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Ecuador: the country's *progress from* chronic to *moderate inflation*

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A new stabilization programme has been in effect in Ecuador since September 1992. This article examines the nature of this economic policy, briefly compares it with other stabilization efforts made in the country in the 1980s, and evaluates its achievements so far. By the end of 1993 it had been possible to bring inflation down to 32% per year, after five years in which the rate had averaged more than 55%. It has thus been possible to progress from a situation of chronic inflation to one of moderate price rises, but this has been accompanied by a decline in economic activity, in spite of the drop in real interest rates and the use of the exchange rate as a nominal anchor. Despite the latter, however, the trade balance has not suffered as much deterioration as might have been expected. The study ends with a rapid review of the obstacles that will have to be overcome in the future in the light of a further appreciable reduction of inflation in 1994, as planned by the monetary authorities.

I

Introduction

The performance of the Ecuadorian economy over the last ten years has been fundamentally unstable, for both domestic and external reasons. Rates of saving and investment fell substantially compared with the previous decade, while economic growth was only moderate. Generally speaking, the living conditions of most of the population deteriorated, and the Ecuadorian economy fell behind the rest of Latin America after having been among the most dynamic in the 1970s.

The problems worsened particularly from 1987 onwards, when inflation began to gather speed. Despite the stabilization efforts made as from the second half of 1988, the situation did not improve, as prices rose by an average of 57% per year between then and 1992.

In September 1992, only a few days after a new government had taken office, a new stabilization programme was applied. So far, the results have been encouraging, since the macroeconomic balances have been restored, inflation has been significantly reduced, and the international reserves have been substantially increased, although at the same time –perhaps inevitably– there has been a marked appreciation of the exchange rate in real terms and a slackening of economic growth. Considerable progress has been made in the fight against inflation, but there is still a long way to go, since so far it has been possible to move from a situation of chronic inflation to one of moderate price rises.[1] The experience of other countries of the region indicates that moderate inflation is particularly difficult to overcome.

This article aims to evaluate the results of the adjustment programme initiated in September 1992. In addition, it briefly analyses the short-term outlook for the economy in the light of the government's announced aim of bringing inflation down to a significantly lower level (section I); reviews the background to the introduction of the present stabilization programme, since this will make for a better understanding of the nature of the stabilization strategy chosen (section II); examines this strategy and makes a brief comparison with earlier stabilization programmes tried out in the country in the 1980s (section III); analyses the present situation and indicates the achievements and shortcomings of the policy applied (section IV); comments briefly on the feasibility of achieving the further appreciable reduction of inflation proposed by the government for 1994 (section V), and finally notes the most important conclusions that may be drawn (section VI).

II

Background to the present stabilization programme

Although the problems experienced by Ecuador during the last decade are usually associated with the external debt crisis, they were really being incubated in the 1970s and began to show themselves early in the 1980s. Thus, when the economy began to grow strongly with the initiation of petroleum exports and the subsequent rise in international oil prices, distortions were building up which were reflected in severe

□ The author wishes to express his gratitude for the valuable comments made by Augusto de la Torre, Santiago Bayas and José Samaniego, who of course bear no responsibility for any errors which may exist in this article.

[1] This level of inflation is usually defined as one in which prices rise by between 15% and 30% per year.

imbalances in the fiscal and external accounts.[2] The problems got worse in the first few months after the restoration of democracy in the country –that is to say, towards the end of 1979–, following the adoption of measures which led to fiscal expansion and a big increase in production costs.[3]

This situation could be endured as long as international interest rates stayed low and, in general, as long as the necessary external financing was available. The external debt crisis therefore uncovered problems which had been building up in the course of previous years.

From the onset of that crisis, there was an increase in the external vulnerability of the economy. Various exogenous events in the following years caused the country to suffer heavy foreign exchange losses: among these events were the floods in late 1982 and 1983, which caused a contraction in traditional exports, and the 1987 earthquake, which obliged the country to suspend its petroleum exports for some five months. Generally speaking, there was a steady decline in the terms of trade throughout the 1980s. In order to tackle these problems, adjustment policies were adopted on the external front, but these were not always accompanied by coherent policies in the area of aggregate demand, so that the decade was marked by growing inflation. Table 1 gives an overview of the performance of the Ecuadorian economy during this period.

Early in 1983, a first stabilization programme was put into effect, its aim being to tackle the external debt crisis and the destructive effects of the floods in the coastal region of Ecuador, which had reduced banana, coffee and cocoa exports. This adjustment programme was of a completely orthodox nature, being based on a fiscal and monetary adjustment, supplemented with a policy of depreciation of the exchange rate in real terms. As a result, between 1982 and 1983 it was possible to eliminate the non-financial public sector deficit, which had been amounting to nearly 7% of GDP, while the external current account deficit went down from over 11% to only 1% of GDP, thus making it possible to reduce the end-year inflation by more than half between 1983 and 1984 (from 52.5% to 25.1%). The restoration of the macroeconomic balances and the lower inflation made possible the reactivation of the economy, which grew by over 4% per year in 1984 and 1985.

