# PROJECT CONCEPT DOCUMENT

## I. BASIC DATA

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| **Country:** | Ecuador |
| **Date:** | October 29, 2004 |
| **Project name:** | Competitiveness Enhancement Program (Policy Based Loan) |
| **Project number:** | EC- L1004 |
| **Division Chief:** | Ana Maria Rodriguez-Ortiz, (FI3) |
| **Project team:** | Leader: Frank Nieder (FI3); other members: Hunt Howell (FI3), Claudio Maggi (FI3), Francesca Castellani (OD5), Guillermo Arrivillaga (CEC), Bernadete Buchsbaum (LEG), Jean-Marc Aboussouan (PRI) and Rosario Gaggero (FI3) also assisted in the preparation of this document. |
| **Date of Project Outline:** | April 26, 2004 |
| **Borrower:** | Republic of Ecuador |
| **Executing agency:** | Ministry of Economy and Finance (MEF) |
| **Financing plan:** | IDB: OC US$ Up to 200 million<br>Total: US$ Up to 200 million |
| **Tentative dates:** | Analysis Mission January 2005<br>Loan Committee March 2005<br>Board May 2005 |
| **PTI:** | No |
| **SEQ:** | No |

## II. BACKGROUND

### A. Economic structure and need for greater competitiveness

2.1 The decision to dollarize the economy in 2000 has brought a new dimension to the challenge that Ecuador faces to compete in international markets. While it has helped achieve macroeconomic stability, bring inflation under control from the hyperinflationary levels experienced during the financial crisis of 1999-2000, reduce interest rates and country risk, it has introduced an additional source of rigidity, associated with the inability to manage monetary and exchange rate policy, in an economic system whose performance has historically been dependent on the conditions of international markets.

2.2 In a dollarized economy, the only effective macroeconomic stabilization instrument is fiscal policy. The Fiscal Responsibility Law (LOREYFYT), approved in 2002, provides a suitable framework to ensure necessary fiscal discipline. The law establishes caps on real spending, an oil-revenues stabilization fund, and schedules for the reduction of the non-oil fiscal deficit and the debt to GDP ratio. Compliance with this law is critical to maintain macroeconomic stability and to sustain a dollarized monetary system.

2.3 The impossibility to resort to currency devaluation to improve competitiveness in the short run emphasizes the role of productivity in the ability to compete internationally. This further underscores the shortcomings of a little diversified economic structure and its implications for the vulnerability of the whole economy.

2.4 Despite the real appreciation resulting from high inflation and a prolonged strength of the dollar in exchange rate markets in the aftermath of dollarization, exports performance has been satisfactory. Non-oil exports have been growing at an annual rate of 11% since 2001 and oil exports recorded an increase of 26% in 2003, which were boosted with the construction of a heavy crude oil pipeline. Traditional exports grew, in volume terms, at 17% between 2001 and 2003 and non-traditional exports at around 6%.[1]

2.5 An analysis of the factors underpinning this outcome highlights the presence of a particularly favorable external environment characterized by: (i) high export prices of both traditional and non-traditional goods; (ii) favorable weather conditions that benefited commodity exports; (iii) strong demand for Ecuadorian goods thanks to the recovery of the USA economy, and (iv) the weakness of the dollar since mid-2003, which helped mitigate a real exchange rate appreciation, which took place during the initial years of dollarization, and thereby improve export profitability.

2.6 Economic performance was satisfactory in 2003 and continues to be in 2004. IMF projects a 5.5% growth rate, inflation below 3%, and a primary surplus of the Non-Financial Public Sector (NFPS) of 4.6% of GDP for 2004. However, these higher growth numbers, as well as improved fiscal performance largely reflect the dramatic rise in oil prices. The non-oil economy is expected to grow by only 1% in 2004. In addition, in spite of continued reductions in overall debt levels, the government's continued lack of access to international financial markets leaves it with a US$500 million financing gap in 2005. In collaboration with other multilateral institutions, the proposed PBL would help close this financing gap.

2.7 The fact that improved export, growth and fiscal performance has largely been dependent on exogenous factors points to the importance and the difficulty of the competitiveness challenge that Ecuador faces. Moreover, while dollarization has

[1] Commodities account for 74% of total exports and oil for 40%. Traditional non-oil exports (49% of total non-oil exports) consist of bananas, shrimps, tuna, coffee and cocoa. Non-traditional exports include processed foods, flowers, forest products, and a range of manufactured goods.

been crucial to create the conditions for macroeconomic stability, its sustainability as well as rapid economic growth, in a small economy such as Ecuador, depends on accelerating productivity and increasing the productive sector's capacities to effectively integrate itself into the global economy.

