 3½ percent (Figure 1). The strong growth in the oil sector that followed the completion of a new oil pipeline in 2003 has tapered off, but high oil prices have helped bolster confidence and underpin domestic demand.

- Employment growth has remained sluggish, however, and the unemployment rate, which averaged 10.7 percent, was little changed from 2004.

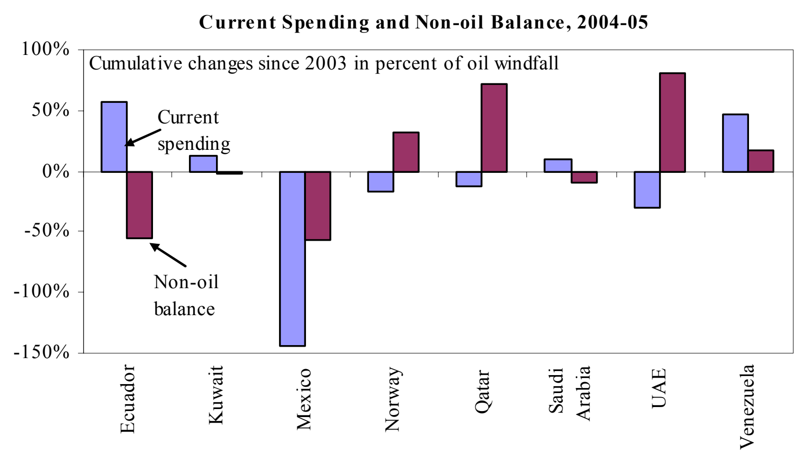
- Driven mainly by strong growth in bank credit and public spending, 12-month CPI inflation rose from less than 2 percent in June 2005 to 4 percent at the end of the year despite frozen domestic fuel prices (Figure 2).

- The external current account deficit is estimated to have remained unchanged at about 1 percent of GDP, reflecting rapid import growth which offset strong increases in oil and non-oil exports led by shrimp and metal products (Figure 3). While oil sector FDI inflows increased, non-oil FDI remained low, at less than 1 percent of GDP.

3. **Investor confidence has improved.**

- Banking system credit and deposits grew strongly in 2005, while liquidity remained at comfortable levels and other stability indicators continued to improve (Figure 4). Moreover, there was no evidence of spillover effects on deposits or on interest rates from the political turbulence. However, bank intermediation is still well below pre-crisis levels and deposits are overwhelmingly at short maturities.

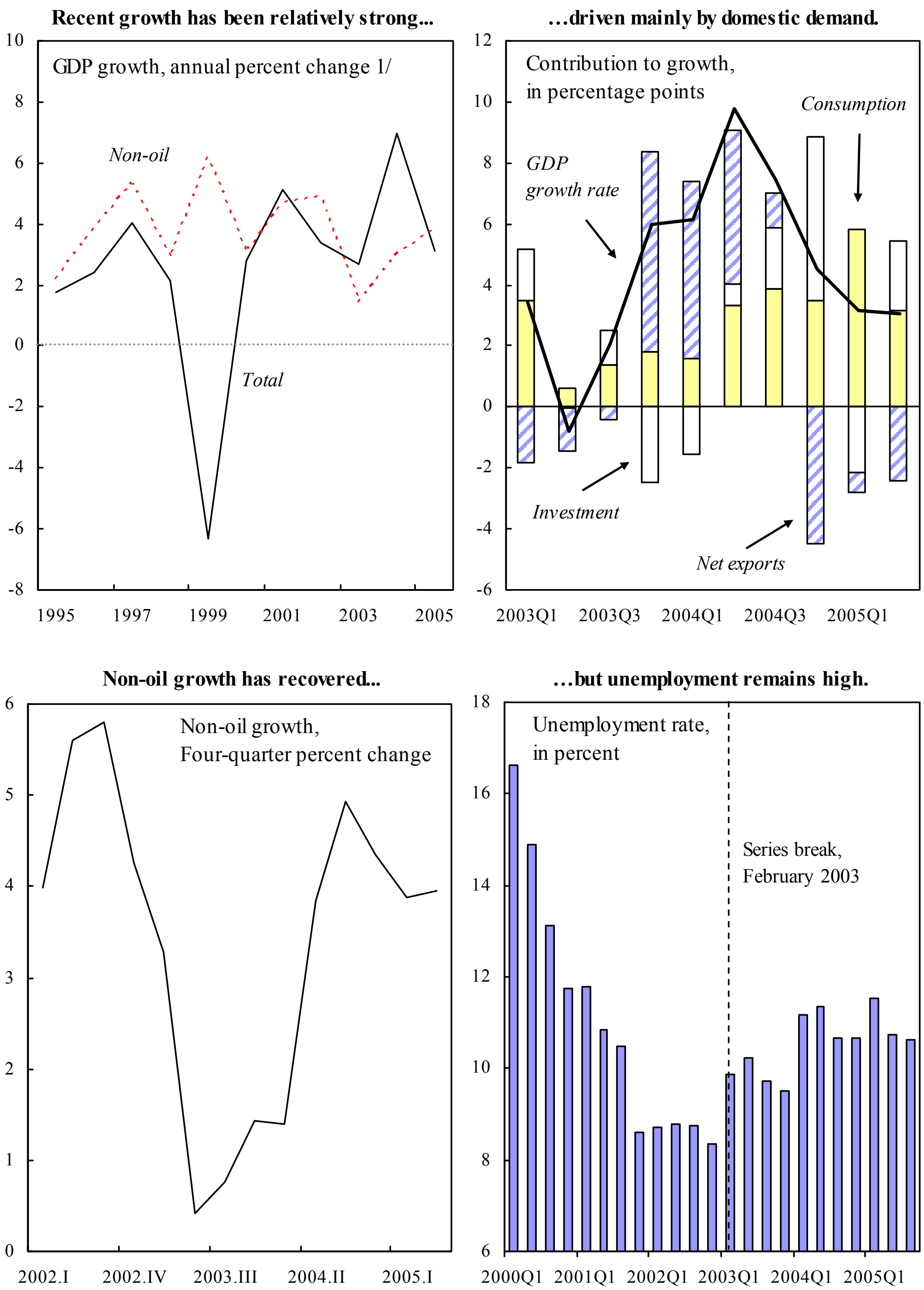
- The authorities successfully regained access to international capital markets with a US$650 million bond issue in December 2005. The 10-year bullet bond, with a yield of 10.75 percent (95 basis points below that of the existing 2012 global bond) was greatly oversubscribed. Nevertheless, the EMBI spread, although having declined substantially in the past year, remains the widest among Latin American countries.



4. **Although public debt ratios continued to fall and liquidity problems eased in 2005, the underlying fiscal stance has weakened (Figure 5).** In recent years, non-financial public sector (NFPS) primary surpluses have been maintained consistently above 4 percent of GDP, reflecting mainly high oil revenues, which have helped reduce public debt from over 90 percent of GDP in 2000 to 43 percent of GDP in 2005. However, the non-oil deficit is projected to have increased to 5 percent of GDP in 2005, driven by the growing cost of fuel subsidies (owing to fixed domestic prices) and the continued rapid expansion of recurrent spending, especially in wages and pensions.

5. **The authorities aim to restrain recurrent spending in their 2006 fiscal program to make room for larger capital and social spending while maintaining an overall primary surplus above 4¾ percent of GDP.** Their budget proposal envisages growth in wages and pensions of 4 percent, compared with 15 percent a year during 2002–05. However, capital spending is projected to rise by some 40 percent, in line with the authorities' priority of addressing the country's outstanding social and infrastructure needs. Under current WEO oil price projections, the authorities' program would be consistent with an increase in the NFPS surplus to 4.8 percent of GDP from 4.2 percent in 2005 and a decline

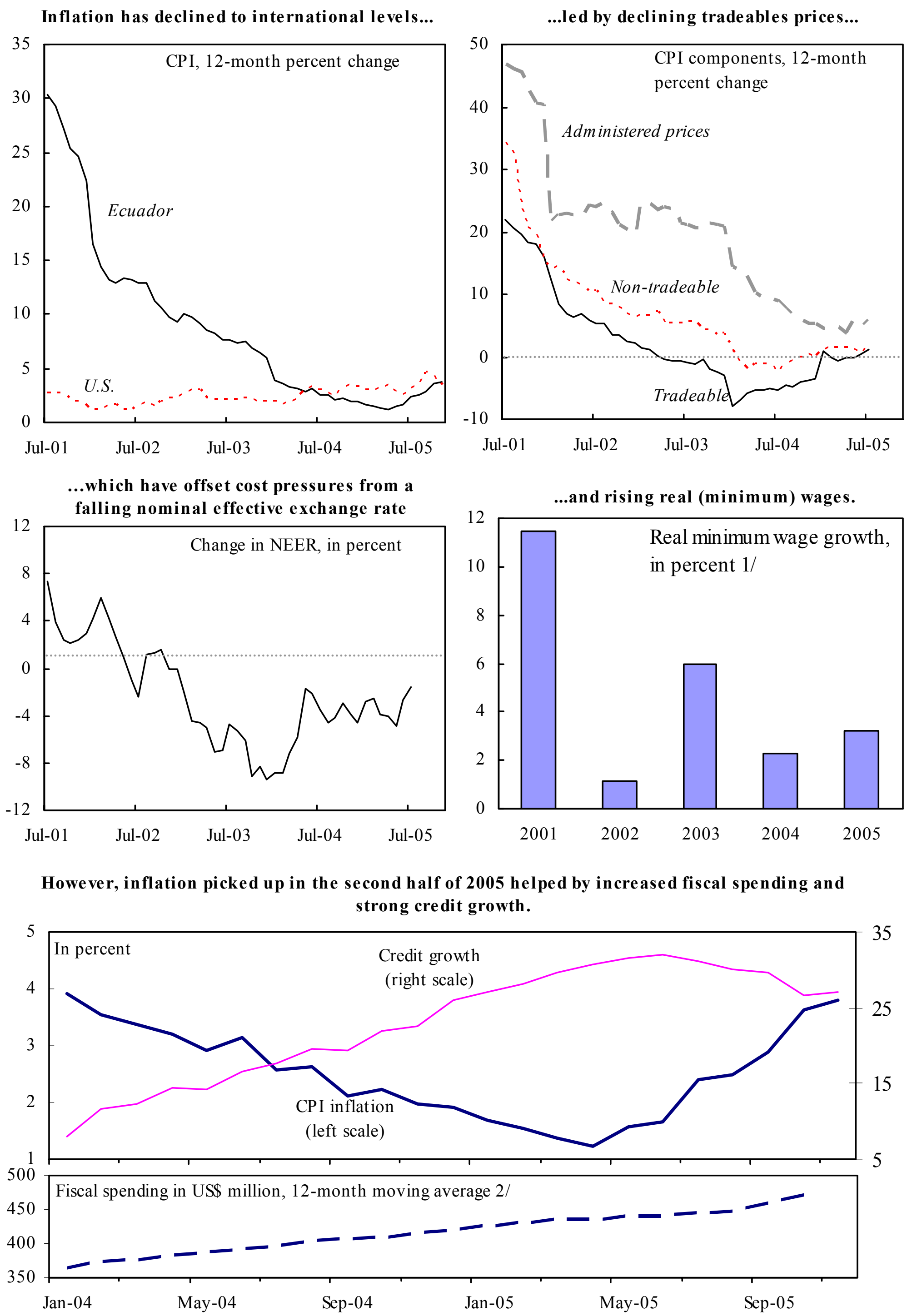
Figure 1. Ecuador: Real Sector



Sources: Central Bank of Ecuador; and Fund staff estimates.

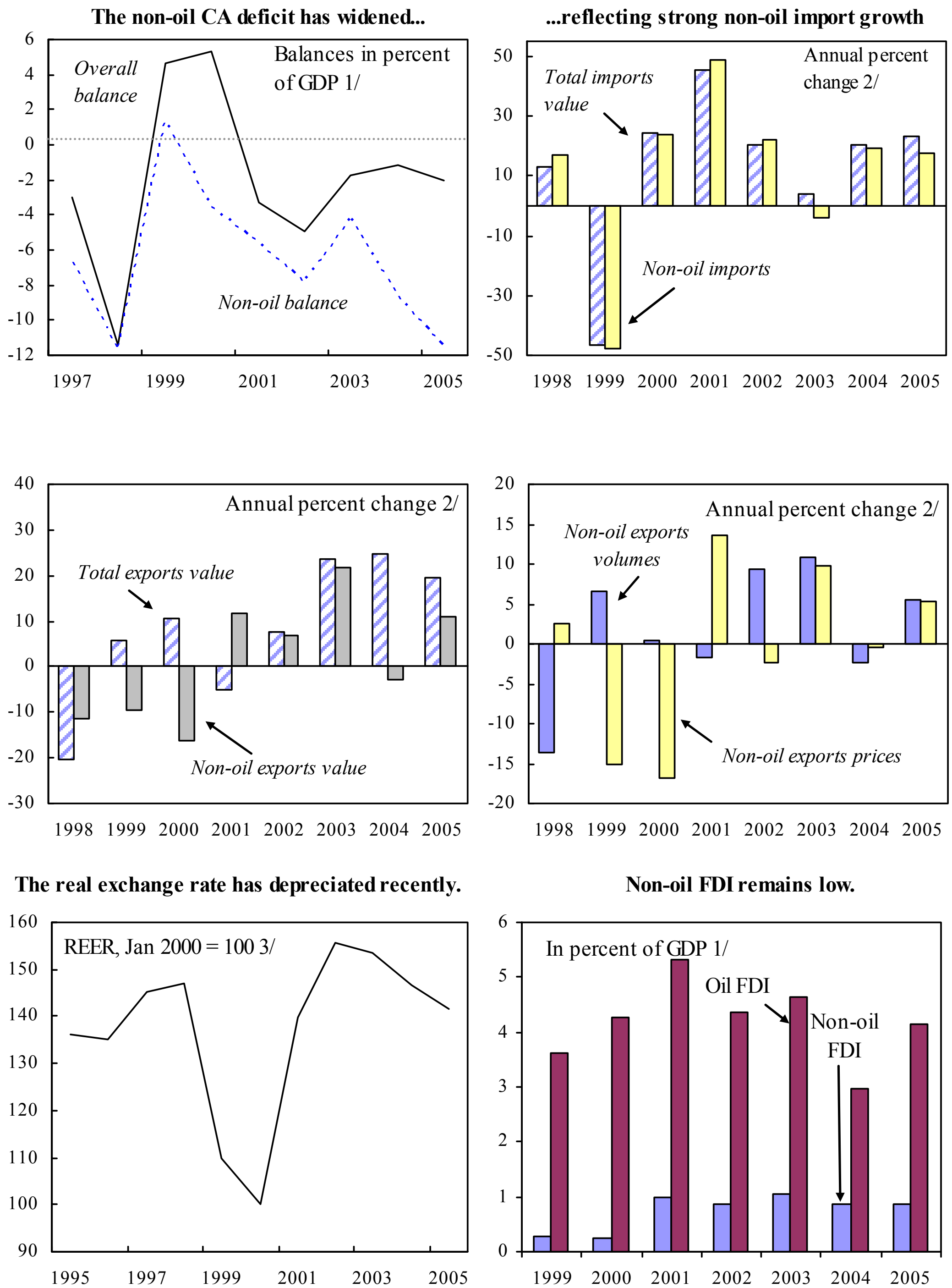
1/ 2005 observation is for the first half.

Figure 2. Ecuador: Prices



Sources: Central Bank of Ecuador; and Fund staff estimates.
1/ Staff projection for 2005.
2/ Fiscal spending is NFPS current primary spending plus returned social security contributions.

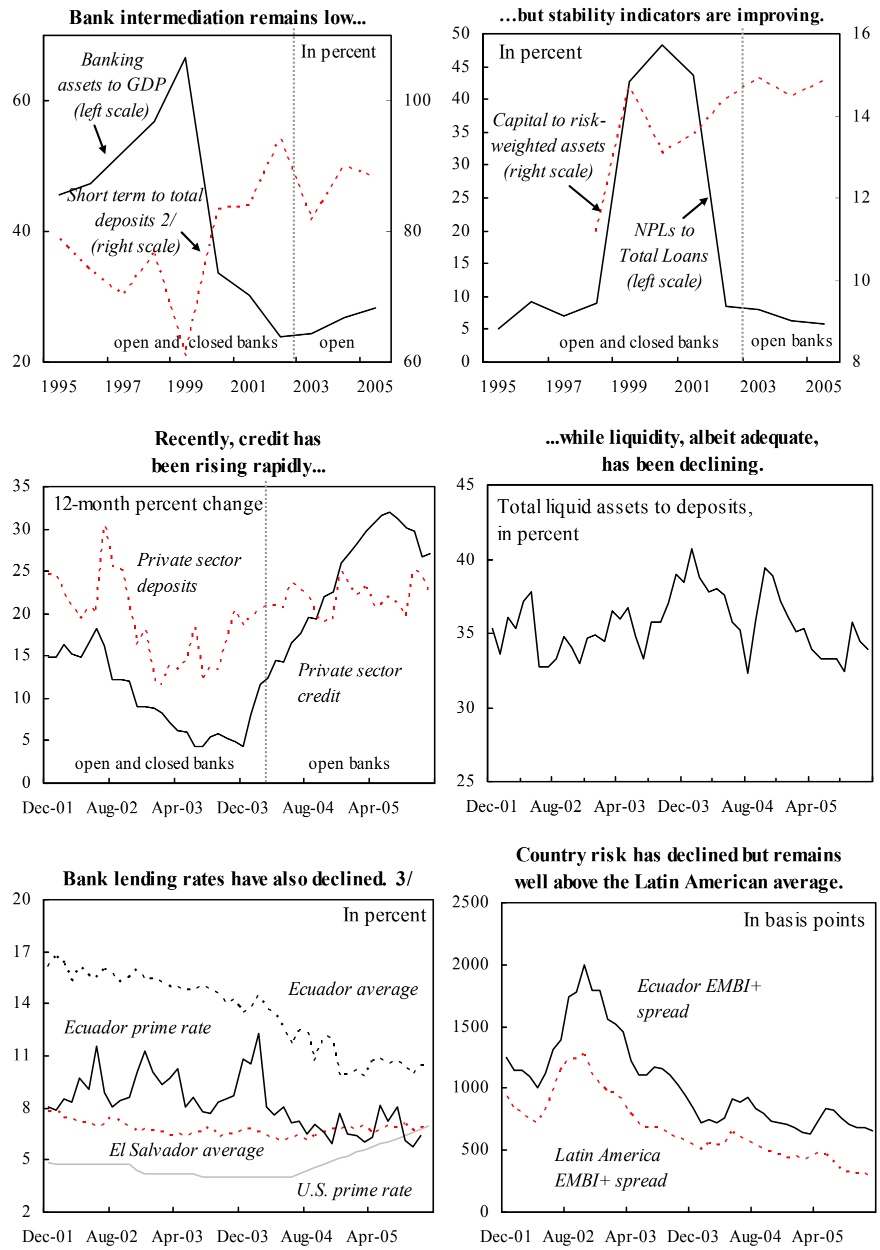
Figure 3. Ecuador: External Sector Indicators



Sources: Central Bank of Ecuador; and Fund staff estimates

1/ 2005 observation is for the year ending in June.
2/ 2005 observation is for the year ending in September.
3/ 2005 observation is January–September average.