This recovery process was interrupted by the rapid slump in oil prices in 1986 and the 1987 earthquake. Because of the shortage of foreign exchange, Ecuador ceased to service its external debt with the commercial banks, but on the domestic front the policies applied were not in keeping with this, because instead of becoming more contractive they became increasingly expansive. As a result, the fiscal and external imbalances got worse, and the annual growth rate of the monetary base ("seigniorage") rose still further, leading to a decline in the net international reserves to negative levels in mid-1988, cumulative inflation of nearly 50% per year in the first seven months of that year, and severe distortions in relative prices. This deterioration of the economy coincided with the last year of office of the then government.

A few days after taking office, at the end of August 1988, the new government adopted a stabilization programme which it called the National Emergency Plan, of a similar nature to the economic programme successfully applied in 1983. Essentially, the aim was to bring relative prices back in line and gradually reduce the existing macroeconomic imbalances. After the initial adjustment,[4] the main components of this programme were the establishment of an exchange policy based on gradual adjustments announced in advance, with the aim of maintaining the competitiveness of the sectors of the economy producing tradeable goods, and similar gradual adjustments in the prices of public goods and services, especially gasoline. Despite these efforts, however, at the end of 1989 inflation had only gone down to 54%, in contrast with the target of 30% announced by the government, and this undermined the credibility of the economic programme. At the same time, the programme had a high cost in terms of production, since the growth rate was barely positive.

[2] The way this external shock was transmitted was through the appreciation of the real exchange rate, which encouraged a form of resource allocation favouring domestic production activities and consumption to the detriment of the sectors producing internationally tradeable goods (except petroleum). This phenomenon has been extensively studied in the economic literature under the name of the "Dutch disease". In this respect, see for example Corden and Neary (1982) and Corden (1984) and, with particular reference to Ecuador, de la Torre (1987) and Jácome (1989).

[3] Due, for example, to the doubling of minimum wages and the reduction of the working day by nearly 10%.

[4] The measures included a 45% devaluation, price rises for public goods and services (in particular, the domestic price of gasoline was doubled), elimination of the wheat subsidy, wage increases of the order of 16%, and other measures in the area of taxation.

TABLE 1

Ecuador: macroeconomic indicators, 1980-1990

Year	Annual growth rate				As a proportion of GDP			Indexes	
					Balance				
	Real GDP	CPI [a]	M1 [b]	TT [c]	NFPS [d]	Current account	Seigniorage [e]	REER [f]	Real wages
1980	4.9	16.3	28.0	6.6	-4.7	-7.0	1.4	110.0	139.1
1981	3.9	17.2	11.3	-5.8	-5.6	-10.0	0.7	125.2	121.4
1982	1.2	24.4	20.2	-16.1	-6.7	-11.5	0.9	122.6	109.3
1983	-2.8	52.5	30.4	-22.4	...	-1.2	1.0	116.7	101.4
1984	4.2	25.1	42.2	0.4	-0.6	-2.6	2.2	96.3	102.0
1985	4.3	24.4	23.6	-2.0	1.9	1.0	1.5	100.0	100.0
1986	3.1	27.3	20.4	-27.1	-5.1	-5.7	2.0	80.5	103.6
1987	-6.0	32.5	32.3	-5.2	-9.6	-11.9	2.3	61.9	95.5
1988	10.5	85.7	53.8	-22.0	-5.1	-5.8	3.1	46.5	78.1
1989	0.3	54.2	38.1	2.7	-2.9	-4.6	1.8	53.8	61.6
1990	2.3	49.5	52.2	5.7	1.1	-1.2	2.4	49.5	57.9

Source: IMF, *International Financial Statistics*, various issues. Central Bank of Ecuador, *Información estadística mensual*, various issues.
[a] Consumer Price Index. [b] Money supply. [c] Terms of trade. [d] Non-financial public sector. [e] Annual increase in monetary base. [f] Real effective exchange rate (reduction indicates depreciation.)

From that time on, the fiscal effort was reduced, partly because Ecuador benefited from the rise in oil prices caused by the Gulf War. Exchange rate policy remained unchanged but included occasional discreet adjustments to keep the real exchange rate stable in line with criteria based on the purchasing power parity theory.[5] Against the background of this economic policy and a favourable international environment, inflation was kept at around 50% in 1990 and 1991 and the growth rate rose to 3.0% and 4.9%, respectively, thanks largely to the increase in banana and shrimp exports, which also raised the level of the international reserves.

Important changes were made at the structural level, the most important being the opening up of the economy, with the average level of customs tariffs plus import surcharges going down from 37% to approximately 15%, while the tariff spread was also reduced. This opening up of the economy was supplemented with the gradual establishment of a free trade area with Colombia and Venezuela. On the other hand, however, Ecuador continued to build up arrears in the servicing of its external debt with the commercial banks, and this adversely affected its image with the international financial community.

During the first half of 1992 the economy deteriorated still further, coinciding with the period of transition to a new government. The excess domestic demand due to the fiscal sector expansion had a bigger impact on the net international reserves than on price levels, and in the first seven months of the year the reserves dropped to less than half their previous level. In addition, the real exchange rate and prices of public goods and services lagged behind their real values, which they had maintained during the previous three years.

What happened in these months was a typical example of a "balance of payments crisis" (Krugman, 1979): the economic agents developed the idea that the new government would devalue the currency as part of a new stabilization strategy, and there was therefore an attack on the exchange rate in the form of capital flight which caused a decline in the international reserves of the Central Bank, a rapid rise in domestic interest rates, and, in general, demonetization of the economy.

