ECUADOR'S DEBT SUSTAINABILITY

An alternative view

November, 2004

Ecuador's Debt Sustainability

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Introduction

When the new president Lucio Gutiérrez took office on January 15th, 2003 a man came to power who through his election campaign had intimated a change in Ecuador's economic and social policy. A further promising sign for social and political stability was the fact that his government coalition included the party of the indigenous people, the Patchakutik, which is strongly linked with the indigenous umbrella organisation, CONAIE. The only change that took place, however, was that neoliberal policy, led by the guidance of the IMF, came faster and more radical than before. The appointment of Mauricio Pozo, a strong neoliberal politician to the post of the minister of economy and finances was the first sign of the true line Gutiérrez was heading for. This was corroborated by the almost immediate signing of the Letter of Intend handed over by the IMF.

Measures taken, such as the drastic increase of electricity and telephone tariffs, petrol and gas, new legislation on the labour markets and the freezing of wages in the public sector are highly unpopular and hit the poorest the most. However, the economic course Gutiérrez took had fortune on its side: Petrol prices remained high all year through in 2003 and 2004, a weak dollar helped Ecuador's exports, although dollarization left its negative mark on Ecuador's industry. And finally, due to the strong Euro, remittances of the many Ecuadorian migrants in Europe have risen against expectations. These factors helped that in the end a growth rate of 2.7% occurred in 2003, which in spite of the positive surrounding was much lower than expected.

After Gutiérrez had broken almost all his electoral promises on the social, political and economical front, not only his coalition partners Pachakutik and MPD (Movimiento Popular Democrático – a leftwing party) but also most of the people who had voted for him turned their back on the president. The breaking of the coalition and the inability to integrate the strong movement of the indigenous people into a coherent, socially responsible and broadly accepted national policy is a sadly missed opportunity and a strong destabilizing factor for the nearer future of the country.

The main objective of the current policies is the settlement of obligations on external debt. Although Gutiérrez misses almost no opportunity to state publicly that Ecuador's debt and the financial burden are too high, he does everything (im)possible to satisfy the creditors' interests. The most outstanding example is certainly the inexcusable procedure and actions taken with regard to the construction and operation of the new OCP pipeline. Violating international standards of both, human rights and ecological sustainability, led by the pressure to extract and export as much oil as possible the sooner the better, Gutiérrez risks not only a social clash but also an ecological catastrophe. Although, the national government remains entirely responsible for its actions, it has to be stated, that it is furthermost international pressure that determines the irresponsible policy. There is no way in current debt management mechanisms to reduce Ecuador's unsustainable debt other than by paying it off cent by cent.

A thorough sustainability analysis of Ecuador's public debt, both internal and external, and the accompanying risks clearly shows that the economic, social, ecological and institutional situation in Ecuador is deteriorating. The requirements set by the IMF, the Worldbank and other multilateral institutions as well as creditor governments to accelerate debt repayment, enhances the negative impacts of growing annual debt services, as they provoke the increase of poverty, higher and faster extraction of crude oil and the destruction of other natural assets and they aggravate the current social and institutional crisis.

Ecuador and the IMF

Ever since the outbreak of the debt crisis in Ecuador in the early 80ies the IMF plays a decisive role in determining the policy of the country. Both, the most recent engagement of the government with the IMF, as well as the quality of the 2003 and 2004 budgets and the proposed budget for 2005, which prioritise stabilization policies to social and economic policies, are based on the characteristics established in the Ley Orgánica de Responsabilidad, Estabilización y Transparencia Fiscal (*Fiscal Responsibility, Stabilisation and Transparency Law)* which came into effect in January 2003. This Law clearly shows IMF handwriting as it was processed by the institutional powers under the tuition of this institution. The essential aspects of this law are the following:

- The Central Government's primary budget – excluding interests on debt – must not grow more than 3.5% (plus inflation).
- The deficit in the non oil sector must be reduced by 0.2% of GDP annually until it reaching zero.
- Public debt must be reduced in each governmental period (4 years) by at least 16% of GDP until reaching the level of 40% of GDP and after that must be kept at this level.

One of the first actions Lucio Gutiérrez carried out after taking up office in January 2003, was the signing of an IMF agreement. Among the measures were the increase of electricity and telephone tariffs, clearance of all payment arrears, several structural reforms (customs, civil service, taxes, public enterprises, elimination of cooking gas subsidies, increase of fuel prices), and the liquidation of closed banks. This Stand by agreement, originally meant to end in March 2004 and now extended until the end of 2004, has already envisaged several corrections in its two reviews (see below). Nevertheless, regardless of alarming signs the optimistic tone has been maintained.

This optimistic vision corresponds to the substance of two other documents that have been published in 2003 on the economic development and debt sustainability in Ecuador:

Ecuador - Selected Issues and statistical appendix; (13.3.03)

Staff Report for the 2003 Article IV consultation, request for a stand-by arrangement, and approval of an exchange restriction; (14.3.03);

The macroeconomic framework is estimated to be defined by an intense GDP growth, boosted primarily through increased oil income after the start of the operation of a second pipeline for heavy crude oil by a private consortium (OCP) in the second half of 2003, increased investment and financial intermediation, due to strengthened confidence and reduced country risk. According to the IMF projections, this would raise GDP growth to 3,5% in 2003 and up to 6% in 2004, remaining high for three years to eventually find its level at 3,5%. Moreover, inflation is to fall down to 4% in 2004 and the current account deficit will decline, again due to increased oil exports.

Regarding an average growth in the past 12 years of 2,1% these are courageous projections, that can only be explained by the high weight the boosted oil sector is given. Yet, the Fiscal programme even includes a safety cushion due to:

- A conservatively calculated oil price of 18 US$ which is to be maintained in the budget calculations (windfall gains should then lead to an even stronger primary surplus).
- Contingent claims that currently are in process of litigation or arbitration and eventually could result in additional financing needs are to be contained by the negotiation of payment schedules.

Thus, two potential risks that could threaten the outcome of the fiscal program are to be addressed: A low oil price and additional finance needs. Moreover, the IMF has the expectation that the legislative agenda within the IMF agreement will affect the economy positively.

This optimistic economic outlook directly effects the projections of the external debt situation of the country. If by rapid GDP growth the denominator is increased, the debt/GDP coefficient will be reduced even if the numerator, i.e. external debt, increases. Accordingly, the baseline-scenario the IMF draws is a very “robust” one with total public debt going down to 21,5% of GDP in 2008.

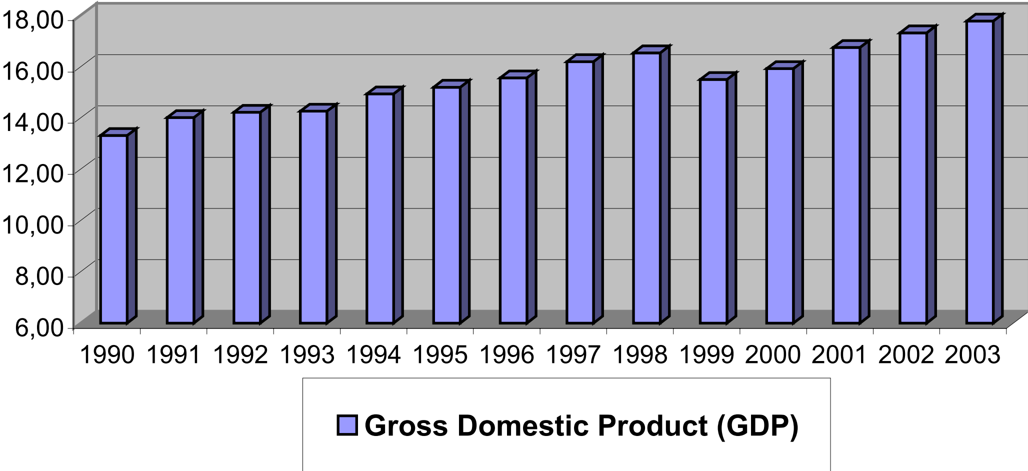
This scenario parts from the assumption of a 3,5-6% growth rate until 2008, due to higher oil revenues, the assumption of an increasing primary surplus of 6 to 7% from 2003 onwards, and the assumption of a decline of the sovereign spread. It is claimed that the decline in the debt ratio is relatively „robust to partial shocks“. Most of the shock scenarios for 2002 to 2008 lead to a decline of external debt to GDP from 59,6% to 25,1% in the best case and to 55,9% in the worst case.

Full operation of the OCP pipeline has the potential to double oil exports. Although this does not refer to the state revenues, that will only increase by about 200-300 million US$ a year for the period of operation, it is rather private investors that will take the benefits, increased oil income is the key to the “robust” scenario. This is due to the fact that oil revenues from the OCP are to be used by 70% to debt servicing and debt buyback.

Recent developments

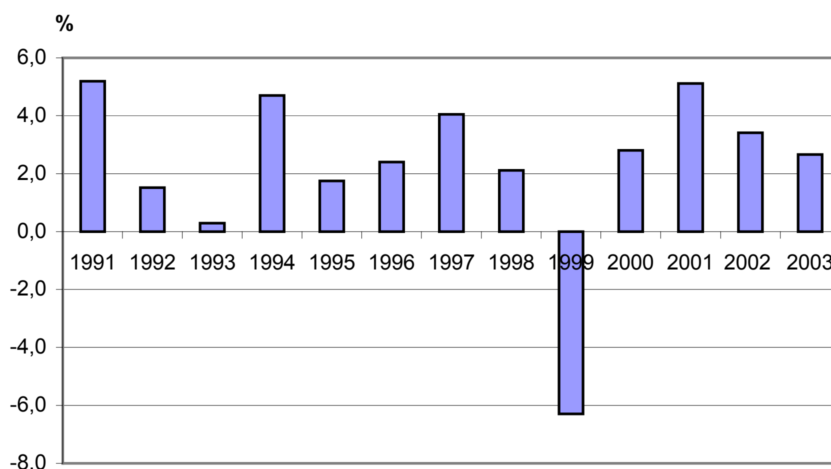
After Ecuador suffered a severe economic and banking crisis in 1999, to which dollarization was the radical answer, and after the consolidation period had settled the biggest waves, for a short while it looked like the economy was recovering. Real GDP increased steadily although after the regaining the pre-crisis level in 2001, the growth rate dropped again. In 2003 GDP was at 17.78 billion US$.

Graph 1: Development of GDP: 1990-2003



Source: BCE, Boletines mensuales, March 2004

Graph 2: GDP growth rate: 1991-2003



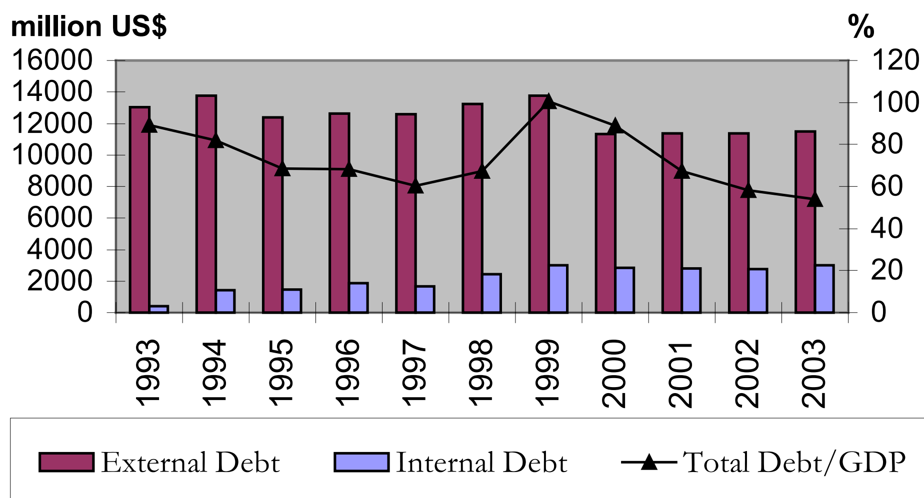
Source: BCE, Boletines mensuales, March 2004

However, a close look shows easily that this recovery is far from being "robust", and rather fragile as it heavily depends on external factors, such as the oil price, the remittances of migrants in Europe and the USA, or a low dollar exchange rate, instead of a solid reactivation of the economy. The only sector that has effectively been reactivated is the oil sector which shows the dangerously one-dimensional alignment of a seeming recovery.

