Program Information Document (PID)

Concept Stage | Date Prepared/Updated: 20-Aug-2020| Report No: PIDC30348

BASIC INFORMATION

A. Basic Project Data

Country	Project ID	Project Name	Parent Project ID (if any)
Ecuador	P174115	Ecuador Third Inclusive and Sustainable Growth DPL (P174115)	P171190
Region	**Estimated Board Date**	**Practice Area (Lead)**	**Financing Instrument**
LATIN AMERICA AND CARIBBEAN	Oct 20, 2020	Macroeconomics, Trade and Investment	Development Policy Financing
Borrower(s)	**Implementing Agency**		
Ministry of Economy and Finance	MEF		

Proposed Development Objective(s)

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

Financing (in US$, Millions)

SUMMARY

Total Financing	500.00

DETAILS

Total World Bank Group Financing	500.00
World Bank Lending	500.00

Decision

The review did authorize the preparation to continue

B. Introduction and Context

Country Context

1. **Ecuador has been suffering from a combination of three shocks: a sharp oil price decline, a need for external financing, and large COVID-19 related demand and supply shocks.** These shocks came in the context of existing macroeconomic imbalances and social unrest, even before the COVID-19 crisis. While Ecuador's dollarization regime helps to keep inflation low, it places a strong burden on the fiscal policy response to this crisis. Political uncertainty is

growing with elections due in February 2021. The COVID-19 crisis is ongoing, and Ecuador has been one of the countries hit hardest. As of August 17, over 100,000 cases were reported – including 6,083 deaths. The true number may be higher; the Economist's Excess Deaths Tracker[1] estimates 28,536 excess deaths between March 1 and July 31, or 166 per 100,000 people – the third highest of all countries tracked. The government responded quickly to the COVID-19 pandemic and rolled out temporary programs to support vulnerable segments of the population. However, poverty rates, which had increased slightly in the past five years due to slow growth and a tight fiscal position, are still expected to soar due to the current crisis. The World Bank estimates that more than 1.5 million people could fall back into poverty in 2020. In addition, while fiscal consolidation efforts were underway before the crisis, the fiscal deficit could reach around 9 percent of GDP in 2020. Adapting to this challenging context requires a combination of continued health crisis response measures and a solid medium-term reform program to continue addressing macro-fiscal imbalances and ensure future growth is sustainable. This process must be managed carefully to safeguard the social achievements of the last two decades and to protect the vulnerable to the maximum extent possible.

2. **Ecuador's macroeconomic policy framework – in light of the successful debt restructuring negotiations with private bondholders and the expected new EFF arrangement with the IMF – is deemed adequate for this operation, but significant downside risks need to be carefully monitored.** The government is committed to reducing the fiscal imbalance to secure sustainability, maintain international reserves, set the ground for economic recovery, and foster private investment. In addition to the debt restructuring agreed in August with private creditors and with the China Development Bank and a new medium-term program with the IMF, Ecuador is likely to receive financing support from other IFIs to cope with the emergency and implement a medium-term reform agenda. These positive developments are expected to bring public debt onto a sustainable path. However, Ecuador is vulnerable to downside risks, including prolonged global impacts of the pandemic, low or volatile oil prices, and appreciation of the US dollar. On the domestic front, risks stem from the unknown depth and duration of the COVID-19 containment measures and the fiscal pressures associated with it. Finally, natural disasters could generate additional stress to the macroeconomic framework, and a complex political context could impede or delay the implementation of key reforms.

