Program Information Document (PID)

Appraisal Stage | Date Prepared/Updated: 18-Apr-2020 | Report No: PIDA28627

BASIC INFORMATION

A. Basic Project Data

Country	Project ID	Project Name	Parent Project ID (if any)
Ecuador	P171190	Second Inclusive and Sustainable Growth (P171190)	P169822
Region	Estimated Board Date	Practice Area (Lead)	Financing Instrument
LATIN AMERICA AND CARIBBEAN	05-May-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 development and supporting the economic recovery; iii) promoting public sector efficiency and fiscal sustainability during the recovery.

Financing (in US$, Millions)

SUMMARY

Total Financing	500.00

DETAILS

Total World Bank Group Financing	500.00
World Bank Lending	500.00

Decision

The review did authorize the team to appraise and negotiate

B. Introduction and Context

Country Context

1. **Ecuador achieved high growth and significant social gains during the last oil price boom, but it accumulated macroeconomic vulnerabilities.** Between 2001 and 2014, growth in the Gross Domestic Product (GDP) averaged 4.5 percent, well above the regional average of 3.3 percent. During this period, real GDP per capita increased by 43 percent. Poverty fell from 37 to 22 percent of the population between 2007 and 2014, lifting 1.4 million people out of poverty. Social gains were supported by higher labor incomes, greater income redistribution, and better access to services. These results were accompanied by a large expansion of the public sector which became the main driver of growth after 2007. Public spending soared from 20 percent of GDP in 2004 to 44 percent of GDP by 2014, driven by expansions in both investment and current spending. Public sector growth led to an expansion in service delivery, but at the expense of efficiency.[1] The fiscal expansion was partially financed by higher oil revenues.[2] However, over this period, Ecuador also dismantled its sovereign oil funds, incurred in selective debt default, and increased its public debt from 17 percent of GDP in 2012 to 27 percent of GDP in 2014. This expansionary fiscal stance accentuated the symptoms of Dutch disease, which when combined with a non-conducive business environment, dampened private investment.

2. **The country now faces the challenge of adjusting its economy to low and volatile oil prices and to tightened external financing, while navigating the impacts of the COVID-19 crisis.** Due to its dollarized economy and limited fiscal buffers, Ecuador could neither rely on currency depreciation nor undertake countercyclical fiscal policies to respond to shocks such as the oil price dropped in 2014. As revenues plummeted in 2014, the Government cut spending (mainly public investment), which accentuated the economic deceleration in 2015-16. Despite these efforts, fiscal deficits widened, arrears accumulated, and the public debt increased swiftly, from 27 percent of GDP in 2014 to 48 percent in 2019. External imbalances have led to a sharp decline in Ecuador's international reserves since 2015, with temporary relief when Ecuador managed to mobilize costly external financing. Poverty reduction lost momentum during this time, with the poverty rate increasing slightly between 2014 and 2019. This reversal trend is expected intensify in 2020 due to the effects of the COVID-19 health crisis; almost 1.5 million people could fall back into poverty during the year.[3] While initial reform efforts introduced in 2018 and 2019 improved Ecuador fiscal conditions, the COVID-19 health crisis adds unforeseen pressures to the economy. Adapting to this challenging context requires the combination of quick crisis response measures and a solid medium-term reform program to continue addressing macro-fiscal imbalances and shifting from an economic model that is state-led to one that is balanced and productivity-driven. This process must be managed carefully so as to safeguard the social achievements of the last two decades and protect the vulnerable.

Relationship to CPF

3. **The WBG CPF FY19-FY23 for Ecuador aims at rebalancing the economy, reigniting sustainable growth and protecting the vulnerable.** The CPF was prepared in parallel to the first operation in the DPL series and jointly approved by the World Bank Executive Board of Directors in June 2019. It focuses on achieving the WBG's twin goals—ending extreme poverty and boosting shared prosperity—through three interdependent areas where expected results are aligned

[1] Ecuador Systematic Country Diagnostic (SCD) 2018.
[2] In 2011, the government renegotiated oil contracts with the private sector, resulting in a larger share of oil revenues flowing to the public sector
[3] Olivieri, S. (2020) The perfect storm: the welfare and distributional impact of the triplet crises in Ecuador, Mimeo, Quito, Ecuador.

with the Government's priorities outlined in *Plan de Prosperidad* and the key challenges identified by the 2018 Ecuador SCD. These are: (i) Supporting Fundamentals for Inclusive Growth; (ii) Building Human Capital and Protecting the Poor, and (iii) Enhancing Institutional and Environmental Sustainability. Pillars 1 and 2 of the proposed DPF series support CPF objectives under the results area (i), while Pillar 3 supports CPF objectives under the results area (ii).