The recovery of the first years after the crisis is also to be seen as a logical process of catching up to painfully lost development progress during the crises and therefore should not be taken for granted and perpetuated in the development projections. Finally, for 2003 the expectations for economy growth had to be corrected down from 3,5% to 3%, after the first half of the year had actually seen a shrinking of the economy, and the construction of the OCP was coming to an end. In the end, growth rate in 2003 was at 2,7%, and even this could only be reached because the exploitation of oil and mining saw a considerable growth in the third and last quarter, while most other sectors of the economy kept shrinking.

After the crisis in 1999 received a debt reduction by private creditors, which reduced their share of public debt notably (Brady Bonds), however, as this debt reduction was not accompanied by a comparable treatment from the part of the bilateral creditors in the Paris Club, the overall level of public debt remained high. Moreover, in the same period, internal debt increased considerably, as the government had to raise money to manage the banking crisis. With a drop in GDP during the crisis in 1999 the ratio of Public Debt to GDP rose to over 100%. However, after the renegotiation of the Brady Bonds and a fairly stable level of public debt hereafter, together with a steady increase of GDP, this ratio could be brought down again to 54%.

Graph 3: Development of external and internal Debt



Source: BCE, Boletines Mensuales, March, 2004

The picture of Ecuador's post-crisis economy is quite mixed. While consumer price inflation could be brought down even below the level projected by the IMF, it still remains high considering that the country has dollarized its economy. Other indicators have fallen short of expectations which is not yet a disaster for the economy. However, these developments should be taken more serious instead of keeping up too optimistic projections that close the eyes to potential downward risks.

Table 1: economic projections

		proj. IMF	Real dev. (BCE)	proj. IMF
	2002	**2003**	**2003**	**2004**
Real GDP	3,0	**3,5**	**2,7**	6,0
Domestic Demand (contribution to growth)	7,6	**3,6**	**2,3**	4,6
Foreign balance (contribution to growth)	-4,5	**-0,2**	**0,4**	1,4
Consumer price inflation	9,4	**6,5**	**6,1**	4,0
Current Account Balance (% of GDP)	-5,0	**-5,3**	**-0,5**	-4,1
Oil export growth	7,0	**-7,2**		27,0
Non-oil exports growth	5,1	**5,1**	**14,0**	5,3
Import growth		**3,7**	**-6,3**	8,1
Primary surplus (% of GDP)	4,5	**5,2**	**4,7**	6,7
Overall balance (% of GDP)	1,0	**1,9**	**1,7**	3,6
Public Sector Debt	59,6	**51,7**	**54,0%**	44,1

Source: IMF (2003): Article IV Consultation and Central Bank of Ecuador

Economically sustainable? Downward risks

The picture the IMF and the Ecuadorian government are painting suggests that within a few years all debt problems will be overcome. Based on seemingly alleviating developments in the recent past this picture is to feign stability to attract investors and to calm creditors. However, at a closer look the stability is very fragile and far from being a sound basis for further development. This is especially true if we look at the social and environmental side-effects, as we will deal with later. Yet, even from a purely economic perspective, there remain too many downward risks that seriously affect the economic sustainability of Ecuador's development.

Primary surplus

The Stand-by agreement from March 2003 projected a primary surplus of the public sector of 5.2% of GDP for 2003. When oil production of the state-owned oil company PetroEcuador broke down in the first half of the year due to a workers' strike and a rupture of the pipeline near Quito, this objective could only be maintained due to a considerably higher oil price than projected. A simple trick was used in the first IMF review (July 2003) to overcome the problem of reduced oil revenues and to maintain the target in spite of that: The conservatively calculated oil price (18 US$ per barrel) was fixed at an annual average of 24,70 US$ a barrel. Although this matches better the real price development, the conservative price calculation originally was meant to serve as a safety cushion, which in case of a more favourable development should lead to a higher primary surplus. Now the opposite is the case: Additional spending on wages and in the cash assistance program for the poor have been paid off by higher oil prices than expected. Yet, even with the higher oil prices the objective could not be met, as Ecuador only reached a primary surplus of 4,7% (Reuters, March 5th, 2004). Therefore, new calculations of the income side in the first IMF review were complemented by a few measures on the expenditure side including cuts and transfers.

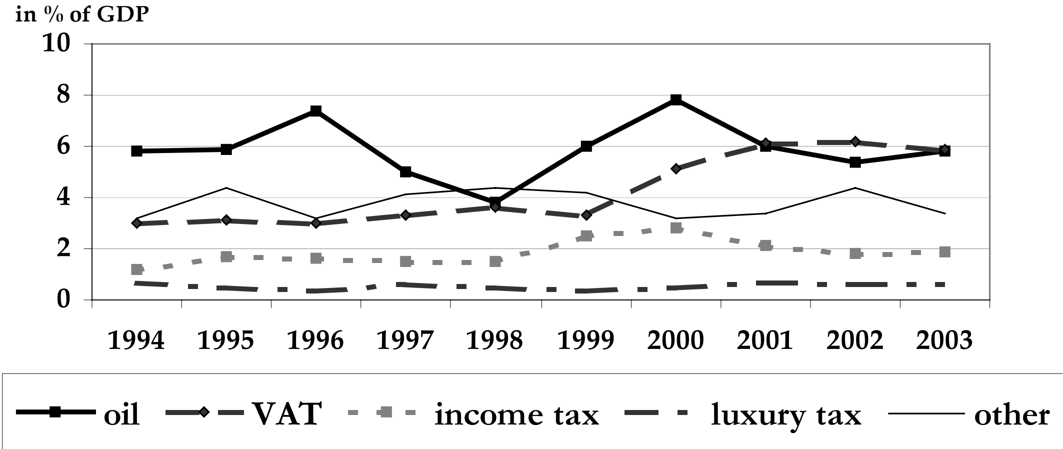
One of the prior actions to be taken to stabilize the budget situation was the ending of the freeze of the electricity and telephone tariff adjustments, which was effectuated in January 2003 (25% increase) with an inflationary effect, as well as a wage freeze, after the 2002 wage increase which had taken place against the Fund's advice. The latter could not be kept, as a teachers' strike early 2003 forced the government to grant a wage increase. This promise with an extra cost of 180 million US$ from 2004 onwards, as well as a 27% pension increase (additional spending of about 100 million US$ a year) will show effect in the future budgets. Whether the prescribed measures, such as reducing employment and eliminating invoice subsidies to the electricity sector can be carried through to the extent required is questionable as social tensions are critical.

On the income side, the policy of tariff adjustments and cuts has come to an end: Higher tariffs not only harm the poor but also start to affect economy negatively, as enterprises are already hit by the increasing loss of competitiveness due to dollarization. Thus, Gutiérrez has already announced that there will be no further increases on gas and petrol in 2004, rather tariffs on electricity and international phone calls will be lowered by 5% and 30% respectively.

However, the 6.75% target for the primary surplus in 2004 will also come under pressure from another side: The continuously low internal demand represents a substantial risk to further state income. In 2003 internal demand has by far failed the IMF projections and was only at 2.3% (instead of 3.6% as projected). Value Added Tax accounted for one third of last year's budget. After a considerable increase, which is not only due to an increase in the rate but also to improved levy by the

corresponding authority, this income pillar is now stronger than the income on petrol. Although it is a positive sign that the budget has become less dependant on oil revenue, it is not in the sense of distribution justice if of all taxes, the indirect ones are chosen to fill the gap. Moreover, the tendency of favouring indirect taxes to foster the state's revenues does not support a boost of internal demand.

Graph 4: Development of goverment budget revenue 1994-2003



Source: Central del Ecuador: Boletines Mensuales, February 2004.

Two thirds of total income are made up by these two pillars: Oil revenue and VAT, and both pillars are not very likely to increase considerably: oil income in 2004 will be mainly due to increased oil export. The largest part of higher export earnings fall to private companies, the enhanced oil revenues of the state by law are destined to debt servicing. While this will help to overcome debt overhang, additional revenues cannot be reinvested to boost domestic economy. If debt overhang was reduced by substantial debt reduction, the few additional revenues could bring about positive effects on other tradable sectors, such as manufacturing and agriculture, as well as internal consumption and revenues on VAT.

Luckily enough the oil price remained high in 2004. Yet now, the development of oil revenues confronts new risks due to the lack of cash for further investment from the part of the state-owned PetroEcuador. In January 2004 the company's oil exports dropped by 13% to only 108.456 barrels per day, as compared to 124.603 barrel per day in December. Thus, total revenue fell although the average price per barrel was almost 3 US$ above the price in December and PetroEcuador had to scale back its 2004 production targets (Reuters, February 5th, 2004). Just recently in March, after a landslide the SOTE was torn and had to be shut down for two weeks. During the process of reconstruction, PetroEcuador used the OCP for transporting its crude to the coast. This lowers the oil quality as the lighter crude of PetroEcuador is mixed with the heavy grades of the OCP, failing to fuel the countries refineries which can only process lighter grades. The incident shows that risks remain high, even if the world market price favours the oil sector. Instead of investing in improved productivity and efficiency of the state company's output and exploiting capacities, the state starts to sell off its fields, that are currently producing below potential, and the higher quality reserves to private investors.

With decreasing direct revenue from the oil sector, which counts for 33% of government revenue, with little growth of domestic demand and possibilities to compensate for these losses from the part of the non-oil revenues, and with expenditure remaining high due to non discretionary spending, there is little reason to believe that primary surplus will be any higher than the previous year. If the average oil price remains high, the best that could be achieved is the result of last year. But what happens if the oil price is lower, let alone if it drops to the 18US$ envisaged in the IMF program? If further adjustments than are needed and gaps should again be filled with increasing VAT, this will affect disproportionately people with lower income and thus internal demand. If gaps are not filled through an increase in income tax, new debt – external or internal - would have to be incurred.

Are debt buybacks coming in?

The second downward risk is also – as anything in Ecuador – closely related to the oil sector, as revenues from the new OCP pipeline by and large are designated for debt servicing. When Ecuador renegotiated its Brady Bonds in 2000, a fixed time table for debt buybacks of the new Global Bonds was accorded. The main objective is to reduce the spread for Ecuador's refinancing and lower internal interest rates which have remained high in Ecuador since the crisis in 1999. Although the spread could be lowered considerably from over 1.500 in 1999 to below 700 basis points in the beginning of 2004, it remains very sensitive and with the recovery having slowed down, it had risen again to over 900 points in May 04. Nevertheless, the state's obligation to buy back the debt titles are also an implicit means through which the rates of the titles rose considerably and in times when oil prices are high have reached up to more than 100% (Bono Global 12). Any way, the government has to pay the price either through higher spreads or through higher prices for debt buybacks.

The money for the debt buybacks is to come from increased oil revenue. Within the *Fiscal Responsibility and Transparency Law*, an oil fund (FEIREP) was set up to channel additional income stemming from the difference of the oil price of exported oil and a reference price established in the budget to calculate the budget income from the oil sector. Thus, this fund is a parallel financial structure aside from the Government's budget, as it is administered by the Central Bank as the fiduciary operator under the control of a Commission chaired by the Treasury. In the 2003 and 2004 Budget a reference price of 18 US$ per barrel was established while the average oil price for Ecuadorian oil was at 25.66 US$ in 2003 and could reach about 28 US$ per barrel in 2004.

The money that is channelled through this fund – also by law – is to be spent according to the following terms:

- 70% are to be used to cancel public debt: of these 15% can be used to cancel the state's debt with the Social Security System (IESS), the remaining 85% are to be used to repay the global bonds.
- 20% are to be used as with a classical oil stabilization fund accumulating resources to be able to compensate for revenue losses due to a fall in oil prices as well as for unexpected emergencies. However, regarding the permanent liquidity shortages of the budget it seems highly unlikely that a sufficient amount could be accumulated to confront effectively a budget imbalance.
- The remaining 10% are to be used for social spending in the education and health sector.

