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DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

ECUADOR

EMERGENCY PROGRAM FOR MACROECONOMIC SUSTAINABILITY AND PROSPERITY

(EC-L1255)

LOAN PROPOSAL

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ABBREVIATIONS

CAF	Development Bank of Latin America
CETEs	Certificados de tesorería [treasury certificates]
CUT	Cuenta Única del Tesoro [Treasury Single Account]
EFF	Extended Fund Facility
EMBI	Emerging Markets Bond Index
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
LFP	Ley Orgánica para el Fomento Productivo, Atracción de Inversiones, Generación de Empleo y Estabilidad y Equilibrio Fiscal [Law on Productive Development, Investment Attraction, Job Creation, and Fiscal Stability and Balance]
MEF	Ministry of Economy and Finance
NFPS	Nonfinancial public sector
OC	Ordinary Capital
PPP	Public-private partnership
SDL	Special Development Lending
SRI	Servicio de Rentas Internas [Internal Revenue Service]
UNDP	United Nations Development Programme
WAL	Weighted average life

PROJECT SUMMARY

ECUADOR
EMERGENCY PROGRAM FOR MACROECONOMIC SUSTAINABILITY AND PROSPERITY
(EC-L1255)

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<tr><th colspan="7">Financial Terms and Conditions</th></tr>
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Project at a Glance
Program objective/description: The objective of the program is to support government actions to: (i) reestablish macroeconomic stability; (ii) restore fiscal sustainability; (iii) strengthen the institutional framework for the Central Bank; and (iv) safeguard social expenditure in support of the vulnerable population. The structure and content of the program are aligned with the recently approved Extended Fund Facility (EFF) arrangement with the IMF. The program is structured under the Special Development Lending (SDL) modality with the sole operation to be disbursed in a single tranche.
Special contractual conditions precedent to release of the single tranche: The single disbursement of loan proceeds will be contingent on fulfillment of the policy conditions summarized in the Policy Matrix (Annex II) and Policy Letter, and on fulfillment of the conditions contained in the loan contract (see paragraph 4.2).
Exceptions to Bank policy: None.

Strategic Alignment			
Challenges:[b]	SI ☑	PI ☐	EI ☐
Crosscutting themes:[c]	GD ☐	CC ☐	IC ☑

[a] Under the Special Development Lending category (document AB-3134) and its Operational Guidelines (document GN-2031-17), this operation will be documented under the Flexible Financing Facility (FFF) with limited debt management options. The borrower has the option of requesting currency and interest rate conversions. The Bank will take operational and risk management considerations into account when reviewing such requests. The applicable amortization schedule for this loan will consist of equal, semiannual installments that begin to accrue at the end of the grace period.

[b] SI (Social Inclusion and Equality); PI (Productivity and Innovation); and EI (Economic Integration).

[c] GD (Gender Equality and Diversity); CC (Climate Change and Environmental Sustainability); and IC (Institutional Capacity and Rule of Law).

I. PROJECT DESCRIPTION AND RESULTS MONITORING

A. Background, problem to be addressed, and rationale

1.1 **Background.** Ecuador is facing a macroeconomic crisis, as seen in a significant loss of competitiveness, an overvalued exchange rate, growing public debt, and major fiscal imbalances. In addition, the government has sizeable gross financing requirements coupled with low and declining reserves. The international environment, including a hardening of financing terms and crude oil price volatility, poses additional challenges and aggravates the current state of affairs.

1.2 The end of the commodity supercycle in 2014 was especially hard on the Ecuadorian economy. Crude exports are the main source of nonfinancial public sector (NFPS) revenue and of hard currency for the country,[1] which had to face the 2015 oil shock with limited fiscal headroom.[2] Between 2015 and 2016, as a result of the shock and the fiscal policy response (initial contraction of public investment on the order of 5% of GDP), Ecuador experienced five consecutive quarters of GDP contraction.[3] It was the deepest economic recession since the country formally dollarized its monetary system in the early 2000s. While a moderate economic recovery did take place in 2017 (with real GDP growth of 2.4%), it was driven by a temporary rally in crude prices and an interruption of the fiscal adjustment. In 2018 the economy returned to a downward path, closing out the year with GDP growth of just 1.1%. For 2019, the International Monetary Fund (IMF) projects negative growth at around -0.5%.[4] This new economic slowdown is primarily due to the government's renewed efforts at fiscal consolidation in view of its difficulties in covering its still significant financing requirements and stabilizing the public debt burden.

1.3 **Weak fiscal management.** The oil shock of 2015 forced a drastic change of direction in Ecuadorian fiscal policy. In the preceding years, fiscal policy had been decidedly expansionary. As a result, the NFPS grew from 35% of GDP in 2008 to 44% of GDP in 2014, including high overall deficits toward the end of that period.[5] Starting in 2015, triggered by the fall in the price of crude, the size of the country's public sector began contracting to around 37% of GDP in 2017 and 2018. The fiscal consolidation effort was particularly intense during two periods: (i) in 2015, when Ecuador became the country in the region that most drastically reduced its primary expenditure in response to the end of the commodity supercycle;[6] and (ii) from mid-2017 onward, in the context of the 2018-2021 Plan for Prosperity described in paragraph 1.11. The adjustment effort has enabled a significant improvement in the fiscal balance of the NFPS, which went from an overall deficit

[1] Before the oil shock, crude oil accounted for close to one third of total NFPS revenues and more than 50% of the country's exports.

[2] In 2013 and 2014, Ecuador ran overall NFPS deficits of 4.6% and 5.2% of GDP, respectively, even though the price of Ecuadorian crude in those years was still, respectively, US$96 and US$84 per barrel.

[3] Source: Central Bank of Ecuador.

[4] The Government of Ecuador has more optimistic projections, situating growth in a range of -0.5% to 0.5% (Ministry of Economy and Finance (MEF), 2019).

[5] Source: Central Bank of Ecuador.

[6] Source: Inter-American Development Bank (IDB), 2016. Time to act. Latin America and the Caribbean facing strong challenges. Latin America and Caribbean Macroeconomic Report.

of 8.2% of GDP in 2016 (primary deficit of 6.7% of GDP) to an overall deficit of 0.9% of GDP in 2018 (primary surplus of 1.5% of GDP).

1.4 These public finance developments led to a rapid growth in NFPS funded debt, which went from 20% of GDP in 2013 to 46.1% of GDP at year-end 2018.[7] This debt level exceeds the statutory ceiling of 40% of GDP under the fiscal rules introduced in Ecuador toward the end of the last decade.[8] In August 2018, to prevent noncompliance with the rule from leading to a halt in the required public financing while the fiscal consolidation process is being completed, the National Assembly approved the Law on Productive Development, Investment Attraction, Job Creation, and Fiscal Stability and Balance (LFP). This law put the statutory debt ceiling temporarily on hold in exchange for more ambitious commitments by the central government regarding the adjustment and the launch of a reform of the fiscal rules. In addition to the rise in the overall amount of debt in relation to GDP, there has been a significant deterioration in the terms of the Ecuadorian public debt. Between 2009 and January 2019, the weighted contractual interest rate on the public debt increased from 4.9% to 6.6% (from 4.3% to 6.9% in the case of the external debt, partially offset by a decrease in the cost of the internal debt from 6.5% to 5.8%). During the same period, the weighted maturity of the debt shortened from 9.7 years to 7.8 years.[9]

1.5 **High external financing requirements.** Despite declining substantially with respect to the period 2015-2017, NFPS gross financing requirement in 2018 were 8.3% of GDP, whereas the current account deficit closed out the year at 0.7% of GDP. In 2019, the country faces estimated gross financing requirements equivalent to 5.6% of GDP.[10] To cover these deficits, Ecuador relies primarily on external credit. Although the country has been active in the capital markets until relatively recently (the last issue was in January 2019), it has lost access to financing on affordable terms to finance its macroeconomic imbalances. As shown in Figure 1, despite the economic measures adopted by the government since the middle of last year (see description of the 2018-2021 Plan for Prosperity in paragraph 1.11), the country risk has risen significantly. Between November 2018 and January 2019, the Emerging Markets Bond Index (EMBI) stood at an average of 745 basis points, compared to 497 basis points in the first quarter of last year. For this reason, the coupon of the last sovereign bond (10.75%), issued in January 2019, was nearly 300 basis points higher than the coupon of the immediately preceding bond (7.87%), issued a year earlier with an identical maturity.[11] Figure 2 shows the coupon for the 15 costliest debt instruments issued by emerging economies on the capital markets between January 2016 and February 2019. Seven of these bonds were issued by Ecuador, reflecting the unsustainable

7 Source: IMF.

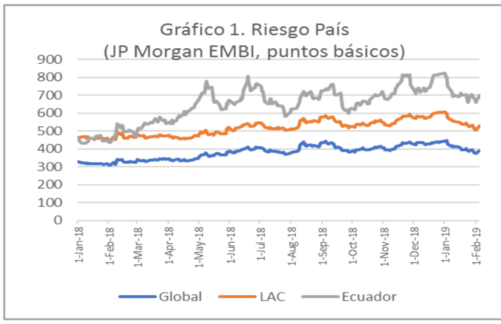
8 Code of Public Planning and Finance (2010).