## B. Constraints to enhanced competitiveness

2.8 Ecuador needs to overcome a series of challenging obstacles to improve the competitiveness of its productive sectors, as it suffers from major deficiencies in both the business environment faced by firms, as well with regard to the capabilities and practices of local firms. The depth and scope of the challenges faced by Ecuador are indicated by the results of the most recent World Economic Forum (2003-4) international ranking of the competitiveness environment and firm capacities. Ecuador was ranked for most of the composite indicators in the bottom 15% of all countries included in the survey, and amongst the bottom quarter of Latin American and Caribbean countries. Problems are not concentrated in a narrow set of factors, but are widespread, reflecting the country's difficulties to implement and sustain structural policy and institutional reforms. The following section outlines the degree and nature of the obstacles faced by firms to improve their competitiveness..

**Table 2**
**Ecuador Ranking of Selected Competitiveness Indicators**

| Indicator | 2002-3 (Out of 80) | 2003-4 (Out of 102)[2] |
|---|---|---|
| Access to Financing | 76 | 91 |
| Judicial Security* | 78 | 94 |
| Public Institutions | 75 | 80 |
| Infrastructure | 73 | 78 |
| Human Capital* | 70 | 83 |
| **Business Environment** | **77** | **86** |
| **Sophistication of Company Operations and Strategy** | **74** | **82** |

Source: WEF. * Indicates composites that average several relevant WEF indicators.

### 1. Macroeconomic stability

2.9 Macroeconomic stability represents a crucial element in the quest for greater competitiveness as it provides a less volatile and less risky environment for longer-term investment decisions, as well as contributing to a supportive incentive framework by keeping inflation low to avoid real exchange rate misalignments (i.e. pressure on the price of non-tradable goods), and to limit public sector borrowing so not to crowd out the private sector. In a dollarized economy this stability depends primarily on sound fiscal management, which in Ecuador will require full compliance with the Fiscal Transparency Law.

[2]Additional countries included in 2003-4 are primarily under-developed Sub-Saharan counties and newly established Eastern European states, which tend to have poor business environments.

### 2. Factors of production

2.10 Markets for both finance and labor are ineffective and inefficient, limiting the abilities of firms to adjust to international competitive pressures. In the case of finance this results in limited access, which greatly constrains firms' abilities to invest and grow, and in the case of labor markets, a series of distortions increase labor costs and limit flexibility, while the education system fails to generate the human capital resources needed to increase labor productivity.

2.11 **Access to Finance.** Even with the recovery of the banking sector, by August 2004 bank credit to the private sector represented only about 20% of GDP, a low figure even amongst Latin American nations, while lending interest rates to large corporate clients are still over 10% or between 7-10% in real terms.[3] Effective interest rates for smaller firms are several times this level. Capital markets are incipient and do not provide a significant alternative source of financing for firms. Firms complain that financial intermediaries are too conservative and unwilling to take risks. In the past, the government policy reaction has often been to establish interest rate controls and directed credit mechanisms of one kind or another. The problem, however, is less deficiency on the part of the banks or need for public resources, but rather that the costs and risks of financial intermediation are excessive, due to a range of factors. These include the history of macroeconomic instability, the high cost and low quality of information about clients that lead to information asymmetries, an insecure legal basis for financial transactions, the absence of a lender of last resort in a dollarized monetary system, as well as insufficient incentives for the adoption of new financial technologies that can lower the costs and risks of financial services.

2.12 **Labor markets and human capital.** The manner in which wage levels are determined and additional mandated labor benefits do not allow labor costs to reflect productivity. In particular, wage levels in the formal sector are set in relation to legally defined sectoral minimum wages and government salaries that are both determined largely in response to political considerations. Second, firms must pay 15% of all profits to their workers. Finally, severance payments are amongst the highest in Latin America, which increases labor costs and limits firms ability to adjust rapidly to changing market conditions. A tri-partite (labor, government, and private sector) initiative is underway to develop a consensus labor market reform. However, the strong difference of interests between the groups complicates the development of a politically viable and effective reform. Given their complexity and the uncertainty about the outcome, authorities have requested that labor market reforms not be included as a condition for this operation.

2.13 In terms of human capital, while the average education level of the work force, 7.5 years, is higher than what would be expected for countries with comparable

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[3] Successful emerging market economies, such as Chile, have bank credit to GDP ratios of over 80%, while Malaysia and Korea have ratios that exceed 100%.

levels of per capita income, the educational system is amongst the least effective in Latin America, with average test scores ranking last for Latin American countries surveyed by UNESCO. Moreover, the system for on-the-job training still focuses on publicly provided or directed services, which do not meet the specialized needs of firms or their workers. A potentially more effective demand-driven training program has formally been established, but its execution has not met expectations, and resources are directed towards the traditional supply–oriented program.

### 3. Rules of the game

2.14 Rules of the game for doing business are neither transparent nor efficiently implemented, resulting in both high transaction costs and increased risks for firms. This is true both with regard to the judicial system, as well as with administrative and bureaucratic procedures.

