The IMF returns to Ecuador

In March 2019, the International Monetary Fund (IMF, the Fund) released the details of the $4.2 billion loan agreement signed by the Ecuadorian government. The structural adjustment programme demands a massive rollback in government spending, with aggressive cuts targeting public sector workers, along with a series of institutional reforms. Despite previous recognition from the IMF of the success of Ecuador's public sector-led growth strategy of the previous decade, the Fund is now dismantling the model and replacing it with an austerity programme designed to attract private sector investment.

Background

Between 2007 and 2017, Ecuador underwent a series of economic and institutional changes, pursuing a public-sector led growth strategy. As an oil exporter, Ecuador used the revenues from oil to increase public investment in both capital goods and development of services such as health and education. Overall, social spending increased from 4.3 per cent of GDP in 2006 to 8.6 per cent in 2016 and public investment increased from 4 per cent of GDP to 10 per cent in the same period.[1]

The reforms of this era pushed back against "Washington consensus" policies, through measures such the introduction of capital controls, which helped both stabilize financial flows, while also raising revenues for the government. The 2008 constitution formally ended central bank independence, a move that gave Ecuador some space to conduct monetary policy even though it is a dollarized economy.

Despite being hit by two major external shocks in this period, the global financial crisis in 2008 and collapse of oil prices in 2014, Ecuador's economy grew faster than it had in the past, and social indicators improved significantly. From 2007 to 2016, poverty declined by 38 per cent, from a poverty rate of 36.7 to 22.9 per cent, and the GINI coefficient fell from 0.55 to 0.47, which marks a significant decrease in inequality.[2]

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[1] http://cepr.net/images/stories/reports/ecuador-2017-02.pdf

[2] For more details about Ecuador's reforms in this era, see http://cepr.net/images/stories/reports/ecuador-2017-02.pdf (http://cepr.net/images/stories/reports/ecuador-2017-02-spanish.pdf)

Ecuador's current president ran for election on a platform promising to continue these reforms and programs. However, he has since pivoted back to neoliberal policies and entered a structural adjustment programme with the IMF.

Overview of IMF Programme

The IMF programme consists of a series of supply-side reforms that are meant to make Ecuador more attractive to private sector investors. The programme is organized around four pillars: "boosting competitiveness and job creation; strengthening fiscal sustainability and the institutional foundations of Ecuador's dollarization; protecting the poor and most vulnerable; and improving transparency and bolstering the fight against corruption."[3] This note will expand on the implications of these stated goals, along with the concrete policy steps demanded by the IMF as part of the loan.

The agreement is built on the explicit assumption that reducing wages and labour protections, along with other measures to liberalize Ecuador's economy, will attract private investment to the country and in turn lead to growth. Even under a scenario in which this strategy would work, the short-term costs of the adjustment are still to be borne by Ecuador's working people.

Table 1: Macroeconomic Projections

	2018	2019	2020	2021	2022	2023
Real GDP Growth	1.1	-0.5	0.2	1.2	2.7	2.3
Unemployment Rate	3.7	4.3	4.7	4.8	4.6	4.5
Expenditure (% of GDP)	37.2	35.2	34.6	32.6	32.0	31.8
Revenue (% of GDP)	36.3	35.2	38.3	35.5	34.8	34.7
Debt-to-GDP Ratio	46.1	49.2	46.8	45.2	40.8	36.6

Source: IMF (2019)[4]

Table 1 presents the IMF's macroeconomic projections for Ecuador. The Fund projects that Ecuador's economy will only shrink by 0.5 per cent of GDP in 2019, then return to growth in 2020, while sharply reducing government expenditures. Meanwhile, the IMF expects revenue collection to increase, and the debt-to-GDP ratio to decline after 2019. Unemployment is expected to increase at the beginning of the programme, from 3.7 percent in 2018, to a peak of 4.8 per cent in 2021. It is important to consider that the unemployment prediction is made under the assumption that the programme will meet its growth targets.

[3] https://www.imf.org/en/Publications/CR/Issues/2019/03/20/Ecuador-Staff-Report-for-the-2019-Article-IV-Consultation-and-Request-for-an-Extended-46682
[4] https://www.imf.org/en/Publications/CR/Issues/2019/03/20/Ecuador-Staff-Report-for-the-2019-Article-IV-Consultation-and-Request-for-an-Extended-46682

The IMF has a well-documented pattern of overestimating growth projections in its programmes.[5] Most recently, in the case of Argentina, growth projections were adjusted downwards by over 3 per cent for one year, only a few months after the initial agreement was published. These errors stem from overestimating the positive impact of the structural reforms, along with understating of the negative effects of spending cuts on the economy.

