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**INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT**

**INTERNATIONAL FINANCE CORPORATION**

**AND**

**MULTILATERAL INVESTMENT GUARANTEE AGENCY**

**COUNTRY ENGAGEMENT NOTE**

**FOR**

**THE REPUBLIC OF ECUADOR**

**FOR THE PERIOD FY2016-2017**

**February 8, 2016**

**Bolivia, Chile, Ecuador, Peru and Venezuela Country Management Unit  
Latin America and the Caribbean Region**

**The International Finance Corporation  
Latin America and the Caribbean Region**

**Multilateral Investment Guarantee Agency**

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## **CURRENCY EQUIVALENTS**

US dollar used as legal tender, effective January 2000

## **FISCAL YEAR**

January 1 – December 31

## **WEIGHTS AND MEASURES**

Metric System

	<b>IBRD</b>	<b>IFC</b>	<b>MIGA</b>
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## ABBREVIATIONS AND ACRONYMS

AECID	Spanish Agency of International Cooperation for Development ( <i>Agencia Española de Cooperación Internacional para el Desarrollo</i> )	ENAS	National Strategy for Water and Sanitation ( <i>Estrategia Nacional de Agua y Saneamiento</i> )
AP	Proud and Sovereign Fatherland Alliance ( <i>Alianza PAIS - Patria Altiva i Soberana</i> )	ENEMDUR	Urban and Rural Employment, Unemployment and Underemployment Survey ( <i>Encuesta de Empleo, Desempleo y Subempleo Urbano y Rural</i> )
ASA	Advisory Services and Analytics	ENIEP	National Strategy for Equality and the Eradication of Poverty ( <i>Estrategia Nacional para la Igualdad y Erradicación de la Pobreza</i> )
B40	Bottom 40 percent of the population	EOP	End of Period
BdE	State Development Bank ( <i>Banco de Desarrollo del Ecuador</i> )	ESANUT	National Health and Nutrition Survey ( <i>Encuesta Nacional de Salud y Nutrición</i> )
BDH	Human Development Bonus ( <i>Bono de Desarrollo Humano</i> )	ESW	Economic and Sector Work
CAF	Latin American Development Bank ( <i>Banco de Desarrollo de América Latina</i> )	FHH	Female Headed Household
CCT	Conditional Cash Transfer	FI	Financial Institution
CEDLAS	Distribution, Labor and Social Studies Center at La Plata National University ( <i>Centro de Estudios Distributivos, Laborales y Sociales de la Universidad Nacional de La Plata</i> )	FM	Financial Management
CEN	Country Engagement Note	FY	Fiscal Year
CO <sub>2</sub>	Carbon Dioxide	GFDRR	Global Facility for Disaster Reduction and Recovery
CPI	Consumer Price Index	GDP	Gross Domestic Product
CY	Calendar Year	GoE	Government of Ecuador
ECME	Consolidated Energy Matrix Strategy ( <i>Estrategia Consolidada de la Matriz Energética</i> )	GVC	Global Value Chains
ECV	Living Conditions Survey ( <i>Encuesta de Condiciones de Vida</i> )	IDB	Inter-American Development Bank
EIB	European Investment Bank	IFC	International Finance Corporation
		IMF	International Monetary Fund
		INEC	National Institute of Statistics and Census ( <i>Instituto Nacional de Estadísticas y Censos</i> )
		ISN	Interim Strategy Note
		IVA	Value-Added Tax ( <i>Impuesto al Valor Agregado</i> )
		LAC	Latin America and Caribbean

LAIF	Latin American Investment Facility (of the European Union)	SERCE	Second Regional Comparative and Explanatory Study ( <i>Segundo Estudio Regional Comparativo y Explicativo</i> )
LPG	Liquid Petroleum Gas		
MAGAP	Ministry of Agriculture, Livestock, Aquaculture and Fisheries ( <i>Ministerio de Agricultura, Ganadería, Acuacultura y Pesca</i> )	SETEP	Technical Secretariat for the Eradication of Poverty ( <i>Secretaría Técnica para la Erradicación de la Pobreza</i> )
MCDS	Coordinating Ministry of Social Development ( <i>Ministerio Coordinador de Desarrollo Social</i> )	SME	Small- and Medium-Sized Enterprises
MDG	Millennium Development Goals	SORT	Systematic Operations Risk-rating Tool
MIGA	Multilateral Investment Guarantee Agency	TERCE	Third Regional Comparative and Explanatory Study ( <i>Tercer Estudio Regional Comparativo y Explicativo</i> )
MIPRO	Ministry of Industry and Productivity ( <i>Ministerio de Industrias y Productividad</i> )	U.S.	United States
NDP	National Development Plan	WASH	Water, Sanitation and Hygiene
NFPS	Non-Financial Public Sector	WB	World Bank
NOAA	National Oceanographic and Atmospheric Administration	WBG	World Bank Group
NPL	Non-Performing Loan	WSS	Water and Sanitation Services
PES	Poverty Eradication Strategy	y-o-y	year-on-year
PIU	Project Implementation Unit		
pp	Percentage Point		
RAS	Reimbursable Advisory Services		
ROA	Return on Assets		
ROE	Return on Equity		
sd	Standard Deviation		
SEDLAC	Socio-Economic Database for Latin America and the Caribbean		
SENAGUA	National Water Secretariat ( <i>Secretaría Nacional del Agua</i> )		
SENPLADES	National Secretariat of Planning and Development ( <i>Secretaría Nacional de Planificación y Desarrollo</i> )		

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## I. INTRODUCTION

**1. The proposed Country Engagement Note (CEN) for Fiscal Years 2016-2017 presents a program aimed at strengthening the World Bank Group's (WBG) relationship with the Government of Ecuador (GoE) over the next two years.** This CEN follows a FY14-15 Interim Strategy Note (ISN), which provided an opportunity to re-initiate the dialogue in the country, and develop analytical work and lending operations in limited areas of engagement. The ISN successfully kick-started the engagement process after an extended period of limited dialogue. A number of issues make it difficult to define a comprehensive medium-term program. First, Presidential elections scheduled for early 2017 introduce an element of uncertainty. Second, the WBG and the GoE need time to fill a number of analytical gaps. Finally, the current adverse macroeconomic context poses an additional risk to the pace of implementation of a comprehensive program. Thus, this CEN proposes to help advance the engagement with Ecuador by enhancing policy dialogue, deepening the WBG's knowledge, and providing a flexible framework that allows the WBG to respond effectively to the changing macroeconomic conditions in the country.

**2. Ecuador is a middle-income country with an economy heavily dependent on natural resources.** Oil accounted for over half of total exports in 2014, with food and agricultural goods following with approximately one-fourth of exports. In a fully dollarized economy, these exports play a critical role, injecting dollars into the country and supporting the financing for imports. The decline in oil prices by more than half since 2014 is placing a substantial strain on the economy as a whole, and the fiscal and external accounts, in particular.

**3. During the past decade of high oil prices, Ecuador made significant gains in reducing poverty and promoting shared prosperity.** Between 2000 and 2014, GDP per capita increased by 45 percent in real terms. Poverty rates fell from 38.3 percent to 25.8 percent between 2006 and 2014, and the income of the bottom 40 percent of the population (B40) saw annualized growth rates of nearly 7 percent, compared with only about 4 percent nationwide.<sup>1</sup> These advances have placed Ecuador among the top performers in Latin America and the Caribbean (LAC) in terms of reducing poverty and improving shared prosperity. These gains, however, are coming under stress.

**4. The drop in oil prices in 2014, coupled with the strengthening of the U.S. dollar are raising concerns on whether these social advances can be sustained in the coming years.** The macroeconomic effects of the new global context have widened Ecuador's fiscal and external imbalances. With limited buffers to draw upon, the GoE has taken measures since 2014 to partially offset the impact of lower oil prices on the economy, involving budget cuts and restrictions on imports, including temporary tariff surcharges. The Government has also taken some steps to promote private investment and job creation, which nonetheless remain depressed.

**5. The proposed CEN for FY16-17 provides a platform for the WBG to continue to support Ecuador during a period of uncertainty amidst a rapidly changing context, and develop deeper knowledge about the broader development challenges of the country through strategic analytical work.** Building on the ISN, the CEN proposes to focus on supporting the GoE's efforts

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<sup>1</sup> These are consumption based poverty rates computed using the Encuesta de Calidad de Vida (ECV). The income based poverty and extreme poverty rates, computed with the Encuesta Nacional de Empleo, Desempleo y Subempleo Urbano y Rural (ENEMDUR) for December 2015 were 23.3 percent and 8.45 percent, respectively.

to: (a) sustain gains in basic service delivery and strengthening safety nets, (b) promote economic diversification in a constrained macroeconomic environment, and (c) mitigate risks from climate change and other environmental threats. With this, the WBG expects to assist the Government to advance social services for vulnerable population, enhance access and quality of infrastructure for the B40, and identifying ways to foster economic diversification consistent with Government demand. In addition, while maintaining a focused and overall limited program, the CEN will retain a flexible approach to support emerging economic and social priorities consistent with the WBG's twin goals. Finally, the proposed CEN will contribute to further developing the analytical underpinnings to advance towards the preparation of a broader, medium-term engagement framework for the WBG.

## II. COUNTRY CONTEXT

### A. Political Developments

**6. During the past decade, Ecuador has seen a period of relative political stability.** The country had eight presidents over the course of 13 years before the election of the incumbent President in 2007. The presidential movement, *Alianza PAIS* (AP), holds a majority of seats in the National Assembly. However, the 2014 subnational elections marked a notable shift in the predominance of AP at the local level, with all major cities (Quito, Guayaquil, Cuenca, among others) electing opposition candidates.

