

ECUADOR

2003

Growth slowed in 2003 for the second year in a row. According to the Central Bank, GDP grew 2.7%, down from 3.4% in 2002. Investment and consumption fell, as the new government was unable to project a clear horizon for business. GDP expanded, largely due to the start of operations of the Heavy Crude Pipeline (OCP). Soon after winning the election on a centre-left platform, President Gutierrez named a conservative economic team, which reached an agreement with the IMF calling for an ambitious pro-market reform program. While this calmed market fears, the administration's policies were openly opposed by indigenous groups in the coalition. The President broke up the coalition, thus losing 20 votes in a 100-member congress. With the administration down to just six votes, legal reform will be very difficult.

The early IMF agreement and commitment to continuing dollarisation helped stabilise expectations despite the political problems. Unemployment fell to about 9%. End-of-year inflation declined from 9.4% in 2002 to 6.1%, finally allowing single-digit average inflation (7.9%) and a reduction in the gap with international inflation; this reduction, along with the depreciation of the US dollar, is partially reversing the loss of competitiveness suffered over the past three years. The real exchange rate rose 6.3% (depreciated) in 2003, helping slow import growth while exports performed well. The current account deficit was narrowed

significantly from US\$1.2 billion in 2002 to US\$424 million in 2003. Meanwhile, very strict spending by the Ministry of Finance yielded a surplus of 1.2% of GDP for the non-financial public sector, helping to reduce the debt-to-GDP ratio to 54%.

OUTLOOK FOR 2004–05

GDP growth will accelerate markedly in 2004. If oil prices remain close to current levels, GDP growth should hover at 5%. Inflation should cease to cause concern in 2004 (and beyond). Under the dollarised monetary system, it should fall to 2.8% by the end of 2004 and remain close to international rates from then on.

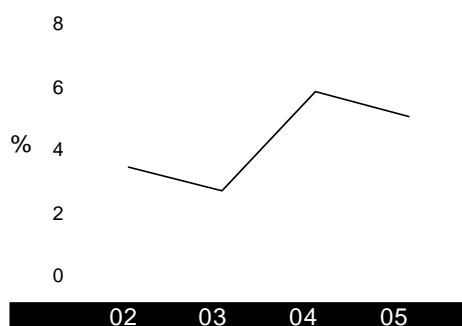
The non-oil economy poses serious challenges. Low total factor productivity is contributing to minimal competitiveness, and growth will be concentrated on a few sectors. Continued contractionary fiscal policies and low domestic confidence levels continue to contribute to low liquidity in the banking system. Ecuadorians are keeping their money abroad, and banks, without a lender of last resort, are keeping 40% of excess reserves overseas. This trend is contributing to a shallow financial system that cannot manage to bring interest rates down to single digits despite having low inflation. Consolation lies in the real exchange rate, which is expected to continue to depreciate, helping exporters.

The operation of the dollarisation regime will continue to provide a stable business environment. End-of-

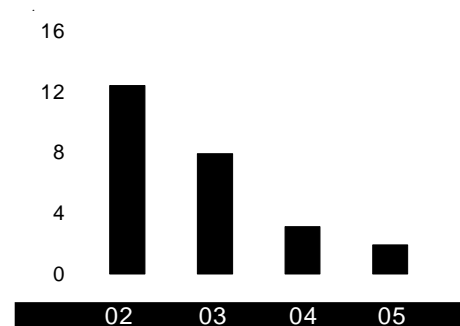
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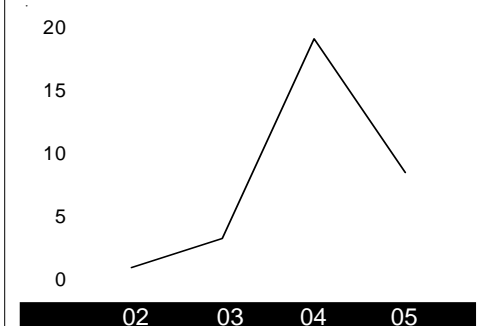
GDP growth



CPI inflation



Export growth



year consumer inflation is projected to fall to about 2.8% in 2004, below the official projection. With an expected weak dollar and a strengthening Colombian peso, the real exchange rate should depreciate another 5%, aiding exporters, who would by then be working at close to the long-term equilibrium.

