Program Information Document (PID)

Appraisal Stage | Date Prepared/Updated: 20-Oct-2020 | Report No: PIDC30348

BASIC INFORMATION

A. Basic Project Data

Country	Project ID	Project Name	Parent Project ID (if any)
Ecuador	P174115	Ecuador Third Inclusive and Sustainable Growth DPL (P174115)	P171190
Region	Estimated Board Date	Practice Area (Lead)	Financing Instrument
LATIN AMERICA AND CARIBBEAN	24-Nov-2020	Macroeconomics, Trade and Investment	Development Policy Financing
Borrower(s)	Implementing Agency		
Republic of Ecuador	Ministry of Economy and Finance		

Proposed Development Objective(s)

This DPF series supports measures aimed at: i) responding to COVID-19 to protect the vulnerable; ii) removing barriers to the private sector and supporting the economic recovery; iii) promoting public sector efficiency and fiscal sustainability post-crisis.

Financing (in US$, Millions)

SUMMARY

Total Financing	515.00

DETAILS

Total World Bank Group Financing	500.00
World Bank Lending	500.00
Total Non-World Bank Group Financing	15.00
Trust Funds	15.00

Decision

The review did authorize the team to appraise and negotiate

B. Introduction and Context

Country Context

1. **The proposed Third Inclusive and Sustainable Growth Development Policy Financing (DPF) is the final operation in a programmatic series of three.** The DPF series – designed initially to comprise two operations – was adjusted to respond to the impacts of the global COVID-19 crisis and now consists of three loans. The first DPF, for US$500 million, was approved by the World Bank's Board of Executive Directors in June 2019, while the second was approved in May 2020. The second operation was split into two (DPF-2 and DPF-3) and a new pillar was added to support the COVID-19 response (Pillar 1). The priority areas identified during the design of the DPF series remain critical to recover from the crisis and to continue supporting Ecuador's transition towards a sustainable and inclusive growth model in the post-pandemic period. These priority areas are grouped into two pillars – one to remove barriers to private sector development to create employment and inclusive growth (Pillar 2) and one to promote public sector efficiency and fiscal sustainability (Pillar 3). Special considerations are given to climate change and natural resource management, including through fiscal risk management, energy pricing, and transparency in natural resource management. This proposed US$515 million operation provides critical financing to Ecuador in a context of deep crisis. As with the previous operation, it will include a concessional contribution on a non-reimbursable (grant) basis under the Global Concessional Financing Facility (GCFF) of US$15 million (DPF2 included a US$6 million grant).[1] The GCFF was set up to support middle-income countries hosting large numbers of refugees, as Ecuador has done for Venezuelan refugees.

2. **Ecuador has experienced a triple shock: a sharp oil price decline, lack of access to external financing, and the COVID-19 related demand and supply shocks.** These shocks occurred in the context of existing macroeconomic imbalances and social unrest. COVID-19 has significantly worsened fiscal pressures: the deficit is now expected to reach 9 percent of GDP in 2020, despite continued fiscal consolidation efforts. Ecuador's dollarization regime is expected to keep inflation weak, but it overburdens fiscal policy response. Political uncertainty is growing with elections due in February 2021.

3. **Ecuador has been one of the countries hit hardest by COVID-19.** As of August 17, over 100,000 cases were reported resulting in over 6,000 deaths. The actual number is likely to be substantially higher; the Economist's Excess Deaths Tracker[2] estimates 31,500 excess deaths between March 1 and October 2, 2020, or 183 per 100,000 people – the second-highest of all countries tracked. The government responded quickly and rolled out temporary programs to support vulnerable segments of the population. However, poverty rates, which had increased slightly in the past five years due to slow growth and a tight fiscal position, are still expected to soar due to the current crisis. The World Bank estimates that almost 1.5 million people could fall back into poverty in 2020. Adapting to this challenging context requires a combination of continued health crisis response measures and a solid medium-term reform program to continue addressing macro-fiscal imbalances and ensure the sustainability of future growth. This process must be managed carefully to safeguard the social achievements of the last two decades and to protect the vulnerable to the maximum extent possible.