2.15 **Judicial security.** Ecuador's judicial system and enforcement of property rights suffers from excessively complicated and costly official processes, as well as a lack of transparency and consistency in their execution. For example, it takes on average of 330 days to legally resolve a dispute over a bounced check, as compared to 30 days in the United States.[4] In addition, over 90% of procedures are written, instead of oral, which tends delay judicial process and facilitates non-transparency. There are also limited mechanisms to hold judges accountable, which facilitates political interference and further discourages transparency. While these legal risks affect all firms operating in the formal sector, they particularly discourage foreign investment as well as the advancement of new entrepreneurs, who do not have the social network to avoid or navigate through the judicial system. A recent World Bank Investment Climate Survey of entrepreneurs in Ecuador reports that unreliable protection of property rights is one of the major reasons why large multinationals have withdrawn or refrained from investing in Ecuador.[5] More positively, a comprehensive reform of the Civil Procedure Code, which would simplify court procedures and establish oral arguments for most cases, is underway. Specialized IDB (EC-L1011) and World Bank judicial sector modernization programs are under development and would support the implementation of judicial sector reforms.

2.16 **Bureaucratic procedures.** The time and cost to comply with bureaucratic procedures are especially high, and create incentives for corruption as firms try to expedite these processes though informal means. The aforementioned World Bank survey estimates that about 16% of management time is spent on dealing with government regulations, the highest of all countries surveyed. An example is that it requires 10 different procedures and up to 32 days for imports to clear customs in Ecuador, with non-traditional exports tending to take longer, compared to Honduras where it takes up to 10 days Similarly, it is estimated that it takes on

[4] World Bank, Doing Business website.
[5] "Ecuador: Investment Climate Assessment," World Bank. 2004.

average of 90 days to establish a business at a cost of about 50% of per capita GDP, compared to Chile where it takes on average of 28 days at a cost of 10% of per capita GDP.

### 4. Access to markets

2.17 **Transport infrastructure and services.** The cost of transporting goods from Ecuador either by ship or air is significantly higher than competing countries, putting Ecuadorian firms at a significant disadvantage, both with regard to exporting and the cost of imports. For air cargo, which is particularly important for the most dynamic non-traditional exports of flowers, fruits and vegetables and fresh fish, as well as for higher value-added lower weight items such as high fashion clothing, costs are several times higher than other countries in the region. For example to ship goods from Quito by air to United States cost 92% more than from Bogotá. For shipping transport, Ecuadorian exporters pay on average 50% more than their Peruvian competitors. While part of these higher costs are related to the lower volume of Ecuador, in the case of shipping, inefficient port facilities contribute to high shipping costs, while discretionary and restrictive entry policies for air cargo as well as the failure to secure the highest international standard for airports, limit competition as well as access to air facilities in other countries. Efforts to reform the institutional structure of ports and allow for private operation have not been able to overcome the obstacles posed by intractable vested interests opposing such reforms. However in the case of air transport, reforms have been presented to Congress, which if approved, would allow for the granting of the highest standard for civil aviation authorities by the United States (FAA Category 1), and thereby allow Ecuadorian airlines to regain access to the US market. With secured access to the US market, authorities would be willing to adopt an open-skies policy for air cargo.

2.18 **Foreign trade policy.** Ecuador has already substantially liberalized its foreign trade regime, while it is committed, though a World Bank Programmatic Loan to gradually reduce the number of remaining import licenses and reduce remaining anti-export biases. The major remaining obstacles, however, are less due to explicit trade policies, but rather the weak implementation of trade procedures, which, as noted above, result in delays and large opportunity costs.

2.19 Ecuador is in the midst of negotiations on a Free Trade Agreement (FTA) with the United States, Ecuador's largest trading partner. An IDB program (1524/OC-EC) is providing assistance to bolster Ecuador's technical capacities to both negotiate and subsequently implement the FTA. This agreement would imply a further opening of, and greater competition in, local markets, as well as presenting new opportunities for Ecuadorian firms in the fiercely competitive US market. To secure approval of the FTA and the increased market access it will engender, Ecuador will need to implement a series of complementary legal and institutional measures.

### 5. Other infrastructure services

2.20 **Energy and telecommunications**. In spite of abundant low-cost hydroelectric potential, Ecuador's electricity costs are higher than neighboring countries and reliability is low. To a large extent this is due to a weak institutional and regulatory structure, which discourages effective and efficient management, leading to excessive distribution losses that currently reach almost 30%, as well as forced cross-subsides that keeps prices for most consumers below economic costs, and thereby discouraging needed private investment. In the telecommunication sector, the dominant fixed-line system is controlled by two state-owned regional companies. Investment levels are amongst the lowest in the region, and long-distance calls are priced far above regional norms to subsidize local service. The aforementioned World Bank Programmatic loan supports institutional and regulatory reforms in both sectors.

### 6. Institutional framework for private/public sector communication and cooperation

2.21 A public/private sector national competitiveness council, the *Consejo Nacional de Competitividad* (CNC), was established in 2001, as a means to ensure effective communication between the private sector and public sector for the identification, definition and implementation of measures and to sustain an effective competitiveness initiative. The Council, is lead by the President of the Republic or his permanent representative, who is usually a leading representative of the private sector, and also includes 8 ministerial ranked officials, 8 private sector representatives, and one representative each of municipal governments and of workers. This council is an important mechanism for the private sector to communicate its needs and priorities to the national government. While the CNC already plays an important role, for the institution to effectively carry out its mandate, a modification in its legal statutes is needed to clarify its functions and to assure it has the instruments to carry them out. At the regional level, however, there is an absence of joint public/private institutions to lead and promote competitiveness. Experience in other countries, particularly in Colombia, has shown that these regional institutions are especially effective at organizing public private sector cooperation and promoting regional industrial clusters.