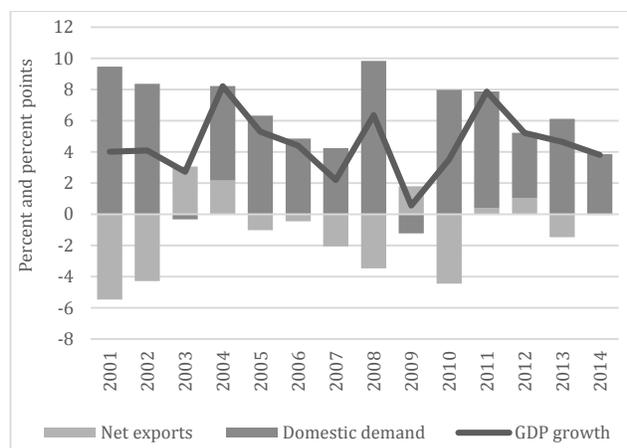
**7. Presidential elections are scheduled for 2017 and, therefore, 2016 is expected to be a year of wide political debate.** In December 2015, the National Assembly approved a series of constitutional reforms, including an amendment that would allow for the indefinite re-election of public officials. This amendment restricts the incumbent President and other officials who are currently serving their second terms from running in the next elections, while leaving the door open for their candidacy in a subsequent election after May 2017. The candidates are expected to present their intentions to run by October 2016.

### B. Recent Economic Developments

**8. Over the past decade, Ecuador experienced growth in the context of a favorable external environment that together with foreign savings financed a large expansion of the public sector.** GDP growth averaged 4.8 percent per annum over 2004-14, mostly through expanding domestic demand (Figure 1). The average price for Ecuadorian oil in 2004 was around US\$40 per barrel, which more than doubled to about US\$85 per barrel by 2014, with oil representing around two-fifths of total exports and one-third of fiscal revenues between 2004 and 2014. The main driver of growth from the demand side has been government-boosted public demand, centered on public investment. On the other hand, private investment has stagnated, due in part to a challenging investment climate (Figure 2). Furthermore, foreign direct investment during the last five years has remained under 0.8 percent of GDP, averaging US\$551 million per year, well below the regional average. On the supply side, after a sizable expansion of oil production in the early 2000s, growth was driven largely by subsectors linked with government activities (hydroelectricity and water, mining, public administration and transport). Non-oil subsectors related to private demand grew as well

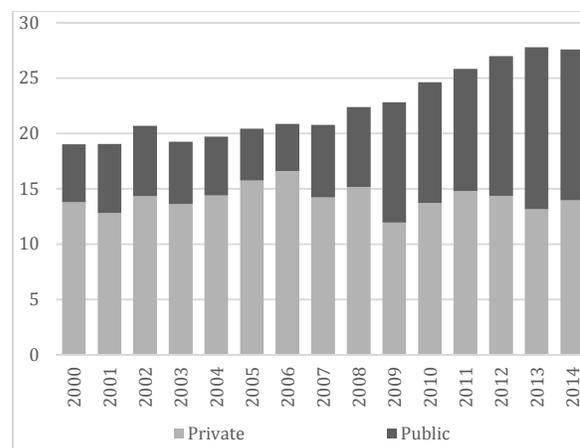
(construction, professional services, aquaculture, telecommunications, manufacturing and agriculture), but at a slower pace than those associated with the public sector.<sup>2</sup>

**Figure 1: GDP growth decomposition**



Source: Central Bank of Ecuador.

**Figure 2: Private and public investment**



Source: Central Bank of Ecuador.

**9. The Government expanded significantly, supported by buoyant revenues and public borrowing.** Aiming at better service provision (social assistance, health, education, security and infrastructure), the authorities more than doubled government expenditures as a percent of GDP—from 20 percent in 2004 to 44 percent in 2014. In particular, capital expenditures increased from 4 percent to 15 percent over the same period. The bulk of this expansion was funded out of oil revenues and public debt. The windfall, however, ended following the sharp decline in oil prices since the end of 2014. The country’s overall fiscal balance for the non-financial public sector (NFPS) widened in 2012, and reached 4.6 and 5.3 percent of GDP, respectively in 2013 and 2014 (Figure 3). The official public debt to GDP ratio, which had fallen to 19.2 percent in early 2010, went back to 30 percent by the end of 2014.

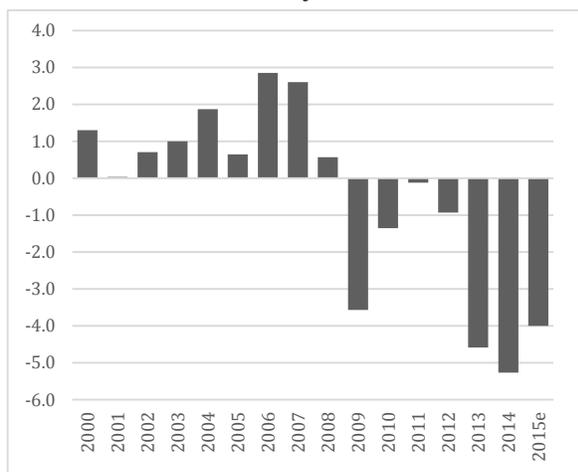
**10. Ecuador is now facing severe external and fiscal challenges linked to the fall in oil prices and the appreciation of the U.S. dollar.** During the first ten months of 2015, Ecuadorian oil prices averaged US\$45 per barrel, representing a major and likely non-temporary price shock. Since Ecuador has a fully dollarized economy (which has anchored monetary policy credibility since the early 2000s and has broad support among the population), the country was also affected by the dollar appreciation. The brunt of the economy’s adjustment to the negative shock has fallen on fiscal and income policies. On the external front, the current account deficit increased from 0.6 percent of GDP in 2014 to around 3.0 percent of GDP through September 2015, year-on-year. The impact of the terms of trade deterioration and dollar appreciation on the external front has been contained through temporary hikes in import tariffs and trade restrictions. While effective in containing some imports in the near term, these are also hampering the competitiveness of exports that rely on imported

<sup>2</sup> Ecuador recently re-initiated its engagement with the International Monetary Fund (IMF). An off-site Article IV consultation was conducted in 2014, followed by a standard, in-country Article IV consultation in 2015, the first since 2007. The resulting Article IV Staff Report was discussed by the IMF Board of Directors, and subsequently published in October 2015.

intermediate inputs—the real exchange rate appreciated 7.6 percent y-o-y in November 2015. As of December 2015, international reserves stood at around US\$2.4 billion, less than 2 months of imports or 3 percent of GDP.

**11. With limited buffers to draw upon, the GoE started to make some fiscal adjustments in 2015, mainly through capital expenditures.** Among others, these adjustments included: (a) the postponement of non-priority public investment, except for strategic projects; (b) a temporary freeze of public sector wages that is expected to start containing the wage-bill at 9 to 10 percent of GDP, a level that is already high by regional standards; (c) a tax amnesty and the import tariff measures that increased fiscal revenues; and, (d) revision of the electricity subsidy, and fuel subsidies for specific sectors. External financing from multilateral and bilateral entities, most notably from China, are helping to fill the gap, but still fall short of meeting the full financing needs. After those measures, authorities expect that the overall fiscal deficit for 2015 will reach about 3.6 percent of GDP.

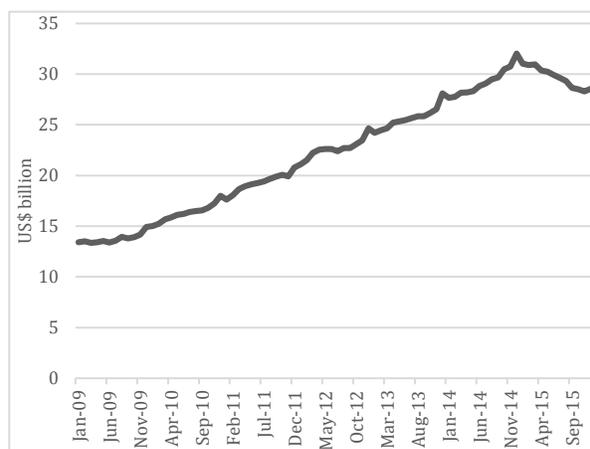
**Figure 3: Non-financial public sector balance**  
Percent of GDP



Note: (e) Expected

Source: Central Bank of Ecuador and staff estimates.

**Figure 4: Deposits at private financial institutions**



Source: Central Bank of Ecuador.

**12. Economic activity is decelerating rapidly as a result of the negative terms of trade shock, and with the risk of natural disasters looming.** GDP fell 0.4 percent quarter-on-quarter in the third quarter of 2015, after contracting 0.6 percent in the second, and remained almost stagnant in the first. Growth is not expected to recover in the near term owing to the additional adjustments required to cope with the external shocks and the limited availability of financing, while the response of the private sector is expected to remain modest due to the complex macroeconomic scenario. The situation is further aggravated by the threat of natural disasters (e.g., eruption of the Cotopaxi volcano and the “El Niño” phenomenon).

**13. The financial sector has been liquid and well capitalized in recent years.** Several measures have been put in place to strengthen the resiliency of the financial sector since the mid-2000s.<sup>3</sup> The

<sup>3</sup> Some of these measures include the establishment of the systemic liquidity fund and strengthening of the deposit insurance fund.

financial sector is liquid (with short term liquid assets as a share of short term liabilities at approximately 29.6 percent at end-December 2015, as banks have high liquidity needs in a dollarized economy, are well-capitalized (with a capital adequacy ratio of 13.8 percent at end-October 2015), and have a relatively low level of non-performing loans (NPLs) of 3.7 percent at end-December 2015.

**14. However, the deteriorating economic environment is contributing to increased credit and liquidity risks in the financial sector.** In 2015, the financial sector faced additional challenges. The stock of private sector deposits declined, impacting in particular large banks (Figure 4). In response, the Central Bank has increased the reference ceiling for deposit rates offered by commercial banks. Credit growth has also stagnated, with barely any growth in the first eleven months of 2015, as banks' and other agents' cash preference increased in the current economic environment. Banks are now facing higher funding costs and credit risk, with NPLs increasing in specific, more cyclical segments, such as consumer lending (7.0%) and microenterprises (6.1%).

**15. In addition, the economic outlook is affecting financial intermediation.** As banks have increased their preference for short-term lending against longer term financing (also due to the modest long-term funding sources), financial intermediation is being impacted negatively. Financial intermediation is already low in Ecuador, with credit accounting for about 31 percent of GDP, compared to 37 percent in LAC and 48 percent in similar peer country income groups. Access to finance, which is the second most important obstacle to firms' operations<sup>4</sup>, is becoming an increasingly important challenge for enterprises. Banks' margins are lower in the new operating environment, and their profitability indicators are some of the lowest in Latin America (Return on Equity, ROE, of about 9.0 percent, and Return on Assets, ROA, of less than 0.9 percent at end-December 2015). Public policies like interest rate caps exacerbate the banking sector's current challenge of maintaining lending, and can lead to inadequate allocation of credit to specific segments.

