Table II. 4. Ecuador: Sources of Growth--International Comparison

	Growth Rates			Contribution from		
	GDP	Capital	Labor	Capital	Labor	TFP
Ecuador						
1975-93	3.6	4.9	3.4	3.6	0.9	-1.0
1975-80	6.4	8.6	2.4	6.3	0.6	-0.5
1980-85	3.0	5.0	3.7	3.9	1.0	-1.9
1985-90	2.4	3.1	4.6	2.1	1.3	-1.0
1990-93	1.8	1.9	2.7	1.2	0.8	-0.2
Venezuela (Elias, 1992)						
1960-70	5.4	3.5	3.4	1.9	1.2	2.3
1970-80	3.9	7.1	3.6	4.1	1.5	-1.7
1980-85	-1.3	1.3	2.5	0.8	1.1	-3.2
Peru (Elias, 1992)						
1960-70	5.3	4.4	2.7	2.9	0.9	1.5
1970-80	3.7	4.7	3.1	3.1	1.1	-0.5
1980-85	-0.4	1.7	3.1	1.1	1.1	-2.6
Colombia (Elias, 1992)						
1960-70	5.2	3.6	3.1	2.2	1.2	1.8
1970-80	5.8	4.9	4.6	2.9	1.8	1.1
1980-85	2.3	4.6	3.0	2.8	1.3	-1.8
Brazil (Elias, 1992)						
1940-80	6.4	6.5	2.6	3.3	1.3	1.9
1960-70	5.9	5.3	2.7	1.6	2.2	2.1
1970-80	8.2	12.3	3.1	5.3	1.8	1.1
1980-85	1.7	3.2	2.4	1.3	1.3	-1.0
Brazil (Abreu and Verner, 1997)						
1930-93	6.1	7.4	2.7	5.1	0.8	0.2

Sources: Elias (1992); Abreu and Verner (1997); and Fund staff calculations.

Table II. 5. Ecuador: Contributions to Growth, 1991-99

	1991-93	1994-96	1997-99	1991-99
Overall real GDP growth	3.5	2.9	-1.2	1.8
Growth contribution from:				
Petroleum sector	36.7	15.1	-29.1	7.6
Nonpetroleum sector	63.3	84.9	129.1	92.4
Non-oil real GDP growth	2.9	2.7	-1.4	1.4
(Contribution to non-oil growth by sector)				
Agriculture	0.1	26.8	0.3	9.1
Manufacturing	30.2	21.5	14.3	22.0
Electricity	2.4	0.1	1.1	1.2
Construction	-6.0	1.8	7.6	1.2
Trade	24.1	20.0	17.3	20.5
Transport	12.6	9.3	8.7	10.2
Financial services	55.3	11.9	-3.3	21.3
Other services	42.9	22.1	25.5	30.2
Public administration	-68.6	-16.1	5.5	-26.4
Others	7.0	2.6	23.0	10.9
(Contribution to overall growth by demand component)				
Domestic demand	55.8	55.8	77.3	63.0
Consumption	39.4	49.3	22.4	37.0
Investment	16.4	6.5	54.9	26.0
Net export	44.2	44.2	22.7	37.0

Source: Fund staff calculations.

III. The Crisis in the Banking Sector[11]

30. By early January 2000, Ecuador's banking sector had deteriorated to the point where sixteen financial institutions, accounting for about 65 percent of the financial system's on-shore assets,[12] had been intervened or closed[13] by regulatory authorities during the previous 18 months; the level of non-performing loans had reached 45 percent of outstanding loans; and the fiscal cost of the crisis was estimated at US$2.6 billion or 20 percent of GDP. This chapter provides an analysis of how the banking crisis evolved, and of the key elements of the restructuring strategy that is now being implemented.

31. In the period before 1998, the capital basis of some of the biggest banks had been eroded due to inadequate banking practices, increasing the banking system's vulnerability to external shocks. These practices were possible because of long-standing legal, regulatory and supervisory weaknesses, compounded by strong conflict of interest. When a series of external shocks (*El Niño*, world oil prices, emerging markets, financial crisis) hit the Ecuadoran economy in 1997/98, the banking system was therefore rapidly consumed by a combined solvency and liquidity crisis. In its turn, the banking crisis undermined monetary and exchange rate policy in a vicious circle that culminated with the announcement of dollarization in early January 2000. A comprehensive restructuring strategy has been developed to return the banking system to a viable financial position. This strategy comprised measures to restore confidence in the banking system through short-term liquidity management, banking crisis management, and medium-term strengthening of the regulatory framework and institutions. Although implementation of the strategy has been uneven, in part because of political pressures, several major improvements have been implemented that are critical for the success of the bank restructuring process. Deviations from the strategy agreed upon, especially in the early stages, substantially increased the fiscal cost of the crisis, adversely impacted the exchange rate, and further deteriorated the solvency situation of the banking system.[14]

A. The Origins of the Crisis

32. The origins of the current banking crisis could be found in widespread operational and management weaknesses that were allowed to persist because of long-standing and inter-related institutional weaknesses in bank supervision and regulation, and a bias towards

[11] Prepared by Fernando Delgado, Antonio Pancorbo and WHD staff.

[12] Out of the 24 banks remaining under private control, four banks are foreign owned.