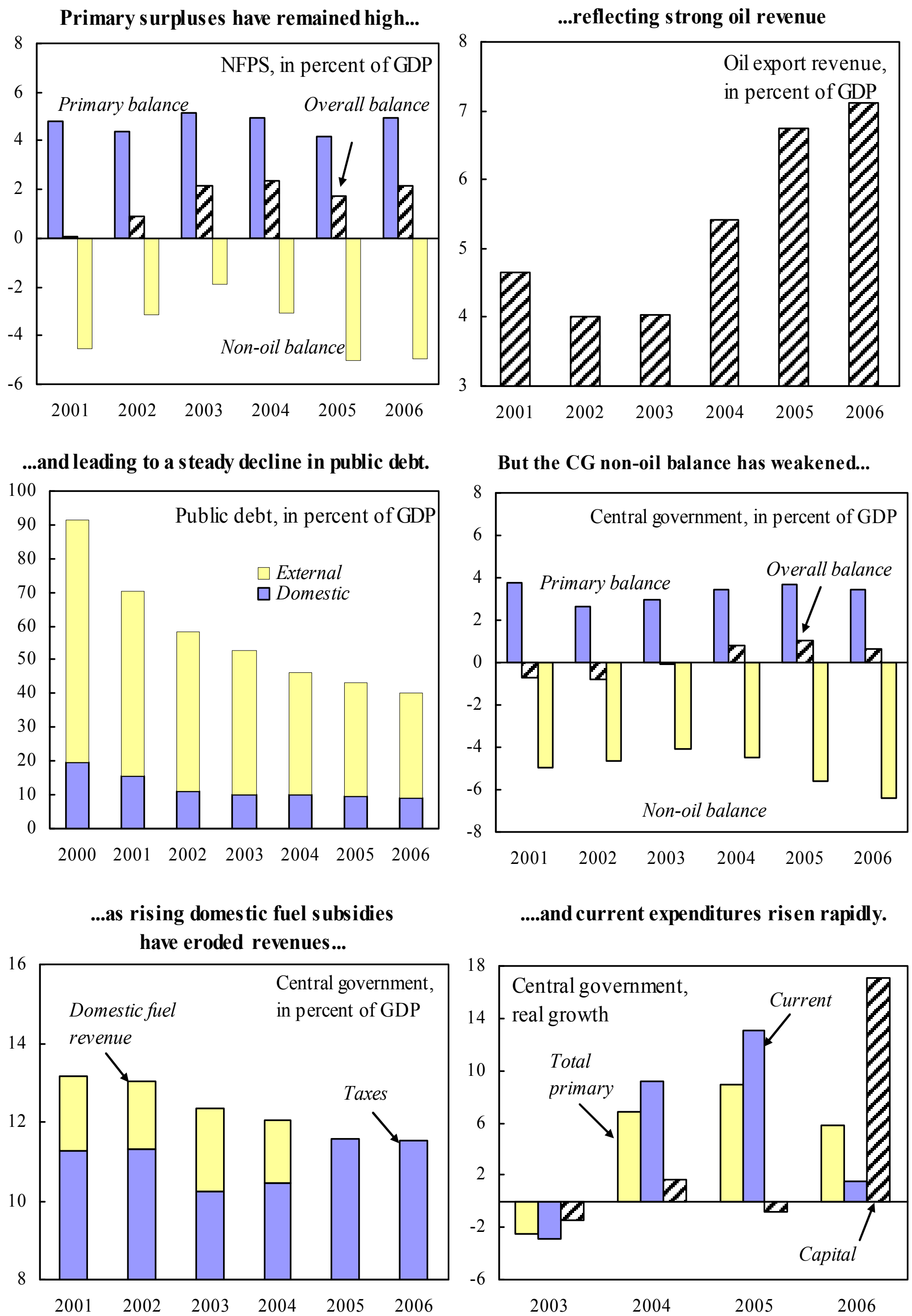
Figure 4. Ecuador: Monetary Sector Indicators 1/



Sources: Central Bank of Ecuador; Bank Superintendence and Fund staff estimates.

1/ Yearly data for 2005 based on November figures.
2/ Short term deposits include sight and term deposits with maturities under 91 days.
3/ Ecuador average refers to 84-91 day loans. El Salvador average refers to short-term loans. Ecuador prime is the corporate rate for loans with maturities below 30 days.

Figure 5. Ecuador: Fiscal Indicators 1/



Sources: Ministry of Finance and staff; and Fund staff estimates.

1/ Staff projections for 2005 and 2006.

in public debt to 40 percent of GDP. However, the non–oil deficit would remain unchanged, reflecting a further substantial increase in the cost of fuel subsidies. The fiscal program for 2006, which also includes significant resources earmarked for liability management operations, appears to be adequately funded, reflecting the recent bond issue and approved disbursements in January 2006 from the Latin American Reserve Fund (FLAR). The authorities also expect to receive US$400 million in budget support financing from the multilaterals, half of which appears to be well in train.

6. **There has been little progress in implementing structural reforms to enhance the prospects for long-run growth or address key economic vulnerabilities as discussed in the 2004 Article IV consultation**. Rather, many of the measures that have been implemented in the last year weakened the macroeconomic policy framework.

- **Reforms stalled in Congress.** The Gutierrez government made three unsuccessful attempts to pass oil sector reforms in Congress, and had two electricity reform proposals rejected. Congress also rejected (without debating) an omnibus bill containing proposals for reforms in the oil and electricity sectors, fiscal area, pension system, labor market, and financial system, many of which were in line with recommendations of the 2004 Article IV consultation. In December 2005, Congress again rejected an electricity reform bill that aimed to settle intra-sector debts and introduce incentives for greater private participation in electricity generation.

- **The overall framework for fiscal policy has weakened**. In June, Congress approved a reform to the fiscal responsibility law (FRL)—sponsored by the new government—that eliminated the FEIREP oil fund, removing capital spending from the ceiling on primary expenditure growth, and increasing the earmarking of oil revenues (Box 1).

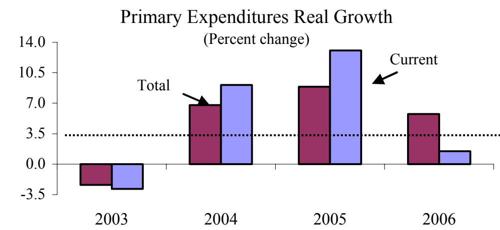
- **The actuarial deficit of the pension system has increased**. Congress approved a bill which returns the accumulated assets of the Social Security Institute's (IESS) reserve fund to employees every three years.[1] In addition to the impact on the actuarial deficit, the reform potentially complicates liquidity management for the central government since about half of the IESS's portfolio is invested in government paper.

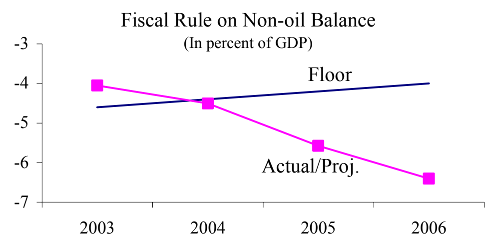
[1] This supplementary fund, with assets of US$780 million (2¼ percent of GDP), was set up to finance severance and pension benefits for employees. This reduction in pension system assets is not matched by a corresponding reduction in pension system obligations to future retirees.

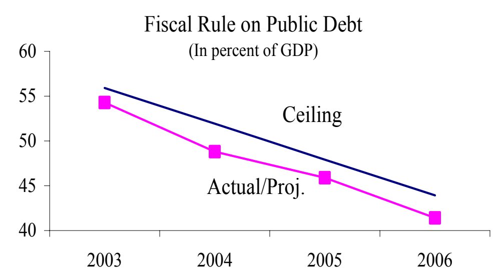
Box 1. Modifications to the Fiscal Responsibility Law

The authorities' decision to change the Fiscal Responsibility Law (FRL) was based on a desire to increase resources for capital and social spending. Even though compliance with the original law was far from perfect, the June 2005 reform of the FRL weakened the overall framework for promoting fiscal discipline.

- The reform removed capital spending from the 3.5 percent cap on annual real increases in central government primary expenditure.
- It retains the requirement that the non-oil fiscal deficit decline by 0.2 percent of GDP per year, but this provision was violated in both 2004 and 2005.
- It eliminated the FEIREP oil fund, bringing heavy crude oil revenues into the budget, and reallocating resources formerly earmarked for debt buybacks toward social spending and credits aimed at reactivating the economy.







The staff's main concerns are the following:

- With more resources being made available to the budget, the reform has given rise to new pressures to increase spending.
- The funds earmarked for economic reactivation are to be managed by two public development banks beset by management and institutional problems, raising the risk that the resources may be misused.
- The earmarking of revenues for a host of expenditure categories has increased budget rigidities—a long concern in Ecuador—relative to the original law.
- The likelihood of any heavy crude oil revenues being used for external debt buybacks, as originally intended, was further reduced.

- **The tax base has been eroded**. A government-supported law granting generous tax incentives to foster investment in various sectors was approved by Congress.[2] The law's effectiveness to encourage investment is doubtful, but it would weaken the tax base and complicate tax administration.

- **Some headway was achieved in financial sector reforms**. The Superintendency of Banks tightened up regulations governing capital and liquidity in line with the 2004 FSAP recommendations. Congress approved new anti-money laundering legislation and passed a law to strengthen the operation of credit bureaus. However, a new banking law recently sent to Congress by opposition parties raises serious concerns (Box 2).

Box 2. The Draft Banking Sector Law

The largest party in Congress has sponsored a draft bill that aims to channel more credit to productive activities and reduce the cost of financial intermediation. In particular, the draft legislation seeks to:

- **Cap intermediation spreads**. The central bank would be required to set a ceiling on lending rates at 300 basis points above the central bank's reference rate—the 3-month prime rate for the corporate sector—and a floor on deposit rates at 70 percent of the reference rate. All fees and commissions on loans would be abolished.

- **Direct lending to productive activities**. Banks would be required to lend at least 75 percent of their deposits to productive sectors and would have to place remaining deposits in the central bank. The central bank would determine the allocation of credit among productive sectors based on their share of GDP according to the national accounts. Banks would be subject to stiff fines for non-compliance.

The authorities concur with the staff that the current draft legislation, if approved, could result in a sharp reduction in financial intermediation. Moreover, the credit allocation guidelines would likely undermine prudent credit management, thus threatening the soundness and stability of the banking system.

Congress is considering modifications to the draft bill. Amidst opposition from the financial community and warnings from the Superintendency of Banks and the central bank, Congress is reportedly considering eliminating directed lending from the bill and relaxing intermediation caps by setting them according to credit type—commercial, mortgage, consumer, and micro-credit.

[2] The law would provide a 10–12 year tax holiday (on income taxes, custom duties, and municipal taxes) for new companies undertaking a minimum investment of US$2–7 million in strategic sectors, including hydroelectricity generation, oil refining, and production of high technology instruments.

II. Macroeconomic Outlook and Risks

Ecuador: Main Economic Indicators, 2003–06				
			Projections	
	2003	2004	2005	2006
(In percent)				
Real GDP growth	2.7	6.9	3.2	2.7
CPI Inflation, eop	6.1	1.9	4.0	3.0
(In percent of GDP)				
External current account	-1.7	-1.1	-1.0	-0.9
NFPS Primary balance	4.7	5.0	4.2	4.9
of which : non-oil primary	0.7	-0.4	-2.6	-2.2
NFPS Overall balance	1.7	2.3	1.7	2.2
NFPS Public debt	52.6	46.5	43.2	40.0

7. **The inherent volatility in international oil prices and the unsteady domestic political situation imply a large degree of uncertainty for short-term macroeconomic projections.** On the basis of current oil futures prices, which imply an average WTI oil price of US$61 per barrel in 2006, staff projects real GDP to grow at 2¾ percent, with non-oil GDP expanding at a similar pace. CPI inflation would fall to 3 percent in 2006, reflecting a deceleration in credit and government spending growth, while the external current account deficit would remain at about 1 percent of GDP. The NFPS surplus would rise to 4.9 percent of GDP, slightly higher than in the authorities' program, reflecting lower capital spending which would more than offset somewhat higher current spending.

8. **However, the economic outlook is subject to substantial risks.**

- **Spending pressures.** The authorities will be challenged to keep recurrent spending and capital transfers to subnational governments within tight program limits, given the strong demands for increases from powerful interest groups, and the presence of large cash holdings from recent credit disbursements. However, such spending overruns could be partially offset by a lack of institutional capacity to execute the large capital budget.

- **Oil prices.** Given the strong dependence of the budget on oil revenues, a fall in the price would substantially reduce the financing cushion for the fiscal program: every US$1 decline in the price of oil would reduce the central government overall balance by about 0.1 percent of GDP.

- **Inappropriate policy initiatives.** The recent legislative changes to the FRL, pension system and tax incentives, and the banking reform bill now in Congress demonstrate that the tendency for damaging legislation is high. A continuation of this pattern could lead to a sudden sharp deterioration in confidence, with possibly serious spillover effects on the banking system.

9. **In the absence of policies to address underlying vulnerabilities and advance key growth-enhancing reforms, the medium–term outlook would be characterized by low growth and an increased susceptibility to shocks that could undermine the sustainability of the dollarization system (Table 8 and Figure 6).**

- **Low growth.** Based on current economic trends, annual real GDP growth would average about 2¼ percent over the next five years, with oil production trending downward on account of continued low investment by PetroEcuador and a failure to establish an attractive regime for new private investment. Limited progress on structural reforms would likely prevent the non-oil sector from sustaining growth above its long-run average rate of 2.6 percent, resulting in continued high poverty and unemployment rates and possibly increased social pressures.

- **Deteriorating fiscal outlook.** In the public sector, the NFPS surplus is projected to decline by 2½ percentage points of GDP over the medium term, large financing gaps would emerge, and public investment would be crowded out, reflecting gradually declining oil revenues, continued recurrent spending pressures, and limited access to credit. Potentially severe cash flow problems would increase the risk of default or a possible disorderly forced exit from dollarization.

- **Banking system fragility.** The reluctance of depositors to lengthen the maturity of their deposits indicates that the recent improvement in confidence is not yet deep-rooted. This increases the likelihood that any worsening in the overall macroeconomic environment could produce negative spillover effects in the banking system, which could quickly turn into systemic banking problems because of the effective absence of deposit insurance or any lender of last resort.

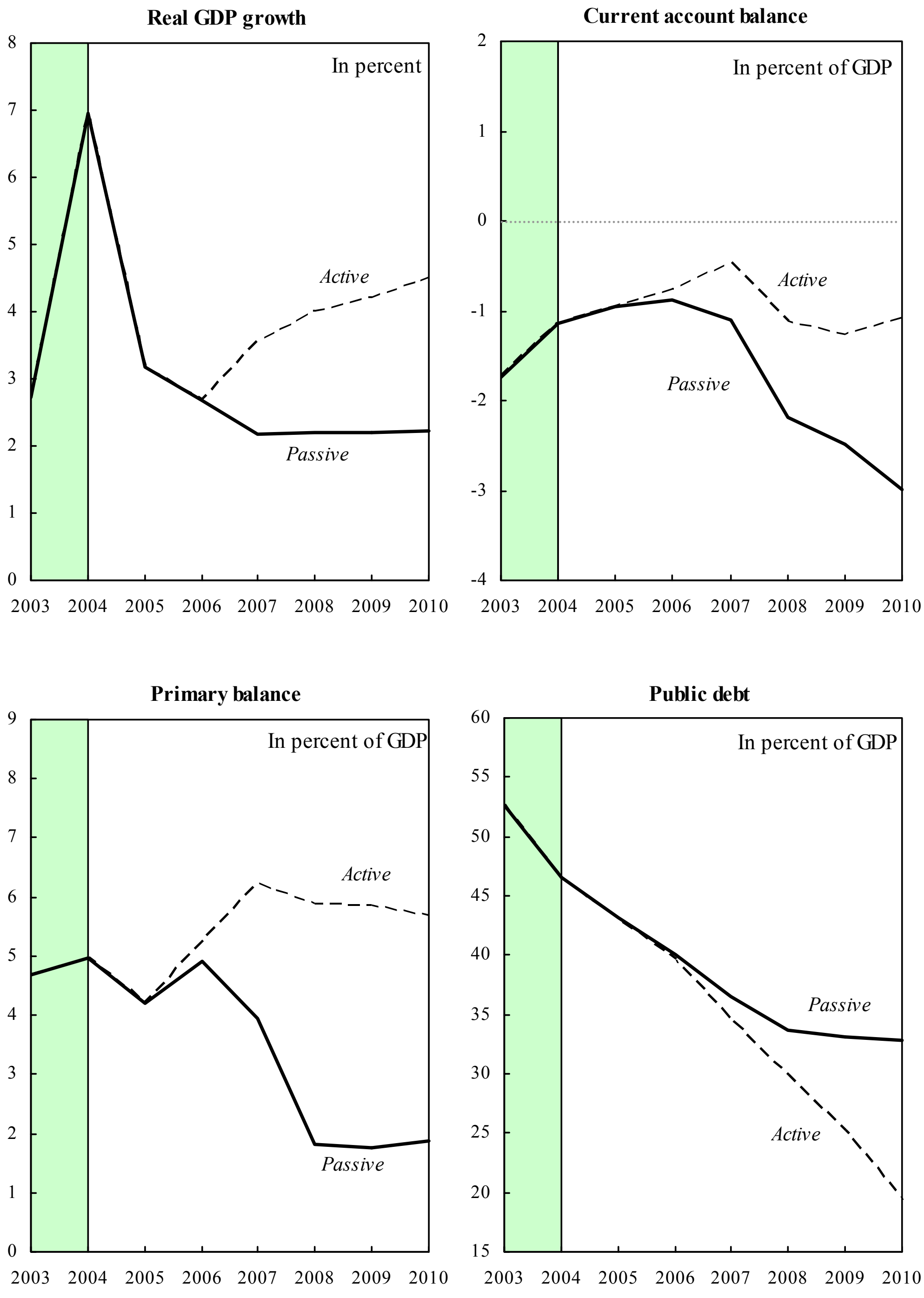
- **Increased susceptibility to shocks.** Though the debt-to-GDP ratio would continue to decline gradually, the debt sustainability analysis (Appendix I) shows that in the event of below-average overall economic performance or lower (but still high) international oil prices, fiscal and external sustainability problems would likely resurface.

10. **The staff has prepared an active policy scenario based on a strong effort at fiscal consolidation and the implementation of key pro-growth structural reforms (Table 9 and Figure 6).**

- In the fiscal area, the non-oil primary deficit would be reduced by between 2–3 percent of GDP with measures to widen the tax base, lower fuel and pension subsidies, contain the wage bill in part through civil service reform, and reduce revenue earmarking. This would allow for a reallocation of spending toward public investment and social spending while sustaining large primary surpluses which would be boosted by higher oil revenue from increased production. As a result, public debt would fall to about 20 percent of GDP by 2010.

- Real GDP growth would reach 4½ percent in 2010, reflecting efficiency gains from reforms to public enterprises, better management of the country's oil resources, strengthening the supervisory and regulatory framework of the banking system, trade liberalization, and other measures to improve the investment climate.

Figure 6. Ecuador: Medium-Term Scenario, 2003–10



Sources: Ministry of Finance; Central Bank of Ecuador; and Fund staff estimates and projections.

III. Report on the Discussions

11. **While recognizing some positive aspects of recent performance, staff emphasized that Ecuador should be doing more to take advantage of the favorable external conditions to strengthen the macroeconomic policy framework and advance structural reforms.** The authorities agreed with the need to tighten fiscal discipline in 2006, and to advance reforms that would underpin improved fiscal management and enhance competitiveness and the business environment, while stressing the importance of trying to address Ecuador's large social needs. Staff recognized the difficult political situation faced by the authorities and urged them to work to build the necessary consensus to facilitate the implementation of these reforms.

A. Fiscal Policy

12. **While the recent large decline in public debt is an important step toward reducing fiscal vulnerabilities, fiscal management remains subject to fundamental weaknesses that could jeopardize macroeconomic stability and the achievement of growth and poverty reduction goals.** Discussions focused on (i) achieving a strong fiscal policy outcome in 2006; (ii) improving the fiscal policy framework; and (iii) reducing vulnerabilities associated with oil dependence and budget inflexibility, while improving expenditure quality.