[5] In addition, the export sector was provided with a subsidy through the decision that the Central Bank should buy that sector's foreign exchange in advance, with recalculation of the amount paid to take account of the difference between the rate prevailing when the foreign exchange was handed over and the rate applicable on the date of shipment of the goods. Exchange losses on this account came to nearly 1% of GDP in 1991, representing a substantial primary injection of liquidity.

III

The Macroeconomic Stabilization Plan

Only a few days after its entry into power, the government which took office in August 1992 introduced a new adjustment programme: the Macroeconomic Stabilization Plan. The main short-term aim of this Plan was to achieve "rapid reduction of inflation and a sounder fiscal and external position", while in the longer term its fundamental aim was to "reform the public sector" in order to make possible the "modernization and economic development" of the country (Banco Central del Ecuador, 1992).

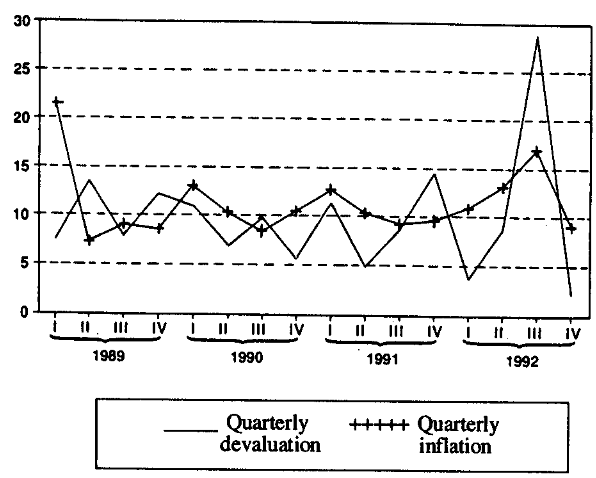
This plan was different from the previous two programmes. This time, it involved shock therapy designed to bring about a rapid decline in inflation, instead of the more gradual approach adopted before. Moreover, the exchange rate was used as an anchor, in contrast with the previous two programmes, in which the money supply had been responsible for this function. Thus, the exchange rate was now used as a stabilization instrument, at the expense of the competitiveness of those sectors of the economy trading with the exterior. In this sense, this new experiment is similar to the adjustment programmes tried out in the Southern Cone countries in the late 1970s, which have been the subject of a number of studies (Solimano, 1990; Kiguel and Liviatan, 1992; Végh, 1992.

Once again, both the exchange rate and the prices of public goods and services rose significantly at the beginning of the programme. This time, however, the adjustment was greater, in order to leave more room for keeping these variables stable in the future. This largely broke the inflationary inertia which had been furthered by the continual adjustments made in these prices. The main measures adopted to begin with included a devaluation of some 30% and substantial increases in the prices of petroleum products and electricity. In particular, gasoline prices were raised by over 125%, while the price of gas for domestic use rose by nearly 300%. Since then, the two main pillars of the new economic policy have continued to be exchange policy and fiscal adjustment.

Exchange rate management, in particular, has been aimed at doing away with the inflationary expectations entertained until a short while ago by the economic agents, largely associated with the previous exchange rate regime, which had been based on mini-devaluations announced in advance. This close link between variations in the nominal exchange rate and price levels may be seen from figure 1. In order to break this link, after the initial devaluation the exchange rate was used as a nominal "anchor", although a fixed exchange rate was not established.

From the operational point of view, a band was established within which the exchange rate was permitted to float, so that it would remain stable in keeping with the Central Bank guidelines. This arrangement avoided both the macroeconomic problems associated with the application of rules designed to adjust the nominal exchange rate so as to keep it at a given level in real terms (Adams and Gros, 1986; Montiel and Ostry, 1991) and the constraints associated with the maintenance of a fixed exchange rate for a substantial length of time, which tends to give rise to appreciation of the real exchange rate and other macroeconomic repercussions. Subsequently, the band was eliminated, so that the current system consists of a managed float.

FIGURE 1
Ecuador: Devaluation and inflation
(Quarterly evolution)



Since the ceiling of the band became credible as a result of the initial over-devaluation and strict fiscal discipline was displayed in the following months, the expectations of depreciation were considerably reduced. The return on financial assets expressed in sucres therefore became very attractive, and this stimulated the inflow of capital.

Thus, discipline in handling the public finances was identified as a necessary condition for the success of the stabilization programme, as demonstrated by the experience of other countries of the region which had succeeded in stabilizing their economies. The policy applied has been based fundamentally on severe restriction of State spending rather than the raising of resources through taxes.

The role of monetary policy has been less prominent. This should not come as a surprise, since when the exchange rate is kept stable, monetary policy tends to be endogenous. In this context, during the early months the monetary efforts were aimed at partially sterilizing the monetization due to the increase in the international reserves, in order to avoid excessive growth of the amount of money in the economy. More recently, attention has shifted to the aim of moderating interest rate variations.

Unlike what happened with stabilization programmes adopted in other countries, such as Mexico and Israel (the so-called heterodox approaches), in the beginning the Macroeconomic Stabilization Plan did not explicitly include incomes policy as an integral part of the anti-inflation strategy. This is understandable in view of the low level of indexation characterizing the Ecuadorian economy and, above all, the lack of an environment favourable to the generation of consensus among the different sectors of society.

