INVESTMENT SECTOR PROGRAM

(EC-0194)

EXECUTIVE SUMMARY

Borrower:	Republic of Ecuador		
Executing agency:	Ministry of Economy and Finance		
Amount and source:	IDB: (OC) Total:	US$ US$	150 million 150 million
Financial terms and conditions:	Amortization Period: Grace Period: Disbursement Period: Interest Rate: Supervision and Inspection: Credit Fee: Currency:	20 Years 5 Years 18 Months variable 1.00 % 0.75 % U.S. Dollars from the Single Currency Facility	

Objectives:

The proposed Investment Sector Program is intended to support the Government of Ecuador's (GOE) macroeconomic stabilization program, and its development objective to establish and consolidate an enabling environment to promote the participation of the private sector in the economy and begin the resolution of intervened financial institutions while protecting the social groups most vulnerable to the adjustment process.

Description:

In addition to compliance with the macroeconomic stabilization program agreed with the International Monetary Fund, the program includes the following components: i) private sector participation in infrastructure; ii) resolution of intervened financial institutions; and iii) social protection. These components are at the centerpiece of the GOE's macroeconomic program.

The private sector participation in infrastructure component supports measures intended to provide the groundwork for a private-sector-led rehabilitation and expansion of the power and telecommunications sectors while at the same time substantially

reducing the need for public investments in these sectors. It also includes measures intended to promote a transparent and objective privatization process in the power sector.

Policy conditions under the component for the resolution of intervened financial institutions, a key element of the GOE financial restructuring strategy agreed upon with all international financial institutions, focus on short-term measures to facilitate and accelerate an effective and transparent resolution of intervened institutions, which currently make up about half of the system's assets. In particular, the program supports the contracting of first-rate private management under performance-based contracts to administer and liquidate the assets of closed banks and to restructure open institutions to prepare them for reprivatization.

The social protection component supports policy measures to protect key social services that benefit the poor from further erosion, and improve the capacity for allocating and using resources in the social sectors efficiently; improve targeting of key social programs to the poor and strengthen the safety net; and supplement the purchasing power of the poor.

The program is supported by a fast-disbursing operation in an amount of US$150 million, designed in two tranches of US$60 million each--programmed ex-ante to be fulfilled in a period of six months after Board approval--; and one floating tranche of US$30 million supporting the establishment of a transparent and objective process for private sector participation in the power sector. The expected disbursement period is 18 months.

Program implementation will be carried out in close coordination with lending programs by the World Bank and the Andean Development Corporation, and the IMF Stand-by program approved in April 2000.

Bank's country and sector strategy: The proposed program is consistent with the Bank's country strategy since it supports the Government's macroeconomic stabilization program, the participation of the private sector in the economy, financial sector measures and social protection of the most vulnerable groups. The program's components, which have been developed in the context of the Bank's specific sector strategies and in line with the country's macroeconomic stabilization program with the IMF, have benefited from continued Bank involvement in these sectors.

Environmental and social aspects: The program supports the establishment of the environmental regulatory framework applicable to the power sector. Environmental assessments of all 25 power companies will

complement this initiative and serve as the basis for defining the treatment of environmental aspects and related institutional arrangements. Additionally, resources from IDB Loan 1136/OC-EC have already been allocated for the institutional strengthening of the regulatory agency.

The program also supports policy measures to protect key basic social services that benefit the poorest groups of the population, and lay the basis for an effective social safety net. These measures are intended to protect these groups from the worst effects of the adjustment process.

Benefits: The program has been designed to provide timely support for macroeconomic recovery and stabilization, and advance some relevant reforms to set the basis for restoring and sustaining economic growth. Progress on structural reforms, particularly an enhanced and effective private sector participation in the economy, and progress in the resolution of intervened financial institutions would support the implementation of the GOE's macroeconomic program.

The successful implementation of the social protection component is expected to restore an adequate level of spending in key social services and programs that serve the poor; support adequate funding levels or cash transfer programs designed to protect the incomes of the poor from further erosion and for investment projects that generate demand for unskilled labour; and allowing the country to enjoy a technical, transparent, objective, and uniform instrument for identifying and selecting individual beneficiaries for social programs based on the socioeconomic characteristics of all households.

Risks: In addition to the political risks which include the potential for social unrest which may prevent the GOE from implementing stabilization and adjustment measures; and the fragility of the coalition that supports the reform program, the proposed program has the following risks: i) lack of progress in improving macroeconomic policy management and conditions; ii) slow reform implementation; and iii) weak institutional capacity.

Regarding the macroeconomic risk, the major risk of the program, the April agreement with the IMF on a stabilization program and the recent announcement of a package of economic reforms one month ahead of schedule underline the GOE's commitment to the reform process and help mitigate this risk.

The potential slow reform implementation risk has been mitigated by the recent enactment of the Economic Transformation Law,

which paves the way for most reforms and the close coordination among international financial institutions. With respect to institutional capacity, substantial available technical cooperation resources have already been allocated for supporting infrastructure and financial sector agencies to timely implement reforms

Special contractual conditions:	The policy matrix (Annex I), policy letter (Annex II) and action plan (Annex III) govern the conditions for the disbursement of each of the tranches.
Poverty-targeting and social sector classification:	This policy-based program is not considered to be poverty-targeted. Nevertheless, it supports specific measures to protect key basic social services that benefit the poorest groups of the population, and lay the basis for an effective social safety net. These measures are intended to protect these groups from the worst effects of the adjustment process, increasing the viability of the proposed reforms and the macroeconomic stabilization program.
Exceptions to Bank policy:	None

I. INTRODUCTION

1.1 Ecuador is in the midst of an unprecedented economic crisis, which demands exceptional financial resources to resolve it. This crisis presents a tremendous challenge to the Government of Ecuador (GOE), which has responded by structuring an economic program to stabilize the economy and establish the conditions for restoring and sustaining economic growth. In order to support the GOE's stabilization efforts, international financial institutions have committed to provide about US$2 billion in financing over the period 2000-2002.

1.2 This document presents an Investment Sector Program, an integral component of the GOE's economic program, which is intended to support the GOE's macroeconomic stabilization program, and provide the basis for some reforms in the infrastructure and financial sectors while protecting the social groups most vulnerable in a period of adjustment. The proposed program is supported by a fast-disbursing operation in an amount of US$150 million, and has been designed in two tranches of US$60 million each, programmed ex-ante to be fulfilled in a period of six months after Board approval; and one floating tranche of US$30 million supporting the establishment of a transparent and objective process for private sector participation in the power sector.

II. Frame of Reference

A. Macroeconomic Framework

2.1 Ecuador's economy has performed poorly since the early 1980s. After accumulating debt for a decade, the 1980s debt crisis caused a growth crisis from which Ecuador has never fully recovered. Natural disasters and volatile conditions in world primary commodities markets have also affected growth. Over the 1980s and 1990s real gross domestic product (GDP) grew slightly less than the population, while the public debt continued to grow rapidly. Moreover, since early 1998 Ecuador has been undergoing a severe macroeconomic crisis, caused by a combination of external and climatic shocks, made worse by political instability, and in some instances inadequate macroeconomic management and policy responses. Ecuador's heavy public-sector debt has also been a debilitating burden on the economy. The public sector debt-- including public and publicly guaranteed debt and the Central Government's domestic debt in bonds--rose to US$13.7 billion or the equivalent of over 110% of GDP in 1999; with interest accruals representing about 32 of total fiscal expenditures. In September 1999, Ecuador became the first country to default on Brady bonds.

2.2 Following several weeks of severe exchange-rate depreciation in late 1999, the previous administration announced that it would dollarize the economy in January 2000. When the current administration took office that same month, it inherited a desperate economic situation characterized by a sharp contraction of real GDP, rising unemployment, accelerating inflation, a large fiscal deficit and mounting public sector payment arrears, and a banking system deep in crisis. The new government maintained the commitment to the dollarization program and in order to restore confidence in economic management, stem the decline in economic activity, and lay the basis for renewed economic growth committed to undertake a program of economic reforms.

2.3 To that end, in March 2000 Congress approved the Economic Transformation Law (ETL), which is the core of the Government's stabilization and structural-reform program and sets the framework for dollarization. This legislation also paves the way for a strengthened framework for addressing the problems of the financial sector, a more flexible labor market, and should facilitate increased private foreign and domestic investment in key sectors of the economy. The government also expects that it will send a strong positive signal to the official international community, and to private investors, and thereby will help mobilize financial support for the economic and structural reform process.

2.4 **Recent economic reforms**. On May 25, 2000, the GOE announced a major package of economic reforms which included a sharp reduction in fuel subsidies, offset by an increase in public and private sector wages and increased government transfers to the poor; these adjustments were effective on June 1. Basic gasoline and diesel prices were increased by 72% and 92%, respectively. The politically sensitive price of domestic cooking gas was left unchanged, although the IMF

agreement called for a 40% increase. Nevertheless, other compensatory measures such as an average increase of 300% in the price of fuel oil, jet fuel and other derivatives, were implemented. The GOE also announced a 71% average increase in electricity tariffs, and progressive adjustments in the next 2 years.

2.5 These measures were also accompanied by a social compensatory package. As of June 1, 2000, public sector employees will receive a progressive salary increase of between 48% and 70%, with those on the lowest income levels receiving the largest percentage increases. The GOE will also boost transfers to the poor by 75% via the Bono Solidario. Disabled persons' allowances will be doubled, while pensioners in the state scheme will have payments increased by 40%. The package also includes a US$30 increase in the monthly minimum wage within in the private sector.

2.6 This economic package was largely in line with the measures set out in the April IMF letter of intent. The IMF has welcomed the measures as essential to improve economic conditions and enhance the prospects for recovery. Nevertheless, IMF staff have begun assessing their overall impact. The package was announced one month ahead of schedule, underlying the GOE's commitment to a politically difficult reform process.

2.7 **International Support for the GOE's economic program**. On April 19, 2000, the International Monetary Fund (IMF) approved a 12-month Stand-By Arrangement for about US$300 million. Previously, in a statement in March, the IMF, World Bank, the Inter-American Development Bank (IDB) and the Andean Development Corporation (CAF) jointly promised to provide about US$2 billion in financing over 2000-2002 to support Ecuador's stabilization effort. This includes the Bank's proposed Investment Sector Program and other programs for a total of over US$600 million; World Bank support of about US$425 million; and CAF support of US$700 million. The Paris Club is expected to approve a new rescheduling scheme, under which Ecuador would clear accumulated debt-service arrears and reschedule amortization due in coming years. Finally, official creditors' actions are expected to help persuade holders of Ecuador's defaulted external bonds to agree on a new arrangement that would reduce the debt-servicing burden. Discussions with private creditors have resumed following approval of the Stand-by.

