CENTER FOR ECONOMIC AND POLICY RESEARCH

"Headwinds to Growth": The IMF Program in Ecuador

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Executive Summary

In March 2019, the board of directors of the International Monetary Fund approved an Extended Fund Facility arrangement with Ecuador for $4.2 billion in loans. The IMF has so far disbursed about $900 million of lending under this arrangement. The remainder is anticipated to be disbursed over the next three years, if the IMF agrees at regular intervals that the government has sufficiently lived up to its commitments under the agreement.

The objectives of the agreement were summarized by Christine Lagarde, managing director of the IMF at the time the agreement was concluded:

> The Ecuadorian authorities are implementing a comprehensive reform program aimed at modernizing the economy and paving the way for strong, sustained, and equitable growth. The authorities' measures are geared towards strengthening the fiscal position and improving competitiveness and by so doing help lessen vulnerabilities, put dollarization on a stronger footing, and, over time, encourage growth and job creation.

However, a careful examination of the IMF agreement and analysis, including of assumptions, data, and proposed policies, casts serious doubt as to whether this agreement, if adhered to, will accomplish these stated goals. On the contrary — although no one can say for sure — lower GDP per capita, higher unemployment, and increased macroeconomic instability appear as more likely outcomes of the program.

At the heart of the IMF program strategy is the restoration of investor confidence in the economy. However, the first obstacle to such confidence-boosting is the macroeconomic policy of the program itself, most importantly the large fiscal adjustment that it entails. This amounts to about 6.0 percent of GDP over the next three years, including a very large fiscal surplus of 3.8 percent of GDP in 2020 that is unlikely to occur. The negative to low growth environment that this fiscal consolidation would be expected to induce would likely have a negative impact on confidence in the economy.

In fact, the program itself projects a recession this year, with a contraction of real GDP of 0.5 percent. Furthermore, there is a projected rise in unemployment for each of the first three years of the program. However, even these forecasts appear to be quite over-optimistic for a number of reasons.

First, the program's projection of a return to growth in 2020 is not believable. It is based on a forecast of foreign private sector investment that is difficult to imagine, and without a plausible economic foundation. The IMF predicts -0.3 percent of GDP (-$0.3 billion) of net foreign private sector financing in 2019 (negative implies capital flight), but this somehow turns into a cumulative positive

4.9 percent of GDP ($5.4 billion) between 2019 and 2022 (positive means capital inflow). This contrasts sharply with the -1.9 percent of GDP (-$2.0 billion) of net foreign private sector financing in 2018 and a cumulative -17 percent of GDP (-$16.5 billion) between 2015 and 2018.

It is not clear from the program what would precipitate such a stunning reversal of international capital flows, from a large net outflow to a large net inflow, especially with such a negative growth outlook for the economy as projected by the IMF over these next few years.

Despite the serious negative impact of the program on the real economy, the program includes as a target the accumulation at least $5.0 billion in (gross) international reserves by year-end 2019; and a total of $11.8 billion in (gross) international reserves by year-end 2022.

In a reasonably optimistic scenario, but not quite as remarkable as the IMF's projections, we expect Ecuador's international reserves to reach only $3.7 billion by year-end 2019 and to decrease to $1.9 billion by year-end 2022. For the IMF's model, private sector cross-border financial flows — mainly disbursements of private external debt and repatriation of assets held abroad, not Foreign Direct Investment (FDI) — are the most important determinants of reserve accumulation, for external sector sustainability and, apparently, for economic growth. Without this wishful financing, we project -1.1 percent GDP growth in 2019 and continued recession through 2021.

The sizable fiscal consolidation measures in the program appear to be due at least partly to an accounting misunderstanding. As noted, the program projects (and targets) very high levels of official international reserves. The program assumes that to increase reserves, the government must accumulate deposits at the Central Bank. But to accumulate these reserves, the program calls for the government to run fiscal surpluses. Therein lies the misunderstanding: Ecuador's international reserves do not normally vary due to a change in government deposits.

For example, consider an increase in government spending on wages. In a simplified example, we can see this as a debit in a government account at the Central Bank, and a credit in another, private account at the Central Bank. These are both changes in central bank liabilities. The Central Bank's reserve assets do not change. Despite the fact that Ecuador has adopted the US dollar as its domestic currency, the Central Bank's international reserve assets do not change as a result of changes in the government budget (unless there is a change in government spending on imports). Only international transactions — mostly private sector transactions — can change the level of international reserves.

Other program commitments would also not be expected to be good for restoring confidence in the economy. These include: (1) expected significant credit rationing, (2) the mere existence of an IMF bailout, which is often interpreted by financial markets as a sign of increased risk; and, (3) the acknowledgment that "social and political opposition" to the program is likely. However, IMF directors expressed the belief that "[a] more efficient tax system, public wage restraint, enhanced access to the formal labor market through improved hiring processes, and better governance will all contribute to a vibrant, private sector led growth model."

Also, measures intended to accomplish the large fiscal adjustment include cutting the public sector wage bill by $1 billion (in a combination of wage cuts and firing of up to 140,000 employees throughout the public sector); increasing energy prices through the reduction of subsidies (2.1 percent of GDP); raising fees for government services and public utilities; increasing indirect taxes — most likely the Value Added Tax (VAT, a tax on consumption) — and doing away with VAT exemptions that currently benefit most households.

The program includes a minimal 0.4 percent of GDP ($0.4 billion) in social spending, along with "enhanced targeting" for this spending, in order to compensate for the removal of the fuel subsidies; but this is far too small to compensate for the impacts of the fiscal adjustment.

The IMF program relies on supply-side reforms to make Ecuador's real exchange rate more internationally competitive, and therefore to improve its current account balance. This is known as a strategy of "internal devaluation." In other words, since Ecuador has adopted the US dollar and therefore cannot reduce the nominal value of its currency, the IMF program introduces measures that are claimed to reduce its real value internationally while maintaining the same nominal value, in order to make the country's exports and import-competing industries more competitive and thereby improve the current account balance.

The program claims that the supply-side measures, primarily labor deregulation, privatization and trade liberalization will contribute to increased labor productivity and thus the internal devaluation, if real wages are kept well below the productivity increases.