4. **Ecuador's macroeconomic policy framework is deemed adequate for this operation given the successful debt restructuring negotiations with private bondholders and the new EFF arrangement with the IMF—but significant downside risks remain and need to be carefully monitored.** Limited macroeconomic buffers make Ecuador vulnerable to downside risks, including prolonged impacts of the pandemic, low or volatile oil prices, and appreciation of the US dollar. On the domestic front, risks stem from the unknown depth and duration of the COVID-19 containment measures

and the fiscal pressures associated with it. Finally, natural disasters could generate additional stress to the macroeconomic framework, and a complex political context could impede or delay the implementation of key reforms.

Relationship to CPF

5. The DPF series plays a central role in the World Bank Group's enhanced engagement with Ecuador, and, as noted above, this series is accompanied by a significant amount of Technical Assistance. The WBG's FY19-FY23 Country Partnership Framework (CPF, report no. 135374-EC), discussed by the World Bank Board of Directors on June 11, 2019, constitutes the first full-fledged WBG Strategy for Ecuador since 2007. The DPF series underpins two of the three results areas covered by the CPF. Pillars 2 and 3 of the proposed DPF series support CPF objectives under results area i) Supporting Fundamentals for Inclusive Growth, while Pillar 1 supports CPF objectives under results area ii) Building Human Capital and Protecting the Poor.

C. Proposed Development Objective(s)

6. This DPF series supports measures aimed at: i) responding to COVID-19 to protect the vulnerable; ii) removing barriers to the private sector and supporting the economic recovery; iii) promoting public sector efficiency and fiscal sustainability post-crisis.

Key Results

7. This DPF series targets increased support for vulnerable households during the COVID-19 crisis, reforms that can help spur private-sector led growth after the crisis, and key structural reforms to promote fiscal sustainability.

D. Project Description

8. **Pillar 1 helps protect vulnerable segments of the population against the impacts of the COVID-19 crisis through well-targeted social programs, improved access to unemployment benefits, and solidarity towards migrants.** The impacts of the COVID-19 crisis are expected to be particularly severe on poverty and vulnerability. During the crisis, income and job losses could lift the poverty rate by almost seven percentage points, pushing almost 1.5 million people into poverty. In addition, the conditions of those who are already poor have worsened. The vulnerable include a large Venezuelan migrant population that has entered Ecuador in recent years. The government is committed to creating fiscal

[1] Pending GCFF approval. The Global Concessional Financing Facility (GCFF) is a partnership sponsored by the World Bank, the UN, and the Islamic Development Bank Group to mobilize the international community to address the financing needs of middle-income countries hosting large numbers of refugees.

[2] Available at: https://www.economist.com/graphic-detail/2020/07/15/tracking-covid-19-excess-deaths-across-countries. The Excess Deaths Tracker estimates deviation from the expected monthly or weekly deaths based on historical averages. A total of 23 countries/territories were tracked at the time of writing with only Peru and Mexico City having higher excess deaths as a share of population.

space and allocating it effectively to protect poor and vulnerable households and to mitigate the impacts of the crisis on these groups.

9. **Actions under Pillar 2 focus on creating jobs by removing structural barriers to private sector post-crisis recovery, and in particular on those that distort key prices of capital and labor.** By doing so**,** these reforms will contribute to higher productivity and competitiveness. In the presence of rigid labor laws in a dollarized economy, the appreciation of the real exchange rate has contributed to a loss of competitiveness of the tradable sectors of the economy. Some of the policies that accompanied the expansion of the state's footprint in the economy were harmful to private sector development. Several barriers, including regulatory uncertainty, high costs to open and close businesses, distorting labor market regulation, and distortions in financial markets, have negative effects on the performance and resilience of private firms. In previous years a series of legal changes stymied private investment (domestic and foreign). In addition, the time and costs involved in registering a new business in Ecuador are high compared to regional peers. Minimum wages have grown above productivity, undermining competitiveness. The complex wage-setting process is distortive and leaves little room to adjust to economic fluctuations. Limited access to finance is also considered an important obstacle by businesses. Regulatory barriers limit financial sector performance. For example, the absence of a technical methodology to set interest rate ceilings excludes borrowers from formal credit markets. Tackling these barriers could foster a more dynamic and resilient private sector, which is better equipped to weather economic shocks such as the COVID-19 crisis and which is able to reestablish productive relations in the post-crisis period, thus creating jobs.