2.8 In the short run, the impact of the proposed Investment Sector Program and other related programs will be to increase the country's net indebtedness. Nevertheless, growth recovery, inflation, and the fixed exchange rate should work to reverse this increase in the medium term. The Government's capacity to service the debt over the medium term will depend on several factors, including: i) oil-export revenues; ii) the GOE's ability to sustain appropriate fuel prices; iii) taxation performance; iv) privatization proceeds; v) and the Government's ability to contain non-interest public expenditure, while at the sometime addressing the need to increase expenditure on education, health, social welfare, and basic infrastructure investment; and vi) reaching satisfactory agreements with external

creditors. Finally, for the macroeconomic program to succeed burden sharing and debt restructuring with private creditors is required.

2.9 In addition to the recently approved IMF program, the World Bank, CAF, and the IDB are currently structuring their respective programs, which are being designed in a complementary manner on the basis of the GOE's economic program. Annex IV presents a summary of all the programs supported by international financial institutions (IFI). The World Bank Structural Adjustment Program, approved on June 22, 2000, includes measures to support the GOE's macroeconomic program; fiscal including tax reform; financial sector restructuring; privatization of infrastructure, and social protection. CAF support also emphasizes public sector reform, including tax reform and privatization of public infrastructure; and financial sector strengthening. In addition to supporting the GOE's macroeconomic stabilization program, the IDB priorities include private sector participation in infrastructure, the resolution of intervened financial institutions, and social protection. The proposed program will support reforms in these priority areas where the Bank has been actively involved with the country, and that are fundamental elements of the GOE's macroeconomic stabilization program.

B. Private Sector Participation in Infrastructure

2.10 The GOE's macroeconomic program includes reforms aimed at boosting productivity, raising potential output, and strengthening the regulatory framework for the power and telecommunications sectors, expected to be privatized in the near term. This is expected to lead to increased coverage and quality of service, and improved competition and efficiency with the corresponding gains to consumers.

2.11 **Power.** Ecuador needs substantial investments to meet the expected growth in demand and to rehabilitate and expand the transmission and distribution systems. In order to meet these financing needs at a time of scarce financial resources, the GOE is committed to increase the participation of the private sector; and to that end, it has announced its plans to privatize the assets it currently owns, and to promote the construction of new power projects by the private sector

2.12 The structure of Ecuador's electricity sector changed significantly after the implementation of the electricity law of 1996. As a result, the INECEL, the former state owned electricity monopoly, has already been unbundled, and transformed into 25 companies: six generation companies, one transmission company, and 18 distribution companies, all owned by the Government's Solidarity Fund. EMELEC provides service to the Guayaquil area. Regulatory and oversight functions have been under the purview of the Consejo Nacional de Electricidad (CONELEC) since its establishment in 1997.

2.13 In support of the GOE's policy decision to promote the participation of the private sector in the operation, maintenance, rehabilitation, expansion of the system, the

Economic Transformation Law included reforms to 1996 electricity law, paving the way for the privatization of 51% of the assets currently owned by the GOE. This recent legal change provides a sufficient basis for a competitive sector and private sector development. This legal framework is complemented by existing regulations issued by CONELEC since its establishment. These include regulations for: i) the operation and procedures of the wholesale market; ii) the establishment of CENACE as the operator of the wholesale market; iii) concessions, permits and licenses; iv) the dispatch and operation of the national interconnected system; and v) tariff regulation.

2.14 While there is a legal basis for proper tariff setting, and a tariff methodology has been established including subsidies to low income consumers, tariff adjustments have been delayed. To revert this situation, on May 24, 2000 CONELEC approved a progressive tariff adjustment program that calls for an initial average increase of 71% which went into effect on June 1, 2000, resulting in an average rate of 0.0427 US$/kWh, and subsequent average monthly increases of 4% during a two-year period; this tariff adjustment program is expected to increase the average price of electricity to US$0.0824. Additionally, there is a cross subsidy in place whereby users with consumption levels above the average in the concession area are charged an additional 10%; the proceeds of this additional charge are distributed among those users with consumption levels below the ational average. Implementing these adjustments as scheduled will send a positive signal to potential investors of the GOE's commitment to ensure the financial sustainability of the sector, and should facilitate the privatization process.

2.15 In order to advance the preparation of the privatization process, the Consejo Nacional de Modernización del Estado (CONAM) has already retained the services of a consortium led by an international investment bank--with resources from IDB Loan 1136/OC-EC, to provide overall advice and to help them structure and complete these privatizations. The consortium has already completed the technical, operational, financial, environmental, and legal diagnostics for all 25 companies; and is currently defining the model that will serve as the basis for the privatization process. While the recent unbundling of the industry and the structuring of sector regulations are key steps in the reform process, a well structured, transparent and objective privatization process is expected to consolidate a more competitive environment, and allow the financing of sector infrastructure.

2.16 **Telecommunications.** Fixed telephone services are offered by two state-owned companies, ANDINATEL (515,000 lines) and PACIFICTEL (539,000 lines) and by a municipally-owned company, ETAPA (76,000 lines). Telephone density of fixed services is 9/100 inhabitants. There are also two cellular companies, each with a national franchise, CONECEL (197,000 subscribers) and OTECEL (187,000 subscribers). Other telecommunications companies include seven offering trunking services, five offering paging, and 19 Internet Service Providers.

2.17 The government made two attempts to sell ANDINATEL and PACIFICTEL, one in November 1997 and another in April 1998. These attempts failed for three basic reasons. First, an unrealistic base-price had been established. Second, the percentage that could be sold was limited to 35%. Third, domestic telephone rates have been below costs.

2.18 The legal and regulatory framework has been based on the Special Telecommunications Law of 1992, amended in 1995 and 1997. There are three institutions involved in telecommunications regulation. The Consejo Nacional de Telecomunicaciones (CONATEL), established in 1995, is responsible for issuing regulations; the Secretaria Nacional de Telecomunicaciones (SENATEL), established in 1995, provides technical support to CONATEL; and the Superintendencia de Telecomunicaciones (SUPTEL), established in 1992, is in charge of compliance. The separation between regulation and compliance is mandated in the Constitution. The Government is considering consolidating the functions of CONATEL and SENATEL to improve the institutional framework for telecommunications regulation.

2.19 The ETL included very well targeted reforms to the existing legal framework. This new framework opens up the telecommunications sector to competition; introduces the concept of a fund to promote universal service; establishes the principle that tariffs should be based on costs; and increases the proportion of the state-owned companies that can be sold to private investors from 35% to 51%, thus removing an important constraint to privatization. The implementation of a competitive model can not be achieved without the preparation and issuance of a number of key regulations, including those dealing with licensing, universal service, interconnection and spectrum management.

2.20 In order to promote competition, procedures for issuing licenses must be agile. Additionally, it would be necessary to develop a transparent mechanism to subsidize services, as the present system of cross-subsidies is not compatible with a fully competitive environment. Clear rules for interconnection are also necessary to ensure that the incumbents do not use their market power to stifle competition. As wireless services are the fastest way to introduce competition, and as the radio spectrum is a scarce resource, an efficient system for spectrum allocation and management is necessary for the rapid introduction of competition.

2.21 **Strategy and Ongoing Bank Support**. The Bank strategy for the infrastructure sectors focuses on supporting the redefinition of the roles of the state and the private sector; the restructuring of the sectors and the establishment of regulations that promote more competitive markets; the privatization of sector enterprises; and capacity building measures for the public sector to effectively perform its roles as policy maker and regulator. Since early 1998, the Bank technical team has been providing continued technical support to the GOE for the restructuring of the power and telecommunications sectors. The policy measures proposed in this program benefit and build on this continued technical support. In the power sector, the Bank team has undertaken an assessment which identified issues

affecting the sector; has supported the GOE in structuring the terms of reference for the privatization of sector enterprises and in the definition of a sector strategy; and has supported the organization of a seminar in Ecuador in which the rationale for sector reform was discussed with representatives from civil society. The Bank team has also been very active in supporting the GOE monitor the work of the investment bank responsible for structuring the privatization process; and has participated as an observer in a meeting organized by the GOE to present to and obtain views on the privatization process from sector workers. In the telecommunications sector, the IDB team has supported the GOE in drafting a new law, which is ready for presentation to Congress.

C. Financial Sector Restructuring

2.22 Ecuador is in the midst of attempting to resolve an unprecedented financial crisis. Since August, 1998 15 banks representing over half of the banking system's on-shore assets have been intervened. Twelve of these banks, accounting for about 16% of total assets have been closed to be liquidated, and the remainder is being operated under temporary control of the Deposit Guarantee Agency (AGD)--the state agency created to manage the resolution of intervened banks and a deposit guarantee scheme--until they are reprivatized. The strong external shocks in 1998 harmed debtors ability to pay and reduced bank liquidity, on an already weak financial system due to ineffective supervision and consequent inappropriate financial practices. The system, especially in off-shore operations, was plagued by high levels of insider lending, term and currency mismatches, and excessive portfolio concentrations. At end-1998, off-shore institutions, which largely conducted operations with nationals in Ecuador but booked them off-shore in tax havens, accounted for over 35% of the banking system's assets.

Table 1. Status of Banks as of March, 2000

Classification	Local Banking Assets (% of System)	Local Banking Assets (US$ Billion)	Number Of Banks	Non-performing Loans (% of Portfolio)
Private Ownership	49%	2.4	25	20%
Operating, under state ownership. [1]	35%	1.7	4	55%
Closed, assets to be liquidated	16%	0.7	12	79%

Source: Superintendency of Banks

2.23 Insufficient and inappropriate bank restructuring and macroeconomic adjustment further deepened and extended the crisis, including the decision to freeze over half of banks deposits in March 1999. Reflecting the declining confidence in the system, since the end-1998 both assets and deposits of the system have fallen by

[1]This includes Banco Continental which was intervened by the Central Bank in 1996 and remains in operation under Central Bank ownership. This bank is expected to be merged with a larger bank under AGD control and the merged entity to be reprivatized.

over half. By February 2000, close to 35% of the operating banks' loan portfolio was non-performing, compared to 8% in December, 1998. Solvency and liquidity problems appeared to be most serious among some of the banks under temporary state control.

2.24 In order to deal with this crisis, the GOE with the IMF, and in collaboration with technical staff of the Bank, the World Bank and CAF, have developed a two-stage strategy to first stabilize and lay the legal basis for a financial sector restructuring; and second, to define and begin the implementation of the restructuring measures to restore confidence and the effective functioning of the banking system within the constraints of a dollarized system. The Economic Transformation Law provides the legal basis for the implementation of a financial sector restructuring and to improve the enforcement capabilities of financial sector supervisors.

2.25 The first stage of the strategy, already largely implemented, was designed to stabilize the system and provide the legal basis for the financial sector restructuring. It included four basic set of measures: i) the unfreezing of US$1.2 billion of frozen deposits in operating banks starting on March 13, 2000, where cash is provided for deposits less than US$4,000, and negotiable certificates for deposits greater than US$4,000; ii) the establishment of lender of limited resort mechanisms to provide liquidity to banks to address limited shortfalls and provide greater confidence to the system; iii) the definition of a debt restructuring framework in which larger debtors (greater than US$50,000) would be treated in a case-by-case manner and negotiations conducted on a voluntary basis and; (iv) the enactment of legislative changes for a financial sector restructuring and enhanced enforcement capabilities of financial sector supervisors via the approval of the ETL and issuance of a Presidential decree for debt restructuring.