Recommendations include increasing the probation period for workers, lower firing costs, and establishing part-time jobs without more favorable remuneration. Examples of privatizations — referred to as "public asset concessions" — listed are "airlines, utilities and other publicly owned enterprises." The degree to which these privatization measures would increase productivity is unclear — the reports do not provide estimates — and therefore also unclear is how it would improve Ecuador's real exchange rate, and, thus, how it would improve Ecuador's current account.

Instead of taking advantage of the remaining flexibilities that Ecuadorian dollarization allows, the program requires, by year-end, an institutional reform package heavily biased in favor of the financial sector. This is in clear conflict with Ecuador's economically progressive constitution. The program calls for lifting of interest rate ceilings and for reinstating operational independence to the Central Bank. It also requires a prohibition of central bank financing of the public sector, demands taxpayer subsidy of banks' external-domestic liquidity mismatch and requires fiscal rules such as a balanced budget clause. This would make dealing with the likely downturns over the next few years much more difficult than it has been in the last decade, thus worsening the projected economic impact of the program.

Furthermore, required legal reforms imply scrapping the development planning ministry as a lead actor in the budgeting process. Finally, alongside the above-mentioned labor deregulation, the program requires a regressive tax reform that prioritizes indirect taxes. Civil society organizations, and, notably, Ecuador's ombudsman, have filed lawsuits alleging that the agreement itself is in violation of Ecuador's constitution.

The program projections are heavily dependent on favorable oil prices. The IMF staff simulates an oil shock scenario similar to the ones recently faced by Ecuador in 2009 and 2015. The oil shock scenario would imply a real GDP contraction of 2.5 percent in 2019, a negative 11 percent of GDP impact on the government balance through 2020; as well as a 14-percentage point increase in the debt to GDP ratio by year-end 2020. This scenario appears to assume the government would have access to financing to cover the oil shock (large-scale, timely, and inexpensive financing was available in previous cases due to coordination between the Central Bank and Treasury). However, it is highly unlikely that, given the additional institutional rigidities demanded by the program, the oil shock can be absorbed by additional debt. The IMF program, as this paper explains, rolls back many of the progressive economic reforms undertaken by previous administrations, which allowed the government to respond to previous crises. Therefore, the impact of an oil price shock on the real economy would likely be higher than estimated.

In conclusion, the acknowledged but surprisingly low impacts on growth projected to result from the large fiscal adjustment are overly optimistic. Among other implausible events, they rely on an unrealistically small fiscal multiplier, unbelievably large foreign capital inflows, and an absence of oil shocks. Ecuador's vulnerable and rigidly dollarized economy cannot be resilient to fiscal shocks without coordination between the Central Bank and Treasury, including central bank financing of some public spending. At the same time, Ecuador is not an attractive choice for international private capital flows; on the contrary, capital flight — including to physical cash — is a major concern for the Ecuadorian economy. This will likely worsen with the forecast economic contraction. The "headwinds to growth" — to use the IMF's terminology — fiscal adjustment and labor deregulation measures will have a significant negative impact on Ecuadorian families' day-to-day living standards, including increases in unemployment, inadequate employment and, most likely, poverty.

Introduction

In March 2019, the board of directors of the International Monetary Fund (IMF) approved a loan arrangement with Ecuador under its Extended Fund Facility (EFF) for $4.2 billion.[1] The EFF provides long-term loans that are designed to cover balance of payments shortfalls while the country implements agreed-upon structural reform programs. Ecuador's loan is tied to a program with evolving macroeconomic and institutional targets, with successive disbursements after review of those targets' fulfillment. It is unlike the $400 million emergency credit facility that the Central Bank of Ecuador received without conditions from the IMF after the 2016 earthquake on the Ecuadorian coast. Under the current loan agreement, $650 million was disbursed in March; quarterly disbursements of $250 million are expected this year, rising to $350 million in 2020 and 2021. Accompanying the IMF loan, there is an offer of up to an additional $6.0 billion from other international financial institutions; this includes, in 2019, a projected $1.3 billion from the World Bank and the Inter-American Development Bank (IDB), in addition to previously programmed lending from these institutions.

Past World Bank and IDB loans in Ecuador were directed to public infrastructure investments, but the program calls for a significant reduction in such spending. Therefore, it appears that World Bank and IDB loans will be directed to current expenditures on social programs. The Ecuadorian Constitution forbids debt financing of current expenditures, except in the case of a national emergency. Ministry of Finance officials have repeatedly labeled the potential World Bank and IDB disbursements as "freely available" (*de libre disponibilidad*). We interpret these statements as implying that the loan proceeds will not actually be used to stimulate the domestic economy, but will constitute liquid deposits used to shore up the Treasury's account at the Central Bank along with the Central Bank's international reserves.

President Lenin Moreno's government requested this loan after a long conversation with IMF staff, which he initially met with in October 2017. Official statements regarding a possible agreement with the IMF were purposely ambiguous and mainly emphasized technical support. In fact, government officials denied any such agreement with the IMF was being negotiated as late as October 2018, barely three months before the announcement that an agreement had been reached.[2] The October 2018 statement came well after some "prior actions" — preconditions for securing the IMF package — were fulfilled, specifically with the August 2018 passage of the "Ley de Fomento Productivo"[3] and, later, with the increase in gas prices. The former is a fiscally conservative law except for its inclusion

1 This paper was prepared prior to the release of the IMF's first review of the program, published July 3, 2019. See IMF (2019d).
2 El Universo (2018).
3 IDB (2019).

of an outright tax amnesty, though the vast majority of benefits of the amnesty accrued to the largest corporations, mainly transnational oil companies. The passage of this law was also marred by parliamentary procedure irregularities and it went into effect as a result of a time limit default, without a parliamentary vote on its final version.[4]

The program associated with this arrangement is mostly focused on a sizable fiscal adjustment, deregulation of the capital account, and significant institutional changes that heavily favor the financial sector, as explained below. The IMF lending and other multilateral funding is conditioned on a significant rollback of the macroeconomic and institutional reforms undertaken by previous administrations.