The debt buyback from the oil revenue, originally scheduled for the last quarter of 2003 (29 million US$) started in January 2004. The FEIREP had accumulated some 110 million US$ and the Central Bank bought domestic bonds and short-term debt worth 35,9 million US$ (LatinPetroleum.com,

January 22nd, 2004). Also in the other two spending areas resources have already been used in 2004. From December 2003 until September 2004 a total of 463 Mio. US$ had been accumulated in the FEIREP. However, with internal demand being so low, there have been indications that the government might well prefer to pay off internal debt to reinvest this money into the economy (Notimex, April 12th 2004). This would mean that at least external debt would not be reduced as foreseen by way of debt buybacks. And later in April Labour Minister Raul Izurieta even revealed the governments considerations to spend a higher percentage of the oil fund revenues (of up to 40%) on development projects to the debit of spending on debt buy back which would then only amount to 40% (Reuters, April 21st, 2004). An increase in public spending as a consequence of several worker's strikes (see below) could make such a plan necessary.

For 2005 the government expects to accumulate some 542 Mio. US$ in the FEIREP. The annual additional revenue from OCP is – full capacity provided – an estimated 300 million. Apart from that the FEIREP receives eventual surpluses of the central government budget. Thus, the suggested figure could only be achieved if primary expenditure is not increased on other fronts. However, the government's budget is very tight and heavily earmarked by non-discretionary spending. There is little room for extra spending in the oil fund. Provided that additional oil revenues through OCP go as foreseen into the oil fund, to achieve the total of 300 million would assume that the pipeline runs at projected capacity. The IMF in its "Selected Issues" (IMF 2003b) schedules full capacity of both pipelines for 2005, which than is maintained until 2026[1]. According to the Fund, Ecuador is already experiencing a dramatic increase in oil extraction and transportation to almost full capacity in 2004.

Reality looks very different. With a severe drop in state production through PetroEcuador, and with private investments failing to come in as expected, Ecuador is far from reaching the expected 850.000 barrels per day. Although overall output has increased from 389.000 bpd in December 2002 to 500.000 bpd in December 2003 and even risen to an average of 517.000 bpd in the first half of 2004, this is by no means full capacity. Private oil companies are reluctant to fill the gap through increased investment. They are put off by a tax dispute with the government and obviously awaiting better conditions for the extraction contracts recently on the bid. "Some of the biggest companies, giants like ExxonMobil and BP that could be spending billions of dollars to drive the development of Ecuador's oil industry, are long gone. Other companies are considering leaving or scaling back their investment, oil consultants and company officials say. Ecuador, analysts say, is not getting nearly the amount of investment that was once expected." (Herald Tribune, February 2nd, 2004).

Moreover, the institutional and legal framework is still very weak to allow efficient and smooth course of oil investment. After the continuously poor production performance of PetroEcuador state fields were out on a bid for private companies to produce oil there. To make them more attractive to foreign investors, Lucio Gutiérrez reduced the minimum level of the state's participation of its own oil possessions from 35% to 0% (Reuters, March 1st, 2004), which again shows that the high pressure of quick earnings also leads to a tremendous selling off of State's assets. In the end, the bid had to be called off due to legal problems. But the selling off of assets is going on: As the state-owned PetroEcuador lacks money for further investment to improve its production capacities, and with a tight fiscal position cannot hope for resources, it will keep on offering the state oil wells, which produces

[1] Until 2026 full capacity is to be exhausted, although interestingly enough just a few paragraphs earlier a less optimistic calculation of proven reserves shows that wells might well run dry already in 2018.

lighter and more expensive oil than the crude oil, to private companies, thus reducing further the state's benefits of the oil production, being left behind with the ecological damage.

Thus, the increase in oil production and exportation in recent time has been mainly due to the increase in the share of private oil companies and special contracts which in 2003 for the first time surpassed the share of state-owned PETROECUADOR. For 2004 the state's share is projected to decrease even further while the share of the private oil companies and contracts will increase, a tendency that is maintained and intensified in 2005. With increased extraction by private oil companies, the state's share through participation and royalties in private extraction is shrinking further. While in 2003 it was still at one third, it will go down to about 27% in 2004 and is estimated to a lower 25% in 2005.

Table 2: Oil Production and Exportation

Millions of barrels	**2003**	**projected 2004**	**estimated 2005**
Production			
PETROECUADOR	74.5	73.5	68.5
Private oil companies and special contracts	78.0	118.7	134.7
Total	152.5	192.2	203.2
Export			
PETROECUADOR*	43.0	48.4	38.1
Private oil companies and special contracts	49.4	86.6	103.9
Total	92.4	135.0	142.0
State's Participation and Royalties			
Private oil companies and special contracts	25.9	32.1	33.5
In % of production	33.2	27.0	24.9

*** Includes state's participation and royalties**
Fuente: BCE, Información Estadística; y, Ministerio de Economía y Finanzas

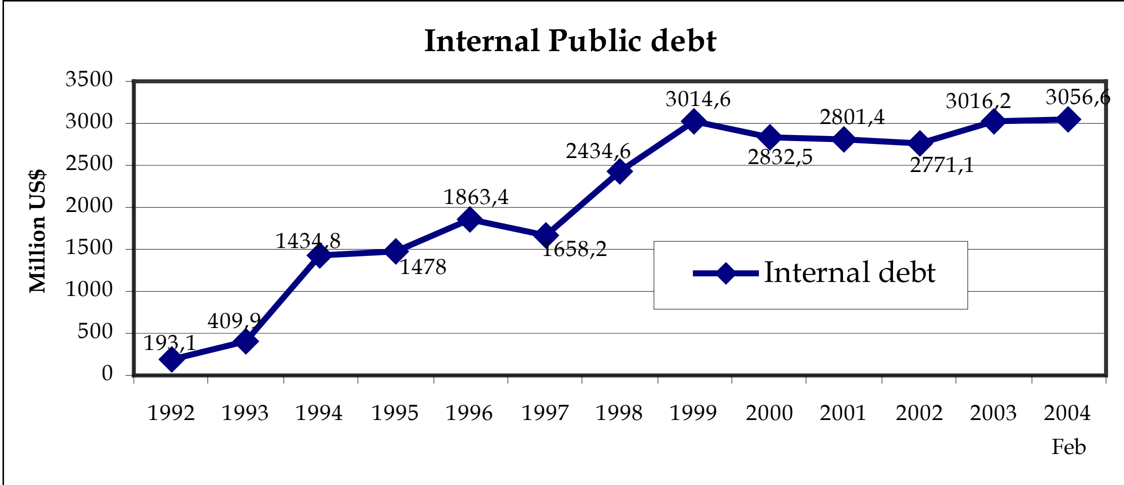
This data shows the increasing possession of private oil companies in extraction, transport and export of Ecuadorian oil and a decreasing relevance of the state-owned PETROECUADOR. Currently, the private oil companies benefit much more from the high oil price than the Ecuadorian state which together with the Ecuadorian people suffers natural asset losses as well as irrecoverable ecological damage. This puts further pressure on the Government's budget and it is questionable if due to liquidity constraints of the budget the assumed amount of additional resources can be channelled to the FEIREP to buy back foreign debt.

Internal Debt: Shifting the problem

With or without the oil revenues, the government recently has done everything to pay off its external debt. Thus, considerable reductions in the external debt/GDP ratio could be achieved, due to an increased denominator (GDP) and a fairly stagnant numerator (external debt) since the renegotiations in 2000. By the end of 2003, this ratio could thus be brought down to 43%. Who is paying the bill? For one part, it is the population because public spending is limited to a certain level which means that theoretically the government could not increase wages to avoid real wage deterioration, increase public investment to create more jobs or increase public social spending to meet its internationally agreed Millennium Development goals. The government can not always correspond to the fiscal discipline required by the IMF programme which results in the risk of non-compliance with the primary surplus

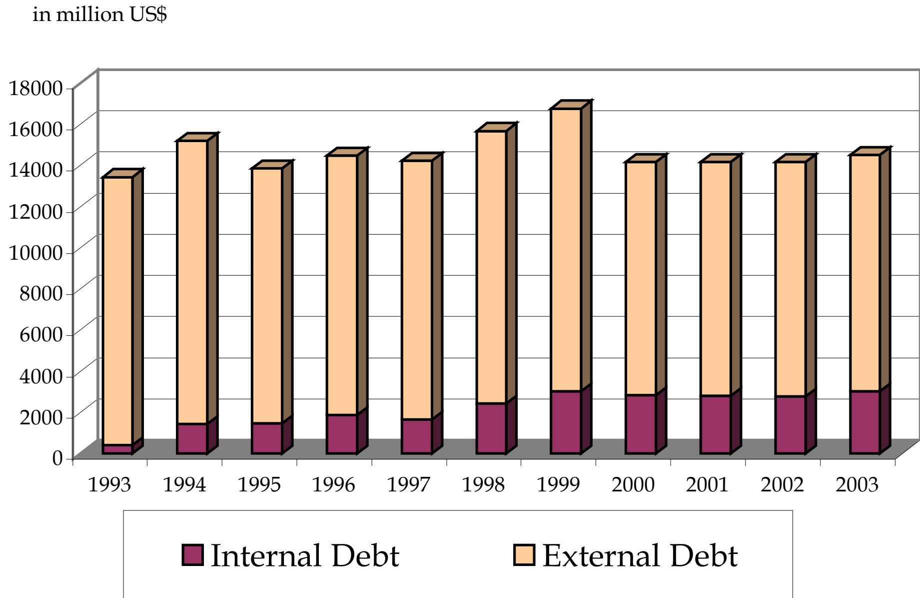
target as described above. Therefore, due to intense internal pressure, the government has also fallen back on another strategy to refinance external debt: the accumulation of internal debt. It is the government's strategy to finance the budget deficit after immense interest payments by raising not external but internal debt.

Graph 5: Development of Internal Debt: 1992 - 2004



Source: Ministerio de Economía y Finanzas, Marzo 2004

Graph 6: Share of Internal Debt in Total Debt



Source: Ministerio de Economía y Finanzas, Marzo 2004

As we can see in graph 6, in the early 90ies the public internal debt played a minor role in Ecuador's debt structure. It was only in the mid-nineties that figures went up considerably. While in 1992, internal debt was only about 2.7% of GDP, in 1999 it went up to 18.1% (BCE Ecuador). Since then, in absolute figures, the debt has not been reduced and stagnates around 3 billion US$. However, with the economy recovering from the crisis, internal debt rates relatively to the GDP have gone down to 11.4% in 2002 and 11.2% in 2003 (BCE Ecuador). In a presentation given in early 2004 a Central Bank official

explained how public financing will increasingly depend on internal debt, as projections for disbursements of external debt are going down while amortizations remain high. This financing gap will be filled with new placements of internal bonds – while external debt will decrease, internal debt will pay the bill. On the one hand it seems wise to take up internal debt rather than to raise external debt even further. On the other hand, just shifting the problem is not a solution. And in a dollarized country, internal debt is foreign currency just the same. Thus, internal bonds are not necessarily a cheap option: 41.2% of the debt stock are with the Agency for Guarantees of Deposits (AGD) with an interest rate of 9.35%, a rate which is still quite high.

Table 3: Financing external debt with internal debt („-" indicates gap)

Year	External debt			Internal debt			
	Disburse-ments	Amorti-sation	External financing gap	Disburse-ments	Amorti-sation	Internal financing gap	Financing gap (Ext. + Int.)
2004	676	824	-147	1401	756	645	498
2005	684	926	-242	1000	599	401	160
2006	468	1073	-587	1000	529	472	-115
2007	299	1074	-740	1000	504	496	-244

Source: BCE, desendeudamiento, PowerPoint Presentation Jan 2004

Export competitiveness is declining

Ecuador traditionally had a trade balance surplus mainly due to its petrol exports which usually amount to 30-40% of total exports. Oil exports are projected to boost in the future, although as we have seen, it is questionable whether they will materialize at the expected height. In the last two years, boosting income growth was rather due to high oil prices than to higher production. However, exports in the non-oil sector have also grown in 2003, though to a lesser extent.