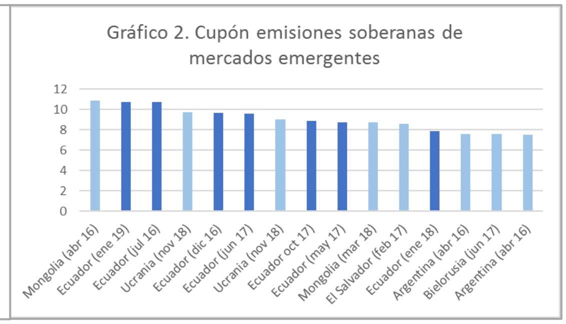
9 Source: MEF.

10 The weight of the repayments is estimated to be equivalent to 5.6% of GDP in 2019. The gross financing requirements in 2019 match the debt amortization amounts (since there is estimated to be an overall fiscal balance). Source: IMF.

11 One of the reasons why the government decided to issue bonds on the international markets at such a high cost is that the US$1 billion raised through that issue was essential for closing the projected financial gap for 2019, in the absence of which the country would have been unable to obtain the multilateral financial support described below.

financing strategy that the government has been implementing in recent years, aggravated by the uncertainty created by the country's economic conditions and the growing risk aversion of institutional investors in an increasingly complex global environment for emerging markets.





Source: Bloomberg.

1.6 **Erosion of liquidity buffers.** External liquidity buffers have also been deeply eroded by the oil shock and by certain policy decisions, further reducing the country's leeway for addressing its current macroeconomic difficulties. At year-end 2018, the gross stock of international reserves was US$2.158 billion, equivalent to 1.25 months of imports, the lowest level of any emerging economy.[12] The country's net international reserves went from US$1.065 billion in 2014 to -US$2.271 billion in 2017 and -US$1.677 billion in 2018, suggesting that this buffer no longer exists in practice.[13]

Table 1. Selected economic and fiscal indicators

	2013	2014	2015	2016	2017	2018
Real GDP growth (annual percentage change)	4.9	3.8	0.1	-1.2	2.4	1.1
Adequate employment rate (percentage of the EAP)	47.9	49.3	46.5	41.2	42.3	40.6
Inflation (period average)	2.7	3.6	4	1.7	0.4	-0.2
Current account (percentage of GDP)	-1	-0.7	-2.2	1.3	-0.4	-0.7
Consolidated public debt (as defined by the IMF)	20.0	27.1	33.8	43.2	44.6	46.1
Total NFPS revenue (percentage of GDP)	39.2	38.4	33.6	30.3	32	36.3
Total NFPS expenditure (percentage of GDP)	43.7	43.6	39.7	38.6	36.6	37.2
Primary fiscal balance (percentage of GDP)	-3.5	-4.2	-4.7	-6.7	-2.4	1.5
Overall fiscal balance (percentage of GDP)	-4.6	-5.2	-6.1	-8.2	-4.5	-0.9
NFPS gross financing requirements (percentage of GDP)	7.1	10.8	14.3	19.1	16.8	8.3
Net international reserves (US$ millions, as defined by the IMF)	1,059	1,065	423	-961	-2,271	-1,677

Sources: Central Bank of Ecuador, INEC, IMF, MEF.

1.7 On 11 March of this year, in view of its lack of access to market financing on affordable terms and the difficult macroeconomic situation it faces, Ecuador signed

[12] Source: Central Bank of Ecuador.

[13] Definition of the IMF arrangement, Technical Memorandum. This figure is obtained by subtracting the following from the gross national reserves: (i) reserves-related current liabilities to nonresidents (the IMF loan proceeds not directly used to cover the government's fiscal needs); and (ii) deposits kept by financial institutions in the Central Bank, primarily as bank reserves.

an agreement with the IMF under the Extended Fund Facility (EFF) with the main objective of reducing the nonoil primary deficit by 5% of GDP over the next three years. Paragraphs 1.13 to 1.15 describe the assistance being provided by the IMF and multilateral institutions to the Government of Ecuador to strengthen its public finances. In addition, in response to an urgent request from the government, the Bank is offering it a support package that includes this program under the Special Development Lending (SDL) category (see paragraph 2.7). This SDL program is a budgetary support lending instrument aimed at helping to address the effects of the macroeconomic crisis on the country's economic and social progress. It is an emergency program and will play an essential role in ensuring the success of the fiscal consolidation process and the launch of a structural reform agenda allowing the private sector to take over from the public sector as the main driver of Ecuador's economic growth, as the government intends.

1.8 **Unbalanced model of economic development.** The development model promoted in Ecuador from 2008 until the onset of the oil shock relied too heavily on public expenditure as the engine of growth. This model was a disincentive to private initiative and included a web of regulations and institutions that discouraged entrepreneurship. As a result, between 2009 and 2016 the gross fixed capital formation attributable to the private sector accounted for 13.2% of GDP, a lower average than in most of the countries in the region and very far removed from the levels recorded in the Organization for Economic Cooperation and Development (OECD) countries (around 18% of GDP) and other emerging markets.[14] Net foreign investment flows were particularly low, averaging 0.8% of GDP between 2007 and 2015 as compared to 3.3% of GDP in Latin America and the Caribbean as a whole. The lower weight of private investment in Ecuador is largely due to the shortcomings of its business climate, as suggested by the fact that the country is ranked 123 out of 190 countries by the World Bank's Doing Business report, with a lower score than almost any other country of the region.

1.9 **Social performance.** In 2017, with a score of 0.752 points, Ecuador was ranked 86th on the Human Development Index, having climbed six places since 2005.[15] This allowed the country to exceed the average score of Latin American and Caribbean countries (0.737). In the years preceding the oil shock, Ecuador made large gains in reducing poverty. The income poverty rate fell from 38.3% in 2006 to 25.8% in 2014, while monetary poverty declined from 37.6% to 22.5%.[16] At the same time, consumption-based extreme poverty declined from 12.9% to 5.7% and income-based extreme poverty declined from 16.9% to 7.7%. Poverty reduction in Ecuador was largely the result of strong economic growth during that period. However, redistribution driven by public policy also played an important role in the improvement of the indicators, thanks to an increase in social expenditure between 2000 and 2015.[17] While this positive performance allowed a burgeoning middle class to emerge, close to 40% of the Ecuadorian population remains at risk of

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[14] Source: Central Bank of Ecuador.

[15] Source: United Nations Development Programme (UNDP).

[16] Source: INEC and World Bank, 2016. Report on consumption poverty: Ecuador 2006-2014.

[17] Source: IDB, 2018. Ecuador: Country development challenges.

sliding back into poverty.[18] This means that the social gains achieved by the country since the turn of the century may prove fragile and could be partially reversed if the macroeconomic crisis worsens and the current scenario of low economic growth drags on.

1.10 In fact, signs of stagnation are already apparent in the social indicators for Ecuador. Between December 2014 and December 2018, the income-based poverty and extreme poverty rates not only stopped declining but actually rose slightly (from 22.5% to 23.2% and from 7.7% to 8.4%, respectively), and a similar movement was observed in terms of inequality (the Gini coefficient having gone from 0.467 to 0.469). The main transmission channel through which the country's macroeconomic hardships disrupt the dynamics of upward social mobility is the labor market. In recent years, full employment has been deeply affected; thus, the percentage of Ecuadorians able to generate employment income equal to or higher than the minimum wage has fallen from 49.3% in December 2014 to 40.6% in December 2018. The female population has been particularly hard-hit by this trend, now with an adequate employment rate of just 32.5%. The empirical evidence points to a relationship between macroeconomic crises and a worsening of public health indicators, including increases in the incidence of certain diseases, such as mental health and obesity.

1.11 **Government strategy.** In mid-2017 there was a change of direction in the country's economic policy, as set forth in the so-called 2018-2021 Plan for Prosperity. The new strategy is based on the following reforms: (i) reduce the size of the State; (ii) reduce excessive spending on goods and services; (iii) make public procurement processes more transparent; (iv) streamline the portfolio of State-owned enterprises; (v) sustain public investment by means of private-sector contributions through public-private partnerships (PPPs); (vi) reinforce the reserves and technical capacity of the Central Bank; (vii) improve access to stable and predictable external financing on better terms; (viii) develop natural resources responsibly; and (ix) reduce fossil fuel subsidies, liberalizing gasoline and diesel prices. This reform program is supplemented by measures aimed at expanding social protection coverage, boosting development of the private sector, and enhancing transparency and the fight against corruption.

1.12 In addition, the Ecuadorian authorities are committed to launching a reform agenda to improve the investment climate and enable the private sector to become more dynamic and partially offset the impact of the fiscal adjustment. As part of this strategy, the LFP included: (i) barring the Central Bank from purchasing Treasury certificates and bonds; (ii) a new framework of fiscal rules that combines limits on public debt, limits on spending growth (supported by safeguard clauses and corrective mechanisms), and an oil stabilization fund that in the future will be helpful in implementing countercyclical fiscal policy measures; (iii) fiscal deficit reduction commitments (including cutbacks on fossil fuel subsidies); and (iv) improvements in the transparency of public debt statistics, among other provisions. At the same time, a program of simplification of procedures and regulatory reforms is under way, and the government is trying to devise a more effective system for collaboration between the public sector and the private sector

[18] Source: Centro de Microdatos Armonizados de las Encuestas de Hogares de América Latina y el Caribe [Center for Harmonized Microdata from Household Surveys in Latin America and the Caribbean].

to help improve the investment climate. There has also been a change of course in trade and investment attraction policy; thus, the government has initiated a dialogue process that will potentially lead to new trade agreements with the Pacific Alliance and other countries, and the country has renewed its commitment to enabling companies to have access to international arbitration arrangements for the resolution of disputes.