2.26 These legal changes addressed many of the most important legislative deficiencies. In particular, they: i) give broader and more specific powers for prompt corrective actions and the imposition of penalties to the Superintendent of Banks; ii) allow banks to operate under the minimum capital adequacy requirement, if they have time-bound rehabilitation plans approved by the Superintendency of Banks; iii) provide legal protection to staff and directors of those institutions involved in bank supervision and restructuring; and iv) eliminates the blanket deposit guarantee gradually over three years; and v) provide the AGD with an extra-judicial power of foreclosure (coactiva). The establishment of regulations for these measures is still underway.

2.27 To date, the first stage of the strategy has worked better than expected. Fears of significant deposit shortfalls as a result of the deposit unfreeze did not materialize. Indeed since the end of February, 2000 free deposits have increased by over US$300 million or more than 15%. Moreover, the net liquidity position of vulnerable banks under temporary state control has improved. However, the liquidity of some banks still remains precarious, as a range of possible shocks could lead to a rapid loss of confidence and sharp deposit outflows. The establishment and funding of the lender of last resort mechanisms should help

reduce this threat as long as the run is not systemic in nature. It should be noted however, that solvency of banks has continued to deteriorate with the rising loan delinquency rate.

2.28 The second stage of the strategy focuses on both the definition and implementation of a more rapid resolution process for intervened institutions and improving the solvency of all operating banks based on best international practices. In addition, it includes measures to strengthen financial sector supervision and the enforcement of an appropriate incentive framework.

2.29 The strategy deals with the resolution of intervened institutions by supporting the rapid and transparent liquidation of the assets of closed banks, and the improved management and reprivatization of open institutions under AGD control. Recapitalization of operating banks will require bringing capital and loan and provisioning standards gradually up to international standards and the establishment of rules and mechanisms for access to limited public resources that will be designed to catalyze the provision of private capital. A Supervision Plan that identifies the measures necessary to enhance supervision and the incentive framework aimed at bringing supervision up to international standards based on the Basle Core Principles has been approved by the Superintendency of Banks. The Plan includes measures to improve the informational basis of the financial system, including the establishment of international accounting standards. As part of efforts to enhance transparency and effective supervision, the GOE is committed to eliminate off-shore bookkeeping operations within 18 months as agreed with the World Bank.

2.30 **Strategy and Ongoing Bank support**. The Bank has worked in close collaboration with the IMF, World Bank ad CAF to develop the joint financial sector strategy, an integral component of the GOE's program with the IMF. The policy measures proposed in this program are all included in this joint strategy and correspond to short-term measures expected to be taken in the context of the already agreed economic program. In order to provide initial support to the macroeconomic program and back the initial measures for the restructuring of the financial sector, the Bank has already restructured and disbursed remaining resources from the Financial Sector Loan (833/OC-EC). In addition, the Bank's ongoing Financial Sector Technical Cooperation Loan in coordination with a World Bank Technical Assistance Loan will continue to provide resources to support much needed institutional strengthening measures. Given the depth of the financial crisis and the time required for its resolution, the Bank and other financial institutions are expected to provide further support to the GOE's efforts to resolve the crisis, and strengthen the financial sector consequent to the proposed program.

D. Social Protection

2.31 The current crisis has developed within a context of already high and increasing poverty and social inequality, decreasing social expenditure and a deterioration of

social services. The percentage of the population living in poverty increased from 32% in 1995 to approximately 69% by the end of 1999. Extreme poverty defined as insufficient income to consume a minimum food basket increased from 15% to 17% from 1995-1998 to 34% by the end of 1999. Poverty rates increased most sharply in rural areas, with 75% of the rural population currently living in poverty, compared to 69% in 1999 and 54% in 1994. Open unemployment doubled between May 1998 and August 1999 rising from 8.5 to 16.9 percent, and underemployment rose from 46.5 to 54.7 percent over the same period due to the loss of jobs in the formal sectors of the economy. The unemployment rate for the lowest income quintile is double the national average. This trend of deepening poverty has been accompanied by worsening inequality, with the income GINI coefficient increasing from 0.54 in 1994 to 0.58 in 1998.

2.32 While the crisis has affected all Ecuadorians, it has increased the vulnerability of the poor in particular, compromising their human capital development by means of decreased school attendance, poor nutrition and deficient infant care, and a general deterioration of maternal and infant health. As the incomes of the poor have declined, they have coped by withdrawing children from school to work, reducing food consumption and the nutritional value of food consumed, deferring medical attention, selling assets including productive assets such as tools, and decreasing other discretionary expenditures such as clothing and medicines.

2.33 School enrollment figures have not changed substantially, but absenteeism has more than doubled, and the amount of time children spend working for money has more than tripled. The result is a potentially irreversible decline in the human capital of the poor. Absenteeism is a bigger problem in the rural areas and in the lowest quintiles of the population. More than 20% of the children aged 6-15 living in rural areas are not enrolled in school and the absentee rates in quintiles 1 and 2 are 19% and 14%, respectively. Preventive care for pregnant women and young children is often foregone as a discretionary expense. In 1999, 36% of the beneficiaries of the Bono Solidario (a cash transfer program introduced in 1998 to compensate the poor for the elimination of untargeted gasoline, cooking gas and electricity subsidies) postponed medical attention for at least one family member; of this 36%, two-thirds did not attend to the medical needs of children younger than 15 years of age. Similarly, children are given lower priority than adults in sharing food, especially if they receive free snacks at school.

2.34 Declining incomes and living conditions of the poor have been compounded by a sharp decline in social sector spending, which even prior to the crisis was significantly below Latin America and Caribbean averages. Public spending in education and health declined in 1999 by 0.7 and 0.2 percentage points of GDP, respectively, from an already low base (averaging 3.1 and 1.0 percent of GDP in 1995-1998). This reduction in social expenditure has resulted in the disruption of social services, as the GOE resorted to salary arrears in the face of an increasing fiscal deficit. During the first six months of 1999, for example, schools and health centers were closed for an equivalent of one and a half months. In addition to low levels of expenditure, serious deficiencies in the targeting of social

expenditure and social programs reduce their impact on the poor and vulnerable groups.

2.35 In 1998 the government began to make efforts to put in place an adequate social safety net, replacing generalized energy subsidies by a targeted cash subsidy, through the creation of the Bono Solidario. The program, with an estimated annual cost of US$100 million, currently benefits almost 1.4 million households. The Bono is administered efficiently, has low operating costs and reaches a large percentage of the urban poor. Notwithstanding its relative success, it has failed to reach the rural poor, as well as a significant number of the indigent in urban areas, while leakages to the non-poor remain a problem.

2.36 The increase in poverty and the deterioration of the human capital has made evident the urgent need to construct effective social protection mechanisms targeted to the poorest groups of the population. Therefore, the GOE has assigned the highest priority to addressing the needs of the poorest segments of the population, protecting them from the worst effects of the adjustment process and improving their human capital and earning capacity over the medium term. In order to achieve this objective, the GOE program with the IMF includes specific measures to effectively safeguard resources for social programs as well as to increase the effectiveness of targeting. In order to minimize the risk of desertion and absenteeism among poor children, and thus protect their human capital, the GOE is also currently designing a cash transfer program conditioned on school attendance, the Beca Escolar, which would provide monthly stipends to the poorest families.

2.37 **Strategy and Ongoing Bank Support**. One of the central objectives of the Bank strategy is the alleviation of poverty, through a combination of social protection programs and investments in human capital for the most vulnerable groups. The Bank is currently financing a number of projects directed at these groups, including Redes Amigas (1142/OC-EC), which supports improvement in basic education in rural and marginal areas; and Nuestros Niños (1056/OC-EC), which finances non-governmental organization provision of early childhood services for poor children. The latter is being accelerated in the context of the crisis, and is expected to cover 160.000 children over the next six months. The proposed program draws on the same strategy: protecting priority social expenditures which benefit the poor and prevent further erosion of human capital with particular emphasis on basic education, primary health care, and nutrition. In addition, it lays the foundation for the construction of a more effective social safety net through the development of a transparent, objective and standardized targeting mechanism, which can be applied to a variety of social programs, so as to increase the effectiveness of social spending. In the beginning, this mechanism would be applied to the Beca Escolar, expected to be financed by the IDB and the World Bank under the Social Protection Program (EC-0190), currently under preparation. The Social Protection Program is also expected to provide technical assistance to strengthen the government's capacity to plan, monitor and evaluate

social programs and expenditures, thus enabling it to better cope with the impact of economic adjustment.

E. Previous Bank Experience

2.38 Ecuador's track record in the execution of Bank sector reform programs is poor. The Bank has financed three sector programs for the reforms of the financial, agricultural, and transportation sectors (loans 833/OC-EC; 831-2/OC-EC; and 842/OC-EC, respectively). All these programs have experienced difficulties in execution due to a large extent to a lack of political will, but also to weak institutional capacity. Given the current crisis, the policy measures proposed in this program and other multilateral institutions programs are limited to and fully consistent with those already included in the GOE's economic program with the IMF. In addition, the actions taken to date, particularly the ETL and the economic reforms announced at the end of May 2000 demonstrate the GOE's will to undertake their economic reform program.

F. Bank Strategy and Rationale for Bank Involvement

2.39 The proposed program is consistent with the Bank country strategy since it supports macroeconomic stability, the participation of the private sector in the economy, financial sector restructuring and social protection of the most vulnerable groups. The program's components, which have been developed in the context of the Bank's specific sector strategies and in line with the country's macroeconomic stabilization program with the IMF, have benefited from continued Bank involvement in these sectors.

2.40 The size and financing of the program is commensurate with the fiscal and economic costs of the GOE reforms. Also, Ecuador is facing important fiscal constraints, and is counting on disbursements from multilateral institutions to meet its important and immediate shortfall in funding for external debt service. The closely coordinated partnership of the Bank with other multilateral lending agencies will effectively support the GOE accomplish their stabilization program, and structural reform and fiscal adjustment objectives. Finally, the social protection component, designed and closely coordinated with the World Bank, supports protecting the poor from the worst effects of the adjustment process, increasing the viability of the proposed reforms.

III. THE PROGRAM

A. Objective

3.1 This program is intended to support the GOE's macroeconomic stabilization program, and its development objective to establish and consolidate an enabling environment to promote the participation of the private sector in the economy and begin the resolution of intervened financial institutions while protecting the social groups most vulnerable to the adjustment process.

B. Components

3.2 In order to meet this objective, the program includes the following components: i) private sector participation in infrastructure; ii) resolution of intervened financial institutions; and iii) social protection.

1. Private Sector Participation in Infrastructure

3.3 **Objective**. This component is intended to provide the groundwork for a private-sector-led rehabilitation and expansion of the power and telecommunications sectors while at the same time substantially reducing the need for public investments in these sectors. It is also intended to promote a transparent and objective privatization process in the power sector.