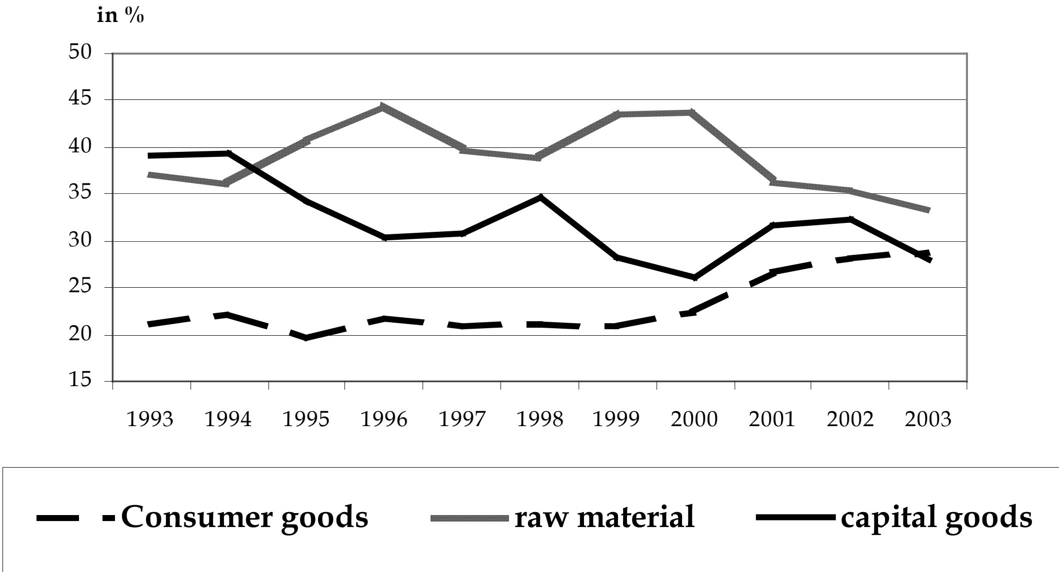
Table 4: Development of Trade Balance: 1994 - 2003

Year	Export (FOB)	Import (FOB)	Trade Balance
1994	3.842.682,67	3.209.424,28	633.258,39
1995	4.380.706,14	3.737.209,52	643.496,62
1996	4.872.648,23	3.570.888,95	1.301.759,28
1997	5.264.362,97	4.520.051,26	744.311,71
1998	4.203.048,76	5.109.930,27	**-906.881,51**
1999	4.451.084,33	2.736.902,13	1.714.182,20
2000	4.926.626,45	3.400.952,38	1.525.674,07
2001	4.678.436,46	4.936.033,52	**-257.597,06**
2002	5.036.121,20	5.953.426,21	**-917.305,01**
2003	6.038.498,71	6.071.117,21	**-32.618,50**

Source: BCE, Totales de Exportaciones e Importaciones, at December 2003

Already in 2001 the downward trend of the trade balance has materialized with an increased commercial deficit which worsened considerably in 2002: Passing from a surplus of 1.526 million US$ in 2000 to a deficit of 907 million US$ only two years later. This trend is mainly due to increased imports while exports differed little between 1996 and 2002. As in 2003 the construction of the OCP came to an end, increase in imports slowed down and the trade balance recovered again, yet, still remaining negative. Dollarization has favoured the imports of consumer goods, which have increased their share steadily from 21% in 1999 to 29% in 2003. These new imports have replaced goods from national production, thus also damaging local production (ILDIS 2004: 44). On the other hand, capital goods have seen a considerable increase after the contraction in the crisis, yet have slowed down hereafter. While dollarization and the increasing real exchange rate have motivated the import of consumer goods, it has undermined the potential of exports as well as local production and demotivated the imports of capital goods. If this trend can not be stopped and the trade balance is worsened by high share of consumer goods, Ecuador runs the risk to follow the same track as Argentina in the second half of the 90ies. Then, a trade deficit would have to be financed by debt, without a meaningful impetus for productivity or further development.

Graph 7: Development of imports



Source: BCE, Informacion Estadistica, March 2004

While the growth in imports slowed down in 2003, the exports made a pleasant development by growing almost 20%. A closer look shows that the biggest share of this growth was due to a 28% growth of exports in the oil sector, although the non oil sector made an encouraging development as well in the first half of 2003. It must be stated, though, that both, development in the oil sector and in the non-oil sector were strongly induced by high prices for oil and other primary products rather than higher production rates. If the oil price remains high throughout 2004, which can be hoped for, this year could see a trade balance surplus for the first time in four years, if the growth in import of consumer goods slows down. Nevertheless, the high dependency on the oil sector and especially on the oil prices remains disturbing and has increased again in the second half of 2003. Table 5 shows how volatile this export sector has been in recent years and how much the volatility is related to the oil price.

Table 5: Development of exports in the oil and non-oil sector

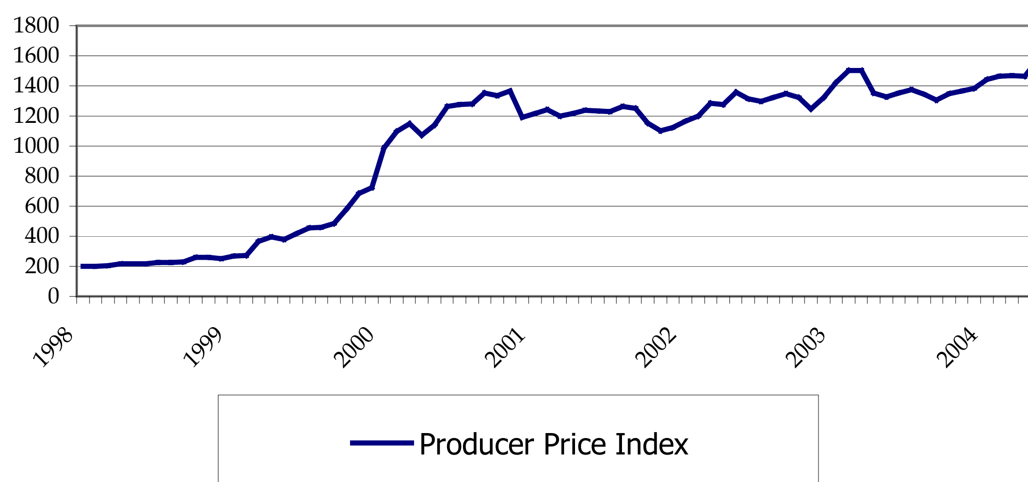
In thousands US$	Total Exports	of which: crude oil and derivates (in %)	Growth	of which: non oil sector (in %)	growth	Memo: Oil price per barrel
1994	3.842,68	34,0	3,83	66,04	40,3	13,68
1995	4.380,71	34,9	17,25	65,08	12,3	14,83
1996	4.872,65	35,9	14,30	64,11	9,6	18,02
1997	5.264,36	29,6	-10,95	70,42	18,7	15,45
1998	4.203,05	22,0	-40,73	78,04	-11,5	9,20
1999	4.451,08	33,2	60,32	66,76	-9,4	15,50
2000	4.926,63	49,6	65,06	50,42	-16,4	24,87
2001	4.678,44	40,6	-22,21	59,39	11,8	19,16
2002	5.036,12	40,8	8,16	59,20	7,3	21,82
2003*	6.038,50	43,7	28,48	56,28	14,0	25,66

Source: BCE, Totales de Exportaciones e Importaciones, at December 2003

***2003: contribution of oil and non oil sector at own estimation**

Since the introduction of dollarization, the inflation rate has gone down to below 10%, though in a very slow process of over two years after its introduction, and at end 2003 has settled at 6,1%. Only for 2004 – four years after the introduction of the dollar – an acceptable inflation rate of around 2% can be expected. However, producers' prices have risen considerably after the tremendous depreciation that took place in fixing the exchange rate of the Sucre in the process of dollarization. In 2001, this trend slowed down, partly due to the dollar devaluation to boost US exports, yet due to higher price indices real exchange rate appreciation has become a problem: Adding to the accumulated appreciation of previous years it puts Ecuador's export products at a disadvantage on the world market.

Graph 8: Development of the Producer's Price Index (1995=100)

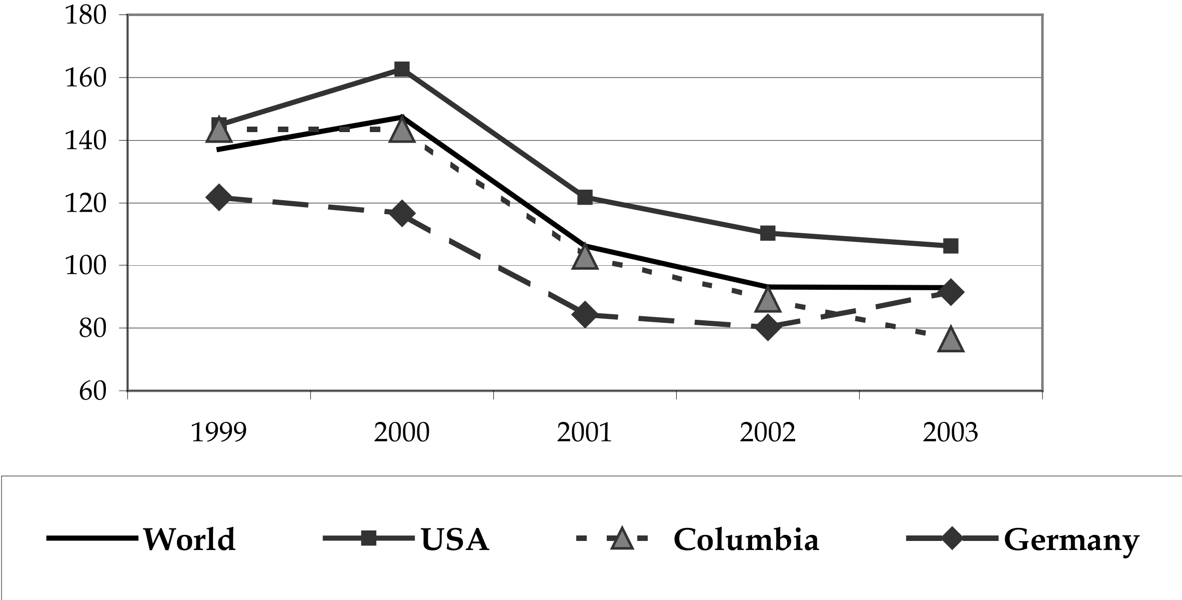


Source: Banco Central del Ecuador, Boletines Estadísticos, May 2004.

Moreover, the appreciation of the real exchange rate promotes higher imports, which – as we have seen above – have caused the deterioration of the trade balance in recent years. Graph 9 below shows the development of the real exchange rate and of the bilateral exchange rate with some important trading partners. Here we can see that the advantage that was meant to be given to the export sector through the huge devaluation of the Sucre has long gone.

As the US$ has been very weak with regard to the Euro, there is a slight easing of the situation for the Eurozone (see Germany). However, Europe is not the most important trading partner for Ecuador (12% of total). On the other side, the real exchange rate has continued to deteriorate towards those countries that exchange most with Ecuador. Especially alarming is the development of the bilateral real exchange rate to neighbouring countries, such as Columbia and Peru, and other Latin-American countries. They are not only an important partner for regional trade that buy about a third of Ecuador's exports, they are also the countries that compete with Ecuador on the market with a partly similar range of export products. Here, naturally Ecuador looses its competitiveness. Especially small and medium size exporters will feel this and indeed already have: According to a study of the CORPEI (Corporation for Promoting Exports and Investment), of 1778 exporting companies that existed in 2002, in the first half of 2003, 963 had to shut down due to problems of competitiveness.