1.13 **Multilateral support.** As a core component of the reorientation in economic policy over the past year, the government has reached out to multilateral institutions, especially the IMF. This has led to a request for an arrangement with the IMF, to be supplemented by resources from other multilateral institutions. In the short term, the arrangement will enable the government to avoid resorting to the market to cover its financing needs on excessively onerous terms while the fiscal consolidation process moves forward and measures are put in place to reinforce the sustainability of the dollarization system. In the medium and long term, the program will support the implementation of structural reforms enabling a migration to a development model in which the private, rather than the public, sector is the main catalyst for economic growth.

1.14 The IMF is supporting the government through an EFF arrangement for an amount of approximately US$4.2 billion that was approved on 11 March 2019 and began to disburse on 15 March 2019. In addition, international agencies will support Ecuador with up to US$6.0 billion in financing over the next three years The Bank will contribute approximately US$1.68 billion of that amount in new approvals between 2019 and 2021.[19] The multilateral financing package being negotiated by the government will be supplemented with resources from the Development Bank of Latin America (CAF), the World Bank, the European Investment Bank, the Latin American Reserve Fund, the French Development Agency, and the United Nations Development Programme (UNDP). In total, the authorities expect to mobilize close to US$10.0 billion in financing over the next three years. This would enable the country to avoid returning to the market until its fiscal position is stronger, and institutional investor confidence has been restored, increasing the appetite for Ecuadorian sovereign debt securities.

1.15 One of the main goals of the EFF arrangement is to restore fiscal sustainability. Accordingly, the arrangement sets a target of reducing the NFPS nonoil primary deficit, including subsidies, by 5% of GDP over the next three years, including a cutback equivalent to 2% of GDP in 2019. The fiscal and structural reform measures included in the EFF arrangement are expected to succeed in reducing the deficit from -5.3% in 2018 to -3.3% in 2019, -1.3% in 2020, and -0.3% in 2021. As a result of this adjustment, the overall balance of the NFPS will reach equilibrium in 2019 and show a surplus of 3.8% of GDP in 2020, and 2.9% of GDP in 2021. This would reverse the direction of the public debt and in the medium term (2023) bring it once again below the statutory limit of 40% of GDP. The key components of the EFF arrangement, which envisages adjusting and deepening the reforms contained in the 2018-2021 Plan for Prosperity, are: (i) reinforce the dollarization system; (ii) support competitiveness, growth, and job creation, including by launching a labor reform and a tax reform, among other measures; (iii) protect the poor and vulnerable

[19] Including US$1.1288 billion in 2019, US$241.5 million in 2020, and US$300 million in 2021 (see paragraph 2.7).

from the effects of the adjustment by increasing social expenditure in 2019 and establishing a minimum level of social assistance expenditure from 2020 onward; and (iv) promote transparency and good governance, including through the approval of a new anticorruption law. More specifically, putting dollarization on a stronger footing will require: (i) restoring prudence in fiscal policy (including by instituting a tax reform in late 2019, reducing the size of the State, better targeting of energy subsidies, eliminating excessive spending, strengthening the public procurement system, and enhancing transparency in the management of State-owned enterprises); (ii) reinforcing the institutional framework for the Central Bank (by strengthening its technical capacity and increasing the stock of international reserves, as well as by publishing the Central Bank's financial statements in accordance with International Financial Reporting Standards (IFRS)); and (iii) enhancing the soundness of the financial system.

1.16 **Problems to be addressed.** As evidenced by the priority measures included in the 2018-2021 Plan for Prosperity, the updated medium-term social and macroeconomic program laid out in the Memorandum of Economic and Financial Policies agreed upon with the IMF, Ecuador is facing the challenges of recurrent macroeconomic and fiscal instability, weakening of the institutional and regulatory framework for Central Bank operations, and risk of leaving the poor and vulnerable segments of the population without social safety nets. In response to these challenges, the authorities will undertake essential reforms in the following key areas of economic policy:

1.17 **Growing fiscal instability associated with a weak policy and management framework.** Despite the fact that tax revenue remained stable between 2013 and 2018 at around 14% of GDP, the rise in expenditure has resulted in significant deficit levels. The nonoil primary balance of the NFPS, including oil subsidies, was -7.6% of GDP in 2016 and an estimated -5.3% of GDP in 2018, which is unsustainable.[20] Identifying this fiscal magnitude as a core target of the fiscal consolidation process is particularly important since it will make it possible to assess the impact on the reduction of fossil fuel subsidies, as described in paragraph 1.21.

1.18 **A fiscal adjustment excessively based on investment spending cuts, without proportional adjustments to current expenditure.** After the State's overall public expenditure had expanded between 2009 and 2014 (rising 115% in nominal terms over that period), Ecuador's fiscal adjustment following the oil shock took the form of a cutback in investment spending (see Figure 3). This expenditure category was reduced from more than 15% of GDP between 2013 and 2014 to an estimated 7% of GDP in 2018.[21] The reduction in investment spending limits the sustainability of aggregate demand in the short term and, given the complementary nature of infrastructure investment, makes it difficult to attract private capital. In addition, cutbacks of the type introduced in Ecuador limit both the country's

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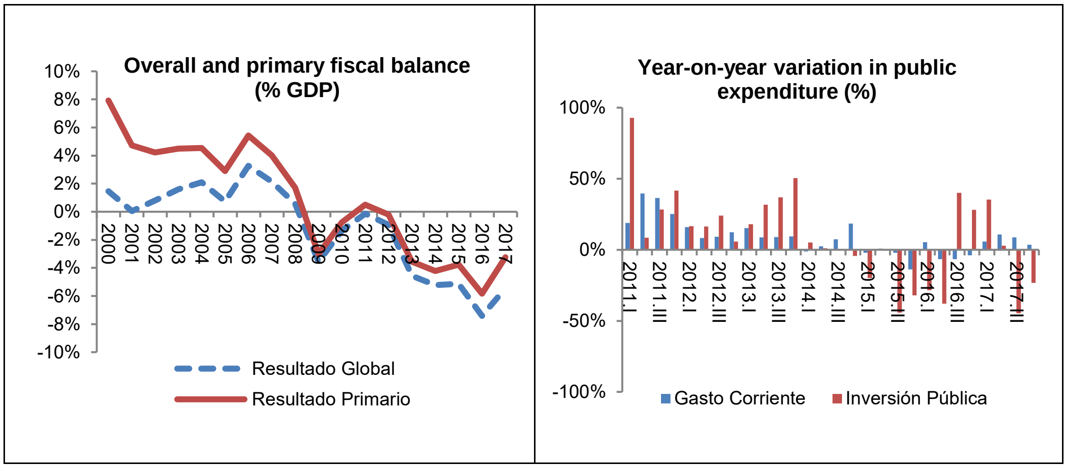
[20] Source: IMF.

[21] Ardanaz M. and Izquierdo A. (2017). Current expenditure upswings in good times and capital expenditure downswings in bad times? New evidence from developing countries. IDB Working Paper Series IDB-WP-838, offering empirical evidence of the procyclical nature of investment expenditure in Latin America and the Caribbean, which is more pronounced than in other emerging economies.

potential for growth and its chance to close the infrastructure gaps with respect to more advanced economies.

Figure 3. Overall and primary balance and year-on-year variation in public expenditure



Source: Central Bank of Ecuador

1.19 In contrast, current expenditure rose as a percentage of GDP from 27.3% in 2013 to an estimated 27.7% in 2018, although its composition changed. The fastest-growing categories of current expenditure were interest (due to the increase in public debt) and social security benefits (since structural reforms would be required to curb their impact on total expenditure). However, the wage bill (which averaged around 10% of GDP between 2013 and 2018) was still rising in late 2018, while spending on goods and services was declining.

1.20 Consequently, additional efforts at fiscal consolidation should focus on reducing current expenditure (particularly wages). Streamlining this item would open up significant room in the fiscal consolidation process and make it possible to limit the impact of additional cuts in investment spending on the country's potential for growth.[22] There are close to 80,000 temporary contracts available and more than 14,500 vacancies unfilled in the Ecuadorian civil service, even though the corresponding budget allocation has been made.[23] In addition, public employees generally earn more than their peers in the private sector. (The wage gap between the public and private sectors in Ecuador is estimated at 50%, the widest in the region.)[24] This is particularly true at State-owned enterprises, which in the last decade have on average contributed 1% of GDP to the State fiscal deficit.

1.21 Identifying the NFPS nonoil primary balance, including subsidies, as an essential outcome indicator under the IMF arrangement underscores the need to reduce expenditures in fossil fuel subsidies, which have been particularly onerous for the State in the past. The subsidies on fossil fuels implemented between 2013 and 2018 (including the estimate for 2018) amounted to approximately US$23.8 billion,

[22] DIA (2018) estimates that efficiency improvements in compensating government employees could yield savings of 2.2% of GDP or 5.7% of total expenditure in Ecuador.

[23] Source: MEF.

[24] DIA 2018.

an average of close to US$4.0 billion a year (approximately 4% of GDP on average).[25] The decline in crude oil prices helped to reduce these subsidies from a peak of US$7.24 billion in 2013 to US$1.53 billion in 2016. However, in the absence of measures to liberalize fuel prices, any increase in the price of crude would return the country to a situation in which 3% to 4% of GDP is set aside for subsidies of this type.

