Ecuador's dollarization: the good, the bad and the ugly

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1. Background

The adoption of a new monetary system, as it occurred in Ecuador, can be heralded as the most important event of the last century, and certainly as a challenge for the new millennium. This change was the culmination of many political and economic events that took the country to abandon its monetary sovereignty without proper planning as a response to the specific interests of determined economic groups. To some analysts this action could represent the last possibility of creating an order in a society where reaching consensus within the traditional model was almost impossible; therefore, the need for a radical change.

Two years have passed since its formal inception. The results are contradictory, and the social and economic leaders cannot foresee an optimistic future. There are groups that benefited directly from the crisis and of the dollarization process, particularly bankers and individuals with big debts. As for the other sectors such as the poor, the blue-collar workers, and the middle class, they have seen an increasing risk and deterioration of their economic well being.

The dollarization cannot be analyzed with the conventional political-economic tools; it must rather be interpreted from the point of view of political economics. It manifests itself as a response to the interests of specific individuals with ties to well-known financial groups which have strong connections in the political, social arenas, and to the media[1] as well. The dollarization was originally conceived as a political solution to resolve the profound economic, social, and governability crisis produced by the neo-liberal model. Now it appears more as "callejón sin salida" Argentinean style.

The banking holiday, the freeze of deposits, and the bail out of the banking system (march 1999) using public money shows, once more, the perverse logic of the crisis: a great transfer of wealth from the Ecuadorian population to the private financial system.

The official dollarization became a desperate alternative to avoid an acceleration of the inflation (in reality non-existent). This action showed the inability of the *elites* to push for the coherent monetary policy needed to stabilize the economy. Two decades of difficult and senseless adjustments, monitored by the IMF (International Monetary Fund), resulted in a high social cost which has doubled the poverty level, and the inequity of the distribution of income.

Originally, the adopted measures brought a benefit to the productive sector. The *overshooting* in the exchange rate (per year devaluation of about 250%), and the establishment of a fixed exchange rate of 25,000 sucres/dollar gave a wide yield margin to the Ecuadorian exports. Nevertheless, as seen by the evolution of the real exchange rate during the years 2000 and 2001, this caused a big loss to the price of the Ecuadorian products due to the inability to stop the inflationary process.

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[1] Mr. Michael Camdessus FMI manager-director, after a visit to the country declared "…because of the incestuous relationship between bankers, big business and politics that are the obstacle for the well being of economic policies in Ecuador".

In the absence of automatic mechanisms (such as the oil stabilization fund, or a labor fund) which could help stabilize the negative effects of potential real or nominal shocks, and confronted with the meek productivity and competitiveness-quality of the production mechanisms, the only factors that helped to implement the new economic agenda were the oil prices during the year 2000 and the financial aid given by the IMF, along with the dollars sent by the emigrant population during 2001.

2. The new macroeconomic evolution: stabilization elements and latent imbalances

According to recent estimates by the Economic Commission for Latin America (CEPAL) for the year 2001 the rate of growth for Ecuador was the highest in Latin America.

The projected GDP growth forecasted by the economic authorities should be higher than the 4.6% for the year 2001. Nevertheless, the growth is basically attributed to the "OCP effect" (the new pipeline for heavy oil crude), which had been postponed by more than 10 years and which was only started during the last quarter of 2001.

Table 1. Ecuador: goods and services offer and demand
-Variation rates-

	1997	**1998**	**1999**	**2000**	**2001**
GDP	3.4	0.4	-7.3	2.3	4.6
Imports	8.8	5.5	-39.0	18.7	25.9
Expenditure	2.0	1.8	-10.4	1.8	2.6
Gross capital formation	4.0	6.3	-35.5	10.5	30.5
Exports	4.3	-3.2	-0.4	-0.2	7.8

Source: Central Bank of Ecuador

This GDP growth (which confirms the petroleum sector's influence in the Ecuadorian economy) is accompanied by a strong expansion of imports which reveals, more than an economic bonanza, a distortion of the relative prices. The level of goods and services in Ecuador is among the highest in Latin America[2].