### 7. Business capacities and effectiveness of business development policy and programs

2.22 In three key areas for Ecuadorian businesses to compete internationally, local capacities are especially weak. Firms generally do not associate to collectively solve joint problems or organize themselves into effective value chains. For Ecuadorian firms, which are small by international standards, this willingness and capability to work together is especially critical in order to establish effective industrial clusters and to assemble some economies of scale to compete with larger international competitors. Secondly, firms' capacity to innovate and to utilize more sophisticated and productive production processes is limited, which

fundamentally constrains their abilities to increase productivity. Finally, firms devote few resources to train and upgrade the productivity of their staff. In all of these areas, Ecuador ranks near the bottom of Latin American countries. Not surprisingly, government programs and the efforts of private organizations in these areas are limited and largely ineffective, even though experiences in other countries show that external programs can be effective to improve capacities and change behavior in these areas.

## C. Government policy

2.23 The current government has given increased attention to competitiveness, including it as one of the five pillars of its governing strategy. An indication of importance placed on competitiveness was that one of the first executive measures of the government was to transfer the CNC to the Presidency, in order to give it more political support. The CNC prepared, with IDB support and the active participation of private sector working groups, a national competitiveness plan, *Agenda Ecuador Compite* (AEC), which details and establishes priorities for policy, institutional, and programmatic measures, assigns institutional responsibilities and specifies the time frame for their implementation. The Agenda was formally established as government policy by an Executive Decree in early 2004.

2.24 The Agenda has two objectives: (i) The sustained increase in the productivity of the productive sectors; and (ii) Diversification of the economy away from its dependence on natural resources towards goods and services with greater local value added. Given the scope of challenges faced by Ecuador the Agenda includes ten strategic areas for action, including (i) Human Capital; (ii) Governance; (iii) Finance; (iv) Infrastructure; (v) Judicial Security; (vi) Macroeconomic Stability; (vii) Human Capital and Labor Markets; (viii) Innovation, Technology and Connectivity; (ix) Trade Liberalization; and (x) Natural Resource Management. In addition, the Agenda emphasizes that macroeconomic stability is a fundamental necessary condition for improved competitiveness, and includes a series of measures critical to achieve and maintain this objective.

## D. Program strategy

2.25 The proposed Competitiveness Enhancement Program is designed to support the needs of business to compete internationally and grow, by: (i) improving key elements of the business environment in which they operate; and (ii) to directly improve the capacities of firms to compete by improving the effectiveness of business development policy and programs. Given the breath of obstacles faced by firms, the program will focus on a limited set of areas of actions that will be selected based on: (i) their expected effectiveness and their priority to the business sector and government, as reflected by the AEC; (ii) the feasibility of the implementation within the context and timeframe of a Policy Based Loan, and (iii) their complementarity with competitiveness related reforms supported by

other multilateral financial institutions. A table is included in Annex III show the relationship of the proposed PBL operation with other programs of the Bank and other multilateral and bilateral institutions. **The Program has been designed in close and active coordination with the World Bank, CAF, IMF and USAID.**

2.26 Based on these criteria, the program is expected to include measures in five areas to improve the business environment; (i) Macroeconomic Stability; (ii) Access to Finance; (iii) Rules of the Game; (iv) Access to Markets/Air Transport; and (v) the Institutional Framework for Private/Public Sector Cooperation and Competitiveness.[6] In addition, the PBL would include a component designed to improve the effectiveness of business development policy and programs, focusing on promoting more effective collaboration between firms to bolster the development of effective clusters; incentives and capacities for technological innovation at the firm and industry level; and on-the job training.

## E. Bank strategy

2.27 The new Bank's country strategy (GN-2338) for 2004-2006 to be submitted for the approval by the Board of Directors in November 2004 identifies the need to reduce vulnerability to internal and external shocks, as Ecuador's major development challenge. Consistent with the previous country strategy (2000-2002), the strategy calls for the Bank to focus its efforts on (i) building the basis for a more dynamic productive sector, and (ii) promoting social development and the protection of the most vulnerable sectors of society. The proposed operation program corresponds to the first objective of the strategy, and would be a key element of the Bank's program in this area. In addition, by attempting to reduce the transaction costs of government regulations and procedures and to enhance the effectiveness of government supported business development programs; the proposed operation would also help fulfill the overarching institutional objective of the Country strategy to improve the efficiency of government.