Relationship to CPF

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

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

C. Proposed Development Objective(s)

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

Key Results

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

D. Concept Description

6. **This operation concentrates on addressing several binding constraints for an economic recovery and job creation led by the private sector as well as a return to fiscal sustainability.** The critical reforms supported align minimum wage increases with productivity growth, begin to deregulate interest rates, and gradually remove fuel price subsidies. It, therefore, prioritizes the removal of distortions created by indirect government interventions in the economy, such as through price controls or subsidies. Addressing distortions created through *direct* government control by owning the means of production (e.g., SOEs) are also critical and require significant political capital and sustained implementation capacity over a more extended period. Finally, the operation continues to recognize the importance of emergency measures to protect the most vulnerable as long as the immediate COVID-19 crisis continues. Overall, it is critical that these reforms are accompanied by an effective communication strategy to ensure broad-based understanding of objectives and to ensure awareness about the compensation mechanisms put in place.

7. **This DPF series continues to support measures to reduce the negative impacts of the COVID-19 pandemic on vulnerable populations.** Pillar 1 supports efforts to mitigate the impacts of the pandemic through temporary measures to expand access to social welfare and grant quicker access to unemployment benefits as well as by showing solidarity with migrants.

8. **This operation also supports significant structural reforms that can help the country to rebound and achieve sustainable economic growth, with notable reforms to various price control mechanisms, which have benefited from substantial WB Technical Assistance.** As in DPF-2, actions under Pillar 2 focus on removing barriers to private sector development to support the post-crisis recovery. Actions include measures to assist the private sector, which has long been stymied by regulatory uncertainty, high costs to open and close businesses, rigid labor market regulation, and distortions in financial markets that have negative effects on the performance and resilience of private firms and discourage investment. Minimum wages have grown above productivity, undermining export competitiveness in a dollarized economy. The complex minimum wage-setting process is distortive and leaves little room for firms to adjust to economic fluctuations. Limited access to finance is also considered an important obstacle by businesses. Regulatory barriers limit financial sector performance. For example, interest rate ceilings exclude borrowers priced out of formal credit markets under current caps. This DPF, therefore, addresses measures to support a private sector recovery such as: facilitate exports, strengthen competition, and stimulate entrepreneurship. In addition, it supports "big-ticket" reforms that have also benefited from significant Technical Assistance (TA) from the World Bank. This technical support includes a new minimum wage setting formula and increased transparency and simplicity in setting interest rate caps, including a pilot to set caps using a formula for one segment of the market.

9. **The third pillar promotes public sector efficiency and fiscal sustainability post-crisis, including reduced energy subsidies.** The actions under this pillar will help to create much-needed fiscal space going forward. They include fuel import and price reforms, which continue an agenda of support to reduce Ecuador's large and poorly targeted fuel subsidies and create incentives for increasing efficiency in the sector while ensuring compensation mechanisms are in place to mitigate the impact on vulnerable groups. Actions supported under this pillar will also help to strengthen the Ministry of Economy and Finance's (MEF's) responsibility and oversight during budget preparation and execution, improve information exchange and monitoring, align budgetary processes and public investment planning with the fiscal sustainability objectives, and create a sound framework to manage fiscal risks to help cope with exogenous shocks. Finally, this pillar supports measures needed to progress toward EITI membership, which will promote transparency and accountability in this sector. All these activities have benefited from World Bank TA.

10. **This operation has, combined with other ongoing support, paid particular attention to climate risks and transparency in the natural resources sector, and is aligned with the country's climate change mitigation and adaptation objectives.** It supports reforms that will rationalize energy subsidies and improve sector efficiency, reducing the gap between final prices, production costs, and market values for fuels and electricity while protecting poor and vulnerable populations (PA #9). Moreover, efforts to improve fiscal oversight and to ensure a sound framework to manage fiscal risks (PA #8) is accompanied by a WB TA to model and estimate climate risks under this framework. Finally, it supports measures that may have significant positive effects on the environment by promoting good agricultural practices, including a better control of the use of pesticides and fertilizers (PA #7). Together, the reforms supported are part of a broader effort to introduce renewable energy to diversify the country's energy matrix as well as to increase the physical and fiscal resilience of the country to natural and geological occurrences including earthquakes, volcanic eruptions, tropical storms, floods, and landslides, as well as to extreme climate events, the frequency of which is expected to increase with climate change.

