DOLLARIZATION: WAVE OF THE FUTURE OR FLIGHT TO THE PAST

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INTRODUCTION

Political leaders are given to grand gestures, designed to change the nature of the political debate. Latin American leaders are no exception, and the 1990s provided numerous examples: Alberto Fujimori in Peru dissolving the Congress in 1992 and going to war with Ecuador before the 1995 elections; Andrés Pastrana committing to a peace process with the FARC in Colombia; or Itamar Franco implementing Cardoso’s Plano Real in Brazil in 1994.

On the economic front in the early 1990s, virtually all Presidents adopted a radical program of liberalization, privatization, and openness to private international capital. They were successful in dominating the debate, if not in altering the objective economic conditions. However, by the end of the decade, the grand economic gestures had run their course. Argentina and returning Economy Minister Domingo Cavallo were being forced to back off from their 1991 policy of convertibility. President Hugo Chavez of Venezuela travelled to Iraq and Russia in an effort to realign external relations, which was unlikely to have much impact. Vicente Fox’s efforts to include Mexicans living in the U.S in the economy of Mexico did not change the nature of that reality in the short run. The grandest gesture of them all, the decision by Jamil Mahuad of Ecuador to dollarize the economy in 2000, led to domestic turmoil and then his replacement by Vice-president Gustavo Noboa.

Mahuad left, but dollarization remained and was followed by similar steps in El Salvador and Guatemala. While the political imperative was less a factor in those countries, the model provided by Ecuador made the step much easier. Subsequent dollarization decisions in other countries will be even easier. Predictions of a completely dollarized Western Hemisphere are numerous (Schuldt, 2001; Trejos, 1999; Tuculet, 2001).

Will the Western Hemisphere see the extension of official dollarization to other countries in this decade and will Latin America become an official dollar bloc, with the dollar as the common currency? Alternatively, will this be a momentary phenomenon, with Argentina’s escape from its link to the dollar providing the more powerful lesson for economic policy-makers? To answer this question, dollarization must be placed in historical context. This is followed by an assessment of the costs and benefits, both economic and political, for a given country that adopts the dollar as its currency. The dollarization choice is unlikely to be the result of bloodless calculation of costs and benefits, so the internal and external pressures that might lead to dollarization must be understood. These theoretical considerations are then placed beside the actual Ecuadorian dollarization program. The entire analysis provides the basis for examining the likely scenarios for the Latin American exchange rate regimes and possible dollarization in the coming decade.

DOLLARIZATION PAST AND PRESENT

Official dollarization, the formal adoption of the dollar as the domestic currency, is not solely a phenomenon of the 1990s; in addition, unofficial dollarization has long been a Latin American reality.

Panama was the first country in the Western Hemisphere to dollarize. When it became an independent nation in 1903, the balboa was established as its official currency,
based on the gold standard at “1.5046 grammes of pure gold.” (Crosby, 1915, p. 23) However, because of the U.S. role in its creation, the Panamanian government had to allow the dollar to circulate freely at $1 = 1 balboa by 1904, as agreed in the dollar association treaty with the U.S. In addition, the $10,000,000 paid to Panama for the right to build the canal, augmented by a $250,000 payment per year and expenditures by Canal personnel, made dollars abundant and available. (McCullough, 1977, p. 612) Although the balboa could still be traded in New York at a ¼ percent discount in 1915, it was naturally supplanted as the medium of exchange, as a result of dollar availability and the existence of a dollarized economy in the Canal Zone. The last paper balboas were printed in 1941, and the balboa was relegated to a fractional transaction currency, its status today.

Cuba’s Monetary Law of 1914 also allowed the dollar to circulate freely at a fixed rate with the peso, and it banned transactions in Spanish or European currencies. (Wallich, 1960) Until the late 1920s, dollars constituted over 70 percent of Cuba’s currency. In the early 1920s, a proposal to establish a branch of the Federal Reserve Bank of Atlanta in Havana was seriously considered, since the country had no Central Bank.  