## F. Bank experience with competitiveness policy based loans

2.28 The Bank is building its experience with policy-based loans with competitiveness objectives. Two loans were approved in this area in 2003; they include a program in Peru (1503/OC-PE) and in El Salvador (1492/OC-ES). As these loans were only recently approved, one cannot yet evaluate their effectiveness. Yet, similar Investment Sector Loans that were implemented in the early 1990s were among some of the more effective Bank policy based loans. A key lesson learned from the development of these programs, especially in Peru, is that a strong institutional framework to promote a competitiveness initiative is critical to its success.

[6] By supporting reforms in these areas, the program would be a key element in Bank support for the implementation of Business Climate Initiative Action Plan, which is currently being developed by the government in cooperation with the private sector

2.29 The Bank experience with policy-based loans in Ecuador, however, has been difficult. Of the five sector loans approved by the IDB for Ecuador over the past ten years, only one was fully disbursed without requiring a significant restructuring of the original loan. This record reflects to a large extent political instability that discourages consistent policies and leads to repeated changes in the senior positions of the executing agency, as well as the conflictive nature of political discourse that tends to block the implementation of structural reforms. Unlike past programs, this program has and will continue to actively foster and encourage public/private sector participation and discourse during both the preparation and implementation of the reforms. This should help build a broad political consensus that would allow supported reforms to move forward in spite of inevitable changes in the political arena.

# III. PROGRAM

## A. Objectives and description

3.1 The **objectives** of the program are: (i) to improve the Ecuadorian business environment; and (ii) to strengthen the capacities of local firms to compete internationally.

3.2 **Description.** The program would meet these objectives by supporting policy, institutional and programmatic reforms that (i) create a more competitive external environment for firms by reducing the economic costs and improving access to and the quality of productive inputs and factors of production; or by lowering the transaction costs and the risks of doing business in Ecuador; and (ii) enhance the effectiveness of business development programs in improving local firms' capabilities and behavior for increasing their productivity and ability to compete internationally. The program would have a component to meet each of these goals. A tentative set of measures to be included in the Program has been discussed with authorities, and is summarized in the attached preliminary policy matrix (Annex I). The final design of the program, however, will depend on further analysis and discussion with authorities regarding the needs and feasibility of measures in each area.

3.3 This support would come via a Policy Based Loan that would link disbursements to the implementation of reform measures over a term of no less than 18 months, and a parallel Technical Cooperation (EC-L1016) that would finance technical assistance to facilitate and accelerate the implementation of the reforms, including the coordination and supervision of the program by the executing and sub-executing agencies.

## B. Structure of the program

### 1. Improvement in the business climate

#### a) Macroeconomic stability

3.4 The program would support the maintenance of a medium-term macroeconomic framework required for a successful competitiveness initiative. To help ensure that an appropriate macroeconomic context is in place, the GOEC has committed to enter into an agreement with the IMF that would permit the Fund to monitor periodically the country's performance. These periodic reviews would permit the Fund to assess the country's progress under the agreed set of targets.

#### b) Access to finance

3.5 The program would address two factors contributing to the high costs and risks of financial intermediation: (i) access to, and the quality of, information for both financial institutions and their clients, and (ii) the weak legal basis for financial transactions. These areas were selected due to their importance in lowering the costs and risks of financial intermediation, and because they are the most conducive to improvement through policy reforms.

3.6 Measures to enhance **financial information** would include: (i) strengthening the legal foundations for the effective operation of private credit bureaus, and (ii) establishing regulatory norms for the full and transparent dissemination of information on the cost of financial services (truth in lending).

3.7 To address **legal insecurity for financial transactions**, the program would support a participative process, with the financial and non-financial private sectors to: (i) strengthen the legal and institutional basis for financial transactions, with an initial focus on secured financial transactions, and (ii) establish a modern and effective legal framework for resolving corporate insolvency. Legislative changes would be necessary to significantly address these issues. In order to give more flexibility for the fulfillment of conditions related to these changes, consideration will be given to the option of including these legislative reforms as conditions for a floating tranche.

#### c) Rules of the game

3.8 In this area, the Program would support reforms that reduce the transaction costs and the risks posed by the judicial enforcement of property rights and contracts, as well as those posed by bureaucratic procedures. With regard to **judicial security,** the Program would not include any specific policy conditions, but measures to improve judicial enforcement of property rights and contracts would be supported in the Judicial Sector Strengthening Program (EC-1011).

3.9 With regard to **bureaucratic procedures**, the Program would support an initiative that would (i) identify the priority reform areas based on their economic

impact, and (ii) implement an agreed action plan of administrative measures to reduce the transaction costs and risks in these priority areas. The CNC and MEF would sign agreements with the respective responsible agency regarding the timely implementation of these reform measures. Diagnostics indicate that the greatest impact can be obtained by focusing on simplifying and improving the efficiency of foreign trade procedures and those required for the formal establishment of private companies.

**d) Access to markets: air cargo**

3.10 To reduce air cargo costs the program would encourage greater competition in the air cargo market and facilitate greater entry by supporting the approval of legislation that is necessary for the Federal Aviation Authority (FAA) of the United States to grant its highest-level standard (Category 1) to Ecuadorian civil aviation authorities, and the subsequent implementation of an open-entry policy for air cargo services.