### C. Poverty and Shared Prosperity

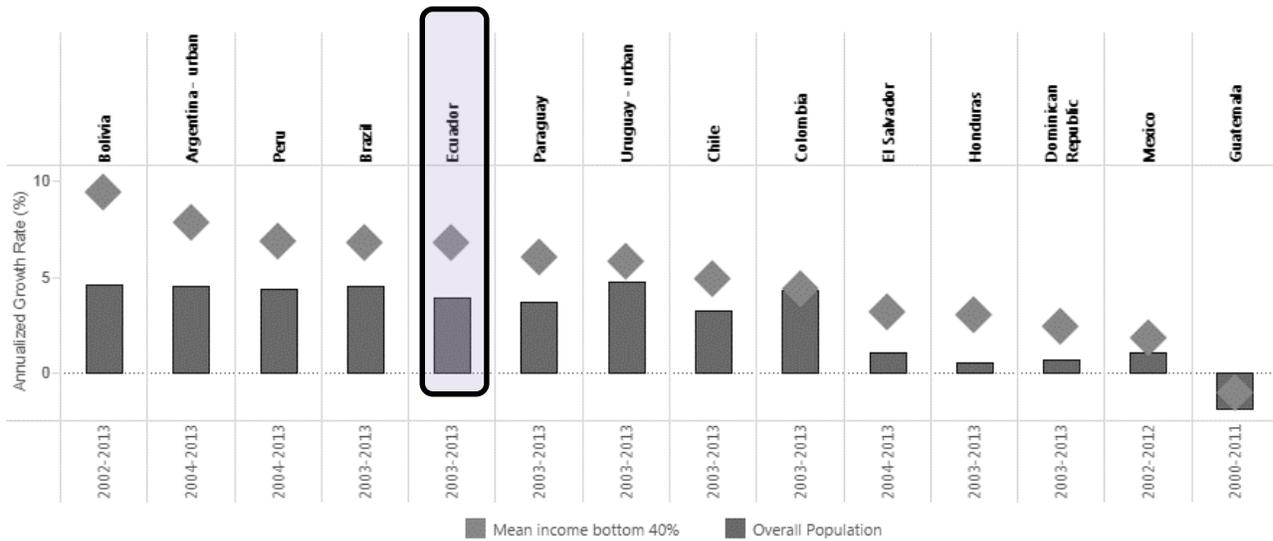
**16. A remarkable feature of Ecuador's recent period of prosperity is that it has been widely shared.** The mean income of the B40 percent of the population has grown by an annualized rate of almost 7 percent between 2003 and 2013, while the rate of growth of average income has been slightly under 4 percent. In LAC, only Bolivia and Argentina had larger growth in income of the B40, while Peru and Brazil had levels similar to Ecuador (Figure 5).<sup>5</sup> Income inequality has declined, in particular since 2007, with the Gini coefficient falling by 7 points, from 0.54 in 2007 to 0.47 in 2013. In LAC, during the same period, the Gini decreased on average only 2 points, from 0.54 to 0.52 (World Bank 2015).

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<sup>4</sup> Enterprise Surveys 2010.

<sup>5</sup> Data is from the WB's LAC Equity Lab (Centro de Estudios Distributivos, Laborales y Sociales of the Universidad Nacional de La Plata - CEDLAS and the World Bank) and World Development Indicators.

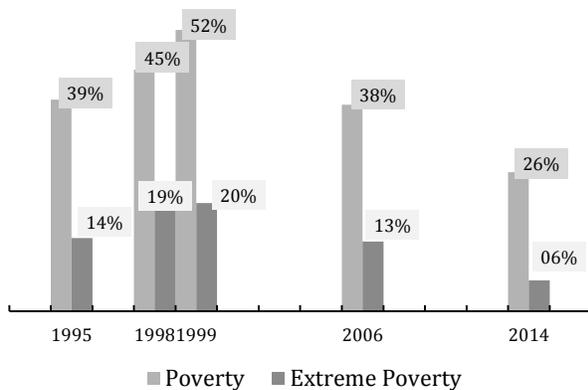
**Figure 5: Income growth, average and bottom 40 percent. LAC countries, 2003-2013**



Source: LAC Equity Lab tabulations of SEDLAC (CEDLAS and the World Bank) and World Development Indicators. The original data source for Ecuador is the ENEMDUR.

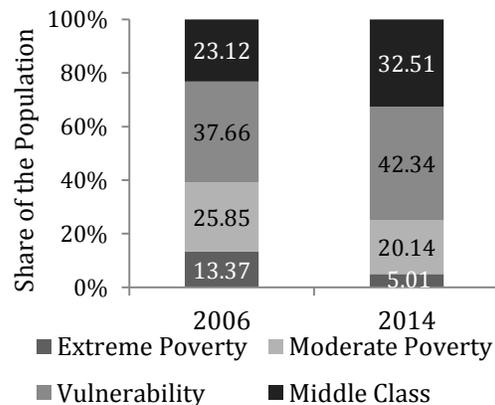
17. Ecuador’s middle class has expanded, but the vulnerable remain the population’s largest socio-economic group. The reduction in extreme and moderate poverty has grossed up the middle class, but also enlarged the population near the poverty line (Figure 6). Between 2006 and 2014, the number of persons in Ecuador’s middle class increased relatively more than the total vulnerable population– defined as those in a household that face a greater than 10 percent probability of falling back into poverty (Figure 7). As of now, the vulnerable population is the largest group in the country, and a continuation of this transition is critical in order to consolidate Ecuador’s status as a middle class country.

**Figure 6: Poverty trends, Consumption-based, 1995 – 2014**



Source: Ecuador Poverty Assessment (forthcoming). Based on data from the Encuesta de Calidad de Vida (ECV).

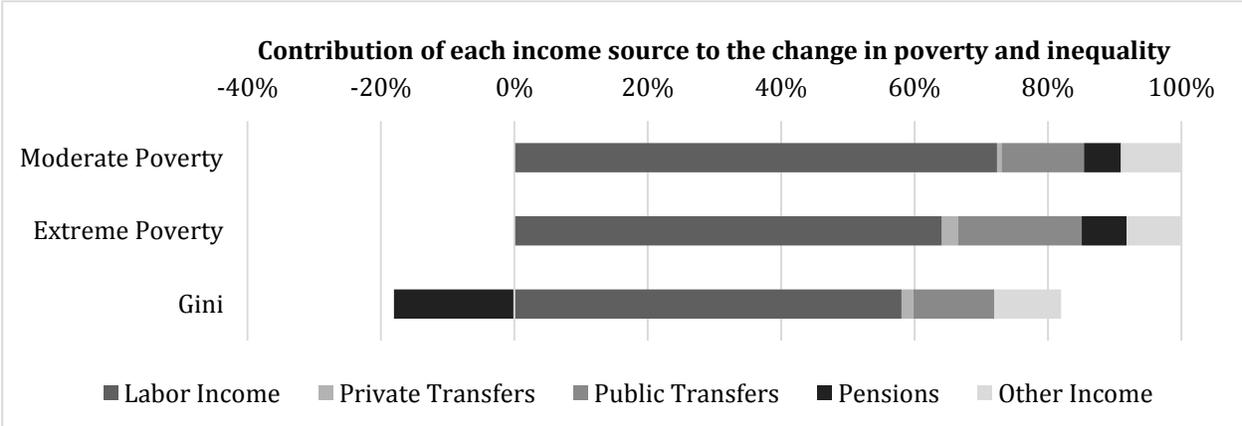
**Figure 7: Poverty, vulnerability and middle class trends. 2006-2014**



Source: ECV2006 and ECV2014. Authors’ calculation.

**18. Labor income has been the main contributor to the reduction of poverty and inequality, followed by public transfers.** Labor income has contributed towards more than 70 percent of the reduction in poverty, almost two-thirds of the reduction in extreme poverty, and 90 percent of the decrease in inequality. By 2014, the average household derived 70 percent of its income from labor markets (Figure 8). Public transfers from the *Bono de Desarrollo Humano* (BDH) program have been the second most important contributor to the reduction in poverty and inequality. In particular, public transfers contributed towards almost 20 percent of the total reduction in extreme poverty and income inequality, while BDH’s contribution to moderate poverty has been more modest (12 percent).

**Figure 8: Drivers of change in poverty and inequality in Ecuador, 2006-2014**



Source: ECV2006 and ECV2014. WBG calculations. Notes: The figure shows the Shapley Decomposition of poverty and inequality changes (see Barros et al. (2006) and Azevedo, Sanfelice and Cong Nguyen (2012) for more details).

**19. Poverty reduction from 2006 to 2014 has been widespread, even among different geographical areas.** Poverty gains took place in both urban and rural areas, as well as in the country’s three distinct natural geographic regions (Highlands, Coast and Amazon regions). Poverty in rural areas fell 14 percentage points (pp), while in urban areas the reduction was 9 pp. From the perspective of natural regions, the percentage of poor dropped 9 pp in the Highlands, 15 pp in the Coast, and 12 pp in the Amazon. Despite generalized progress, regional disparities remain. Rural poverty is three times higher than urban poverty, and poverty in the Amazon region is almost twice as high as poverty in the Highlands and Coast regions (Table 1).

**Table 1: Regional Incidence of Poverty in Ecuador, 2006-2014**

	Incidence (%)	
	2006	2014
<b>Poverty</b>		
Urban	24.9	15.5
Rural	61.5	47.3
Sierra	33.8	24.5
Costa	40.3	24.8
Amazonia	59.7	47.7
National	38.3	25.8
<b>Extreme Poverty</b>		
Urban	4.8	1.9
Rural	26.9	13.8
Sierra	12.2	5.6
Costa	10.8	4.2
Amazonia	39.6	21.8
National	12.9	5.7

Source: WBG calculations using ECV 2006, 2014

**20. Poverty reduction also has been differentiated along ethnic lines.** While poverty declined among all ethnic groups between 2006 and 2014, Afro-Ecuadorians experienced the most notable decline in poverty (19.3 pp), and indigenous people saw the slowest reduction (6.1 pp). With respect to gender, while female-headed households (FHH) have been on the rise over the same period, the non-poor among them has grown at a faster rate than the poor.