Strengthening the 2006 fiscal policy stance

13. **Recent inflationary pressures and the increased dependence on volatile oil revenues highlight the need for a tighter fiscal stance than contained in the authorities' fiscal program.** The authorities agreed that a firm approach to budget execution in 2006 is needed. They reaffirmed their commitment to fiscal discipline and to resisting pressures for spending increases beyond program levels, including the additional spending tacked on by Congress to the government's budget proposal (amounting to 1 percent of GDP). The authorities intend to fully offset the additional transfers to subnational governments implied by the Congress's reclassification of oil revenues[3] by reducing discretionary capital spending (0.4 percent of GDP). They plan not to act on the other increases voted by Congress, since they can legally reduce (or increase) the

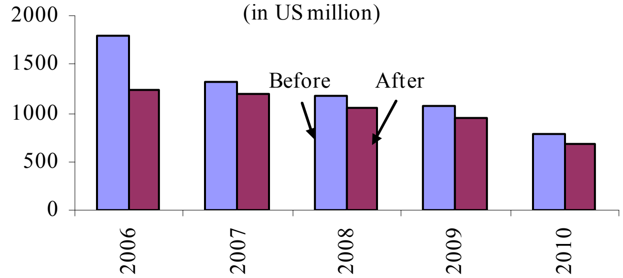
Ecuador: Operations of the NFPS

	2005	2006		
	Proj.	Author.	Baseline	Active
	In percent of GDP			
Revenue	28.0	28.6	28.6	28.7
Oil	7.2	7.1	7.1	7.1
Non-oil	20.9	21.5	21.5	21.6
Primary expenditure	23.8	23.8	23.7	23.5
Current	18.0	17.3	17.5	17.3
of which: wages	9.0	8.5	8.7	8.5
Capital	5.8	6.5	6.2	6.2
Primary balance	4.2	4.8	4.9	5.2
Overall balance	1.7	2.1	2.2	2.6
of which: non-oil balance	-5.0	-5.1	-5.0	-4.5

[3] By reclassifying oil revenues from capital revenues to current revenues, Congress made oil revenues subject to a 15 percent sharing rule with subnational governments.

approved budget by 5 percent without Congress's approval. While welcoming the authorities' intention to increase the primary surplus relative to 2005, the mission urged them to aim for additional savings in order to reduce the non-oil deficit. In particular, the mission emphasized the need to reduce fuel subsidies and to carefully prioritize projects in the capital budget.

Possible impact of debt management strategy on scheduled amortizations 1/
(in US million)



1/ Assumes US$450 million in T-bills and US$600 million in Global bonds are retired.

14. **The authorities are aware that their recent success in obtaining external financing could create additional spending pressures.** To minimize this risk, they intend to put the proceeds of the recent bond issue in a special-purpose escrow account, to be used for debt management operations only. The mission endorsed the authorities' plan to use the proceeds from the bond issue and the FLAR loan to retire short-term debt and high interest Global 2012 bonds, which begin amortizing in 2006. These operations would generate cashflow savings, smooth out the debt amortization profile, and reduce rollover risk.

Improving the fiscal policy framework

15. **The mission recommended that the authorities begin work on a new draft fiscal responsibility law for the next government.** Despite the frequent non-compliance with the spirit of the original fiscal rules, the mission argued that a strong FRL could serve as an important institutional tool in support of a strong policy commitment to fiscal discipline and sustainability. An enhanced FRL should incorporate greater transparency in the fiscal rules (including in the definitions of target variables such as capital spending or the non-oil balance) and stronger accountability of the Minister of Finance. A new law should also target a debt-to-GDP ratio substantially lower than 40 percent in order to lessen vulnerabilities to oil prices and financing difficulties, and develop a fiscal rule for the non-oil balance that not only reduced dependence on finite oil wealth but is also consistent with utilizing that wealth in an intertemporally efficient and equitable manner. Staff estimations suggest that a central government non-oil primary deficit in the range of 1½–3 percent of GDP (consistent with the staff's active scenario) would be consistent with keeping the oil wealth constant in real terms and reducing the debt-to-GDP ratio to safe levels.[4] The authorities indicated that they are preparing proposals to remove inconsistencies among various rules (apart from the FRL) that affected the budget and agreed to include a review of the FRL in their technical work agenda.

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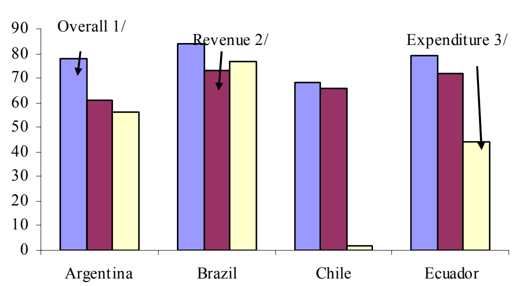
[4] This calculation is highly sensitive to assumptions about key parameters, e.g., the long run price of oil, and about the rate of return on public investment in human and fixed capital. See the Selected Issues chapter on fiscal sustainability.

Policies to improve fiscal management

16. **A growing dependence on oil revenues in recent years has made the budget increasingly vulnerable to a fall in international oil prices.** The mission highlighted the importance of boosting tax revenue through reforms that would simplify and broaden the base of the tax system, and also enhance economic efficiency. In this context, the mission regretted the passage of the recent tax incentives legislation but welcomed the authorities' plans to push ahead with various reforms in 2006, including some that remained incomplete from the 2003–04 Stand-By Arrangement with the Fund such as (i) strengthening the rules related to transfer pricing; (ii) introducing a simplified turnover tax for small businesses; and (iii) eliminating low-yield, administratively cumbersome, taxes. The authorities indicated that the tax incentives law seeks to increase investment in key, specific sectors, and that their overall tax reform strategy was geared toward broadening the base and simplifying the system.

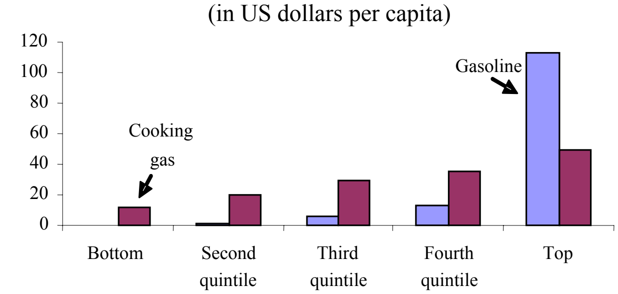
17. **The high degree of budget rigidity in Ecuador has contributed to liquidity problems, made fiscal policy procyclical, and reduced expenditure quality.** To reduce budget rigidities, it would be crucial to control the growth of the wage bill, including through a renewed effort at civil service reform.[5] A new reform would need to have a more comprehensive coverage of civil servants and outline specific policies to control the growth of the wage bill, including through rationalizing public sector employment. It would also be essential to substantially reduce revenue earmarking, the large subsidies for fuel and electricity, and government contributions to pensions, all of which are highly distortionary and very poorly targeted.

Budget Rigidity in Selected Latin American Countries 1/
(In percent of primary revenue)



Source: Fund staff estimates
1/ Mandatory spending plus discretionary spending with earmarked revenues.
2/ Earmarked revenues
3/ Mandatory spending

Gasoline and cooking gas subsidies: implicit transfers
(in US dollars per capita)



Source: World Bank and Fund staff estimates..

18. **The authorities agreed on the need to tackle these problems but want to proceed cautiously given their political sensitivity.** - The officials acknowledged the need for a gradual reduction of fuel subsidies (which amount to 5¼ percent of GDP) to reduce

[5] The 2004 civil service reform sought to bring coherence to wage setting and employment practices. However, it applies only to 25 percent of public servants, while excluding teachers, health workers, and the military.

budgetary pressures and create space for better-targeted social spending and infrastructure investment. Also, the authorities have announced an increase in electricity tariffs beginning in April 2006, the first such increase since 2003. The mission emphasized that even though the current government's ability to advance politically sensitive reforms is likely to be limited, it was important to begin the groundwork, both in terms of technical work and consensus building, for broader reforms by the government that will take office in 2007.

19. **Following the changes made by Congress to the pension system in 2005, and a ruling earlier in the year that portions of the 2001 social security reform were unconstitutional, the authorities have begun preparations for a comprehensive pension reform**. They agreed that any pension reform should substantially reduce the pension system's actuarial deficit and lower the government's pension contribution, which, at a required 40 percent of the total pension bill, imposes a heavy burden on the budget and benefits mostly middle and upper classes. The mission welcomed the fact that the authorities were in discussions with the Social Security Institute to resolve the government's outstanding debt to that agency. The authorities have requested Fund technical assistance to design the pension reform.

B. Long-Run Growth and Competitiveness Issues

20. **Structural reforms that sustain competitiveness and improve the investment climate are needed to increase long-run economic growth and employment.** The authorities agreed with the mission that policies need to be targeted at enhancing the petroleum sector, diversifying the export base, reducing vulnerabilities in the fiscal area and the financial system, increasing the efficiency of public enterprises, trade liberalization, and containing domestic wage and price pressures.

Enhancing the oil sector

21. **A coherent policy for the development of the oil sector, including a reform of PetroEcuador, is needed to fulfill the sector's potential as catalyst for stronger overall long-term growth** (Box 3)**.** Management problems and declining crude production by PetroEcuador, inadequate refining capacity, frozen domestic prices, and rising imports of oil products have prevented Ecuador from fully benefiting from the current high international oil prices. Sizable investment is needed to reverse the output decline of PetroEcuador's fields and improve refining capacity. The authorities indicated that they were planning a comprehensive administrative reform of PetroEcuador (with possible technical assistance from the World Bank), including an external audit as a key first step. The mission encouraged the authorities to define a concrete timetable for the implementation of this reform. The authorities agreed that additional private investment was needed in both extraction and refining and hoped to soon auction new fields for exploration and exploitation in coming months. To attract private investment, the mission highlighted the need to eliminate legal uncertainties and depoliticize the setting of oil derivative prices.

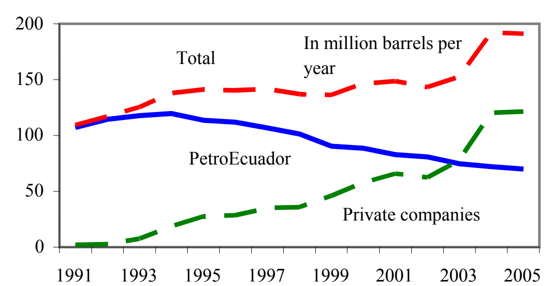
Box 3. Policy Reforms for More Efficient Oil Resource Management

Issues

- Total production has increased slowly (except for the large increase in 2004) as rising private output has offset a 40 percent decline at PetroEcuador since 1994, which reflects underinvestment, and administrative and governance problems.

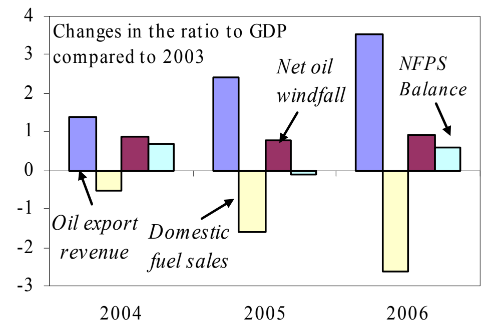
- Private crude oil production uses only 70 percent of the capacity of the new pipeline but is unlikely to increase significantly because of relatively low investment (compared to what is needed to substantially boost output), reflecting (i) uncertainty about the legal framework, especially given outstanding disputes with government on VAT reimbursement, a charge of contract violation against the largest producer, and the government's recent announcement that it wants to renegotiate all contracts; and (ii) lack of new exploration licenses since 1998.

Ecuador: Crude Oil Production 1/



1/ 2005 is Fund staff projection.

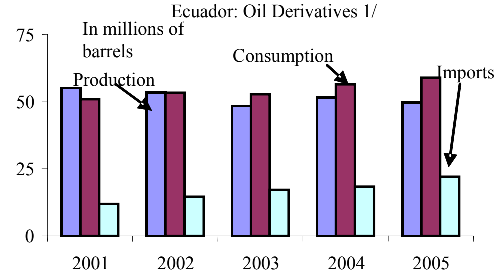
Public sector windfall



- Total refining capacity has not increased since the late 1980s because of the problems at PetroEcuador and the reluctance of the private sector to invest given the politicized price-setting framework for oil derivatives.

- Domestic oil derivative prices have been frozen since early 2003. With unchanged refining capacity and increased consumption, in part due to cross-border smuggling to Peru and Colombia (where the retail price is more than four times higher), import volumes of oil derivatives have almost doubled in the last 4 years. The total value of the subsidy[1] reached 5¼ percent of GDP this year, severely reducing Ecuador's net oil windfall gain.

Ecuador: Oil Derivatives 1/



Sources: PetroEcuador and staff projections.
1/ Staff projection for 2005.

Policy Recommendations

- Develop a coherent oil sector policy, specifying the role of PetroEcuador, a strategy for restoring production in PetroEcuador's light crude oil fields,[2] and a plan to auction new exploration and production licenses for undeveloped Amazon fields.

- Implement a comprehensive reform of PetroEcuador to improve administrative efficiency, governance, and transparency. As a first step, undertake a financial audit of the company. Liberalize the domestic fuel market, involving mainly the deregulation of prices, and the curtailment of PetroEcuador's monopoly in wholesale distribution and storage. This would improve the climate for private sector investment in downstream activities (refining and retail sales).

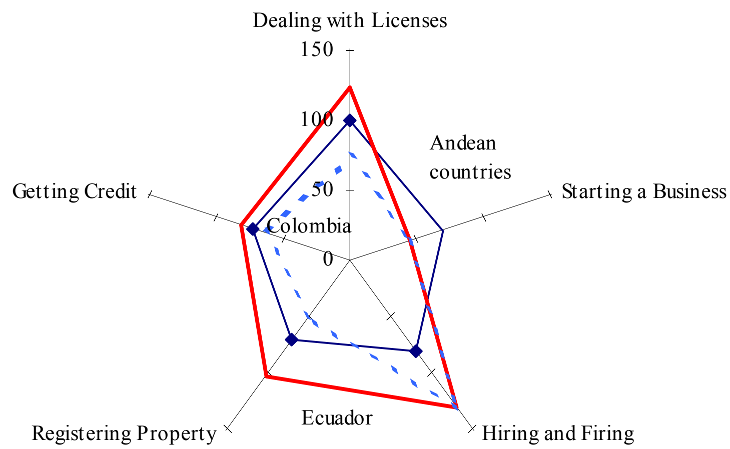
- In the planned renegotiation of contracts with oil companies, it will be important to establish clear and transparent rules for private sector participation in the sector, avoiding ad hoc decisions that may lead to governance problems.

[1] Calculated as the difference between import and domestic prices multiplied by the volume of domestic sales.
[2] The investment needed to restore output to mid-1994 levels is estimated at US$0.5–1 billion.

Competitiveness issues

22. **So far, there is no clear evidence that the dollarization system has been associated with cost-competitiveness problems, but this should be no reason for complacency.**[6] While non-oil export volumes are estimated to have grown strongly in 2005, and the real exchange rate has declined recently, there are a number of risk factors that could undermine Ecuador's competitiveness: (i) further strengthening of the U.S. dollar relative to Ecuador's main trading partner currencies; (ii) the threat of rising inflationary pressures, especially if public spending continues to rise fast; and (iii) with low investment, real wages could rise faster than productivity. Furthermore, Ecuador ranks very low in cross-country competitiveness and business climate assessments,[7] and its narrow export base, dominated by commodities with volatile international prices, continues to make the external accounts vulnerable to swings in international market conditions.

Business Climate Indicators 1/



1/ Ranking out of 155 countries. World Bank. Doing Business database, 2005

23. **The authorities agreed with the staff on the need for structural reforms to improve the competitiveness of Ecuadoran firms.** They indicated that a free trade agreement (FTA) with the United States was key to their efforts in this area and that discussions were well-advanced.[8] They expected the FTA to lock-in favorable access to Ecuador's key export market already provided under a series of preferential arrangements that could otherwise expire, and also act as a catalyst for important institutional reforms (e.g., customs reform and investor rights protection), which would improve the investment climate. The mission agreed that an FTA could bring benefits, but also encouraged the authorities to continue trade liberalization efforts at the multilateral level. The mission emphasized the importance of reducing labor market rigidities, including by eliminating the 15 percent mandatory profit-sharing required from private firms, as crucial for improving economic efficiency and the investment climate, as well, as promoting employment growth.

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[6] See the Selected Issues chapter on competitiveness.

[7] For example, the country was ranked 103rd out of 117 countries in the 2005 growth competitiveness index of the World Economic Forum, reflecting, in particular, the poor ratings in the public institutions and technology subindices.

[8] Negotiations between the United States and Ecuador are expected to be concluded in February 2006.

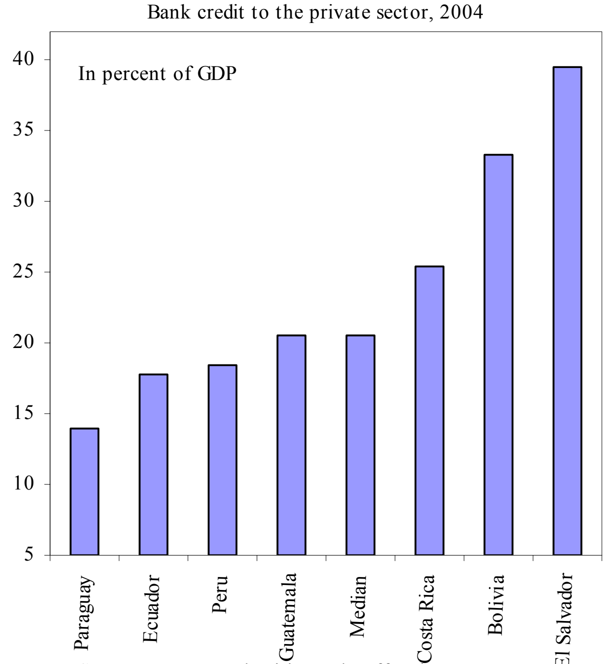
Electricity and telecommunications

24. **Inefficiencies in public enterprises in electricity and telecommunications are a drain on fiscal resources and an obstacle to growth.** In the electricity sector, tariff setting is highly politicized and distribution companies are poorly managed and generate losses, putting pressure on the budget and leading to a large accumulation of intra-sector debts. These problems have deterred private investment in electricity generation, resulting in the highest generation costs in South America, which hurts competitiveness. The authorities said that they are taking measures to address these problems, including by putting the telecommunications and electricity distribution companies under private sector management, and raising electricity tariffs to substantially reduce the electricity-consumption subsidy from April 2006. The mission welcomed these initiatives while emphasizing that depoliticizing tariff-setting decisions was key to attract private management and investment into the sector. The authorities also indicated that they were continuing to work with Congress to resolve their differences on the electricity reform bill. While supporting this reform, the mission urged caution in the design and scope of payment guarantees to private generators to minimize the risk of the government accumulating sizable liabilities.

Reducing vulnerabilities and improving efficiency in the financial system

25. **The 2004 FSAP noted that the financial system had become more resilient since the 1998–99 financial crisis but stressed the need to reduce remaining vulnerabilities.** The FSAP focused on the need to improve supervision and regulation; increase minimum capital requirements; establish a well-financed liquidity fund (to provide lender-of-last-resort protection) and a limited-coverage deposit insurance system; strengthen creditor rights; and improve bankruptcy procedures to facilitate and speed up the recovery of assets by banks. These reforms are crucial to further improve confidence in the system to help reduce interest rates and increase financial intermediation, which is low by international standards.

Bank credit to the private sector, 2004



Source: country authorities and staff estimates.

26. **The authorities have developed a detailed work plan to address some of the FSAP recommendations**. Apart from the reforms implemented over the past year mentioned in paragraph 6, the work plan includes plans to (i) submit to Congress a bankruptcy and creditors' rights bill in the first quarter of 2006; (ii) finalize draft legislation to strengthen the payments system; (iii) continue to implement regulations tightening the

definition of liquidity and capital; and (iv) develop better risk management practices. Officials explained that their lack of progress thus far on the FSAP recommendations to set up an adequately-financed liquidity fund, strengthen the deposit guarantee system, resolve the issue of frozen deposits, or liquidate the remaining closed banks was mainly the result of legal obstacles and a difficult political environment.

27. **The mission strongly cautioned against the banking system bill currently in Congress.** The mission emphasized that instead of administrative regulations to determine interest rates and credit allocation as envisaged in the bill, a durable reduction in interest rates and expansion of banking sector intermediation would depend on the maintenance of macroeconomic stability, the reduction of economic vulnerabilities, and progress on the reform priorities recommended in the FSAP. The authorities also expressed concern about the bill, and indicated that they were working to correct its shortcomings.