1.22 **Erosion of the institutional framework and independence of the Central Bank of Ecuador.** Under the 2008 Constitution, the Central Bank of Ecuador does not act independently but instead implements the economic policy dictated by the Executive Branch. The financial statements of the Central Bank, including its consolidated balance sheet, are published annually but are not subject to external auditing by an independent firm (nor is there a legal mandate to publish them). The Central Bank has an audit committee but its internal auditing function is weakened. The Central Bank published its internal audit and governmental audit (through the State Comptroller General's Office) reports only until 2014. In addition, to date, the financial statements of the Central Bank are neither prepared nor published in accordance with IFRS, the internationally accepted standards.

1.23 The drop in international reserves described in paragraph 1.6 is due in part to the policy, initiated in late 2014, of investing a portion of the Central Bank's international reserves in treasury certificates (CETEs) issued by the MEF. This quasifiscal use of the international reserves was made possible by the approval of the Monetary and Financial Code in September 2014. By reforming the system of Central Bank balance sheets, this code enabled the Central Bank to manage its assets and liabilities comprehensively, thus removing prior restrictions on the management of freely available international reserves. The value of government securities on the Central Bank balance sheet peaked at US$5.858 billion in April 2017, then fell to US$2.492 billion in February 2018 as a portion of these debt securities was amortized through a transfer of the State's equity interest in several public financial institutions (another illiquid asset), and as the government stopped making active use of this public financing mechanism in recent months.[26]

1.24 To put dollarization on a stronger footing and create the external liquidity buffers that Ecuador needs in order to reduce its economic vulnerability, it is essential to address a reform of the Central Bank that can prevent a recurrence of quasifiscal management of the country's international reserves. Ecuador has taken the first clear steps in this direction. Firstly, the payment of CETEs by transferring the central government's interest in public banks (in the amount of US$2.138 billion) has been invalidated and will have to be reversed. In addition, the 2018 LFP bars the Central Bank from investing in securities issued by public sector entities. Nevertheless, the regulatory limits on budget financing by the Central Bank should be reinforced.

1.25 **Risk of a decrease in social assistance expenditure as part of the adjustment.** Under the 2008 Constitution, funding for education and health must be increased every year by 0.5% of GDP until they reach minimum levels of 6% and 4% of GDP, respectively. However, since this rule applies to the budgeted

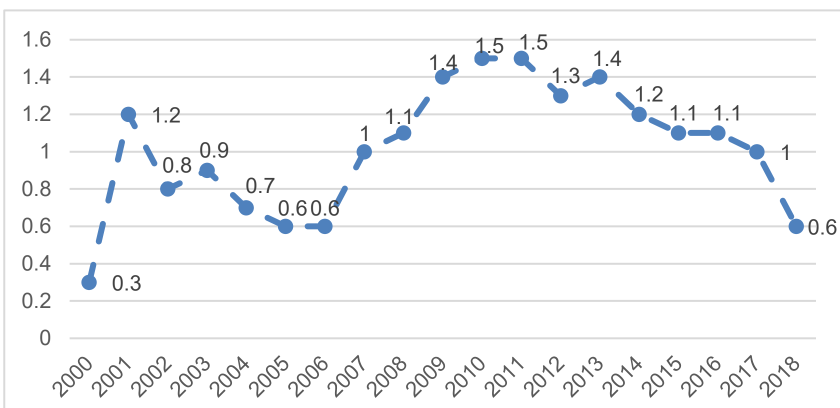
[25] Source: Central Bank of Ecuador.

[26] Source: Central Bank of Ecuador (Weekly Monetary Bulletin).

expenditure but not to the accrued expenditure, this target may be met even if the expenditure amounts are reduced.[27]

1.26 The constitutional safeguards for public expenditure in education and health do not extend to other categories of social protection expenditure. In general, the accrued economic and social inclusion budget as a percentage of GDP has fallen since 2013, when it was 1.4%, to 1% in 2017.[28] The social assistance expenditure includes the Bono de Desarrollo Humano [Human Development Voucher], Bono de Desarrollo Humano Variable [Variable Human Development Voucher], Pensión Adultos Mayores [Older Adult Pension], Pensión "Mis Mejores Años" ["My Best Years" Pension], Pensión Para Personas Con Discapacidad [Pension for Persons with Disabilities], Bono Joaquín Gallegos Lara [Joaquín Gallegos Lara Voucher], and Registro Social [Social Registry].[29] The assistance provided by these programs in 2018 is estimated at US$700 million. In the context of a lengthy adjustment, and despite the constitutional requirement, sustaining a fiscal effort that protects the poorest and most vulnerable population is essential. This will be especially important if, as a result of the adjustment program, the country's pace of growth slows, with its attendant impact on employment. Given such circumstances, with a broad swath of the Ecuadorian population in a vulnerable position, it is imperative to ensure coverage of, and access to, social protection services.

Figure 4. Accrued economic and social inclusion budget (% of GDP)



Source: Ecuadorian Integrated Social Knowledge and Statistics System.

II. Eligibility Criteria

2.1 In light of the macroeconomic crisis facing Ecuador, exemplified by limited access to external financing and unstable fiscal position, the country has requested emergency support from the Bank. Provided in coordination with other international financial institutions and anchored in the recently approved Extended Fund Facility

[27] As shown, the accrued expenditure on education decreased from 5% of GDP in 2013 to 4.4% of GDP in 2016.

[28] Source: Sistema Integrado de Conocimiento y Estadística Social del Ecuador [Ecuadorian Integrated Social Knowledge and Statistics System].

[29] The crucial institutions in executing these expenditures include the Ministry of Economic and Social Inclusion, the Ecuadorian Social Security Institute, and the MEF.

(EFF) arrangement for Ecuador, the Bank's support takes the form of this single-tranche special development lending (SDL) operation. The operation aspires to offer additional assistance to Ecuador in restoring the country's macroeconomic sustainability, while the fiscal consolidation process moves forward and structural measures are put in place to: (i) reinforce the pillars of the dollarization system; (ii) enable migration to a development model where the private, rather than the public, sector is the main engine of economic growth; and (iii) sustain and safeguard the social protection expenditures for the poorest and most vulnerable populations.

2.2 The SDL category, established in the Proposal for the Creation of a Special Development Lending Category (document AB-3134) approved by the Board of Governors on 30 June 2017 pursuant to Resolution AG-9/16 and its Special Development Lending Category Operational Guidelines (document GN-2031-17), is a budgetary support lending instrument for dealing with macroeconomic crises[30] and preserving social gains and economic growth in countries of the region facing a macroeconomic crisis. This is the second SDL program submitted to the Bank's Board of Executive Directors, after the Macroeconomic Emergency Program to Protect Economic and Social Progress in Barbados (loan 4656/OC-BA), approved in November 2018. The Government of Ecuador meets the eligibility criteria for this loan (document AB-3134), inasmuch as Ecuador: (i) is experiencing a macroeconomic crisis (see Section I.A); and (ii) has a lending arrangement approved by the IMF. The EFF arrangement was approved by the IMF on 11 March 2019 (see paragraphs 1.14 and 1.15). The EFF arrangement is expected to last three years, during which time the IMF will disburse about US$4.2 billion in quarterly tranches commencing in March 2019. The first disbursement, for US$651.47 million, was made on 15 March 2019 (the EFF arrangement lists the structural conditions). The amount of the SDL operation (US$500 million) is within the established limit: 2% of the country's GDP or a maximum of US$500 million.[31]

2.3 The Policy Matrix for this program includes: (i) the three conditions established by the EFF for disbursement of its first tranche (see conditions II.c-i, III.a-ii, and III.a-iii in the Policy Matrix, Annex II),[32] which are prior actions completed in March 2019; (ii) the conditions fulfilled by the Government of Ecuador between August 2018 and March 2019 (see conditions II.a, II.b, and III.a-i in the Policy Matrix, Annex II); and (iii) provisional measures forming part of the EFF structural conditions (see condition IV.a in the Policy Matrix, Annex II), aimed at safeguarding social expenditure in support of the vulnerable population. All policy conditions of the SDL program have been fulfilled, are aligned with the EFF, and do not involve any additional transaction costs for the Government of Ecuador, since all means of verification for this program have been agreed upon and validated between the authorities and the Bank.

30 Defined as a situation in which the country potentially lacks sufficient financing on affordable terms to meet its international obligations (document GN-2031-17).

31 Whichever of the two is less; this is the limit of fresh funds per country (paragraph 4.6, document AB-3134).

32 In accordance with the Proposal for the Creation of a Special Development Lending Category (document AB-3134) and its Operational Guidelines (document GN-2031-17).

2.4 The Policy Matrix takes into account: (i) the Policy Letter sent to the Bank by the Government of Ecuador;[33] (ii) the condition of completing the three prior actions allowing and formalizing the disbursement of the first EFF tranche; (iii) the reform measures completed by the Government of Ecuador between August 2018 and March 2019; and (iv) the provisional measures, which are aligned with the structural benchmark parameters of the EFF arrangement.

2.5 **Bank operational support and lessons learned in Ecuador.** The Bank has a portfolio of 31 operations in Ecuador for US$3.2563 billion (mainly in the infrastructure and environment sectors),[34] making it the country's largest multilateral lender. The outstanding debt represents 3% of GDP, 6.5% of NFPS funded debt, and 8.1% of public expenditure.

2.6 In addition, as of year-end 2018, IDB Invest had US$382.8 million in active loans and administered US$255 million in B-loans and third-party funds, mainly in the infrastructure (transportation and energy), health, tourism, and financial sectors. The nonreimbursable technical cooperation and investment grant portfolio currently consists of 43 operations for US$40 million, 77% of which (US$30.6 million) has been disbursed.