#### **D. Challenges for Poverty Reduction and Shared Prosperity**

**21. Further strides in poverty reduction and shared prosperity are likely to be harder to achieve in an environment of shrinking public resources, slowing economic growth and rising environmental and climate-change related risks.** The current downturn could place similar pressures on social outcomes and economic opportunities that could require a realignment of the Government’s strategy with emerging challenges. On

the one hand, the resources available to the Government to continue the pace of implementation of its transformational strategy have become more restricted, while, on the other hand, the urgency is greater to deliver on the diversification efforts to create opportunities in areas of economic activity other than oil. With lower public resources and economic growth, the ability to prioritize public expenditures and policies towards the achievement of national goals becomes even more critical.

**22. The following identified challenges draw from recent analytical work carried out by the WBG and the dialogue with the authorities in priority sectors.** In particular, the WBG has supported a series of technical and analytical activities, relevant for advancing towards the twin goals. These analyses address broad issues such as productivity growth and poverty, as well as sectoral focused ASAs, which include an umbrella social safety nets technical assistance, skills development strategy, and services for competitiveness. While WBG information and analytical background has become more robust over the last year, increased technical dialogue could help further fine-tune the identification of challenges and their prioritization, and facilitate appropriate financing options.

#### **Securing Macroeconomic Stability to Sustain Reductions in Poverty and Inequality**

**23. Persistent low oil prices pose significant challenges to growth, macroeconomic management, and poverty and inequality reduction.** Lower commodity-related revenues, less fluid external financing, and full dollarization are putting pressure on the fiscal and external accounts. The Government is adjusting public spending to reduce the fiscal and external imbalances in order to regain overall macroeconomic stability, but the extent of the needed adjustments will depend on an evolving and uncertain environment. The situation is further complicated by the potential impact of El Niño and possible eruption of the Cotopaxi volcano. However, lower public spending and weakened overall confidence – which reduce the private sector’s willingness to invest

– affect growth prospects. Given that poverty reduction and major gains in welfare of the B40 have been driven by rising employment and income opportunities, these social gains may suffer under the current, more constrained circumstances. The challenge that emerges then is to articulate strategies and actions that build on the human capital and physical investments made over the past decade and generate sustained opportunities anchored on a strengthened macroeconomic framework.

**24. In this context, the Government is facing the challenge of managing the drop in public revenues by way of enhancing the effectiveness of public management.** The authorities are called to prioritize and consolidate public spending to align them with available resources. This includes improving decision-making based on cost-benefit analysis, as well as improve the efficiency of bureaucratic processes. Advancing the effectiveness of public management, both in revenues and expenditures, requires the strengthening of institutions and the capacities of and between the national and sub-national levels of government. The GoE has initiated a process to strengthen both technical and administrative aspects of local governments. While progress has been made to advance local capacities, it remains a process under construction, particularly with respect to smaller municipalities. In the short-term, the Government sees increased diversification of financing sources, including partnerships with bilateral and multilateral institutions, as a way to mobilize both resources and expertise.

#### **Advancing the Delivery and Sustainability of Basic Services to the B40**

**25. The Government’s agenda to improve the delivery of basic services is very much a work in progress, with significant investments made and results achieved, but much remains to be completed.** Important public expenditure priorities, such as those in education, social protection, water and sanitation, and transport, require additional resources and policy support to bring them to fruition.

**26. Further progress in inclusion requires strengthening the resilience of the B40 given the current economic context, and improve their labor market perspectives.** Challenges include improving the quality of labor supply among the poorest quintiles (i.e. measured by educational achievements and learning outcomes)<sup>6,7</sup>; improving the relevance of the school curriculum for the labor market; decreasing the share of young people who neither work or study; and reducing chronic malnutrition (around a quarter of all children under five years of age have stunted growth). High levels of informality in Ecuador also warrant a targeted approach to protect the incomes for these highly vulnerable groups. Each of these factors impacting labor supply also bears a gender dimension, where women face substantially lower labor force participation and higher rates of unemployment, especially among young women between 15 to 24 years, while having higher levels of education.

**27. Likewise, gaps in the access, quality and reliability of water and sanitation services present a continued development challenge.** Only 17 percent of households nationwide have access to water that is demonstrably safe (i.e. suitable for human consumption according to international standards).<sup>8</sup> The lack of safe drinking water and poor waste management pose major

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<sup>6</sup> The improvements in the past years have concentrated in the third and fourth quintile.

<sup>7</sup> Only 10 percent of 8<sup>th</sup> graders reach satisfactory level in math, literature and language.

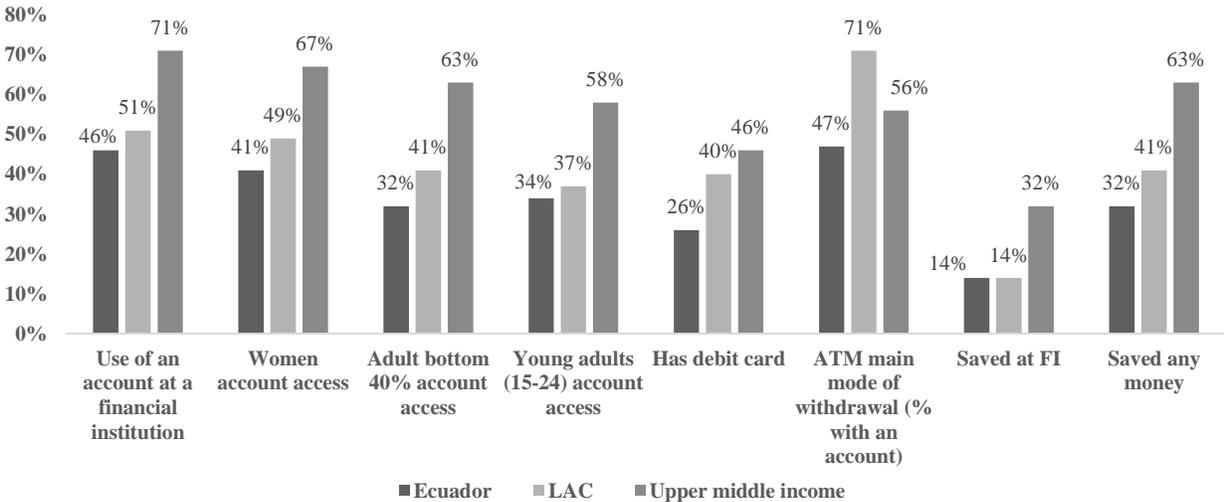
<sup>8</sup> BdE (2013). “Macro Programa de Saneamiento Ambiental Nacional PROSANEAMIENTO.”

health risks for the population, especially the poor, children and elderly. Children from poor households, and particularly indigenous children, are exposed to chronic malnutrition and deficient services overall. Together, these are the main causes of chronic malnutrition that affects 58 percent of indigenous children.<sup>9</sup> At the same time, poor sanitation is a key driver of rising urban environmental challenges.

**28. Urban inhabitants face rising mobility, environmental and social challenges.** With over 64 percent of Ecuadorians now living in cities, urban centers are coming under mounting pressure as congestion and air pollution are increasing, traffic accidents are on the rise and travel times are escalating, and the production of waste is outstripping the capacity to manage it. Many of the burdens of congested environments, such as worsening security and access to services and employment opportunities fall disproportionately on women. Reversing these trends can improve the quality of life, health, jobs and access to basic services for the poor and more broadly the B40. There is, therefore, the need to promote the sustainable development of metropolitan regions, ensuring that city governments are equipped to meet these challenges with planning tools, innovative financing instruments (for infrastructure, housing, transport, etc.), and development policies that can support sustainable and integrated urban growth that favors inclusion.

**29. Furthermore, Ecuador faces significant challenges in financial inclusion.** Based on the latest available data of the World Bank’s Findex database (2014), Ecuador performs more poorly than the LAC and Upper Middle Income Economy (UMIE) averages on key indicators, with only 32 percent of B40 adults with account access, 26 percent with debit card ownership, and 41 percent of women’s account access in Ecuador (Figure 9).

**Figure 9: Financial inclusion**



Source: WB Global Findex.

<sup>9</sup> Chronic malnutrition, for 2012 was 20.3% and it higher for poor children (23.7%) compared to non-poor children (17.4%). The same pattern is observed between rural (23.4%) and urban (19%) children and between poor urban (22%) and poor rural (25%) children (Source: ESANUT 2012, WB calculation).

## **Advancing Energy Sector Investments and Reforms**

**30. Ecuador remains in the process of consolidating its energy agenda that was set in place before the drop in oil prices.** The Consolidated Energy Matrix Strategy (ECME) aims to increase hydroelectric and gas-based thermal generation by establishing a more efficient and clean energy system to reduce both imports and subsidies while meeting projected demand. The GoE has committed investments of around US\$12 billion to modify the energy matrix and replace diesel consumption in power generation for hydropower and natural gas, and at the household level to replace Liquefied Petroleum Gas (LPG) stoves with electric induction stoves. Implementation of the Government's strategy is on track, with major deliverables slated for 2017. In addition, a revision of the current structure of incentives for investment in the oil sector is needed so as to encourage private sector involvement, especially under the current global oil market scenario of lower prices.

## **Strengthening the Foundations for the Growth of Non-Oil Sectors**

**31. Enabling a path of economic growth, less dependent on oil, focused on diversification and access to external markets and that generates quality employment will be another challenge.** The scope for economic diversification and inclusion are limited by growing macroeconomic imbalances, the low productivity of the non-oil economy and its weak links with the global markets. Productivity in Ecuador lags behind that of its peers in LAC, and has been stagnant or decreasing with respect to the United States since 2001. The gaps in productivity are likewise large within the country and range from 110 percent to 2,000 percent between the top 10 percent and the bottom 10 percent of firms within the same major economic sector. In addition, links between the Ecuadorean economy and the global economy are weak. The share of foreign value added in Ecuadorian exports, 80 percent of which are primary products, is only a third of the value of countries highly integrated into Global Value Chains (GVCs), like Mexico or Malaysia.