Finally, little has been done in the social field. The government has shown no intention of trying to give a social content to public spending, as was done in other countries (such as Chile and Mexico) which sought to offset the cost of the adjustment. The government's position in this respect has been that the greatest social benefit for the people is the reduction of inflation.

IV

Results of the Macroeconomic Stabilization Plan

All in all, the application of the Plan has brought positive results, since most of the main macroeconomic indicators have developed favourably (table 2). In particular, inflation has markedly slackened, a sound external financial position has been attained, and the fiscal deficit has been significantly reduced, even though the international environment has not been very favourable for the development of the domestic economy. On the other hand, economic activity seems to have slowed down markedly and the real exchange rate displays a growing lag. Less progress has been made at the structural level than in the field of stabilization.

1. Reduced inflation and higher international reserves

The most important achievement of the Macroeconomic Stabilization Plan has undoubtedly been the reduction of inflation to around 30% by the end of 1993, representing a reduction of the growth rate of prices by almost half since December 1992. This has had two important effects. The first of these is that it broke the inflationary inertia which had dogged the Ecuadorian economy during the previous five years, thus helping to cause the economic agents to lower their inflationary expectations. Figure 2, which shows the monthly evolution of inflation in 1988-1992 and 1993, [6] is eloquent in this respect. It may thus be seen that during the last year –except in May, when the government faced a serious domestic policy crisis which raised doubts about the continuation of the economic adjustment and caused an outbreak of speculation– the monthly rate of inflation was clearly below the monthly average for the period 1988-1992.

[6] Inflation of 1.5% was expected for December 1993.

TABLE 2
Ecuador: Main macroeconomic indicators

	1991	1992	1993[a]
	Percentage changes		
Growth of GDP	4.9	3.5	1.5
Inflation (end-year)	49.0	60.2	32.0
Inflation (annual average)	48.7	54.6	46.5
Real effective exchange rate (minus sign indicates depreciation)	4.8	-1.8	15.0
Money suply	47.1	43.3	42.0
Quasi-money	63.6	61.7	63.0
Terms of trade	-5.3	-3.2	-6.0
	Absolute values (millions of dollars)		
Net international reserves	760	782	1 250
Exports FOB	2 851	3 008	2 812
Imports FOB	2 207	2 027	1 940
	As a percentage of GDP		
Non-financial public sector	-2.0	-2.9	-0.5
Trade surplus	5.7	8.5	6.5
Current account balance	-4.1	-0.1	-2.4
Gross investment	21.7	24.1	21.1
Total external debt [b]	106.0	105.0	102.5

Source: IMF, *International Financial Statistics,* various issues; Central Bank of Ecuador, *Información estadística mensual,* various issues.
[a] Projected figures.
[b] Excluding interest on arrears of interest payments in the case of the external debt subject to restructuring under the Brady Plan.

FIGURE 2
Ecuador: Monthly inflation, 1988-1992 and 1993
(Percentages)

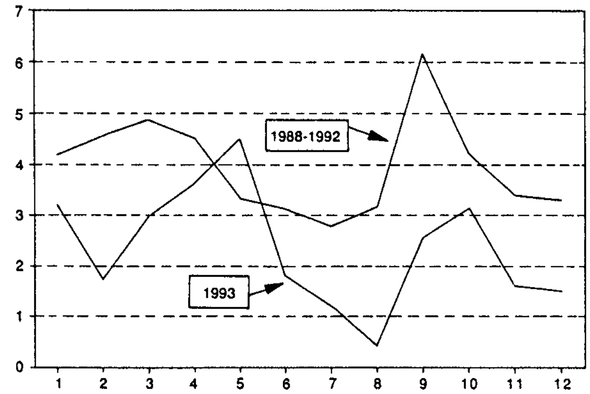
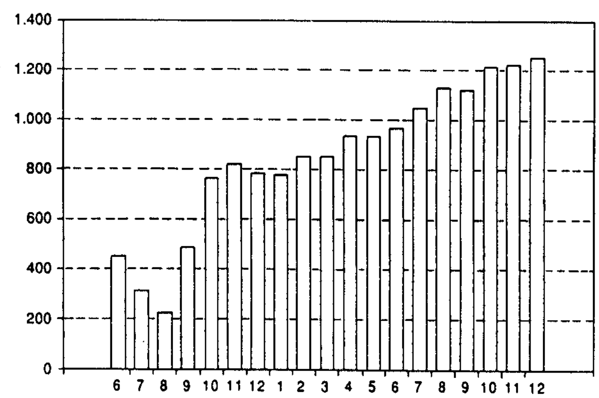


FIGURE 3
Ecuador: Net international reserves, June 1992 - December 1993
(Millions of dollars)



The second effect was that it maintained the credibility of the Plan, since inflation at the end of 1993 was very close to the target level originally announced by the government.

A further positive result has been the recovery of the international monetary reserves and their growth to the unprecedented level of some US$1.25 billion at the end of 1993 (figure 3). This level of international reserves not only contributes to the stabilization of the country by giving it a sounder external financial position but also makes more feasible the possible restructuring of the Ecuadorian external debt with the commercial banks in the coming months. It should be noted, however, that this increase in the reserves has been due fundamentally to inflows of short-term capital rather than to an improvement in trade, as we shall see below.