TABLE 1

Selected Indicators, 2018–2022

	2018	2019	2020	2021	2022
Real GDP growth, %	1.1	-0.5	0.2	1.2	2.7
Real GDP growth with oil shock, %	1.1	-2.5	-1.8	1.2	2.7
Real GDP growth, % (CEPR)	1.1	-1.1	-1.8	-0.3	1.2
Unemployment, %	3.7	4.3	4.7	4.8	4.6
Government balance, % GDP	0.9	0.0	3.8	2.9	2.8
Primary government balance, % GDP	1.5	2.7	6.5	5.5	5.1
Primary government balance with oil shock, % GDP	1.5	-3.3	1.5	2.5	4.1
Debt/GDP	47.0	49.0	47.0	45.0	41.0
Debt/GDP with oil shock	47.0	57.0	61.0	64.0	60.0
Reserves, billions $	2.2	5.0	7.8	11.4	11.8
Reserves, billions $ (CEPR)	2.2	3.7	3.0	4.0	1.9
Current account, % GDP	-0.7	0.4	1.4	1.5	1.5
Net Foreign private sector financing, % GDP	-1.9	-0.3	2.2	1.4	1.5
Net Foreign private sector financing, % GDP (CEPR)	-1.9	-1.5	-1.0	-1.0	-0.8

Source and note: IMF (2019b) and authors' calculations.

A Confidence Shock

President Moreno mentioned the official reason for agreeing to an IMF loan in a three-and-a-half minute national broadcast on February 20, 2019: "This money will allow for work and employment opportunities for those who still can't find something stable," he said. And, "payments to government suppliers and local governments will be expedited."[5] The assertion regarding employment appears to contradict IMF staff projections for the economy under the program, which show rising

4 Arauz (2018b).
5 Presidencia de la República del Ecuador (2019).

unemployment (As can be seen in **Table 1**). Moreno also indicated that these loans would have "interest rates not above 5 percent," in an implicit reference to more expensive debt incurred on previous occasions, including to Wall Street bondholders and Chinese banks.[6] However, the main message was that the IMF agreement was important as a signal of confidence from the international community in Ecuador's economic management.[7]

This signal of confidence may be successful if directed at bondholders — although even that is doubtful, as bond markets may interpret the projected economic weakness combined with increased foreign debt as increasing the risk of default. If successful with bondholders, the IMF agreement may contribute to an increase in the price of Ecuadorian bonds and thus reduce spreads in future foreign debt bond issuances.[8] But interestingly, benefits from such a spread reduction would not be taken advantage of given that the program forecasts no foreign debt bond issuance in the next three years[9] and projects a downward debt-to-GDP path for the extent of the program. Furthermore, bond spreads for Ecuador tend to be mainly driven by fluctuations in oil prices rather than trends in "confidence."

This can be seen in **Figure 1**, which shows Ecuador's country risk plotted against the inverse of oil prices. Since the end of 2018, Ecuador's country risk has fallen very closely in tandem with the rise in oil prices. Argentina's country risk is included for comparison. The two countries' bond spreads would normally move in a similar pattern, since they are in a similar market for investors. However, we can see the sharp divergence in 2019, as Ecuador's bond spread falls with rising oil prices, while Argentina's shoots up in response to the economic crisis there (which led to an IMF loan of $57 billion, the largest ever).

6 CNN en Español (2017).
7 Presidencia de la República del Ecuador (2019).
8 The Economy and Public Finance Forum president, Marco Flores, noted that the $1 billion January 2019 bond issuance, when spreads were at their peak, resulted in a worryingly high 10.75 percent interest rate. This was despite the fact that the bond issue was three-times oversubscribed and an agreement with the IMF had already been reached before December 2018 (as revealed by the IDB's conditionality). See Flores (2019); AP (2019).
9 The government did issue $1.1 billion of bonds in June in order to buy back bonds due in 2020. The bonds issued in June had a 9.75 percent interest rate coupon while bonds due in 2020 had a 9.5 percent average coupon. It appears that the spread decrease did not reduce the interest rate paid by Ecuador.

FIGURE 1

EMBI Country Risk and WTI Spot Price

Sources and notes: BCRD (2019), EIA (2019), and authors' calculations. EMBI refers to the Emerging Market Bond Index.

It is also worth noting that Ecuador issued $1.0 billion in sovereign bonds on January 28, 2019, just before the IMF loan was announced. The Moreno government knew at this point that the IMF agreement was a done deal and would soon be public, and must have expected its sovereign risk and spread to fall in response to the announcement (which they did). A government that was trying to minimize its borrowing costs would be expected to wait until the announcement of the IMF agreement before issuing these bonds in order to take advantage of the reduced spreads.

The expected "confidence shock" would not be likely to have a positive impact among investors in the real sector of the economy either. First, the IMF projects a negative- to low-growth environment for the next few years, including a reduction in per capita income and household consumption; without positive consumer expectations, real-sector investment is more likely to weaken than to improve. Second, the IMF projects a large reduction in credit growth in the financial system; this lack of credit availability would also be a deterrent for private real-sector investment. Third, the existence of the IMF program is itself generally a negative signal to real-sector investors; it shows that economic mismanagement has occurred and countries rarely turn to the IMF for assistance unless they are in serious economic trouble. Recent memories of IMF interventions in Greece and Argentina do not inspire optimism or confidence in the likelihood of the program's success. Finally, the IMF itself shows concern regarding likely "social and political opposition" to the program; investors are aware that widespread social conflict is not conducive to an improved business climate for investment, and that a lack of parliamentary support could make the program difficult or impossible to implement successfully.[10]

Fiscal Consolidation

The program nominally aims for a 5.0 percent of GDP fiscal adjustment over the next three years, including a not unrealistic balanced budget quantitative target for 2019 and a very unrealistic forecast of a 3.8 percent of GDP ($4.0 billion) budget surplus for 2020.

The sizable fiscal consolidation measures in the program appear to be due at least partly to an accounting misunderstanding. As noted, the program projects (and targets) very high levels of official international reserves. The program assumes that to increase reserves, the government must accumulate deposits at the Central Bank.[11] But to accumulate these reserves, the program calls for the government to run fiscal surpluses. Therein lies the misunderstanding: Ecuador's international reserves do not normally vary due to a change in government deposits.

For example, consider an increase in government spending on wages. In a simplified example, we can see this as a debit in a government account at the Central Bank, and a credit in another, private account at the Central Bank. These are both changes in central bank liabilities. The Central Bank's reserve assets do not change. Despite the fact that Ecuador has adopted the US dollar as its domestic currency, the Central Bank's international reserve assets do not change as a result of changes in the government budget (unless there is a change in government spending on imports). Only international transactions — mostly private sector transactions — can change the level of international reserves.[12]

However unorthodox, the government and the IMF agreed to include 1 percent of GDP from "tax amnesty collection in 2018" as revenue for 2019.[13] This unconventional misrecording of revenue data implies that the size of the fiscal adjustment is actually 6.0 percent of GDP.