Graph 9: Development of Ecuador's Real Exchange Rate with regard to the rest of the world and some relevant trading partners

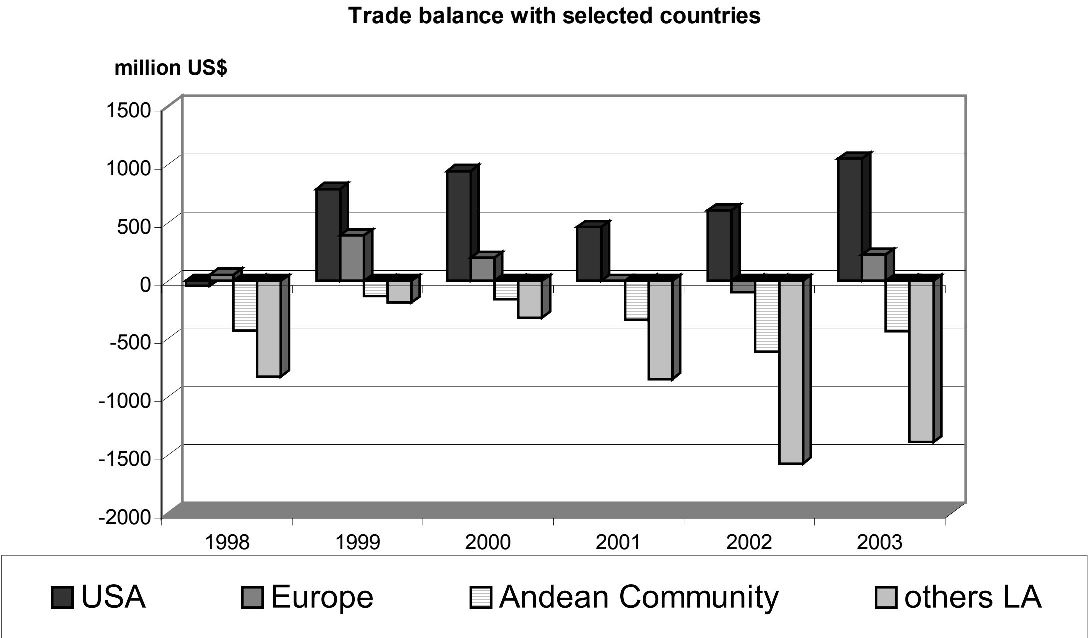


Source: BCE, 2004, 1994 = 100

With regard to the development of the regional trade, the graph (10) below shows clearly, how the trade balance has deteriorated with these countries. Ecuador, formerly exporting rice to Peru, now has to import it from there. Another example of reversed trade structures is the newly arisen import of textiles from Columbia. Although increased exports with the USA so far have compensated for these developments, Ecuador runs the risk that with concentrating exports further to the USA there will also be a concentration of export products, especially oil and banana, rather than the desperately needed diversification of exports. Once the US Federal Reserve decides that the dollar should get strong again, the real exchange rate especially to other Latin American countries will get under pressure again.

A weak US$ and especially the very high oil price have covered the problems of loosing competitiveness in the overall trade balance. In 2003, the level of export could only be maintained through high petrol prices and a constantly high level of emigrants' remittances.

Graph 10: Trade Balance with selected countries



Source: BCE, 2004

Recession of internal productive sectors and internal demand

Due to the characteristics of the oil sector as an enclave industry the boost in this sector stemming from increased extraction and most of all high oil prices has not lead to a comparable boost of the other productive sectors or new linkages. Thus, there is a strong contrast between a very intense growth of the oil sector and tendencies of recession or slow expansion of the rest of the economy, both production of goods and of services. This is also reflected in the fact that there is stagnation of government expenditure and a very slow evolution of private household consumption, while high concentration of growth benefits hamper the improvement of public consumption at a time of reluctant investment and little creation of employment. The dynamics seen in the export growth does not have positive effects on internal demand. After an estimated growth of 6.0% in 2004 (due to a 23% growth in the oil sector), the projections for next year are going down again to 3%. This shows that the boost in the oil sector has not lead to a reactivation of the economy as a whole.

The reactivation of the economy is also severely threatened by high interest rates. While inflation could be brought down (although too slowly) to about 2% by 2004, the nominal interest rate could not be brought down to the same extent, so that the real cost of credits remains high, much higher than the international rate. Especially the interest rates of private banks have resisted the decrease of inflation due to the international country risk and the parlous state of the enterprises and internal economy.

Table 6: Interest Rates of Private Banks (average rates)

Year	Operations of 30-83 days		Máxima convencional 2/	
	Nominal	**Real 1/**	**Nominal**	**Real**
2002	15.9	3.0	21.8	8.3
2003	14.9	6.5	18.2	9.5
January - August 2004	13.1	9.7	16.2	12.7

Source: BCE, Información estadística Mensual, septemer 2004.
1/ Using as deflator the CPI.
2/ Mostly used for consumers

The little positive effects on the productive non oil sectors of Ecuadorian economy, further limited by high real interest rates and restrictions of the state's budget, generate in the domestic economy tendencies of recession or at least slow evolution and a parlous state of employment. More than half of the economically active population – unemployed and underemployed – find themselves in such a parlous state of occupation and of low annual income, with the logical consequence of low consumption and little hope to overcome this situation.

Socially irresponsible

Poverty and social development in Ecuador

Policies of structural adjustment have been applied in Ecuador since 1982. So far, they were not able to overcome the country's structural problems with regard to sustained growth, poverty and lack of employment. The contrary is the case: Income distribution and social inequality have increased. This is an essential factor with regard to further development and poverty eradication, as higher inequality means that more growth is needed to reduce poverty.

After the lost decade of the 1980s with a negative real economic growth per capita of –0.6%, Ecuador experienced also a difficult period in the 1990s with a severe crisis towards the end of the decade and consequently a stagnation of per capita income 1990 and 1999 (CAS, 2003: 9). Regarding a longer period, the picture looks just the same: GDP per capita has only grown 0,2% annually between 1975 and 2001. After the severe economic and banking crisis in 1999, Ecuador has dropped back in the HDI ranking from position 72 (1999) to position 97 (2003) (UNDP HDI 2003).

Potentially a rich country, Ecuador is one on the poorest in South America, with a high portion of poverty and absolute poverty. Income poverty rose from 34% to 56% between 1995 and 1999, and is much higher in rural areas (77%) and indigenous rural communities (over 90%). About one third of the rural population lived in extreme poverty in 1999 and the crisis of 1999 ruined most of the gains of urban poverty reduction of preceding years (CAS, 2003: 9f.).

Also some other relevant poverty indicators range among the worst in Latin America: The infant mortality rate was at 24 (per 1.000 life births) in 2001 (UNDP HDI, 2003). The (urban) unemployment rate was at 9,4% between 1990 and 1999, with a tendency to worsen since the year 2000 and a constantly high level of underemployment (around 55%). In March 2004 unemployment reached 11,9%, the highest rate since April 2001 and a considerable increase since January 2003 (8,2%). Worst hit with unemployment is the Coast. Underemployment which includes those workers that work half

time or receive less than the minimum wage, including the informal sector, was at 43,2%, as compared to 32,1% a year earlier (Dow Jones, 06.04.2004). Indicators like primary and secondary school enrolment have hardly changed since 1990 and are considerably lower in rural areas and among indigenous groups.

An accompanying negative effect of the bad labour situation in the country is the ongoing emigration. Since the middle of the 90ies, when the economic crisis started, there has been an increased flow of migrants, mainly working force with an above average education. 500.000 migrants fled the country since 1997, i.e. about 10% of the economically active population, leaving one in 12 children with at least one parent abroad (CAS, 2003: p. 11). The brain drain continues: The annual INEC survey reveals a considerable shrinkage of the Ecuadorian workforce, with 162,000 people dropping out of the economically active population from December 2002 to September 2003; presumably this is mostly due to emigration (www.ecuadoranalysis.com, December, 29th, 2003). With 1.5 billion US$ annually the migrants' remittances nowadays are the second most important source of foreign currency. Thus, in a way, Ecuador is exporting its poverty.

Dollarization may have helped to generate more quickly economic growth and lower the inflation rate and consequently poverty has declined since 2000, however, "the benefits of economic growth since dollarization have accrued to a greater extent to wealthier Ecuadorians, and inequality has continued to rise […], as new employment opportunities for workers lagged behind the recovery in economic growth, and a large one-time adjustment in prices led to an initial decline in real wages" (CAS, 2003: p. 10).

The level of the minimum wage in Ecuador has deteriorated more than in all other LA countries except Uruguay between 1995 and 2002 (CEPAL, 2004: 40) and has reached 166.10 US$ (in the private sector) since the beginning of 2004. With the inflation being brought down recently, real wages, that had gone down by 2000 to buy only three quarters of what they had bought before, have recovered to the levels of the mid-nineties. Still, it needs more than 1,6 recipients of a minimum wage to obtain the critical items of the consumption basket for a family of four which currently is calculated at 270.14 US$. The basic consumption basket of goods lies even higher at 385.58 US$ and would need 2.3 times the minimum wage. In the beginning of 2004, the minimum wage has reached the acquisitive power it had in 1995, i.e. nine years lost in development. However, with a high level of un- and underemployment and a very bad social security system it should be kept in mind that the minimum wage is far from being the minimum amount every Ecuadorian can count on, which can also be seen in the high level of income poverty.

Moreover, and this brings us back to the previous chapter, the recuperation of real wages (minimum and average) through the increase of the wages, in a dollarized country necessarily means a relative increase in the cost of labour with regard to especially neighbouring countries, thus resulting in the loss of competitiveness previously mentioned (ILDIS, 2004: 41).

Towards the Millennium Development goals?

At the UN-Millennium Summit in 2000 member nations agreed on a number of development targets, known as the Millennium Development Goals (MDG). The first goal is halving the level of poverty by 2015 (basis year 1990). According to a World Bank analysis from the Latin American Unit it will be "very unlikely" for Ecuador to reach this first goal, though some objectives for other indicators in the

health and education sector might be met. This analysis parts from an average growth rate of 2.7% (calculated by the World Bank) and includes some other social variables. (Hicks & Wodon, 2002: 4)

Much stronger and unfortunately much more pessimistic is the picture the UN Economic Commission for Latin America and the Caribbean (CEPAL) draws when including the variable of income distribution in projecting the probability to reach the goal of cutting poverty in half. In their simulation the development of both variables, growth and income inequality in the 1990s are prolonged in the future. Because of an increase in income inequality, according to this simulation, Ecuador is one of five countries that would actually see higher levels of extreme poverty.

Indeed, income concentration has increased between 1997-2002 more than in all other Latin American countries except Argentina (CEPAL, 2004: 21). This continues the road of the 90ies, when Ecuador was one of the very few Latin American countries to increase income inequality. While the richest 10% of the population received 11.4 times as much than the poorest 40% in 1990, this relation increased up to 15.7 times as much in 2002 (CEPAL, 2004: 73). "In fact, the increases were sufficiently large that, if extended forward and combined with the observed growth rates in the 1990s, poverty would continue to increase indefinitely and there would thus be no convergence towards the Millennium poverty targets at all" (CEPAL et. al., 2002: 29).

This analysis parts from the poverty data obtained in 1999, when poverty in Ecuador was at an temporary high because of the economic crisis. Fortunately, more recent data lead to believe that the pre-crisis poverty level could be re-established at least in urban areas (CEPAL, 2004: 54). However, the analysis makes a very strong point (and this does not only count for Ecuador) for something that is not really new, yet never has found its way to resulting in new economic policies: Redistribution of income is desperately needed to obtain the Millennium Development targets. This has also been supported by a more recent CEPAL study, which finds that a better income distribution would lower the necessity of growth to reach MDG or make them be reached much earlier. An average growth rate of 5.3% (4.0% per capita) would be necessary for those countries with medium level of poverty to achieve the MDG of halving poverty by 2015. However, a reduction of 5% of the GINI Index could fasten this process by up to five years (CEPAL, 2004: 65f.). If we accept the more realistic average growth projections of the World Bank of 2.7%, Ecuador "could meet [its] targets with respect to the international poverty line by combining average annual growth rates in GDP per capita of less than 3%, with cumulative reductions in their Gini coefficients of less than 4%" (CEPAL, 2002: 44). Regarding the fact that a quarter of a century of stagnating per capita income lie behind the country it is about time to fight the biggest enemy of poverty reduction: income inequality.

Policies of redistribution are needed

In spite of the well established knowledge of the necessity to reduce income inequality, past and current policies are rather biased against the poor, which can be seen in the "disproportionate tax burden borne by lower-middle income compared to higher-income Ecuadorians, subsidies that disproportionately benefit the richer half of the population, the low level of social expenditures compared to other Latin American countries, and the low quality of those social expenditures, whether in terms of the efficiency of public services, or the degree to which they are targeted to the poor, or the degree to which they provide an countercyclical support to the poor" (CAS, 2003: p. 12).