[13] Out of which, 12 institutions have been closed.

[14] Those aspects of the banking strategy most directly linked to dollarization are discussed in the next chapter.

bailing out troubled banks rather than enforcement of prudential standards. Lax credit policies, large credit concentration, abuse of connected lending, and even some openly fraudulent mismanagement cases, substantially deteriorated the solvency situation of the largest banks in the country.

33. Despite a long-standing effort supported by the Interamerican Development Bank to strengthen the Superintendency of Banks (SoB), bank supervision was hampered by frequent turnover of key staff in the SoB, including the position of Superintendent. Staff was poorly trained, badly equipped, and lacked motivation in the absence of a clear mission. Moreover, necessary disciplinary measures against banks were often not taken due in part to the lack of legal protection for supervisory staff and to conflict of interest cases. Lack of effective prudential supervision was especially acute in the case of offshore subsidiaries of banks, which provided an easy way to circumvent regulations and controls and, ultimately, contributed a substantial share of the losses of failed banks.

34. The prudential legal and regulatory framework was not suited to the nature of the banking system's operations, nor to the supervisory capabilities of the SoB. The current financial institutions law, introduced in 1994 to promote financial sector liberalization, provided the main part of this framework. The law modernized several aspects of capital requirements, including limits to related lending and credit concentration, and external audit requirements. However, it relied too heavily on financial institutions' self-regulation, and failed to support the development of oversight and enforcement capabilities in the SoB. Against this background, regulatory forbearance frequently replaced any meaningful corrective actions.

35. Moreover, Ecuador has a history of bailing out borrowers and depositors. In 1981, congress passed a law whereby all debts—of banks and of other debtors—denominated in US dollars were assumed by the central bank (CBE) in exchange for debts denominated in *sucre* at a below-market exchange rate. By 1987, a large proportion of the restructured debts of the 1981 sucretization scheme was non-performing. To alleviate the consequent solvency and liquidity problem, banks were allowed to repay liquidity assistance credits from the CBE with public debt at face value, at a time when the debt was quoted at a 60 percent discount in the secondary market. These practices extended into late 1995 and early 1996 when, as a result of a widespread non-bank financial institution crisis following a rapid credit expansion, two mid-sized banks were affected through subordinated debt holdings and other risky investments. Instead of dealing aggressively with the insolvent banks, the CBE extended liquidity credits and, ultimately the banks were taken over by a private bank[15] and by the CBE itself.[16]

[15] Filanbanco acquired Banco de los Andes in 1994.

[16] Banco Continental.

36. The combination of ineffective supervision, inadequate legislation, and regulatory forbearance created an environment of serious moral hazard in which bankers were implicitly discouraged from improving operational and managerial practices because the expectation of a bailout at taxpayers' expense sharply reduced their cost of failure. As a result there was a considerable increase in high-risk credit and investment operations. This occurred partly through connected lending operations, and partly through lending in foreign currencies to economic activities that had no natural hedge.[17] Demand for credit in US dollars grew sharply because lending rates in US dollars did not reflect adequately the risk of the operations, as relatively cheap funding was obtained from external lines of credit and off-shore deposits and exchange rate risk incurred by borrowers was disregarded (Figure III.1).

B. The Outbreak of a Systemic Liquidity Crisis

37. The Ecuadoran banking system was highly vulnerable when severe external shocks hit Ecuador in 1997–98 (i.e., the *El Niño* weather phenomenon and the decline in world oil prices). Three factors combined to trigger a liquidity crisis. First, the economic downturn prompted by these shocks weakened banks' balance sheets through an increase in non-performing loans (Table III.1). Second, the Russian crisis in the fall of 1998 and the subsequent reassessment of emerging market risk by international financial markets induced a severe drainage of liquidity through a reduction in external credit lines (Figure III.2). Third, as the problems in the banking sector gradually became public knowledge during the fall of 1998, confidence declined and a substantial deposit flight took place (Table III.2).

38. Liquidity problems first affected the weakest banks, exposing their insolvency problems. Banco de Préstamos, where asset overvaluation problems were substantial, was closed in August 1998. Liquidity of the two largest banks, Filanbanco and Banco del Progreso, rapidly deteriorated, resulting in the take-over of Filanbanco by the Government Deposit Insurance Agency (AGD) in December 1998 (after substantial liquidity resources had been received from the CBE).[18] The run on the *sucre* during the first months of 1999, resulted in the abandonment of the exchange rate intervention bands and a large depreciation of the *sucre*-dollar exchange rate. This lead to a further deterioration in the asset quality of banks which, combined with deposits flight increased their solvency and liquidity problems.

[17] 67 percent of total on-shore credit portfolio of the banking sector was dollar denominated by end-March 1999. It has been estimated that less than 25 percent of the borrowers have dollar-denominated income and, therefore, banks were overexposed to the exchange rate risk of their customers in over 50 percent of their portfolio.

[18] Intervention of Filanbanco was delayed until passage of the law creating the AGD and extending a blanket deposit guarantee, thus effectively increasing the State share in the cost of the banking crisis.