10 The Economist (2019).
11 IMF (2019b): 13, 25, 66.
12 BCE (2019a).
13 IMF (2019b): 16.

In 2019, as can be seen in **Table 2**, the largest adjustment is projected to come from the elimination of fuel subsidies and a consequent rise in energy prices. The impact on government revenue is projected to be an increase equal to 1.7 percentage points of GDP. According to the IMF, it entails "(i) [an] increase in the prices of retail, domestic and industrial gasoline, (ii) [an] increase in the price of diesel for certain fishing categories, (iii) removal of the subsidies in industrial gas, and (iv) [an] increase in the price of electricity."[14]

TABLE 2

Fiscal Consolidation Measures (percent of GDP)

	2019	2020	2021	2019–2021
REVENUE	-0.3	1.4	-0.4	0.7
2019 Tax reform	0.0	1.4	0.4	1.8
Earlier adopted tax changes	-1.2	0.0	0.1	-1.0
Elimination of capital exit tax	0.0	0.0	-0.2	-0.2
Asset monetization (net)	0.8	0.0	-0.8	0.0
Other revenues	0.1	0.1	0.0	0.2
EXPENDITURE	2.3	0.6	1.4	4.3
Wages and salaries	0.5	0.3	0.2	1.0
Goods and services	0.5	0.1	0.1	0.8
Other spending	0.0	-0.1	0.0	-0.1
Capital spending	0.0	0.4	0.6	0.9
Fuel subsidies	1.7	-0.1	0.5	2.1
(of which: price change)	1.3	-0.1	0.0	1.2
(policy change)	0.4	0.0	0.5	0.9
Social spending	-0.4	0.0	0.0	-0.4
TOTAL	2.0	2.0	1.0	5.0

Source: IMF (2019b).

The second-largest adjustment in 2019 is expected to come from "revenues from leasing of government assets to private sub-contractors for temporary use and maintenance. For 2019, this includes the proceeds from the concession of the Sopladora hydropower plant."[15] Construction of the plant, which took five years, was completed in 2016 at a cost of $755 million.

Half of the $1 billion in cuts to the public sector wage bill that the program envisions are expected to occur in 2019 through a combination of wage cuts and the firing of up to 140 thousand public sector

14 IMF (2019b): 16.
15 Ibid.

employees.[16] This has already been taking place in state-owned enterprises, and in the public administration in general including in the health and education ministries.

In 2020, the most important fiscal consolidation will come from raising indirect taxes — most likely the Value Added Tax (VAT) — and doing away with VAT exemptions that currently benefit most households. This is projected to generate 1.4 percent of GDP in additional revenues. It is expected that the tax legislation will have to be implemented by year-end 2019.

In addition to capital spending cuts every year, the program forecasts that 2020 revenues derived from the leasing of government assets will include the proceeds from electric line concessions. In other words, not only will capital spending be curtailed, but the program anticipates many public sector assets to be privatized (See "Supply Side Reform" section for more).

The program includes a minimal 0.4 percent of GDP ($0.4 billion) increase during the first year and "enhanced targeting" in social assistance spending to compensate for the removal of fuel subsidies, but this is an order of magnitude smaller than the size of the fiscal adjustment. To implement these changes, the government has already created a new institution in charge of the "new social registry" — a data intensive system "to ensure that the bulk of expenditures goes to the bottom 20 percent of the income distribution."[17] However, citing "enhanced targeting," the government has already announced cuts to the school feeding program and uniforms for schoolchildren.[18]

The IMF admits that the fiscal adjustment measures will be "headwinds to growth," which results in a projected contraction of 0.5 percent of real GDP in 2019. Even though the IMF uses a small fiscal multiplier of 1.0,[19] due to the magnitude of the fiscal adjustment[20] it forecasts a rise in unemployment for each of the first three years of the program. The IMF's Debt Sustainability Analysis estimates[21] that absent such a large fiscal adjustment, Ecuador's GDP would grow between 5 and 8 percent annually through 2022, as opposed to the IMF's projected 0.8 percent average annual growth over these four years of the program. However, even this reduced growth appears to be optimistic, as explained below.

The IMF's forecast of a relatively small recession in 2019 and a return to growth in 2020 relies on unrealistic projections for foreign private-sector investment. The forecasts reveal an improbable

16 ITUC (2019).
17 IMF (2019b): 18.
18 Ecuador Inmediato (2019).
19 IMF (2019b): 53.
20 IMF (2012).
21 See "Figure 3. Ecuador: Public DSA – Realism of Baseline Assumptions (concluded)" in IMF (2019b).

reversal and overly optimistic behavior of private-sector capital flows. Without this wishful (see below) private-sector financing from abroad,[22] we project negative 1.1 percent GDP growth in 2019 and continued recession through 2021, as can be seen in **Table 1**.

The program projections are also heavily dependent on favorable oil prices. The IMF staff simulates an oil shock scenario similar to the ones Ecuador faced in 2009 and 2015. The oil shock would imply a real GDP contraction of 2.5 percent in 2019, a negative 11 percent of GDP impact on the government fiscal balance through 2020, and a 14-percentage point increase in the debt-to-GDP ratio by year-end 2020. This scenario appears to assume that the government would have access to financing to cover the oil shock (large-scale, timely, and inexpensive financing was available in previous cases due to quantitative easing made possible by coordination between the Central Bank and Treasury). However, given the additional institutional rigidities demanded by the IMF program, it is highly unlikely that an oil shock can be absorbed with the use of additional debt financing. Therefore, the impact on the real economy would likely be higher.

Reserve Accumulation

The program includes a target of accumulating at least $5.0 billion in (gross) international reserves by year-end 2019. The intention to increase reserve accumulation is likely a response to pressure from domestic banks. The program requires "the Central Bank, over time, to cover all its liabilities vis-à-vis banks with international reserves. This would be consistent with the need in dollarized economies for a backing rule that backs specific central bank liabilities."[23]

In practice, this amounts to keeping $1.4 billion from the IMF, and about $1.3 billion from the World Bank and the IDB expected in 2019 as treasury deposits at the Central Bank, thus sterilizing any possible stimulus from these funds to the domestic economy. As noted above, the IMF seems unclear on how international reserves work in a dollarized regime.[24] With this faulty understanding, the IMF ambitiously shoots for $11.8 billion in (gross) international reserves by year-end 2022.