**32. The GoE has identified 22 priority value chains, many of which are linked to the agricultural sector.** A prosperous agricultural sector could contribute to addressing social gaps and fostering inclusion. Between 1999 and 2014, the rural population declined from 40.2 percent to 30.9 percent of the total population, reflecting a rapid flow from rural to urban areas. Nonetheless, 79 percent of indigenous people remain in rural areas. Agriculture, however, in 2014 employed only 16.6 percent of the labor force. Yet, notably, the share of women in the female labor force working in agriculture went from 19.7 percent in 1999 to 26.1 percent in 2014, implying that the rural labor force is increasingly female. At the same time, the population living in rural areas, especially children, lags behind the general population in several dimensions of quality of life and opportunities. Chronic malnutrition in children is one of the most serious problems in rural areas.

## **Containing the Impact of Climate Change and Environmental Threats**

**33. Ecuador's extreme vulnerability and high exposure to natural hazards poses major economic challenges.** Approximately 96 percent of the population lives in coastal and mountainous regions, exposed to seismic, volcanic, flood, landslide and El Niño hazards. Climate change models predict an increased occurrence of extreme events (drought, floods and frosts), rising temperatures at higher altitudes, and temporal and spatial changes in rain patterns. Drought has been recorded in some provinces in the northern coastal and central regions. Frequent landslides affect urban areas and infrastructure. Poor land use planning in urban areas has led to the increase of settlements in

inadequate locations, environmental degradation of river basins, farmland expansion and inferior building standards.<sup>10</sup> Currently, there are three alert declarations in place related to the Cotopaxi volcano, Tungurahua volcano, and the El Niño phenomenon; a State of Emergency is also in place for El Niño. The potential damages and losses (estimated at US\$ 6 billion<sup>11</sup>) would have an important negative impact on Ecuador's economic and social development.

### III. GOVERNMENT STRATEGY

**34. The GoE's 2009 National Development Plan was updated in 2013, following a participatory process.** The *Plan Nacional para el Buen Vivir 2013-2017* (the NDP) outlines the Government's strategy towards a more democratic, equitable, sustainable and productive Ecuador. The Government, under the leadership of SENPLADES, has identified public policies and specific targets for each of these objectives and has put in place a system to monitor progress in each area. In addition, public investments are aligned from the central level through to the subnational governments to ensure concordance with the objectives of the NDP. SENPLADES, through its Technical Secretariat for the Eradication of Poverty (SETEP), has also developed and is implementing a National Strategy for Equality and the Eradication of Poverty (ENIEP) to more directly address issues of poverty and inequality in the Government's planning and decision-making processes.

**35. The eradication of extreme poverty and the transformation of the productive matrix are the two broad objectives that have been at the center of public policy in the implementation of the NDP.** The Government's strategy foresees further deepening of social gains covering different stages of life and multidimensional concepts of well-being. A high priority is being given to diversification of the economy beyond oil and towards a value-intensive economy capable of delivering better quality jobs and opportunities to an increasingly educated and healthy population. This has been further emphasized in the GoE's identified priorities for international cooperation.

**36. The Government is taking steps to protect progress towards its key priorities and sustain the gains in poverty reduction and shared prosperity.** The positive economic conditions of the recent past have already seen clear signs of contraction. At the same time, several of the Government's flagship projects are expected to come online in 2016, including hydroelectric plants, reforms in the quality and efficiency of education, and an increase in the coverage of water and sanitation services (WSS), among others. The GoE continues to prioritize strategic initiatives, particularly those intended to consolidate the social gains achieved over the past decade (education, social protection, etc.) and promote a new productive agenda (energy, technical skills development, etc.).

**37. However, the current macroeconomic pressures are focusing attention to secure economic stability.** The brunt of the adjustment is being taken by capital expenditures – largely delaying public investment projects unless external financing can be secured. In that regard, resources from bilateral and multilateral entities prove critical to advance on some strategic projects.

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<sup>10</sup> [www.gfdrr.org/sites/gfdrr/files/region/EC.pdf](http://www.gfdrr.org/sites/gfdrr/files/region/EC.pdf)

<sup>11</sup> Data from the Secretaría de Gestión de Riesgos.

Meanwhile, the Government concentrates its efforts towards the development of a medium-term sustainable macroeconomic framework.

#### IV. EMERGING LESSONS

**38. The WBG's renewed engagement in Ecuador through the FY14-15 Interim Strategy Note (ISN) has supported the GoE's objectives towards poverty reduction and equity.** Under the ISN, the WBG supported selected government initiatives under three pillars: (a) sustainable and inclusive economic growth; (b) access to social protection and quality services for all; and, (c) institutional strengthening of the public sector to improve services. The efforts under the ISN, through lending and ASA, demonstrate a relationship still in the process of consolidation.

**39. The ISN was the appropriate instrument to reengage with Ecuador.** The initial areas of engagement under the ISN were defined principally around infrastructure investment at the subnational level. This provided the opportunity to demonstrate the WBG's comparative advantages as a strategic partner in terms of technical rigor, operational effectiveness and financial benefits. However, given the short period since the reengagement, and issues with portfolio implementation, there are few results to show at this stage.

**40. Project implementation and disbursements have been improving after a period of slow and protracted advancements.** The re-engagement has required an extensive effort to help develop capacity within implementing agencies to become familiar with World Bank-financed projects' policies and procedures. This is especially the case among projects implemented at the municipal level, where institutional capacity is weaker and understanding of World Bank policies and procedures more limited. Recently approved projects reflect increased readiness for implementation, with effectiveness conditions and bidding processes under preparation ahead of World Bank Board approval. In addition, the inclusion of projects at the national level, where institutions possess greater knowledge of the processes of multilateral organizations, is facilitating improvements in project implementation.

**41. Advisory services and analytics (ASA), at both the subnational and national levels, opened possibilities for providing technical advice to the Government in selected priority policy areas.** ASA products have allowed the WBG to contribute with technical inputs around issues such as informality and the labor market, productivity and competitiveness, the graduation process from conditional cash transfer programs, the national strategy for water and sanitation, among others. Under the ISN period, the WBG also initiated the first Reimbursable Advisory Services (RAS) activities in the country with work on services for competitiveness in global value chains. The richness of the technical exchanges reflects the technical capacity and professionalism of the Government counterparts, while demonstrating the value-added of the dialogue with the WBG. Building upon this foundation, the CEN is expected to deepen the analysis through the ASA products to strengthen the knowledge base required to engage in a fruitful policy dialogue needed to develop a comprehensive partnership program over the medium-term.

**42. While private sector development initiatives were limited under the ISN, the importance of a more vibrant private sector remains key to achieve greater balance in the economy.** In this context, IFC has become an increasingly important player in the WBG's engagement in Ecuador.

IFC renewed its engagement in Ecuador during the ISN period. The outstanding portfolio tripled during this period, contributing to operations principally in the financial and agribusiness sectors, and re-opening trade finance guarantee programs that had been put on hold since FY09. Support to the productive sector, specifically through financing to SMEs, will remain a critical area of engagement under the CEN. The WBG's continued collaboration to Ecuador's productive sectors can enhance the broader impact on this evolving agenda.

**43. The collaboration among development partners in Ecuador has consolidated financial support and project implementation.** The positive coordination among multilateral and bilateral agencies has proven one of the strengths of international cooperation in Ecuador, to the country's benefit. The majority of recently approved World Bank financed operations are co-financed with other international development partners.<sup>12</sup> The Quito Metro Project represented the first World Bank-financed project with established protocols of collaboration among four multilateral banks (IDB, CAF, EIB, and WB). These collaborative efforts have helped to distribute risks, while increasing development outcomes. Under the CEN, the WBG will, together with the GoE, continue to promote opportunities for effective international cooperation to further leverage the impacts of the WBG's financial and technical assistance.

#### **Active Portfolio**

**44. The World Bank's active portfolio in Ecuador comprises six projects, with performance now improving after initial delays.** Currently, two projects are considered problem projects, due to delays in project effectiveness (Quito Metro Line One Project) and low disbursements (Manta Public Services Improvement Project). The portfolio is beginning to show signs of improvement with both an increase in disbursements (currently with a disbursement ratio above 28 percent) and reductions in the periods required for loans to become effective ahead of the established deadlines. The Ecuador portfolio continues to require close implementation support and proactive dialogue with counterparts in order to improve project execution.

**45. IFC committed portfolio in Ecuador stands at about US\$250 million, including US\$21 million in trade finance guarantees.** The portfolio is composed of eight projects in agribusiness and forestry, eight in financial markets, including five trade finance guarantees and one in the health sector. Four of these projects totaling US\$105 million were approved in CY15 and, as of end-CY14, portfolio clients were reaching 84,000 farmers, employing 21,000 people and had 102,000 active loans to SMEs. Supporting the WBG's vision for achieving universal financial inclusion by 2020, in FY15 alone, IFC provided loans to three Ecuadorian banks totaling US\$100 million; these clients are expected to be reaching about 90,000 SMEs for US\$4.5 billion, of which around 10,000 loans for US\$352 million to women, by end-tracking period. Advisory also has an active program in corporate governance, agribusiness, and banks. MIGA does not have any outstanding guarantee contracts in Ecuador.

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<sup>12</sup> The Quito Metro Project is co-financed with the IDB, CAF and EIB. The Guayaquil Wastewater Treatment Project is co-financed with EIB. The Sustainable Modernization of Family Farming project is co-financed with the Spanish Cooperation (AECID).

## V. PROPOSED PROGRAM AND FUTURE ENGAGEMENT (FY16-FY17)

**46. This CEN presents a program aimed at consolidating the WBG's relationship with the GoE over the next two years and respond as needed to a rapidly changing context.** The engagement proposed under the CEN represents a small subset of interventions in response to the challenges posed in the country, based on existing knowledge, experience and analysis of what is feasible to implement effectively. The proposed WBG activities build on the ISN and respond to the Government's request for support in targeted areas of intervention aligned under the objectives of the Government's *Plan Nacional para el Buen Vivir 2013-2017*. The activities included in this CEN identify key priorities under the Government's NDP that intersect with the WBG's twin goals of poverty alleviation and shared prosperity. This selective engagement will, hopefully, provide experience and build trust to solidify and deepen the relationship between the GoE and the WBG, both in terms of lending and ASA proposed under this CEN. On this basis, the WBG is expected to be in a more solid position at the end of the CEN period to work in partnership with the GoE to help define and design a more comprehensive program of assistance that supports common goals of poverty alleviation and shared prosperity.