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

Poverty and Social Impacts

11. **The prior actions supported by the proposed operation are expected to have positive or neutral impacts on poor households and vulnerable groups in the short term.** In the medium and long term, the expected effects are overall positive. The measures to provide emergency cash transfers and to shorten the access time to unemployment benefits will benefit households directly. The migration strategy will benefit both Venezuelan refugees and migrants, as well as households in host communities. The measures to reduce financial distortions will not have an immediate impact on households as the gradual reform progress will start by flexibilizing the corporate interest rate ceiling. In the medium term, fewer financial distortions are expected to contribute positively to welfare through the overall expansion of credit supply and job creation. The adoption of an objective and pre-defined formula for setting the minimum wage is not expected to have any welfare effects in the short term. (Minimum wages cannot be reduced, as per the Constitution mandate). However, in the medium and long-term, it is expected to improve socioeconomic conditions by boosting competitiveness and fostering the creation of formal jobs. Measures that enhance competition will likely have no significant welfare effects in the short run. However, these policies might have an indirect positive impact on welfare in the medium-long-run through growth, lower consumer prices, and enhanced labor conditions (i.e., increase in formal employment). The measures to strengthen fiscal resilience will indirectly benefit poor households by bolstering macroeconomic stability, preventing fiscal imbalances that could threaten pro-poor spending, and reinforcing the

necessary conditions for accelerated growth. The gradual removal of gasoline and diesel subsidies would have an impact on the welfare of poor and vulnerable populations. However, the GoE is implementing a compensation mechanism for these populations who are part of the current Social Registry. Thus, this measure is expected to compensate for any adverse effect of the reform at the poorest 40 percent of the population.

Environmental, Forests, and Other Natural Resource Aspects

12. **None of the prior actions are expected to have significant negative impacts on the country's environment, forests or other natural resources, while three are expected to have positive impacts.** Prior Action #7 may have significant positive effects on the environment by promoting good agricultural practices, including a better control of the use of pesticides and fertilizers, improved water quality and efficiency, improved waste management, sustainable techniques for soil preparation, among other requisites. Therefore, this policy has the potential of reducing soil, water and air contamination, and exposure of workers and consumers to environmental health risks. The Bank will deepen its analysis on the environmental aspects of this prior action in the next stages of the DPF preparation, especially on the adequacy of country's systems to enforce pesticides regulations. To complement Prior Action #8, the GoE will adopt a model to estimate climate risks under the new fiscal risk management framework. This initiative is likely to increase the country's resilience to natural disasters, including extreme weather events. By phasing-out gasoline subsidies, Prior Action #9 is likely to have significant positive effects on the country's environment, particularly by contributing to reduce air pollution and greenhouse gas emissions. The climate co-benefits for this operation are estimated to be up to 30 percent.

CONTACT POINT

World Bank

Simon Davies, Pietro Calice, Sergio Olivieri, Tanja K. Goodwin

Borrower/Client/Recipient

Ministry of Economy and Finance
Richard Martinez
Minister
aaviles@finanzas.gob.ec

Implementing Agencies

MEF
Ana Avilés
Advisor
aaviles@finanzas.gob.ec

FOR MORE INFORMATION CONTACT

The World Bank
1818 H Street, NW
Washington, D.C. 20433
Telephone: (202) 473-1000
Web: http://www.worldbank.org/projects

APPROVAL

Task Team Leader(s):	Simon Davies, Pietro Calice, Sergio Olivieri, Tanja K. Goodwin

Approved By

Country Director:	Marianne Fay	

CONTACT POINT

World Bank

Simon Davies
Senior Economist

Borrower/Client/Recipient

Ministry of Economy and Finance
Richard Martinez
Minister
aaviles@finanzas.gob.ec

Implementing Agencies

MEF
Ana Avilés
Advisor
aaviles@finanzas.gob.ec

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Task Team Leader(s):	Simon Davies

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Country Director:	Marianne Fay	03-Sep-2020