IV. Staff Appraisal

28. **Aided by high international oil prices, Ecuador's macroeconomic performance in 2005 was generally positive, exhibiting resilience in the face of a difficult political environment.** The strong growth in the oil sector that followed the completion of the new pipeline in 2003 has tapered off, but high oil prices have helped bolster sentiment and underpin growth in the non-oil sector. At the same time, confidence in the financial system continued to improve, with strong expansion in both deposits and credit and further declines in interest rates, and public debt has continued to fall. These factors helped Ecuador regain international market access with the successful placement of a US$650 million bond in December 2005, the first voluntary international issue since 1997.

29. **Although the short-run outlook remains positive, significant concerns remain about Ecuador's policy framework and medium-term outlook.** The non-oil deficit has risen, reflecting difficulties in controlling spending and the rising cost of fuel subsidies. Moreover, recent structural reforms—most notably the changes to the fiscal responsibility law, the pension system, and the tax incentives law—have weakened the economic policy framework. The recent increase in inflation is worrisome.

30. **Given current favorable external conditions, policymakers should be doing more to address serious underlying vulnerabilities, especially in the fiscal area and the financial system, and to advance on pro-growth structural reforms.** Reforms that reduce vulnerabilities, sustain competitiveness, and improve the investment climate would also allow the economy to fully reap the benefits from dollarization, especially low interest rates and a stable investment and trade environment.

31. **The staff supports the authorities' goal to strengthen the fiscal policy stance in 2006 to address recent inflationary pressures and to put the public finances on a more sustainable track.** In particular, it would be important to sustain the restraint on recurrent spending envisaged in the draft budget, and moderate the planned growth in capital expenditures. The authorities would need to firmly resist pressures for more spending, including finding offsets to Congress's changes to the draft budget, which are likely to intensify in the lead up to the October 2006 elections. In this context, it will be key for the

authorities to adhere to their commendable plans to use proceeds from the recent bond issue strictly for debt management purposes.

32. **To enhance fiscal sustainability over the medium term, it will be important to strengthen the institutional framework for promoting fiscal discipline, reduce dependence on oil revenue, increase budget flexibility, and improve the quality of government spending**. The authorities should consider redesigning the FRL to target a debt-to-GDP ratio substantially lower than 40 percent; increase transparency in the fiscal rules; improve accountability; and strengthen compatibility of the fiscal rules with the efficient use of the country's oil wealth. The staff welcomes the authorities' plans in the area of tax reform to eliminate exemptions, broaden the tax base, and simplify the tax system. To reduce budget rigidity and improve spending quality, significant reductions in revenue earmarking and in poorly-targeted subsidies are crucial. In this context, the authorities are urged to move quickly to reduce the cooking gas subsidy and prepare for a substantial reduction of all other fuel subsidies while strengthening the social-safety net to protect vulnerable groups. It will also be important to develop a coherent civil service reform to control wage costs, and to move ahead with plans to reform the pension system. As resources are freed up for capital and social spending, it will be necessary to improve procedures for evaluating, prioritizing, and monitoring projects so as to ensure high standards of efficiency.

33. **A coherent policy for the development of the oil sector, including a comprehensive reform of PetroEcuador, is long overdue, and will be key to ensure that the oil sector fulfills its potential as a catalyst for stronger overall long-term growth.** A first step will be to define a timetable for the administrative reforms at PetroEcuador, including the external financial audit of the company, and the auctioning of oil fields to private investors. The authorities also need to develop and implement an investment plan to reverse the decline in PetroEcuador's crude production and strengthen refining capacity. To attract greater private investment to the sector, it will be important to eliminate legal uncertainties and strengthen the regulatory framework. In the case of refining, plans to attract private investment would also require liberalization of the domestic oil derivatives market, including depoliticizing price setting, and phasing out PetroEcuador's monopoly in the wholesale market.

34. **The authorities are urged to follow through on the 2004 FSAP recommendations to address banking system vulnerabilities while improving the efficiency of the system and achieving a durable reduction in interest rates**. Ongoing efforts to improve supervision and regulation are to be commended, and the staff also welcomes plans to strengthen the payments system and bankruptcy procedures for the quick recovery of assets by banks. However, reforms to create an effective deposit insurance system and to enable the central bank to provide an adequate lender-of-last-resort facility are vital to enhance the stability of the financial system. At the same time, the government should strongly oppose the banking reform bill to introduce administrative controls on interest-rate spreads and credit allocation currently being debated in Congress, including through presidential veto, if necessary.

35. **Competitiveness remains a concern in the context of the dollarized economy.** While there is no clear evidence that dollarization has been associated with cost-competitiveness problems to date, it is crucial that macroeconomic policy focuses on

reducing recent inflationary pressures. Ecuador's narrow commodity-heavy export base, and low rankings in international competitiveness assessments highlight the need for reforms to raise economic efficiency and improve the investment climate. In this context, the staff endorsed plans to contract private management for public enterprises in electricity distribution and telecommunications, reduce electricity subsidies, and settle electricity intra-sector debts. While these measures will also help attract private investment in lower-cost electricity generation, it will be crucial to depoliticize the setting of electricity tariffs, allowing them to reflect costs. The staff viewed positively the authorities' efforts to finalize an FTA with the United States, which apart from improving market access could catalyze reforms in governance and legal security, where Ecuador scores very low in business-climate surveys. The staff also stressed the importance of increasing labor market flexibility and improving customs to further raise economic efficiency and improve the investment climate.

36. **The lagging reform agenda has become ever more urgent as time has gone by without its implementation.** Many of these reforms imply confronting powerful vested interests and changing long-established relations between the government and the private sector, and between the private sector and the rest of the world. These obstacles have been compounded by the lack of a strong political base or congressional representation by successive governments. It will therefore be crucial for the authorities to devise an effective strategy to build the necessary consensus in favor of this reform agenda, and in this context, they should endeavor to place these issues at the forefront of next year's election campaign discussions.

37. **Data provision for surveillance purposes is adequate overall but the statistical base remains uneven**. In particular, there are shortcomings in certain areas of the balance of payments statistics, the fiscal accounts, and labor market data. The authorities have requested technical assistance from STA in the area of balance of payments and have expressed interest in having an update of the ROSC in FY2007. Ecuador has subscribed to the SDDS.

38. **Ecuador maintains an exchange restriction in the form of blocked deposits in closed banks.** Since there exists no formal timetable to resolve the problem, staff does not recommend Board approval of this restriction.

39. It is expected that the next Article IV consultation with Ecuador will be held on the standard 12-month cycle.

Table 1. Ecuador: Selected Social and Economic Indicators

I. Social Indicators

GDP per capita in US$ (2004)	2,325	Literacy rate 1/	91
Unemployment (November 2005)	9.7	Life expectancy at birth (years)	74
Estimated poverty rate	35	Infant mortality (per 1,000 live births)	25

II. Economic Indicators

	2002	2003	2004	Projections 2005	Projections 2006
(Annual percentage changes; unless otherwise indicated)					
National income and prices					
Real GDP	3.4	2.7	6.9	3.2	2.7
Oil	-6.7	11.8	33.2	1.4	1.0
Non-oil	4.9	1.5	3.1	3.5	3.0
Domestic demand (contribution to growth)	9.1	1.9	5.3	7.4	3.7
Foreign balance (contribution to growth)	-5.7	0.8	1.6	-4.2	-1.0
Real GDP per capita	1.9	1.2	5.4	1.2	1.3
Consumer price index period average	12.6	7.9	2.7	2.4	3.4
Consumer price index end-of-period	9.4	6.1	1.9	4.0	3.0
Banking system					
Liabilities to the private sector 2/	18.2	18.6	27.1	20.0	12.2
Credit to the private sector	13.6	4.5	28.6	21.9	11.6
Average deposit rate (in percent) 3/	5.1	5.0	3.8	4.0	…
Average lending rate (in percent) 3/	15.4	13.5	9.8	10.5	…
EMBI Ecuador (bps, end of period) 3/	1,801	799	690	642	…
EMBI spead Latin America (bps, end of period) 3/	1,007	521	420	288	…
External sector					
Exports	7.7	23.6	26.8	27.6	10.1
Oil	8.5	26.5	62.4	38.8	12.9
Non-oil	7.6	21.6	1.2	14.6	6.2
Imports	19.9	2.8	20.1	27.5	8.6
Terms of trade, national accounts data (deterioration -)	4.3	2.9	7.0	5.5	3.3
Real effective exchange rate (depreciation -) 4/	11.3	-1.3	-4.6	-3.3	…
(In percent of GDP)					
Public finances					
Revenue	26.0	25.4	27.0	28.0	28.6
Non-interest expenditure	21.5	20.7	22.0	23.8	23.7
Primary balance (deficit -)	4.5	4.7	5.0	4.2	4.9
Interest bill	3.5	3.0	2.7	2.5	2.7
Overall balance (deficit -)	1.0	1.7	2.3	1.7	2.2
Total public debt	**58.2**	**52.6**	**46.5**	**43.2**	**40.0**
Domestic	11.3	10.4	10.0	9.5	8.9
External	46.9	42.2	36.5	33.7	31.1
Saving investment balance					
National saving	22.8	25.9	26.7	26.3	26.4
Gross investment	27.7	27.7	27.8	27.2	27.3
Foreign saving = - external current account balance	4.9	1.7	1.1	1.0	0.9
Memorandum items:					
Exports (in millions of US$)	5,050	6,240	7,911	10,090	11,105
of which : oil	2,061	2,607	4,234	5,875	6,630
Foreign direct investment (in millions of US$)	1,275	1,555	1,160	1,540	1,573
Use of Fund resources (percent of quota)	75.0	86.8	61.4	18.1	5.0
Net foreign assets at the Central Bank (in millions of US$)	1,008	1,160	1,437	2,108	2,784
Non-oil balance of the NFPS (percent of GDP)	-3.0	-2.4	-3.1	-5.0	-5.0
Central government deposits in *cuenta unica* (in millions of US$)	118	92	215	628	333
Oil price Ecuador mix (US$ per barrel)	21.4	26.4	31.8	41.7	46.5
Oil price WTI (US$ per barrel)	26.1	31.1	41.5	56.5	60.6
Nominal GDP (millions of US$)	24,311	27,201	30,282	32,667	35,351

Sources: Central Bank of Ecuador; Ministry of Finance; and Fund staff estimates and projections.
1/ Based on percent of population aged 15+.
2/ In 2004–06 includes a broader definition of deposits in all open financial institutions.
3/ November data for 2005.
4/ September data for 2005.

Table 2. Ecuador: Central Government Operations, Net Accounting

	2003	2004	Projections 2005	2006
	(In millions of U.S. dollars)			
Non-oil Revenue	**3,778**	**4,098**	**4,328**	**4,647**
Taxes	2,789	3,166	3,778	4,076
Of which : VAT	1,583	1,720	1,978	2,117
Income tax	592	702	936	1,016
Excises	181	202	222	242
Import duties	382	454	574	625
Domestic sales of petroleum derivatives 1/	568	478	-18	-110
Other	420	455	568	681
Primary expenditure	**4,183**	**4,649**	**5,294**	**5,901**
Current	2,866	3,255	3,848	4,116
Wages and salaries	1,864	2,049	2,377	2,507
Purchases of goods and services	329	363	401	449
Other	673	843	1,071	1,160
Of which: Transfers to Social Security	231	331	430	473
Bono de Desarrollo Humano	168	173	167	192
Capital	1,317	1,395	1,446	1,785
Capital Spending	675	736	774	929
Transfers to Municipalities	642	658	672	856
Adjustment in treasury accounts ((-) increases expenditure)	130	0	0	0
Non-oil Primary balance	**-275**	**-551**	**-966**	**-1,255**
Interest	827	814	856	1,009
Non-oil Overall balance	**-1,102**	**-1,364**	**-1,822**	**-2,264**
Oil revenue from exports	**1,072**	**1,604**	**2,171**	**2,482**
Primary Balance	**797**	**1,053**	**1,205**	**1,227**
Overall balance	**-29**	**240**	**349**	**218**
	(In percent of GDP)			
Non-oil Revenue	**13.9**	**13.5**	**13.3**	**13.1**
Taxes	10.3	10.5	11.6	11.5
Of which: VAT	5.8	5.7	6.1	6.0
Income tax	2.2	2.3	2.9	2.9
Excises	0.7	0.7	0.7	0.7
Import duties	1.4	1.5	1.8	1.8
Domestic Sales of petroleum derivatives	2.1	1.6	-0.1	-0.3
Other	1.5	1.5	1.7	1.9
Primary expenditure	**15.4**	**15.4**	**16.2**	**16.7**
Current	10.5	10.7	11.8	11.6
Wages and salaries	6.9	6.8	7.3	7.1
Purchases of goods and services	1.2	1.2	1.2	1.3
Other	2.5	2.8	3.3	3.3
Of which: Transfers to Social Security	0.8	1.1	1.3	1.3
Bono de Desarrollo Humano	0.6	0.6	0.5	0.5
Capital	4.8	4.6	4.4	5.1
Capital Spending	2.5	2.4	2.4	2.6
Transfers to Municipalities	2.4	2.2	2.1	2.4
Adjustment in treasury accounts ((-) increases expenditure)	0.5	0.0	0.0	0.0
Non-oil Primary balance	**-1.0**	**-1.8**	**-3.0**	**-3.5**
Interest	3.0	2.7	2.6	2.9
Non-oil Overall balance	**-4.0**	**-4.5**	**-5.6**	**-6.4**
Oil revenue from exports	**3.9**	**5.3**	**6.6**	**7.0**
Primary Balance	**2.9**	**3.5**	**3.7**	**3.5**
Overall balance	**-0.1**	**0.8**	**1.1**	**0.6**
Memorandum items:				
Real growth in primary expenditure (percent)	-5.4	10.2	8.9	5.8
Real growth in current expenditures (percent)	-2.8	9.1	13.1	1.5
Current balance (in percent of GDP)	4.3	5.4	5.5	5.7
Non-oil current balance (in percent of GDP)	0.3	0.1	-1.1	-1.4
Total debt of central government (in percent of GDP)	50.6	45.9	43.2	39.5
Total public debt (FRL definition, in percent of GDP)	54.3	48.8	45.9	41.4

Sources: Ministry of Finance; Central Bank of Ecuador; and Fund staff estimates and projections.

1/ Transfers from PetroEcuador generated by the domestic sales of oil derivatives net of derivative import costs.

Table 3. Ecuador: Central Government Financing
(In millions of U.S. dollars)

			Projections	
	2003	2004	2005	2006
Gross financing needs	**1,737**	**2,826**	**3,374**	**2,022**
Central government deficit	29	-240	-349	-218
Deposit build-up (+)	113	98	560	65
Amortization	1,594	2,587	2,866	1,775
External	680	802	936	941
Domestic	914	1,784	1,929	834
NFPS	558	1,132	1,113	629
Private Sector 1/	356	652	816	205
Debt buybacks	0	381	297	400
Gross identified financing	**1,252**	**2,708**	**3,300**	**1,204**
Central government surplus	0	0	0	0
Bond issues	1,082	2,580	3,083	764
External 2/	0	0	650	0
Domestic	1,082	2,580	2,433	764
NFPS 3/	795	1,797	1,532	629
Private Sector 1/	286	784	901	135
Loan disbursements	336	241	298	439
External - Project loans	276	198	194	319
Domestic	60	42	104	120
Net change in accounts payable	8	33	-14	1
Net arrears accumulation	-262	-78	-13	0
Of which: external	-132	-12	-13	0
Other 4/	88	-68	-54	0
Exceptional/program financing	**485**	**118**	**73**	**818**
Rescheduling/debt relief	70	1	0	0
FLAR	0	0	0	400
IDB	100	0	0	198
WB	130	0	0	100
CAF	100	117	73	120
IMF	85	0	0	0
Unidentified	0	0	0	0
Memorandum Items:				
Multilateral Financing	415	118	73	818

Sources: Ministry of Finance; Central Bank of Ecuador; and Fund staff estimates and projections.

1/ Includes public financial institutions.

2/ For 2005, includes bilateral financing from Venezuela in the amount of US$200 million.

3/ Includes the refund of contributions to the social security reserve fund (totaling 2.2 percent of GDP) in 2005-06.

4/ For 2005, reflects the value of discount given on the December 2005 bond issue.

Table 4. Ecuador: Operations of the Nonfinancial Public Sector, Net Accounting

	2003	2004	Projections 2005	2006
	(In millions of U.S. dollars)			
Revenue	**6,908**	**8,177**	**9,155**	**10,123**
Revenue from oil exports	1,096	1,638	2,207	2,516
Non-oil revenue	5,658	6,202	6,818	7,377
Taxes	3,164	3,595	4,321	4,655
Social security contributions	900	1,024	1,106	1,163
Domestic sales of petroleum derivatives	568	478	-18	-110
Other	1,027	1,106	1,409	1,670
Operating surplus of public enterprises	155	338	130	230
Primary expenditure	**5,635**	**6,674**	**7,785**	**8,386**
Current	4,305	5,062	5,894	6,182
Wages and salaries	2,288	2,586	2,945	3,076
Purchases of goods and services	948	1,032	1,144	1,210
Social Security Benefits	516	665	1,047	1,041
Other	553	778	759	855
Capital	1,460	1,612	1,890	2,204
Fixed capital spending	1,446	1,628	1,860	2,176
Net-lending	14	-16	30	29
Discrepancy (unrecorded operations, (-) increase expenditure)	130	0	0	0
Primary balance	**1,273**	**1,504**	**1,370**	**1,737**
Interest	820	797	808	972
Overall balance	**453**	**707**	**562**	**765**
	(In percent of GDP)			
Revenue	**25.4**	**27.0**	**28.0**	**28.6**
Revenue from oil exports	4.0	5.4	6.8	7.1
Nonpetroleum revenue	20.8	20.5	20.9	20.9
Taxes	11.6	11.9	13.2	13.2
Social security contributions	3.3	3.4	3.4	3.3
Domestic sales of petroleum derivatives	2.1	1.6	-0.1	-0.3
Other	3.8	3.7	4.3	4.7
Operating surplus of public enterprises	0.6	1.1	0.4	0.7
Primary expenditure	**20.7**	**22.0**	**23.8**	**23.7**
Current	15.8	16.7	18.0	17.5
Wages and salaries	8.4	8.5	9.0	8.7
Purchases of goods and services	3.5	3.4	3.5	3.4
Social security benefits 2/	1.9	2.2	3.2	2.9
Other	2.0	2.6	2.3	2.4
Capital	5.4	5.3	5.8	6.2
Fixed capital spending	5.3	5.4	5.7	6.2
Net-lending	0.1	-0.1	0.1	0.1
Discrepancy (unrecorded operations, (-) increase expenditure)	0.5	0.0	0.0	0.0
Primary balance	**4.7**	**5.0**	**4.2**	**4.9**
Interest	3.0	2.6	2.5	2.7
Overall balance	**1.7**	**2.3**	**1.7**	**2.2**
Memorandum items:				
Real growth in primary expenditure (percent)	-1.9	16.5	11.6	2.2
Non-oil primary balance (percent of GDP)	0.7	-0.4	-2.6	-2.2
Non-oil balance (percent of GDP)	-2.4	-3.1	-5.0	-5.0
Current balance (in percent of GDP)	6.6	7.7	7.5	8.4
Non-oil current balance (in percent of GDP)	2.5	2.2	0.8	1.3
GDP (in millions of U.S. dollars)	27,201	30,282	32,667	35,351

Sources: Ministry of Finance; Central Bank of Ecuador; and Fund staff estimates and projections.

1/ From 2003 onward, includes revenues accruing to the oil stabilization fund (FEIREP).

2/ Includes the refund of contributions to the social security reserve fund (totaling 2.2 percent of GDP) in 2005-06.