**e) Institutional framework for public/private cooperation and competitiveness**

3.11 At the national level, the program would support strengthening the legal statutes of the CNC in order to clarify its responsibilities and to assure it has effective instruments to carry them out. These responsibilities should focus on promoting communication and consensus between the public and private sectors on competitiveness issues, monitoring and coordinating the implementation of the national competitiveness agenda; and promoting discussion and awareness of the importance of competitiveness to meet Ecuador's economic and social goals. At the regional level, the program would support the establishment of a mechanism to promote the establishment of regional public/private competitiveness initiatives and institutions.

### 2. Enterprise development

3.12 The objective of this component would be to improve the effectiveness of business development policies and programs in improving the productivity and economic performance of participating firms. To meet this objective the Program would support: (i) the definition and approval of a policy for publicly-supported business development programs, which establishes criteria for public support, requiring demand-driven financing, competitive selection mechanisms based on transparent selection criteria, decentralized management, significant counterpart financing requirements by participating firms, and other financial incentives be linked to the meeting of program objectives; (ii) the design, implementation and evaluation of pilot programs that meet these criteria for collaborative ventures and technological innovation, and in the case of on-the job training, the reform of the on-going demand-driven program to ensure that it operates effectively and fully utilizes its funding efficiently.

### C. Cost and financing

3.13 The project would be financed by an US$200 million policy-based loan, which is proposed to be disbursed in two disbursements of US$80 million, and one floating tranche of US$ 40 million tied to the effectiveness of legislative reforms to improve access to finance. The PBL would be complemented by the parallel TC operations totallingapproximately US$1.3 million, of which about US 0.3million would be financed from non-reimbursable FSO resources. and the remainder from a TC loan or from a dedicated fund financed by the MEF from budgetary resources. The latter may be necessary given requirements under the Fiscal Responsibility Law that limits the use of borrowed resources only for investment activities.

## IV. EXECUTION OF THE PROGRAM

### A. Borrower and executing agency

4.1 The Ministry of Economy and Finance (MEF) would be the borrower and the executing agency. The MEF has considerable experience in the management of multisectoral policy-based loans, both with the IDB and the World Bank.

### B. Execution and administration of the project

4.2 The MEF will be the general coordinator of the loan and TC operation, but will delegate responsibility for the execution and administration of the different components of the loan to specialized entities, which also have legal responsibilities for the areas of policy and institutional reform included in the program. These institutions would also act as sub-executing institutions for the proposed Technical Cooperation in their respective areas.

4.3 The Consejo Nacional de Competitividad would be responsible for measures regarding the institutional framework, and would coordinate the implementation of the initiatives regarding the streamlining of bureaucratic procedures, and the improvement of business development policies and programs. In addition, it would support the MEF with the general coordination of the Program. Projusticia, the technical Secretariat of the Supreme Court, would be responsible for the measures regarding judicial security. The Superintendent of Banks would be responsible for measures regarding access to finance. Finally, the Consejo Nacional de Aviación Civil would be responsible for measures regarding air transport.

4.4 During the development and execution of the program, these institutions would also organize the involvement of other key actors in each area from both the public and private sectors to assure that reforms meet priority needs and to build consensus to facilitate execution.

### C. Execution and disbursement time

4.5 It is expected that the execution and disbursement time for the PBL would be no less than 18 months. The Technical Cooperation however would be expected to require about three years for execution and disbursement given the longer time needed to train and strengthen institutions to continue with the implementation of secondary aspects of the proposed conditionality.

### D. Monitoring and evaluation

4.6 The intermediate results ("outcomes") expected from the program are listed in the tentative policy matrix (Annex I). Given the practical difficulties of measuring some of these results, emphasis will be placed on the use of administrative records data and "off the shelf" indicators. Baseline and progress data for each of the indicators will be collected by the executing agency for an eventual analysis approximately two years after the final tranche release. Data pertaining to the execution period will be available for the preparation of the Project Completion Report. Guidelines for this purpose will be prepared with the executing agency prior to loan approval that specifies: (i) the definition of each indicator; (ii) baseline values; and (iii) the methodology to be used for its collection and analysis. This information would be included in the Loan Document in a development effectiveness matrix.

## V. DEVELOPMENT IMPACT

### A. Benefits and results

5.1 The direct benefits and development effectiveness of the program would be measurable and be in the form of (i) reductions of the economic costs, improved access to, and quality of productive inputs and factors of production or the lowering of the transaction costs and the risks of doing business in Ecuador, and (ii) the improved economic performance and productivity of firms that participate in reformed business development programs. It is expected that the economic value of these benefits would exceed by several times the financial costs of the loan. These direct benefits should result in improvements in the productivity of the Ecuadorian productive sector, and their increased ability to compete internationally, as evidenced by greater exports in non-traditional and higher-valued added products. However, these benefits at the level of the productive sector would be difficult to attribute to the measures supported by the Program, and would be apparent sometime after the reforms are implemented.