10. **Actions under Pillar 3 promote improvements to the allocation of government resources, and support a climate-friendly and orderly fiscal consolidation in the post-crisis period.** Weak budgetary processes and current spending rigidities have prevented a more strategic and equitable approach to fiscal rebalancing, forcing the government to rely on large capital spending cuts to address fiscal gaps. Relatively low non-oil revenues have added to fiscal pressures that have been further intensified by the COVID-19 crisis. Reforms supported under Pillar 3 seek to address these challenges. They strengthen the MEF's responsibility and oversight during budget preparation and execution, improve information exchange and monitoring, align budgetary processes and public investment planning with the fiscal sustainability objectives, and create a sound framework to manage fiscal risks to help cope with exogenous shocks. Additionally, these reforms support changes in the pricing of energy products, reducing incentives for carbon emissions, and creating incentives for productivity and efficiency gains. These policies also create the necessary fiscal space to continue, expand and strengthen the most vulnerable population.

E. Implementation

Institutional and Implementation Arrangements

11. **Disbursement arrangements.** The financing is proposed to be comprised of a Loan for an amount of USD$500,000,000 and funds from the Global Concessional Financing Facility (GCFF) for an amount of USD$15,000,000. Once the financing is approved and declared effective, based on the borrower's request, the World Bank will disburse the financing proceeds into the bank accounts[3] held by the BCE denominated in U.S. dollars that form part of the country's official foreign exchange reserves. The funds will be then immediately transferred into the STA managed by the Ministry of Finance and into a specific account internally designated as "CX". Such account will be tagged in the e-sigef system

[3] The loan funds and the GCFF funds will be deposited in different accounts with the objective of having better control.

using a specific code that allows for the identification of each specific loan and financier. Overall, the STA has an adequate level of control as it can manage virtually segregated accounts where the Government can track the use of funds through the e-sigef system. The Borrower, within 30 days after the withdrawal of the financing from the financing Account, shall report to the Bank: (a) the exact sum received into the bank accounts; (b) the record that an equivalent amount of the financing has been accounted for in the Borrower's budget management systems; and (c) the details of the accounts to which the equivalent of the Financing proceeds will be credited.

12. **Auditing arrangements.** The World Bank reserves the right to request an audit of the bank account to be conducted by independent auditors acceptable to the Bank, in accordance with consistently applied auditing standards acceptable to the Bank. If such audit is required, the borrower should furnish to the Bank as soon as available, but in any case not later than four months after the date of the Bank's request for such audit, a certified copy of the report of such audit, of such scope and in such detail as the Bank shall reasonably request, and make such report publicly available in a timely fashion and in a manner acceptable to the Bank; and furnish to the Bank such other information concerning the loan account and their audit as the Bank shall reasonably request.

F. Poverty and Social Impacts, and Environmental, Forests, and Other Natural Resource Aspects

Poverty and Social Impacts

13. **The prior actions supported by the proposed operation are expected to have positive or neutral impacts on poor households and vulnerable groups in the short term; in the medium and long-term, the expected effects are overall positive**. The poverty and social impact assessment (PSIA) follows Bank guidelines and analyzes the potential distributional impacts of the government's program. It covers poverty and shared prosperity implications, as well as other welfare-related outcomes such as household income and expenditures, employment, and prices. The policies supported by this operation, such as compensating the impacts of the COVID-19 crisis, are expected to protect vulnerable populations. The prior actions aimed at removing barriers for private sector development are expected to continue the medium-term reform agenda during the recovery period. These actions are designed to facilitate private sector investment and enhance Ecuador's competitiveness. Finally, the measures for increasing efficiency in the mobilization and allocation of public resources and the elimination of fuel price distortions are expected to strengthen the fiscal position of the government. These policies provide funds that can be focused on the poorer households (e.g., through the financing of health, education, and social assistance) and facilitate development. The expected effects are based on quantitative analysis, a review of academic literature and additional information gathered during the preparation of the operation.