Mexico was an early example of unofficial dollarization during the last century. The country had switched from a silver based currency to the gold standard in 1905, “and the system worked splendidly from the time it was put into effect until the year 1913.” (Crosby, 1915, p. 19) At that point, competing insurgent groups began to issue their own currency. At one point, there were 21 different currencies in circulation in Mexico, and the only acceptable monies were gold or silver coins, for the most part minted in the U.S. Monetary stability gradually returned after 1925; but as late as 1933, 33 percent of deposits were in foreign currency (dollars). This fell rapidly, to 6 percent by 1937, when the Depression dried up dollar flows and domestic monetary stability returned to Mexico. (Ortiz, 1982, 441-443)

These experiences suggest that dollarization is likely to occur under three circumstances, short of external imposition:

- if there is ample availability of dollars to the domestic economy;
- if there is domestic instability that affects the functioning of the financial system and the confidence of domestic economic actors;
- if there is an important dollarized sector of the economy.

These elements, particularly the first two, contributed to the unofficial dollarization of much of Latin America in the 1970s and 1980s. Petro-dollar recycling gave Latin America ample access to dollar resources from 1973-1980 in the form of dollar denominated loans, which increased more than five-fold to $220 billion. (Table 1) Debt and interest payments increased ten times to $21 billion per year. Even before the debt crisis of 1982, economic instability had increased throughout the hemisphere, when governments attempted to postpone the reckoning for the increase in oil prices. Even oil producers such as Mexico were far from immune. The peso had been fixed to the dollar since 1954, but it was devalued in 1976, and again in 1982 when Mexico could no longer pay its international debt. All of Latin America faced similar problems. Widespread unofficial dollarization laid the basis for the third element. For example, foreign currency deposits in Uruguay rose from 5 percent in 1973 to 45 percent by 1977. In Peru in 1984, dollar denominated deposits were 73.7 percent of total deposits (Jameson, 1990).

This experience has affected the position of Latin America vis-a-vis the dollar in several ways. First, generating dollar revenues has come to be a major concern of all
governments, for the debt must be paid. Defaults, such as those of the 1930s, are not acceptable and are very costly. Ecuador experienced this reality when it defaulted on its Brady Bonds in late 1999 and became a pariah to the international financial community. Second, the mechanisms for moving between dollars and the domestic currency are now well known to domestic actors, and most countries offer “dollar deposits” in their banking systems. It is much more common to find sectors of the economy, e.g. tourist areas or exporters with only the U.S. as their market, that operate regularly in dollars. Thus, it is very difficult for governments to use policy to constrain the behavior of domestic economic actors, who can often offset policy steps by going to the dollar sector. Finally, the Federal Reserve Board’s policy of targeting short-term interest rates in the U.S. has resulted in ample international dollar liquidity since the late 1980s. As a result, estimates of the share of U.S. currency held outside the U.S. reach as high as 66 percent (Carlson and Keen, 1996).

The end result has been to make the exchange rate regime a central policy issue in all Latin American countries, much more than had been the case in early periods. The case studies in Frieden and Stein(2001) and Wise and Roett(2000) document how the wide range of policies that Latin American governments had used to maintain international equilibrium have gradually been eclipsed by the requirement to establish and maintain a credible and competitive exchange rate. This increased emphasis on exchange rates has made it progressively more difficult to utilize the “fixed but adjustable” or “crawling peg” regimes that had been characteristic since the demise of Bretton Woods in 1973. The orthodox position today is that countries must choose between floating rates or a hard peg—such as dollarization.(Fischer, 2001a)

When examined more closely, this conclusion has two bases. The first is the rapid growth in the volume of international financial transactions and the inability or unwillingness of governments to limit and control them. Streeten(2001, 37) suggests that such transactions sum to $2 trillion per day, 98 percent of which is speculative. As a result, if international markets decide that a currency is misaligned, reactive capital flows will put tremendous pressure for an adjustment.² The second is the weight of dollar debt on most of the economies. It is not uncommon for 50 percent of government revenues to be committed to debt repayment. Since most of the debt is denominated in foreign currency, any large change in the exchange rate will increase the real cost of debt payments by nationals, causing such steps to take on ever-greater weight. Given the magnitude of the claim on government revenues, one result is that the ability of a government to satisfy social demands is greatly diminished.³