The staff report's reserve adequacy analysis does not account for the existence of the "liquidity fund," a 3-percent-of-GDP-sized trust fund specifically designed as a buffer for the financial system's

22 Contrary to fiscal multipliers, private capital flows have a significant import component and inflows may end up as deposits in the financial system. We use a conservative multiplier of 0.6.
23 IMF (2019b): 21.
24 IMF (2019b): 32–50.

potential cash shortfalls — an artificial lender of last resort in a dollarized economy.[25] This fund invests all of its assets in reserve-holding institutions such as the Bank of International Settlements and the Latin American Reserve Fund and, occasionally, the liquidity fund has been even larger than the Central Bank's gross international reserves.

Additionally, a characteristic of Ecuador's dollarized financial system that mitigates the need for large official international reserves is the great share of monetary assets directly held abroad by the domestic financial system. In fact, banks' liquid assets abroad are often larger than the country's entire international reserves. Interestingly, the IMF projects that domestic banks will reduce their holdings of liquid assets abroad (mainly in US banks) from $5.0 billion at year-end 2018 to $4.0 billion by year-end 2019 and to $2.9 billion by year-end 2022 in what could be interpreted as a loss of liquidity in the domestic banking system in general. Such a loss of domestic liquidity is worrisome, considering that the Fund has recommended deregulating international capital flows for Ecuador (see below).

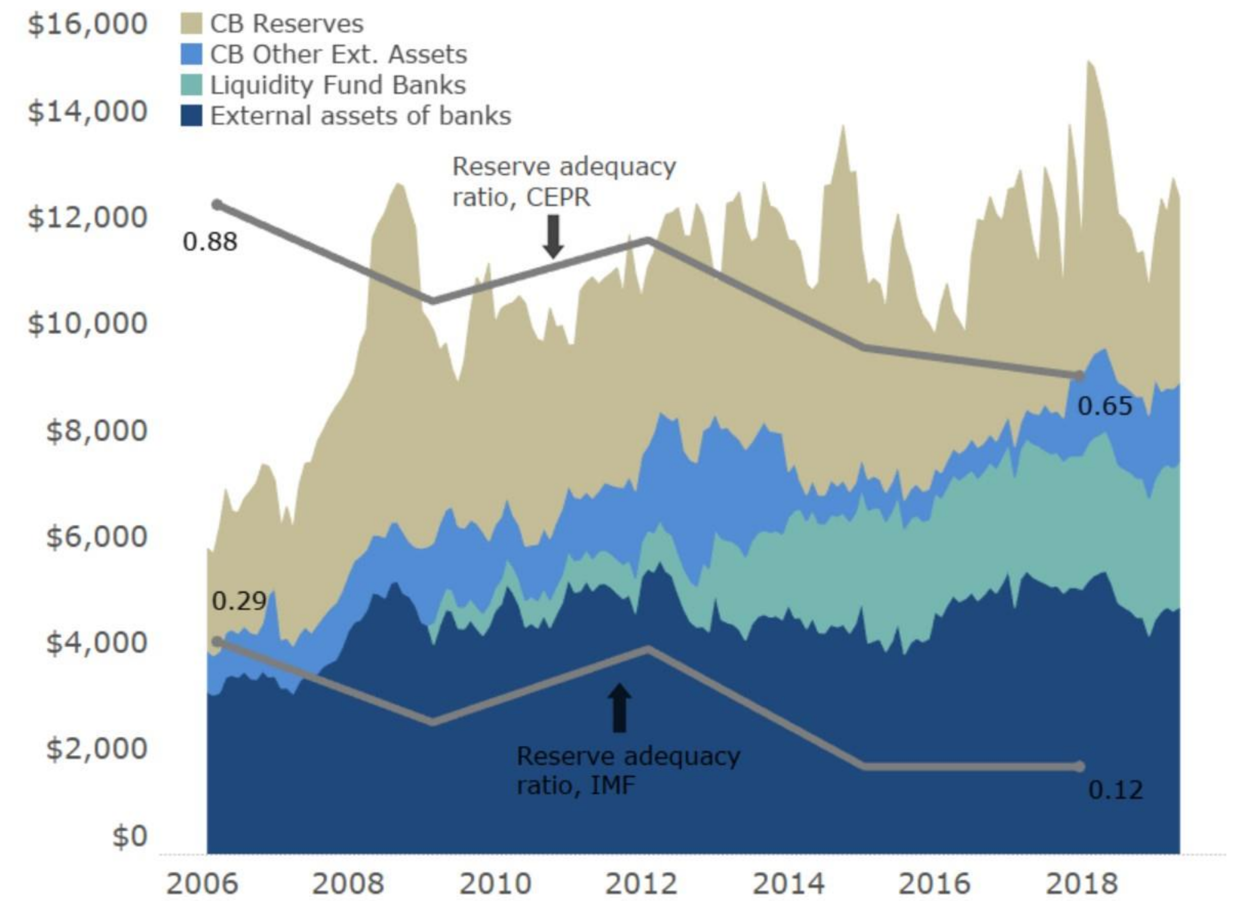
Additionally, the IMF analyses do not consider the Central Bank's other external liquid assets (mainly gold valuation of capital gains) and the domestic banking system's indirect offshore subsidiaries' monetary assets abroad, which, in practice, are linked to the Ecuadorian financial system's monetary dynamics.[26]

If the IMF would have considered in its analysis the holdings of banks' liquid external assets, the result would have been that instead of having a 12 percent reserve adequacy ratio in 2018, it would have been 65 percent. This is shown in **Figure 2**.

25 In an economy with its own national currency, the central bank normally acts as the lender of last resort in the event of a financial crisis.
26 Arauz (2018a).

FIGURE 2

External Reserve Assets



Source and note: IMF(2019b) and authors' calculations.