2.7 The IDB Group Country Strategy with Ecuador 2018-2021 (document GN-2924) establishes an indicative lending envelope of US$500 million per year, which will be modified by moving up, to 2019, the expected approvals for 2020, which are part of the Ecuador support program in the context of the recently approved IMF program. With this approval, the Bank has committed to approve approximately US$1.1288 billion in 2019, including this SDL for US$500 million, focused on providing emergency support to address the effects of the macroeconomic crisis; a policy-based loan (PBL) to support structural reforms in fiscal management; and several investment loans for US$328.5 million.[35] The proposed sequence of support allows the Bank to address Ecuador's urgent reform needs in the short, medium, and long term. As part of the last set of operations, the Bank is processing two investment loans to support structural reforms in the fiscal area (see paragraph 2.9). Thus, the Bank's support program contains a combination of emergency support (SDL), support for the regulatory and institutional aspects of structural reforms in fiscal management (PBL), and investment loans to make the reform efforts more sustainable. Once this scenario is confirmed, the Bank projects investment loan approvals for US$241.5 million in 2020, and US$300 million in 2021.

2.8 The Bank is executing and processing a substantial portfolio of operations in support of the fiscal reforms in Ecuador in the form of several different financial support instruments and a wide array of technical cooperation operations. Through the Program to Enhance Fiscal Capacity for Public Investment (loan 4670/OC-EC), the Bank is initiating support for the participation of private resources in public

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[33] In accordance with the operational guidelines for the SDL category (see page 7, figure 2, proposal to carry out an SDL operation, document GN-2031-17), a policy letter is requested and included in the Policy Matrix (see Annex II, paragraph I.a).

[34] Data from March 2019.

[35] These operations include programs in the following areas: (i) investment attraction and facilitation; (ii) water and sewer systems; (iii) modernization of financial administration; (iv) housing; (v) competitiveness policies; (vi) State-owned enterprise reform; and (vii) tax management efficiency.

infrastructure projects under the PPP modality.[36] Through the Internal Revenue Service Improvement Program in Ecuador (loan 3325/OC-EC), the Bank is helping to increase revenue through greater compliance with tax obligations by strengthening the management capacity of the Ecuadorian Internal Revenue Service (SRI). The lessons learned in execution of these programs notably include the need to synchronize the efforts to improve tax compliance mechanisms, focusing on enforcement and audit, which will be addressed in the operation, now being processed, to support improved tax management (see paragraph 2.9).

2.9 In 2019, the Bank is processing three new operations: (i) a PBL whereby the Bank will support the regulatory and institutional implementation of key structural reforms for fiscal sustainability, sustainable growth, and stability of the main indicators of social development; (ii) support for reform of the Executive Branch's State-owned enterprise system, with the primary objective of reducing the State's fiscal burden associated with owning inefficient enterprises; and (iii) an investment loan to support the process integration of the SRI and Servicio Nacional de Aduana del Ecuador [Ecuadorian National Customs Service] (SENAE), which will assist in making tax administration more efficient and effective. Through these operations, the Bank provides sustained supplementary support for the implementation of structural reforms included in the EFF framework, particularly in the areas of State-owned enterprises, public investment through PPPs, and tax reform. This shows that, as a whole, these operations contribute to the sustainability of the reforms to be introduced, once the SDL resources are disbursed, while ensuring the Bank's assistance in the medium term in continuing to work with the Government of Ecuador in the aforementioned areas.

2.10 **The Bank's experience in the region and lessons learned.** The Bank has extensive experience supporting governments of the region in overcoming macroeconomic crises and fiscal imbalances such as those faced by Ecuador. The SDL program approved for the Government of Barbados (loan 4656/OC-BA) was aimed at supporting government action to: (i) restore macroeconomic stability; (ii) adopt fiscal adjustment measures to foster a sustainable fiscal balance in the short and medium term; and (iii) protect social expenditure so as to preserve the social gains achieved. In 2014, the Bank approved a Development Sustainability Contingent Credit Line for Ecuador (loan 3415/OC-EC), which offered liquidity to address the external shock of falling oil prices. In 2010, the Bank offered budgetary support to the Government of Jamaica through the Human Capital Protection Program (loan 2299/OC-JA), which offered support to sustain progress in poverty reduction, as well as support to the most vulnerable by protecting social assistance expenditure. In addition, the Fiscal Consolidation Program (loans 2359/OC-JA and 2502/OC-JA) supported the reduction of the public debt and the reduction of fiscal imbalances. The Bank has also supported reform processes undertaken by various governments of the region with a view to strengthening fiscal sustainability through PBL programs such as the Fiscal Consolidation Support Program in Honduras (loan 3590/BL-HO), the Public Finance Strengthening Program in Mexico (loans 3201/OC-ME and 3676/OC-ME), the Program to Deepen Fiscal Reform in Colombia (loan 4552/OC-CO), and the Fiscal Strengthening Program for Inclusive

[36] Loan 4670/OC-EC is in an initial stage of execution, so it has not been possible to identify and draw specific lessons that may be relevant to the present operation.

Growth in El Salvador (loan 4542/OC-ES). The lessons learned from these programs have been instrumental in formulating this SDL program. These lessons notably include: (i) the use of multiple financial instruments to maximize the efficiency of Bank support for the reform program, a strategy followed in Ecuador that includes this operation, a PBL, and several investment loans to support improvements in State fiscal management; (ii) the need to synchronize implementation of the operation with that of the EFF arrangement, which has been facilitated by numerous technical and coordination meetings with the IMF teams and those of other multilateral institutions; and (iii) prevent the emphasis on fiscal adjustment from prevailing over the structural reform objectives, and prevent this adjustment from affecting the level of protection for the poor and vulnerable population.

2.11 **Coordination with other donors.** During the preparation of the SDL operation, the Bank has coordinated with the IMF and other multilateral and bilateral financial institutions on the emergency assistance to Ecuador associated with the EFF arrangement. The technical coordination with IMF staff took place at the senior management level and at the operational level with a view to determining the amount of the operation, the timetable for approval of the various programs, the terms for formulation of this operation, and the exchange of necessary information on the reforms underpinning the emergency assistance. Coordination with the CAF, the World Bank, and other donors was implemented through coordination forums and senior management meetings led by the MEF and the Office of the President of the Republic (see paragraph 1.14). Once the operation has been disbursed, the program will be monitored by means of quarterly IMF visits and reports to assess the degree of compliance with the arrangement and eligibility for subsequent disbursements. These evaluations will be made in coordination with the other donors. The Bank will also share its progress in implementing the initiatives it is leading in the fiscal management areas (see paragraph 2.9) with the IMF and the other donors.

2.12 **Strategic alignment.** The program is consistent with the Update to the Institutional Strategy 2010-2020 (document AB-3008) and is aligned with the development challenge of social inclusion and equality through measures to ensure that essential services are maintained in areas of health, nutrition, early childhood, education, older adult pensions, and persons with disabilities. The program is also aligned with the crosscutting theme of institutional capacity and rule of law through institutional strengthening for fiscal sustainability. The program will contribute to the Corporate Results Framework 2016-2019 (document GN-2727-6) through higher tax revenue as a percentage of GDP. The program is aligned with the Sector Strategy: Institutions for Growth and Social Welfare (document GN-2587-2) in the areas of strengthening of public sector management and finance and macrofiscal management, and is consistent with the Fiscal Policy and Management Sector Framework Document (document GN-2831-8), which emphasizes the importance of institution-strengthening to enhance the quality of public expenditure and improve fiscal equity and social inclusion. The program is aligned with the IDB Group Country Strategy with Ecuador 2018-2021 (document GN-2924), particularly the strategic objectives of mitigating the fiscal risk associated with oil price volatility, generating efficiencies and boosting the quality of public expenditure, and facilitating access to investment finance. The program is aligned with the 2018-2021 Plan for Prosperity and the 2017-2021 Development Plan of

the Government of Ecuador by contributing to the objectives of macroeconomic and fiscal stabilization.

A. Objectives, components, and cost

2.13 The objective of the program is to support government actions to: (i) reestablish macroeconomic stability; (ii) restore fiscal sustainability; (iii) strengthen the institutional framework for the Central Bank; and (iv) safeguard social expenditure in support of the vulnerable population. The structure and content of the program are aligned with the recently approved Extended Fund Facility (EFF) arrangement. The program is structured under the Special Development Lending (SDL) modality with the sole operation to be disbursed in a single tranche. The components will be as follows:

2.14 **Component I. Macroeconomic stability.** The objective of this component is to ensure a macroeconomic framework consistent with the program objectives as established in the Policy Letter and Policy Matrix.

2.15 **Component II. Restore fiscal sustainability.** The objectives of this component are:

(i) Optimize the fuel subsidy system for the benefit of the poor and vulnerable. The conditions to be fulfilled by the borrower are:

a. Eliminate the subsidy on premium gasoline as of December 2018.[37]

b. Reduce the subsidy on regular gasoline by 75% from its 2018 initial level as of December 2018.[38]

c. Reduce the subsidy on regular gasoline with ethanol by 65% from its 2018 initial level as of December 2018.[39]

(ii) Realign the State's wage bill to optimize its size. The conditions to be fulfilled by the borrower are:

a. Implement a government agency merger or elimination program, doing away with provisional appointments and naming temporary administrators for the eliminated ministries.[40]

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[37] With estimated savings of US$82 million in 2019.

[38] With estimated savings of US$321 million in 2019.

[39] With estimated savings of US$339 million in 2019.