39. The liquidity crisis was exacerbated by a series of policy measures that eventually backfired. The first of these was the failure to deal decisively with Banco del Progreso, the second largest bank in the country, when problems started to emerge. The second was the introduction of the financial transactions tax[19] in December 1998, which prompted a sudden preference for cash by individuals and corporations that further exacerbated liquidity tensions in the banking system. A blanket deposit guarantee, that included offshore deposits and external trade lines, was passed in December 1998 to calm the situation.[20] The AGD was established to administer the guarantee and manage the disposal of assets in closed banks. However, given the solvency problems of several large banks as well as the weak fiscal situation, there was little credibility in the deposit guarantee. The result was a chain of closures of 6 small banks and the liquidity crisis of Banco del Progreso during the first months of 1999.

40. By early March 1999 the liquidity situation of Banco Progreso had reached a critical stage. The bank had received all liquidity assistance available from the CBE under its law but was still unable to meet its payments. The insolvency situation of the bank was well know, but the owner of the bank was also extremely influential politically and was able to prevent the timely intervention of the bank.[21] Since the government did not have the resources to take over Banco Progreso and keep it open,[22] and it was feared that its closure could trigger a widespread deposit run (exacerbated by the coincidental currency run), the authorities decided, on March 11, 1999, to freeze all demand and savings deposits for six months and all time deposits for one year. Also, a one-week bank holiday was declared to allow time to find a solution to keep open Banco del Progreso.

C. The Restructuring Strategy

41. Immediately after the generalization of the banking crisis prompted by the bank holiday and the deposit freeze, a bank restructuring strategy was designed with the help of staff from the Fund and other multilateral financial institutions. The strategy aimed at

---

[19] A one percent tax was charged on any bank transaction, including both credits and debits, and in any kind of account.

[20] Fund staff advised against passing the deposit insurance law extending a blanket guarantee to off-shore subsidiaries and without first closing the insolvent institutions.

[21] The bank closed its doors unilaterally immediately after the banking holiday ended, but the existing owner and management were left in control until a new Superintendent of Banks took office four months after the bank suspended operations.

[22] To maintain Filanbanco's operation after take over by the AGD required over US$800 million, most of it in liquidity assistance through rediscount of government bonds at the CBE.

restoring the banking system to solvency and profitability at least fiscal cost in order to provide support for economic recovery and a basis for sound macroeconomic management. Measures to restore confidence in the banking system were divided in three broad categories.

42. **Short-term liquidity management** measures that included: (i) making the deposit guarantee credible while minimizing its monetary impact by transferring guaranteed deposits and credit lines to open banks; (ii) minimizing the liquidity impact on the banking system and on the exchange rate by gradually unfreezing deposits when conditions so allow; (iii) use CBE monetary management instruments to aggressively mop up the liquidity injected to support guaranteed deposit payments and intervened banks' recapitalization through rediscount of government bonds; (iv) strict enforcement of limits to liquidity assistance from the CBE and collateral rules; and (v) immediate intervention of banks defaulting on their payments/clearing obligations or cases of serious fraud and gross mismanagement.

43. **Banking crisis management** measures aimed at establishing the framework for systemic restructuring through: (i) creating an institutional framework assigning overall responsibility for the systemic bank restructuring to one full-time official at ministerial level, complemented by external review boards in each stage of the restructuring process;(ii) undertaking a comprehensive audit of all banks by international audit firms and based on common and uniform criteria to determine solvency levels; (iii) applying burden-sharing criteria for losses minimizing fiscal costs and avoiding bailouts of existing owners; (iv) developing a transparent and accountable framework for dealing with assets of nonviable banks, creating a legal and institutional capacity to adequately manage and resolve a large number of problem assets through reforming the legal and institutional framework, and developing an asset resolution strategy aimed at minimizing fiscal costs; and (v) reviewing the incentives framework to promote private recapitalization of banks, including an adequate period to adapt to new prudential regulations according to international best practices.

44. Measures to **strengthen the regulatory and incentive framework in the medium-term**, including: (i) an in-depth restructuring of the SoB to improve its efficiency in legal and regulatory enforcement, eliminate political influence, and solve regional and conflict of interest problems; (ii) bringing prudential regulations in line with international standards, ensuring compliance with Basle Core Principles (especially capital adequacy) at the end of the restructuring process; (iii) limiting the role of specialized public financial institutions; and (iv) implementing an effective strategy for corporate and household debt restructuring based on negotiations between private parties, relying on market mechanisms, and avoiding the use of fiscal resources.

D. The Implementation of Bank Restructuring Measures and its Impact on the Unfolding of the Crisis

45. Implementation of the bank restructuring strategy has been uneven. Strong conflict of interest situations have delayed or prevented taking some of the most urgent measures, such as prompt intervention of insolvent and/or grossly mismanaged banks. Lack of political support and social unrest prevented timely passage of key legislation and forced the

authorities to unfreeze deposits at a faster pace than allowed by the system's liquidity situation and the strength of the currency. This uneven implementation contributed importantly to the decline in confidence and to the increase in the fiscal cost of the crisis.

46. However, taking into account the difficult economic, political and social situation, the authorities did achieve some major improvements that are critical for the future success of the bank restructuring process. Along with other minor measures, substantial progress has been achieved in three key areas of the strategy: the international audits process, the legal and regulatory reform, and the corporate debt-restructuring scheme.

