

ECUADOR

STATEMENT BY THE IMF REPRESENTATIVE AT THE MEETING WITH PRIVATE CREDITORS ON "THE ECUADORAN RECOVERY PROGRAM," NEW YORK, MAY 16, 2000

My purpose today is to provide you with an overview of the economic situation in Ecuador as seen from the vantage point of the IMF. As you know, the current economic situation is extremely difficult, although over the last few months the government has made a very important start to address its economic problems. A constructive dialogue between the Ecuador authorities and its private sector creditors will be one of the essential elements in resolving the economic crisis.

I will focus on the government's economic program and how this will likely affect Ecuador's medium-term capacity to service its external debt. Last month, the IMF's Executive Board approved a one-year Stand-By arrangement (for about US\$306 million) in support of the government's economic program. The arrangement, jointly with commitments by the World Bank, the IDB, and the Andean Development Corporation, will provide urgently needed external financing to Ecuador to support the government's economic program and pave the way for a return to medium-term viability. However, the balance of payments situation will remain extremely difficult, in both this and subsequent years. Therefore, a reorganization of Ecuador's external debt will be required to restore medium-term viability.

It is useful to remind ourselves about the **severity of the current crisis and its causes**. Real GDP stagnated in 1998 and fell by about 7½ percent in 1999. The unemployment rate doubled to about 17 percent over the last two years, and there was a large increase in the number of people living in poverty. Twelve-month inflation in consumer prices rose from 31 percent at end-1997 to 89 percent in April 2000 and producer prices rose much faster, suggesting there is still significant inflation in the pipeline. The external current account ballooned to a deficit of 11 percent of GDP in 1998, but the collapse of domestic demand and external financing constraints, caused by very large capital flight, forced a severe import compression—imports fell by half—and resulted in a current account surplus of about 6 percent of GDP in 1999.

These developments reflected the combination of adverse external factors (including *El Niño* and the collapse in world oil prices in 1997–98) and inadequate domestic policies—including a widening public sector deficit and delays in taking timely action to deal with a fragile banking system, which eventually undermined monetary policy. The problems were exacerbated by longstanding structural rigidities, and political gridlock which made it difficult to get support for the needed redirection of economic policies.

The administration of President Noboa has begun a program of adjustment and reform based on the official dollarization of the economy and accompanying structural reform. **The macroeconomic framework of the program** assumes a further decline in real GDP in the first half of 2000, but targets a recovery to 3½ to 4 percent growth (year-on-year) in the

second half. Notwithstanding the process of dollarization, substantial price increases are likely for a period with the pass-through of the earlier sharp depreciation. Indeed, developments in the last two months suggest that the 12-month inflation rate is likely to end the year above the level targeted in the program—it may reach about 85 percent—although we still expect the monthly rate to fall to under 1 percent by year-end.

The program has four key elements: dollarization of the economy; a considerable fiscal adjustment; bank restructuring; and structural reforms, especially in the oil, electricity, and telecommunications sector. The nonfinancial public sector deficit would be reduced to under 4 percent of GDP in 2000. This requires an increase in the primary fiscal surplus from 4 percent to 6½ percent of GDP. The improvement in the fiscal balance is being achieved through a combination of: (i) higher fiscal revenues from oil exports (although I should note that the program is conservative in its oil price assumptions for 2000—an average price of US\$20 per barrel for Ecuador’s blend); (ii) large increases in domestic fuel prices aimed at reducing costly subsidies; (iii) extension of the temporary import tariff surcharge through end-2000; and (iv) tight control over expenditures, including on the wage bill. The government also intends to submit to congress in September a tax reform aimed at consolidating the programmed improvement in the public finances for 2000, and achieving a more efficient tax structure.

