Student Economic Review, Vol. 17, 2003, pp. 167-173

DOLLARISATION: THE CASE OF ECUADOR

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Barry John Rafferty provides a theoretically sound treatment of dollarisation in Ecuador, backed up with a plethora of facts from reliable sources.

Introduction

Official dollarisation is a monetary regime under which a government adopts foreign currency, the dollar, as the predominant or exclusive legal tender.[1] The rationale for dollarisation lies mainly in availing of the monetary stability it provides. Many relatively small countries have used and continue to use foreign currency as legal tender, including such diverse countries as Panama, Liechtenstein, and now East Timor.

President Jamil Mahuad announced in January 2003 that Ecuador was to dollarise, replacing the sucre with the US dollar, in a bid to restore stability to an economy in the midst of a severe crisis. On September 13, 2000, the sucre ceased to be legal tender and Ecuador (with a population of nearly 13 million) became the most populous dollarised country in the world. Ecuador therefore provides an ideal test case to evaluate the efficacy of dollarisation as a monetary regime and its capacity to induce positive economic growth.

The Crisis

In January 2000, Ecuador was battling with an economic crisis that had been building up over the previous two to three years. Indeed, GDP fell by some 7.3 % in 1999.[2] Unemployment and underemployment were particularly high, at 15.1% and 46% respectively.[3] The primary causes of this crisis consisted of a number of

[1] Joint Economic Council, Washington D.C., (July 1999).
[2] Economist.com, *Country data, Ecuador*.
[3] Schuler, (2002).

exogenous shocks. These included falling oil prices; the effects of El Niño induced flooding; and a series of financial crises in East Asia, Russia, and of particular importance in Brazil. These shocks were exacerbated by public sector dependence on oil, the political fragmentation of Congress and weak administration, as well as a weak banking system that was characterised by semi dollarisation. With reference to the last point, 60% of bank loans were denominated in dollars by December 1998 and this had risen to 91% by March 2000.[4]

Falling oil and tax revenue as a result of declining oil prices in 1998 caused the fiscal deficit to widen to 5.7%.[5] Decreasing oil export revenue and fears of devaluation also induced the current account deficit to widen to a massive 10.7%.[6] Banks accumulated large proportions of bad loans as private borrowers began to default on their debt. This saw a decline in banks' assets. Capital began to flow out of Ecuador. Savers in banks began to fear that the banks might fail and began to remove savings, fearing a devaluation. The Treasury sought to dispel such fears by guaranteeing all bank deposits. The Deposit Guarantee Agency was set up and put failing banks into public hands. Indeed, by January 2000, banks representing 60% of total commercial bank assets were in public hands.[7]

In February 1999, the Central Bank floated the exchange rate, to limit foreign reserve losses, thus ending the crawling peg band system.[8] Massive depreciation and hyperinflation ensued. Private borrowers with sucre incomes were forced to default on dollar loans and banks were hit hard once again. In March 1999, a bank holiday was declared and bank deposits were frozen. The banks were recapitalised via a $1.6 billion Treasury bond issue and liquidated by a 136% increase in the monetary base for 1999.[9]

In August 1999, the government was forced to default on its external Brady Bond debt. This exacerbated depreciation of the sucre. By the end of 1999, the sucre had depreciated from 6825 per dollar to 20243 per dollar, and during the first week of January 2000 it fell to as much as 28000 per dollar in the interbank market.[10] Inflation jumped to 60.7% in 1999.[11] It is quite clear that the economy was in crisis, with monetary instability aggravating the situation. The decision to restore monetary stability via dollarisation should therefore be viewed against this backdrop.

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[4] Beckerman, (2001).
[5] Economist.com, *Country data, Ecuador*.
[6] Economist.com, *Country data, Ecuador*.
[7] Beckerman, (2001).
[8] Beckerman, (2001).
[9] Beckerman, (2001).
[10] Schuler, (2002).
[11] Economist.com, *Country data, Ecuador*.

Dollarisation Goals

Dollarisation was adopted to try to restore monetary stability and confidence in the Ecuadorian economy, thus attracting FDI into the country whilst also stemming capital outflows. It was hoped that inflation would fall to levels compatible with price stability and thus rid Ecuador of the harmful effects of hyperinflation. Lower inflation and a stable currency could furthermore encourage saving and private investment and lead to a lower rate of interest. In short, it was intended that dollarisation would provide a platform for the economy to return to growth.

