

Dollarization: A Case Study of Ecuador

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Abstract

The purpose of this paper is to conduct a cost and benefit analysis of Ecuador's decision to abandon its domestic currency, the Sucre, with the U.S. dollar in the year 2000. In light of the evidence that will be put forth in this paper, it is argued that official dollarization in the short-run has generated benefits to the economic well being of Ecuador beyond that of an initial stabilizing effect where the costs associated with the regime have had a relatively minor impact thus far.

Keywords: Ecuador economy, dollarization, exchange rates, Latin America

I. Introduction

In the last decade, the idea of dollarization has surged the forefront of monetary policy alternatives for Latin American countries.²As economists all over the world continue to struggle to formulate coherent explanations for the spillover potential of financial crises, policymakers and economic advisors have been searching for ways to protect their economies. A plethora of proposals have been put forward including international finance architecture, the institution of capital controls and the application of stricter monetary and fiscal regimes.³ However, within Latin America, the implementations of currency boards and dollarization have been the most common.⁴ Recently, in an effort to provide stability to its economy, Ecuador has implemented official dollarization by adopting the U.S. dollar, as it's official currency.⁵At the turn of the 21st century, Ecuador experienced a near total-breakdown of its monetary system caused by both exogenous and endogenous macroeconomic shocks, which consequentially led the country to abandon its national currency, the Sucre, and replaced it with the U.S. dollar.⁶An analysis of Ecuador's turbulent economic situation from 1994 until 2014 is crucial in understanding how dollarization came about, the associated impacts and what it will entail for the future.

First, an introduction to dollarization will be outlined in order to understand why it was chosen among other alternative fixed exchange rate regimes. Secondly, an analysis of fundamental macroeconomic variables from 1994 until 1999 will contextualize the fundamental problems that were central to the monetary crisis throughout the nineties. Thirdly, an analysis of the costs and benefits of dollarization will highlight the short-term stabilization benefits of this regime including lower inflation, lower interest rates, growth in GDP, and improved economic openness.

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²*Responding to Global Crises: Dollarization in Latin America* (Atlanta: Federal Reserve Bank of Atlanta, 1999), 3.

³Ibid.

⁴Ibid.

⁵Andrew Berg and Eduardo Borensztein, *Full Dollarization: The Pros and Cons*, IMF Economic Issues Series No. 24 (Washington: International Monetary Fund, 2000).

⁶Paul Beckerman and Andres Solimano, *Crisis and dollarization in Ecuador: stability, growth, and social equity* (Washington: The World Bank, 2002).

Lastly, although it will be argued that Ecuador's economy has shown signs of macroeconomic improvement, this paper will continue the assessment of dollarization by discussing how Ecuador's future still remains vulnerable to external shocks due to its loss of monetary policy independence. Overall, it will be concluded that the dollarization regime in Ecuador has produced short-term benefits by stabilizing the economy, however, after only fifteen years it is premature to say what the full impact will be over the long run.

Why Dollarization?

The currency of a nation serves three necessary functions: as a medium of exchange, as a store of value and as a unit of account.⁷ Moreover, for a nation's money to fulfill its proper role in the national economy, all three of these functions must simultaneously exist. Nonetheless, in times of a macroeconomic crisis, a currency may lose one or all of these necessary properties and cease to function efficiently. Following the abandonment of the gold standard during World War I and the Breton Woods Conference after World War II, countries have been desperately seeking ways to promote global economic stability during such crises.⁸

Throughout Latin America, the optimal way to obtain such stability has been through the use of currency boards, which involves pegging the local currency to a major convertible currency or dollarization where the local currency is abandoned in favor of the exclusive use of a foreign currency. Moreover, dollarization acts as another kind of fixed exchange rate that is implemented when countries are plagued with poor monetary performance, high inflation levels or for strategic trade and political reasons.⁹ Overlaying this definition onto the context of Ecuador, who suffered from hyperinflation in the 1990s, reaching an all-time high in 2000 at 96%, we can begin to understand why official dollarization was a chosen regime among other alternatives (Appendix 1). Subsequently, extensive research has been conducted in the last few years on dollarization regarding the perceived costs and benefits. Ecuador's President Jamal Mahuad was drawn to the benefits of dollarization as the regime assured a short-cut towards securing a reliable nominal anchor against inflation, lower transaction costs, reduce the country's risk premium on foreign borrowing and provide greater economic openness and transparency – all of which occurred.¹⁰