A deeper than projected recession would mean missing other targets. Revenue collection decreases during a recession, and given the strict conditionality on expenditure levels, there is the likelihood of even further spending cuts. Lower revenues, and lower GDP growth mean that the debt-to-GDP ratio will continue to grow. A weaker economy means unemployment is also likely to be higher than currently predicted by the IMF.

Fiscal consolidation

Overall, the loan programme requires a fiscal consolidation (deficit reduction) of 5 per cent of GDP over only 3 years, consisting of mostly sharp expenditure cuts, along with some tax increases. In practice, "strengthening fiscal sustainability" means a reduction in public sector employment and spending cuts on government programmes, along with increased taxes.

Table 2: Fiscal consolidation measures as percent of GDP

	2019	2020	2021	2019-2021
Revenue Measures	**-0.3**	**1.4**	**0.4**	**0.7**
Expenditure Measures	**2.3**	**0.6**	**1.4**	**4.3**
Wages and salaries	0.5	0.3	0.2	1
Fuel subsidies	1.7	-0.1	0.5	2.1
Social Spending	-0.4	0	0	-0.4
Other	0.5	0.4	0.7	0.8
Total	**2.0**	**2.0**	**1.8**	**5.0**

Source: IMF (2019)[6]

Table 2 illustrates the tax increases and spending cuts demanded by the agreement. While tax revenue is expected to decrease slightly in 2019, a large increase in tax collection is required for 2020. It is unclear what tax measures the government of Ecuador will introduce to achieve that target, especially as the government will need to account for the lost revenue from the removal of a tax on capital outflows (raised about 1 per cent of GDP in revenue per year)[7]. One of the IMF's

[5] https://www.imf.org/external/pubs/ft/wp/2013/wp1301.pdf
[6] https://www.imf.org/en/Publications/CR/Issues/2019/03/20/Ecuador-Staff-Report-for-the-2019-Article-IV-Consultation-and-Request-for-an-Extended-46682
[7] http://cepr.net/images/stories/reports/ecuador-2017-02.pdf

suggestions is making permanent a temporary increase in the value added tax – a regressive measure that would hurt consumers.

The programme includes a phaseout fuel subsidies over the next 3 years, resulting in savings of 2.1 per cent of GDP. While fuel subsidies can be regressive, a quick phaseout can cause prices to increase significantly. Recall that IMF support for a rapid fuel subsidy removal has stoked the recent and violent social conflict in Haiti

An increase in social assistance is meant to alleviate the impact of the cuts on the most vulnerable segments of the population. However, 0.4 per cent of GDP is a small amount and insufficient to compensate for the rest of the cuts. This small increase represents the "protect the poor and most vulnerable" pillar of the programme, something it is unlikely to truly fulfil.

Public sector employment

As seen in **Table 2**, the programme results in a reduction of the public sector wage bill – total spending on salaries for public workers – by 1 per cent of GDP over the next 3 years. This reduction translates into roughly $1 billion dollars of lost income for Ecuadorian workers. Overall, the government has committed to reducing its wage bill by about 10 per cent of the current level. This will be achieved by a combination of wage reductions, layoffs, and a commitment to only renew one of every two expiring employment contracts.[8] If the savings on the wage bill were to be achieved only through workforce reduction, it would mean about 140,000 lost jobs.[9] However, given that there will be a combination of reducing wages of current employees along with the reduction of the workforce, it is hard to estimate exactly how many jobs will be lost.

The IMF justifies this demand by stating that public employment grew too fast in the period between 2005 and 2015.[10] This statement lacks the context, namely the increased investment in provision of social services. As spending on healthcare, education, and social services almost doubled, it is not surprising that the public sector labour force grew as an essential part of providing quality public services.