14. **Policies under Pillar 1 are aimed at protecting and including vulnerable populations as a result of the COVID-19.** The measures to provide emergency cash transfers and to shorten the access time to unemployment benefits will benefit households directly. Estimates show that the welfare situation of beneficiary households would improve because of the conditional cash transfer provided by the second wave of the program. Notably, most beneficiaries of these transfers are women (90 percent). The poverty incidence and gap would be reduced by 5 and 3 percentage points, respectively, among beneficiary households. Shortening the access time to unemployment benefits would cushion the reduction in household labor income and prevent them from falling into poverty. Notably, migrants are not overlooked by the government in this

crisis. Implementing the human mobility agenda through the Venezuelan migration strategy will benefit both Venezuelan refugees and migrants and households in host communities. This strategy has already started by extending the approval period for pending humanitarian visa applications. Between August 31 and September 10, 2020, almost 2,000 humanitarian visas were issued.

15. **The policies under Pillar 2 aim to remove barriers for private sector development and would not have negative impacts on households' welfare in the short run**. The measures to reduce financial distortions will not immediately impact households as the gradual reform progress will flexibilize the corporate interest rate ceiling. In the medium term, fewer financial distortions are expected to contribute positively to welfare through the overall expansion of credit supply and job creation. The adoption of an objective and pre-defined formula for setting the minimum wage is not expected to have any welfare effects in the short term. (Minimum wages cannot be reduced, as per the Constitution.) However, in the medium and long-term, it is expected to improve socioeconomic conditions by boosting competitiveness and fostering the creation of formal jobs. Measures that enhance competitiveness and trade (i.e., by reducing or eliminating import tariffs) will likely have no significant welfare effects in the short run. However, these policies might have an indirect positive impact on welfare in the medium to long run through growth, lower consumer prices, and enhanced labor conditions (i.e., increase in formal employment).

16. **Prior Actions under Pillar 3 are expected to have neutral or positive distributional effects in the short and medium-term.** The measures to strengthen fiscal resilience will indirectly benefit poor households by bolstering macroeconomic stability, preventing fiscal imbalances that could threaten pro-poor spending, and reinforcing the necessary conditions for accelerated growth. The introduction of a price smoothing formula for fuel products that adjusts domestic prices to international references prices would impact the welfare of poor and vulnerable populations. However, these populations will benefit from better use of fiscal resources through improved services (i.e., education and health) and directly through social assistance programs, proposed to be supported through Pillar 1 of this operation. Thus, no negative impact is expected for the bottom 40 percent of the population.

Environmental, Forests, and Other Natural Resource Aspects

17. **None of the prior actions are expected to have significant negative impacts on the country's environment, forests, or other natural resources**. By phasing out gasoline subsidies, Prior Action #10 is likely to have positive effects on the country’s environment by contributing to reducing air pollution, and on the global environment by reducing greenhouse gas emissions.

G. Risks and Mitigation

18. **The overall risk of this operation is assessed as high.** There are key risks that could affect the achievement of the development objectives of this DPL series. They include political and governance risks, domestic and external macroeconomic risks, and fiduciary and stakeholder risks. While the program's design incorporates risk-mitigation measures, some risks cannot be fully extenuated. However, the short and long-term benefits of the operation are considered to outweigh the risks. While Ecuador is vulnerable to multiple risks and faces structural challenges, the

authorities' medium-term strategy to enhance revenue mobilization and maintain expenditure control is expected to curb the rising debt trajectory, and the operation is instrumental to the GoE's medium-term strategy for fiscal consolidation.

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APPROVAL

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