Secondly, given that Ecuador has historically struggled with endemic corruption and weak government transparency, it has been argued that the implementation of dollarization could enhance the country's economy through legal stability and political credibility.¹¹ For example, George Calvo found that policymakers in Latin America generally have non-credible macroeconomic policies, which attribute to higher volatile and high interest rates.¹² Referring to Appendix 2, which illustrates the real interest rates from 1994 until 2006, we can see a transformation from volatile and high rates before 2000 to a sudden drop and stabilization. Furthermore, as one of the poorest countries in Latin America, Ecuador is known for its social unrest and economic instability of the past few decades.¹³ From its period of military rule in the 1960s to the decade of hyperinflation in the 1990s, attributed to low oil prices and agricultural damages caused by El Niño, it has sustained a weak economic environment.¹⁴

⁷George S. Tavlas, *The International Use of Currencies: The U.S. Dollar and the Euro in Finance and Development*, Volume 35, #2, (Washington, International Monetary Fund, 1998).

⁸Sen Choudhury, Eesha, "Dollarization and Currency Boards," (Lecture 13, ECON 314, McGill University, Montreal, November 2014).

⁹Ibid.

¹⁰Luis I. Jacome H., *The Late 1990s Financial Crisis in Ecuador: Institutional Weaknesses, Fiscal Rigidities and Financial Dollarization at Work*, IMF Working Paper, (International Monetary Fund, 2004).

¹¹Jake Dizzard, Christopher Walker and Vanessa Tucker, "Countries at the Crossroads: An Analysis of Democratic Governance" (Rowman and Littlefield, 2012).

¹²George Calvo, *Capital markets and the exchange rate: with a special reference to the dollarization debate in Latin America*. (Federal Reserve Bank of Cleveland, 2001).

¹³Irene Caselli, "Ecuador: Stability but at what price?" BBC News, Quito, 28 May 2013.

¹⁴Ibid.

This atmosphere consequentially cultivated a permanent fear of future inflation, where banks charged high interest rates for loans in the local currency, businesses borrowed in U.S. dollars to get lower interest rates and there was a general lack of saving in local currency.¹⁵ Moreover, policymakers' last consideration for official dollarization stemmed from the already existing partial dollarization. This form of unofficial dollarization has been rampant for decades and stems from the historic precariousness of the nation's economy and the resulting distrust of the Sucre.¹⁶ It is these main functions and advantages of dollarization, coupled with the economic instability of Ecuador that pushed policymakers' to make such a radical decision towards abandoning the Sucre.

Inevitably, dollarization also produces extensive disadvantages to an economy through the loss of monetary policy independence and the restrictive impact on fiscal policy, exposing themselves to greater vulnerability during macroeconomic crises.¹⁷ Acknowledging this drawback, it can be argued that there is no consensus on whether formal dollarization is good for stability and growth over the long term.¹⁸ From here, this paper will highlight the ways in which Ecuador has benefitted in the short-run in terms of lower and more stable inflation and interest rates, producing a more stable environment for trade and investment, thereby stimulating economic growth.

Ecuador's Economic Background Prior to 2000: a Period of Hyperinflation

From 1994 until 1999, Ecuador's economy stalled with a real GDP growth of 1.84 percent.¹⁹ It was only until the late 1990s that Ecuador's local currency, the Sucre, suffered severe levels of hyperinflation. This hyperinflation was partly due to a combination of exogenous and climatic factors in 1997 and 1998. Among these were declining oil export prices and the El Niño weather phenomenon that devastated the country.²⁰

Zooming in on the economic trends, Ecuador's last strong year was in 1994, where GDP grew by 4.3 percent and inflation was at 27.4 percent (Appendix 3). However, in 1995 an increase in military spending due to a border war with Peru brought a balanced budget into a significant deficit.²¹ Ecuador's massive public and private debt can be visually depicted in Appendix 4 showing that in 1999 the balance of public and private debt represented 77 percent and 19 percent of GDP. This is also shown in Appendix 5 depicting a negative GDP annual growth at -4.7 percent. Unfortunately, Ecuador's bad luck did not end there and their agriculture, roads and transportation experienced most of the damages caused by El Niño from 1997-1998.²² This had an impact on GDP, where the total expected net losses valued in terms of foregone earnings were estimated at US\$112.3 million, or 4.7 percent of agricultural GDP and 0.6 percent of total GDP (Appendix 6).²³ The exogenous impacts of El Niño combined with the 1997 fall in oil prices, which is the country's main export product, continued to strain Ecuador's economy (Appendix 7).²⁴

Additionally, the simultaneous East Asian financial crisis led to a decline in currencies and other assets in countries throughout Latin America, which had indirect repercussions on Ecuador's economy.²⁵ In the monumental year of 1999, the Ecuadorian Central Bank floated the exchange rate in order to limit the international-reserve loss caused by the devaluation in Brazil.²⁶

¹⁵Myriam Quispe-Agnoli and Elena Whisler, *Official Dollarization and the Banking System in Ecuador and El Salvador* (Atlanta: Federal Reserve Bank of Atlanta, 2006).