Table 5. Ecuador: Nonfinancial Public Sector Financing
(In millions of U.S. dollars)

	2003	2004	Projections 2005	2006
Gross financing needs	**1,543**	**2,122**	**2,425**	**2,237**
Nonfinancial public sector deficit	0	0	0	0
Deposit build-up (+)	362	425	516	786
Amortization	1,098	1,519	1,792	1,202
External	743	836	976	997
Domestic 1/	356	683	816	205
Additional debt reduction	77	76	91	250
Other financing requirements 2/	5	102	26	0
Gross identified financing	**1,051**	**2,004**	**2,352**	**1,419**
Nonfinancial public sector surplus 3/	453	707	562	765
Bond issues	286	784	1,551	135
External 4/	0	0	650	0
Domestic	286	784	901	135
Loan disbursements	356	298	306	490
External - Project loans	316	267	299	419
Domestic	40	30	6	70
Net change in accounts payable	-4	59	0	0
Net arrears accumulation and unidentified financing 5/	-41	156	-13	-1
Of which : external	-137	-11	-13	0
Other 6/	0	0	-54	31
Exceptional/program financing	**492**	**118**	**73**	**818**
Rescheduling/debt relief	77	1	0	0
FLAR	0	0	0	400
IDB	100	0	0	198
WB	130	0	0	100
CAF	100	117	73	120
IMF	85	0	0	0
Unidentified	0	0	0	0
Memorandum Items:				
Total debt (in percent of GDP)	52.6	46.5	43.2	40.0
Of which: domestic	10.4	10.0	9.5	8.9
external	42.2	36.5	33.7	31.1

Sources: Ministry of Finance; Central Bank of Ecuador; and Fund staff estimates and projections.

1/ Includes public financial institutions.
2/ Includes financial assistance to public banks.
3/ Includes the refund of contributions to the social security reserve fund (totaling 2.2 percent of GDP) in 2005-06.
4/ For 2005, includes bilateral financing from Venezuela in the amount of US$200 million.
5/ Information about the financial position of some agencies within the NFPS is incomplete.
6/ For 2005, reflects the value of discount given on the December 2005 bond issue.

Table 6. Ecuador: Summary Accounts of the Financial System

	2002	2003	2003-New	2004	Projections 2005	2006
			I. Central Bank			
Net foreign assets	**1,008**	**1,160**	**1,160**	**1,437**	**2,108**	**2,784**
Net domestic assets	**-704**	**-839**	**-839**	**-1,046**	**-1,624**	**-2,244**
Net credit to the nonfinancial public sector	77	10	10	-349	-976	-1,603
Net credit to the banking system	356	108	108	109	125	131
Other assets net	-1,137	-957	-957	-806	-773	-773
Central bank fully backed liabilities	**304**	**321**	**321**	**391**	**485**	**540**
			II. Banking System 1/			
Net foreign assets	**728**	**1,012**	**1,615**	**1,977**	**2,088**	**2,771**
Net domestic assets	**5,029**	**5,818**	**2,676**	**3,388**	**4,350**	**4,458**
Net assets held in the central bank	190	254	202	289	354	398
Net credit to nonfinancial public sector	177	349	23	-170	-329	-919
Net credit to the private sector 2/	3,483	3,641	3,713	4,680	5,807	6,535
Other domestic assets	1,180	1,573	-1,262	-1,411	-1,482	-1,556
Liabilities to the private sector	**5,757**	**6,830**	**4,291**	**5,365**	**6,438**	**7,229**
Deposits	5,304	6,316	4,283	5,365	6,438	7,229
Other	453	514	8	0	0	0
			III. Other Financial Institutions 3/			
Net foreign assets	...	...	**48**	**53**	**75**	**103**
Net domestic assets	...	...	**638**	**913**	**1084**	**1197**
Net assets held in the central bank	...	...	47	72	64	72
Net credit to nonfinancial public sector	...	...	-83	-83	-83	-83
Credit to the private sector 2/	...	...	1,014	1,401	1,604	1,735
Other domestic assets	...	...	-340	-477	-501	-526
Liabilities to the private sector	...	...	**687**	**965**	**1158**	**1301**
Deposits	...	...	684	965	1158	1301
Other	...	...	2	0	0	0
			IV. Consolidated System 4/			
Net foreign assets	**1,736**	**2,173**	**2,824**	**3,467**	**4,271**	**5,659**
Net domestic assets	**4,061**	**4,707**	**2,203**	**2,921**	**3,392**	**2,942**
Net credit to the nonfinancial public sector	253	360	-49	-602	-1,388	-2,604
Net credit to the private sector	3,483	3,641	4,727	6,081	7,411	8,270
Other net domestic assets	325	706	-2,475	-2,559	-2,631	-2,724
Liabilities to the private sector	**5,797**	**6,880**	**5,028**	**6,388**	**7,663**	**8,602**
			(Flows, in millions of U.S. dollars)			
Net foreign assets	**156**	**437**	**...**	**643**	**804**	**2,135**
Net domestic assets	**745**	**647**	**...**	**718**	**471**	**68**
Net credit to the nonfinancial public sector	-292	107	...	-553	-787	-1,940
Net credit to the private sector	417	158	...	1,354	1,329	2,174
Other assets	620	382	...	-84	-72	-166
Liabilities to the private sector	**901**	**1,083**	**...**	**1,361**	**1,275**	**2,203**
Memorandum items:						
M2 (percentage change)	18.7	19.1	...	27.1	20.0	12.2
M1 (percentage change)	31.1	19.2	...	28.5	...	...
Net credit to private sector (percentage change)	13.6	4.5	...	28.6	21.9	11.6
Public sector deposits at central bank	1,027	1,235	1,235	1,507	2,110	2,713
Central government deposits "cuenta unica"	118	92	92	215	641	346

Sources: Central Bank of Ecuador, and Fund staff estimates and projections.

1/ The previous methodology included open and closed commercial banks, the new one includes only open commercial banks.

2/ Does not exclude loan provisions starting in 2003 new methodology.

3/ Includes the BNF, CFN, finance companies, cooperatives, savings and loans, and the BEV.

4/ Includes the BCE, open commercial banks, and the other financial institutions.

Table 7. Ecuador: Balance of Payments

	2003	2004	2005	2006	2007	2008	2009	2010
			Projections					
			(In millions of U.S. dollars)					
Current account	**-471**	**-345**	**-312**	**-308**	**-413**	**-869**	**-1,048**	**-1,328**
Trade account	-107	291	372	553	172	-498	-911	-1,375
Exports, f.o.b.	6,240	7,911	10,090	11,105	11,175	11,103	11,127	11,231
Of which: petroleum products	2,607	4,234	5,875	6,630	6,485	6,222	5,980	5,806
Imports (f.o.b.)	-6,346	-7,620	-9,719	-10,552	-11,002	-11,602	-12,038	-12,606
Of which: oil sector investment 1/	-886	-582	-884	-902	-934	-959	-987	-1,016
Of which: oil derivatives	-676	-867	-1,464	-1,575	-1,549	-1,524	-1,502	-1,493
Services (net)	-2,140	-2,558	-2,800	-3,091	-2,944	-2,861	-2,760	-2,716
Of which: interest payments	-1,114	-1,164	-1,031	-1,142	-1,019	-924	-857	-827
Transfers (net)	1,776	1,922	2,116	2,229	2,358	2,491	2,624	2,763
Capital account	**742**	**655**	**1,214**	**416**	**306**	**200**	**1,103**	**1,541**
Net public sector capital	-33	-515	12	-578	-673	-590	-402	-388
Direct investment	1,555	1,160	1,540	1,573	1,636	1,686	1,741	1,820
Of which : oil sector	1,265	896	1,360	1,387	1,438	1,476	1,518	1,562
Other net private sector capital 2/	-780	10	-338	-578	-657	-897	-236	110
Of which : banks	-284	-362	-111	-683	-141	403	-234	-400
Overall balance	**270**	**309**	**902**	**108**	**-108**	**-669**	**56**	**213**
Financing	**-270**	**-310**	**-902**	**-926**	**8**	**569**	**-156**	**-313**
NFA at the BCE (increase -) 3/	-152	-277	-671	-676	8	569	-156	-313
FEIREP net deposit accumulation	-81	-26	-164	0	0	0	0	0
Debt buybacks	0	0	0	-250	0	0	0	0
Public sector arrears, net (decrease -)	-137	-11	-13	0	0	0	0	0
Debt relief obtained	100	4	0	0	0	0	0	0
Other 4/	0	0	-54	0	0	0	0	0
Financing gap	**0**	**0**	**0**	**818**	**100**	**100**	**100**	**100**
FLAR	0	0	0	400	0	0	0	0
Possible program loans	0	0	0	418	100	100	100	100
Residual financing gap	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**
			(In percent of GDP, unless otherwise specified)					
Current account	**-1.7**	**-1.1**	**-1.0**	**-0.9**	**-1.1**	**-2.2**	**-2.5**	**-3.0**
Non-oil current account	-4.3	-8.6	-9.8	-10.6	-9.9	-10.0	-9.4	-9.1
Trade balance	-0.4	1.0	1.1	1.6	0.5	-1.3	-2.2	-3.1
Exports	22.9	26.1	30.9	31.4	29.7	27.9	26.5	25.2
Imports	-23.3	-25.2	-29.8	-29.8	-29.2	-29.2	-28.6	-28.3
Total external debt	**59.5**	**53.4**	**49.9**	**44.4**	**38.4**	**32.9**	**29.9**	**27.8**
Total external debt service ratio								
(As percentage of exports GNFS)	**33.4**	**37.3**	**30.9**	**29.8**	**29.7**	**26.4**	**21.9**	**21.1**
			(In percentage change)					
Exports, f.o.b.	23.6	26.8	27.6	10.1	0.6	-0.6	0.2	0.9
Petroleum	26.5	62.4	38.8	12.9	-2.2	-4.1	-3.9	-2.9
Non-oil	21.6	1.2	14.6	6.2	4.8	4.1	5.4	5.4
Import, f.o.b.	2.8	20.1	27.5	8.6	4.3	5.5	3.8	4.7
Petroleum	191.0	28.1	69.0	7.6	-1.7	-1.6	-1.4	-0.6
Non-oil	-6.1	29.0	19.4	9.6	5.5	7.0	4.7	5.7
Memorandum items:								
Net foreign assets at the BCE 3/								
(As percentage of imports GNFS)	1.5	1.5	2.0	2.6	2.4	1.9	1.9	1.9
(in millions of U.S. dollars)	1,160	1,437	2,108	2,784	2,776	2,207	2,363	2,676
LIBOR interest rate (percent)	1.23	1.79	3.63	4.51	4.65	4.68	4.68	4.68

Sources: Central Bank of Ecuador; and Fund staff estimates and projections.

1/ Imports of goods related to new foreign investments in the oil sector.
2/ Includes errors and omissions.
3/ Includes liabilities to the IMF and excludes deposits of the FEIREP oil fund.
4/ For 2005, reflects value of discount given on the December 2005 bond issue.

Table 8. Ecuador: Passive Medium-Term Scenario

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
I. Output and Prices														
(Annual percentage changes)														
Real GDP	4.1	2.1	-6.3	2.8	5.1	3.4	2.7	6.9	3.2	2.7	2.2	2.2	2.2	2.2
Oil	-2.9	-2.6	-8.7	1.2	8.0	-6.3	11.4	33.2	1.4	1.0	-0.6	-0.6	-0.6	-0.6
Non-oil	5.3	2.9	-5.9	3.0	4.7	4.9	1.5	3.1	3.5	3.0	2.6	2.6	2.6	2.6
Consumer prices														
End of period	4.1	-0.6	-29.2	-7.7	37.7	12.6	6.1	1.9	4.0	3.0	3.0	3.0	3.0	3.0
Period average	4.2	4.7	-25.2	-10.1	22.4	9.4	7.9	2.7	2.4	3.4	3.0	3.0	3.0	3.0
Exchange rate (- depreciation, pa) 1/	7.6	1.6	-30.8	-6.6	39.4	11.3	-1.3	-4.6	-3.3	...	...	...	...	...
(In percent, period average)														
Interest rate	7.0	6.7	8.8	7.2	7.1	6.0	6.1	5.8	5.7	6.9	7.0	7.5	8.0	8.4
(In percent of GDP, unless otherwise indicated)														
II. External Sector														
Current account balance	-3.0	-9.3	5.7	5.3	-3.3	-4.9	-1.7	-1.1	-1.0	-0.9	-1.1	-2.2	-2.5	-3.0
III. Public Sector														
Nonfinancial public sector														
Primary balance	2.2	-0.9	3.4	7.7	4.3	4.5	4.7	5.0	4.2	4.9	4.0	1.8	1.8	1.9
of w/c: non-oil primary balance	-3.2	-3.3	-1.5	-0.1	-0.5	0.5	0.7	-0.4	-2.6	-2.2	-2.2	-3.6	-3.0	-2.4
Overall balance	-2.1	-5.1	-4.6	1.0	-0.5	1.0	1.7	2.3	1.7	2.2	1.2	-0.8	-0.9	-0.8
Central Government														
Primary balance	2.8	-0.1	3.9	6.5	3.7	2.6	2.9	3.5	3.7	3.5	1.7	0.8	0.8	0.2
of w/c : non-oil primary balance	-5.1	-2.3	-4.7	-7.3	-5.2	-3.7	-1.0	-1.8	-3.0	-3.5	-4.3	-4.5	-3.9	-4.0
of w/c: tax revenue .	…	8.6	8.9	10.2	11.3	11.3	10.3	10.5	11.6	11.5	11.5	11.4	11.3	11.3
of w/c: domestic sales of oil derivatives.	…	1.5	1.3	1.4	0.9	1.9	2.1	1.6	-0.1	-0.3	-0.2	0.0	0.1	0.2
of w/c : wages and salaries .	…	6.5	5.4	4.4	5.2	6.9	6.9	6.8	7.3	7.1	7.4	7.6	7.7	7.8
of w/c : capital expenditures .	…	4.5	4.4	4.1	6.8	5.0	4.8	4.6	4.4	5.1	5.0	5.0	3.8	3.7
Overall balance	-1.2	-4.1	-2.9	0.1	-0.7	-0.8	-0.1	0.8	1.1	0.6	-1.0	-1.8	-1.9	-2.5
Fiancing gap	…	…	…	…	…	…	…	…	0.0	0.0	1.2	2.3	2.7	3.0
IV. Public Debt														
Total public debt (gross)	62.5	65.9	101.6	91.4	70.2	58.2	52.6	46.5	43.2	40.0	36.5	33.7	33.1	32.8
Domestic debt	8.9	9.8	18.7	19.4	15.7	11.3	10.4	10.0	9.5	8.9	8.8	8.8	10.2	11.8
External debt	53.6	56.2	82.8	72.0	54.5	46.9	42.2	36.5	33.7	31.1	27.7	25.0	22.9	21.0
Total net public debt 2/	...	...	...	...	...	...	50.0	44.0	39.1	36.1	34.2	32.6	32.0	31.8
Memorandum items:														
Private investment	18.4	21.7	11.0	17.2	22.1	23.3	24.5	24.4	24.1	23.7	23.6	23.2	22.7	22.5
Oil price (Ecuador mix, US$ per barrel)	15.5	9.2	15.1	24.6	19.1	21.4	26.4	31.7	41.1	46.5	45.1	43.8	42.6	41.9
Oil price (WTI, US$ per barrel)	20.6	14.4	19.2	30.3	25.9	26.1	31.1	41.5	57.7	65.5	63.3	60.8	59.8	58.8

Sources: Ecuadoran authorities; and Fund staff estimates and projections.

1/ September data for 2005.

2/ Gross debt minus central government deposits.

Table 9. Ecuador: Active Medium-Term Scenario

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
I. Output and Prices														
(Annual percentage changes)														
Real GDP	4.1	2.1	-6.3	2.8	5.1	3.4	2.7	6.9	3.2	2.7	3.6	4.0	4.2	4.5
Oil	-2.9	-2.6	-8.7	1.2	8.0	-6.3	11.4	33.2	1.4	1.0	2.8	3.4	4.1	4.8
Non-oil	5.3	2.9	-5.9	3.0	4.7	4.9	1.5	3.1	3.5	3.0	3.7	4.0	4.2	4.5
Consumer prices														
End of period	4.1	-0.6	-29.2	-7.7	37.7	12.6	6.1	1.9	4.0	3.0	3.0	2.2	2.2	2.2
Period average	4.2	4.7	-25.2	-10.1	22.4	9.4	7.9	2.7	2.4	3.4	3.5	2.5	2.2	2.2
Exchange rate (-depreciation, pa) 1/	7.6	1.6	-30.8	-6.6	39.4	11.3	-1.3	-4.6	-3.3	...	...	...	...	...
(In percent, period average)														
Interest rate	7.0	6.7	8.8	7.2	7.1	6.0	6.1	5.8	5.7	6.9	6.8	6.6	6.4	6.2
(In percent of GDP, unless otherwise indicated)														
II. External Sector														
Current account balance	-3.0	-9.3	5.7	5.3	-3.3	-4.9	-1.7	-1.1	-1.0	-0.8	-0.5	-1.1	-1.3	-1.1
III. Public Sector														
Nonfinancial public sector														
Primary balance	2.2	-0.9	3.4	7.7	4.3	4.5	4.7	5.0	4.2	5.2	6.2	5.9	5.8	5.7
of which : non-oil primary balance	-3.2	-4.8	-2.8	-1.5	-1.4	-1.4	0.7	-0.4	-2.6	-1.9	-0.3	-0.3	-0.1	-0.2
Overall balance	-2.1	-5.1	-4.6	1.0	-0.5	1.0	1.7	2.3	1.7	2.6	4.1	3.9	4.1	4.1
Central Government														
Primary balance	2.8	-0.1	3.9	6.5	3.7	2.6	2.9	3.5	3.7	3.9	4.3	4.2	4.1	4.0
of which : non-oil primary balance	-5.1	-3.8	-5.9	-8.7	-6.1	-5.6	-1.0	-1.8	-3.0	-3.2	-2.1	-1.8	-1.8	-1.8
of which : tax revenue	…	8.6	8.9	10.2	11.3	11.3	10.3	10.5	11.6	11.5	11.7	11.9	12.0	12.1
of which: domestic sales of oil derivatives	…	1.5	1.3	1.4	0.9	1.9	2.1	1.6	-0.1	-0.2	1.2	1.8	2.3	2.2
of which : wages and salaries	…	6.5	5.4	4.4	5.2	6.9	6.9	6.8	7.3	6.9	6.8	6.8	6.8	6.8
of which : capital expenditures	…	4.5	4.4	4.1	6.8	5.0	4.8	4.6	4.4	5.1	5.2	5.6	6.1	6.1
Overall balance	-1.2	-4.1	-2.9	0.1	-0.7	-0.8	-0.1	0.8	1.1	1.0	1.8	2.0	2.1	2.2
Financing gap	…	…	…	…	…	…	…	…	0.0	0.0	0.0	0.0	0.0	0.0
IV. Public Debt														
Total public debt (gross)	62.5	65.9	101.6	91.4	70.2	58.2	52.6	46.5	43.2	39.8	34.7	30.0	25.3	19.6
Domestic debt	8.9	9.8	18.7	19.4	15.7	11.3	10.4	10.0	9.2	8.4	7.5	6.2	4.4	2.1
External debt	53.6	56.2	82.8	72.0	54.5	46.9	42.2	36.5	34.0	31.4	27.2	23.9	20.9	17.5
Total net public debt 2/	...	...	...	...	...	...	50.0	44.0	39.1	35.7	30.7	25.9	21.2	15.7
Memorandum items:														
Private investment	18.4	21.7	11.0	17.2	22.1	23.3	24.5	24.4	24.1	23.7	24.3	24.7	25.0	25.0
Oil price (Ecuador mix, US$ per barrel)	15.5	9.2	15.1	24.6	19.1	21.4	26.4	31.7	41.1	46.5	45.1	43.8	42.6	41.9
Oil price (WTI, US$ per barrel)	20.6	14.4	19.2	30.3	25.9	26.1	31.1	41.4	57.7	65.5	63.3	60.8	59.8	58.8

Sources: Ecuadoran authorities; and Fund staff estimates and projections.
1/ September data for 2005.
2/ Gross debt minus central government deposits.