Labour Reforms

The attack on workers in this programme extends beyond the public sector. "Boosting competitiveness and job creation", which is the first pillar of the programme, asks for a reduction in labour costs. The programme proposes both a reduction in wages, along with chipping away at labour rights and protections. Because Ecuador's economy is dollarized, a devaluation of the exchange rate to boost competitiveness abroad is not an option. The IMF argues that Ecuador is

[8] https://www.imf.org/en/Publications/CR/Issues/2019/03/20/Ecuador-Staff-Report-for-the-2019-Article-IV-Consultation-and-Request-for-an-Extended-46682
[9] Based on available public employment numbers http://www.ecuadorencifras.gob.ec/empleo-marzo-2019/
[10] https://www.imf.org/en/Publications/CR/Issues/2019/03/20/Ecuador-Staff-Report-for-the-2019-Article-IV-Consultation-and-Request-for-an-Extended-46682

stuck with an overvalued exchange rate, and therefore proposes a reduction in real wages. This is based on the logic behind that lower labour costs will help attract investors and boost the country's exports. The IMF also recommends reforms to business law based on the highly-criticized *Doing Business* report of the World Bank.[11]

Developments in the labour share of income for Ecuador (the share of value added that goes to workers and not corporate profit), which should be welcomed by the IMF due to general public statements about the loss of labour share, are instead criticized.[12] The attack on labour rights is justified by a claim that the labour share of income for Ecuador has grown too much in the last decade. However, it fails to mention that at about 37 per cent, it is exactly in line with the average for emerging market and developing economies.[13]

The IMF goes even further to claim that Ecuador's minimum wage is too high, justifying the claim by comparing it to regional peers. This comparison is unfair, since many neighbouring countries have gone through major currency depreciations in the last few years, which make their wages seem relatively lower in dollars. It also makes this judgement regardless of living costs or an analysis of the wage policies and trends in the neighbouring countries. Ecuador's minimum wage is set by a special commission in accordance to living costs. It is misguided to attack minimum wages, which are key to assuring adequate living standards and shared prosperity. The IMF's approach fails to provide policy space for wage-led growth strategies and the pursuit of social goals including inequality reduction and is based on a view that wages should fall to a regional benchmark.

Besides calling for a reduction in wages, the IMF promotes flexibilization and increased precariousness of private sector work, claiming that the lower costs for employers would translate into job creation. Among the policies advised by the IMF are an increase of probation periods for new employees, eliminating severance payments for workers who resign, and introducing a broader range of temporary and part-time work contracts.[14]

The layoffs in the public sector, along with these measures, will undermine bargaining power and put further downward pressure on wages, which is the stated goal of the IMF. However, this will hurt the economy further by depressing aggregate demand. It could also widen income inequality, risking a reversal from Ecuador's path of inclusive growth.

[11] https://inequality.org/research/world-banks-simplistic-claims-business-regulations-jobs-inequality/
[12] https://www.imf.org/en/News/Articles/2018/01/23/tr012318-world-economic-outlook-update-press-conference
https://www.imf.org/en/Publications/WEO/Issues/2017/04/04/world-economic-outlook-april-2017
[13] https://blogs.imf.org/2017/04/12/drivers-of-declining-labor-share-of-income/
[14] https://www.imf.org/en/Publications/CR/Issues/2019/03/20/Ecuador-Staff-Report-for-the-2019-Article-IV-Consultation-and-Request-for-an-Extended-46682

Institutional Reforms

While the IMF recognizes the disadvantages that dollarization brings to Ecuador, forcing it to use a currency that is highly overvalued, it demands the country "strengthen the foundations of dollarization." In practice, this means a return to monetary policy orthodoxy promoted by the IMF, including central bank independence. The government has already passed a law banning the central bank from helping finance government operations and will continue to phase out the unorthodox tools that helped it weather the shocks of the last decade. Given that Ecuador is dollarized, this means a complete renunciation of monetary policy as a tool. In the aftermath of the financial crisis and oil shocks, Ecuador's central bank engaged in both Quantitative Easing and issuance of electronic money, which helped minimize the impact of these shocks on the economy.[15] Under the new rules, those tools will no longer be available to address future shocks.

Another major reform that the IMF is demanding is the elimination of capital controls. Ecuador's tax on capital outflows has helped the country raise revenue, while also stabilizing flows. Capital outflows triggered by external factors have caused a series of currency crises in the past year, and the IMF's research department recognized the negative impacts of capital account liberalization.[16] The loan agreement is demanding Ecuador give up this measure despite its proven success.

Looking forward

The IMF programme for Ecuador risks erasing the social progress of the last decade. After steadily declining for over a decade, poverty and inequality are again on the rise, a trend that is likely to continue. To make matter worse, entering a vicious loop of austerity means that Ecuador's debt burden will increase relatively to GDP. At the end of the programme Ecuador might find itself with a weakened social contract, a smaller economy, and a higher debt burden.

[15] http://cepr.net/images/stories/reports/ecuador-2017-02.pdf
[16] https://www.imf.org/external/pubs/ft/wp/2015/wp15243.pdf