### B. Social and Environmental Impact

5.2 The program should have a neutral direct environmental impact, as it supports the implementation of a number of policy measures that do not affect directly physical outputs. The program might have both positive and negative indirect environmental impacts, which, however, are not clearly identifiable. Direct social

impact should also be negligible, but the program should have substantial positive indirect social impact via the generation of employment, which should contribute to higher household incomes.

## VI. Issues

6.1 **Political Support.** Frequent ministerial and senior staff changes and makes it difficult to maintain a viable political consensus and institutional momentum for the implementation of reforms. During both the development and implementation of the program, a participative process will be followed in which the private sector is actively involved, with the aim of developing strong political support for the program. Particular efforts at building a strong consensus in the private sector will be made for reforming the legal basis for financial transactions, which might be the politically most challenging area In spite of these measures, there still remains the risk that political instability could stall progress in the implementation of the program, including the maintenance of sound macroeconomic policies.

6.2 **Program implementation and management.** The weakness of some Ecuadorian institutions combined with the range of areas covered by the program makes program implementation and management potentially difficult. To address these potential problems, the MEF would organize a specialized unit to manage and supervise the program, in close coordination with the CNC, which has the responsibility to coordinate and monitor the implementation of a national competitiveness agenda. The parallel Technical Cooperation operation would provide these institutions, as well as the sub-executing agencies, with additional resources and technical assistance so that they have the know-how and capabilities to effectively implement and manage the program.

6.3 **Fiduciary Risk**. The Country Financial Accountability Assessment (CFAA) indicates the possibility of fiduciary risks in Ecuador. However, the Bank in cooperation with the World Bank is providing technical assistance to strengthen financial management to mitigate these risks.

## VII. Status

7.1 Consultants have been contracted to conduct the needed analysis for the definition of policy, legislative institutional and programmatic changes that the program will support. It is expected that they will conclude most of their work by January 2005. With this schedule, a Project Document could be prepared for consideration by the Board during the first half of 2005.

**Tentative Policy Matrix**
**Ecuador: Competitiveness Enhancement Program**
**(EC-L1004)**

| Area/Objective | First Disbursement | Second Disbursement | Measurable Results |
|---|---|---|---|
| **I. IMPROVEMENT IN THE BUSINESS CLIMATE** | | | |
| **1. Macroeconomic Context.** Maintain an economic policy framework that contributes to macroeconomic stability. | Implementing a macroeconomic policy framework that is consistent with the objectives of the program, and which is formally monitored by the IMF. | Implementing a macroeconomic policy framework that is consistent with the objectives of the program, and which is formally monitored by the IMF. | Inflation kept at international levels. Government spending constrained, and debt reduced as a percentage of GDP, consistent with current version of the Fiscal Responsibility Law. (LOREFYT). |
| **2. Access to Finance.** Reduce the risks and costs of financial intermediation. | Strengthen the legal basis for the operation of private credit bureaus that have access to information on all types of payment history, not exclusively credit operations with regulated financial institutions. | Evaluation of operating environment of private credit bureaus to ensure that there are no legal or regulatory obstacles that hinder their effective operation and access to payment history from variety of sources. | Private credit bureaus are operating with access to information on payment history from broad variety of sources. Increased use of credit histories from credit bureaus by banks in their credit decisions. |
| | Approval of norms by the Junta Bancaria to assure transparent and complete dissemination to the public of information on the costs of financial services of regulated financial institutions. | Effective enforcement of the norms on the accessibility and transparency of information on the cost of financial services. | Financial institutions publish and broadly disseminate transparent and complete information on the cost of financial services. |

| Area/Objective | First Disbursement | Second Disbursement | Measurable Results |
|---|---|---|---|
| | Establish a consultative process with representative of financial and non-financial private sectors, and government authorities to develop a reform to improve the execution of contracts and property rights for financial transactions.<br><br>Preparation of a draft legal reform for secured financial transactions that meets international standards. | Effectiveness of legal and institutional reforms that improve the enforcement of contracts and property rights for secured financial transactions that that meets international standards.* | More rapid and less costly execution of credit collateral/guarantees. Increased level of debt secured with moveable property. |
| | Establish a consultative process between government, private sector and civil society to reform the legal and institutional framework for the resolution of corporate insolvency.<br><br>Preparation of draft law for the resolution of corporate insolvency that meets international standards. | Effectiveness of legal reform for the resolution of corporate insolvency that meets international standards.* | More rapid and secure resolution of corporate insolvency. |

* Conditions for possible floating tranche.