C. Proposed Development Objective(s)

4. **The proposed operation is the second in a programmatic DPF series supporting reforms under three pillars that seek to help Ecuador respond to COVID-19 to support the vulnerable, foster the private sector development in the economic recovery, and promote public sector efficiency and fiscal sustainability during the recovery. It combines COVID-19 response measures to structural reforms that helped strengthen Ecuador's economic position to help navigate the COVID-19 crisis and recovery.** The three proposed pillars are interlinked and mutually reinforcing. Measures under Pillar 1 supports COVID-19 crisis response, helping maintain the livelihood of vulnerable segments of the population during the crisis through cash transfers. It also helps maintain formal jobs in the private sector, finally measures un this pillar help open fiscal space for crisis response. Pillar 2, which aims at removing barriers to private sector development through improvements in productivity improve the chances of firm and employment survival during the crisis and will likely generate better jobs and improving household income in the post crisis. Finally, efforts to promote a more efficient mobilization and allocation of government resources under Pillar 3 are expected to reduce the Government's footprint in a sustainable manner through efficiency gains that will further free up resource in the short run and ensure fiscal sustainability in the post crisis. Pillars 3 and 2 reinforce each other, while Pillar 3 will enable to crowd-in private investment, Pillar 2 will increase economic activity generating additional fiscal revenues. Pillar 1 help the chances that the dividends of Pillars 2 and 3 reflect on better outcomes for vulnerable segments of the population in the post crisis.

Key Results

5. **The expected results of the operation include** protecting the livelihood of vulnerable individuals during the COVID-19 crisis, protecting employment during the crisis, opening fiscal space for priority spending during the crisis, protecting migrants, removing barriers to firm entry and operations, by establishing a new Simplified Stock Corporation modality, improving minimum wage setting process; expanding the reach of the financial sector and reducing distortions; improving the budget preparation process and aligning it with fiscal sustainability objectives; increasing efficiency in the purchase of goods and services and personnel; and modernizing fuel and electricity pricing to rationalize subsidies and increase efficiency.

D. Project Description

6. **Pillar 1 support reforms that seek to protect vulnerable segments of the population against the impacts of COVID-19 crisis and fiscal efforts to create fiscal space for crisis response.** Ecuador witnessed substantial economic and social gains between 2007 and 2014. High economic growth coupled with an improved income distribution helped lift 1.4 million people out of poverty. The onset of the COVID-19 and the stringent containment measures, which are critical to save lives, are creating economic hardship for many households. The poor and vulnerable that frequently work informally, do not have assets, and rely on daily income to cover their basic needs, will be disproportionally affected by these

economic impacts. Almost 4 out 10 informal workers could fall into poverty, contributing for a third of the 1.5 million individuals who are expected to become poor in 2020 as consequence of the crisis.[4]. The Government is committed to implementing reforms that can create fiscal space for crisis response and ensure that existing space is allocated towards effectively protecting the poor and the vulnerable, helping mitigate the impacts of crisis.

7. **Pillar 2 support reforms focused on removing barriers for private sector development, which will support the post-crisis recovery.** These barriers range from regulatory uncertainty, high costs to open and close businesses, and distortions in financial markets that limit access. Previous administrations enacted a series of legal changes that stymied private investment. For example, the government of Ecuador changed the structure of oil contracts to retain a higher share of oil revenue at the same time as it withdrew from ICSID. These changes discouraged foreign direct investment. Reforms are needed to bolster a more amenable environment for firm entry and operation. Despite recent progress, regulations make it difficult to open and close a firm. The time and costs involved in registering a new business in Ecuador are high compared to regional peers. The wage setting process have led to rigidity and distortions as wage increases have surpassed productivity gains. Access to finance is also considered by business to represent an important obstacle, especially for larger firms. Reforms under pillar 2 aim to reduce barriers to private sector development, supporting a more balanced growth process. They include regulations lowering costs for opening firms, improving minimum wage setting, and reducing financial sector distortions.