Table 10. Ecuador: Selected Vulnerability Indicators

	2000	2001	2002	2003	2004	Projections 2005	2006
Key economic and market indicators							
Real GDP growth (in percent)	2.8	5.1	3.4	2.7	6.9	3.2	2.7
CPI inflation (period average, in percent)	-7.7	37.7	12.6	7.9	2.7	2.4	3.4
Short-term interest rate (in percent) 1/		5.5	5.1	5.0	3.8	4.0	…
EMBI spread (bps, end of period) 1/	2,866	1,233	1,801	799	690	642	...
Exchange rate NC/US$ (end of period)				US$ is national currency			
External sector							
Exchange rate regime				US$ is national currency			
Current account balance (percent of GDP)	5.3	-3.3	-4.9	-1.7	-1.1	-1.0	-0.9
Net FDI inflows (percent of GDP)	-1.6	6.3	5.2	5.8	3.8	4.7	4.4
Export growth (US$ value, GNFS)	12.6	-3.7	8.2	14.3	27.1	24.6	9.7
Real effective exchange rate (1995 = 100) 2/	73.1	102.2	113.8	112.3	107.2	103.7	...
Gross international reserves (GIR) in US$ billion	1.2	1.1	1.0	1.2	1.4	2.1	2.8
GIR in percent of ST debt at remaining maturity	33.1	32.0	35.1	31.4	38.2	57.8	79.4
Net international reserves (NIR) in US$ billion	0.0	0.9	0.7	0.8	1.2	2.0	2.8
Total gross external debt in percent of GDP	86.0	69.0	67.1	59.8	53.4	48.7	44.2
Of which : ST debt (original maturity in percent of GDP)	25.2	6.6	9.5	6.6	5.1	4.1	3.2
Private sector debt (in percent of GDP)	14.0	14.5	20.2	17.4	16.8	16.0	13.2
Total gross external debt in percent of exports of GNFS	223.6	252.9	264.1	227.2	180.0	145.8	128.1
Gross external financing requirement (in US$ billion)	2.6	3.9	16.0	15.0	14.3	13.1	11.8
Public sector 3/							
Overall balance (percent of GDP)	1.0	-0.5	1.0	1.7	2.3	1.7	2.2
Primary balance (percent of GDP)	7.7	4.3	4.5	4.7	5.0	4.2	4.9
Debt-stabilizing primary balance (percent of GDP)	n/a	n/a	...	-0.7	-0.8	1.1	1.9
Gross public sector financing requirement (in percent of GDP)	16.4	9.4	5.4	4.3	5.6	5.8	4.1
Public sector gross debt (in percent of GDP)	91.4	70.2	58.2	52.6	46.5	43.2	40.0
Of which: External debt from official creditors (in percent of total)	46.4	46.8	51.7	51.8	48.0	43.3	44.9
External debt from private creditors (in percent of total)	32.4	30.9	28.7	28.4	28.9	33.5	31.7
Domestic debt linked to foreign currency (in percent of total)	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Domestic debt linked to ST interest rate or inflation (in percent of total)	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Public sector net debt (in percent of GDP) 4/	83.7	64.2	52.8	46.7	39.8	34.6	29.4
Financial sector 5/							
Capital in percent of risk-adjusted assets	13.1	13.5	14.4	14.9	14.5	14.8	...
NPLs in percent of total loans	34.7	13.4	8.4	7.9	6.4	5.7	...
Provisions in percent of NPLs	83.1	115.5	131.4	127.3	119.0	126.9	...
Return on average assets (in percent)	-2.2	-0.4	1.2	1.1	1.2	2.3	...
Ratio of liquid assets to deposits 6/	42.2	44.3	38.7	40.5	37.2	33.9	...
FX deposits (in percent of total deposits)	100.0	100.0	100.0	100.0	100.0	100.0	100.0
FX loans (in percent of total loans)	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Sources: Central Bank of Ecuador; Ministry of Finance; and Fund staff estimates and projections.

1/ November data for 2005.
2/ January-September data for 2005.
3/ Nonfinancial public sector.
4/ Public sector gross debt net of deposits in the banking system.
5/ Includes banking system, which is fully dollarized. November data for 2005.
6/ The ratio of available funds and tradable securities to demand and term deposits.

Table 11. Ecuador: Millennium Development Goals

	1990	1994	1997	2000	2003	2004
1. Eradicate extreme poverty and hunger	*2015 target = halve 1990 $1 a day poverty and malnutrition rates*					
Population below $1 a day (percent)	...	2.0	17.7	...	...	...
Poverty gap at $1 a day (percent)	...	0.5	7.1	...	...	...
Percentage share of income or consumption held by poorest 20%	...	...	3.3	...	...	...
Prevalence of child malnutrition (percent of children under 5)	...	...	14.3	...	...	...
Population below minimum level of dietary energy consumption (%)	...	...	5.0	...	...	...
2. Achieve universal primary education	*2015 target = net enrollment to 100*					
Net primary enrollment ratio (percent of relevant age group)	97.8	...	97.0	99.4	99.5	...
Percentage of pupils reaching grade 5 (percent)	...	...	77.0	78.0	...	...
Youth literacy rate (percent ages 15-24)	...	...	...	96.4	...	...
3. Promote gender equality	*2005 target = education ratio to 100*					
Ratio of girls to boys in primary and secondary education (percent)	...	...	100.7	100.6	100.4	...
Ratio of young literate females to males (percent ages 15-24)	...	...	...	100.1	...	...
Share of women employed in the nonagricultural sector (percent)	37.3	40.2	39.6	40.2	41.1	41.1
Proportion of seats held by women in national parliament (percent)	5.0	...	4.0	17.0	16.0	16.0
4. Reduce child mortality	*2015 target = reduce 1990 under 5 mortality by two-thirds*					
Under 5 mortality rate (per 1,000)	57	43	...	32	27	27
Infant mortality rate (per 1,000 live births)	43	34	...	27	24	24
Immunization, measles (percent of children under 12 months)	60	72	75	84	99	99
5. Improve maternal health	*2015 target = reduce 1990 maternal mortality by three-fourths*					
Maternal mortality ratio (modeled estimate, per 100,000 live births)	...	...	...	130	...	...
Births attended by skilled health staff (percent of total)	...	...	...	91.3	...	...
6. Combat HIV/AIDS, malaria and other diseases	*2015 target = halt, and begin to reverse, AIDS, etc.*					
Contraceptive prevalence rate (percent of women ages 15-49)	52.9	56.8	...	65.8	...	...
Number of children orphaned by HIV/AIDS	...	...	...	...	...	...
Incidence of tuberculosis (per 100,000 people)	202.4	180.1	164.9	151.1	138.4	138.4
Tuberculosis cases detected under DOTS (percent)	...	...	...	5.3	36.9	36.9
7. Ensure environmental sustainability	*2015 target = various (see notes)*					
Forest area (percent of total land area)	43.1	...	...	38.1	...	...
Nationally protected areas (percent of total land area)	...	...	...	...	18.3	18.3
GDP per unit of energy use (PPP $ per kg oil equivalent)	5.9	5.9	5.3	5	48	...
CO2 emissions (metric tons per capita)	1.6	1.3	1.7	2	...	...
Access to an improved water source (percent of population)	69	...	...	...	86	...
Access to improved sanitation (percent of population)	56	...	...	...	72	...
Access to secure tenure (percent of population)	...	...	...	...	...	...
8. Develop a Global Partnership for Development	*2015 target = various (see notes)*					
Youth unemployment rate (percent of total labor force ages 15-24)	13.5	14.9	18.9	13.5	...	...
Fixed line and mobile telephones (per 1,000 people)	47.8	60.3	86	135	311.6	311.6
Personal computers (per 1,000 people)	1.9	9.8	16.8	21.7	31.1	...

Source: World Development Indicators database.

Note: In some cases the data are for earlier or later years than those stated.

Goal 1 targets: Halve, between 1990 and 2015, the proportion of people whose income is less than one dollar a day. Halve, between 1990 and 2015, the proportion of people who suffer from hunger.

Goal 2 target: Ensure that, by 2015, children everywhere, boys and girls alike, will be able to complete a full course of primary schooling.

Goal 3 target: Eliminate gender disparity in primary and secondary education preferably by 2005 and to all levels of education no later than 2015.
2,015.00

Goal 4 target: Reduce by two-thirds, between 1990 and 2015, the under-five mortality rate.

Goal 5 target: Reduce by three-quarters, between 1990 and 2015, the maternal mortality ratio.

Goal 6 targets: Have halted by 2015, and begun to reverse, the spread of HIV/AIDS. Have halted by 2015, and begun to reverse, the incidence of malaria and other major diseases.

Goal 7 targets: Integrate the principles of sustainable development into country policies and programs and reverse the loss of environmental resources. Halve, by 2015, the proportion of people without sustainable access to safe drinking water. By 2020, to have achieved a significant improvement in the lives of at least 100 million slum dwellers.

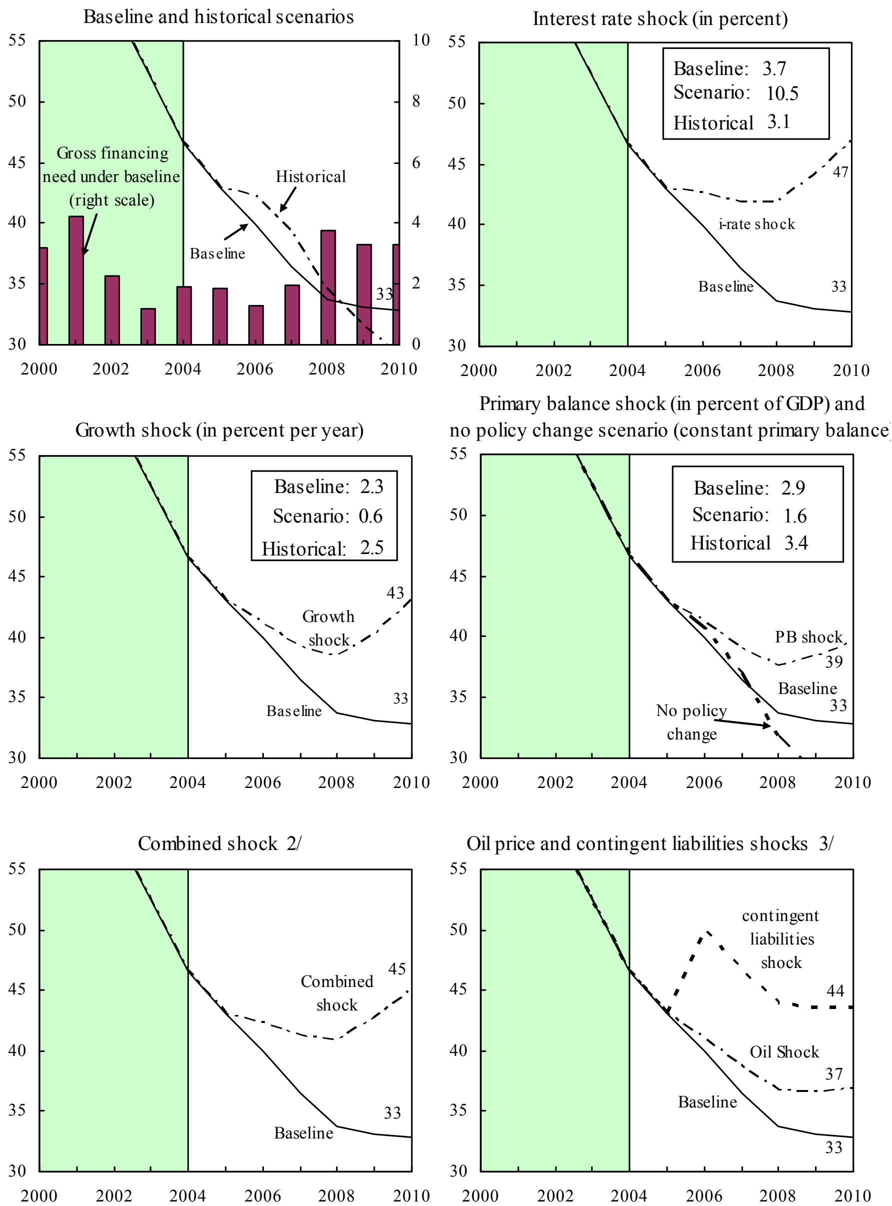
Goal 8 targets: Develop further an open, rule-based, predictable, non-discriminatory trading and financial system. Address the Special Needs of the Least Developed Countries. Address the Special Needs of landlocked countries and small island developing states. Deal comprehensively with the debt problems of developing countries through national and international measures in order to make debt sustainable in the long term. In cooperation with developing countries, develop and implement strategies for decent and productive work for youth. In cooperation with pharmaceutical companies, provide access to affordable, essential drugs in developing countries. In cooperation with the private sector, make available the benefits of new technologies, especially information and communications.

Table 1. Ecuador: Public Sector Debt Sustainability Framework, 2000-10
(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	Debt-stabilizing primary balance 9/
Baseline: Public sector debt 1/	91.4	70.2	58.2	52.6	46.6	**43.0**	**40.0**	**36.5**	**33.7**	**33.1**	**32.8**	**0.8**
o/w foreign-currency denominated	91.4	70.2	58.2	52.6	46.5	43.0	40.0	36.5	33.7	33.1	32.8	
Change in public sector debt	-9.8	-21.1	-12.0	-5.7	-6.0	-3.6	-3.1	-3.5	-2.8	-0.7	-0.3	
Identified debt-creating flows (4+7+12)	3.7	-22.0	-10.4	-7.4	-7.7	-5.1	-5.5	-3.6	-1.1	-1.0	-1.0	
Primary deficit	-7.7	-4.6	-4.4	-4.2	-5.0	-4.2	-4.9	-4.0	-1.8	-1.8	-1.9	
Revenue and grants	27.6	24.2	26.1	25.4	27.0	28.0	28.6	27.7	27.0	26.1	25.6	
Primary (noninterest) expenditure	19.9	19.6	21.7	21.2	22.0	23.8	23.7	23.8	25.2	24.4	23.7	
Automatic debt dynamics 2/	11.3	-17.4	-6.0	-3.2	-2.7	-0.9	-0.5	0.3	0.7	0.8	0.8	
Contribution from interest rate/growth differential 3/	11.3	-17.4	-6.0	-3.2	-2.7	-0.9	-0.5	0.3	0.7	0.8	0.8	
Of which contribution from real interest rate	14.3	-13.9	-4.0	-1.8	0.6	0.4	0.5	1.1	1.5	1.5	1.5	
Of which contribution from real GDP growth	-3.0	-3.5	-2.0	-1.4	-3.3	-1.4	-1.1	-0.8	-0.8	-0.7	-0.7	
Contribution from exchange rate depreciation 4/	0.0	0.0	0.0	0.0	0.0	...	...	...	...	...	...	
Other identified debt-creating flows	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Privatization receipts (negative)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes (2-3) 5/	-13.5	0.9	-1.6	1.7	1.7	1.6	2.4	0.2	-1.7	0.3	0.8	
Public sector debt-to-revenue ratio 1/	331.5	289.7	223.4	207.0	172.6	153.6	139.6	131.7	125.1	126.6	128.1	
Gross financing need 6/	3.2	4.2	2.3	1.2	1.9	1.9	1.3	1.9	3.8	3.3	3.3	
in billions of U.S. dollars	0.5	0.9	0.5	0.3	0.6	0.6	0.5	0.7	1.5	1.4	1.5	
Scenario with key variables at their historical averages 7/						**43.0**	**42.3**	**39.3**	**34.5**	**31.6**	**29.2**	**0.1**
Scenario with no policy change (constant primary balance) in 2005-2010						**43.0**	**40.7**	**37.0**	**31.8**	**28.7**	**26.0**	**0.7**
Scenario with WTI at 40 dollars per barrel in 2006-2010						**43.0**	**41.0**	**38.6**	**36.7**	**36.6**	**36.8**	**...**
Key Macroeconomic and Fiscal Assumptions Underlying Baseline												
Real GDP growth (in percent)	2.8	5.1	3.3	2.7	6.9	3.2	2.7	2.2	2.2	2.2	2.2	
Average nominal interest rate on public debt (in percent) 8/	6.3	6.8	5.7	5.8	5.6	5.7	6.9	7.4	7.7	8.2	8.5	
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	13.3	-18.7	-6.2	-3.1	1.5	1.2	1.5	3.1	4.3	4.7	5.0	
Nominal appreciation (increase in US dollar value of local currency, in percent)	0.0	0.0	0.0	0.0	0.0	...	...	...	...	...	...	
Inflation rate (GDP deflator, in percent)	-7.0	25.5	11.9	8.9	4.1	4.6	5.4	4.3	3.3	3.5	3.5	
Growth of real primary spending (deflated by GDP deflator, in percent)	7.3	3.7	14.2	0.4	11.2	11.6	2.2	2.3	8.2	-1.0	-0.4	
Primary deficit	-7.7	-4.6	-4.4	-4.2	-5.0	-4.2	-4.9	-4.0	-1.8	-1.8	-1.9	

1/ Indicate coverage of public sector, e.g., general government or nonfinancial public sector. Also whether net or gross debt is used.
2/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; α = share of foreign-currency denominated debt; and ε = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).
3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi (1+g)$ and the real growth contribution as -g.
4/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha\varepsilon(1+r)$.
5/ For projections, this line includes exchange rate changes.
6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.
7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.
8/ Derived as nominal interest expenditure divided by previous period debt stock.
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Figure 1. Ecuador: Public Debt Sustainability: Bound Tests 1/
(Public debt in percent of GDP)



Sources: Central Bank of Ecuador, Ministry of Finance, and Fund staff estimates and projections.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.

2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.

3/ A permanent decline of the oil prices (WTI) to US$40 and 10 percent of GDP shock to contingent liabilities occur in 2006. The standard scenario assuming 30 percent real depreciation is excluded because Ecuador uses dollar as its legal tender.

Table 2. Ecuador: External Debt Sustainability Framework, 2000–10
(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	Debt-stabilizing non-interest current account 7/
A. Baseline: External debt	82.9	68.4	66.8	59.5	53.4	**49.9**	**44.4**	**38.4**	**32.9**	**29.9**	**27.8**	**-3.9**
Change in external debt	-15.1	-14.6	-1.6	-7.3	-6.1	-3.5	-5.5	-6.0	-5.5	-3.1	-2.0	
Identified external debt-creating flows (4+8+9)	-5.2	-23.1	-9.6	-11.1	-8.7	-5.3	-4.8	-4.2	-2.9	-2.3	-1.7	
Current account deficit, excluding interest payments	-12.8	-1.5	0.7	-2.4	-2.7	-2.2	-2.4	-1.6	-0.1	0.5	1.1	
Deficit in balance of goods and services	-7.9	2.6	5.0	1.5	0.7	1.2	0.8	1.8	3.5	4.3	5.1	
Exports	37.2	27.2	25.4	26.6	29.6	34.2	34.7	32.9	31.2	29.7	28.5	
Imports	29.3	29.8	30.4	28.1	30.4	35.5	35.5	34.7	34.7	34.0	33.6	
Net non-debt creating capital inflows (negative)	-4.5	-6.3	-5.2	-5.7	-3.8	-4.7	-4.4	-4.3	-4.2	-4.1	-4.1	
Automatic debt dynamics 1/	12.1	-15.3	-5.0	-3.0	-2.2	1.6	2.0	1.8	1.5	1.4	1.2	
Contribution from nominal interest rate	7.6	4.8	4.2	4.1	3.8	3.2	3.2	2.7	2.3	2.0	1.9	
Contribution from real GDP growth	-2.9	-3.2	-2.0	-1.6	-3.7	-1.6	-1.2	-0.9	-0.8	-0.7	-0.6	
Contribution from price and exchange rate changes 2/	7.4	-16.9	-7.3	-5.5	-2.3	...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2–3) 3/	-9.8	8.6	8.0	3.8	2.6	1.9	-0.6	-1.8	-2.7	-0.7	-0.3	
External debt-to-exports ratio (in percent)	223.0	251.8	262.8	223.7	180.0	145.8	128.1	116.8	105.6	100.4	97.4	
Gross external financing need (in billions of U.S. dollars) 4/	2.1	2.9	3.9	4.1	4.3	4.3	4.2	4.2	4.1	3.2	3.3	
in percent of GDP	13.5	13.8	16.0	15.0	14.3	13.1	11.8	11.2	10.2	7.6	7.3	
Scenario with key variables at their historical averages 5/						**49.9**	**45.2**	**38.3**	**29.9**	**23.2**	**16.7**	**-3.7**
Scenario with WTI at 40 dollars per barrel in 2006–10 6/						**49.9**	**49.5**	**47.7**	**45.5**	**45.0**	**45.0**	**...**
Key Macroeconomic Assumptions Underlying Baseline												
Real GDP growth (in percent)	2.8	5.1	3.3	2.7	6.9	3.2	2.7	2.2	2.2	2.2	2.2	
GDP deflator in U.S. dollars (change in percent)	-7.0	25.5	11.9	8.9	4.1	4.6	5.4	4.3	3.3	3.5	3.5	
Nominal external interest rate (in percent)	7.4	7.6	7.2	6.9	7.2	6.4	7.0	6.5	6.4	6.5	6.6	
Growth of exports (U.S. dollar terms, in percent)	12.6	-3.7	8.2	17.1	24.1	24.6	9.7	1.1	0.0	0.9	1.6	
Growth of imports (U.S. dollar terms, in percent)	21.0	34.2	18.0	3.5	20.1	26.0	8.3	4.2	5.4	3.8	4.7	
Current account balance, excluding interest payments	12.8	1.5	-0.7	2.4	2.7	2.2	2.4	1.6	0.1	-0.5	-1.1	
Net non-debt creating capital inflows	4.5	6.3	5.2	5.7	3.8	4.7	4.4	4.3	4.2	4.1	4.1	

1/ Derived as $[r - g - \rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator in U.S. dollar terms, g = real GD
ε = nominal appreciation (increase in dollar value of domestic currency), and α = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as $[-\rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock. ρ increases with an appreciating domestic currency ($\varepsilon > 0$) and rising inflat (based on GDP deflator).