As can be seen in **Figure 3**, the IMF projects -$0.3 billion[27] of net foreign private sector financing outflow in 2019 (negative means capital flight) and a cumulative $5.4 billion inflow between 2019 and 2022 (positive means capital inflow).[28] This grossly contrasts with the -$2.0 billion of net foreign private sector financing in 2018 and a cumulative -$16.5 billion (negative means capital flight) between 2015 and 2018.[29] Again, this shows how unrealistic the program's assumptions are, and it is dependent upon these unrealistic assumptions that the economy does not fall into a much deeper recession than the program projects, as a result of fiscal tightening and other adjustment measures.

27 The IMF's first program review, published in July 2019, updated the 2019 projected net foreign private sector financing outflow (capital flight) from -$0.3 billion to -$1.2 billion, much closer to CEPR's predicted -$1.6 billion. Despite the almost $1 billion increase in net capital outflows, the IMF did not update its real sector variables during its first review. See IMF (2019d).

28 Net foreign private sector financing includes net foreign direct investment, net foreign investments in portfolio flows (not including purchase of government securities), and net other investment (mainly external private loans and deposits abroad).

29 These totals are calculated from IMF (2019b): Table 4. Ecuador: Balance of Payments.

FIGURE 3

Net Foreign Private Sector Financing (billions of dollars)

Source and notes: IMF (2019b), authors' calculations. Negative values indicate capital flight.

In our reasonably optimistic scenario (see **Table 1** above),[30] which is not quite as optimistic as the IMF's projections, we expect international reserves to reach $3.7 billion by year-end 2019 and to decrease to $1.9 billion by year-end 2022. Thus, as we have seen, the large targeted and projected reserve accumulation depends on these grossly unrealistic projections of private sector cross-border financial flows (mainly disbursements of private external debt and repatriation of assets held abroad, not FDI).

30 Our scenario adopts the optimistic projected FDI and portfolio financing, but keeps the 2018 projection constant for other investment financing for 2019 through 2022.

Capital Account Deregulation

The IMF program has a strong bias toward eliminating controls on international capital flows that were successful in the past in reducing the risk of financial and balance of payments crises. From the EFF agreement:

> Ecuador has a five percent tax on financial transfers abroad above specific thresholds (including payments for certain imports). Revenues from this tax amounted to 0.8 percent of GDP in 2016. The tax constitutes both an exchange restriction subject to Fund approval under Article VIII and a [Capital Flow Management measure] on capital outflows.[31]

Given the commitment to deregulate Ecuador's capital account by removing the capital outflow tax by March 2020,[32] it is possible that the IMF is factoring in a large and continuous net inflow of speculative capital willing to take advantage of the sizable interest rate arbitrage between the United States and Ecuador's dollarized economy.[33] Even so, Ecuador should consider that relying on hot money flows for reserve buildup would significantly increase external and financial sector vulnerabilities to sudden withdrawals.[34]

In a footnote, IMF staff seem to agree with this position:

> With the balance of payments outlook having deteriorated and Ecuador now seeking a Fund program, the current circumstances can be considered as crisis or imminent crisis conditions. In this context, this might not be the right time to remove the tax on transfers abroad (as CFM), but the measure should not be permanent, and plans should be made for phasing it out once macroeconomic stability is restored, and the reserve position is strengthened.[35]

In addition to the removal of the capital outflow tax, the Fund recommends deregulating the "domestic liquidity requirement" for banks, a capital account management measure that "helped bring billions of dollars back into the country" and contributed to effective oversight of banks' liquid assets

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31 IMF (2019b): 65.

32 "Staff also supports Board approval for the retention for a one-year period of the exchange restriction arising from the foreign exchange outflow tax given that it is maintained for BOP reasons, is temporary and non-discriminatory." IMF (2019b): 30.

33 "The authorities intend to phase this tax out once macroeconomic stability is restored and the reserve position is strengthened and as a means to encourage inflows that will be used to finance new private investment." IMF (2019b): 14–15. Alternatively, the IMF may be counting on illicit capital inflows: "flows which are difficult to measure, such as those related to tourism, remittances, or illicit activities, and which would typically be part of errors and omissions, might instead by *[sic]* captured in currency and deposits." IMF (2019a): 42.

34 For a recent analogous experience, see the episode in Argentina known as "the treason by J.P. Morgan." Burgueño (2019).

35 IMF (2019b): 65.

and, indirectly, to increasing Ecuador's official international reserves.[36] In May 2019, the government de facto eliminated the domestic liquidity requirement by changing the interpretation of accounting standards so that the liquidity fund's assets, which are invested abroad, would be considered "domestic." This measure allows banks to increase their holdings of liquid assets held abroad by $2.7 billion. Even if not immediate, such a large capital outflow could seriously threaten Ecuador's official reserves and would be akin to a speculative attack.

Supply-Side Reforms

IMF directors state: "[a] more efficient tax system, public wage restraint, enhanced access to the formal labor market through improved hiring processes, and better governance will all contribute to a vibrant, private sector led growth model."[37]

The IMF program relies on supply-side reforms in an attempt to improve Ecuador's real exchange rate and its current account, which is reminiscent of the European authorities' "internal devaluation" doctrine in eurozone countries. The IMF insists on an overvalued real exchange rate of 31 percent by choosing one of its Research Department's "consumption" External Balance Assessment (EBA) models, despite Ecuador's development situation more closely resembling one that is captured by the "investment" model, which would estimate only a 7 percent overvaluation.

The IMF argues that the "consumption" model is more appropriate, given that Ecuador is in the "top 25 percent [in terms of oil export quantity] in the group of oil exporters."[38] This is a questionable criterion, since Ecuador is OPEC's smallest exporter. Additionally, the IMF argues that the "investment" model is better suited for countries without access to international capital markets. However, Ecuador has tapped international capital markets as recently as January 2019, and it is the program's quantitative debt criteria that limits Ecuador's access to these markets. Considering this reality, the most responsible way forward would have been selecting the midpoint of both models: this would result in an estimate of a 19 percent overvalued exchange rate. The implications of such a rate are still significant, but would be less burdensome in terms of the implied "internal devaluation" measures.