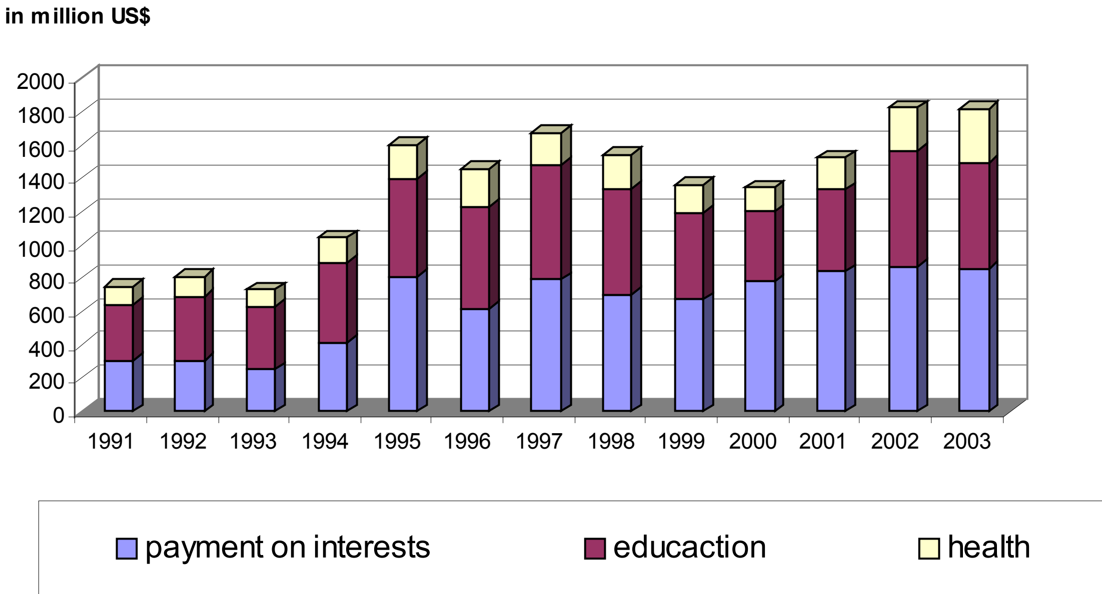
The only focus so far has been growth, which undoubtedly is essential for poverty reduction, yet must be combined with policies of equalling income distribution. With regard to the envisaged growth it

should develop its own distributive possibilities in concentrating on broadening the domestic basis for productivity and income generating measures rather than focusing on exports in capital intensive industries such as for example the oil sector. However, specific measures of redistribution must accompany growth supporting policies to secure that economic growth will also lead to improve rapidly the living conditions of the poor.

Nevertheless, progressive policies are not on the agenda. The opposite is the case: In taxation, for example, the VAT has been increased in recent years and since the beginning of the 80ies has multiplied its share in total non-petrol revenues. While in the beginning of the 80ies the contribution of the VAT to revenues was more or less equal to the contribution of the income tax, by 2001 the former made up for 40.6% of non-petrol revenues while the latter only contributed with 15.2% (UNDP, 2003: 153). In march 2004, the VAT amounted to 159.8 million US$ while income tax was 64.7 million US$ (Reuters, 14.04.2004). The increasing dependency on indirect taxes will not help to stop the deterioration of income distribution. Thus, the growing amount of debt servicing from the beginning of the 80ies onwards has led most governments to fall back on regressive policies to improve the balance on the income side.

Moreover, fiscal constraints and the compulsion to household consolidation in the adjustment period, together with rising expenditure on debt servicing have left their marks on the structure of public expenditure. In 1986 debt service contributed with 24.0% of central government's expenditure and equalled more or less the expenditure on education (23.5%), while central government spent 6.7% on health. In 2002 41.2% of the government's budget was spent on debt servicing, while education participated only with a sad low of 9.0% and health with 3.1%.

Graph 11: Government Expenditure on Interests and Social Services



Source: BCE, Boletines Estadísticos, May 2004

In the last two years, debt servicing has been rigorously paid, in spite of its high and further rising amount. In the first 8 months of 2004 2,440 million US$ have been paid in debt servicing, which corresponds to 107% of the amount foreseen in the budget. The high assignation of resources into debt servicing goes along with a very low fulfillment of obligations in the other components of the

budget as can be seen in the table (7) below. In the first 8 months expenditure on debt service has increased by 53% with regard to the comparable period a year before. In the same period, disbursements in education and health have been reduced to about half of the disbursements made the year before.

Table 7: Budget Expenditure of Central Government according to sectors (January to august of each year)

Million US$	2003	2004	Growth rate(%)
Debt service	1.595	2.440	53.0
General services	1.325	1.269	-4.2
Health and communal development	188	84	-55.3
Education and culture	371	186	-49.9
Agricultural Development	61	28	-54.1
Transport and comunication	110	57	-48.2
Other	126	60	-52.4
TOTAL	3.776	4.124	9.2
Budget	6.701	6.951	3.7
Percentage effectuated in 8 months	56.3	59.3	

Source: Central Bank Ecuador, Información Estadística Mensual.

Thus, although the 2004 budget (as well as the 2005 budget) actually provides for an increase in expenditure in education and health up to 2.8% of GDP and 1.3% respectively, disbursements in the current budget are far behind the schedule. The rigorous priority that is given to the payment of interests and amortization leaves very little room to comply with promised assignments for the other budget components.

While many conditionalities set in the current (and past) IMF Stand-by agreement might be sensible for budget stability, the inherent social impacts, especially with regard to subsidies' cuts, unfreezing of tariffs, freezing of wages etc. are a considerable attack on social welfare. These measures are carried out on top of the continuous decrease in social spending. And the poor have the weakest lobby. One example of last year shows how the budget surplus objective was again settled on the back of the poor: It had been agreed in the structural adjustment programme that an increase in the *bono solidario* should compensate the poorest sector for the rise in tariffs. However, the pressure to lower expenditure in the fiscal year led the government to introduce this increase not immediately but only more than half a year later, after the IMF itself had reminded the government of this omission.

The price paid: Political Instability

The austerity measures decided by Gutiérrez right from the beginning of his presidency have left him without the political basis that supported him in his election campaign: the indigenous movement and the poorer social sectors. For a few months Gutiérrez found new political allies, basically the right wing Social Christian Party (Partido Social Cristiano – PSC), that represents mainly economically powerful sectors of the coast. They didn't formally pact with Gutiérrez' party Patriotic Society (*Sociedad Patriótica*), but supported him on a case to case basis. In the first days of April, however, the leader of the PSC publicly pronounced the end of this alliance because of corruption within the government (Reuters, April, 12th2004). This leaves Gutiérrez with 5 deputies of over 100 in Parliament. Now even louder, critics of the opposition request the president's leave. Left without a political basis in Parliament it

seems highly unlikely that Gutiérrez will be able to accomplish both his term and the projected reforms. Lacking support by both right-wing as well as left-wing parties, Gutiérrez will now confront even greater difficulties to bring forward the reforms requested by the IMF. Consequently, in April the Minister of Economics, Pozo said, that the political dynamics in the country impede the implementation of structural reforms and that it was his fault having tried to change too many things at the same time. (Notimex, April, 12th 2004).

To survive politically Gutiérrez has to make concessions to potential allies, as for example the military: After an increase in their salaries in the middle of April, the Armed Forces reiterated their support of the head of the State.(AP, April 16th 2004, El Universo, April 21st 2004). It speaks for itself that the government has to "buy" the support of the Military and shows how delicate the political situation actually is. In the same line are the concessions Gutiérrez had to make to the demonstrating teachers or other state employees. In May 2003 the teachers of public schools went on strike for over four weeks. Unable to end the confrontation in another way, Gutiérrez promised an increase in wages; a promise he didn't comply with until January this year after a second wave of strikes. But not only teachers, also personnel of other public sectors such as e.g. the health sector have gone on strike requesting not only an increase in payments but sometimes just plainly being paid at all. Most recently, prison guards stopped their strike against desolate working conditions after 28 days, after being promised a budget increase of 300.000 US$ a month (el comercio, April 20th 2004). Perceived deprivation is high in Ecuador and brings about political tensions. Therefore, these concessions are not only a measure to remain in power but also sometimes the only remedy to avoid political unrest. However, the government's budget is very tight and under pressure not to raise government spending. According to the IMF agreement, there would be no room for an increase in the wage bill – and the IMF is watching closely. Being unable to confront strikes other than with raising salaries, the government will not be able to fulfil both, the promises made to the strikers and a rigid policy with regard to government spending. This shows very clearly the conflict between budget and political stability as well as the indissoluble dilemma of combining austerity measures with a poverty oriented policy.

The strike wave and the deteriorated popularity of president Gutiérrez - in a recent opinion poll only 16% voted for Gutiérrez (AP April 13th 2004) - show that people are no longer willing to bear the burden of the austerity policy on their backs. Until now, a broad grass-root opposition has not developed. However, following an attack against Leonidas Iza, the leader of the Confederation of Indigenous Peoples of Ecuador (CONAIE, the main indigenous peoples' organisation), in early February, the indigenous movement has regrouped and plans further potentially destabilising nationwide protests in the coming weeks (Economist, February 26th 2004 EIU). A speaker of the CONAIE stated that the final goal is Gutiérrez' resignation.

The IMF states in its well-known logic that "there is no room for slippages" to maintain the fiscal objectives of the program acknowledging at the same time that "tasks will require patience and perseverance, and careful coalition building, given that Ecuadorian society is very divided along income, ethnic, and regional lines" (IMF, 2003: 4). Given the fact, that consumer prices in the dollarized country still rise by 6%, that the minimum wage can still not pay by far the basic consumption basket, that real wages by now only have reached the level they had in the mid-nineties, and that per capita income has virtually stagnated over 25 years, the logic should be the other way round: There is no room for fiscal adjustments that harm the poor and are a threat to political stability to reach the fiscal objectives and secure debt servicing.

Ecologically disastrous

Oil – curse or blessing for the people?

Twenty years of structural adjustments have also left their marks on nature. Where export boost has diversified over the years it was above all within the range of other primary commodities (oil, bananas, café, shrimps, flowers etc.). The boost of exports has thus put heavy pressure on natural resources. However, export boost has not boosted likewise the country's growth and wealth, as we have seen above. Especially in the oil sector, the export boost in the middle of the world oil crisis and increased creditworthiness lead to the dramatic rise in foreign debt, due to uncontrolled over-borrowing, supported by the very eagerness of creditors to lend the oil money profitably. In the end export earnings were used more and more to cover debt servicing. In 2003, Ecuador spent 37% of its export earnings on servicing its public debt, 22% of export earnings were spent on external debt servicing. Thus, debt was not only paid off with the foreign currency obtained from exports, but also with the most valuable resource Ecuador has and now partly has lost forever: its nature and biodiversity.

While the tremendous devastation of the mangroves for increased shrimps production is an example of more recent irretrievable destruction of highly valuable and sensitive biospheres, the most long-lasting and probably the worst damage has been done by oil industry. Since extraction began in the 70ies, over 76 million litres of oil ran out of leaks, with over 14 major spills only in the past 3 years. Toxic residues and drilling waste and their consequences can still be seen in many parts where oil extraction took place or one of the numerous spills due to earthquake, landslides or volcano eruption took place.

The poor have benefited little from oil exploitation, neither in the area of oil production itself, which still ranges among the poorest in Ecuador, nor the poor in general in the country, as growth, and especially pro-poor growth, has failed to come. This corresponds to the findings the recently published Extractive Industries Review, commissioned by the Worldbank, came up with: Many of the countries that depend heavily on the extraction of natural resources have not made substantial progress in economic growth since 1960 (EIR, 2004: 12). Also the performance of the Ecuadorian governments in handling the oil sector in the past 30 years is very poor. As we have seen, the country has seen decades of little or no growth and has instead accumulated large sums of debt.

The authors of the EIR found that in order to make extractive industries productive for poverty alleviation, good governance, transparency, no corruption and a good and countercyclical management of resources is needed (EIR, 2004: 12). All these are not precisely the attributes former and current governments in Ecuador can actually dress up with. A comparison of the EIR-findings from detailed research in three developing countries and the situation in Ecuador makes clear that the activities of the extractive industries in Ecuador could not meet the only justification for the massive environmental destruction that could possibly be brought forward: poverty alleviation.