[40] A number of ministries are merged: Ministry of Electricity and Energy, Ministry of Mining, and Secretariat of Hydrocarbons are merged into the Ministry of Hydrocarbons, which is renamed the Ministry of Energy and Nonrenewable Natural Resources. The Ministry of Industries and Productivity and the Institute for Export and Foreign Investment Promotion are merged into the Ministry of Foreign Trade and Investment, which is renamed the Ministry of Production, Foreign Trade, and Investment and Fisheries. The Ministry of Aquaculture and Fisheries is converted into the Technical Secretariat of Aquaculture and Fisheries. Four secretariats are eliminated: The National Secretariat of Public Administration, Technical Secretariat for Comprehensive Drug Prevention, Secretariat of Intelligence, and National Secretariat of Communications, and the Secretariat of Water is merged with the Ministry of Environment. The Secretariat of Risk Management is converted into a service. The National Institute of Energy Efficiency and Renewable Energy is merged with the National Geological, Mining, and Metallurgical Research Institute. The Institute for Regional Amazonian Ecodevelopment is eliminated and a Technical Secretariat for the Special Amazonian Territorial District is created. An estimate of the savings generated through this strategy is being completed.

b. Eliminate 14,533 vacancies (in 2018-2019), which are not to be reinstated.[41]

c. Reduce 11,500 temporary contracts (up to January 2019).

d. Reduce the salary scale for high-ranking public officials.

(iii) Enhance the transparency of the external debt to optimize its management. The condition to be satisfied by the borrower is: Deliver detailed information on the NFPS external debt, including information on all collateralized debt and debt with similar arrangements, such as repurchase agreements, debt requiring escrow deposits abroad and similar accounts, and other, similar debts involving a pledge, sale/resale, or encumbrance of assets. The information on collateralized debt and debt with similar arrangements included all contracts associated with such debt; information on escrow deposits abroad and similar accounts that could serve as collateral; and detailed information on each lender regarding the outstanding balance of the debt, its terms (including amounts committed, sold/resold, or encumbered, as well as commitments or obligations related to the purchase of related or unrelated goods and/or services from the lender), and the projected debt service tables.

2.16 **Component III. Strengthen the institutional framework for the Central Bank.** The objective of this component is to strengthen the institutional and regulatory foundations of the Central Bank. The conditions to be fulfilled by the borrower are:

a. Bar the Central Bank, through the 2018 LFP, from investing in securities issued by public sector entities.

b. Approve, pursuant to a resolution of the Monetary Board (Monetary and Financial Policy and Regulation Board), a regulation barring quasifiscal expenditures by the Central Bank, as well as any direct or indirect loan to the NFPS, including through public banks. This resolution covers the purchase of securities, advances or guarantees, or financial transactions as a condition precedent for loan operations by the government, but does not cover foreign trade credits.

c. Publish the 2017 financial statements of the Central Bank, to enhance the transparency of its operations. The government also commits to publish the future financial statements as they become available, prepare them in accordance with the IFRS from 2019 onward, and publish them in accordance with the IFRS from 2021 onward.

2.17 **Component IV. Safeguard social expenditure in support of the vulnerable population.** The objective of this component is to sustain social expenditure so as to preserve social gains. The government has committed to increase expenditure on social assistance by US$370 million in 2019 (including increased coverage of the Human Development Voucher, allocations to the Joaquín Gallegos Voucher for persons with disabilities, increased coverage of the noncontributory pension system, and improvement and updating of the Social Registry). The government

[41] With estimated wage savings for the State of US$244 million in 2019.

has also committed to establish a minimum social assistance expenditure level of 1% of GDP for 2020-2021.[42]

B. Key results indicators and program beneficiaries

2.18 The expected impact is to improve the NFPS fiscal balance by increasing its nonoil primary balance (including fuel subsidies) from -5.3% of GDP in 2018 to -0.3% of GDP in 2021. The principal outcomes are: (i) decrease in NFPS current expenditure from 27.7% of GDP in 2018 to 24% of GDP in 2021; (ii) increase in net international reserves from -US$1.677 billion in 2018 to US$7.455 billion in 2022; (iii) decrease in NFPS funded public debt from 46.1% of GDP in 2018 to 45.2% of GDP in 2021;[43] and (iv) US$370 million increase in social expenditure in 2019 (approaching 1% of GDP) and social expenditure maintained at 1% of GDP in 2020-2021.

2.19 The program will benefit:

a. The central government, which will obtain fiscal savings to be applied to priority public expenditure, debt repayment, and deficit reduction. Reducing fossil fuel subsidies (on premium and regular gasoline as well as on regular gasoline with ethanol) will entail annual savings of US$742 million for the government (2018 cost of subsidies on premium gasoline: US$82 million; on regular gasoline: US$321 million; and on regular gasoline with ethanol: US$339 million). Fuel price liberalization will also translate into higher tax revenues for the State. The State's policies of optimization through the elimination of 14,533 vacancies that may not be reinstated, will save the State US$244 million in 2019. These funds will help to restore fiscal sustainability and debt sustainability.

b. The general population, as the State's cost of finance falls due to a decrease in external financing requirements as well as an increase in the repayment period and a decrease in the cost associated with loans from multilateral and bilateral entities. Assuming that the Government of Ecuador would have continued to seek financing on the market at a cost similar to the past two years (weighted average of 8.85%) in the absence of the multilateral support it is now receiving, the savings to the government from access to these funding sources can be estimated. Taking only the proceeds of the EFF and SDL financing with a weighted average interest rate of 3.5%, the annual savings in interest payments is US$230 million. If one takes as a basis the total multilateral and bilateral financing (approximately US$10 billion) being arranged by the government, the annual savings could reach US$545 million. In addition to the State's future savings from the substitution of funding sources, the announcement of the program is being well received by the market, as suggested by the movement in the EMBI. Between 19 February (the day before the announcement of the arrangement with the IMF) and 27 February, the EMBI fell 98 basis points, portraying the impact that the government's current strategy could have on achieving more favorable sovereign lending terms. According to IMF estimates, if the fiscal consolidation and public debt reduction

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[42] Social expenditure is computed as the sum of the following spending programs: Human Development Voucher, Variable Human Development Voucher, Older Adult Pension, "My Best Years" Pension, Pension for Persons with Disabilities, Joaquín Gallegos Lara Voucher, and Social Registry.

[43] The MEF projection for 2022 is 40.1% of GDP.

strategy is successful, Ecuador's sovereign spreads could narrow by 175 basis points.

c. The vulnerable and low-income population receiving social protection benefits, as social spending rises by US$370 million in 2019 and a minimum level of 1% of GDP is established for 2020-2021.

d. The private sector, which will benefit from a stable macroeconomic and fiscal context that promotes investment and from structural reforms in the labor and tax areas that are conducive to business development and enhance certainty as to the law. To this end, the Bank will offer sustained support for the implementation of structural reforms in the areas of State-owned enterprises, public investment through PPPs, and tax reform (see paragraph 2.9).

III. FINANCING STRUCTURE AND MAIN RISKS

A. Financing instruments

3.1 This special development lending (SDL) program will be financed from the Bank's Ordinary Capital resources and is part of the Bank's regular lending program approved in the Long-term Financial Plan. As such, it will not exceed the lending program.[44] The operation is being prepared and approved in coordination with the Extended Fund Facility (EFF). The single-tranche structure and the supplementary financing arrangements with the IMF provide a flexible and effective mechanism for supporting complex, long-term reforms that require actions be taken in a certain sequence. The SDL resources will be transferred to the government in a single disbursement deposited into a Central Bank account indicated by the Ministry of Economy and Finance (MEF) that forms part of the Treasury Single Account (CUT) system.

3.2 The amount of this program is US$500 million, in addition to the approximately US$4.2 billion under the EFF arrangement in 2019-2021, bringing the total to US$4.7 billion. The following were taken into account in determining the loan amount: (i) the size of the macroeconomic adjustment package required to address the macroeconomic crisis; (ii) the US$4.2 billion available at the IMF; and (iii) the fiscal and balance of payment gaps, country debt sustainability, and risk factors (see paragraph 3.3 of the Operational Guidelines for the SDL category (document GN-2031-17)). The program will help to cover the country's gross financing requirements, estimated at US$5.903 billion (5.6% of GDP) for the remainder of 2019, US$500 million of which (0.47% of GDP) will be provided by the Bank through the SDL resources.[45]

B. Environmental and social safeguard risks

3.3 Under Directive B.13 of the Bank' Environment and Safeguards Compliance Policy (Operational Policy OP-703), this operation, a budgetary support loan, requires no

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[44] The Long-term Financial Plan is a long-term financial planning and programming document that proposes annual allocations of lending. It was created to meet the requirements of the Ninth General Increase in the Resources of the IDB related to the Income Management Model. The SDL operation does not exceed the Bank's regular lending program or the capital ratio.

[45] Additionally, the World Bank has committed approximately US$1.744 billion in support for the reform program in the same period, and the CAF, approximately US$1.8 billion.

environmental impact classification. No social or environmental risks are foreseen since the operation will not finance investment projects involving works or infrastructure.

C. Fiduciary risks

3.4 No fiduciary risks have been identified for this program. The proceeds will be transferred directly to the CUT to cover financing requirements, and the executing agency has the necessary financial management instruments and control system for this purpose. The proceeds will be disbursed once the policy measures established in the loan contract have been completed.