47. **International audits** of all private banks and two government-owned banks, limited basically to asset valuation, were conducted between May and July 1999, in broad agreement with the principles and criteria established in the bank restructuring strategy. Based on the results of the audits and adjustments to this made by a team of international advisors (Evaluation Unit), banks were classified into three categories: capital compliant ("A"), which would remain under private control; capital deficient ("B"), which would be intervened and subject to a recapitalization program aimed at maximizing recapitalization from private funds; and negative net worth ("C"), which would be immediately taken over by the AGD and resolved. On July 30, 1999 the results of the audit process were announced and action was taken to put C banks under AGD control and to put B banks under a capital-strengthening program. However, due in part to failure to secure passage of crucial legal reforms in congress[23] and to limitations of the Ecuadoran prudential regulations, not all criteria and principles established in the restructuring strategy were applied. As a result, the capital deficiency of the banking system according to international best practices was up to 50 percent larger than the figure reported by the Evaluation Unit. Application of the former criteria would also have resulted in a worse classification of some banks and the need to immediately resolve at least two more big banks that were initially spared from the AGD take over.[24] Despite these shortcomings, the bold and timely announcement of the audit's results and the support measures taken helped achieve a substantial, albeit temporary, rebound in public confidence in the banking system.

48. **The legal and regulatory reform** has taken place against the background of a divided congress, conflict of interest situations, and a strong negative public opinion against banks. Reforms have therefore generally been approved later than needed (most of them only

[23] Congress passed banking legislation the day before the announcement of the international audits results was due, but in a manner that changed substantially the original intent of the law that had been submitted, forcing the authorities to veto the law and improvise resolution techniques within the pre-existing legal framework that placed the burden of recapitalization on the State, and provided a temporary bail-out of bank owners at a higher fiscal cost.

[24] Banco del Pacífico and Banco la Previsora. The insolvency of both banks eventually surfaced and both institutions were taken over in October 1999.

in the context of the Economic Transformation Law (*Trole I*) in March 2000) and some important issues remain outstanding. However, substantial progress has taken place in a number of areas: (i) establishing a framework which provides incentives for the private recapitalization of banks;[25] (ii) increasing legal protection to officers involved in the bank restructuring process; (iii) increasing the AGD's asset management authority and capabilities, which have been weak; (iv) bringing prudential regulations in the areas of loan classification and provisioning; and fit and proper requirements for bank owners and management up to international best practices; and (v) establishing a fund, aimed at provided exceptional liquidity assistance to banks.

49. **The corporate debt-restructuring scheme** approved in June 2000 includes two elements. One is a framework for systemic and compulsory restructuring of small debtors,[26] aimed at easing the acute social problems created by the economic and currency crisis by extending loan maturities and introducing gradually increasing payment schedules. The other is a largely voluntary procedure for large borrower workouts, with strong incentives for both banks and corporations to reach restructuring agreements.[27] The schemes avoid any direct fiscal subsidy to borrowers or any generalized bailout for large borrowers. These measures were a precondition for effective bank restructuring, given the rapid deterioration in banks' asset quality (see Table III.1) and the widespread expectations of a borrowers' bailout based on previous experiences. If implemented successfully, the restructuring scheme will help restore the viability of a large number of corporate and individual borrowers, and improve banks' cash inflow and solvency over the medium term; while minimizing the direct fiscal cost, reducing the risk of further bank failures, and establishing the basis for the recovery of the real sector.

50. In some other important areas, however, implementation deviated substantially from the agreed bank restructuring strategy or lagged behind the anticipated timetable. These areas include some of the short-term liquidity management measures, and inconsistencies between the objective to restore confidence in the banking system and macro policies. These

---

[25] These measures are still incomplete, as existing interest rate caps and banking fee restrictions are strong disincentives for private investment in the banking sector, and draft legislation to allow existing shareholders and management to retain ownership and control of their banks when they are complying with a recapitalization program remains to be approved within the Law for Promoting Citizens' Investment and Participation ("Trole II") that was submitted to congress in July 2000.

[26] Up to US$ 50,000, including some 800,000 debtors (over 92 percent of total loans in the system) representing around 12 percent of the total bank credit portfolio.

[27] An important piece of this framework is still missing. Private banks should be allowed exceptional access to enhanced foreclosure procedures (*coactiva*) for those borrowers failing to regularize their situation before the restructuring deadline.

deviations and delays from the agreed implementation schedule contributed to the deterioration of solvency, liquidity and profitability of the banking system during 1999 and early 2000, substantially increased the fiscal cost of the crisis, and contributed importantly to the collapse of the sucre in late 1999.

51. **Problems with short-term liquidity management measures** include actions (or lack thereof) relating to the coverage and payment of the deposit guarantee, the timetable and procedures to unfreeze deposits, forcing banks to accept certificates of frozen deposits (CDRs) at face value, and the use of liquidity management mechanisms.

52. Political decisions affecting the coverage and payment procedures of the deposit guarantee increased the fiscal cost and liquidity pressures. These procedures defined a burden sharing structure whereby most of the cost of the crisis was assumed by the Government.[28] Specific measures included (i) bailing out Banco de Préstamos depositors that were not covered by the deposit guarantee law in March 1999;[29] (ii) bailing out Solbanco's shareholders in July 1999;[30] (iii) guaranteed liabilities of closed banks were not transferred to open banks due to legal problems that have not been resolved yet;[31] and (iv) failure to

---

[28] The first and more important of these decisions was the approval of the blanket deposit guarantee in December 1998, including all solvent and insolvent banks.