Dollarisation in Ecuador: Results

Dollarisation has been fairly successful in relation to achieving the goals set out for it. GDP has returned to growth, with a rate of increase of 5.6% for 2001.[12] The unemployment and underemployment rates were also down to 8.5% and 30.5% by 2002.[13] This is in part due to dollarisation, but also due to a rise in the price of oil, resulting in increased oil revenue, and also some domestic reform. The benefits that can be attributed to Ecuador are as follows:

- Inflation has been reduced from 60.7% in 1999 to 23.5% in 2001. The reduction has not been as quick as expected mainly due to the choice of exchange rate at which dollarisation took place. The choice of 25000 sucres per US dollar significantly undervalued the sucre. Also, taking a US Dollar base, consumer prices actually fell by 45.4% in 1999.[14] Therefore, given the exchange rate that was chosen, and the fact that inflation tended to lag the exchange rate, it was inevitable that inflation would take a while to fall to levels comparable to the US. The US dollar base fall in consumer prices in 1999 gave some room for inflation given the exchange rate without eroding competitiveness too much.
- Capital channels were reopened and Ecuador's credit rating improved. Ecuador's foreign debt was renegotiated and a 40% nominal reduction was agreed to by creditors. The IMF also extended a three year standby loan. FDI was encouraged by monetary stability and increased from $636 million in 1999 to $1369 million in 2001.[15] A significant amount of this increase went towards the construction of a new oil pipeline which will nearly double oil output when completed and opened in 2004.

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[12] Economist.com, *Country data, Ecuador*.
[13] Schuler, (2002).
[14] Schuler, (2002).
[15] Latin Business Chronicle.com.

- The budget deficit has been transformed into small surpluses in 2000 and 2001.
- Interest rates have fallen and business confidence has increased. Loans to firms have increased and a rise in investment has been the overall result.

Dollarisation: Future prospects

In terms of whether dollarisation will be successful in the future in facilitating sustained growth to occur in Ecuador, a number of concerns have arisen.

- Should inflation continue to exceed the American level, or should rival countries devalue their currencies, Ecuador could face a loss of competitiveness. Without the option to devalue, Ecuador could end up in another economic crisis. However, Schuler (2002) points out that a stable currency will benefit a country more in the long run than competitive devaluations which elicit only short-run gains. Schuler indicates that the sucre depreciated by a factor of around 3 in 1999, but prices only increased by a factor of around 0.6. Despite the resultant gain in competitiveness, Ecuador suffered its worst economic year in history. This should highlight that it is more important to have a stable currency as opposed to resorting to competitive devaluations, where inflation often erodes the competitiveness gain. Panama is an example of a country that has done better, with greater price stability than neighbouring countries.
- The banking system still hasn't fully recovered from the crisis preceding dollarisation. A key indicator is the large difference between interbank interest rates (which fell to 4.92% in 2002) and the lending rate to private borrowers (which stood at 13.09% in 2002).[16] This is partly due to an attempt by the banks to recapitalise their assets, but more so, it is due to the lack of international banks operating freely in Ecuador, competing away interest rates on private loans in excess of those found in the US.
- Ecuador remains extremely vulnerable to external shocks. The dependence on oil and other commodities can result in large falls in export and public revenue when commodity prices fall. Also, Ecuador's climate leaves it open to the harmful effects of earthquakes and the phenomenon of El Niño.
- Ecuador still lacks the structural reform necessary to maintain stable growth over a long period of time. A fragmented congress makes legislation very difficult to get passed and undermines the efforts and effectiveness of the administration. The tax system is inefficient and should be replaced with a broader tax base featuring lower tax rates spread across more items. The government is strongly lacking in transparency. Indeed, Ecuador ranked 89th of

[16] Schuler, (2002).

102 countries surveyed by Transparency International.[17] As a consequence, inefficient use is made of public funds. In addition to this, Ecuador is also characterised by a legal system which is often arbitrary, making it very difficult for creditors to collect debts.[18]

Conclusion

From the example of Ecuador, it is evident that dollarisation can succeed in providing greater monetary stability. In an area where monetary instability has been the norm, dollarisation can have the effect of substantially ameliorating economic performance. Monetary stability is however no guarantee of good economic performance. To be successful over the long-term, dollarisation must be matched by a commitment to ensure that efficiency and competitiveness are paramount. A good institutional framework, with efficient and transparent public decision making and intervention are a major priority. So too is an efficient and just legal system and the internationalisation and strengthening of the banking system. Whilst dollarisation is no guarantee of success, it can provide the platform of monetary stability from which economic growth can take off if the appropriate policies are subsequently adopted and implemented. However, without monetary stability, it is highly unlikely that such a growth take-off will occur regardless of what other reforms are implemented.

The effect of dollarisation in Ecuador has been to hurl the country towards monetary stability. Whilst the initial outlook is an improvement, ultimate success will depend on real factors affecting the efficiency and productivity of the country. In this context, monetary stability can be seen as a prerequisite for growth, and dollarisation as an effective means of achieving the prerequisite. Ultimately though, the success of dollarisation will depend upon whether the opportunity is fully grasped to tackle remaining inefficiencies and hindrances to an efficient, productive economy, and to build upon a platform of monetary stability.

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[17] Beckerman, (2001).

Statistical Appendix

	1998	1999	2000	2001
Exchange Rate,E.O.P. (Sucres per US$)	6825	20,243	Dollarised at 25000 sucres	Dollarised at 25000 sucres
GDP (% real change per annum)	0.4	-7.3	2.3	5.6
Inflation (consumer prices, %, sucre base)	43.4	60.7	91.0	23.5
Budget balance (% GDP)	-5.7	-4.8	1.7	0.7
Current Account Balance/GDP	-10.7	6.9	6.8	-4.2

Sources: Economist.com, *Country Data, Ecuador*. Schuler, (2001).

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