8. **Pillar 1 support reforms that promote a more efficient mobilization and allocation of government resources, supporting an orderly fiscal consolidation post-crisis.** Weakness in budgetary process and current spending rigidities have prevented a strategic fiscal adjustment and the government has relied most capital spending cuts to address fiscal imbalances in recent year. Relatively low non-oil revenues added to fiscal pressures. Reforms proposed under pillar 1 seek to address these challenges. They help strengthen MEF's capacity and oversight during budget preparation and execution, aligning budgetary processes with fiscal sustainability objectives, in line with international best practices. Reforms also help improve procurement and HR processes, allowing for savings on goods and services and personnel spending. Additionally, Reforms support changes on the pricing of energy products aligning incentive and reducing Ecuador's large and poorly-target subsidies.

E. Implementation

Institutional and Implementation Arrangements

9. **Ministry of the Economy and Finance (MEF) will be the main coordinating agency for monitoring and evaluation among other participating ministries.** The prior actions detailed in this operation are the prime responsibility of the following ministries and agencies: MEF, Ministry of Energy, Ministry of Production, Investment, and Commerce, National Planning Agency (SENPLADES) Energy, Hydrocarbon Regulatory Agency (ARCH), and Electricity Regulatory Agency (ARCONEL). ANSES, and the Office of the Presidency of Cabinet of Ministers. MEF would be the coordinator with other ministries on monitoring of the results indicators, which are based on publicly available information. The World Bank will be monitoring the implementation of the DPF program through regular supervision missions and the preparation of the DPF 2. The World Bank will also collaborate with the Ministry of the Treasury on the monitoring the key indicators for the DPF.

[4] Olivieri, S. (2020), The perfect storm: the welfare and distribution impacts of the triplet crises in Ecuador, Mimeo, Quito, Ecuador.

10. **The program outcomes will be monitored through the measurement of the progress toward the achievement of results indicators included in the policy and results matrix.** This measurement seeks to assess progress toward the implementation of the policy and institutional measures supported by the proposed DPF series and will be evaluated following the disbursement of the first DPF. MEF will have the responsibility of presenting the information related to the reform implementation and progress made toward results on time and in a format satisfactory to the World Bank.

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

Poverty and Social Impacts

11. **The Prior Actions supported by this operation are expected to have neutral or positive effects on poverty in the short term and overall positive effects over the medium and longer terms.** This assessment[5] follows the Bank guidelines and provides an analysis of the potential distributional effects 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 the measures for increasing the efficiency in the mobilization and allocation of public resources are expected to strengthen the fiscal position of the government. In addition, the prior actions aimed at removing barriers for private sector development are expected to facilitate trade, private sector investment and reduce access to financing from abroad in Ecuador. Although not all these policies and programs would have direct effects on poverty and inequality, their overall impact on welfare is estimated to be neutral or positive. Finally, the crisis response measures for protecting vulnerable populations are expected to have significant positive impacts on the welfare of the less well-off in the short run, by helping mitigate large negative impacts of the crisis. The expected effects are based on quantitative analysis, the review of academic literature and additional information gathered during the preparation of the operation.

Environmental, Forests, and Other Natural Resource Aspects

12. **The proposed DPF presents a moderate risk of adverse environmental impacts if suggested mitigation strategies are not put in place.** Prior Actions 1, 2, 3, 4, 5, 6, 7, 8, and 9 are not likely to have impacts on the country's environment or its natural resource base. Prior Action 3 is likely to have positive environmental impacts.

G. Risks and Mitigation

13. **The overall risk rating of this operation is assessed as High**. The major risks to the operation's ability to achieve its development objectives include political risks, macroeconomic risks and institutional capacity for implementation and sustainability risks. In addition, political and governance, fiduciary, and stakeholder risks are considered substantial. These risks have been exacerbated in the context of the COVID-19 crisis and the collapse in oil prices. If macroeconomic risks were to materialize, they would adversely affect the Government's ability to implement and sustain the reform efforts – especially if they trigger social discontent – and hence make the outcome of the development agenda support by this DPF series less successful. The political dynamics could also affect the Government's ability to mobilize parliamentary support

[5] This PSIA has been prepared by Sergio Olivieri (ELCPV), Ivan Gachet (ELCMU), Ana Rivadeneira (ELCPV) and Jaime Fernandez (ELCPV).

to approve some of the reforms included in the program. The DPF program is designed to include flexibility for DPF 3 to be adjusted in case some of these risks materialize.

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APPROVAL

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