[29] Congress decided to extend the blanket deposit guarantee to Banco de Préstamos' depositors, even though the bank had been closed before passage of the blanket guarantee law and its depositors had already received up to US$2,000 per customer, which was the limited deposit guarantee existing a the time of the banks' closure. The fiscal cost of this decision was estimated at about US$200 million.

[30] Solbanco's main depositor was a public employees' pension fund. The bank showed acute solvency problems early in 1998 and the pension fund decided to capitalize part of its deposits to reestablish compliance with the minimum capital adequacy ratio. However, the problems of Solbanco ran deeper than expected and the international audit process showed that the bank had a negative capital position. According to the bank restructuring strategy, owners of insolvent banks would loose their stakes and the banks would be taken over by the AGD for resolution. However, the authorities decided to reverse the 1998's deposit capitalization in order to prevent the new shareholders (former depositors) from losing their capital stakes and their deposits (as related parties deposits were not covered by the deposit guarantee). The fiscal cost of this measure was estimated at about US$75 million.

[31] Despite efforts of the two State-owned banks which were in charge of guaranteed deposits cash payments to retain these funds, the results were relatively modest (averaging 60 percent of the funds in Filanbanco an 15 percent in Banco Continental). As a result, a larger proportion of guaranteed deposits left the banking system in the last few months of the year.

promptly take over insolvent banks, which, in some cases, were left for months under the control of their former owners and management.

53. Forced by political and social pressures, the authorities accelerated the timetable to unfreeze deposits in several occasions from May to November, 1999 and, following a ruling by the Attorney General, implemented unfreezing procedures in March 2000 that substantially increased the liquidity vulnerability of the system.[32] Fortunately, partly due to the initial success of the dollarization and the announcement of the Fund supported program and financial support from other IFIs, deposits in the on-shore banking system did not decline but slightly increased since March 2000 (Table III.4).[33]

54. The authorities passed a decree in November 1999 forcing banks to accept payment of credits with certificates of frozen deposits (CDRs) in any bank (including closed banks) at face value, up to the amount of the credit lines granted to each bank by the National Financial Corporation (CFN – a second-tier public development bank).[34] This measure had a negative effect on liquidity and portfolio structure of banks and has caused the technical bankruptcy of the CFN.

55. Due in part to the weak liquidity situation of most banks, but also to inadequate interest rate policies, the CBE was unable to mop up the large liquidity injections (Table III.3) generated by the rediscount of government bonds used to pay guaranteed deposits, recapitalize and provide liquidity to banks taken over by the AGD, and by the accelerated unfreezing schedule.

56. **Inconsistencies between the objective to restore confidence in the banking system and macro policies**. The timing and nature of the debt strategy followed by the authorities, and the monetary and exchange rate policy mix that followed immediately after the external debt default contributed to weaken confidence in the banking system and introduced incentives contrary to the strengthening of banks.

---

[32]Instead of swapping frozen time deposit balances above US$4,000 for 3 to 7 year government bonds, banks were instructed to issue their own bonds but, de facto, were given ample leeway to pay the full balances in cash. Also, mutual funds' investments, for an amount of about US$500 million, were fully unfrozen in cash on March 13, 2000. Fortunately, an aggressive policy by most banks, helped by the high cost of changing banks introduced by the financial transactions tax, succeeded in maintaining most deposits within the banks.

[33] However, several Constitutional Court rulings since November 1999, establishing the immediate unfreezing of any remained frozen deposit balances, are bound to create problems for the more liquidity-squeezed banks, although the risk of a systemic liquidity crisis has substantially decreased since March 2000.

[34] The banks could then use these CDRs to cancel the CFN lines.

57. By September 1999, Ecuador's default on its Brady bonds prompted a reversal of the rebound in confidence into the banking system and the currency that had followed the announcement of the international audits results and the adoption of a flexible exchange rate system. [35] The renewed liquidity pressures, due to deposit and capital flight and the continuous reduction in external credit lines (Figure III.3), exposed the deep insolvency and liquidity problems of the three large banks intervened after the international audits, forcing the AGD to take them over. Also, domestic government bonds became illiquid after the restructuring, depriving banks of their most liquid domestic instrument.

58. Monetary policy was slow to react after the default and subsequent exchange rate pressures. Interest rates remained unchanged despite the accelerating depreciation of the sucre. The result was a **loss of monetary control**. The rapid expansion of base money to pay out deposits, provide liquidity to and recapitalize banks taken over by the AGD, combined with the initial lack of response in interest rates policy, made it impossible for the CBE to mop up much of the large liquidity injections (Table III.3 and Figure III.2 on base money expansion, ER collapse and CBE intervention interest rates). This contributed to the collapse of the exchange rate, and further eroded confidence in the banking system as non-performing loans grew larger. The banks' liquidity situation worsened as deposit flight continued under the impulse of the exchange rate crisis at a time when their external credit lines continued to contract. When the CBE finally reversed its position on interest rates, it was essentially too late, since the levels necessary to ensure exchange rate stability were unsustainable for the banking sector, further contributing to increase the level of non-performing assets.[36]