| Area/Objective | First Disbursement | Second Disbursement | Measurable Results |
|---|---|---|---|
| **3. Rule of the Game.**<br><br>**Bureaucratic Procedures.** Reduce the cost and time to complete official bureaucratic procedures. | Establish a Plan of Action of measures, to streamline or eliminate a prioritized list of bureaucratic procedures, based on their expected economic impact (reduction of transaction and opportunity costs). | Implementation of the measures of the Plan of Action, not requiring legislative changes, and that are scheduled to be completed during the execution period of the loan. | Lower transactions costs and time required to complete a set of bureaucratic procedures that have been the greatest economic impact. |
| **4. Access to Markets: Air Cargo**: Improve the quality and lower the cost of air cargo services. | Effectiveness of legislative reforms required for obtaining US Federal Aviation Authority "category one" status for Ecuadorian civil aviation authorities. | Establishment of an open entry policy for the provision of air cargo services. | Lower cost of international air cargo services and reduced cost differential between Ecuador and regional competitors. |
| **5. Institutional Framework**: Greater coordination and complementarity between public and private efforts to improve competitiveness at both the national and local level. | Modify the legal statutes and institutional structure of the Consejo Nacional de Competitividad, via an Executive Decree, in order clarify its responsibilities and to provide it with streamlined mechanism to make and execute decisions. | Implementation and effective operation of approved institutional structure for the CNC. | CNC is meeting the benchmarks established in its annual workplan, and the implementation of the Agenda Ecuador: Compite, is in accordance with established timetable. |
| | Develop a mechanism to support the establishment of regional public/private sector initiatives and institutions for the promotion of competitiveness. | Effective implementation of mechanism to promote competitiveness initiatives at local level. | Increased number of regional public/private sector competitiveness councils have been established and are operating. |

| Area/Objective | First Disbursement | Second Disbursement | Measurable Results |
|---|---|---|---|
| **II. Business Development Policies and Programs** | | | |
| **6. Business Development Services**: Establish business development mechanisms that effectively improve the capacities, and behavior of firms to increase productivity and compete in local and international markets. | Comprehensive evaluation of business development programs and conduct of a workshop to share results with executing and donor agencies.<br><br>Approval of policy for business development services that establishes guidelines and criteria for publicly supported programs, which promote collaborative ventures between firms and technological innovation. Policy should require: demand-driven financing, transparent selection criteria, decentralized management, significant counterpart financing requirements by participating firms, and other financial incentives be linked to the meeting of program objectives.<br><br>Presentation by Ministry of Labor of reform proposal to increase the coverage and effectiveness of the demand-driven on the job training program of the Consejo Nacional de Capacitación y Formación (CNCF). | Implementation of pilot programs that meet policy and program criteria.<br><br>Evaluation of progress and preliminary results of pilot programs and conduct of workshop with executing and donor agencies to share lessons learned and propose policy and programmatic adjustments..<br><br>Implementation of reform of demand-driven on-the job training program of CNCF that increases coverage and effectiveness. | Increased number of firms are participating in business development programs that meet specified policy criteria, and the average labor productivity and economic performance of these firms has increased more than the average for similar non-participating firms. |

**COMPETITIVENESS ENHANCEMENT PROGRAM**
**(EC-L1004)**

**Estimated Costs for Project Preparation**

| | |
|---|---|
| **1. Resources for Consultancies (to be financed by TC-0301008)** | **$300,000** |
| Coordination of project Preparation | 45,000 |
| Institutional Framework | 30,000 |
| Judicial Security | 40,000 |
| Access to Finance | 130,000 |
| Bureaucratic Procedures | 15,000 |
| Business Development | 40,000 |
| **2. Administrative Resources for Missions** | **4 missions, 16 persons weeks** |
| 2 Orientation Mission (4 persons) | 8 person weeks |
| Analysis Mission (4 persons) | 6 person weeks |
| Negotiation Mission (3 persons) | 2 person weeks |
| **3. Administrative Resource for Work in Office** | **34 person weeks** |
| Team Leader | 10 weeks |
| Members of Team | 21 weeks |
| Lawyer | 3 weeks |

**ECUADOR (EC-L1004)**
**MULTILATERAL AND BILATERAL SUPPORT OF COMPETIVENESS MEASURES:**
(Bold indicates policy-based programs; italics indicate investment or technical assistance operations.)

| AREA | PBL (EC-Ll004) | Other IDB | World Bank | IMF | CAF | Bilateral |
|---|---|---|---|---|---|---|
| **Macroeconomic Stability** | **X** | | **X** | **X** | | |
| **Financial Markets** | **X(Access)** | | | | *Venture capital* | *AID, Supervision* |
| **Labor Markets** | | | **X** | | | |
| **Judicial Security** | | *Judicial Sector Modernization (EC-L1011)* | *Judicial Modernization* | | | |
| **Bureaucratic Procedures** | **X** | | *Customs* | | | *AID, Customs* |
| **Access to Markets:Infrastructure** | **X(Air Transport)** | *PRI: Quito Airport (EC-L1005)* | *Ports Roads* | | *Roads* | |
| **Trade Policy** | | *Foreign Trade Management (EC-L1001)* | **X** | | | |
| **Energy and Telecommunications** | | | **X** | | | |
| **Institutional Framework** | **X** | | | | | |
| **Business Development** | **X** | | *Quality, Technology* | | *Cluster promotion, Internet development.* | EU, Export Promotion |