3.4 **Description**. In the **power sector**, the program supports the approval and dissemination of the strategy for the privatization of the sector; and the consolidation of a regulatory framework for its modernization, currently under preparation. The privatization strategy, which will be approved by the Consejo de Modernización del Sector Eléctrico[2] (COMOSEL) and announced by the highest level of Government includes the strategy, rationale, details, sequencing, and timetable for the privatization of the distribution, generation and transmission companies; details of the consultation process with sector workers, and other representatives of civil society at the various stages of the privatization process; the mechanisms to ensure a transparent and objective privatization process; the need to continue strengthening the autonomy and independence of the regulatory agency; and the GOE's commitment to consolidate the regulatory framework, including the progressive adjustments in tariffs required for them to cover economic cost of service in the medium term.

3.5 Regarding the regulatory framework for the power sector, the program specifically supports the development of regulations for antitrust, quality of service, and environmental aspects, all of which are in the critical path to successfully advance an effective privatization process, and for promoting competition and protecting the interests of consumers. Antitrust regulations will

[2]The COMOSEL is headed by the President of CONAM, and includes the Minister of Energy and Mines, the President of the Solidarity Fund, and two representatives from sector workers and professionals.

specify the rules to prevent potential anti-competitive practices that may lead to market concentration and power. This is particularly relevant in view of the imminent transfer of control; and ownership of sector enterprises to the private sector, and the need to ensure that a sufficient number of operators contribute to the establishment of a competitive market. Quality of service regulations are critical to ensure that adequate distribution system maintenance and expansion are undertaken, leading to a continuous and reliable service to the final consumer. Environmental regulations will establish the rules and procedures applicable to the sector to prevent, control, mitigate potential impacts of all activities, including operation and construction. Prior to their final issuance, drafts of these regulations will be presented and discussed in public hearings.

3.6 While sector restructuring is underway and regulations are being completed, Ecuador has failed to establish a credible privatization process in the infrastructure sectors. Therefore, the program also includes **a floating tranche** intended to support a transparent and objective process to promote the participation of the private sector in one or more public power distribution companies, covering the equivalent of 25% of total residential customers. This is consistent with the sequencing proposed in the privatization strategy, and should send a positive signal and provide comfort to the private sector that the GOE is committed to the implementation of their economic plan. In addition to the technical and financial aspects of the transaction, the request for proposals for the sale of the distribution companies will include the treatment of environmental aspects and the related institutional arrangements.

3.7 In the **telecommunications sector**, despite the recent elimination of the exclusivity of service and the increase in the proportion of shares that can be sold to the private sector, further changes are required to develop a framework conducive to private sector participation. To achieve this objective and given the political difficulties in the country, the Government is considering two approaches. Under the first best approach, a new telecommunications law would be enacted. Under the second best approach, regulations would be issued to implement the pro-competition policy enunciated in the ETL. These regulations will not require approval by Congress.

3.8 The first best approach would give greater certainty to investors. The Government has already completed the preparation of a draft law which includes measures designed to ensure that interconnection is obligatory and that fees are cost-based, helping competition by new entrants; and it also proposes mechanisms to encourage a rational use of the spectrum. The draft law also combines the functions of CONATEL and SENATEL in one agency that will be responsible for developing and issuing all regulations.

3.9 The second best approach could also promote competition and would consist of pro-competition regulations to implement the ETL. At present, the Government is taking a number of significant steps to accomplish this including drafting of regulations for concessions and licenses for telecommunications services that will

be offered in a competitive framework, and the development of regulations for a fund to promote universal service. Additionally, the Government has also requested proposals from five firms to carry out a tariff study that will include an estimation of the costs of providing different telecommunications services, the development of a tariff rebalancing plan, and the development of a tariff policy for the sector. Based on the results of the tariff study, CONATEL plans to implement a tariff rebalancing program that is expected to reduce international long distance rates and increase rates for domestic services.

3.10 CONATEL and SENATEL also plan to initiate the drafting of regulations for interconnection and unbundled leasing of network elements, and for spectrum management. CONATEL/SENATEL have developed a set of principles to guide the drafting of these regulations These include principles related to: i) licensing; ii) interconnection; iii) universal service; and iv) spectrum management. Regulation developed on the basis of these principles can contribute importantly to the promotion of competition and the modernization of the sector. Available resources from IDB loan 1136/OC-EC would be used to finance the preparation of these regulations.

3.11 The principles related to licensing include: i) administrative simplicity for granting licenses and permits; ii) no limits to the number of permit to encourage competition; iii) flexibility to permit the adoption of new technologies; and iv) fixed term permits will be granted to give greater certainty to investors. The principles related to interconnection include: i) interconnection is obligatory at any technically feasible point; ii) interconnection charges will be composed of access charges and use charges; and iii) interconnection terms will the subject of negotiations between private agents, and the regulator will only intervene in those cases where an agreement can not be reached in a reasonable period of time. The universal service principles are: i) universal service will be financed by a fund that will receive fees based on total revenue of all telecommunications operators; and ii) the fund will operate with transparency. Finally, the principles related to spectrum management include: i) maximization of efficiency; and ii) use of auctions when appropriate.

2. Resolution of Intervened Financial Institutions

3.12 **Objective.** This component is designed to facilitate and accelerate the process to resolve intervened financial institutions. Bank support would help assure a transparent and effective resolution process for both open and closed banks, and thereby reduce additional fiscal losses by disposing of assets quickly before they lose more value and by increasing returns. The component focuses on short-term actions that are in the critical path for the resolutions of these institutions.

3.13 **Description.** Getting the assets of intervened institutions quickly out of the direct control of the AGD, either by sale, liquidation or contracting their administration to specialized private asset management firms, should increase eventual returns and help to reactivate the economy by getting assets into the control of actors who

have the incentives and capabilities to increase their economic and market value. In line with these objectives, the program supports the definition of a time-bound program for the transparent and rapid disposition of the assets of closed intervened banks. A critical measure of this time-bound program will be to contract private asset management firms to administer and liquidate those assets of closed intervened banks which can be freely transferred.[3] To that end, the program supports the contracting process of these firms up to the point where firms have been pre-qualified and requests for proposals issued.

3.14 Since almost half of the deposits and assets of operating banks are in open AGD banks, and some of these institutions are considered to be amongst the most vulnerable in terms of liquidity and solvency, measures to improve the performance and facilitate their prompt privatization, preferably to first-tier international financial institutions, are crucial to both restoring confidence to the system as a whole and to minimize the fiscal costs of the restructuring process. Experienced and highly qualified international banking professionals will be hired under performance based contracts to manage these institutions in order to ensure effective management operating under appropriate incentives. These managers will be responsible for restructuring these institutions to prepare them for reprivatization.

3.15 In conjunction with the IMF and World Bank, the Bank will also monitor the other elements of the financial sector restructuring strategy, in particular the system to improve solvency and measures to enhance supervision and the incentive framework for banks and financial groups. These other elements are included in the Policy Letter (Annex II). In addition, the Bank will directly assist in the implementation of the Strengthening Plan for the Superintendency of Banks via the Financial Sector Program Technical Cooperation (834/OC-EC). This plan includes measures to: i) improve on- and off-site supervision, including information systems; ii) rationalize the organization of the Superintendency of Banks based on functions to facilitate effective consolidated supervision and the implementation of human resource policies to attract and retain qualified and motivated personnel; and iii) modify the regulatory framework to enhance the incentive framework for regulated institutions.

3. Social Protection

3.16 This component has the following three specific objectives: i) protect key social services that benefit the poor from further erosion and improve the capacity for allocating and using resources in the social sectors efficiently; ii) improve targeting of key social programs to the poor and strengthen the safety net; and iii) supplement the purchasing power of the poor.

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[3] A significant part of the loan portfolio of the closed AGD banks is connected lending upon which there are legal restrictions on their restructuring. Accordingly, the most effective liquidation mechanism is likely to be foreclosure, which the AGD cannot legally transfer to third parties.

3.17 With respect to the first specific objective to protect key social services and programs during 2000 and 2001, the program supports the protection of a set of priority social expenditures during 2000-2001. To that end, the Government has proposed a list of high-priority expenditures on basic services and programs targeted to the poor, together with minimum spending levels. These include spending on basic education, primary health care and disease control, and targeted assistance programs, including conditional cash transfers.

3.18 **Eligibility criteria for protected social sector expenditures**. Social sector expenditures to be protected have been selected on the basis of their impact on the human capital and living conditions of the poor. The group of expenditures has been organized in the following categories, according with their level of priority. Category A, with the highest priority, includes the financing of current costs of guaranteeing key basic social services that serve the poor, including primary and basic secondary education, primary health care and disease control, and the Bono Solidario and Beca Escolar, two cash transfer programs that complement the income of poor groups. Category B includes programs aimed at assisting the most vulnerable groups including indigenous communities, children under six years old, school age children with nutrition problems, and programs focused at improving basic social services in poor areas, including rural basic education and rural health care. Specific programs in this category were selected based on an analysis of their demonstrated institutional and executing capacity. Category C includes secondary education and secondary health care services, which are important in terms of human capital development and social protection, but not as critical as these expenditures in the former categories. Category D includes total expenditures in the rest of the social sectors.

3.19 The total amounts allocated to each group of expenditure items in Category A, as well as the corresponding monthly allocations, will be maintained or increased during 2000. For Category B, the aggregate amount and aggregate monthly allocations will be maintained or increased during 2000, but amounts may be reallocated among expenditure groups within the Category, depending on the relative pace of program/project execution. Expenditures in Category C may fall below the targeted amounts if expenditures in Category A and/or B increase by an equivalent amount. The aggregate amount transferred to expenditures in Category D may fall below targeted amounts if transfers for expenditures in Categories A, B, and/or C increase by an equivalent amount. The following table shows the groups of expenditures included in each category:

Table 2. Social Sector Expenditure Program for 2000

Ranking	Item/Program	Budget Floor (US$ million)
1	Escuelas Primarias (Hispanas) (0-6)	96.6
1	Escuelas Primarias (Bilingües) (0-6)	5.2
3	Plan Ampliado de Inmunizaciones (salud)	2.2
4	Subcentros, centros y Hosp. Cantonales (salud)	25.5
5	Educación secundaria básica (7-9)	40.7
6	Control y vigilancia de enfermedades	3.5
7	Admin. Provincial Regional (salud)	7.4
8	Bono Solidario	99.4
9	Beca escolar	10.0
	Total Category A	**290.5**
10	PRODEPINE (World Bank)	11.2
11	Fondo indígena y otros	6.1
13	Nuestros Niños (IDB)	10.4
14	FASBASE	5.0
15	Redes amigas	2.4
16	ORI (Operación Rescate Infantil) y Convenios Niñez	8.9
17	FISE	12.7
18	Colación y Almuerzo escolar	11.3
	Total Category B	**68.0**
19	Hospitales provinciales	19.2
20	Educación secundaria (10-12)	61.0
	Total Category C	**80.2**
	Total, Protected Social Sectors Expenditures	**438.9**
	Category D: Total, Rest of Social Expenditures	**133.9**
	Total Social Sectors Expenditures	**672.8**

3.20 The program also supports the definition of the budget for 2001 providing the following: i) for social sector expenditure items to be protected, spending levels should be equal, in aggregate, to at least 15% of the central government budget, not including debt amortization, or the amounts shown in the following table, whichever are greater; and ii) for total social sector expenditures including education, health social welfare, labor and housing, spending levels should be equal to an aggregate amount of at least 20% of the central government budget.