¹⁶Hale E. Sheppard, "Dollarization of Ecuador: Sound Policy Dictates U.S. Assistance to this Economic Guinea Pig of Latin America", (Indiana University International and Comparative Law Review, 2000).

¹⁷Sen Choudhury, Eesha, "Dollarization and Currency Boards," (Lecture 13, ECON 314, McGill University, Montreal, November 2014).

¹⁸*International Monetary Fund Country Report: Ecuador* (Washington: International Monetary Fund, 2006).

¹⁹See Appendix 3

²⁰Vos, Velasco, Labastida. *Economic and Social Effects of El Niño in Ecuador, 1997-1998* (Washington D.C.: Inter-American Development Bank, 1999).

²¹Stanley Fischer, *Ecuador and the IMF* at the Hoover Institution Conference on Currency Unions (California: International Monetary Fund, 2000).

²²Vos et al. *Economic and Social Effects of El Niño in Ecuador*, 15.

²³Ibid.

²⁴Ibid.

²⁵Paul Beckerman, *Longer-term origins of Ecuador's pre-dollarization crisis* (Washington D.C.: the World Bank, 2002), 18.

²⁶Alain de Janvry, Nigel Key and Elisabeth Sadoulet, *Agriculture and Rural Development in Latin America* (Berkeley, California: Food and Agriculture Organization, 1997), 52.

The decision to float the Sucre precipitated a monetary free fall as the market-correcting forces brought the currency to its true value. Referring to Appendix 8, which provides a table of Ecuador's macro-performance indicators, the value of the Sucre fell from 6,825 saucers per U.S. dollar in 1998 to 20,243 per U.S. dollar in 1999. This moreover increased depositor concerns and eventually led to massive cash withdrawals and capital flight.

In addition to this loss, the government aggravated the domestic rate of inflation by printing excessive quantities of money to insure the deposits of their unsound banking institutions.²⁷ This is visually shown in Appendix 1 where the rate of inflation rose from 36.1 percent in 1998 to 96 percent in 2000. In August of 1999, the situation in Ecuador was at its peak and caused the nation to default on its Brady bond issues, which amounted to an estimated 6.5 billion dollars (almost half of its public external debt)²⁸. By the end of 1999, it was clear that the government had lost its ability to control its domestic money supply, its domestic price level and the exchange rate. Overall, the economic downturn in 1999 was characterized by hyperinflation, sharply falling real wages and a depreciating exchange rate that pushed workers into unemployment or underemployment in the informal sectors.²⁹ From here, the nation was left with two policy choices: a total adoption of the U.S. dollar or the continued path of hyperinflation.³⁰

The Turning Point: Benefits and Costs of President Mahmud's Call for Dollarization

Inflation

The period of hyperinflation cultivated in the late 1990s produced a turbulent crisis that pushed President Jamil Mahuad in January 2000 to follow a process of official dollarization. The exchange rate at which local currency would be exchanged for U.S. dollars was fixed at 25,000 saucers per dollar.³¹ As stated previously, some of the most common benefits of dollarization are to lower inflation levels, lower transaction costs, and generate greater economic openness and transparency providing a boost to international trade than alternative currency regimes. Within the context of Ecuador, the monetary authority was unable to control inflation throughout the 1990s, whereby dollarization was promoted as the only option. First and foremost, dollarization was expected to bring the inflation rate under control since the monetary authority would no longer be able to influence the money supply. Referring to Appendix 1, Ecuador's inflation rate decreased significantly from 96 percent in 2000 to 37.6 percent in 2001.

This immediate fall in inflation is certainly beneficial, however, there was an immediate cost associated with how long the reduction took. It took until 2003 for the inflation rate to reach single digit levels at 7.9 percent (Appendix 1). This can be partially explained through the associated loss of the monetary policy instrument as a result of dollarization, which increased the importance of fiscal policies in macroeconomic management. It became the main instrument in managing demand and inflationary pressures, explaining the lag in decreasing inflation rates. It has been argued that fiscal policy may have indeed been too expansionary during this transition, delaying the adjustment of the Ecuadorian dollar inflation to U.S. levels.³² Overall, the decline of inflation has continued since 2000, with minimal ups and downs as compared to the years before the regime was implemented. Therefore, not only did the high levels of inflation fall, but also did the overall volatility as it anchored itself to the U.S. inflation levels at 2.74 percent in 2004 (Appendix 9).