A central element of the program is **a strategy to restructure the banking system**, which has been in deep crisis for more than a year. Since late 1998, fourteen financial institutions, accounting for about 65 percent of the system’s onshore assets, have been intervened or

closed by the deposit insurance agency. Nonperforming loans averaged about 42 percent of the total loan portfolio and external credit lines have dropped by more than half to US\$0.8 billion. The main elements of the banking strategy are: (i) establishing the legal basis for bank restructuring, including by allowing banks to operate under continued private ownership when they fall below the minimum CAR provided a strengthening program is agreed with the superintendency of banks; (ii) strengthening the solvency of banks by revising rules for loan classification and provisioning, bringing the composition of bank capital up to Basle standards; (iii) facilitating the resolution of closed banks, particularly by strengthening the asset management and control capabilities of the deposit insurance agency; (iv) strengthening banking regulation and supervision; and (v) restructuring viable debts of households and companies, with the emphasis on a case-by-case approach for larger debts.

Economic developments so far in 2000 have been better than anticipated. The cumulative public sector deficit was lower than projected partly reflecting better than expected tax revenues. Liquidity developments in the banking sector are also better than expected; in aggregate, the time deposits that were unfrozen in March have remained in the banking system and there has been a net reflow of deposits. The official dollarization process appears to be on track; the central bank has stopped issuing *sucre* liabilities, and the official reserve position—net of dollarization requirements—has strengthened moderately.

The government's economic program is subject to substantial risks. Political resolve will be required to sustain the fiscal adjustment, including the fuel price increases, and implement the necessary financial restructuring. Despite the good outturn of recent months, the overall

liquidity position of the banking system remains very fragile and, given the lack of any substantial lender-of-last-resort facility, any significant run on deposits would cause major problems. Nevertheless, the authorities have made a decisive start to implement their program; if this momentum is sustained, together with support from the international financial community, the recent turnaround in confidence should be sustained.

Let me now turn to a discussion of Ecuador's future capacity to service its external liabilities. I will frame this discussion in terms of the financing gap in the balance of payments and the external debt and debt-service burden (see tables).

Let me emphasize at the outset that any projections of medium-term developments, starting from the depth of a severe economic crisis and recession are subject to considerable uncertainty. There could be wide margins of error around the likely path of economic recovery, the path of the real exchange rate in the aftermath of the collapse in the sucre followed by dollarization, and the ultimate fiscal cost of cleaning up the banking system. The evolution of key external parameters—most notably the world oil price and interest rates—will also affect the assessment of sustainability.

Let me start with the balance of payments for 2000. The current account surplus is expected to fall (to US\$220 million or about 2 percent of GDP) as part of the massive contraction in imports that occurred last year is unwound. Taking account of scheduled debt service payments; likely foreign direct investment inflows; a further (but much smaller)

outflow of private capital (part of which has already occurred) as confidence is gradually restored; and the need to normalize arrears to official and private creditors that amounted to US\$925 million at the beginning of the year, the financing gap is projected at a little under US\$1.5 billion. The equivalent fiscal financing gap, after taking account of clearance of domestic arrears and the restructuring of domestic bonds that has already taken place, would be of a similar magnitude—some US\$1.6 billion. The projections also take account of the use of international reserves to complete the dollarization process and disbursements from the IMF (of which US\$268 million will be disbursed in 2000), which will be used to rebuild the cushion of free reserves.

To help fill the gaps, the government is seeking the assistance of all its official and private sector creditors. The multilateral agencies (World Bank, IDB, and Andean Development Corporation) will be providing significant new exceptional financing, for a total of US\$435 million in 2000. This is in addition to the normal disbursements from these agencies already included in the capital account. The Paris Club will meet later this week to consider Ecuador's request for a rescheduling of arrears and debt service falling due during the period of the Fund-supported program. Discussions are underway with foreign banks to seek maintenance of their exposure under interbank and trade-related credit lines, and arrears of US\$63 million on credit lines guaranteed by the deposit insurance agency to nine closed banks were restructured in January 2000.

The ratio of total external debt to GDP is expected to reach almost 180 percent by the end of this year, of which about 145 percent is public sector debt, although the bulk of the increase

from 1999 reflects the sharp contraction of GDP in US\$ terms, following the real depreciation of the exchange rate. The external debt service ratio, before any debt relief, would be about 41 percent, up from 36 percent in 1999.