2. Fiscal adjustment, appreciation of the real exchange rate, and lower interest rates

As was to be expected, effective contributory factors in these results were the severe restriction of public expenditure and the form of exchange rate policy applied, which led to an inflow of capital from abroad and a fall in interest rates.

One fiscal adjustment measure was the accumulation of deposits of the non-financial public sector in the Central Bank –amounting to around 3% of the 1993 GDP– during the first year of application of the Macroeconomic Stabilization Plan. As a result of this policy, a virtual balance in the fiscal accounts was achieved in that year. Such a big accumulation of deposits in the Central Bank also served to partly offset the high level of monetization caused by the increase in the international reserves, thus avoiding an excessive increase in the monetary variables which might otherwise have adversely affected the fight against inflation.

This assertion is backed up by figure 4, which shows the close relationship between the monthly flows of net international reserves and net deposits (credits less deposits) by the non-financial public sector in the Central Bank. The sterilizing effect of the fiscal restriction has partly reduced the need for the sale of short-term securities (Monetary Stabilization Bonds) by the Central Bank, thus avoiding an excessive increase in the quasi-fiscal deficit.

Not even such a great fiscal effort would have been sufficient to bring inflation down to the levels actually reached, however. The strategy of initial over-devaluation of the sucre made possible the subsequent stability of the nominal exchange rate in 1993, and this not only changed the inflationary expectations but also lessened the inertia persisting from previous years.

The impact of the tariff reform and the establishment of the free trade area also helped to slow down inflation. This opening up of the economy, together with the exchange rate lag already referred to, meant that the prices of tradeable goods remained stable.

At the same time, the initial over-devaluation and subsequent stability stimulated a strong inflow of capital, as expected, which exerted downward pressure on the nominal exchange rate and growing appreciation of the currency in real terms. The massive inflow of capital into Ecuador was due to the same factors responsible for this phenomenon in other countries of the region (Calvo, Leiderman and Reinhart, 1993) and in general terms was an external shock which substantially aided the process of stabilization of the Ecuadorian economy. Above all, this capital entered the country because the yield on assets in sucres was much higher in the early months of the economic programme: a situation which lasted almost the whole of 1993 (figure 5). [7] This capital flow made a significant contribution to the rapid improvement in the international reserves from September 1992 onwards.

[7] Figure 5 compares the yield on the short-term securities (Monetary Stabilization Bonds) offered by the Central Bank with a maturity of 91 days with the yield given by the sum of the Prime Rate plus the expected depreciation, i.e., $r - (r^* + e^e)$.

FIGURE 4

Ecuador: Variation in international monetary reserves and net credits to the non-financial public sector, September 1992 - November 1993

(Monthly flows)

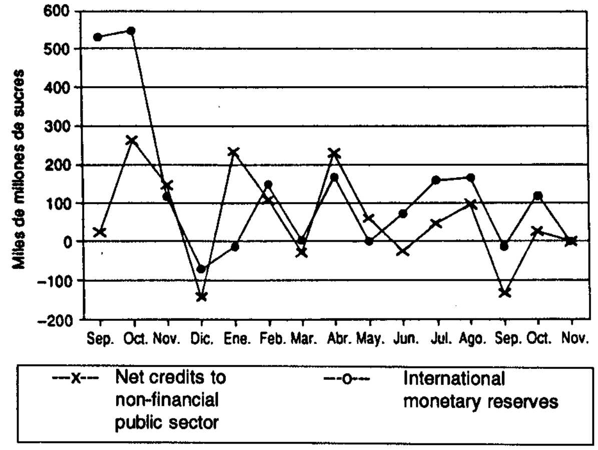
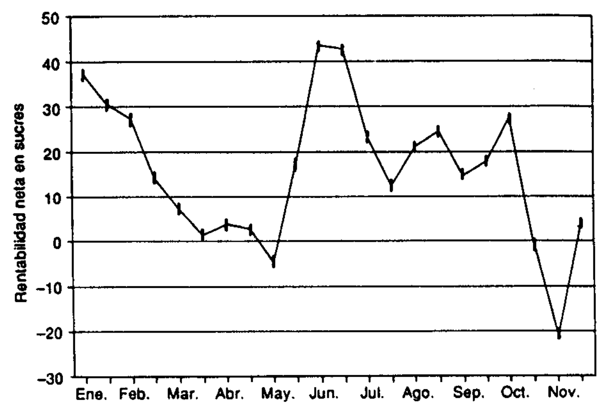


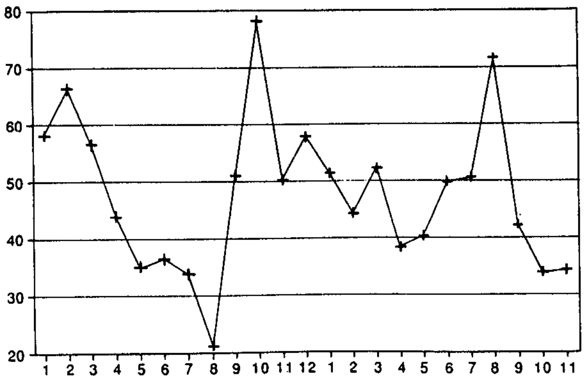
FIGURE 5

Ecuador: Difference in yield between assets in sucres and in dollars, 1993



Thus, there was rapid remonetization of the economy from September 1992 onwards (figure 6), at rates in keeping with the slackening growth of prices. This was because the demand for money increased under the Monetary Stabilization Plan as a result of the change in the portfolio of assets of investors in favour of assets in sucres, because of their higher relative yield. As no imbalance occurred in the money market, the growth in the amount of money in the economy did not cause a rise in general price levels.