Table 8: Conclusions drawn from EIR in comparison with the situation in Ecuador

Conclusions drawn from EIR-related research in Peru, Tanzania and Indonesia	Situation in Ecuador
1. Revenue often not transferred to affected communities Although in some countries laws are created to secure that revenues go back to the affected communities, these laws have shown little to no effect.	Especially the Amazonian communities and indigenous peoples have not seen any wealth being transferred back to their communities. They have seen stagnating or increasing levels of poverty as well as labour migration and increased rates of cancer and deaths due to polluted drinking water and soil.
2. Increased social antagonism and conflict Often social unrest accompanies investment activities in extractive industries under the structural reform programmes which again has had direct negative impacts on the investment climate in the country.	In the light of past experiences with oil extraction, the aggressive government policy to extract as much oil in as little time as possible and the ruthless way it ignores the interests of affected people as well as national law, while militarily supporting the profit oriented interests of the oil companies, has raised severe conflicts between affected communities and oil companies/ military.
3. Exacerbated macroeconomic imbalances. Countries have shown increased vulnerability to external shocks, due to increased dependency on primary commodities and other negative effects, such as stifled private sector development.	Ecuador is one of the countries in Latin America with the most weight of primary products in its exports. Economic development in the past virtually is a reflection of oil prices.

Sources: EIR, 2004: 14 Several Sources, news agencies, etc.

In spite of all these negative experiences and unfavourable conditions, far away from coming to an end, the policy of increased dependency from oil is now even intensified. Increased oil production in Ecuador is linked to the building of a new pipeline for heavy crude oil by a private corporation (OCP Limited) and increased extraction by its shareholders basically in the Amazon jungle to fill the pipeline. If not ecologically, how can there be a contribution to sustainable development? The EIR argues that extractive industries can only be seen as being a source of sustainable development "if it improves the welfare of future generations by, for example, raising other forms of capital, such as human capital (if revenues are used, say for education) or social capital (EIR, 2004: p. 3f.).

However, in the logic of the IMF the benefit of the entire Ecuadorian population from oil production can only be achieved if revenues are spent in debt servicing. Even in the Worldbank's Country Assistance Strategy remaining oil reserves are solely seen as a source of rapid income, as "[t]here are few industries in which Ecuador could increase production as rapidly as in hydrocarbons", although at least recognizing that Ecuador "has fallen short of best practices in ensuring adequate prevention and management of potential environmental and social impacts." (CAS, 2003: p. 15)

This again corresponds to the findings of the EIR. While IMF programmes are concerned with short-term macroeconomic stabilization, they usually do not consider the soundness of social and environmental policy or institutional frameworks. Thus, where extractive sectors play a role, according to the IMF's approach it is one component to promote aggressive privatization for short-term deficit financing. "This did nothing to ensure the creation of competition, efficiency gains, development of a

domestic private sector, or environmentally and socially sound development strategies for the extractive sectors" (EIR, 2004: 16).

The OCP project

The new pipeline of the oil consortium OCP Ltd. traverses with a length of just over 500 km the country from the receiving terminal in Lago Agrio in the Amazon region, over the Andes, to the harbour on the Pacific coast at Esmeraldas. On its way, it passes seven protected areas of sometimes unique biodiversity and several active volcanoes. Highly sensitive biodiversity hot spots, South America's first "Important Bird Area", and the water reserves of Papallacta that provides parts of the capital Quito with drinking water are affected by the operation of the pipeline. However, far worse is the foreseeable damage the heavily increased oil exploitation will have on large parts of the Amazon rainforest as well as indigenous peoples who live there.

OCP has the capacity to transport up to an additional 450.000 bpd of heavy crude oil and thus double oil exports. Although for most of its trajectory it roughly parallels the 30 year old SOTE pipeline, just near Papallacta it deviates from the SOTE to pass north of Quito. Particularly but not solely this deviation has been subject of high controversy because it is here that it traverses the most rich and sensitive protected areas, including the Mindo Nambillo Cloud forest reserve.

OCP's Environmental Impact Assessment (EIA) was not carried out by independent experts, nor did it include a serious analysis of alternatives. The decision in favour of the controversial northern route, "the most important decision of the entire OCP construction - that should have been taken by means of the EIA process - was taken long before the EIA began." (Goodland, 2002: 1). Other severe failures are the lack of adequate public consultation with affected people, analysis of impacts on Natural Habitats, including an evaluation of the main impacts of increased oil production, violations of legally protected conservations areas, the lack of a full socio-economic analysis, including a participatory resettlement plan and adequate (preferably land-to-land) compensation. Thus because of time pressure and fiscal constraints, the government in its obedient way to serve creditors' and investors' interests conducted clear violations of national and international law, human rights and Worldbank standards (which OCP had several times stated to comply with, a misrepresentation revealed by the long-standing Worldbank employee Dr. Robert Goodland who was one of the fathers of these standards).

Protests and conflicts:

Both, the process of the building of the pipeline and the increased extraction activities necessary to fill it, are highly controversial and source to large protest movements worldwide and severe social conflict in the country, because of the violation of national environmental law and human rights as well as grave environmental damage.

Indigenous people consider the activities of the oil companies in the area to be a serious threat to their traditional living space. The Huaroani who live in the Yasuni National Park, declared biosphere reserve by the United Nations in 1989, have been fighting against oil exploitation for years. Equally, indigenous people in the southern rainforests (including exploration blocks 23 and 24) have been fighting and indeed prevented oil work in their area since 1998. In May 2003, the peoples of the Shuar, Achuar and Zápara again expressed to the media their opposition towards oil exploration in their area.

All these conflicts between indigenous people and oil companies have become more intense since the government has built large parts of its fiscal programme on rapid increased oil revenue and has come

under time pressure to fulfil these commitments. Now even less than before, consensual solutions are sought, instead police and armed forces together with private security companies are sent to enforce the interests of the oil companies and meanwhile form part of every day life in the Ecuadorian Amazon region. In October 2003, the government decided to reinforce military and police control in the Amazon region to break indigenous resistance and allow oil companies to realize their projects. Again, the government sees its duties primarily in securing investors' and creditors' interests rather than considering to protect legitimate interests of its own people that have elected them. A rather absurd situation occurred when the US-based company Burlington had to call back the Ecuadorian military after it had announced to use force against their own people to overcome indigenous protest.

It is most of all bad experiences the indigenous people have had with the policies of the oil companies, practiced in the past, such as for example the policy of scorched earth and the dreadful waste management, that intensifies the conflicts. What the affected people see is that all the wealth of the nation goes through their region, while they are still among the poorest in the country and all they are left with is polluted environment and toxic drinking water. To many of them monetary wealth is only a small part of development. Rather, "secure, effective, and collective rights to lands, territories, and resources traditionally owned or otherwise occupied and used are fundamental to their economic and social development, to their physical and cultural integrity, to their livelihoods and sustenance, and to their understandings of poverty and poverty alleviation" (EIR 2003: 4). Thus, it is fully understandable that indigenous people must see the activities of the oil industries as a threat to their welfare, especially if they do not see any benefits of it, as has been the case in the past.

In view of the tremendous distrust it would be essential and indeed the only viable solution to start a fair and equal dialogue and seek consensus with all stakeholders. However, the fiscal pressure on a very short term basis, makes a fair balance of interests impossible. Instead a common strategy among oil companies is to win over with money and gifts some leaders and thus split communities or make use of the juridical inexperience of the leaders and make them sign contracts that are clearly to their disadvantage. The fight the indigenous people are so highly committed to take on is unfair on all fronts.

Rapid income vs. long-term costs

Oil reserves in Ecuador are very limited. Even less conservative calculations estimate the proven reserves at 4,400 to 4,576 million barrels (IMF, 2003b: 28). At the improved extraction and transportation rate of about 700.000 barrels a day (including the capacities created by the building of the OCP) these reserves would run out by the year 2021. However, even the IMF itself states the insecurity on whether all proven reserves could be "extracted at economically viable costs" (p. 29), raising both environmental concerns and the risks of increased extraction costs due to the transportation problem, opposition in the country, earthquakes, mud slides etc.

So far, the oil sector contributes with around 20% to nominal GDP and up to 50% to public income. The oil factor is extremely potent in times when oil prices are high, while a drop in oil prices has frequently lead to contraction of the economy. Thus, the IMF states correctly: "Policies need to be directed at correcting these imbalances [oil economy vs. non oil economy], in light of the projected sharp decline in remaining oil reserves." (IMF 2003b: 28) However, current policies with the scheduled duplication of oil export seem to be directed to the opposite direction. And as oil reserves are low, Ecuador must pay off its debt as long as they still have oil income.

Doubling extraction does not lead to double revenues by the state, as private companies are the winners. While public sector revenues from current extraction amounts to around 50% of total value, the same amount of lower quality oil only hands over about 5-7% of total value to the budget (IMF, 2003b: 35). With the state owned PetroEcuador running below capacities and still having to import petrol derivates at an amount that actually surpasses the expected income on OCP oil revenues, the question remains, whether improving PetroEcuadors capacities and productivity would not have been the better investment.

At the project or local level there could be a contribution to development as extractive industries' activities "can create job opportunities for local people, encourage local businesses, and provide vital infrastructure for remote communities that do influence development positively, such as roads and education and health care facilities" (EIR, 2003: 17f.). These positive effects have not materialized in the oil sector so far and will hardly come up in the future. It is estimated that after the construction of the new pipeline only very few direct long-term jobs will remain, including many high skilled workers that frequently are recruited from outside the area or even abroad (Amazon Watch, 2001: 10). Where a larger number of workers is brought to a region social problems can occur such as "alcoholism, gambling, prostitution, and violence against women. People's health can suffer as due to the influx of new people or pollution from the site. The existence of new 'winners' and 'losers' from a project may cause rifts in communities. Women are often particularly at risk from the social disruption caused by new projects" (EIR, 2003: 5). Thus, the possible job creations must be weight carefully with the loss of a healthy environment that is so essential to the welfare and perceived wealth of the people who live there. Moreover, they have to be weight with the loss of viable income many people along the pipeline currently receive through their occupation in eco-tourism. This sustainable source of income that directly benefits many lower income segments of society could be lost forever in some parts when just one mud slide courses a major oil spill.

This is not the vision of perpetual grumblers. The implementation of the "oil for debt" logic comes along with high ecological risks resulting both from the location line of the new pipeline and most of all from the pressure to open new wells in the Amazon region. The pipeline will have to resist frequent earthquakes, mudslides or volcano eruptions. Accidents that already occurred in the construction period have caused major destruction on the pipeline, which fortunately had not yet been filled with oil, and point to the fact that the material used is not top quality. These ecological risks and expected environmental damage from increased oil exploitation have an economic dimension that so far have been included in calculations about the viability of the financing model "oil for debt".

To judge the economic dimension of the ecological and social risks the regional Ministry of Environment of the German State North Rhine Westphalia[2] has commissioned an analysis of a public research institute on developmental issues (Deutsches Institut für Entwickungspolitik – DIE). They see the ecological risks in the persistent functioning of the old pipeline, as well as in the location line of the new pipeline. The ecological risk is increased by the large fiscal interests of the government, which will put heavy pressure on nature reserves. Together with the undesirable socio-economic changes of society and violent social conflicts that are expected to arise, the danger of slowing down the diversification of the economy, a particular threat to the increase of ecological tourism as an

[2] As financing for the new pipeline is provided by a German public bank, the regional parliament of North Rhine Westphalia has discussed the dimensions of the OC P project several times.

ecologically sustainable alternative their conclusion is very clear: The short-term macroeconomic benefit are clearly opposed to long-term economic costs due to environmental and social risks.

In a forward looking strategy it would have been wise to adopt a policy that now has been recommended also by the EIR (2004: p. X): "Any extractive industry projects financed within a known 'biological hot spot' must undergo additional alternative development studies. Clear 'no-go' zones for oil, gas, and mining projects should be adopted on the basis of this [Natural Habitat] policy." In a country with a very low standard of rule of law, combined with a high level of corruption it is tremendously irresponsible towards nature and the population to leave them in the hands and interests of oil companies and the military.

Industrial countries have committed themselves at the U.N. Conference on Environment and Development in Rio 1992, and ten years later at the World Summit on Sustainable Development in Johannesburg to support developing countries in conserving natural resources to avoid climate change. Instead of keeping their promises to achieve these internationally agreed objectives, Ecuador's creditors rather have decided to support the ruinous exploitation of natural resources, putting even up with severe human rights violations, as they are not willing to grant substantial debt relief as an exceptional and creative measure to meet their promises. If Ecuador had its debt reduced to an economically, socially and ecologically sustainable level, it would not have to over-exploit its most precious natural asset: biodiversity.