Table 3. Social Sector Expenditures for 2001

Ranking	Item/Program	US$ million
1	Escuelas Hispanas	138.2
1	Escuelas Bilingües	7.4
3	Plan Ampliado de Inmunizaciones	2.4
4	Subcentros, centros y Hosp. Cantonales	36.5
5	Colegios tres primeros grados	58.1
6	Control y vigilancia SIDA, dengue, vacunas y SNEM	3.9
7	Admin. Provincial Regional health	10.6
8	Bono Solidario	109.4
9	Beca escolar	30.0
10	PRODEPINE	12.4
11	Fondo indígena y otros	6.7
13	Nuestros Niños (IDB)	11.5
14	FASBASE	5.5
15	Redes amigas	2.6
16	ORI (Operación Rescate Infantil) y Convenios Niñez	8.9
17	FISE	2.0
18	Colación y Almuerzo escolar	11.3
19	Hospitales provinciales	27.5
20	Colegios tres últimos grados	87.2
	Total services, programs and projects	**572.1**
	Rest of social expenditures	**152.9**
	Total social sector expenditures	**732.0**

3.21 With respect to the second specific objective to improve targeting of key social programs to the poor and strengthen the safety net, the program supports the implementation of an action plan to establish an improved targeting system for selected poverty programs. Using indicators developed on the basis of the Living Standards Measurement Survey, the targeting system will serve as a technical, transparent, objective, and uniform mechanism for identifying and selecting individual beneficiaries for social programs based on the socioeconomic characteristics of all households. This will allow programs to give preference to the poorest and most vulnerable groups, and to prioritize those families that have been most deeply affected by natural disasters or other social or economic crises. In the initial stages, the program will support the application of the targeting system for the *Bono Solidario* and the newly introduced *Beca Escolar* program.

3.22 The first benchmark in this action plan is the completion of a pilot phase designed to validate the new targeting system's instruments. Attainment of this benchmark represents the condition for the second tranche of the program. The pilot phase, financed by the IDB and UNICEF, will be used to validate the household questionnaire, operation manual and software, prior to its application on a larger scale. This initial phase will cover both rural and urban areas in order to capture difficulties specific to either of the domains. Terms of reference for the

consulting firms have been approved and a short list identified. The selection of the firm is scheduled for the end of June 2000, and completion of the pilot is slated for August, 2000. A Technical Cooperation Program (EC-0195) is expected to finance the implementation of this targeting system.

3.23 With respect to the third specific objective to support the protection of the budget for programs that supplement the purchasing power of the poor, the program includes measures to secure minimum budget allocations for selected public investment programs that generate opportunities for unskilled labor. These selected public investments include projects in water and sanitation and basic infrastructure, all with relatively high demand for unskilled labor. The Government will make budgetary transfers equal, in aggregate, to at least US$88.9 million to carry-out the investment projects listed in the following table:

Table 4. Selected Investment Programs, 2000

A. Type of Project	Source of External Financing	US$ million
Water and Sanitation	IDB: Loans 1026-OC; 823-OC; World Bank: PRAGUAS	30.0
Fenómeno del Niño	IDB: Loans 1057-OC; 913-SF; 978-OC; and 1138-OC; World Bank: Loans 4259-EC; and 3390-EC; CAF: 290	39.9
Flood Control; Irrigation	World Bank: Loans 3276-EC; 3730-EC	4.0
Other Infrastructure (Road reconstruction)	CAF: 300	15.0
Total		**88.9**

4. Environmental And Social Aspects

3.24 The program supports the establishment of the environmental regulatory framework applicable to the power sector. Environmental assessments of all 25 power companies will complement this initiative and serve as the basis for defining the treatment of environmental aspects and related institutional arrangements. Additionally, resources from IDB Loan 1136/OC-EC have already been allocated for the institutional strengthening of the regulatory agency. The program also supports policy measures for the protection of key basic social services that benefit the poorest groups of the population, and lay the basis for an effective social safety net. These measures are intended to protect these groups from the worst effects of the adjustment process.

IV. PROGRAM FINANCING AND IMPLEMENTATION

A. Borrower and Executing Agency

4.1 The Borrower will be the Republic of Ecuador. The Ministry of Economy and Finance (MOEF) will be responsible for the execution of the program. Given the multi-sector nature of the proposed measures and the need for the MOEF to coordinate activities outside its scope with various agencies, the MOEF will establish a streamlined unit to coordinate progress and implementation by all responsible government agencies. This unit will coordinate the execution of this program, as well as the GOE's programs with the International Monetary Fund, the World Bank, and the Andean Development Corporation.

B. Program Structure and Financing

4.2 The proposed Investment Sector Program is designed as a fast-disbursing operation in the amount of US$150 million from the Bank's ordinary capital. Resources will be released in two tranches of US$60 million each for a total of US$120 million; and one floating tranche of US$30 million. The first tranche will be released upon Board approval. The expected disbursement period is 18 months.

C. Conditions for Disbursement

4.3 The conditions for disbursement of each of the tranches are set out in the policy matrix attached as Annex I to this document. In addition to these conditions, disbursements of each of these tranches will also be contingent upon compliance with the IMF macroeconomic stabilization program; and maintenance of an adequate policy framework as specified in the policy letter (Annex II).

D. Technical Cooperation

4.4 To date, technical support has been financed with resources from ongoing Bank technical cooperation loans. In the case of the infrastructure component, these activities financed with resources from 1136/OC-EC have included the preparation of all diagnostics--including technical, financial, economic, legal, environmental and social--required to structure the privatization of all power generation, distribution and transmission companies. These resources will also be used to finance the preparation of the regulations for the modernization of the telecommunications sector. Available World Bank resources are also currently being used to complete the preparation of the regulations for the power sector.

4.5 The activities under the financial sector restructuring component have been financed with a technical cooperation financed by the Japan Special Fund (ATN/JF-6620-EC), administered by the Bank. These activities include the financing of legal and financial advisors to help prepare the resolutions for the legislative changes, identify possible legal impediments to the AGD's

implementation of a prompt resolution strategy, complete the establishment of an updated data-base of AGD assets, and the preparation of terms of reference for additional studies and draft performance based contracts for international managers of open AGD banks. This technical cooperation is also expected to finance the preparation of restructuring plans for the open AGD banks. In addition, the ongoing Financial Sector Program Technical Cooperation Loan (834/OC-EC) is being used to assist in the implementation of a Strengthening Plan for the Superintendency of Banks. Simultaneously, a World Bank Financial Sector Technical Assistance Loan will be used to finance complementary activities in these areas as well as the development of a comprehensive strategy linking programs for bank recovery, debt restructuring and asset sales, and effective corporate and household debt restructuring.

E. Disbursement Procedures

4.6 Fast-disbursing resources from the program will be used to finance the total cost in hard currency of eligible imports from the Bank's member countries. The Bank's new simplified procedures for sector loans will apply in this case as established in document GN-2001-2. Funds will be disbursed upon request by the borrower and presentation of evidence of compliance with policy conditions.

4.7 The borrower will maintain a segregated account for deposit of amounts disbursed under the loan. The Ministry of Economy and Finance is responsible for keeping accounting records and for preparing and presenting disbursement requests. The Bank will require the borrower to maintain appropriate records of funds disbursed from the loan, and reserves the right to require the borrower to furnish an audited report of disbursed funds.

F. Inspection and supervision

4.8 The Bank will establish such inspection procedures as it deems necessary to ensure satisfactory execution of the program. The borrower will cooperate fully in providing all assistance and information required for this purpose.

V. BENEFITS AND RISKS

A. Benefits

5.1 The program has been designed to provide timely support for macroeconomic recovery and stabilization, and advance some relevant reforms to set the basis for restoring and sustaining economic growth. Progress on structural reforms, particularly an enhanced and effective private sector participation in the economy, and progress in the resolution of the intervened financial institutions would support the implementation of the GOE's macroeconomic stabilization program. The consolidation of the framework for the modernization of the power and telecommunications sectors, supported by this program, will promote the participation of the private sector in the operation, maintenance, rehabilitation and expansion of the system. The component for the resolution of intervened financial institutions will help ensure a more transparent, effective and prompt resolution process, and thereby help to reduce fiscal costs and strengthen public confidence in the implementation of the country's financial sector strategy.

5.2 The successful implementation of the social protection component would also have several benefits. First, the program is expected to restore an adequate level of spending in key social services and programs that serve the poor during the period 2000-2001, allowing for the normal functioning of basic education schools, primary and secondary health care, disease control programs, and targeted assistance programs. Second, the proposed policy measures support adequate funding levels or cash transfer programs designed to protect the incomes of the poor from further erosion and for investment project that generate demand for unskilled labour. Third, the program also supports the implementation of a Beneficiaries Identification Mechanism (BIM), allowing the country to have a technical, transparent, objective, and uniform instrument for identifying and selecting individual beneficiaries for social programs based on the socioeconomic characteristics of all households.

B. Risks

5.3 In addition to the political risks which include the potential for social unrest which may prevent the GOE from effectively implementing stabilization and adjustment measures, and the fragility of the coalition that supports the reform program, the proposed program has the following risks: i) lack of progress in improving macroeconomic policy management and conditions; ii) slow implementation of reforms; and iii) weak institutional capacity.

5.4 **Macroeconomic framework.** The potential for Ecuador failing to comply with the IMF program poses the major risk for this operation The success of the program depends on significant progress in improving macroeconomic policy management and conditions. In the absence of compliance or sufficient progress, it would be likely that the strategies and actions proposed in the program, especially in the financial and social sectors, would encounter difficulties and

have to be reassessed. Agreements with external creditors may be delayed, and difficulties to meet some external payments may arise, potentially undermining the macroeconomic program. The implementation of a macroeconomic stabilization program supported by an IMF Stand-by Agreement and the permanent monitoring by IMF staff during the next 12 months help to reduce this risk. The recent economic reform package which was largely in line with the measures included in the April IMF letter of intent was announced one month ahead of schedule.

5.5 An inadequate macroeconomic framework, including possible delays in tariff adjustments may also result in a lack of interest on the part of the private sector to participate in privatization processes in Ecuador. In the case of the privatization of the power sector, full diagnostics and assessments including consultations with qualified potential bidders undertaken with the support of an investment bank, this bank's overall advise in structuring the privatization process, and a continued and transparent consultation process with sector workers and other representatives of civil society help mitigate the potential risk of failure. The recently announced economic reform package includes a progressive tariff adjustment program with a 71% average increase which went into effect on June 1, 2000.

5.6 **Implementation of reforms.** Previous Bank experience in Ecuador suggests that the prompt execution of sector reform programs face a high risk. In the case of the proposed program, the GOE has demonstrated its will by recently enacting the Economic Transformation Law, which paves the way for most of the proposed reforms, and by announcing a package of economic reforms in late May, 2000. Also, the Bank and other multilateral agencies have designed a concerted and fully complementary strategy to support the implementation of the GOE's reform program.