FIGURE 6
Ecuador: Monetary base, 1992-1993
(Annual growth rate)



The capital inflow from abroad and the Central Bank's attitude of sterilizing only part of this inflow caused interest rates to fall to negative levels in real terms, with respect to current inflation (table 3).

3. Effect on the real sector

In spite of this fall in interest rates, economic activity went down as a result of the application of the adjustment programme, unlike what has been observed in other countries which have applied stabilization programmes based on an exchange rate anchor (Kiguel and Liviatan, 1992). In the case of Ecuador, the exchange rate lag which has been building up and the impact of the opening-up of the economy carried out in previous years apparently had much to do with this economic stagnation.

Thus, although the stability of the nominal exchange rate was a decisive factor in reducing inflation, it also had negative effects, since it caused the real exchange rate to fall behind by some 15% in the course of 1993 (figure 7).[8] This real appreciation in the exchange rate had an adverse impact on those sectors of the economy trading with the exterior, but acted as a stimulus for non-tradeable activities. The impact on economic activity was further heightened against the background of the opening up of the Ecuadorian economy, since imported goods became cheaper in relative terms as a result of the lowering of tariffs.

[8] Naturally, this figure does not mean that there was an equivalent real appreciation in the exchange rate, since what occurred is not being compared with a given equilibrium level. Moreover, no account is taken either of the shifts that such an equilibrium level might have undergone as a result of real exogenous shocks such as variations in the terms of trade or in permanent capital flows with the exterior.

TABLE 3
Ecuador: Real interest rates, 1992-1993
(Rates on deposits for 90 days)

	Nominal rates (%)	Inflation (%)	Real rates (%)
1992			
January	49.43	48.9	0.5
February	49.46	48.3	1.2
March	49.80	46.7	3.1
April	48.58	49.6	-1.0
May	48.54	48.8	-0.3
June	51.34	50.4	0.9
July	54.34	51.7	2.6
August	61.18	52.2	9.0
September	65.02	61.0	4.0
October	48.74	65.8	-17.1
November	38.89	63.9	-25.0
December	42.30	60.2	-17.9
1993			
January	36.89	58.5	-21.6
February	23.87	55.8	-31.9
March	21.13	56.1	-35.0
April	26.33	53.6	-27.3
May	39.94	54.8	-14.9
June	40.68	52.1	-11.4
July	40.68	49.9	-9.2
August	39.74	46.1	-6.4
September	30.69	35.5	-4.8
October	27.10	31.5	-4.4
November	23.12	32.3	-9.2
December [a]	27.00	33.0	-6.0

Source: Central Bank of Ecuador, *Información estadística mensual*, various issues.
[a] Projected figures.

FIGURE 7
Ecuador: Real exchange rate, June 1992 - December 1993

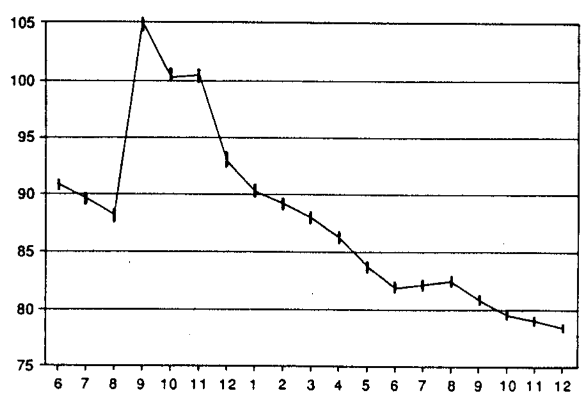


TABLE 4

Ecuador: Annual growth rates of real gross domestic product and of selected sectors, 1991-1993
(Half-years)

	1991		1992		1993
	I	II	I	II	I
Real GDP	5.1	4.7	4.1	2.9	1.4
(excluding petroleum)	4.7	4.1	4.0	2.6	0.9
Petroleum	8.4	8.9	5.3	4.4	5.0
Agriculture	5.6	6.4	6.5	3.0	0.8
Industry	2.4	2.7	5.7	3.2	0.7
Construction	-1.6	0.6	1.0	0.3	1.5

Source: Central Bank of Ecuador, *Cuentas trimestrales*, No. 8, 1993.

The loss of competitiveness of the tradeable goods sector accentuated the recessionary tendency of the economy (table 4). GDP growth slackened with the adoption of the Macroeconomic Stabilization Plan until it sank to only 1.4% per year in the first half of 1993. Tradeable activities slackened even more than this, whereas the construction sector (which is typically non-tradeable) tended to recover. This result is in keeping with the real appreciation in the exchange rate referred to earlier.