The analytical framework of this paper is that Latin America’s international financial relations constitute a “dollar bloc,” an informal but powerful system that binds their currencies to the dominant currency the dollar, and that dominates their international economic relations (Jameson, 1990). The question in this paper is whether dollarization will become the general choice of exchange rate regime in Latin America in this decade because it has become one of the rules for members of the dollar bloc. This would be a very different process from Europe’s where the commitment to the Euro required homogenization of macro policy and convergence of macro indicators, particularly inflation. If dollarization expands, it will most likely be piecemeal and informal. This would be consistent with the U.S. stance, which has been neutral to supportive in theory, while at the same time asserting vigorously that U.S. monetary policy will be operated
completely independently of the desires and needs of dollarized economies. The position that the U.S. will never act as a lender of last resort for a dollarized economy that may face a liquidity crisis has been even more strongly expressed (Summers, 1999). So, the expansion of official dollarization is a question of the evolution of this dollar bloc (Jameson, 2001).

Let us turn now to examine the factors that might influence the dollarization decision, with the goal of understanding more clearly the likely pattern of dollarization across the Western Hemisphere. Let us first see what the costs or benefits of dollarization are likely to be.

**COSTS AND BENEFITS OF DOLLARIZATION**

The argument around fixed versus floating exchange rates is by now quite familiar and need only be referenced here. Floating rates in conditions of free capital movement allow independence in monetary policy and thus can be used to offset international shocks. Fixed rates can be maintained only with capital flow restrictions or passive monetary policy. Their benefit is the credibility they provide for domestic policy makers and the reduction in international transaction costs. The Latin American experience since 1964 suggests that fixed rates have resulted in lower inflation on average, while flexible rates are more successful in avoiding overvaluation of the exchange rate, as expected (Frieden and Stein, 2001). On the other hand, the experience of the 1990s is that all regimes have resulted in overvalued exchange rates, current account deficits, lower inflation, and positive but inconsistent economic growth (Wise and Roett, 2000).

Dollarization is an extreme form of fixed rate and thus incorporates the positives and negatives of fixed rates. Sachs and Larrain(1999) point out that dollarization has added costs. The first is the loss of seigniorage, the income a government can reap through printing money. Unless there is a specific agreement to share seigniorage, as is in the European Monetary Union, all of that income accrues to the U. S. Second, the Central Bank cannot act as a “lender of last resort” by putting liquidity into the system if crisis threatened. Cohen(2000) points out that Argentina, and several other countries, have dealt with this at least partially by establishing Contingent Repurchase Facilities and lines of credit with the IMF that can be drawn on in the event of a crisis. Finally, dollarization is nearly irreversible. If the dollar were no longer a desirable anchor for the domestic currency, it would be very difficult to change the exchange rate regime. To gain a sense of this difficulty, one need only look at Cavallo’s travails in Argentina in 2001 in modifying the convertibility hard peg program to encourage exports.

Cohen(2000) minimizes these economic costs and suggests that the most important costs are political. The country loses a powerful symbol of national identity, a mechanism to generate revenues to confront a crisis, and an instrument of diplomatic insulation. In short “the political implications of dollarization go to the heart of the fundamental purpose of the state: to permit a community to live in peace and preserve its own social and cultural heritage.” (p. 5) His comments underline the significance of the formation of the European Monetary Union and implicitly support the assertion that the EMU did not make sense economically, that it was a political decision (Feldstein, 1997). Even a superficial knowledge of Latin American history suggests that Cohen is correct
about the power of nationalism, and that dollarization is likely to recur as a political issue in times of political strife.

One stabilizing element of the Western Hemisphere Dollar Bloc has been the indirect nature of its rules and norms. It has been predicated on repayment of international debt and progressive liberalization of the domestic economies. Adoption of the dollar as the domestic currency provides a much more tangible target for political opposition. It is possible that globalization and hemispheric integration will completely alter the historic relations of Latin America and the United States. However, it is more likely that continuing differences in power, prestige, and wealth will provide appealing platforms for nationalist and populist leaders and the use of the dollar will be a source of friction. Further support for this view is found in Schmitt-Grohe and Uribe’s (2001) study of the welfare costs of monetary policy rules in Mexico, which indicated that dollarization was the least successful of three policies and had the highest welfare costs as well.