This distortion reflects the continuous drop of the interchange index, which will endanger the dollarization scheme based on a steady positive flow of currency.

On the other hand, the production level reached during the year 2001 represents a partial gain to the levels reached during the first years of the nineties.

Table 2. Ecuador: Gross Domestic Product
-In millions of US dollars-

[2] Vela, Maria de la Paz - Jimenez, Pablo, *Ecuador: el mas caro para su gente*, Revista Gestión n. 87, Quito, pp. 14-21.

1995	1996	1997	1998	1999	2000	2001
18.006	19.157	19.760	19.710	13.769	13.649	17.810

Source: Central Bank of Ecuador

This productivity chart shows how the economy, centered in the construction of the OCP project, was without a major gain in employment. The unemployment index (also underemployment) has come down since the year 2000. It is important to note, though, that half of the active economic population falls within this situation. Moreover, these indexes have the serious bias of hiding the overwhelming emigration phenomena which in the last 2 years acquired the proportions of an "exodus"[3].

Table 3. Ecuador: some economic indicators

	1999	**2000**	**2001** /a
Annual variation index			
Consumer prices	60.7	91.0	24.6
Minimum wages	-10.7	-3.5	11.7
Exchange rate /b	37.4	12.0	-28.6
Interchange relation	6.6	16.5	-8.1
Percentages			
Urban unemployment index	14.4	14.4	10.9
Non financial public sector	-4.7	0.4	0.3
Passive real interest rate	-2.0	-43.3	-28.3
Active real interest rate	7.9	-38.9	-20.9
Millions of dollars			
Exports goods and services	5263	5793	5670
Imports goods and services	4073	4582	6689
Current account	955	1383	-823
Financial balance	-1846	-1167	518
Global balance	-891	216	-305

Source: CEPAL, Apéndice Estadístico

/a Preliminary estimations
/b A negative index means real appreciation

In the labor market, Ecuador faces a complex situation in which wages are extremely low[4]. The persistent inflation –which should have been eliminated with the dollarization scheme-, has reduced the real wages with its purchasing power. Imports have grown but only to satisfy the needs of a small segment of population with a higher income level.

The elimination of risk in money exchange system and the reduction of inflation have been pointed out as the advantages of the dollarization scheme. Establishing the exchange rate of 25,000 sucres/dollar -through legal decree- eliminated any possibility of an exchange rate modification. This also took away the authority from the Central Bank in determining the external value of the money.

[3] Last 2 years is estimated about 500,000 Ecuadorians have emigrated to the USA, Spain and Italy as a primary destination. During the year 2001 this emigrants have sent over U.S. $1.4 billions.
[4] The minimum wage for workers is $127 US dollars/month, which covers only 40% of the family's basic needs (320 dollars).

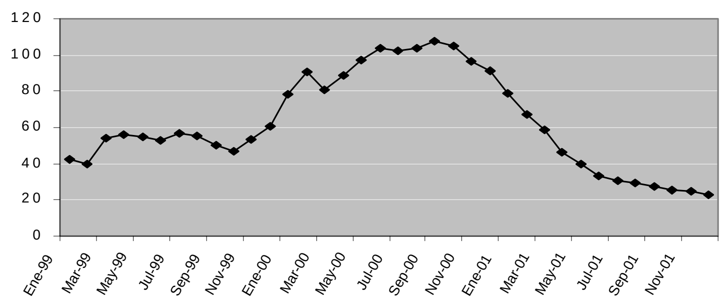
Results are shown which indicate that this scheme prevented hyperinflation although the year 2000 registered the highest inflation index (91.0%) of the Ecuadorian economic history. Nevertheless, the adoption of this scheme allowed some control on the economic expectations, eliminating the source for inflationary pressures.