The IMF Executive Board argues that "subdued" inflation combined with "nominal wage restraint and improving productivity should steadily erode the overvaluation of the real effective exchange

36 Weisbrot, Johnston, and Merling (2017): 4, 10.
37 IMF (2019b): "Executive Board Assessment."
38 IMF (2019b): 62, footnote 3.

rate."[39] The operational term "steadily" is not time-defined anywhere in the program. Wage cuts and a huge growth in inadequate employment are to be expected as part of the internal devaluation strategy. The IMF concedes that measures are "expected to generate a cumulative reduction in the public wage bill [...], helping to restore competitiveness by also influencing private sector wage increases."[40]

However, real exchange rates most heavily depend on the currency behavior of Ecuador's trading partners. The internal devaluation strategy implies "steadily" hoping that trading partners' currencies do not depreciate further.

The IMF presents a simulation of an increase in exports that is due to a real exchange rate adjustment. This simulation considers Ecuador's world "non-oil export market share" as one variable depending on the real exchange rate. It does not consider that Ecuador's main non-oil exports are mineral and food commodities;[41] they are not labor intensive and their prices are determined in global financial markets plagued by speculative forces. They are therefore minimally dependent on Ecuador's real exchange rate dynamics.

In reality, if current account dynamics do improve, it would probably not be due to more exports, but rather because of repression of imports resulting from the "internal devaluation": strict credit rationing including higher interest rates, fiscal adjustment, and wage cuts. This manufactured economic shock is expected to cause a significant reduction in money velocity and may result in increased default rates in the domestic financial system and possible insolvency of weaker banks and cooperatives.[42] The IMF's Executive Board seems to foreshadow this risk: "To better anticipate and adapt to shocks, directors recommended increasing the oversight of banks and cooperatives and building crisis preparedness and contingency planning capabilities."[43] An alternative way of repressing imports, one not at the expense of the domestic economy, could have been an updated and perfectly legal World Trade Organization (WTO) balance of payments safeguard mechanism.[44]

The program claims that the supply-side measures, primarily labor deregulation, privatizations, and trade liberalization will contribute to increased labor productivity. Labor deregulation recommendations include increasing the probation period, reducing the costs of firing employees, and

39 IMF (2019b): 12.
40 Ibid: 16.
41 While government authorities have emphasized the links between mining exports and investment to the flows committed to in the program, the IMF staff report does not consider or explicitly mention the mining sector. While the agricultural sector is labor intensive, it is largely informal and therefore less affected by external conditions or wage policies. See El Universo (2019).
42 A 21 percent reduction in money velocity: from 1.9 in 2018 to 1.5 in 2022. See IMF (2019b): 41.
43 IMF (2019b): "Executive Board Assessment."
44 Weisbrot, Johnston, and Merling (2017).

establishing part-time jobs without bonus pay.[45] Privatizations are now dubbed "public asset concessions" because public ownership of the asset is supposedly preserved in state hands, but the flows derived from the ownership are privatized. The liquidation of these flows is dubbed "monetization."[46] Examples of public asset concessions listed in the program are "airlines, utilities and other publicly owned enterprises."[47] In the memorandum, the Ecuadorian authorities "believe [public-private partnerships] will increase productivity, lessen the pressures on the budget, and create efficiency gains to support economy-wide increases in productivity."[48] However, no estimates are provided for these economy-wide increases. The degree to which the concessions and liberalization measures would increase productivity, much less how they would improve Ecuador's real exchange rate, and thus, how they would improve Ecuador's current account, is unclear.

Institutional Reforms

Moreno's February 20, 2019 TV broadcast foreshadows the content of some of the institutional reforms included in the agreement: "Thanks to my firm decisions, we're not like Venezuela. We have saved dollarization. We have recovered democracy."[49] The assertion on dollarization is perhaps most interesting in economic terms. It seems to be linked to the IMF's emphasis on "strengthening the institutional foundations of dollarization." First, if dollarization has been "saved," it is implied that it was previously at risk of failure. Second, it is necessary to determine how the IMF program is "saving it."

The IMF holds that:

> The foundations of the dollarized system have been undermined by a fiscal policy that is inconsistent with the constraints imposed by dollarization and, in parallel, by an erosion of domestic institutions. The decision to dollarize the economy continues to receive significant public support. However, under the previous administration, policies steadily undermined the viability of the dollarization framework, mainly through central bank financing of fiscal spending.[50]

45 Ecuador already allows half-time jobs and nontenured (fixed-term) jobs. However, these types of jobs must currently pay a 35 percent bonus in hourly wages.
46 Moreno's government issued Decree 740 creating a committee for the monetization of public assets.
47 IMF (2019b): 24.
48 IMF (2019b): 76.
49 Presidencia de la República del Ecuador (2019).
50 IMF (2019b): 9.

The fact that the Central Bank was able to finance fiscal spending is itself a revelation that the institutional foundations of unilateral dollarization are more flexible than have been widely believed.[51] The key term in this phrasing is "viability." One could argue that central bank quantitative easing was a measure that improved the viability of dollarization. According to the IMF's own Debt Sustainability Analysis, absent countercyclical fiscal spending in the most recent 2015–16 oil shock (in part with central bank financing), there would have been consecutive years of negative 4 percent GDP growth. It is these harsh effects on the real economy that would have implied significantly less "public support" — and thus, less viability — for the unilaterally rigid dollarization framework.

Instead of taking advantage of the remaining flexibilities that Ecuadorian dollarization entails, the program requires, by year-end, an institutional reform package heavily biased in favor of the financial sector that is in clear conflict with Ecuador's economically progressive constitution. The program calls for lifting of interest rate ceilings and for reinstating operational independence to the Central Bank. It also requires legally prohibiting central bank financing of the public sector and requiring fiscal rules such as a balanced budget clause. The Fund recommends deregulation of domestic liquidity requirements in order to avoid sovereign-financial contagion but, surprisingly, the Fund ignores the magnitude of the liquidity fund's assets abroad, set up during the previous administration, the main function of which is to sever financial-sovereign dependency and avoid taxpayer bailouts of banks.[52]