Turning to the medium term, the framework underlying the scenarios assumes:

- Real GDP growth that, after some rebound next year, recovers to about 2½ percent annually in the next few years, and gradually rises to 4 percent in the longer term;
- Inflation that remains quite high, but on a declining path, over the next few years as prices react to the pre-dollarization depreciation, but then falls to projected U.S. levels. This results in an appreciation of the real exchange rate until 2005, and a constant rate thereafter;
- A sustained fiscal effort that keeps the primary surplus for the nonfinancial public sector at around 6½ percent of GDP in the next few years, but that gradually declines thereafter—albeit to levels well above historical experience. I should stress that the IMF has not reached agreement on a precise fiscal adjustment path for 2001 onwards; indeed, achievement of this level of primary surplus will be difficult. The purpose of such a scenario is to show that, even with such a strong fiscal adjustment, a significant debt restructuring will be required. As part of the fiscal adjustment, a substantial tax package will need to be introduced in the 2001 budget to shift the composition of revenues toward VAT and excises to facilitate the elimination of the import tariff surcharge, a further reduction in the financial transactions tax, along with a significant reduction in fuel price subsidies;

- A reasonable estimate at this stage of the fiscal cost of the banking crisis would appear to be about US\$2.7 billion (24 percent of GDP in 2000) in bond issues and cash transfers to pay out the deposit guarantee, implying an annual interest carrying cost of about US\$260 million (2.4 percent of GDP). Part of these costs could be offset by asset recovery from closed banks, but our projections only assume a modest asset recovery;
- As confidence recovers, it is assumed there would be a gradual turnaround in the external capital account to renewed net private capital inflows, along with a gradual return of the public sector's normal access to the domestic capital market to help finance the fiscal deficit;
- An average oil price, for Ecuador's blend, of US\$16.3 per barrel in 2001; a further small decline is assumed in 2002, in line with the latest WEO projections, with the real oil price broadly constant thereafter.

On this basis, the external picture would look as follows:

- Total dollar export earnings are projected to grow only moderately next year (mainly because of the expected decline in the average oil price) but then to grow by an average of 8–10 percent annually.
- As imports continue to rebound to a more normal level in 2001, the current account will move into deficit—projected at a little under US\$600 million (3½–4 percent of GDP) over the next two years. Thereafter, the current account deficit is expected to narrow gradually as a share of GDP, although it will continue to grow in dollar terms, largely reflecting the growing interest bill.

- The projections also take into account scheduled amortization (including on the exceptional financing provided in 2000 and in subsequent years—details of the debt service payments on external public debt are shown in Table 2); likely foreign direct investment inflows; some build-up in official dollar holdings for a lender-of-last resort facility; and a gradual turnaround in autonomous capital inflows to the private sector. The resulting external financing gaps, in the absence of any debt reduction, would be around US\$500–700 million over the next couple of years. Financing gaps are likely to persist over the medium and longer term without a more comprehensive restructuring of debt. Accordingly, a restructuring that simply defers debt service payments to later periods will not be sufficient to restore medium term viability.
- The fiscal financing gaps would likely be of a similar magnitude to the external financing gaps. For example, as shown in Table 1, even if the primary fiscal surplus is maintained at 6½ percent of GDP in 2001, the large interest bill, before any debt relief, would imply an overall deficit of about US\$550 million. This would be very difficult to finance on a sustainable basis.
- Even if these gaps could be financed, the projections suggest that, without some extraordinary relief, Ecuador’s external debt and debt service position will continue to be very difficult for many years to come, even under a relatively optimistic assumption of sustained fiscal adjustment. For example, debt/GDP ratios would remain high—over 100 percent—(with most of the decline in the early years reflecting the expected real exchange rate path) and debt service ratios would remain well over 40 percent of exports in the next several years, thereafter declining only gradually.

While such a scenario is clearly subject to considerable uncertainty when projected from the depth of an economic crisis, it does suggest that in order to reach a more sustainable external (and fiscal) position, some extraordinary debt relief will be required. If Ecuador's debt profile is not brought to more sustainable levels, the result is likely to be a lower growth path in which the economy would remain particularly vulnerable to renewed debt servicing difficulties. Such an outcome would not be in the interests of either Ecuador or its creditors and would inevitably affect the capacity to service its debt on a sustainable basis.