Export growth will fuel most of the economic expansion in 2004. Of the 5.8% increase in GDP forecast, about 4.8 percentage points will come from oil. High crude prices and higher output will fuel the sector. Although investment will be lower in 2004 due to the slow policy actions mentioned in the oil sector, at 20.5% of GDP it is still well above the historical average, and should continue to be an important contributor. Meanwhile, consumption will slow because of the end of the cheap import boom and, as deposit real interest rates become positive for the first time in five years, the incentive to save should increase.

A fiscal surplus of around 1.9% of GDP will be generated in 2004. The Fiscal Responsibility Law created an Oil Stabilization and Debt Reduction Fund (also known by the Spanish acronym FEIREP), which earmarks oil revenues coming from the OCP. In 2004 about 2% of GDP is forecast to accrue to this fund. The law calls for 70% of this to be used for buying back public debt. The government has already begun buying back domestic bonds and is coordinating with the IMF on building an external debt strategy. Some buybacks and a swap offer to exchange the high interest rate global bonds are expected from the

government. However, the administration will face the political challenge of convincing the population of the necessity of the debt reduction policies when market prices for global bonds are at 100% and when demand for social spending is rising. Polls indicate high exhaustion of austerity and structural reform. To reach the surplus mentioned, the administration must implement some spending cuts, under negotiation with the IMF.

The stricter budget constraint under dollarisation, necessitated by the government's inability to monetise the deficit, will force the government to stick to the standby program with the IMF in order to meet the financing requirements not covered by the fiscal surplus.

The rate of import growth should remain low in 2004 because of low demand and a depreciating exchange rate. This will almost bring the current account in to balance. FDI will fall somewhat but will remain high (US\$1.3 billion), as investment in the oil sector continues.

In 2004, Ecuador will engage in negotiations over an FTA with the United States. These are expected to culminate in 2005. While significant economic consequences in 2004 are not expected, the FTA is already having important political effects, as the business community rallies behind the administration, warding off destabilising threats from opposition leaders.

RISKS

Lagging public and private investment in oil production will not lead to an oil-

revenue boom. While the government is giving signs that it intends to change direction, the legal reforms needed to jumpstart investor interest are not likely to take effect before 2005. Thus, forecasts beyond 2004 depend on oil sector policies and degree of private investment. Of course, oil prices will play a key role. Fiscal accounts need prices of WTI to remain above US\$24 a barrel.

It is important that a new IMF agreement be reached in 2004. Just as important as the funds the agreement will provide is the positive signal it will send, allowing Ecuador to tap into world financial markets in order to reduce its debt burden. But implementing and following through on the entire IMF program will be challenging, since the government has already demonstrated a weak negotiating arm and must work with a very small number of seats in Congress. The government must also contend with a very tight fiscal situation in a year of local elections, which will generate high political demands for greater spending. The government's austerity policies and instances of political mishandling are damaging the President's popularity (currently close to 10%) and signal political problems ahead.

The most worrisome short-term economic risk continues to be high indebtedness. A 54% public debt-to-GDP ratio looms over this dollarised economy. Even so, the interest bill does not present a high risk due to low international interest rates. The structure of amortisation payments casts a shadow over the forecast period and threatens to jeopardise fiscal sustainability.

The oil sector pushes high growth

The increase in oil output made possible by the OCP, combined with prices of WTI averaging around US\$30 a barrel, will boost the economy. Higher oil production and investment in existing as well as new fields should help keep GDP growth rates above 4% per year.