**47. The CEN is organized under two pillars: Pillar I – Sustaining gains in basic service delivery and strengthening safety nets, and Pillar II - Promoting economic diversification in a constrained macroeconomic environment.** These two pillars also address equity and climate change and environmental issues through a mainstreamed approach in project planning and implementation. The IFC will play an important role to advance the activities particularly under Pillar II, offering new prospects for the private sector to leverage opportunities for entrepreneurship, particularly of SMEs. MIGA also will explore possibilities for re-engagement in Ecuador.

**48. The areas of collaboration between the GoE and the WBG reflect clear points of intersection between the GoE's NDP and the WBG's twin goals.** As such, the proposed CEN seeks to address several key challenges in the country where the WBG has built an increased level of engagement with local counterparts, offering opportunities for greater impact. Likewise, the areas of collaboration reflect priorities of the current administration while addressing broader development goals that will hopefully facilitate their continuation beyond the current administration.

**49. Recognizing that Ecuador is confronting a moment of transition, the WBG stands ready to adjust its program to client demands in the face of changing circumstances.** The areas of engagement selected under the CEN reflect relevant areas to the development agenda for Ecuador. These priorities are expected to remain relevant even should the Government implement tactical shifts in its response to best address continuing challenges. The WBG will maintain flexibility with respect to the specific activities and instruments in this variable context.

### **Pillar I: Sustaining Gains in Basic Service Delivery and Strengthening Safety Nets**

**50. This CEN proposes to contribute to the Government's efforts to maintain or enhance access to basic services and improve their quality, especially amongst the B40.** Despite the advances in the provision of infrastructure and basic social services, salient gaps remain to address urban congestion, access to clean water and sanitation, and education and health services, which weigh heavily on the B40. The activities outlined under this Pillar seek to support the GoE in advancing programs underway to better services for the poor and for populations living in marginal

areas by providing funds and technical assistance. The CEN supports maintaining the momentum and preventing reversals in critical services where important initiatives are underway. The focus is on three areas: (a) social services, with an emphasis on education, social protection; (b) access to water and sanitation services (WSS); and, (c) accessibility and efficiency in public transport. The GoE and the WBG have made important strides in the dialogue in these areas, which the CEN seeks to consolidate. Over the long haul, progress in addressing these gaps is expected to promote inclusion and build more resilient habitats.

## **1.1. Improving Social Services for Vulnerable Populations**

**51. The education reform underway has delivered important improvements in coverage and learning outcomes, but challenges remain.** School attendance has improved at all primary and secondary educational levels. In terms of quality, Ecuador was the country in LAC with the highest improvement in the Third Regional Comparative and Explanatory Study (TERCE-2013), when compared to its performance in SERCE (2006).

**52. Important challenges remain regarding attendance, equity and quality in education.** In 2013, only 23 percent of the children ages 3 and 4 were enrolled in early education. Dropouts are still significant beginning in the eighth grade through the end of upper secondary; the national goal of increasing the net attendance rate for upper secondary education to 75 percent by 2018 remains ambitious. Major differences in educational attainment exist across geographic areas and income groups. On visual vocabulary, the average differences for 36 to 71 month-old children in the poorest quartile and those in the richest quartile is equal to 1.21 standard deviations (sd); the differences are even larger in rural areas (1.64 sd).<sup>13</sup> In upper secondary, the gross enrollment rate in rural areas was 83.3 percent in 2013, compared with 96.5 percent for the same year in urban locations. There is also an increased focus on intercultural and bilingual education to address the existing educational gaps faced by indigenous populations.

**53. The current dialogue on education has benefitted from the lessons of international experience through the design and approval of a World Bank-financed project.** The *Supporting Education Reform in Targeted Circuits* project contributes to the Government's agenda to upgrade school infrastructure, expand teacher and principal training, strengthen school management, and evaluate the impacts of the reform. Already, during project preparation, community leaders, students and parents in the beneficiary areas participated actively in consultations about the school consolidation process. During implementation, the project intends to support evaluations of the impact of teacher training on student outcomes and teacher practices, as well as an impact evaluation of the school consolidation to measure four main outcomes: *coverage/graduation; quality of learning; equity implications, and efficiency in the allocation of resources.*

**54. The WBG will continue its dialogue with the Government on social protection with a view to being ready to support implementation.** An inter-institutional committee on poverty eradication has prioritized the protection of the gains in poverty reduction, largely through employment and social protection measures. The World Bank has contributed to the dialogue with the authorities on numerous key social issues, including graduation strategies for the *Bono de Desarrollo Humano* (BDH), job skills for employability, and the design of simple yet innovative

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<sup>13</sup> Shady (2014.)

strategies to address childhood malnutrition. As such, the WBG will explore opportunities to support the GoE in developing appropriate mechanisms to manage these pressing issues, in the view of the challenging macroeconomic context. Building on its first health operation in Ecuador committed in early FY16, the IFC also will explore options to assist in private sector-based expansion of hospitalization capacity for lower income people and improvement of health care services in metropolitan areas.

## **1.2. Enhancing Water and Sanitation Services (WSS) for the B40**

**55. Access to WSS has progressed greatly over the last decade.** Yet, access rates vary significantly between regions, income quintiles, and ethnic groups. In 2014, the percentage of households connected to a public water distribution network through a piped household connection was 93 percent in urban areas compared to 41 percent in rural areas.<sup>14</sup> Access to safe water supply and sanitation services in Ecuador is clearly regressive, with lower income quintiles having dramatically less access to safe facilities. In 2014, only 57 and 29 percent of the poorest 20 percent of the population were connected to the public water supply and sewer networks, respectively, while the average for the wealthiest 20 percent was 94 and 88 percent, respectively<sup>15</sup>. WSS is also marked by ethnic differences: Indigenous, Montubios and Afro-ecuadorians are disadvantaged in terms of access to sanitary sewerage services with rates of 39 percent, 38 percent and 53 percent, respectively, compared to Mestizo or white households where access rates are 65 and 70 percent, respectively.<sup>16</sup>

**56. The GoE's Poverty Eradication Strategy (PES) sets ambitious targets for access to water and sanitation services.** The PES establishes goals of connecting 83 percent of the population to a public water distribution system through a piped household connection, and 75 percent to a piped sewer network by 2017. The Government has undertaken a major institutional overhaul to upgrade its planning, regulatory, and financing capacity towards these goals, despite a constrained fiscal environment. This includes an increased focus on addressing the capacity of subnational governments to improve their management and operations of such services.

**57. Given the importance of WSS to the country's poverty reduction goals, the CEN will continue to prioritize both financial and technical support in the sector.** Under the ISN, the World Bank provided financial assistance to municipal governments of both Manta and Guayaquil to increase access to improved water and sanitation services at the subnational level. These two investment projects are complemented by technical assistance to water utilities to develop poor-inclusive service delivery mechanisms. *Under the CEN, the WBG intends to continue its support to subnational governments to expand access to and improve the quality of the WSS services.*

**58. The World Bank has been providing assistance to the Government at both ends of the WSS service delivery chain - from policy dialogue to support to frontline service providers.** Under the CEN, the World Bank will continue to provide technical assistance to the Secretariat for Water (SENAGUA) and other agencies, and to operationalize the National WSS and Poverty

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<sup>14</sup> INEC, ENEMDUR December 2014.

<sup>15</sup> INEC, ECV 2013-2014.

<sup>16</sup> INEC, National Household Survey, 2010.

Eradication strategy.<sup>17</sup> Analysis of gender differences – along with other factors associated with vulnerability in service provision such as regions, ethnicity and language – will be a key part of this analysis. The analysis of gender disaggregated information on access, willingness and capacity to connect to the services and on water use, sanitation and hygiene practices will enable the design of appropriate policies and gender informed actions at the specific project level.

### **1.3. Improving Accessibility and Efficiency of Public Transport at the Local Level**

**59. Provision of adequate transport services has lagged the rise of population in urban areas, resulting in increases in travel times and the number of accidents, and lower overall security.** The poorest are those more dependent on non-motorized infrastructure and public transport services, spending around 20 percent of the household income on transit. The Government has been implementing an ambitious connectivity strategy that has expanded and improved the quality of the road networks throughout the country, with results already evident on the ground. Considerable progress has been made in addressing the national transport and logistic challenges (including road networks, ports and airports, as well as alternative modes of transport), but progress in urban areas have proceeded at a slower pace. Partnerships between the national and local governments are seeking a transformation of metropolitan areas, centered on improving mobility and security towards positive impacts on labor opportunities and productivity, as well as overall living conditions of those who are captive to public transport, notably the poor.

**60. The World Bank, jointly with other development partners, will provide initial support to improve accessibility and efficiency of public transport services at the local level.** Over the medium to long-term, the WB will work together with other financiers to launch the construction of one of the major projects for the capital city. The Quito Metro Line One Project, approved in FY14, *aims to improve urban mobility and overall quality of life by reducing travel times, increasing access to jobs, services and markets, decreasing operational costs of the transport services, improving security and comfort (with a particular concern for women's safety) and reducing emissions of pollutants and greenhouse gases.* Fruits from these efforts will come only after the CEN is completed. In addition, the Government requested WB support to enhance the urban transport infrastructure in the cities of both Manta and Ibarra. Urban transport investments in the latter of these would particularly benefit large indigenous and Afro-descendant populations, and facilitate their mobility within its recreational and touristic urban spaces.