On the other hand, the theoretical framework of the “optimal currency area (OCA)” is helpful in understanding the implications of dollarization (McKinnon, 1963). There are four traditional criteria for determining that adoption of another country’s currency is economically beneficial (Sachs and Larrain, 1999, p. 3):

- The economies should be tightly integrated and should experience similar shocks;
- The adopting country is small, open, and its prices are largely set in dollars;
- The adopting country has flexible labor markets that can adjust to shocks;
- The adopting country’s Central Bank has low credibility in undertaking stable economic policy.

Panizza, Stein and Talvi (2000) have added several other criteria in an empirical study of the desirability of dollarization in Central America:

- There must be labor mobility;
- There must be a system of transfers among participants in the OCA.

The last two categories are quite important for the Central American countries as noted above. They conclude that the eight Central American/Caribbean countries they examine could satisfy the criteria for an OCA, and thus El Salvador and Guatemala’s decisions make economic sense.

Application of the theory would require its assessment in each country that might be considering dollarization, or in any set of countries considering a monetary union. The role that other factors play can be seen in the case of Argentina, which had few of the conditions when it adopted convertibility in 1991.

One final approach to assessing the effects of dollarization is to examine the economic performance of dollarized countries, comparing it with comparable countries that have not dollarized. Panama has been widely used as a success story (Moreno-Villalaz, 1999). Another study contrasted the performance of six central American countries with differing degrees of flexibility with Panama and Belize, which have had fixed or dollarized exchange rates (Panizza, Stein and Talvi, 2000). Though any comparison that includes the 1980s in El Salvador, Nicaragua, Guatemala, and Honduras, when civil wars were raging, must be treated with care, the overall conclusion is that the fixed rate/dollarized countries performed better. They found that:

- Domestic interest rates were less affected by international rates, contrary to expectations;
Flexible rate countries had greater variability in GDP growth;
Fixed(credible) countries had lower and less volatile inflation rates;
Fixed countries had lower real exchange rate and real interest volatility;
Fixed countries developed deeper financial systems.

They conclude that “several of the countries under study should give dollarization serious consideration” and that “countries with flexible regimes, while paying a large cost in terms of credibility, did not appear to gain very much in terms of the benefits of monetary independence.” (p. 46)

In any case, economic factors must be considered in any analysis of dollarization. Political issues may indeed dominate, but as greater experience is gained with dollarization, the issues of economic performance will increase in importance. On the other hand, the major influence will be the external or internal pressures for dollarization. Let us examine them.

EXTERNAL PRESSURES FOR DOLLARIZATION

Effective international capital controls would make a crawling peg more feasible. The last decade witnessed the virtual demise of control on flows of international capital. Chile had utilized a deposit mechanism to attempt to skew the flows away from the short term. Malaysia’s response to its crisis was to restrict capital outflows. There was a moment when the IMF suggested that controls along those lines might have a role. However, by century’s turn, even these modest efforts were unsustainable, and the IMF had become silent. For example, in response to the Brazilian crisis of 1998, Chile found itself at a competitive disadvantage and had to remove its restrictions in order to attract foreign capital. Any likelihood of concerted international action to implement a Tobin tax or another mechanism designed to influence capital flows seems very small. Thus the international pressures have been toward the bipolar world of floating or hard pegs.

The intellectual basis for adopting the extreme hard peg, dollarization, is that it ties domestic monetary policy to U.S. monetary policy. Dollarization realizes the fulfillment of the monetarist model in its Friedman variant, which distrusts policy-makers and discretionary macroeconomic policy. In a dollarized economy, there is one less discretionary policy-maker, for the domestic Latin American policy-maker disappears, being replaced by the Federal Reserve Board. The relative success of the two sets of policy-makers might also justify this step. Most Latin American central bankers would not fare well in a comparison with the Fed during the 90s; a comparison based on the 1980s would probably favor the Fed as well, though neither performed very well. Therefore, the success of the Fed, or at least the stability and growth of the U.S., provides an incentive to countries to dollarize, especially to those that have experienced significant economic instability.