59. This year, the introduction of effective interest rate ceilings on loans to well below market rates, reinforced by restrictions on bank fees, have compressed the margins that can be charged to higher risk borrowers and will hamper debt restructuring and a return to normal credit activity. In March, 2000 the congress approved the introduction of an interest rate ceiling on loans calculated as Libor plus the country risk premium plus four percentage points margin, with the specific ceiling to be established by the CBE. Responding to political pressures, the CBE established an initial interest rate ceiling of 24 percent that was further reduced to 20 percent in May, 2000. The Banking Board decided to introduce a further cap by requiring provisions on loans bearing interest rates above 18 percent (23 percent for consumer loans), that acted as a further major disincentive for banks to set interest rates above those levels. In June 2000, to reinforce the ceilings, the Banking Board approved a resolution severely limiting the fees that banks could charge.[37] The authorities have

[35] A partial restructuring of domestic public debt in October 1999 added to these pressures. Maturities on debt falling due through end-2000 were extended and interest rate reduced.

[36] Due to existing provisions regulating the computation of arrears' interest rate, linking them to the original interest rate of the loan, penalty rates resulted lower than current interest rates, thus prompting non-payment by borrowers.

[37] Mainly, no fee could be charged in a loan or in substitution of an interest rate.

introduced a new more flexible formula for calculating the interest rate ceiling in the Trole II and the Banking Board has approved a reduction in the provisioning scale for loans bearing interest rates above 18 percent. The new rules reduce, but do not eliminate the interest rate controls, and would still be an impediment to financial intermediation unless phased out soon.[38]

E. The Fiscal cost of the Crisis

60. The estimated fiscal cost of the banking crisis to date is about US$2.6 billion (20 percent of 1999 GDP),[39] excluding proceedings from any asset recovery by the AGD and costs derived from the need to recapitalize AGD owned banks and from the differential between the interest rates of government bonds held by the CBE and market rates. The cost includes bonds issued by the government on behalf of the AGD for about US$1.4 billion. These were used to recapitalize troubled banks, provide liquidity assistance to banks operating under control of the AGD, pay out deposit guarantees of failed banks, and cover the run-down of external credit lines. It also includes US$850 million to cover part of the remaining guaranteed deposits of closed banks, and also about US$155 million to pay another part of these guarantees in cash, of which only about US$63 million had been paid (in monthly installments of US$12.5 million) through June 2000.[40] In addition, the government has taken over about US$226 million of nonperforming trade credit lines of AGD banks.

---

[38] The provisioning scale for loans bearing interest rates above 18 percent is due to expire at end-March, 2001.

[39] By comparison, the latest estimates of the fiscal costs of other banking crisis are 56 percent of GDP in Indonesia, 21 percent in Korea, 19 percent in Mexico, 17 percent in Finland, 14 percent in Malaysia, 6 percent in Sweden, 3 percent in Norway, 1 percent in Denmark, and negligible in Russia (very few direct fiscal cost were associated with the banking crisis).

[40] Also, about US$100 million guaranteed deposits were paid in cash (obtained through bond rediscount at the CBE) during 1999.

Estimated Cost of the Banking Crisis

(as of June 2000)

	(In millions of U.S. dollars)	(In percent of GDP)
Total	**2,641**	**20.0**
AGD bonds	1,410	10.7
Trade credit lines of AGD banks	226	1.7
Guaranteed deposits of closed banks	850	6.4
Cash provided to cover guaranteed deposits	155	1.2
Memorandum item:		
Estimated total annual "carrying" cost	195	1.5

Source: Fund staff estimates.