5.7 **Institutional capacity.** Some of the key institutions involved in the execution of the program, especially the AGD, have weak institutional capacities. Measures included under the infrastructure component have substantial resources to support their smooth implementation. In the case of the financial restructuring component, the resolution strategy focuses on getting assets out of the direct control of the AGD by rapid sale and liquidation or by contracting their administration and liquidation to private firms, with monitored performance based contracts. Also, ongoing Bank and World Bank programs have also allocated substantial resources to support this institution with specialized advise during the process.

ECUADOR: INVESTMENT SECTOR PROGRAM (EC-0194)
POLICY MATRIX

Issue Areas/ Objectives	Before Board Presentation	Second Tranche
OECONOMIC FRAMEWORK		
the economy and the conditions for economic growth.	Enactment of Economic Transformation Law, which sets out the basis for dollarization and includes important structural reforms. Macroeconomic stabilization program approved by the International Monetary Fund. Compliance with macroeconomic stabilization program.	Compliance with macroeconomic stabilization pro
TE SECTOR PARTICIPATION IN INFRASTRUCTURE		
ate the regulatory rk for the zation of the power	Sector restructuring and preparation of regulations are underway; investment bank activities for the preparation of the privatization of power companies are also underway. Legal framework allows for increased private sector participation in sector enterprises from 39% to 51% of total enterprise assets. Approval by COMOSEL and dissemination of the strategy for the privatization of power sector enterprises (*)	The regulatory framework needed to promote the p of the sector is in place (antitrust, quality of servic environmental regulations).
the conditions for the zation of the nunications sector.	Legal framework allows for increased private sector participation in sector enterprises from 35% to 51% of total enterprise assets Elimination of exclusivity of service. Agreement on the framework to be put in place to promote private sector participation, including spectrum management, and transparent and pro-competition interconnection rules.	The framework needed to promote private sector p including spectrum management, and transparent a competition interconnection rules, is in place.
LUTION OF INTERVENED FINANCIAL INSTITUTIONS		
e implementation of a nt process for the nd efficient resolution ened institutions	Establish a time-bound program for the disposal of assets of closed intervened banks by the AGD that includes private sector management and sale of assets. (*)	Submit to pre-qualified private asset management requests for proposals (RFPs) for the administratio liquidation of the freely transferable loans (greater US$200,000) of closed AGD intervened banks. Contract qualified international banking professio performance based contracts to manage and restru AGD banks to prepare them for reprivatization.

ECUADOR: INVESTMENT SECTOR PROGRAM (EC-0194)
POLICY MATRIX

Issue Areas/ Objectives	Before Board Presentation	Second Tranche
L PROTECTION		
ey social services that the poor from further Improve the capacity ocating and using s in the social sectors y.	Agreement on Social Sector Expenditure Program (SSEP) which includes a set of priority social expenditures to be protected and monitored during 2000-2001	Agreed budget transfers for the SSEP have been mad second semester of 2000; the GOE has budgeted for 2001 the highest of: i) 15% of its central government budget or ii) the amount specified in the SSEP; and t budgeted at least 20% of its CG budget for total socia expenditures.
targeting of key social s to the poor and n the safety net.	Agreement on an Action Plan to implement an improved targeting system for selected poverty programs.	The Government has completed the pilot phase, and and reviewed the survey instrument for the targeting
ent purchasing power or.	Agreement on SSEP which includes budget allocations for the bono de solidaridad and for selected public investment programs that generate opportunities for unskilled labor.	In the second semester of 2000, budget transfers for investment expenditures have been made in amounts least the agreed aggregate amount.
TING TRANCHE: PRIVATE SECTOR PARTICIPATION IN INFRASTRUCTURE		
a transparent and process to promote ector participation.	**Power**: Request for proposals for the privatization of one (or more) public distribution company covering the equivalent of 2 residential customers.	

ding measures

REPUBLICA DEL ECUADOR
MINISTERIO DE ECONOMIA Y FINANZAS

OFICIO No. 2406 DM-SGMEyF-2000

Quito June 26. 2000

Mr. Enrique Iglesias
President
Inter-American Development Bank
Washington. DC

Dear Mr. Iglesias:

The Ministry of Economy and Finance wishes to confirm the request made by the Government of Ecuador to the Inter-American Development Bank (IDB) for a loan to finance an Investment Sector Program designed to support the implementation of our macroeconomic stabilization and structural reform program. In April 2000, the International Monetary Fund approved a twelve-month, US$300m Stand-by facility to support this program. The Government has also requested support from the World Bank and the Andean Development Corporation. In the coming months, Ecuador expects to secure a rescheduling and normalization of accumulated arrears from the Paris Club. The Government also hopes to reach agreement in the near term with external bondholders regarding obligations that have been in a state of default since September 1999.

This policy letter describes the country's current economic situation and our macroeconomic stabilization program, and sets out the overall Investment Sector Program for which the Government is requesting IDB support. Financial assistance by the IDB and other multilateral agencies is essential to support this program in the present context of deep economic and social crisis.

I. THE PRESENT ECONOMIC CRISIS AND ITS SOCIAL IMPACT

Since early 1998, Ecuador has been undergoing one of the worst economic crises in its history. The crisis has had a devastating impact on the poor. Poverty incidence, which had already increased from 34 to 46 percent from 1995-1998, reached 69 percent by the end of 1999, straining the ability of the poor and near poor to cope with income setbacks.

The crisis was caused by a combination of climatic and external economic shocks, including damaging El Niño rains and plunging world oil prices, made worse by political instability and inadequate and miscalculated policy responses. In 1999, real GDP declined 7.3 percent, annual consumer-price inflation rose to 60 percent, and the sucre lost 66 percent of its U.S.-dollar value. The fiscal deficit was 6 percent of GDP, but the current account reversed from an 11-percent-of-GDP deficit in 1998 to a surplus exceeding 6 percent of GDP in 1999. This massive adjustment came about partly because oil-export prices recovered, but mainly because recession and exchange rate depreciation reduced merchandise imports by half. In September 1999, the crisis forced the Government to stop servicing its Brady bonds; as a consequence, Ecuador is now in a state of default on external bonds amounting to US$6.5 billion, about half the public external debt. Altogether, public external-debt accumulation, which reached 91 percent of GDP at the end of 1999, has become a particularly debilitating burden.

The crisis was greatly aggravated by the rapidly deteriorating situation of the banking system. The 1998 shocks affected so many economic sectors that banks' loan portfolios deteriorated sharply, damaging depositor confidence. Ecuador's bank-supervision systems did not deal effectively with the financial-sector crisis. Since late 1998, the Government and the Central Bank extended a guarantee to all deposits and enacted a one-year deposit freeze in March 1999. Subsequently, all bank sight and savings deposits were unfrozen in 1999, while time deposits have been unfrozen this year, with depositors permitted to withdraw US$4,000 in cash from each account and receiving the balance in bank term obligations.

The Government takes the view that a large part of the reason for such poor growth since the 1980s, deepening poverty, and the inability of the economy to respond to the 1998 shocks is that structural adjustment

efforts have been incomplete and uneven over the past two decades. The Government is persuaded that economic stability and rapid progress on structural reform is crucial to ensure economic growth in the longer-term, correct inequitable income distribution and achieve poverty reduction.

The need for structural change is evident across the range of economic sectors. Privatization processes in the electricity and telecommunications sectors, which could bring new investment to improve provision of these services, have been drawn out and remain incomplete. Trade reform and domestic price liberalization are well advanced, but tariff dispersion and regressive energy-price subsidies continue to distort economic activity, provide opportunities for corruption, and have a high fiscal cost. Non-oil taxation is unusually low by Latin American standards, depriving the Government of needed resources to attend urgent social needs. Heavy public debt service and extensive tax earmarking have made public expenditure difficult to allocate efficiently In the financial sector, inadequate commercial-bank prudential regulation and supervision following liberalization in the mid 1990s allowed banks to maintain risky practices, and left the authorities poorly prepared to cope with the 1998 crisis. In the social sectors, real expenditure on basic education and health services, as well on programs targeted to the poor, has been declining to levels inadequate to ensure continued development of human capital or protection of vulnerable groups. Social assistance programs are many, disparate, poorly targeted and of uncertain effectiveness. The Government intends to address these issues in order to bring about the recovery of economic growth, and mitigate the impact of the crisis on the poor.

II. THE MACROECONOMIC STABILIZATION PROGRAM

On January 9, 2000, in response to this unprecedented crisis, the Government announced that it would dollarize the economy as rapidly as possible. In March 2000, Congress approved the Economic Transformation Law (ETL), which sets the framework for the Government's stabilization and structural-reform program and sets the basis for dollarization. Under this law, Ecuador's private and public sectors have been adopting the U.S. dollar as legal currency for transactions, accounting, and contracting purposes. The Central Bank is now using its

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foreign-exchange holdings to repurchase the outstanding sucre currency base.

In April 2000, the Government signed a Stand-by program with the IMF to stabilize the economy. The Government intends to build on this program to bring about economic recovery, as early as possible and to advance its structural-reform program to ensure that the recovery is durable. The Government's program encompasses: (a) the dollarization plan, (b) macroeconomic stabilization to be carried out under the IMF Stand-by, and (c) a structural-reform program covering the public sector including privatization of public enterprises, the financial system, and the social sectors.

The Government's macroeconomic program projects the resumption of positive GDP growth starting in the second half of 2000, December-December inflation of about 60 percent (largely because of the unprecedented depreciation in 1999 and early 2000 and because motor-fuel prices and electricity rates are to be adjusted upward over the year), and a decline in the external current-account surplus to 3 percent of GDP. Over 2000, the Central Bank's foreign-exchange resources would increase by about US$160 million to provide further backing for Central Bank dollar obligations and to meet potential liquidity needs of troubled commercial banks. The non-financial public-sector deficit would decline from about 6 percent of GDP in 1999 to under 4 percent in 2000, with the primary surplus rising from about 4 to about 6.5 percent of GDP. The stabilization program also incorporates various measures to help resolve the banking crisis, and assumes significant supportive actions and lending by Ecuador's other external creditors.

For the years 2001-2003, the Government maintains relatively conservative assumptions regarding economic performance. While the Government is hopeful that economic growth will revive rapidly, its plan is more cautious, assuming a relatively slow recovery. Real GDP growth would be on the order of 2-3 percent. The current account would move from a surplus of 3 percent of GDP to a deficit stabilized at about 2 percent of GDP. The non-financial public-sector deficit would diminish from 4 percent of GDP in 2000 to less than 1.0 percent of GDP by 2003, with a primary surplus on the order of 5.5-6.5 percent of GDP. Throughout the

period, the Government will maintain and increase levels of expenditures for social services and social protection.

Recognizing that the success of stabilization will hinge on further structural reform, in addition to the provisions for implementation of dollarization, the ETL incorporates a broad range of structural reforms, which affect privatization in key sectors, and financial-sector regulation and supervision. Further, the Government is preparing a second Economic Transformation Law (ETL II), which would advance the structural-reform process still further.