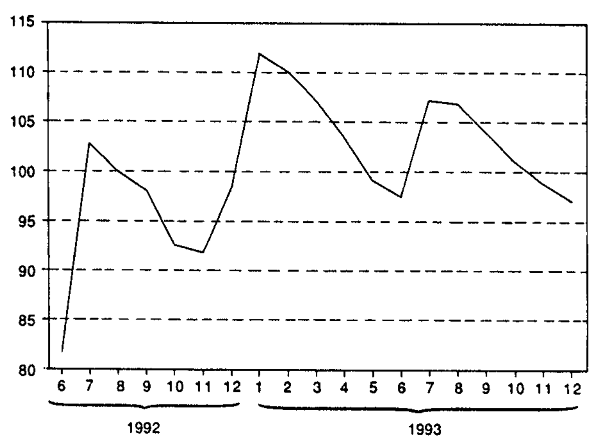
This decline in economic activity would also appear to indicate that the economic agents have decided to "wait and see" with regard to investments until they feel that the stabilization process has been consolidated and that, in general, there is a favourable climate for sustained reactivation.

With regard to wages, minimum wages fell slightly in real terms in the course of 1993, as may be seen from figure 8, which shows the evolution of the minimum living wage together with other benefits and allowances laid down by law for the lowest wage levels.

The evolution of middle-level wages cannot be determined conclusively because of lack of information. It is most likely that they have suffered a further deterioration, however, since the increases decreed by the government were the same in nominal terms for all the various wage levels. Thus, the percentage increase was smaller for those earning more than the minimum wage (the majority of wage-earners), against a background of virtual stagnation of the economy. This flexibility of wages made possible more rapid reduction of inflation, in contrast with other countries where this has been hindered by wage indexing.

FIGURE 8

Ecuador: Evolution of real minimum wages, June 1992 - December 1993



4. The impact on the external sector

In spite of the real appreciation of the exchange rate and the opening up of the economy, it is particularly noteworthy that in 1993 the trade balance suffered only slight deterioration compared with the year before, closing the year with a surplus of approximately 6.5% of GDP. This untypical result contrasts with the experience of other countries, such as Mexico and Argentina, which also tried stabilization programmes using the exchange rate as an anchor, but with adverse effects on the trade balance. In the case of Ecuador, this performance was fundamentally due to a drastic fall in the value of imports in line with the slackening of economic activity, which reduced the impact of the fall in the exchange rate on the value of exports.

Thus, imports as a whole went down in 1993 by some 4% because of the decline in the most important categories in terms of value, namely purchases of capital goods and raw materials. In contrast, as was to be expected, imports of consumer goods grew by nearly 30%.

Export performance was also uneven. Traditional exports (petroleum, bananas, coffee, cocoa and, to a lesser extent, shrimps) turned in a poor performance as a result of exogenous problems and low productivity, and this prevented them from making up for the effects of the exchange lag that built up during the year. In contrast, less traditional exports registered dynamic growth of around 50% between 1992 and 1993, showing the high competitiveness of these activities, but unfortunately these products only account as yet for some 15% of the total exportable supply.

Taking into account the balance on services, which has shown a chronic deficit because of the country's high level of indebtedness, the current account ended 1993 with only a small deficit, so that the capital account probably explains the significant increase of over US$400 million in the international reserves during the year.

The advances in the structural field have not been commensurate with those in the sphere of stabilization. In this respect, the Public Sector Budget Act and the Securities Market Act have been adopted. The first of these is aimed basically at increasing the Ministry of Finance's control of public spending, by including institutions which were previously outside the Ministry's control, such as public enterprises and other bodies linked with the government, in the hope of securing greater rationalization of State expenditure. The second Act is aimed at developing the capital market in Ecuador, and an important feature of it is that it sets up a monetary unit of constant value in order to stimulate saving in the country.

The adoption of the Act on Modernization of the State (the Privatization Act) has suffered excessive delays, since it has been under discussion for almost a year. This has adversely affected the investment climate in the country, since this was the main change that the government proposed to make. It could be said that the scant success registered in the structural field is tending to delay the reactivation of economic activity, in spite of the fall in domestic interest rates, since it affects the expectations that the public finances will be kept on a sound basis and hence that there will be lasting stabilization of the economy.

Furthermore, the country still has not regularized its relations with the international financial community. Interest payments on the external debt with the commercial banks have been suspended since mid-1992; Ecuador had been paying 30% of the amount due since mid-1989, after having suspended such payments altogether since the beginning of 1987. The country has also been in arrears with the Paris Club for several months past. Although the Ecuadorian Government has been negotiating the restructuring of its commercial bank debt for the past year, the fact that agreement has not yet been reached is a further element of uncertainty as regards the future evolution of the economy.

V

Some reflections on the short-term outlook

It may be seen from the foregoing analysis that Ecuador has progressed from chronic inflation (averaging over 50% per year for five years) to moderate inflation (around 30% per year). Future short-term economic policy will be aimed at fulfilling the government's announced objectives of bringing inflation down to 15% by the end of 1994 and reactivating real economic growth to a rate of around 3% per year.