In regards to the inflation process and the relation between money printing and inflation, the Central Bank lost its capacity to print money. Inflation took off, reaching indexes over 90% per year during the first year of dollarization. Inflation was mainly nourished by the growth on monetary aggregates during the year 1999, which were caused by the great expansion of the currency printed by the Central Bank. The issuing of currency was aimed solving the problems caused by the banking crisis during the years 1998-1999, whose cost is estimated to have reached an index higher than 25% of the GDP.

Although prices did not grow rapidly during the year 2001 (and this restrain gives some hope), the question remains about the amount of time it will take to reach international standards[5]. In reality it shows a problem within the structural evolution of prices: inflation is decreasing in the already tradable goods, and the accumulated effects of the sucre's depreciation. Nevertheless, the rise in prices for the non-tradable goods continues[6].

In short, although inflation is diminishing (the slope for the rate of inflation during the month of December 2001 was 22.5%), its behavior is still falling short of the expectations. Furthermore, looking at the Ecuadorian experience for the last 20 years, we can see that it is relatively easier to drop the rate from 100% to 20% and not between 20% to 10%, especially when there are inflationary pressures originated on adjustment of tariffs, salaries, and speculation.

Figure 1: Year inflation rate



Furthermore, the interest rate, since the beginning of the dollarization, remains at high levels (about 15%), creating an obstacle for the private sector investors not oil-related.

3. Dollarization and globalization

[5] During an interview by Juan Carlos de Pablo (*Pasión por crear*, Planeta, Buenos Aires, marzo 2001, p. 207), the Economic Secretary of Argentina, Domingo Cavallo, showed that the dollarization done in basis of an extreme devaluation of the sucre, will maintain an inflation in dollars for some time.

[6] León Camacho, Patricio; *La dolarización: más allá del optimismo inicial, un difícil trayecto*, mimeo, diciembre 2001

In a globalized world, Ecuador's dollarization brings in a negative aspect. Exports cannot flow and imports are stimulated.

As shown in figure 3, during the year 2001, the value of exports dropped 2.1% against 2000, and imports grew strongly (45.9%).

In 2001, current account had a deficit of 823 million dollars (4.6% of GDP) balancing out the surplus of 2000. Current transfer, mainly supplied by Ecuadorian emigrants, had remained at approximately U.S. $1.3 billion dollars supplementing the deficit created by factors of yields and services. These two factors were favored by the softening of the interest rates caused by the restructuring of the foreign debt signed in August 2000, and the fall of the international interest rates during the year 2001.

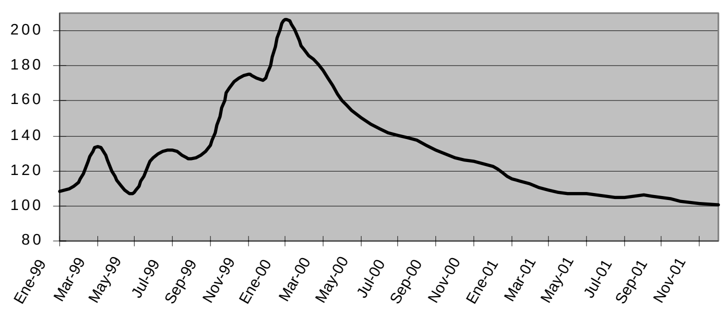
Foreign investments (mostly oil related), reached a record U.S. $1.3 billion dollars. Yet, the loss of the private capital brought a net of approximately 518 million dollars.

In Ecuador, the balance of payments showed a deficit of 350 million dollars, of which two thirds were financed by the IMF and the rest with the international reserves.

The external debt (about 13.5 billion dollars) had no major impact. Nevertheless, it is a heavy burden[7].

In the foreign sector, the problem remains within the evolution of the real exchange rate. With the beginning of the dollarization, Ecuador lost 100% in its competitiveness.

Figure 2: Index of real exchange



The dollarization scheme requires a high degree in efficiency and productivity. Closing the productivity gap with developed countries demands not only macroeconomic policies but, policies of development, productivity (to help competitiveness: infrastructure, promotion, etc), and microeconomic policies (to directly modify businesses with the help of modern technologies)[8]. In this sense, and for the past two years since the dollarization scheme was put in place, very little has been done by the economic authorities.