²⁷David Matthews, *Reassessing the Case of Ecuador's Dollarization* (Journal of Economics and Economic Education Research, 2006).

²⁸J.F. Hornbeck, *Ecuador's Brady Bond Default: Background and Implications* (Congressional Research Service, The Library of Congress, 2000), 3.

²⁹Juan Ponce and Rob Vos, *Redistribution without Structural Change in Ecuador: Rising and Falling Income Inequality in the 1990s and 2000s* (United Nations University, 2012).

³⁰Beckerman, *Longer-term origins of Ecuador's pre-dollarization crisis*, 17.

³¹Quispe-Agnoli and Whisler, *Official Dollarization and the Banking System in Ecuador and El Salvador*, 13.

³²Bob Traa et al., *Selected Issues and Statistical Appendix on Ecuador* (Washington D.C.: International Monetary Fund, 2003), 11.

Gross Domestic Product

Since GDP growth is affected by both inflation and interest rates, dollarization can be depicted as having an indirect positive effect on the growth of Ecuador's economy. Referring to Appendix 5, both the GDP growth rate and volatility increased after dollarization. Economists claim that the introduction of the U.S. dollar triggered an overconfidence regarding investments and spending, where the citizens in Ecuador had high expectations in the U.S. dollar. Moreover, the nation avoided falling further into recession and responded with an output growth of -4.74 percent in 1999 to 1.09 percent in 2000 (Appendix 5). Additionally average GDP growth between the years 1990 until 1999 was 1.8 percent, and has improved to 4.4 percent between 2000 and 2014. The increased volatility of the GDP growth can be deemed as a cost of dollarization attributed to the loss of independent monetary policy, where the fiscal policy and the labour market lacked flexibility to smooth out the business cycle.

Economic Openness

Lastly, official dollarization has also helped stimulate international trade through improved macroeconomic stability and lower transaction costs. Moreover, economic openness, measured as imports plus exports as a percentage of gross domestic product, has increased reflecting strong export growth. As Appendix 10 indicates, the degree of openness as a percentage of GDP (labeled as "trade openness") of the Ecuadorian economy went from 43.8 percent in 1994 to 59.5 in 2000. This increase can be attributed to dollarization, as it makes commercial integration with the U.S. easier by eliminating transaction costs associated with currency exchange. This is displayed in Appendix 11, where Ecuador's share of exports to the U.S. increased from 39 percent in 1998 (pre-dollarization), to 50 percent in 2005 (post-dollarization). Additionally, before dollarization imports of goods and services were consistently greater than exports. After the 2000-year mark, both imports and exports started to converge where exports accounted for 32 percent of GDP and imports were 27 percent of GDP (Appendix 10).

So far, the benefits of dollarization have far outweighed its costs. However, the macroeconomic environment needs to be strengthened further to lower Ecuador's vulnerability to shocks (i.e. continued volatility in GDP after dollarization). From here, fiscal policies could play a more important role to improve financing conditions for domestic enterprises. This would further strengthen export growth, securing the monetary base and could continue to bring down the unemployment rate, which has made drastic improvements from 14 percent in 1999 to 4.1 percent in 2012 (Appendix 12).

Conclusion and Lessons Learned

Since dollarization, the economy has recovered and macroeconomic balances, including inflation, gross domestic product, and trade have been restored. However, the most important benefit that has been established from dollarization is the credibility and confidence that has been restored in the domestic banking system.³³ The financial system has slowly recovered which has reactivated domestic demand through the sharp decrease in inflation.

President Mahuad's choice to dollarize was an extreme measure in search for stability within the Ecuadorian economy. Like any other monetary system, it is oriented as a short-term economic solution. For many Ecuadorians, embracing dollarization has meant giving up independent monetary policy, which is now in the hands of the Federal Reserve System. In addition, The Central Bank of Ecuador has lost its role as the "lender of last resort". However, although these costs are real, the active monetary policy before dollarization had proven to be ineffective given the critical economic state the country reached in the 1990s. Moving forward, it is essential to recognize how this regime has also benefited the overall development of Ecuador with respect to the distribution of wealth across the nation. This can be depicted in Appendix 13, which draws out the Lorenz curve for Ecuador for the years 2000 and 2013, where the wealth distribution among 20 percent of the poorest population increased from 3.3 percent to 4.3 percent. Furthermore, after only fifteen years it might be premature to say what the full impact will be over the long run, however given the analysis made in this paper, it is clear that Ecuador has reaped the short-term benefits of dollarization.

³³Fischer, *Ecuador and the IMF*.