On May 25, 2000, we announced a major package of economic reforms which included a sharp reduction in fuel subsidies, offset by an increase in public and private sector wages and increased government transfers to the poor to be effective on June 1. Basic gasoline and diesel prices were increased by 72% and 92%, respectively. The politically sensitive price of domestic cooking gas was left unchanged, although the IMF agreement calls for a 40% increase. Nevertheless, other compensatory measures such as an average increase of 300% in the price of fuel oil, jet fuel and other derivatives, were implemented. We estimate that these measures will result in an additional USD 120 million for the remaining 2000, with respect to the package that had been originally contemplated in the program agreed with the IMF. We also announced a 71% average increase in electricity tariffs, and progressive adjustments in the next 2 years to lessen the burden on the poorest segments of the population, which should also boost further revenues.

The package was accompanied by additional social compensatory measures that should entirely offset the extra revenue, in line with the fiscal target in our economic program. As of June 1, 2000, public sector employees will receive a progressive salary increase of between 48% and 70%, with those on the lowest income levels receiving the largest percentage increases. We will also boost transfers to the poor by 75% via the Bono Solidario. Disabled persons' allowances will be doubled, while pensioners in the state scheme will have payments increased by 40%.

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II. MAIN ISSUES AND THE GOVERNMENT'S PROGRAM

Ecuador's structural-reform agenda falls into three broad groups: (a) public-sector issues, including private sector participation in the infrastructure sectors; (b) financial sector restructuring; and (c) social protection. This section discusses these issues and the Government's adjustment program.

A. Private Sector Participation in Infrastructure

Since the 1980s, various Administrations have been carrying out sector-by-sector reforms to reduce the role of the State in the productive economy and to pave the way for well-regulated private sector participation in the infrastructure sectors. Nevertheless, privatization of these sectors has been delayed, partly by lack of political consensus, and partly by technical difficulties, which took longer to overcome than originally envisaged. This made it difficult for these Administrations to establish a transparent and objective process to attract potential qualified private investors as partners in financing the rehabilitation and expansion of the country's systems.

In order to overcome these deficiencies, the Government is committed to take the necessary steps to promote the participation of the private sector in the modernization of the infrastructure sectors. This is expected to increase coverage, service quality and overall efficiency while preserving government resources that may be used to attend more pressing social needs. The Government will work to bring about a transparent and objective process to privatize electricity and telecommunications enterprises where significant progress has been made to date. In the electricity sector, a process to restructure the sector is underway; a regulatory agency, CONELEC, has been established and most sector regulations have been issued. With the technical and financial support of the IDB, the Government has hired a consortium led by an investment bank to advise it on the privatization of all distribution, generation and the transmission companies, currently under the Solidarity Fund. The specific modalities of these sales will be determined on the basis of the consortium's diagnostic of each of these companies. The diagnostic process is well advanced and at present we are engaged in preparing a privatization strategy, which will be approved at the highest Government level. The Government plans to first offer through an international

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competitive bidding process the entire distribution business to private investors during the present year; and subsequently, offer the generation and transmission businesses also by means of an international tender. It is our intention to attract as many operators as possible to ensure and benefit from a truly competitive market. As a means to promote a transparent and participatory process, the Government will disseminate this strategy to the public, and will continue to hold consultations with the various interest groups, and civil society throughout the process.

The Government believes that the recent legal changes allowing private investors to buy up to 51 percent of sector enterprises at the time of sale provide an adequate legal framework to privatize sector enterprises. Nonetheless, we will continue to reform the existing regulations and timely complete the preparation of complementary regulations to facilitate the privatization process, while at the same time protecting the interests of our consumers. With the support of specialized consultants, CONELEC will complete the preparation of regulations to promote competition in the sector, establish interconnection rules, control quality of service in the distribution business, and establish the procedures for the functioning of the wholesale market. It will also complete the regulations for environmental aspects of the sector. In preparation for the privatization, the Government will assess the environmental liability and ensure that responsibilities are properly allocated and regulations are fully enforced.

The Government will also continue to promote CONELEC's professionalization, autonomy and independence to better prepare it to effectively undertake their regulatory and monitoring functions as the sector is modernized. Prior to the crisis, the Government had implemented important tariff adjustments. However, as result of the crisis, electricity tariffs have lagged considerably. We are aware that this is a pre-condition for the success of our privatization strategy and for the financial sustainability of the sector. While there is a legal basis for proper tariff setting, and a tariff methodology has been established including subsidies to low income consumers, tariff adjustments have been delayed. To revert this situation, on May 30, 2000 CONELEC announced a progressive tariff adjustment program to lessen the burden on the poorest segments of the population. This adjustment program calls for an average 71% increase which went into effect on June 1, and subsequent average monthly increases of 4% during a two-year period. By December 2000, tariffs for

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consumption levels of up to 300 KWH per month in the Sierra and 400 KWH per month on the coast are expected to reach 60% of real costs, while tariffs for consumption levels above those thresholds are expected to cover 100% of economic costs. Tariffs are expected to cover the economic cost of service at the end of the two-year period. Implementing these adjustments as scheduled will send a clear signal to potential investors of the GOE's commitment to ensure the financial sustainability of the sector, and will certainly facilitate the privatization process

In the telecommunications sector, the Government recognizes that a modern telecommunications sector can contribute importantly to productivity, and that to modernize the sector it is necessary to promote vigorous competition and to increase private participation. A first step to achieve these objectives was the enactment of the ETL which introduced some important modifications to the regulatory framework for telecommunications including the specification that all telecommunications services will be provided in a competitive environment: the creation of a fund to promote the provision of telecommunications services in rural and low income urban areas; and the determination that tariffs should be based on costs. In order to increase the attractiveness to potential buyers of the state-owned telecommunications companies, the ETL also increased the proportion of stock that can be sold from 35% to 51%.

At present, the Government is taking a number of significant steps including drafting of regulations for concessions and licenses for telecommunications services that will be offered in a competitive framework, and the regulations for a fund to promote universal service. The Government has also requested proposals from five firms to carry out a tariff study that will include an estimation of the costs of providing different telecommunications services, the development of a tariff rebalancing plan, and the development of a tariff policy for the sector. Based on the results of the tariff study, CONATEL plans to implement a tariff rebalancing program that will reduce international long distance rates and will increase rates for domestic services CONATEL and SENATEL also plan to initiate the drafting of regulations for interconnection and unbundled leasing of network elements, and for spectrum management

The Government will seek prompt approval of a new legal framework, which will be submitted to Congress in the coming months. This new

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framework will ensure the consolidation of the pro-competition regulatory framework for telecommunications. and will include a number of very positive features. These include: strengthening the regulatory framework through the merger of CONATEL and SENATEL: specifying that interconnection of networks is obligatory, and must be based on forward looking costs: and establishing a fund for the promotion of universal service. This law, drafted with IDB support, has subject to a thorough consultation process with the main market agents. The Government intends to submit this draft law to Congress in the coming months under fast-track procedures.

B. Financial Sector Restructuring

Ecuador's financial system has suffered a severe crisis during the past two years. The lack of effective financial sector supervision, especially of its large offshore operations combined with connected lending, currency mismatches and portfolio concentration implied that many banking institutions were not able to withstand the strong external shocks of 1998. Since August of 1998, fifteen institutions, accounting for about 60% of the systems assets have been intervened Twelve of these are being wound up, and the remainder has been recapitalized and is operating under temporary control of the Agencia de Garantia de Depositos (AGD).

The Government is committed to resolving the banking crisis and to address it's underlying causes. To that end, it has developed a two-stage financial sector restructuring strategy in close consultation with the IMF. IDB. World Bank and CAF. The first stage of the strategy, which has largely been implemented, consisted of measures to stabilize the system, and lay the legal framework for the restructuring strategy. Key stability measures comprised the implementation of limited lender of-last resort liquidity facilities, consistent with a dollarized monetary system, and reaching agreement with the IMF on a 12-month macroeconomic adjustment program. The ETL included key measures to improve the legal basis for the resolution of the banking crisis and enhance financial sector supervision. In addition, a Presidential Decree was enacted that established a framework for a comprehensive debt restructuring. Smaller debtors owing less than US$50.000 will be treated in a systemic manner, allowing banks to concentrate on recovering debts greater than US$50,000, which represent less than 1% of loans. but 85% of the value of

the systems loan portfolio. These larger debtors will be restructured on a case-by-case basis and via voluntary participation by creditors and debtors. The second stage of the strategy focuses on three areas, the restructuring and resolution of the banking system, improving the solvency of banking institutions based on best international practices, and enhancing banking supervision and the incentive framework.

With the enactment of the ETL, the Government now has an improved legal framework for the restructuring and resolution of the banking system. At present, a time-bound and orderly process of the disposal of assets of banks that are being wound up is being developed and is expected to be approved by the AGD Board by June, 2000. The government recognizes that getting these assets quickly out of the direct control of the AGD, and into the control of actors who have financial incentives and the expertise to increase their value--either by sale or by contracting to private asset managers--should increase returns and help to reactivate the economy. For viable banks that remain open under temporary state control, the Government recognizes that leaving these institutions under state control reduces public confidence and increases the final fiscal cost of their resolution. The Government is committed to reprivatize these institutions as soon as market conditions permit; in the meantime, these institutions will be placed under the management of internationally recognized experienced banking professionals hired under performance-based contracts. Business plans to restructure these institutions to prepare them for reprivatization will also be established and implemented. In addition, the AGD will develop a general strategy for the reprivatization of these banks.

In order to improve the solvency of banks, the Government will establish norms, procedures and a timetable for the capitalization of banks. This will include: the implementation of capital adequacy, loan classification and loan provisioning requirements in accordance with international standards; and the rules and mechanisms for access to limited public resources that will be designed to catalyze the provision of private capital. A system of prompt corrective actions for banks that fall below capital adequacy requirements will also be developed and implemented.

The Government is committed to fundamentally improve the capabilities of supervisory institutions and bring supervision standards up to international

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levels based on the Basle Core Principles. To that end, it has developed a strengthening plan which consists of measures to improve on and off-site supervision, rationalize the organization of the Superintendence of Banks including its human resource policies, and enhance the regulatory and incentive framework where necessary. This plan is expected to be approved by the Superintendence of Banks in the coming weeks.

The Government also wishes to confirm its commitment to phase out within a period of 18 months, the offshore banking activities, which have greatly reduced the transparency regarding the condition of the banking sector over the past few years. While some of Ecuador's offshore banks are genuine operations; several are largely paper entities whose books are maintained within Ecuador, set up to evade domestic regulations. Meanwhile, the recent legal reforms have frozen the growth in their assets and provided for more intensive supervision of asset quality.

Given the severe fiscal restrictions under which the Government must operate, fiscal support to the financial sector restructuring process will be highly limited. Accordingly, the Government reaffirms its commitment to use fiscal resources sparingly, efficiently and on a transparent basis. This fiscal limitation implies that the recapitalization of banks will have to come primarily from private sources. In addition, the global deposit guarantee will be phased out. Finally, given the limitations created by dollarization, the financial system will have to be more internationalized to be viable. This need for greater internationalization will be taken into account in the development of the reprivatization strategy of banks under temporary state control.