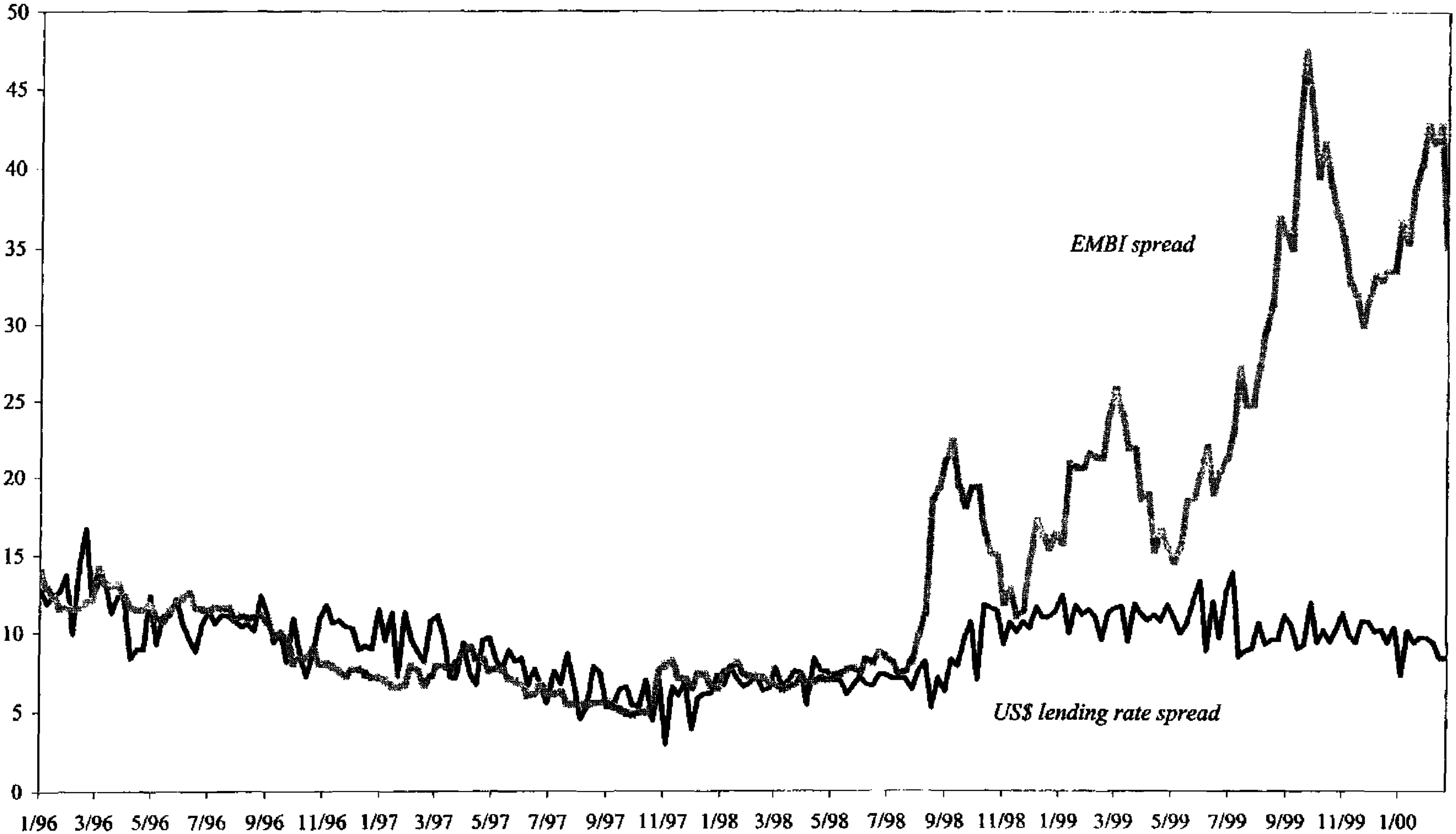
61. While some of these costs were probably unavoidable, given the scale of the macroeconomic crisis facing Ecuador, poor policy choices added substantially to the fiscal cost in the instances mentioned above.

F. Further Crisis Resolution Measures

62. Although the currency stability and halt to the decline in real economic activity achieved since dollarization has had a net positive effect on the banking system, the financial condition of most banks is still very fragile. In order to restore bank solvency, liquidity and profitability, a number of actions remain to be implemented. The key pending issues are: eliminating restrictions on interest rate and banking fees; completing the incentives framework for—and implementing—the schemes for corporate debt restructuring and the private recapitalization of banks; and ensuring that the liquidity recycling facility is fully operational (see next chapter). Other measures needed to ensure the success of the bank restructuring strategy and to minimize the fiscal cost of the crisis are: (i) developing and implementing an effective asset management plan for the disposal of assets acquired by the AGD in the resolution process; (ii) improving the management of banks under AGD control; (iii) developing a reprivatization strategy for banks under AGD control; and (iv) further strengthening banking regulation and supervision.

Figure III.1. EMBI and Ecuadoran Bank U.S. Dollar Lending Spreads 1/

(In percentage points)