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[7] The relation external debt /GDP is almost 80%.

[8] Falconí Morales, Juan; *Competitividad externa y dolarización:* viejos problemas, nuevas ideas?, in Salvador Marconi R (editor), Macroeconomía y economía política en dolarización, Abya-Yala, Quito, abril 2001, pp. 113-128

Ecuador should define a new strategy to enter the broader international scenario played by the dollarization scheme but taking into consideration the restrictions imposed by the dollarization system. In practical terms, devaluation can no longer be used as an option to promote exports, and a desired level of economic activity. For these reasons, short-term macroeconomics policies should be aimed at lowering inflation rates along with a convergence into international levels.

In dollarization, the productivity and competitive earnings are produced by a wide process of productivity changes which ensures an international place. In this sense, the Argentinean case teaches us a lesson.

4. The Ecuadorian dollarization: a high voltage issue

Two years had passed since the introduction in Ecuador of the dollarization process. A few observations can be made.

The dollarization was conceived as an extreme measure in search for stability within the Ecuadorian economy. The cost of such a decision was the loss of monetary sovereignty which carries with it cultural repercussions. After two years, inflation and interest rates continue to be relatively high.

The supply of money in the dollarization process is tied directly to the balances of payments transactions, which require a net income. The lack of contingent mechanisms and instruments of monetary regulations could create inflationary or recessive tensions due to monetary flows. In contrast to the convertibility in the Argentinean scheme which always had a last recourse (the Peso devaluation), potential external shocks due to the rigidity of the dollarization scheme in Ecuador could generate explosive socio-economic situations.

"Pressure valves" (exchange rates and monetary policies) in the productive sector were eliminated by the dollarization. In the USA, the decisions regarding monetary policies are adopted by the Federal Reserve in relation to the cyclical variations of the economy. These do not coincide with the cycle of the Ecuadorian economy. The search for the solution to the economic problems brings collateral risks because of its cyclical variations[9].

The dollarization forces Ecuadorian producers to compete with the rest of the world in terms of productivity. Devaluation in other countries means an automatic loss to the price of the Ecuadorian products in the international market. The problem becomes worse when one takes into consideration the lower productivity of the Ecuadorian industry due to its low technological level, the low level of capacity and training of its labor force, and the high cost of production (interest rates are relatively higher than in other countries; the basic infrastructure and public services are very inefficient, imported prime materials costs are high, and so on).

On the Fiscal arena, tax evasion has been reduced thanks to a more efficient administration in the collection of taxes. Unfortunately, the national budget is way too dependent on the income from the production of oil (uncertain). Fluctuations in the price of oil in the international market make a significant impact in the Ecuadorian economy. The lack of an oil stabilization fund, and the fiscal policies-which are the

[9] Salgado T., Wilma, *Dolarización y globalización: lecciones de la experiencia ecuatoriana,* en Salvador Marconi R (editor), op cit., pp.83-99.

only macroeconomic tool available to the managers of the dollarization agenda- are too fragile and vulnerable. Moreover, a big percentage of the fiscal budget (about 40% during 2001) goes toward servicing the foreign debt at the expense of the social investment.

Finally, dollarization -as any other monetary system- is oriented to the short-term economic solution. If the potential positive results are not implemented within reforms to bring about democratic action in the economic situation, and the redistribution of income to energize the productive mechanisms from its basis, the Ecuadorian dollarization, as well as the convertibility in Argentina will fall sooner than later. This demands immediate action to search for a well thought and carefully planned way out.

The major risk to the dollarization, particularly in Ecuador, comes precisely from the lack of short and long-term perspectives to help strengthen the macroeconomics and the governability of the country. It is essential to empower the economic sector, and the fiscal and tax reforms oriented to the redistribution of income. Also essential is a wide change in the productive area that will allow a raise in productivity and competitiveness. Above all, broad investment in human resources is a must.