3/ For projection, line includes the impact of price and exchange rate changes.

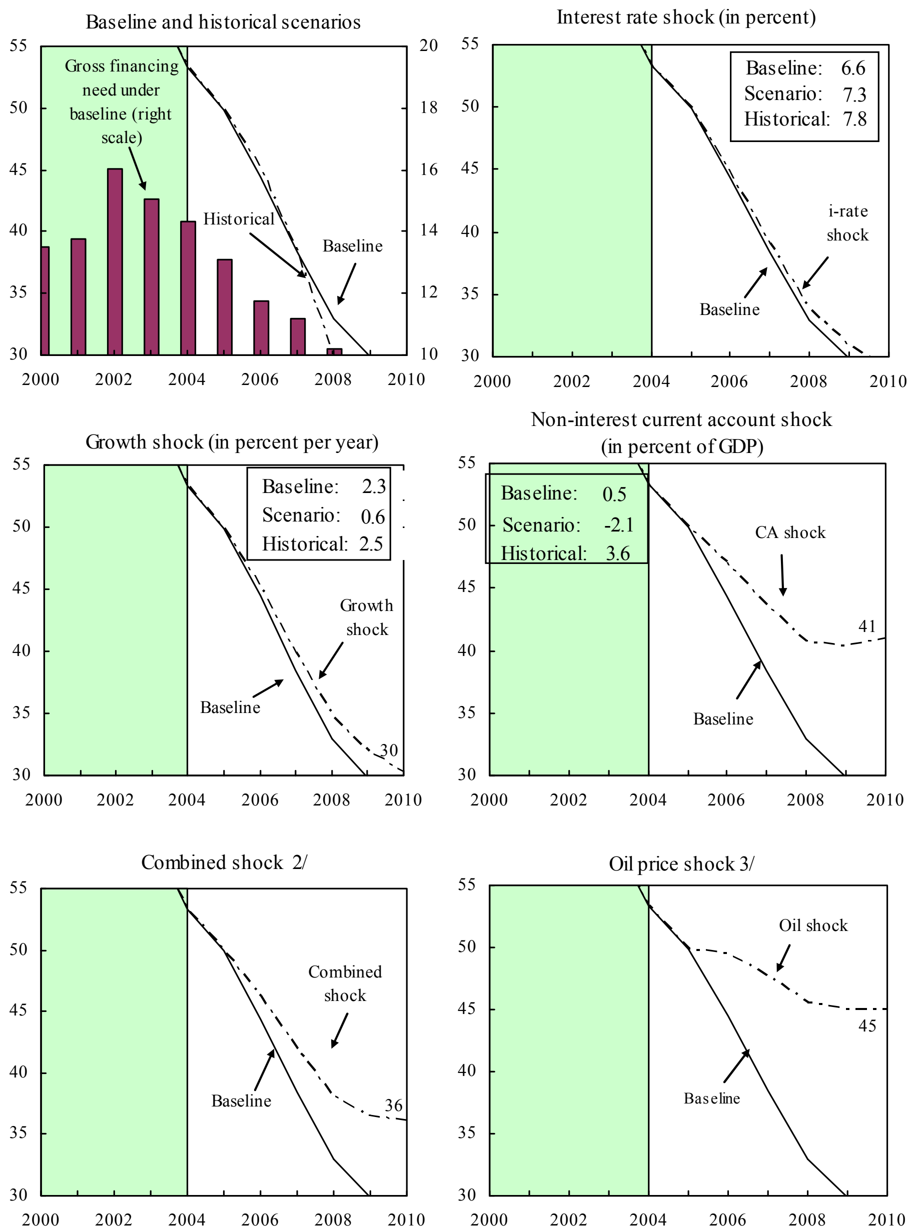
4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

6/ Assuming no effect from fall in oil prices on GDP.

7/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their level of the last projection year.

Figure 2. Ecuador: External Debt Sustainability: Bound Tests 1/
(External debt in percent of GDP)



Sources: Central Bank of Ecuador, Ministry of Finance, and Fund staff estimates and projections.
1/ Shaded areas represent actual data. Individual shocks are permanent 1/2 standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.
3/ A permanent decline of the oil prices (WTI) to US$40. The standard scenario assuming 30 percent real depreciation is excluded because Ecuador uses dollar as its legal tender.

ECUADOR: FUND RELATIONS
(As of November 30, 2005)

I. Membership Status:

Joined: 12/28/45 Status: Article VIII

II. General Resources Account:	SDR Million	In percent of Quota
Quota	302.30	100.00
Fund holdings of currency	343.67	113.69
Reserve position in Fund	17.15	5.67

III. SDR Department:	SDR Million	In percent of Allocation
Net cumulative allocation	32.93	100.00
Holdings	2.02	6.13

IV. Outstanding Purchases and Loans:	SDR Million	In percent of Quota
Stand-By Arrangements	58.52	19.36

V. Safeguards Assessments:

An on-site safeguard assessment was conducted in March 2003 and the safeguards assessment report was approved by management on June 23, 2003. The assessment identified a need to strengthen the audit oversight and reporting frameworks at the BCE. In this regard, the BCE committed to the implementation of the safeguards recommendations, including the timely publication of its annual audited financial statements, which are yet to be published.

VI. Latest Financial Arrangements:

Type	Approval Date	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
Stand-By	03/21/2003	04/20/2004	151.00	60.40
Stand-By	04/19/2000	12/31/2001	226.73	226.73
Stand-By	05/11/1994	12/11/1995	173.90	98.90

VII. Projected Obligations to the Fund (Expectations Basis):
(SDR million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2005	**2006**	**2007**	**2008**	**2009**
Principal	3.78	39.65	15.10	...	...
Charges/Interest	...	2.53	1.26	0.93	0.93
Total	**3.78**	**42.17**	**16.36**	**0.93**	**0.93**

VIII. Projected Obligations to the Fund (Obligation Basis):
(SDR million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2005	**2006**	**2007**	**2008**	**2009**
Principal	...	3.78	39.65	15.10	...
Charges/Interest	...	3.40	2.53	1.27	0.93
Total	**...**	**7.17**	**42.18**	**16.37**	**0.93**

IX. Exchange Rate Arrangement:

On February 12, 1999 the central bank abandoned the exchange rate band and floated the *sucre*. On March 9, 2000 the economy was dollarized at 25,000 *sucres* per U.S. dollar.

Ecuador has accepted the obligations of Article VIII, Sections 2, 3, and 4. However, Ecuador maintains an **exchange restriction** subject to Fund approval under Article VIII, Section 2(a) in the form of a freeze on demand and savings deposits in closed banks. This exchange restriction was approved by the Executive Board on March 21, 2003 until December 31, 2003.

X. Last Article IV Consultation and Recent Contacts:

On July 26, 2004, the Executive Board concluded the 2004 Article IV Consultation. The authorities requested to continue with an intensified surveillance of their policies, and in this context missions visited Quito in December 2004, and May and August 2005.

XI. Technical Assistance:

MAE	FSAP	January 2004 September 2003
MAE	Assist in the design of a strategy for dealing with banks' systemic problems.	January 2000
STA	Assist in the preparation of the central bank accounts under dollarization.	January 2000
MAE	Role of central bank under dollarization.	February 2001
STA	ROSC	April 2002

STA	Balance of Payments statistics	July 2002
FAD	ROSC	December 2003
STA	Monetary and financial statistics	March 2004

XI. Resident Representative:

Mr. Jorge Guzman, stationed in Quito since September 2005, replaced Mr. David Yuravlivker.

ECUADOR: RELATIONS WITH THE WORLD BANK

(In millions of U.S. dollars)

	Commitments	Disbursements	Undisbursed	Repaid	Outstanding
I. IBRD/IDA Operations (as of September 1st, 2005) 1/					
Total loans	2,603.47	2,393.16	210.31	1,704.17	688.99
Active loans	290.4	80.09	210.31	7.50	72.59
Closed loans	2,313.07	2,313.07	0.0	1,696.67	616.4
Active loans (by loan purpose)					
Total	**259.09**	**82.76**	**176.3**		
Adjustment	100	0	100		
Rural development	25.2	15.1	10.10		
Health	45	32.28	12.72		
Water	32.0	25.24	6.76		
Power	23	6.74	16.26		
Governance	33.86	3.4	30.46		

II. IFC Operations (as of September 1st, 2005)

	Loans	**Equity**	**Participation**
Commitments			
Net total held by IFC			
Total undisbursed			

III. IBRD Loan Transactions (calendar year)
(Includes IDA repayments)

	2001	**2002**	**2003**	**2004**	**2005**
Disbursements	123.6	25.2	152	28	23
Repayments	76.5	86.4	93	83	50
Net lending	47.1	-61.2	58	-55	-27

Source: World Bank.

[1] Net of cancellations.

The Bank engagement in Ecuador remains in the Base Case scenario (US$250 million per year: US$100 million for adjustment and $150 million for investment). In the last two FYs, the Bank has approved three projects, all of which are not yet signed: PRODEPINE II (US$36 million in FY04—and is now cancelled); Institutional Reform (US$30 million in FY04—being redesigned by increasing component by approximately $30 million); and the Fiscal Consolidation Programmatic (US$100 million in FY05—currently on hold due to policy reversals on the program supported by the loan). There are three investment operations and one adjustment operation planned for FY06: Rural Roads (US$20 million—has been in the pipeline for the last three FYs), Education (US$35 million), *Bono de Desarrollo Humano* (currently being defined), and Human Development Programmatic (US$100 million—slipped from last year).

ECUADOR: RELATIONS WITH THE INTER-AMERICAN DEVELOPMENT BANK

(As of September 30, 2005)

I. IDB OPERATIONS

(In million of U.S. dollars)

	Approved	Disbursed	Undisbursed
Active loan portfolio total (approved and not fully disbursed)	**503.56**	**263.08**	**240.48**
Total (historical)	**4,223.11***	**3,982.63**	**240.48**

Source: Inter-American Development Bank.

* The total amount approved is US$4,771.0 million. The difference represents cancellations. The outstanding debt to the Bank is US$1,879.0 million.

II. IDB LOAN TRANSACTIONS

(In millions of U.S. dollars)

	1999	2000	2001	2002	2003	2004
Disbursements	141.5	237.7	165.0	86.0	157.2	48.5
Repayments	106.8	124.2	113.6	136.1	139.2	163.7
Net lending	34.7	113.5	51.4	-50.1	18.0	-115.2

Source: Inter-American Development Bank.

The Bank's pipeline for 2005–06 provides for a lending program of eleven operations totaling U$320 million, and a non-reimbursable technical cooperation program of approximately US$8 million. The IDB supports the Government of Ecuador's efforts to increase productivity, to improve social programs for the most vulnerable groups and to enhance the quality of public sector administration. The Bank is completing the preparation of a fast-disbursing programmatic loan for US$100 million to improve competitiveness as well as investment loans in areas such as tourism, potable water, the environment, rehabilitation of urban infrastructure, and natural-disaster prevention.

ECUADOR: STATISTICAL ISSUES

In spite of shortcomings, macroeconomic data are adequate for surveillance purposes. Ecuador subscribed to the Special Data Dissemination Standard (SDDS) in March 1998, and meets the specifications for coverage, periodicity, and timeliness of the data categories. An advance release calendar and the metadata for Ecuador are posted on the Fund's Dissemination Standards Bulletin Board. A data ROSC module was completed in March 2003.

Real sector

Two series of national accounts (NA) are being compiled using 1975 and 1993 as base years and following the methodology of the *1968 SNA* and *1993 SNA,* respectively. Following a data ROSC mission in April 2002, the authorities published, at the end of that year, GDP series for the period 1993–2001 in current and constant 2000 dollars. The authorities have been planning to extend this series to 1965, but this has not been completed. Preliminary quarterly NA is being reported with about a three-month lag. The authorities think that deficiencies remain in the NA, and have asked for technical assistance. Publication of a monthly producer price index (PPI) started in 1998. Labor market data have become more available—monthly surveys are done by a private university while the national statistics bureau does a more comprehensive annual survey. Published survey results include employment, unemployment, participation rates, and some private sector wage data. Reliable data on public sector employment are still unavailable.

Government finance

The compilation and reporting of central government data deteriorated following problems with the introduction of a new information system (SIGEF). Above-the-line data for some nonfinancial public sector entities continue to suffer from long reporting lags and unreliable information. When ownership of public companies was transferred to the Solidarity Fund in 1999, financial information on these companies was no longer recorded. In addition, data on the operations of local governments are only available on an annual basis.

The resumption of reporting annual data on the budgetary central government for publication in the GFS Yearbook is highly recommended. The most recently reported annual GFS data were for 1994.

Monetary accounts

A major effort was undertaken in 2000 by the central bank, with Fund support, to adapt the presentation of its balance sheet to the requirements of official dollarization. Remaining issues were resolved during a monetary and financial statistics mission in March 2004. The 2004 mission concluded that with the introduction of a sectorization matrix (supplementary information to the one obtained through commercial banks' balance sheets), the quality of the sectorization of financial instruments and the distinction between residents and nonresident accounts is adequate. Furthermore, public sector deposits are properly identified in the sectoral balance sheet of depository corporations, as compiled by the mission in collaboration with the authorities. Finally, data on offshore banks are currently being compiled following the same high quality standards as the onshore banks, but have yet to become available.

External sector

Balance of payment and international investment position (IIP) statistics are compiled and disseminated by the CBE. Ecuador, a SDDS subscriber since March 1998, also reports according to the Data Template on International Reserves and Foreign Currency Liquidity, and began disseminating quarterly data on the SDDS prescribed external debt data category (with a one-quarter lag) in June 2003. In August 2001, a STA mission assisted the authorities in resolving a number of technical issues regarding the international reserves template.

Currently, Ecuador reports to STA quarterly balance of payments statistics as well as annual IIP data for publication in *IFS* and the *Balance of Payments Statistics Yearbook*. In October 2002, the authorities reported quarterly balance of payments statistics for the period 1993–2001 as well as annual IIP data for the period 1993–2001. The data are mainly compiled according to the methodology of the fifth edition of the *Balance of Payments Manual (BPM5)*.

The IIP data were prepared with the assistance of a STA mission that visited Quito in July 2002. The mission recommended improvement in the estimates of travel services, introducing surveys of direct investment and portfolio investment, improvement in the recording of external debt transactions, and recording of reserve assets. The mission also made recommendations for further improvements in the compilation of the IIP. While the recording of balance of payments transactions has improved, some deficiencies remain, particularly in the estimation of profit remittances, non-oil direct investment, and private capital flows. The authorities have requested technical assistance to address these issues. STA, with the support of WHD, is considering sending a TA mission on balance of payments statistics in early FY 2007.

Table of Common Indicators Required for Surveillance
(as of December 20, 2005)

	Date of latest observation	Date received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of Publication[6]	Memo Items: Data Quality – Methodological soundness[7]	Memo Items: Data Quality – Accuracy and reliability[8]
Exchange Rates	11/30/05		D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]							
Reserve/Base Money	Oct. 2005	Dec. 2005	D	D	W	O, LO, LO, LO	LO, O, O, LO, LO
Broad Money	Oct. 2005	Dec. 2005	W	W	W		
Central Bank Balance Sheet	Oct. 2005	Dec. 2005	W	W	W		
Consolidated Balance Sheet of the Banking System							
Interest Rates[2]	Nov. 2005	Dec. 2005	W	W	W		
Consumer Price Index	Nov 2005	Dec 2005	M	M	M	O, LO, O, LO	LO, O, O, O, O
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	July 2005	Sept 2005	M	M	M	LO, LO, LO, O	LNO, LO, LO, O, NO
Revenue, Expenditure, Balance and Composition of Financing[3] – Central Government	July 2005	Sept 2005	M	M	NA		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	July 2005	Sept 2005	M	I	Q		
External Current Account Balance	3/31/05	Jul 2005	Q	Q	Q	LO, LO, LO, LO	LO, LO, O, LO, NO
Exports and Imports of Goods and Services							
GDP/GNP	2004	July 2005	Q	Q	Q	O, O, LO, LO	LO, O, O, O, LO
Gross External Debt	8/30/01	9/15/01	M	M	M		

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5] Including currency and maturity composition.
[6] Daily (D); weekly (W); monthly (M); quarterly (Q); annually (A); irregular (I); and not available (NA).
[7] Reflects the assessment provided in the data ROSC or the Substantive Update (published on March 14, 2003, and based on the findings of the mission that took place during April 1l-25, 2002) for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O); largely observed (LO); largely not observed (LNO); not observed (NO); and not available (NA).
[8] Same as footnote 7, except referring to international standards concerning source data, statistical techniques, assessment and validation of source data, assessment, and revision studies

Statement by the Staff Representative on Ecuador
January 25, 2006

Since the issuance of the staff report, Mr. Diego Borja has replaced Ms. Magdalena Barreiro as finance minister in the Palacio government. A staff team visited Quito on January 17–18, 2006 to meet with Mr. Borja to discuss his policy approach. Additional information has also become available on inflation. The information in this statement does not alter the thrust of the staff appraisal.

1. **Inflation ended the year higher than anticipated**. The 12-month CPI inflation rate increased to 4.4 percent (projected inflation was 4.0 percent) in December 2005, largely reflecting surging housing rent inflation and education costs.

2. **The new minister of finance, Mr. Diego Borja, is committed to an economic program that broadly maintains the same lines as that of his predecessor described in the staff report.**

- In discussion with staff, the Minister emphasized the authorities' firm commitment to fiscal discipline and to orient fiscal policy toward reducing recent inflation pressures. He noted that the President had signed a decree to cut spending by 1 percent of GDP from the budget approved by Congress (with cuts in recurrent spending across ministries and the cancellation of low-priority capital projects), to bring overall central government spending back in line with the government's original budget proposal. The authorities' new fiscal target for 2006 is consistent with the staff report's recommended nonfinancial primary surplus of 5.2 percent of GDP. The minister also reiterated the authorities' intention to use excess financial resources to repurchase high-interest external debt and short-term domestic debt.

- The minister outlined plans to strengthen fiscal transparency and expenditure management. In particular, he stated that the government would establish mechanisms to improve the governance, transparency, and public accountability for funds earmarked in the Fiscal Responsibility Law, so as to ensure that they would be used to finance only projects of the highest quality. The staff endorsed efforts to strengthen the oversight of these funds but expressed concern over the important role planned for the public banks in this process, especially given their poor past record in areas of governance and administration.