Fiscal risks – The problem with debt sustainability

Perspectives of sustainability

Based upon the above mentioned findings and on our hypotheses for the period 2005-08, the following perspectives seem likely:

Table 9: Macroeconomic Projections

	2004	2005	2006	2007	2008
GDP Nominal (millions US$)	30.015	31.719	33.184	34.418	35.867
Oil price per barrel (US$)	28 to 30	32.2	29.9	25.9	25.9
Growth rate of real GDP (%)	6.0	3.3	3.8	3.0	3.6
Annual inflation (%)	2.5	2.1	0.8	0.7	0.6
Trade balance (millions US$)	-460	60	70	110	20
Exporting goods (millions US$)	7.350	8.240	8.560	9.080	9.600
Importing goods (millions US$)	7.810	8.180	8.490	8.970	9.580
Current account (% of GDP)	-0.4	-0.3	-0.1	-0.1	-0.1
Deficit of central government (% of GDP)	-2.6	-2.4	-2.3	-2.8	-2.7
Total external debt (public & private % of GDP)	55.1	53.9	50.1	47.8	45.7
Public debt service (domestic & external % GDP)	11.6	11.6	11.1	10.1	10.5
External debt service (% of exportation)	19.9	19.2	18.8	17.1	15.5

Source: For 2004 Central Bank of Ecuador. For the following years projections by Jubileo 2000 Guayaquil

a) Oil price

It is likely that in 2005 the oil price for Ecuadorian oil remains as high or even higher than in 2004 (Merrill Lynch, Emerging Markets, 30 to September, 2004); but it is also expected that in the following years prices will decrease to less than 26 dollars per barrel. It is also likely that the expansion of the annual volumes of extraction and exportation of crude oil will slow down. These circumstances could attenuate - in comparison with 2004 - the impact the oil sector has on the country's economy and national finances. Even if the hydrocarbon exports would increase, that would not necessarily increase state revenues, especially the ones corresponding to the budget of the Central Government. And if the reference price used in the budget will continue to be set below the real market price, the bigger part of the revenue of the crude oil will go to the FREIREP.

b) Trade balance

An increase of exports will depend, on the one hand, on oil exportation; but could also be caused by an improvement of trade relations in other sectors due to international agreements such as the TLC or with the MERCOSUR. However, these agreements will also affect imports. In spite of that, the negative trade balance of 2004 is likely to become positive from 2005 onwards, although only slightly, surpassing in 2007 100 million USS, and descending strongly in the year thereafter.

c) Current account balance

The balance of current account being negative, will probably stay so until 2008, but it will attenuate because of the diminution of external debt service. For the end of 2004 is anticipated negative balance by 118 million USS, sensibly smaller than of the previous year (-455 million USS). Starting 2005 this deficit is forecast to be located below 100 million USS.

d) Inflation

The inflation, measured by the urban consumer price index, has steadily decreased in recent years; it fell from 37,7% in 2001 to 7,9% in 2003, continuing to drop in 2004 when it will probably reach 2.5%. This tendency is likely to continue, with a rise of prices of only 2,1% in 2005, and in the years to follow reaching a percentage below even one percent.

e) GDP Growth

The annual growth rate of real GDP was set at 6% for 2004 but will probably be lower by the end of the year. Therefore in our projections it is sized down to 3,3% in 2005, due to a smaller increase of oil extraction and the continued tendency of a slow evolution of the non oil productive sectors. In the following years it will probably fluctuate between 3 and 3,8 percent. Under normal circumstances, the economic growth of Ecuador oscillates between 2,5% and 4%. Therefore these forecasts seem realistic, if not any extraordinary circumstances occur.

Greater growth rates are difficult to obtain due to the high dependency on oil, which also affects the other economic sectors to a certain extent. Further more, the priority that is given to debt service payment leaves little room for strengthening either investment - which could boost the productive sector - or domestic demand, which has stagnated in recent years.

f) Central Government Budget

The budget for the next years will face a deficit with revenues (current and capital) being 770 Mio. US$ lower than expenses (current and capital, leaving out amortizations of external and domestic debt). This will thus require additional financing which means contracting more domestic and external debt.

Table 10: Projections about the Central Government Budget

	2004	2005	2006	2007	2008
Current and capital revenue (millions US$)	4.867	5.098	5.342	5.353	5.562
Current and capital expenses * (millions US$)	5.637	5.872	6.098	6.302	6.518
Deficit (millions US$)	**-770**	**-774**	**-756**	**-949**	**-956**
Deficit (% of GDP)	-2.6	-2.4	-2.3	-2.8	-2.7

*** does not include payments of amortizations of external and domestic debt.**

SOURCES: For 2004 Central Bank of Ecuador. For the following years projections of Jubileo 2000 Guayaquil

According to our projections budget revenues as percentage of GDP will develop as follows:

- The oil revenue from exports will stay around 4%, as compared to 5.6% in 2002;
- the non oil revenues will drop between 2005 and 2008 from 10,5 to 10,1 percent; and
- the total governmental revenues will decrease from 16,2 % in 2004 to 15,5 % in 2008.

This development generates a complex fiscal problem, mainly due to the regressive tax burden and to high dependence on indirect taxes.

Central Government expenses as related to GDP is expected to develop in a similar way: it will decrease gradually from 18,5% in 2005 to 18,2% in 2008. Thus, the budget deficit will increase from 2,4% to 2,7% of the GDP.

g) Public debt

External and domestic debt will continue to be as important as before, however, domestic debt will also continue to substitute some of the burden external debt has had in the past. This development seemingly improves the image of national debt management, because it reduces the balance of external debt burden, but it does so on cost of an increase of domestic debt.

From 2005 onwards, the service of external debt will slow down, dropping to 40% of total debt service in 2008. At the same time, domestic debt will rise to 60%. The problem with the domestic national debt is its high proportion of short term operations, of a higher interest rates and discounts, which increases the cost of fiscal financing and accumulates imbalances.

Table 11: Projections of debt service

	2004	2005	2006	2007	2008
External (millions US$)	**1.465**	**1.578**	**1.610**	**1.555**	**1.490**
Amortization	795	938	995	950	890
Interest	670	640	615	605	600
Domestic (millions US$)	**2.004**	**2.115**	**2.080**	**1.925**	**2.271**
Amortization	726	800	700	750	800
Interest	278	315	380	425	471
total Amortization (external and domestic) % of GDP)	**8.4**	**8.7**	**8.1**	**7.1**	**7.5**
total Interest (external and domestic) % of GDP)	**3.2**	**2.9**	**3.0**	**3.0**	**3.0**

Source: For 2004 Central Bank of Ecuador. For the following years projections by Jubileo 2000 Guayaquil

h) Financing the deficit

Financing the deficit implies the following measures:

- Using the funds of the FEIREP originally signed for social spending (10%) and for financial stabilization (20%);
- The traditional use of external credit, although to a lesser extent than in the past;
- Increases use of internal credits; and,
- the continued use of exceptional financing.

Table 12: Projections on financing the deficit of the central government budget

	2004	2005	2006	2007	2008
Budget deficit of the Central Government (millions US$)	**-770**	**-774**	**-756**	**-949**	**-956**
Financing (millions US$)					
Use of domestic resources (net domestic debt)	999	610	691	651	651
FEIREP (30% of total: social spending and stabilization)	169	193	185	162	163
Use of external resources (net external debt)	-539	-508	-542	-538	-495
Exceptional financing (additional credits)	**141**	**479**	**422**	**674**	**637**

Source: For 2004 Central Bank of Ecuador. For the following years projections by Jubileo 2000 Guayaquil

Because of the limitations of the three sources mentioned in Table 12, additional credits will be an indispensable source for exceptional financing to cover the deficit. The projections until 2008 foresee a high contribution of net domestic debt (new debt without amortizations) and in smaller quantity resources of the FEIREP. However, the net balance of external indebtedness will be negative by

around 500 million US$ annually. This amount must be added to the deficit that cannot be covered by internal debt plus available funds of the FEIREP. Thus, the requirements for exceptional financing amount to the figures indicated above. According to the projections, these figures will increase every year, reaching a level in 2007/08 similar to the figures of net domestic indebtedness.

i) The total debt burden

The macroeconomic forecasts, projected debt service on long term debt and the need for new financing of the Central Government, show a highly precarious situation in the balance of public debt and shows that it is by now means sustainable. Total balance of public debt will be composed as follows:

- The stock of existing external debt will diminish from almost 11,000 million US$ in 2004 to about 10,000 million US$ in 2008, dropping from 36.6 to 28.0 percent of GDP;
- Internal debt will increase from 4,015 million US$ by the end of 2004 to 6,618 million US$ in 2008, raising its total portion on debts from 13,4 to 19,1 percent; and,
- Exceptional financing will rise from 0,5 to about 2% of GDP. Since these resources will in part be obtained from international bi- or multilateral organizations, total debt stock of external debt will increase. Thus, the drop of the relation of external debt to GDP is hampered by the occurrence of new credit.

Table 13: Balance forecast of public debt

	2004	**2005**	**2006**	**2007**	**2008**
Total Public debts (millions US$)	**15.134**	**15.945**	**16.237**	**16.978**	**17.483**
External	10.978	10.641	10.299	10.137	10.028
Domestic	4.015	4.625	5.316	5.967	6.618
exceptional financing	**141**	**479**	**422**	**674**	**637**
Total Public Debt (% del GDP)	**50.4**	**50.3**	**48.9**	**49.3**	**48.7**
External	36.6	33.5	31.0	29.5	28.0
Domestic	13.4	15.2	16.6	17.9	19.1
Exceptional Financing	0.5	1.5	1.3	2.0	1.8

Source: For 2004 Central Bank of Ecuador. For the following years projections by Jubileo 2000 Guayaquil

The problem with debt sustainability

As shown above, the Ecuadorian development of national debt is strongly related to variables and parameters of the global economy as well as to the public sector. Therefore, any hypothesis or policy of indebtedness in medium term - like the Law of Fiscal Responsibility, Stabilization and Transformation - which pretends to bring down within four years the relation of debt to GDP by 16%, and locate it at 40% in 2006, is doomed to failure. Such politics are more likely to turn themselves into a destabilizing factor which only harden the prevailing tendencies of debt burden.

To conclude the findings of our analysis, we have made the following observations on debt sustainability:

1. It will be extremely difficult to bring down the debt/GDP ratio, because of the high annual amounts of debt service; and, secondly, because of the heavy dependency on the oil economy, which so far as mainly been maintained by high oil prices rather than by the expected increase in oil production. All together, GDP growth could not meet the expectiations.

2. The level of sustainability reached in the present oil boom carries along a wide range of negative impacts, and could only be reached because it prioritises the service of public debt. In the economic sector, the strict priority of debt servicing reduces investment in the productive apparatus; in the social field, it deteriorates the bio-cultural quality of the population and its labour and creative potential; in the ecological sector, it devastates natural and environmental resources (including oil); in the institutional sector, it contributes to the loss of political stability, as the problem of the public financing and the budgetary policies affects the national policies and the political environment.

3. The crisis of sustainability on debt service, has at least five relevant causes:

   a) The low tax burden on direct taxes which fails to distribute tax burden towards the citizens with greater capacity to contribute socially;

   b) The incapacity to control the major tricks of tax evasion and elusion;

   c) The modest participation of the State in the production and exportation of the crude oil produced by the companies and special contracts; and, the resignation of the State to invest into PETROECUADOR and to recover its capacity of production and thus increase governmental oil revenues;

   d) Bad management - unproductive, wasteful and even corrupt - of the public loans and of debt relief obtained in renegotiations; the lack of public control over it's civil servants; and, the amplitude with which the central government authorizes and assumes credits of the sectional governments and independent organizations; and,

   e) The lack of official capacity to negotiate and manage the processes of credit contracting and debt reconstruction.

As we see, the sustainability of the debt competes tenaciously with a maintained level of poverty; a pace of maintained growth of the economy (GDP) around 4% and with the environmental protection and the rational extraction of the reserves of crude oil.

In order to create conditions for alternatives on debt sustainability there is the need to modify the system of concession and participation applied to the companies and oil contracts, as well as the reactivation of PETROECUADOR; the tributary reform in the direct taxes; and the reprogramming of the balance of the long term debt, with a good initial relief, along with conducting an economic and financial policy that optimises the domestic and external resources that will benefice the public sector.

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