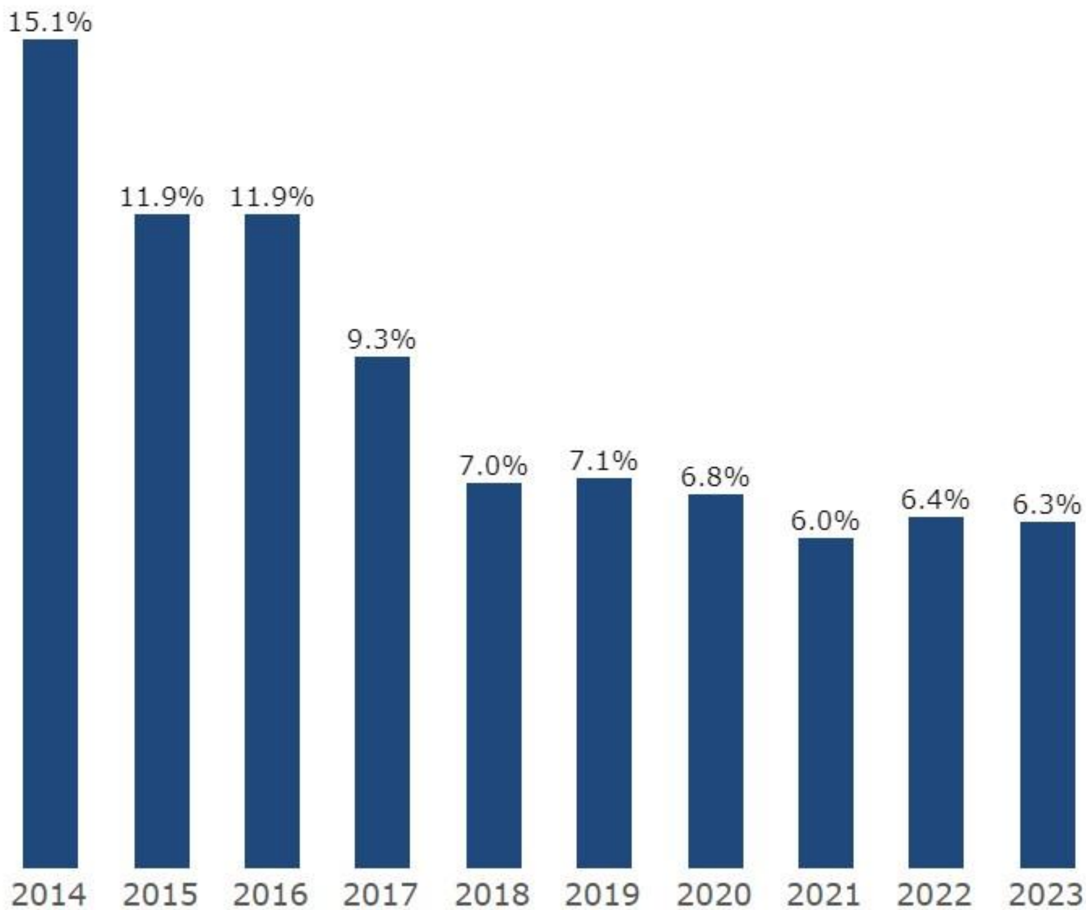
Furthermore, required legal reforms imply scrapping the development planning ministry as the lead actor in the budgeting process. While this may appear minor, it has important implications due to Ecuador's constitutional development model, which emphasizes the role of state-led planning. Development economists such as Ha-Joon Chang have concluded from the history of development planning that it must not be improvised, but actually planned. Without a strong development ministry involved in the budgeting process, the finance-oriented Economy and Finance Ministry would usually take an exclusively fiscal balance approach to the budget. The United Nations Conference on Trade and Development (UNCTAD) has published research estimating the necessary increases in Ecuador's fiscal spending in order to achieve the UN Sustainable Development Goals (SDGs).[53] More specifically, in order to comply with the SDGs by 2030, Ecuador faces a yearly average 3 to 4 percent of GDP financing gap ($7 billion per year in 2017 dollars). The Planning Ministry is precisely the institution that needs to be in charge of reconciling development goals with budget allocations. The IMF has recently published a paper on the importance of greater fiscal financing to reach SDGs.[54]

51 Weisbrot, Johnston, and Merling (2017): 15–17.
52 For a detailed explanation of Ecuador's dollarized regime's sovereign-financial dollar-xeno-dollar links, see Arauz (2019).
53 Munevar (2018).
54 Gaspar et al (2019).

However, as noted above and as can be seen in **Figure 4**, capital spending is programmed to decrease significantly under the IMF arrangement.

FIGURE 4

Capital Spending as a Percent of GDP



Source: IMF (2019b).

In an interview with local media, Anna Ivanova, the IMF's Ecuador mission chief, explicitly stated that Ecuador's "institutions did not work well. We have to change the institutions."[55] In particular, she mentioned the importance of incorporating international arbitration as an incentive for foreign investors. But bilateral investment treaties with international arbitration were declared unconstitutional by Ecuador's Constitutional Court and were terminated by the previous administration.[56]

55 Orozco (2019).
56 Investment Treaty News (2017).

Finally, alongside the abovementioned labor deregulation, the program requires a regressive tax reform that prioritizes indirect taxes. Civil society organizations, and, notably, Ecuador's ombudsman, have filed lawsuits alleging that the agreement itself, including the tax provisions, violates Ecuador's constitution, adding a degree of uncertainty as to the program's success on its own terms. The lack of transparency on the agreement's contents are a major issue in the Ecuadorian courts. Additionally, several Ecuadorian parliamentary representatives have requested that the IMF agreement be discussed and approved by the National Assembly. This is mandated by the constitution, specifically for international agreements that imply economic policy conditionality or commitments to modify laws.

Conclusion

The IMF's projection that the sizable fiscal adjustment mandated by the program will have only a very low impact on growth appears overly optimistic; it relies on a small fiscal multiplier, unrealistically large projected foreign capital inflows, and an absence of oil shocks.

Ecuador's vulnerable and rigidly dollarized economy cannot be resilient in the face of fiscal shocks without central bank-treasury coordination, including exceptional deficit financing, and allowance for the possibility of other measures, as necessary — such as those that had been adopted in response to previous major shocks: e.g., domestic liquidity requirements and use of the WTO's balance of payments safeguard mechanism.

Additionally, investors do not currently see Ecuador as a favored destination for international private capital flows; on the contrary, capital flight — including toward physical cash bills — is a major concern for the Ecuadorian economy.

The fiscal adjustment, rigidifying institutional changes, and labor deregulation measures, can be expected to have a substantially large negative impact on growth and very likely on income distribution. This would cause considerable hardship for millions of working families, including increases in unemployment, in inadequate employment, and, most likely, in poverty.

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