D. Other key risks and issues

3.5 **Macroeconomic and fiscal sustainability.** The structural weaknesses exposed by the oil shock will remain in the medium term, posing a high risk for the country's economy and for the implementation of the adjustment program. In the absence of an improvement in the contribution of private investment, the fiscal consolidation program could have a powerful impact on Ecuador's economic growth. Thus, as a result of the adjustment, the country's GDP growth rate is expected to go from 1.1% in 2018 to -0.5% in 2019.[46] Additional volatility in crude oil prices, as well as exposure to natural disasters such as the recent earthquake in Manabí, could jeopardize the program objectives, which may be summarized as an adjustment of 5% of GDP in the nonoil primary balance of the NFPS (including fossil fuel subsidies). The earthquake had an estimated impact of 3.3% of GDP[47] and required redirecting US$160 million in IDB funds toward reconstruction tasks. The agreed macrofiscal framework under the IMF arrangement includes conservative crude oil price expectations as a mitigation measure. In addition, the government has already cut the deficit target by 0.9% of GDP, showing a commitment to consolidation that precedes the program approved with the IMF. Moreover, the hardening of external financing terms in the current global context poses a risk that will be mitigated through the joint support package provided by the IMF and the multilateral organizations.

3.6 **Public management and governance.** The broad and deep program of structural reforms envisaged in the EFF program will require a high-intensity institutional response and poses a medium-level risk. In the absence of adequate capacity, there is a risk of incomplete implementation of the reforms. Reforms expected to have an immediate impact, such as the labor and tax reforms, require specialized teams and effective allocations of resources for efficient implementation, in addition to priority attention from the authorities. This risk will be mitigated with the ongoing monitoring of the EFF arrangement and with Bank support in the form of financial assistance (through investment loans already in execution or at different stages of processing) and technical assistance in the fiscal area to help the government execute the necessary reforms.

3.7 **Implementation.** Implementing an adjustment program as far-reaching as this requires broad social consensus generally, as well as individualized support for

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[46] The government estimate for 2019 GDP growth is 0.5%, one percentage point higher than the IMF scenario.

[47] National Secretariat of Planning and Development, 2016. Assessment of the earthquake reconstruction costs in Ecuador.

the specific reforms involved. There is a high risk that the reforms will not be fully completed due to a discontinuity in the underlying commitment as a result of pressure from stakeholders. The structural reforms envisaged in the EFF include a labor reform and a tax reform that will require sustained commitment and significant awareness efforts with society at large. This risk will be mitigated through intense and frequent government interaction with the business sector and the social stakeholder representatives aimed at conveying the ultimate objective of the reforms and the benefit that the adjustment program will bring to society as a whole.

3.8 **Reputational risk.** An inefficient or incomplete implementation of the ambitious reform program could pose a medium-level risk to the Bank's reputation as an effective partner in supporting policy reforms in the Andean region. As a mitigation measure, the IDB, the IMF, and the other multilateral institutions (including the World Bank and the CAF) have coordinated the design of their support programs and the monitoring mechanisms for execution of the program and successful achievement of the quantitative indicators. This operation is part of a coordinated agreement between the IDB and the IMF to provide financial support to Ecuador and is essential for efficient implementation of the EFF arrangement. The achievement of positive intermediate outcomes by the EFF, along with the Bank's supervision and leadership in key areas of the reform in Ecuador, will help to mitigate this risk.

IV. IMPLEMENTATION AND MANAGEMENT PLAN

A. Summary of implementation arrangements

4.1 **Borrower and executing agency.** The borrower is the Republic of Ecuador. The executing agency will be the Ministry of Economy and Finance (MEF), which will be responsible for: (i) providing evidence that the conditions for disbursement of the loan agreed upon by the government and the Bank have been fulfilled; (ii) promoting measures to achieve the policy objectives laid out in the program; and (iii) compiling, storing, and providing to the Bank the necessary information, indicators, and parameters for monitoring and evaluation of the program results.

4.2 **Special contractual conditions precedent to release of the single tranche: The single disbursement of loan proceeds will be contingent on fulfillment of the policy conditions summarized in the Policy Matrix (Annex II) and Policy Letter, and on fulfillment of the conditions contained in the loan contract.**

B. Summary of arrangements for monitoring results

4.3 **Monitoring.** The borrower and the Bank will hold regular monitoring meetings. The visits of EFF and IMF staff to Ecuador will be monitoring instruments. The executing agency will compile and process all necessary data for program monitoring and evaluation. Consulting services engaged to verify the Results Matrix indicators and the activities in the Policy Matrix (Annex II) will be financed with administrative funds of the Bank.

4.4 **Evaluation.** Upon conclusion of the EFF arrangement, the Bank will prepare a project completion report (PCR) to assess its impact. The government and the

Bank have agreed on the indicators and benchmark parameters for this evaluation. The evaluations will be financed with administrative funds of the Bank.

4.5 **Policy Letter.** The Policy Letter sent by the Government of Ecuador, reaffirming its commitment to the macroeconomic framework policies agreed upon with the Bank, is aligned with the program Policy Matrix (Annex II) and Results Matrix (Annex I).

RESULTS MATRIX[1]

Objective: The objective of the program is to support government actions to: (i) reestablish macroeconomic stability; (ii) restore fiscal sustainability; (iii) strengthen the institutional framework for the Central Bank; and (iv) safeguard social expenditure in support of the vulnerable population. The structure and content of the program are aligned with the recently approved Extended Fund Facility (EFF) arrangement.

EXPECTED IMPACT

Indicators	Unit	2018 baseline	2019	2020	2021 target	Means of verification	Comments
Impact: Improve the fiscal balance of the NFPS							
NFPS nonoil primary balance (including fuel subsidies) / GDP	%	-5.3	-3.3	-1.3	-0.3	Annual financial report prepared by the MEF.	Source: First IMF review of the EFF arrangement.

EXPECTED OUTCOMES

Indicators	Unit	2018 baseline	2019	2020	2021 target	Means of verification	Comments
Outcome 1: Decrease in NFPS current expenditure							
Current expenditure /GDP	%	27.7	25.5	25.0	24.0	Annual financial report prepared by the MEF.	Source: First IMF review of the EFF arrangement.
Outcome 2: Increase in net international reserves							
Net international reserves[2] (US$ billions)	$	-1.677	1.419	3.935	7.455	Annual financial report prepared by the MEF.	Source: First IMF review of the EFF arrangement.
Outcome 3: Decrease in consolidated NFPS public debt							
Consolidated NFPS public debt [3] / GDP	%	46,1	49.2	46.8	45.2	Annual financial report prepared by the MEF.	Source: First IMF review of the EFF arrangement.
Outcome 4: Social expenditure maintained							
Social expenditure[4] / GDP	%	0.6	1.0	1.0	1.0	Annual financial report prepared by the MEF.	Source: First IMF review of the EFF arrangement.

[1] Given the nature of the SDL operation, the Results Matrix is related to the outcomes of the EFF arrangement.

[2] Gross international reserves minus deposits from other institutions.

[3] Includes the balance of oil presales, treasury certificates (CETEs), Central Bank loans, other liabilities, and domestic floating debt. The 40% fiscal rule applies to this figure.

[4] Social expenditure is computed as the sum of the following spending programs: Human Development Voucher, Variable Human Development Voucher, Senior Adult Pension, “My Best Years” Pension, Pension for Persons with Disabilities, Joaquín Gallegos Lara Voucher, and Social Registry.

EXPECTED OUTPUTS

Output indicator	Unit	2018 baseline	2019	2020	2021 target	Means of verification	Comments
Component II. Restore fiscal sustainability							
1. Fuel subsidy system optimized: i. Subsidy on premium gasoline (fossil fuel) removed. ii. Subsidy on regular gasoline (fossil fuel) reduced. iii. Subsidies on regular gasoline with ethanol, reduced.	Executive decrees	0	1	0	1	Copy of the Official Registry publication of: - Executive Decree 490, Supplement 312 of 24 August 2018, amending the replacement regulations governing the prices of hydrocarbon derivatives issued through Executive Decree 338, published in Official Registry 73 of 2 August 2005 (output 1.i). - Executive Decree 500, Supplement 327 of 14 September 2018, amending the replacement regulations governing the prices of hydrocarbon derivatives issued through Executive Decree 338, published in Official Registry 73 of 2 August 2005 (outputs 1.ii and iii). - Executive Decree 619, Supplement 394 of 26 December 2018, amending the replacement regulations governing the prices of hydrocarbon derivatives issued through Executive Decree 338, published in Official Registry 73 of 2 August 2005 (output 1.i-iii). Decree 690 is the final one amending Decree 338.	Subsidy removal and reduction implemented between August and December 2018.
2. Civil service management optimization plan implemented, including: i. Merger or elimination of ministries and other public entities. ii. Elimination of 14,533 ministry vacancies, which are not to be reinstated iii. Reduction of 11,500 temporary service contracts (nonrenewable contracts of up to 12 months). iv. Reduction of the salary scale for high-ranking public officials.	Executive decrees and ministerial resolution	0	1	0	1	Output 2.i: – Executive Decree 5 of 24 May 2017 eliminating the National Secretariat of Public Administration. – Executive Decree 7 of 24 May 2017 eliminating the Ministry for Coordination of Production, Employment, and Competitiveness; Ministry for Coordination of Strategic Sectors; Ministry for Coordination of Security; and Ministry for Coordination of Knowledge and Human Talent. – Executive Decree 11 of 25 May 2017 converting the Office of Youth of the Ministry of Economic and Social Inclusion into the Technical Secretariat of Youth.	