C. Social Sectors

Prolonged economic stagnation and deepening poverty have stretched the capacity of the poor to cope. Evidence indicates that as their incomes have declined, the poor have reduced food intake and the nutritional value of food consumed, deferred medical attention, sold assets, withdrawn children from school, and decreased other discretionary expenditures, such as medicine and clothing. School enrollment figures are largely unchanged but absenteeism has more than doubled and the time children spend working for money has more than tripled. Preventive care for pregnant women and young children has been forgone. Children receive

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lower priority than adults in sharing food, especially if they receive food at school. These coping mechanisms are likely to have severe negative long-term consequences for health, children's developmental potential, human capital, family stability and social capital.

Loss of income and deteriorating living conditions for the poor have been compounded by declining public expenditure in the social sectors. Overall social spending, excluding social security but including the *Bono de Solidaridad* (a cash transfer to the poor introduced in September 1998 to compensate for removal of price subsidies), fell as a percentage of GDP--in a year when real GDP plunged more than 7 percent--by 0.2 percentage points of GDP from its average in the previous four years. Public spending in health and education declined in 1999 by 0.7 and 0.2 percentage points of GDP, respectively, from an already low base (averaging 4.1 percent of GDP in 1995-1998). Since the *Bono de Solidaridad* represented some 1.2 percent of GDP in 1999, this suggests that this important new safety net mechanism was largely financed at the expense of basic social services. In addition to low public spending levels, inadequate targeting reduces the benefits of social-assistance expenditure received by the most vulnerable groups.

Reduction of poverty is dependent on successful implementation of the macroeconomic and financial sector adjustment measures outlined above. Moreover, a number of the public sector management reforms included in the present program will lay the basis for improved efficiency in these key sectors. In addition, the Government intends to undertake direct measures to mitigate the impact of the crisis on the poor and improve its ability to respond to such crises in the future. To this end, the Government's program focuses on: (a) arresting and reversing the decline in real education, health and social assistance expenditure; (b) enhancing employment opportunities for the unemployed poor; and (c) developing a well-targeted social safety net.

The most urgent measure to prevent further erosion of the human capital of the poor is restoration of adequate expenditure flows for basic services, effective safety net programs, and investment projects that generate demand for unskilled labor. The Government plans to do so as an integral part of its adjustment program. The Government will maintain expenditure levels sufficient to guarantee basic services and programs targeted to the

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poor during 2000-2001, according to quantitative targets agreed with the Bank, including basic (i.e., primary and basic secondary) education, primary health care and disease control, and targeted assistance programs. The spending levels for basic health and education services include provision for projected salary payments in 2000.

The Government will also undertake or complete infrastructure investment projects that would generate relatively high demand for unskilled labor, including projects in basic health, water supply and infrastructure, several of which are targeted to indigenous communities.

In addition to ongoing programs, the Government will introduce a new program of targeted; conditional cash transfers designed to protect the human capital of the poor from further erosion. The first phase of this program will provide cash stipends to families in extreme poverty whose primary-age children stay enrolled in school and maintain a 90-percent attendance rate or better. Beneficiaries of this program will be identified by a new targeting mechanism currently under development, which will also be applied to other targeted social assistance programs.

Finally, I would like to take this opportunity to express our gratitude to the IDB for its continued technical and financial support, especially during the preparation of this program. We remain fully committed to the timely implementation of this sector loan.

Sincerely yours,

Luis G. Iturralde M.
Minister of Economy and Finance

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Ministro de Economia y Finanzas

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ECUADOR: INVESTMENT SECTOR PROGRAM (EC-0194)
ACTION PLAN

ISSUE AREAS/SECTORS	MEANS OF VERIFICATION	RESPONSIBLE AGENCY
	BEFORE BOARD PRESENTATION/FIRST TRANCHE *	
ONOMIC FRAMEWORK		
vith macroeconomic stabilization program.	IMF review of progress on stabilization program.	Ministry of Economy and Finance
ECTOR PARTICIPATION IN INFRASTRUCTURE		
oval by Cabinet and dissemination of the ne privatization of power sector enterprises.	Strategy approved by COMOSEL and/or Cabinet and public announcement of strategy.	CONAM
ications: Agreement on the framework to be o promote private sector participation, ctrum management, and transparent and pro- nterconnection rules.	Submission to the Bank of draft law and/or terms of reference for the preparation of regulations for spectrum management, and transparent and pro-competition interconnection rules.	CONAM
ON OF INTERVENED FINANCIAL INSTITUTIONS		
me-bound program for the disposal of assets rvened banks by the AGD that includes management and sale of assets.	AGD Board approval of satisfactory program for the disposal of assets of closed intervened banks.	AGD
OTECTION		
n a set of priority social expenditures to be monitored during 2000-2001.	Social Sector Expenditure Program.	Ministry of Economy and Finance
n an Action Plan to implement improved em for selected poverty programs.	Action Plan for the identification of beneficiaries under targeted social assistance programs.	Ministry of Social Welfare
n budget allocations for the bono de nd for selected public investment programs opportunities for unskilled labor.	Social Sector Expenditure Program.	Ministry of Economy and Finance
	SECOND TRANCHE	
ONOMIC FRAMEWORK		
vith macroeconomic stabilization program.	IMF review of progress on stabilization program.	Ministry of Economy and Finance
ECTOR PARTICIPATION IN INFRASTRUCTURE		
egulatory framework needed to promote is in place (antitrust, quality of service and l regulations).	Regulations issued and published for antitrust, quality of service, and environment.	CONELEC
ications: The framework needed to promote participation, including spectrum , and transparent and pro-competition on rules, is in place.	New legal framework enacted and published in the Registro Oficial and/or regulations for spectrum management and interconnection issued and published.	CONAM and/or CONATEL

ECUADOR: INVESTMENT SECTOR PROGRAM (EC-0194)
ACTION PLAN

ISSUE AREAS/SECTORS	MEANS OF VERIFICATION	RESPONSIBLE AGENCY
ON OF INTERVENED FINANCIAL INSTITUTIONS		
roposals (RFPs) for contracting private asset firms to administer and liquidate loans of the able loan portfolio of closed intervened	RFPs submitted to qualified private asset management firms.	AGD
ified international banking professionals nance based contracts to manage open AGD	Signed performance-based contracts and curriculum vitae of top-management of open AGD banks	AGD
OTECTION		
t transfers for the Social Sectors Program (SSEP) have been made in the ter of 2000; the GOE has budgeted for the the highest of: i) 15% of its central CG) budget or ii) the amount specified in the GOE has budgeted at least 20% of its CG al social sector expenditures.	Budget execution database by expenditure item covering actual transfers updated through the last day of the previous month, by the fifth working day of each month.	Ministry of Economy and Finance
ent has completed the pilot phase, and review of survey instrument for the hanism.	Progress report on execution of the Action Plan for the identification of beneficiaries under targeted social assistance programs.	Ministry of Social Welfare
semester of 2000, budget transfers for the tment expenditures have been made in l to at least the agreed aggregate amount.	Budget execution database by expenditure item covering actual transfers updated through the last day of the previous month, by the fifth working day of each month.	Ministry of Economy and Finance
FLOATING TRANCHE: PRIVATE SECTOR PARTICIPATION IN INFRASTRUCTURE		
est for proposals (RFPs) for the privatization re) public distribution company covering the 25% of total residential customers.	RFP's submitted to potential investors.	CONAM.

olicy measures which appear in the policy matrix in Annex I as actions before Board presentation were completed with the enactment of the Eco rmation Law.

SUMMARY OF IFI SUPPORT TO ECUADOR

WORLD BANK: STRUCTURAL ADJUSTMENT PROGRAM	
ernization of Public Sector Management	Regulations for oil stabilization fund Tax reform **(floating tranche)** Legal framework for the telecommunications sector, efficient tariff policies for electricity and telecommunica enactment of laws for fiscal control and auditing, and public financial management **(floating tranche)**
ncial Sector Development and orate Debt Restructuring	Institutional framework for intervention, restructuring and resolution of banks Medium-term strategy and action plan for the development of a sound banking system, including reprivatizat and strengthening the banking regulatory and supervisory framework. Corporate Debt Restructuring. Phase out of offshore banking activities booked in Ecuador.
al Sectors/Social Safety Net	Protection of expenditures for social services Targeting system Budget allocation for bono de solidaridad, and for selected public investments
roeconomic Framework	IMF Stand-by Program
c Description	Board Approval: June 22, 2000 Amount: US$150 million Expected Disbursements: 2000: US$70 million at Board approval 2001: US$80 million by the first quarter Total World Bank support expected in 2000-2002: US$425 million
INTER-AMERICAN DEVELOPMENT BANK: INVESTMENT SECTOR PROGRAM	
te Sector Participation in Infrastructure	Strategy for the privatization of the power sector, and power sector regulations. Framework to promote private sector participation in the telecommunications sector. Process of privatization of one power distribution company **(floating tranche)**
ncial Sector Restructuring	Program for the disposal of assets of closed intervened banks. Contracting of private management to administer and liquidate the assets of closed banks and to restructure o institutions in preparation for reprivatization.
al Protection	Protection of expenditures for social services Targeting system Budget allocation for bono de solidaridad, and for selected public investments.
roeconomic Framework	IMF Stand-by Program
c Description	Expected Board approval: July, 2000 Amount: US$150 million Expected Disbursements: 2000: US$120 million, 50% at Board approval (Tranche 1); and 50% by December 2000 (Tranche 2); 2001: US$30 million by June 2001 (floating tranche). Total IDB support expected in 2000-2002: US$620 million
INTERNATIONAL MONETARY FUND: 12-MONTH STAND-BY PROGRAM	
c Description	Amount: US$300 million, expected to be disbursed by April 19, 2001. Approval: April 19, 2000.
ANDEAN DEVELOPMENT CORPORATION: ECONOMIC AND FINANCIAL SUPPORT PROGRAM	
c Description	Amount: US$200 million, approved in May, 2000. Expected Disbursements: US$120m in 2000; US$80m in 2001. Areas: financial sector restructuring; public sector including tax reform; privatization of infrastructure; decen Total CAF support expected in 2000-2002: US$700 million.

PROPOSED RESOLUTION

ECUADOR. LOAN ____/OC-EC TO THE REPUBLIC OF ECUADOR
Investment Sector Program

The Board of Executive Directors

RESOLVES:

That the President of the Bank, or such representative as he shall designate, is authorized, in the name and on behalf of the Bank, to enter into such contract or contracts as may be necessary with the Republic of Ecuador, as Borrower, for the purpose of granting it a financing to cooperate in the execution of an Investment Sector Program. Such financing will be for the amount of up to one hundred fifty million dollars of the United States of America (US$150,000,000) from the Single Currency Facility of the Ordinary Capital Resources of the Bank, and will be subject to the "Special Contractual Conditions" and the "Terms and Financial Conditions" of the Executive Summary of the Loan Proposal.