### **Pillar II: Promoting Economic Diversification in a Constrained Macroeconomic Environment**

**61. Under the CEN, the WBG expects to continue the dialogue with Government around its national strategy to develop the non-oil economy.** However, this effort is constricted by the current adverse macroeconomic circumstances. Given the urgency of the situation, the CEN focuses on critical constraints and opportunities that have been identified in the dialogue with the authorities and the private sector. In order to identify priority actions and articulate an agenda for strengthening

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<sup>17</sup> A Poverty Diagnostic for Water Supply, Sanitation and Hygiene (WASH) will be led by the Poverty and Water Global Practice in close collaboration with key in-country counterparts (SENAGUA, MCDS, INEC, SENPLADES); the Diagnostic will analyze linkages of access and quality of WSS services with health related outcomes, particularly in nutrition, and focus on identifying options for improving access and quality of water supply, sanitation, and hygiene (WASH) services among the poorest 40%.

the non-oil economy, more analytical work and dialogue is needed. Such work would complement Government's efforts to front-load relevant components of its strategy towards the development of the non-oil, high value added sectors. First, attention will be given to address the emerging credit constraints, particularly to small and medium enterprises (SMEs). Building on a recent substantive scaling-up in engagement, the IFC will continue to provide financing for SMEs through the domestic financial sector. Also, the WBG will continue an initial dialogue with the Government on the investment climate and conditions for improving firm productivity and innovation and develop human capital to strengthen linkages with global value chains. Finally, the WBG will work with the GoE to set the basis to increase the opportunities that both the agricultural and the rural economies provide for diversification and inclusion.

## **2.1. Identifying Constraints in the Non-Oil Sectors**

**62. The roadblocks that limit the potential contribution of the private sector in Ecuador are manifold.** Ecuador's economy is highly regulated, beginning with the trade regime. A more consistent, transparent and clearer policy framework could help facilitate increased investment, both foreign and domestic. The level of regulation is onerous on the business environment for enterprises. The 2016 Doing Business Report ranks Ecuador 117th out of 189 economies worldwide, below LAC's regional average of 104. Financing of SMEs is emerging as a critical constraint under the current macroeconomic environment. Also, firms lack adequate knowledge, technology, information and training to participate effectively in the global markets. Lastly, female entrepreneurs face additional challenges; with only 24 percent of businesses owned by women.

**63. The WBG will continue to support these relevant areas, particularly with respect to access to finance, technical training, and a deeper knowledge of the constraints to a more dynamic non-oil economy.** IFC will continue its support to *expand financing opportunities to SMEs and improve the local industry's linkages into the global value chains*. These activities include existing IFC trade finance guarantee programs for export-oriented SMEs. It is expected that no less than 30,000 new SME loans would be made through these operations, with approximately 6,000 aimed towards women. The WBG, building upon recent analytical work on knowledge-intensive business services intends to expand this dialogue to cover options for facilitating increased performance of firms by adopting innovation and productivity adjustments. Also, the WBG seeks to deepen the dialogue on the constraints in the operating environment for firms. In addition, the WBG expects to advance its on-going support on the formation of technical professionals towards job market demands.

## **2.2. Linking Small and Medium Agricultural Producers to Key Value Chains**

**64. Government priorities for rural areas and agriculture focus on increasing productivity and inclusion of marginal populations through greater economic opportunities.** The Transformation of the Productive Matrix strategy priorities for the rural economy include: (a) adding value to the existing production through processing, and expanding production and exports by new players – mainly by small producers—, and (b) diversification into new activities grounded on the ample opportunities that the sector offers with its wide range of natural formations and climates that allow tropical and temperate agricultural production. Due to its diversity, agriculture is an important, and above all sustainable, contributor to the country's economy. The agricultural sector accounted, in 2014, for 9 percent of GDP, with food and agriculture products representing a quarter of exports.

**65. The WBG proposes to work with the GoE in supporting activities that can contribute to increasing the productivity of small farmers, improving their resilience to climate variability, and improving market access.** The IFC expects to continue supporting efforts to finance and provide technical assistance to several key agro-industries, including export-oriented firms in dairy, seafood and fruit industries. *These investments will continue to bring incremental employment in production and distribution networks, develop stronger linkages and better production standards for the company and suppliers/farmers, and/or help increase production capacity and reduce production costs.* Through an approved agriculture project, the World Bank expects to initiate steps to help improve irrigation and water resource management, in combination with enhanced agricultural extension services and development of productive value chains. These efforts will be coupled with capacity-building and technical assistance to strengthen productivity and commercialization, increase value-added and improve market access, also supported by the European Union's Latin American Investment Facility (LAIF).

### **Cross Cutting Theme: Mitigating Risks from Climate Change and Environmental Threats**

**66. Environmental challenges are emerging as pressing development issues in Ecuador.** In the short-term, the likelihood is high that El Niño conditions will be strong and could impact a large number of Ecuadorians. Many scientific models now indicate that the 2015-2016 El Niño could become one of the strongest on record.<sup>18</sup> If so, the Pacific lowlands of Ecuador (where more than 50 percent of the population resides) will experience more rain than normal, and likely suffer significant flooding into 2016. The challenge is to have in place programs to respond to the emerging events in a timely and effective manner, building on the lessons from the previous El Niño episode and relying on the best global knowledge and support of the international community.

**67. Over the medium-to-long term, climate change is likely to affect negatively water and energy production, which are part of Ecuador's strategic investment sectors.** Ecuador has invested heavily in the electricity sector since 2008, mainly through the construction of large and medium hydroelectric plants. Hydro production, while generally more environmentally friendly, is affected by weather fluctuations, which climate change can exacerbate. With warmer temperatures, glacier melting will continue to accelerate, compromising the role glaciers play in regulating water. This will likely intensify existing water shortages in cities and agricultural areas, the biodiversity of the unique high altitude wetlands (*páramos*), and compromise subsistence agriculture practices for high altitude communities, as well as those that partially depend on the *páramos* for water supply. Safeguarding the ecological integrity of upstream watersheds will be critical to sustain environmental flows as well as the capacity and efficiency of the water supply systems.

**68. The WBG will integrate climate smart strategies and disaster risk management in relevant sectors of engagement to help reduce vulnerability and increase resilience in the country.** First of all, the WBG will provide the Government with both financial support, through the Ecuador Risk Mitigation and Emergency Recovery project, and technical assistance in emergency response planning, prevention and reconstruction principally to protect and restore key infrastructure services (WSS, roads and bridges, etc.) in the face of potentially looming natural

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<sup>18</sup> According to the Climate Prediction Center, the US National Oceanographic and Atmospheric Administration (NOAA). See slide 24 from: [http://www.cpc.ncep.noaa.gov/products/analysis\\_monitoring/lanina/enso\\_evolution-status-fcsts-web.pdf](http://www.cpc.ncep.noaa.gov/products/analysis_monitoring/lanina/enso_evolution-status-fcsts-web.pdf) [information as of August 17, 2015].

disasters, as well as the implementation of mitigation measures. This would transcend both pillars of the proposed program of assistance in order to address both the immediate infrastructure needs, as well as the protection of productive sectors. In addition, the sustainability of investments under both pillars will require a view towards reducing the exposure to potential climate-based impacts. As a result, the preparation, design, and implementation of all projects will consider and incorporate as relevant climate smart strategies and disaster risk management strategies. The dialogue between the Government and the WBG on the environment and climate change consequences has taken a cross sectoral approach that some of the initiatives underway are beginning to address, such as the work in rural development, water and sanitation, and mobility. Thus, in rural development, there is a focus on climate smart strategies to address adaptation and mitigation efforts. Likewise, the financing of WSS infrastructure investments will include an analysis of its resiliency *vis-à-vis* climate change and natural disasters. The policy dialogue in the water sector will consider the implementation by SENAGUA of a new water resources management strategy.

## **Program Implementation**

**69. The World Bank Group’s key operational objective during the CEN period is to consolidate the relationship with the Government of Ecuador, and help ensure the effective implementation of projects in the portfolio.** While the ISN provided the opportunity to re-initiate the dialogue in Ecuador, the CEN intends to solidify a deeper engagement in the country. More specifically, the CEN will focus on: (a) key analytical work, building on existing technical dialogue; (b) increased operational assistance, and (c) leveraging opportunities with other development partners. First of all, the WBG is working closely with its technical counterparts in Government to enrich the dialogue in key policy areas, and even to conduct joint analytical activities, such as the forthcoming Poverty Report. While the ASA program under the CEN is expected to strengthen the dialogue on such macro or structural policy issues, it is anticipated that the lending program will focus principally on sectoral priorities. Nonetheless, the WBG will continue to gauge the appropriate mix between analytical work and financing during the course of the CEN period. The WBG will continue to coordinate its dialogue on the program with the economic and planning authorities in order to assure coherence with national priorities and avoid false start-ups that disperse resources. Second, to smooth the implementation of ongoing and recently approved projects, the WBG will combine the use of periodic portfolio reviews with timely follow-up that will facilitate addressing emerging bottlenecks and provide the necessary technical assistance to implementing agencies. The WBG’s increased engagement, through close accompaniment and capacity building, will also help recreate a base of knowledge of WBG policies and procedures among different implementing and other agencies. Finally, coordinating and working together with other international cooperation partners will remain critical to the consolidation of the relationship with the GoE in order to enhance the WBG’s contribution to the GoE’s priority initiatives, increasing impacts and managing risks. The actual volume of IBRD lending will depend on how program performance evolves in the course of the CEN period, continued Government interest in IBRD financing, and on IBRD’s lending capacity and demand from other borrowers. All of these efforts together with increased collaboration with Ecuadorean authorities will hopefully consolidate the relationship that will permit the definition of a fuller program in Ecuador following the CEN period.

## VI. RISKS

**70. The overall operational risks to achieving the objectives of the WBG program are High.** Major risks to program implementation are associated with the macroeconomic context, political/governance issues, institutional capacity for implementation, difficulties in complying with the WBG's fiduciary standards, and the potential risks from natural hazards (Table 2). The IBRD program for the CEN period takes into consideration the WBG risk exposure framework.

**71. On the macroeconomic side, the risk to the program is considered High.** Since Ecuador is a fully dollarized economy, its ability to respond to negative external shocks is limited. The impact of lower oil prices on the fiscal and external balances could threaten fiscal and external sustainability, potentially impacting the availability of fiscal resources for counterpart funding and recurring expenditures, and therefore affect the pace of implementation of the CEN program. The Government is taking measures to address these imbalances, but vulnerabilities to external shocks remain substantial and the consequent macroeconomic effects could materialize in the short-run. To manage these risks, the Government is prioritizing financing from external sources to advance key public investment projects, including securing the complementary fiscal resources needed.

**72. On the political front, with 2016 as a campaign year, Government priorities may well change in the future.** Nonetheless, WBG investments are planned within priority sectors that converge between initiatives of strategic interests for the Government with the WBG's twin goals. WBG projects have clearly identified selection criteria to ensure technical aspects or benchmarks play a catalytic role in the selection of subprojects. In addition, investment projects financed through external sources are being prioritized in order to advance strategic projects. Therefore, the WBG's critical resources will allow the Government to continue important investment projects, under a politicized, and economically constrained environment.