Output indicator	Unit	2018 baseline	2019	2020	2021 target	Means of verification	Comments
						– Executive Decree 376 of 23 April 2018 eliminating the Technical Secretariat for Comprehensive Drug Prevention and transferring its responsibilities to the Ministry of the Interior. – Executive Decree 399 of 15 May 2018 merging the Ministry of Electricity and Energy, Ministry of Mining, and Secretariat of Hydrocarbons into the Ministry of Hydrocarbons. – Executive Decree 520 of 20 September 2018 merging the Ministry of Industries and Productivity and the Institute for Export and Foreign Investment Promotion into the Ministry of Foreign Trade and Investment. – Executive Decree 526 of 21 September 2018 eliminating the Secretariat of Intelligence and creating the Center for Strategic Intelligence. – Executive Decree 533 of 3 October 2018 merging the Ministry of Environment and the Secretariat of Water, the resulting entity being named Ministry of Environment and Water. – Executive Decree 534 of 3 October 2018 converting the National Secretariat of Risks into the National Risk and Emergency Management Service and creating the National Risk and Emergency Management Service Committee. – Executive Decree 535 of 11 October 2018 eliminating the National Secretariat of Communication and creating the General Secretariat of Communication within the Office of the President of Ecuador. – Executive Decree 559 of 14 November 2018 merging the Ministry of Industries and Productivity, the Institute for Export and Foreign Investment Promotion, and the Ministry of Aquaculture into the Ministry of Foreign Trade and Investment.	

Output indicator	Unit	2018 baseline	2019	2020	2021 target	Means of verification	Comments
						– Copy of the Official Registry publication of the Law on Amazonian Territorial District Planning, Supplement 245 of 21 May 2018, eliminating the Institute for Regional Amazonian Ecodevelopment and creating the Technical Secretariat for the Special Amazonian Territorial District. Outputs 2.ii-v. – Copy of the Official Registry publication of Ministerial Resolution 001 issued by the Ministry of Labor on 2 January 2019: Technical provision aimed at streamlining personnel costs in temporary service contracts and eliminating vacancies for positions in the public sector.	
3. Detailed information on the NFPS external debt delivered, including information on all collateralized debt and debt with similar arrangements, such as repurchase agreements, debt requiring escrow deposits abroad and similar accounts, and other, similar debts involving a pledge, sale/resale, or encumbrance of assets.	Document	0	1	0	1	The Government of Ecuador delivered detailed information to the IMF on the external debt of the NFPS on a confidential basis. This information was reviewed and validated by the IMF staff, enabling approval of the EFF arrangement.	The information on all secured debt and debt governed by similar agreements included all contracts associated with this debt; information on foreign escrow deposits or similar accounts that can serve as security; and detailed information on each lender regarding the outstanding debt balance, the terms of the debt (including the committed, sold/resold, or encumbered amounts as well as any commitments or obligations associated with the purchase of related or unrelated goods and/or services from the lender), and the expected debt service tables.

Output indicator	Unit	2018 baseline	2019	2020	2021 target	Means of verification	Comments
Component III. Strengthen the institutional framework for the Central Bank							
1. Central Bank barred from investing in securities issued by public sector entities, pursuant to the 2018 Law on Productive Development.	Law	0	1	0	1	Copy of the publication in Official Registry 309 Supplement of 21 August 2018 of the Organic Law on Productive Development, Investment Attraction, Job Creation, and Fiscal Stability and Balance.	
2. Regulation barring quasifiscal expenditures by the Central Bank, as well as any direct or indirect loan to the NFPS, including through public banks, approved pursuant to a resolution of the Monetary Board (Monetary and Financial Policy and Regulation Board).	Certification	0	1	0	1	Certification from the Monetary and Financial Policy and Regulation Board dated 1 March 2019.	This resolution covers the purchase of securities, advances or guarantees, or financial transactions entered into as a condition precedent for loan operations by the government, but does not cover foreign trade credit.
3. Financial statements of the Central Bank published, to enhance the transparency of its operations.	Financial statements	0	1	0	1	Copy of the published Central Bank financial statements.	The government similarly undertakes to publish the future Central Bank financial statements as they become available; prepare them in accordance with the IFRS starting in 2019; and publish them in accordance with the IFRS starting in 2021.
Component IV. Safeguard social expenditure in support of the vulnerable population							
1. US$370 million increase in social expenditure in 2019 (approaching 1% of GDP) and social expenditure maintained at 1% of GDP in 2020 2021.	Document	0	1	0	1	Submittal of the EFF technical memorandum signed by the Government of Ecuador and the IMF evidencing the government's commitment to maintaining the minimum social expenditure level.	

POLICY MATRIX[1]

Objective: The objective of the program is to support government actions to: (i) reestablish macroeconomic stability; (ii) restore fiscal sustainability; (iii) strengthen the institutional framework for the Central Bank; and (iv) safeguard social expenditure in support of the vulnerable population. The structure and content of the program are aligned with the recently approved Extended Fund Facility (EFF) arrangement.

Components/ Policy objectives	Conditions for the sole operation	Fulfillment status of the conditions[2]
Component I. Macroeconomic stability		
Preserve macroeconomic stability.	I.a: The borrower fulfills the conditions of the Policy Letter and maintains a macroeconomic framework consistent with the program objectives.	Fulfilled (Q1 2019)
Component II. Restore fiscal sustainability		
Optimize the fuel subsidy system for the benefit of the poor and vulnerable.	II.a: Conditions to be fulfilled by the borrower: i. Eliminate the subsidy on premium gasoline as of December 2018. ii. Reduce the subsidy on regular gasoline by 75% from its 2018 initial level as of December 2018. iii. Reduce the subsidy on regular gasoline with ethanol by 65% from its 2018 initial level as of December 2018.	Fulfilled (Q4 2018)
Realign the State's wage bill to optimize its size.	II.b: Conditions to be fulfilled by the borrower: i. Implement a government agency merger or elimination program, doing away with provisional appointments and naming temporary administrators for the eliminated ministries. ii. Eliminate 14,533 vacancies (in 2018-2019), which are not to be reinstated. iii. Reduce 11,500 temporary contracts (up to January 2019). iv. Reduce the salary scale for high-ranking public officials.	Fulfilled (Q1 2019)

[1] The policy conditions of this Policy Matrix are consistent with the SDL program and fully aligned with the EFF arrangement.

[2] This information is purely indicative as of the date of this document. Fulfillment of all specified conditions for disbursement, including the preservation of macroeconomic stability, will be verified by the Bank when the disbursement request is submitted by the borrower and reflected as appropriate in the disbursement eligibility memorandum.

Components/ Policy objectives	Conditions for the sole operation	Fulfillment status of the conditions[2]
Enhance the transparency of the external debt to optimize its management.	II.c: The condition to be satisfied by the borrower is: Deliver detailed information on the NFPS external debt, including information on all collateralized debt and debt with similar arrangements, such as repurchase agreements, debt requiring escrow deposits abroad and similar accounts, and other, similar debts involving a pledge, sale/resale, or encumbrance of assets. The information on collateralized debt and debt with similar arrangements included all contracts associated with such debt; information on escrow deposits abroad and similar accounts that could serve as collateral; and detailed information on each lender regarding the outstanding balance of the debt, its terms (including amounts committed, sold/resold, or encumbered, as well as commitments or obligations related to the purchase of related or unrelated goods and/or services from the lender), and the projected debt service tables.	Fulfilled (Q1 2019)
Component III. Strengthen the institutional framework for the Central Bank		
Reinforce the institutional and regulatory foundations of the Central Bank.	III.a: The conditions to be fulfilled by the borrower are: i. Bar the Central Bank, through the 2018 LFP, from investing in securities issued by public sector entities. ii. Approve, pursuant to a resolution of the Monetary Board (Monetary and Financial Policy and Regulation Board), a regulation barring quasifiscal expenditures by the Central Bank, as well as any direct or indirect loan to the NFPS, including through public banks. This resolution covers the purchase of securities, advances or guarantees, or financial transactions as a condition precedent for loan operations by the government, but does not cover foreign trade credits. iii. Publish the 2017 financial statements of the Central Bank, to enhance the transparency of its operations. The government also commits to publish the future financial statements as they become available, prepare them in accordance with the IFRS from 2019 onward, and publish them in accordance with the IFRS from 2021 onward.	Fulfilled (Q1 2019)
Component IV. Safeguard social expenditure in support of the vulnerable population		
Sustain social expenditure so as to preserve social gains.	IV.a: The conditions to be fulfilled by the borrower are: i. Commit to increase expenditure on social assistance by US$370 million in 2019 (including increased coverage of the Human Development Voucher, allocations to the Joaquín Gallegos Voucher for persons with disabilities, increased coverage of the noncontributory pension system, and improvement and updating of the Social Registration Form); and ii. Commit to establish a minimum social assistance expenditure level of 1% of GDP for 2020-2021.[3]	Fulfilled (Q1 2019)

[3] Social expenditure is computed as the sum of the following spending programs: Human Development Voucher, Variable Human Development Voucher, Older Adult Pension, “My Best Years” Pension, Pension for Persons with Disabilities, Joaquín Gallegos Lara Voucher, and Social Registration Form.

DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

PROPOSED RESOLUTION DE-__/19

Ecuador. Loan ____/OC-EC to the Republic of Ecuador
Emergency Program for Macroeconomic
Sustainability and Prosperity

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 the Emergency Program for Macroeconomic Sustainability and Prosperity. Such financing will be for the amount of up to US$500,000,000 from the resources of the Bank's Ordinary Capital, and will be subject to the Financial Terms and Conditions and the Special Contractual Conditions of the Project Summary of the Loan Proposal.

(Adopted on ___ ___________ 2019)

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EC-L1255