- No significant changes have been made to existing reform proposals in the oil, electricity, and telecommunications sectors, the financial system, or in trade policy. The authorities plan to continue their preparatory work in the area of tax reform and the reduction of fuel subsidies, although the minister felt that it was unlikely, given the delicate political situation, that the government would launch any initiatives before the October elections.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 06/15
FOR IMMEDIATE RELEASE
February 9, 2006

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2005 Article IV Consultation with Ecuador

On January 25, 2006, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Ecuador.[1]

Background

Despite a difficult political environment, economic growth is estimated to have exceeded 3 percent in 2005, with the non-oil sector expanding by 3½ percent. The strong growth in the oil sector that followed the completion of the new oil pipeline in 2003 has tapered off, but high oil prices have helped bolster confidence and underpin domestic demand.
However, employment growth remains sluggish, with little change in unemployment from 2004.

After declining in early 2005, inflation picked up in the second half of the year. The 12-month headline inflation rose from 2 percent in June 2005 to 4.4 percent at the end of the year, in a context of strong growth in bank credit and public spending.

In recent years, non-financial public sector (NFPS) primary surpluses have been maintained consistently above 4 percent of GDP, reflecting mainly high oil revenues, which have helped to reduce public debt from over 90 percent of GDP at end-2000 to 43 percent of GDP at end-2005. However, the underlying fiscal stance weakened in 2005. While the primary surplus of the NFPS is projected at 4.2 percent of GDP, the non-oil deficit is projected to have increased

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies.
On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

to 5 percent of GDP in 2005, driven by the growing cost of fuel subsidies and the continued rapid expansion of recurrent spending, especially on wages and pensions.

The external current account deficit is estimated to have remained unchanged at about 1 percent of GDP, reflecting rapid import growth which offset strong increases in oil and non-oil exports led by shrimp and metal products. While oil sector FDI inflows increased, non-oil FDI remained low in 2005, at less than 1 percent of GDP.

Banking system credit and deposits grew strongly in 2005, while liquidity remained at comfortable levels and other stability indicators continued to improve. Moreover, there was no evidence of spillover effects on deposits or on interest rates from political developments. However, banking intermediation is still well below pre-crisis levels and deposits are overwhelmingly at short maturities.

The authorities successfully regained access to international capital markets with a US$650 million bond issue in December 2005. The EMBI spread declined in the past year, but remains the widest among Latin American countries.

Executive Board Assessment

The Executive Directors commended the Ecuadoran authorities for lowering inflation to international levels and reducing substantially the ratio of public debt to GDP. These achievements, together with high international prices for Ecuador's oil exports, have contributed to a generally positive macroeconomic performance and increasing confidence in 2005, which was reflected in the successful placement by Ecuador of an international bond in December 2005. Directors acknowledged the resilience of the economy in the face of the difficult political environment.

Directors expressed concern, however, about the broader orientation of policies. In particular, the non-oil fiscal deficit has increased significantly, reflecting mainly the rising cost of fuel subsidies and difficulties in controlling recurrent spending. Recent changes in the fiscal responsibility law, the pension system, and the new tax incentives legislation risk weakening the macroeconomic policy framework. Directors urged the authorities to take advantage of the current favorable external environment to address underlying vulnerabilities, especially in the fiscal area and the financial system, to ensure long-run macroeconomic stability, strong and sustained growth, and increasing job opportunities.

Directors commended the authorities for their plan to strengthen the fiscal policy stance in 2006 to address the recent increase in inflationary pressures and to put the public finances on a more sustainable track. They supported the authorities' intention to restrain recurrent spending, strictly prioritize capital and social spending, and take steps to ensure that projects are evaluated, prioritized, and monitored effectively. Directors urged the authorities to resist pressures for more spending in the pre-election period, and welcomed their plans to use proceeds from the recent international bond issue only for debt management purposes.

Directors stressed the need to strengthen the institutional framework for promoting fiscal discipline, reduce dependence on oil revenue, increase budget flexibility, and improve the quality of government spending. Most called for a redesign of the fiscal responsibility law to target a lower debt-to-GDP ratio, improve transparency in the fiscal rules, increase accountability, and encourage the efficient use of the country's oil wealth. The authorities should follow through on plans for tax reform, in particular to eliminate exemptions, broaden the tax base, and simplify the tax system. Directors emphasized the importance of developing a coherent civil service reform to control wage costs, and of moving ahead with plans to reform the pension system and set it on a sound actuarial foundation. They supported the authorities' request for Fund technical assistance on the pension reform. Directors recommended that highly distortional fuel subsidies be reduced substantially and that the social safety net to protect the most vulnerable groups be strengthened to help them cope with the subsidy cuts.

Directors welcomed the ongoing efforts to improve financial sector supervision and regulation, including the progress already made in implementing some of the 2004 Financial Sector Assessment Program recommendations. They urged the authorities to move ahead with other FSAP recommendations to strengthen the banking system, which will help to improve efficiency and achieve a durable reduction in interest rates. Directors welcomed the recent passage of anti-money laundering legislation and a law to strengthen credit bureaus, and the plans to strengthen the payment system and bankruptcy procedures. At the same time, they stressed the need to develop an effective deposit insurance system and a mechanism to provide an adequate lender-of-last-resort function. Also, outstanding issues from the 1998–99 banking crisis need to be resolved, in particular the liquidation of the remaining closed banks, and the return of deposits frozen in these banks. While agreeing that the high costs of intermediation and constraints on access to credit need to be addressed, Directors expressed grave concerns about the provisions in the banking reform bill that would introduce administrative controls on interest-rate spreads and the allocation of credit, as these could stifle the needed expansion of financial intermediation and jeopardize banking system stability.

Directors observed that a significant intensification of structural reforms will be needed to sustain competitiveness, improve the investment climate, and strengthen the economy's resilience to adverse shocks. Slow progress on key structural reforms is preventing the economy from reaping the full benefits of dollarization—in particular, low interest rates and a stable investment and trade environment—and could threaten the sustainability of the dollarization regime in the future.

Directors agreed that a high priority should be given to developing the petroleum sector, including through a comprehensive reform of PetroEcuador. They urged the authorities to define a timetable for administrative reforms at PetroEcuador, including the external financial audit of the company, and the auctioning of new fields for exploration and extraction. It will also be important to eliminate legal uncertainties and strengthen the regulatory framework in the petroleum sector, and to ensure market-based price setting for oil refining and retailing, in order to attract the needed increase in private investment to the sector.

Directors observed that the formal dollarization of Ecuador's economy poses a challenge to maintaining competitiveness, and highlights the importance of raising economic efficiency, increasing labor market flexibility, and improving the investment climate. In that context, Directors supported the authorities' plans to contract with the private sector for the management of the public enterprises in the electricity distribution and telecommunications areas. They noted that, to attract more private investment for the essential expansion of electricity generating capacity, electricity subsidies will need to be reduced and intra-sector debts resolved as planned, and electricity tariffs will have to be set to reflect real generation and distribution costs.

Directors commended the authorities' efforts to finalize a free trade agreement with the United States, which, apart from promoting increased trade and competition, could improve the investment climate. Directors urged the authorities to continue to support multilateral trade liberalization initiatives as well.

Directors noted that data provision to the Fund is adequate for surveillance, but encouraged the authorities to continue to address remaining shortcomings, including in certain areas of the balance of payments statistics, fiscal accounts, and labor market data. They welcomed Ecuador's participation in the Special Data Dissemination Standard (SDDS).

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case. The staff report for the Article IV consultation with Ecuador may be made available at a later stage if the authorities consent.

Table 1. Ecuador: Selected Economic and Financial Indicators

	2002	2003	2004	Proj. 2005
(Annual percentage changes; unless otherwise indicated)				
National income and prices				
Real GDP	3.4	2.7	6.9	3.2
Real GDP per capita	1.9	1.2	5.4	1.2
Consumer price index end-of-period	9.4	6.1	1.9	4.3
Real effective exchange rate (depreciation -) 1/	11.3	-1.3	-4.6	-2.9
Banking system				
Liabilities to the private sector	18.2	18.6	27.1	21.2
Credit to the private sector	13.6	4.5	28.6	26.2
EMBI Ecuador (bps, end of period)	1,801	799	690	669
(In percent of GDP, unless otherwise indicated)				
Public finances				
Revenue	26.0	25.4	27.0	28.0
Non-interest expenditure	21.5	20.7	22.0	23.8
Primary balance (deficit -)	4.5	4.7	5.0	4.2
Overall balance (deficit -)	1.0	1.7	2.3	1.7
Total public debt	**58.2**	**52.6**	**46.5**	**43.2**
Domestic	11.3	10.4	10.0	9.5
External	46.9	42.2	36.5	33.7
Saving investment balance				
National saving	22.8	25.9	26.7	26.3
Gross investment	27.7	27.7	27.8	27.2
Foreign saving = - external current account balance	4.9	1.7	1.1	1.0

Sources: Central Bank of Ecuador; Ministry of Finance; and IMF staff estimates and projections.

1/ October data for 2005.

Statement by Eduardo Loyo, Executive Director for Ecuador
January 25, 2006

1. I would like thank staff for a well-balanced set of papers, which my Ecuadorian authorities have agreed to publish in accordance with the Fund's policy on corrections and deletions. My authorities have also expressed their intention to maintain the current practice of quarterly consultations with the Fund staff.

Recent macroeconomic developments

2. Since the last Article IV consultation in July 2004, most economic indicators have evolved in a favorable manner, a reflection of enhanced confidence and a supportive external environment. Real GDP growth surpassed 3 percent in 2005, following a very strong performance in 2004, when it reached 6.9 percent. Notably, while 2004 growth had been mainly driven by the oil sector, non-oil GDP is expected to have grown faster than the aggregate in 2005, by 3.5 percent.

3. Inflation remains low, in spite of some acceleration over the last few months – CPI inflation closed 2005 at 4.4 percent, compared to 2 percent in 2004. It must be borne in mind that this acceleration has taken place against a background of convergence to inflation rates observed in the US – a critical element in a dollarized economy – which had actually ended with Ecuadorian inflation running for several months *below* US rates. As staff rightly observes, the recent pick-up in inflation has not implied a perceptible loss of competitiveness vis-à-vis the US. In fact, there has been a boost to Ecuador's competitive position with respect to regional trading partners experiencing important nominal appreciations against the dollar. Since 2003, the real effective exchange rate has depreciated by nearly 10 percent. The December 2005 Inflation Report by the Central Bank of Ecuador indicates that "imported" inflation – resulting from nominal *effective* depreciation together with the inflation of trading partners – has had a noticeable influence on the recent price dynamics of tradeable goods in Ecuador.

4. It should also be noted that residential rents have been a key driver of the recent acceleration of inflation. Rents responded single-handedly for no less than 60 percent of the yearly inflation observed in 2005. Rental increases were not only unmatched by other nontradeable items in the consumption basket but were also very unevenly distributed across different areas of the country and types of residence. The causes of such a localized phenomenon are not entirely clear, but they would presumably involve elements of a microeconomic nature.

5. To reach a thorough understanding of the recent inflationary phenomenon in Ecuador, one ought to examine these localized and imported pressures alongside other possible suspects, including growth in credit and fiscal spending. Such examination would shed important light on what could have reasonably been achieved in 2005 with a counterfactual stance towards aggregate demand. Anyway, my authorities are fully cognizant of the

importance of controlling fiscal spending in 2006 in order to avoid a build-up of demand pressures on inflation and to rein in the propagation of any exogenous inflationary shocks.

6. Enormous efforts to maintain a prudent fiscal policy have been a critical element in the authorities' strategy to consolidate macroeconomic stability and enhance private sector confidence. Staff indicates that the non-oil primary balance has deteriorated between 2003 and 2005, with the deficit of the central government increasing from 1 percent to 3 percent of GDP. It must be noted, however, that the net contribution of domestic sales of petroleum derivatives (which are classified as *non-oil* revenues) alone, during that period, fell by a total of 2.2 percentage points of GDP. This deteriorating component reflects the fact that domestic prices of petroleum derivatives have not been kept in alignment with international prices, a policy followed by several countries besides Ecuador when their social safety nets are unable to provide the poor with targeted relief from soaring energy costs. This component of the government's net spending would be automatically scaled back in tandem with a drop in international oil prices, a crucial consideration for any assessment of the budget's overall vulnerability to oil revenue fluctuations.

7. My authorities, however, recognize as imperative to keep in check the increase in the non-oil deficit, as witnessed most recently by the President's Executive Decree of January 13 reducing the projected 2006 budget deficit by US$316 million. They are also aware of the inherently distortionary character of the subsidies to oil derivatives. Regarding the latter, they consider a bottom-up approach to raising public awareness about the inefficiency and inequity of the subsidies to be a critical first step that could, under more propitious political conditions, eventually lead to their reduction. Accordingly, they will encourage and support civil society initiatives to put the theme in the public domain and help disseminate the necessary information.

8. The non-financial public sector (NFPS) has been consistently posting primary surpluses between 4 and 5 percent of GDP, and its overall surplus has hovered around 2 percent of GDP. As a result, the public debt burden has been declining and is set to continue to do so. The net debt of the NFPS is projected to have closed 2005 at 34 percent of GDP, down 4 percentage points from 2004, 11 percentage points from 2003, and a staggering 30 percentage points since 2001. Evidently, the fiscal position could have been even better if the recent upsurge in oil prices had been allowed to reflect itself in an improved overall primary surplus. My authorities are well aware of the policy options they have been facing in the fiscal front in the recent past. On the one hand, there is the option favored by staff of devoting most of if not all the oil windfall to increase the overall primary surplus and to further accelerate the process of fiscal consolidation and debt reduction. The technical merits of such an option are evident. However, it is a course of action that seldom passes the test of political reality, and understandably so in countries like Ecuador, where the fiscal indicators are reckoned by staff to be "generally superior" among Latin American and emerging market economies (Selected Issues, chapter I, paragraph 29), debt reduction is already making considerable progress, and dire social needs renders it very challenging to maintain expenditure constant in face of buoyant oil prices.

9. Foreign financial conditions have been favorable, and Ecuador has made good use of them. In late 2005, and for the first time in eight years, the government successfully placed a 10-year global bond for $595 million. The proceeds of this issuance are to be entirely devoted to repaying or buying back other debt obligations. Notwithstanding the rapid rate of growth of imports, the external current account deficit has remained stable, at only around 1 percent of GDP, comfortably financed by both oil and non-oil FDI.

10. In the domestic financial front, the most salient feature has been the robust increase in bank deposits, a clear sign of confidence in the financial system in general, and in the sustainability of dollarization in particular. As a result, credit to the private sector continues in a salutary process of recovery from the contraction caused by the 1999 banking crisis, in a context of declining non-performing loans and continuous increase in the capital-to-assets ratio. Credit has not yet rebounded completely from the losses associated with the crisis, and the recovery of financial intermediation, if anything, had been deemed too slow. It is in that light that one should assess the acceleration in credit growth observed in 2005, bearing in mind also that the Ecuadorian economy displays one of the lowest ratios of credit to GDP among comparable economies in the region – regional standards being themselves far from stellar – and that enhancing financial intermediation remains a key policy objective.

Structural reforms

11. While the extremely complicated political situation has not derailed the government's efforts at consolidating macroeconomic stability, it has certainly played a decisive role in delaying the reform agenda. The limited action that has taken place in that front is the direct result of the difficulties faced by a government that does not hold a majority in Congress – it is actually not affiliated with any political party – when most structural reforms require congressional approval and the political climate is hotly contested. In all candor, my authorities admit that the electoral calendar – with general elections scheduled for October – is unlikely to make the political situation any easier over the coming months.

12. The reform agenda is long and I shall not delve into the many items on the merits of which staff and my authorities broadly agree, and which were endorsed by the Executive Board during the last Article IV consultation. As staff reports, the authorities are ready to advance preparatory technical work on a number of items, relying in some cases on technical assistance from the Fund and from other multilateral institutions. Broader overtures in the attempt to build social consensus, however, would need to be managed with care in order not to jam the political radar screen and to prevent negative partisan positions towards specific reforms from becoming overly crystallized if caught into the heat of the electoral debate.

13. My authorities feel, however, that important clarifications are in order regarding the changes made to the Fiscal Responsibility Law (FRL) and to the Social Security Institute's (IESS) reserve fund, both of which, staff contends, amounted to a serious weakening of the overall fiscal framework. First of all, with respect to the decision to return assets in the IESS reserve fund to employees after three years, it is important to clarify that this was by no means a government initiative. On the contrary, given the decision of Congress, the government did

all it could to mitigate the adverse fiscal implications by setting up a manageable schedule for the mandated transfers.

14. With regard to the FRL, it is imperative to bear in mind that prior to the changes introduced in 2005, the law established (i) a declining ceiling on public debt; (ii) a path for the non-oil fiscal deficit; (iii) a ceiling on the rate of growth of primary expenditure. Only the latter restriction was partially modified, with the cap now applying to the rate of growth of *current* expenditure. With the interlocking checks on debt, deficits and expenditures that remain in force, my authorities are confident that further satisfactory progress in fiscal consolidation will not be jeopardized by the extra degree of freedom targeted at investment spending.

15. On the elimination of the FEIREP oil fund, also part of the FRL amendment, a few clarifications are also in order. Originally, the purpose of FEIREP was to devote 70 percent of its resources to retire debt, 20 percent for stabilization, and the rest for social expenditure. This administration opted for a different arrangement that calls for resources to be incorporated into the budget, to finance debt buybacks, investment projects and social spending. It should be noted that, when FEIREP was eliminated, there were no accumulated resources in the stabilization account, and the debt retirement account had been repeatedly used to finance spending, through operations in which debt was formally retired with FEIREP funds but an equivalent amount returned right away to the government's coffers in exchange for newly issued debt. Multiple reasons lie behind the decision to eliminate FEIREP, but first and foremost the need to address critical expenditure needs both in the social sectors and with regard to public infrastructure. To this effect, the government has been faithful to its commitment not to use any of the funds to finance wages and pensions.

16. My authorities consider the modifications in the FRL – including the elimination of FEIREP – instrumental to make budgetary management viable under strict compliance with these legal provisions, to which they are fully committed. Ensuring that the additional revenues brought on-budget will be put to the most efficient use – including debt retirement – is certainly a challenge of which they are aware. Meeting that challenge has been placed at the very top of their priority list, and the authorities are on record stating so much in no uncertain terms. To that effect, the Ministry of the Economy is currently designing procedures to ensure that ex-FEIREP resources are allocated on a competitive basis and in accordance with economic merit rather than political pressure. The intention is to put in place safeguards that will effectively protect these funds from the imperfections in the preexisting system of resource allocation, including those pointed out by staff with respect to the operations of the public development banks – their improvement being itself another top priority of the economic team. The government has declared that these resources will not be allocated until adequate safeguards are in place.

17. Regarding the financial sector, my authorities are in the process of addressing many of the issues highlighted in the 2004 FSAP. Recently, the banking superintendency has tightened regulations regarding capital and liquidity, and Congress approved legislation strengthening credit bureaus and incorporating a new AML framework. The authorities also agree with staff on the deleterious effects of the financial sector reform recently proposed in Congress, a

reform that caps intermediation spreads and directs lending to specific productive activities. While it is certainly the case that intermediation spreads remain high and that some sectors rightly complain about difficulties in accessing credit, the government fully understands that the remedies proposed by Congress will likely make matters worse, not better. The Ministry of the Economy, the Central Bank of Ecuador and the Internal Revenue Service are joining forces to design policies capable of addressing legitimate concerns about high bank spreads and service fees without negatively impacting the solidity and efficiency of the financial sector.

Medium-term outlook

18. My authorities take note of the medium-term scenarios presented by staff, and agree with their broad qualitative features despite the huge uncertainty necessarily surrounding any attempt to turn such scenarios into quantitative forecasts. In particular, they acknowledge that growth would be considerably enhanced by progress in key reforms, and that faster growth would translate into higher fiscal revenue and a faster decline in the debt-to-GDP ratio. They are heartened, though, by the conclusion that the debt burden would continue declining even in the no-reform scenario, reaching just over 30 percent of GDP in 2010. While important to consolidate confidence in the resilience of fiscal consolidation, that conclusion is obviously no grounds for complacency since any rate of growth similar to that forecasted in the passive scenario would fall way short of what Ecuador requires to make a serious dent on poverty and unemployment. That being the case, my authorities reiterate their commitment to macroeconomic stability and to make every effort to advance the reform agenda –albeit in an adverse political context that should not be conducive to great progress in the short run.