**73. Further, there are significant challenges with regard to the institutional capacity for implementation of WBG-financed projects that can impact the effective implementation of the CEN program.** The lack of experience of local counterparts with the World Bank policies and procedures has resulted in delayed project implementation, and presents a risk to sustaining operational effectiveness. The issues include a lack of capacity at the subnational level with the procedures and requirements of the multilateral development banks, decentralized operations with participation of regional offices and co-implementing entities, and timely availability of counterpart funds required by the national law to cover recurrent costs and value added taxes. In order to mitigate these risks, the Ministry of Finance is playing a proactive role to provide close accompaniment to counterpart line ministries in order to advance project preparation and implementation, particularly in terms of facilitating internal government processes. The counterpart teams will further these efforts during project preparation in order to jump start implementation, including drafting of bidding documents, identification of staff for PIU, advancing on signing/effectiveness conditions, etc. In conjunction, the WB will initiate a process of regular portfolio reviews, and provide periodic and in situ fiduciary support for local counterparts to augment the Government's actions.

**74. The fiduciary risk remains substantial for the successful implementation of the CEN, since there is still limited experience with the WBG fiduciary procedures, particularly at the subnational level.** Financial Management (FM) risk ratings for ongoing WBG-financed projects are normally considered Substantial during preparation but then downgraded to Moderate once

mitigation measures have been put in place. To mitigate the risk posed by these challenges, the GoE is making efforts to: (a) strengthen central and subnational capacity including through training in World Bank processes and procedures, as well as on-going technical assistance to projects’ staff; (b) carrying out a risk-based supervision strategy for the World Bank portfolio; and (c) updating the existing FM Memorandum of Understanding to ensure timely appointment of external auditors by the General Attorney for World Bank-financed projects. The WBG’s fiduciary specialists will continue working with GoE project counterparts to help strengthen their capacity for implementation.

**75. Ecuador faces the risk of several natural hazards, many of which are linked to climate change.** The *El Niño* phenomenon is a recurring one that threatens life and livelihoods of particularly Ecuadorians residing in the coastal region. Flooding and mudslides due to *El Niño* are now being seen particularly in the coastal areas of Ecuador. Forest fires in the Sierra have also become a common occurrence during its dry season. These, and other multiple natural threats require a mainstream approach to environmental management, which has become part of the Government’s discourse on climate change. Integrated risk management has been incorporated into the legal framework for territorial and sectoral development. The WBG will support this effort by integrating climate smart approaches in project preparation, design, and implementation, providing technical support and supervision for environmental management.

**Table 2: Risks to the CEN Program based on SORT**

<b>Risk Categories</b>	<b>Rating (H, S, M or L)</b>
1. Political and governance	S
2. Macroeconomic	H
3. Sector strategies and policies	M
4. Technical design of project or program	M
5. Institutional capacity for implementation and sustainability	H
6. Fiduciary	S
7. Environment and social	M
8. Stakeholders	M
9. Other: Natural disasters and climate change impacts	H
<b>Overall</b>	<b>High</b>

## ANNEXES

### Annex 1: Ecuador - Selected Economic Indicators, 2006-2014

(Percent of GDP unless otherwise specified)	2006	2007	2008	2009	2010	2011	2012	2013	2014
Real GDP growth rate (%)	4.4	2.2	6.4	0.6	3.5	7.9	5.6	4.6	3.7
CPI inflation (eop)	2.9	3.3	8.8	4.3	3.3	5.4	4.2	2.7	3.7
Real Exchange Rate change (percent) *	-5.6	-7.5	12.7	-5.5	0.3	3.1	0.3	3.3	8.7
Unemployment (as share of urban labor force)**	0.0	4.0	5.2	6.0	4.5	3.9	4.0	3.7	3.7
Real wages (annual percentage change, eop)	3.7	2.8	8.0	4.5	-1.1	12.4	6.2	6.1	3.1
Current Account Balance	3.7	3.7	2.9	0.5	-2.3	-0.5	-0.2	-1.0	-0.6
Exports of Goods	28.2	29.2	31.5	23.1	26.1	29.1	27.9	27.1	26.4
Foreign Direct investment	0.6	0.4	1.7	0.5	0.2	0.8	0.6	0.8	0.8
International Reserves	4.3	6.9	7.2	6.1	3.8	3.7	2.8	4.6	3.9
International Reserves (US\$ billion)	2.0	3.5	4.5	3.8	2.6	3.0	2.5	4.4	3.9
External debt	36.5	34.3	27.4	21.6	20.1	19.3	18.2	19.8	23.9
NFPS Revenues	24.1	26.7	35.8	29.4	33.3	39.3	39.3	39.3	38.7
Oil revenues	6.9	6.5	14.0	8.3	11.3	16.3	13.9	12.1	10.8
NFPS Expenditures	21.2	24.1	35.2	33.0	34.7	39.5	40.3	43.9	43.9
Capital spending	4.2	6.6	11.3	10.7	10.4	11.8	12.5	15.4	15.2
NFPS Balance	2.9	2.7	0.6	-3.6	-1.4	-0.1	-0.9	-4.6	-5.3
Public Enterprises Balance	-0.7	1.7	1.4	1.3	1.9	2.2	2.9	3.4	4.1
Public Debt	28.8	27.2	22.2	16.4	19.2	18.4	21.2	24.1	29.9
- External	21.8	20.8	16.3	11.8	12.5	12.7	12.4	13.6	17.4
- Domestic	7.0	6.4	5.9	4.5	6.7	5.7	8.8	10.5	12.4
Credit to private sector growth (percent, eop)	22.9	15.7	27.6	2.2	24.5	22.5	14.7	10.5	8.7
Non-performing loans (%)	4.0	3.7	3.4	4.1	3.4	3.2	3.8	3.6	3.6

Source: Central Bank of Ecuador and National Institute of Statistics and Census

Note: (\*) ↑ appreciation ↓ depreciation (\*\*) Urban open unemployment of last quarter of each year.

**Annex 2: World Bank Active Portfolio**  
(as of January 31, 2016)

<b>Project Title</b>	<b>Project ID</b>	<b>Commitment Amount (US\$ million)</b>	<b>Status</b>	<b>Approval Date</b>
EC Ibarra Transport Infrastructure Improvement Project	P147280	52.5	Active	January 27, 2016
Supporting Education Reform in Targeted Circuits	P152096	178.0	Active	October 14, 2015
Ecuador - Sustainable Family Farming Modernization Project	P151963	80.0	Active	July 15, 2015
EC Guayaquil Wastewater Management Project	P151439	102.5	Active	April 22, 2015
EC Manta Public Services Improvement Project	P143996	100.0	Active	August 08, 2013
Quito Metro Line One	P144489	205.0	Active	July 25, 2013

### Annex 3: IFC Committed and Outstanding Portfolio

MIS

International Finance Corporation

Report Run Date: 02/08/2016

#### Statement of IFC's Committed and Outstanding Portfolio

Amounts in US Dollar Millions

Accounting Date as of : 01/31/2016

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Region(s): Latin America and the Caribbean  
Country(s) : Ecuador

Commitment Fiscal Year	Institution Short Name	LN Cmt'd - IFC	LN Repayment - IFC	ET Cmt'd - IFC	QL + QE Cmt'd - IFC	GT Cmt'd - IFC	RM Cmt'd - IFC	ALL Cmt'd - IFC	ALL Cmt'd - Part	LN Out - IFC	ET Out - IFC	QL + QE Out - IFC	GT Out - IFC	RM Out - IFC	ALL Out - IFC	ALL Out - Part
2007/ 2008/ 2009/ 2014/ 2015/ 2016	<a href="#">Banco Guayaquil</a>	0	0	0	0	2.57	0	2.57	0	0	0	0	2.57	0	2.57	0.00
2008/ 2009/ 2014/ 2015/ 2016	<a href="#">Banco Internac</a>	40.00	0	0	0	1.91	0	41.91	0	40.00	0	0	1.91	0	41.91	0.00
2015/ 2016	<a href="#">Banco Pichincha</a>	30.00	0	0	0	8.03	0	38.03	0	30.00	0	0	7.98	0	37.98	0.00
2007/ 2008/ 2015/ 2016	<a href="#">Bolivariano</a>	30.00	0	0	0	2.50	0	32.50	0	30.00	0	0	2.50	0	32.50	0.00
2004/ 2007/ 2009	<a href="#">Cartones America</a>	0	0	0	0	0	0.01	0.01	0	0	0	0	0	0	0	0.00
2016	<a href="#">Conclina</a>	15.00	0	0	0	0	0	15.00	0	6.00	0	0	0	0	6.00	0.00
1999/ 2003/ 2008/ 2011	<a href="#">Favorita Fruit</a>	3.27	39.11	0	7.00	0	0	10.27	0	3.27	0	7.00	0	0	10.27	0.00
2010	<a href="#">Moderna</a>	2.18	5.82	0	0	0	0	2.18	0	2.18	0	0	0	0	2.18	0.00
2016	<a href="#">Omarsa</a>	10.00	0	0	0	0	0	10.00	0	0	0	0	0	0	0	0.00
2005/ 2009/ 2013	<a href="#">PRONACA</a>	21.88	23.12	0	5.00	0	0	28.88	0	21.88	0	5.00	0	0	28.88	0.00
2007/ 2008/ 2009/ 2015/ 2016	<a href="#">Produbanco</a>	0	0	0	0	6.14	0	6.14	0	0	0	0	6.14	0	6.14	0.00
2012/ 2016	<a href="#">Tonicorp Holding</a>	66.78	3.22	0	0	0	0	66.78	0	37.45	0	0	0	0	37.45	0.00
<b>Total Portfolio</b>		<b>219.11</b>	<b>71.27</b>	<b>0</b>	<b>12.00</b>	<b>21.15</b>	<b>0.01</b>	<b>252.26</b>	<b>0</b>	<b>170.78</b>	<b>0</b>	<b>12.00</b>	<b>21.08</b>	<b>0</b>	<b>203.86</b>	<b>0.00</b>