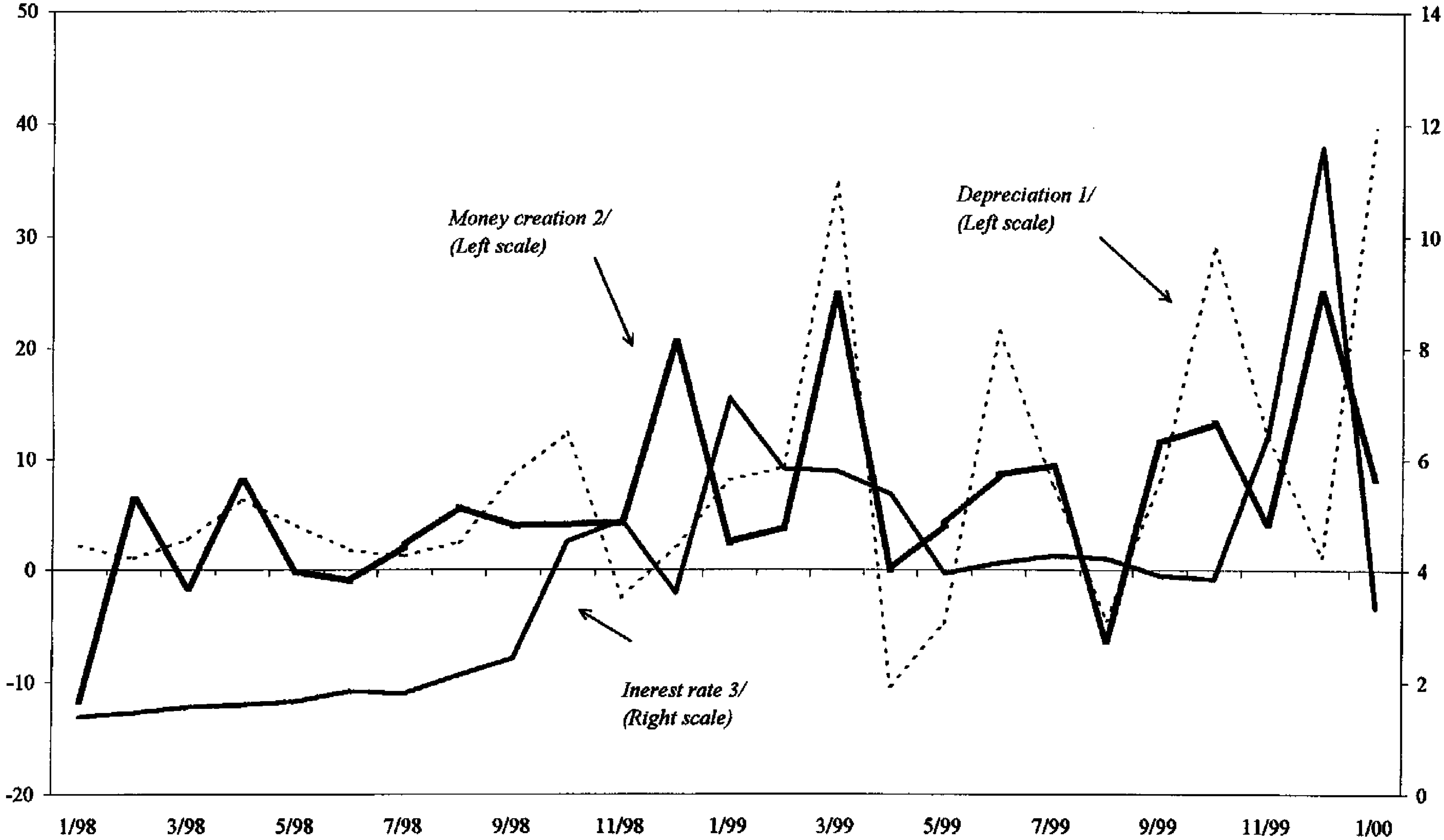
Sources: Ecuadoran authorities and J.P.Morgan.

1/ EMBI spread is the difference between yield on Ecuadoran Brady bonds stripped of collateral and U.S. Treasury bonds of the same maturity. U.S. dollar lending rate spread is the difference between the US$ lending rate in Ecuador and 12-month US$ LIBOR.

Figure III. 2. External Credit Lines of the Ecuadoran Banking System
(In millions of U.S. dollars)

Source: Ecuadoran authorities.

Figure III.3. Ecuador: Depreciation, Money Creation and Interest Rates
(In percent change per month and percent per month)



Source: Central Bank of Ecuador.

1/ Monthly percentage change in sucre/dollar exchange rate (period average).
2/ Monthly percentage change in currency issued (end of period).
3/ Average monthly effective rate on overnight Central Bank *bonos de estabilizacion monetarios* (period average).

Table III.1. Ecuador: Nonperforming Loans

	Dec. 1998	1999 Mar.	Jun.	Sep.	Dec.	Mar. 2000 1/
	(In percentage of credit portfolio)					
Nonperforming loans	6.5	16.7	26.3	29.9	33.3	n.a.
Domestic banks	14.2	18.3	31.7	40.5	44.7	51.4
Offshore banks	3.5	11.9	9.5	11.7	13.5	n.a.
Private banks	4.6	12.8	14.6	18.9	18.9	22.4
Banks controlled by AGD	7.8	22.2	31.1	32.6	37.8	57.1
Closed banks	6.5	14.5	40.1	36.0	40.2	80.0
In *sucres*	14.4	16.0	30.3	37.7	41.4	43.5
In U.S. dollars	5.4	17.1	25.0	28.1	32.0	53.1

Sources: Superintendency of Banks of Ecuador; Fund staff estimates.
1/ On-shore data only.

Table III. 2. Ecuador: Banking System Deposits

	1998				1999				Mar.
	Mar.	Jun.	Sep.	Dec.	Mar.	Jun.	Sep.	Dec.	2000 1/
	(In millions of U.S. dollars)								
Domestic banks	3,368	3,635	3,875	4,281	3,662	3,701	3,626	2,847	2,769
Offshore banks	2,874	1,611	1,575	2,436	3,207	2,827	2,364	1,956	1,529
Private banks	2,694	2,613	2,214	3,322	2,429	2,439	2,528	2,232	2,142
Banks controlled by AGD	3,547	2,633	3,236	3,395	2,590	2,347	1,943	1,481	1,479
Closed banks				0	1,850	1,741	1,519	1,090	677
In *sucres*	2,267	2,481	2,694	2,930	2,063	2,075	1,936	1,298	1,042
In U.S. dollars	3,975	2,765	2,756	3,787	4,806	4,452	4,054	3,505	3,257
Free deposits	6,242	5,246	5,450	6,717	4,402	3,659	3,672	2,865	3,230
Frozen deposits	0	0	0	0	2,467	2,869	2,318	1,938	1,069
Memorandum item:									
Exchange rate S/. Per US$	4,884	5,272	6,211	6,765	9,971	11,124	13,637	19,858	25,000

Source: Superintendency of Banks of Ecuador; and Fund staff estimates.
1/ Does not include data on the off-shore subsidiaries of closed banks.