These two objectives seem difficult to achieve simultaneously, since they involve growing at almost twice the 1993 rate while at the same time reducing the rate of price rises by over half compared with that year. The first objective could be more feasible, since a 10% rise in petroleum production is scheduled for 1994, but there seems little chance of achieving the second aim in view of the current characteristics of the Ecuadorian economy and the arduous and prolonged efforts which have been required in other countries of the region (Colombia, Mexico, Chile) in order to secure a further reduction in moderate levels of inflation.[9]

In principle, in order to secure a rapid reduction in inflation such as that proposed by the government, economic policy in 1994 will have to be based on at least three major elements: control of aggregate demand, maintenance of the exchange rate as a nominal anchor, and an incomes policy in keeping with the proposed inflation target. In addition, in view of the vulnerability of the Ecuadorian economy to external shocks, a decisive role in the results obtained in 1994 will be played by developments in the international environment, especially world petroleum prices, the level of international interest rates, and the possibility to reaching agreement on the restructuring of the external commercial bank debt.

At the same time, it is not clear that, having brought inflation down to around 30%, it is really desirable to seek a further reduction as sharp as that proposed by the government. Although there is general agreement on the costs caused by inflation and, hence, the benefits of bringing it down –if possible, to a single digit– there is less consensus on the speed at which it should be reduced. This usually depends on such factors as the level of confidence in the economic policy, the degree of social consensus on the inflation target proposed, the progress made in structural changes designed to improve the efficiency of markets, and, in general, the political viability of embarking on an adjustment strategy which usually involves recessionary effects and increased unemployment.

In the case of Ecuador, the economic policy enjoys credibility as a result of the success obtained in 1993, when it was possible to bring inflation down to levels very close to the stated target. At the same time, however, there is currently a lack of consensus regarding the proposed economic policy strategy. This is particularly marked in the case of the workers, who are extremely loath to accept wage increases of only 15% (the inflation target for 1994) after a long period when inflation averaged over 50%, and it was still 32% even in 1993.

In the case of the business community, their disagreement is due to the limited progress made in the structural reforms and, especially in certain groups, the policy of maintaining an exchange rate lag. The viability of the policy is all the more difficult because there will be elections in 1994 to replace almost all the members of Parliament: a situation which limits the capacity to impose policies to restrict aggregate demand. Equally disquieting is the possibility of an unfavourable international environment due to a fall in the price of petroleum, which is the main source of fiscal income and the country's leading export item.

In view of these circumstances, it would seem that the strategy for the reduction of inflation in 1994 should be more gradual, while maintaining a firm determination to continue in this direction in subsequent years until levels similar to those of international inflation are reached. This approach would not only be less costly for Ecuadorian society but would also allow the government to effectively reactivate growth in that year and thus maintain the credibility of its economic policy. In this way, it would be possible to make the strategy for the reduction of inflation and reactivation of the economy in Ecuador sustainable in the medium and long term.

VI
Conclusions

This article has sought to give an analysis of the stabilization efforts made in Ecuador since September 1992, which have made it possible to bring inflation down from an average of over 50% in the 1988-1992 period to around 30% at the end of 1993.

After reviewing the economic background to the current stabilization programme, the most important features of the strategy used and the achievements registered up to the end of 1993 were described, with special emphasis on the fiscal discipline applied,

[9] There is an increasing number of studies of processes aimed at progressing from moderate inflation to single-digit rates of price rises. See for example Fernández (1992), Mancera (1992), Jadresic (1992), and Dornbusch and Fisher (1993).

without which it would not have been possible to obtain the success effectively registered. In addition, the use of the exchange rate as a nominal anchor in the process of reducing inflation was highlighted. This strategy made it possible to partially break the previous inflationary expectations, at the cost of relegating to a secondary position the possible role of the exchange rate as an instrument for promoting the tradeable sector of the economy. This is in clear contrast with other adjustment programmes adopted in Ecuador in past years, in which exchange policy was fundamentally aimed at this latter objective.

The recent stabilization experience in Ecuador shows the benefits of a joint policy of fiscal austerity and use of an exchange rate anchor in order to secure a rapid reduction in the rate of price increases in countries which have been suffering from chronic inflation. From another viewpoint, it confirms what has been observed in other Latin American countries: correction of the fiscal deficit is a necessary but not of itself sufficient condition for securing rapid reduction of inflation.

The results obtained also show that in spite of the establishment of an exchange rate anchor, reduction of real interest rates and the absence of substantial levels of indexing, the reduction in inflation has nevertheless been accompanied by slower economic growth, especially in the tradeable sectors (other than petroleum). An atypical result has also been observed in respect of the trade balance, since it has deteriorated to only a modest extent, despite the real exchange rate appreciation. This may be explained by the drastic fall in imports, except for those of consumer goods, which grew significantly. The decline in imports of raw materials and capital goods is in keeping with the slowdown in economic activity, while the growth of imports of consumer goods is due to the appreciation of the exchange rate in real terms.

The study carried out also highlights the slow progress made in the structural changes announced by the government and the absence of social programmes designed to mitigate the cost of the adjustment. The first of these features tends to limit the efficiency which might be expected from markets and raises some doubts about the viability of the stabilization process in the medium and long term. The second feature has not been favourable to a climate of social consensus-building which could make the road to stabilization less arduous.

Finally, with regard to the advisability of defining a strategy for the future aimed at rapidly reducing inflation from 32% to 15% in 1994, as announced by the government, it may be concluded that, once more manageable levels of inflation have been attained, it might be more advisable to pursue a gradual reduction which would at the same time permit the reactivation of economic growth, while maintaining the medium-term objective of bringing inflation down to levels similar to those of the world economy.

(Original: Spanish)

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