In addition, empirical studies that examine the importance of the independence of the Central Bank to economic performance get mixed results at best. Frieden and Stein (2001) found that the independence of the central bank was not an important determinant of exchange rate regime and implicitly of economic performance.

The most common argument in favor of dollarization is that it is the most effective policy to reassure international capital and to restrain domestic inflation, especially in cases of countries characterized by economic and political instability. In
addition, by removing the complexity of translating between domestic currencies and the dollar, exports and imports should be encouraged, increasing domestic integration into the global economy. For example, Courchene and Harris (2000) argue in favor of monetary union of the NAFTA countries on these grounds. To deal with the asymmetry issue, they suggest that Mexico and Canada should have seats on the Board of the Federal Reserve system.

These arguments for dollarization have been made in numerous seminars held throughout the hemisphere, sponsored by local business organizations and conservative think tanks, always with a great deal of publicity. Their influence on policy has varied across the countries, but they have generally pressured policymakers to put dollarization on the table. There has been a long history of “intellectual dollar diplomacy” in the Western Hemisphere, where the economic and political power of the U.S., with the concomitant prestige of its citizens, has been used to influence domestic economic policy in Latin America. The best-documented episode of this diplomacy was the activity of “money doctors” in the first quarter of the twentieth century. Drake (1989, 1994) showed how the combination of foreign advisors and the promise of loans during the 1920s led to the establishment of Central Banks and the adoption of the gold standard throughout most of Latin America.

The recent movement toward dollarization has been encouraged by contemporary “dollar doctors.” Many of the advocates have been U.S.-based economists such as Guillermo Calvo, formerly from the University of Maryland and now Chief Economist of the IDB, Steven Hanke of Johns Hopkins or Kurt Schuler, who was on the staff of the Joint Economic Committee of Congress. One difference grows out of the “globalization” of economic interests. Their presentations and the publicity they generated were generally not under the auspices of the U.S. government. Local business organizations whose members would benefit from operating in an international dollar economy took the lead, though with support from the U.S. side. For example, the former Senator from Florida, Connie Mack, proposed legislation that would have encouraged dollarization (U.S. Senate, 1999). His International Monetary Stabilization Act, authored by Kurt Schuler, would have provided U.S. support for dollarization and would have eventually established sharing in the seigniorage generated by money creation.

The final international pressure comes from owners of capital themselves. An irreversible dollarization program guarantees that foreign capital owners will suffer no exchange rate risk if they provide capital to the dollarized economy. While default risk would continue, absence of exchange rate risk would be a positive element in the calculus of capital flows. Indeed, if the number of dollarized countries increases, they could gain a significant competitive advantage, which in turn would pressure other countries to dollarize to maintain their ability to attract foreign capital. Dollarization will have to move far beyond the small economies that have dollarized to date, but this may become a factor in future capital flow decisions.

INTERNAL PRESSURES FOR DOLLARIZATION

Unofficial dollarization in the 1970s and 1980s was the virus that weakened the role of national currencies in their own domestic financial systems. Inflation and devaluation led citizens to seek alternative stores of value. The traditional gold and silver could serve this role, however the post-Bretton Woods environment undermined their
success. When their price fluctuated between $48 and $4 per ounce for silver and $850 and $250 per ounce for gold, reliance on them as a protection of value was undermined. Ownership of physical goods could provide some security. However, the dollar became the asset that was most successful in this role and it had the added benefit of providing liquidity to its holders. The growth of currency substitution began to undermine domestic monetary policy, and governments responded by attempting to restrict citizens’ access to dollars. The most notable examples were Peru’s and Bolivia’s de-dollarization programs. Both generated extreme reactions in financial markets that underlined the impotence of governments in preventing unofficial dollarization. Mexico’s tesobono experiment was a later failed effort to provide a domestic financial instrument that could confront competition from the dollar.

As a result the dollar became an integral component of the financial and monetary system of each Latin American country. The particular financial structure and legal environment of each country influenced the dollar’s role, and particular economic conditions influenced individuals’ use of the dollar. But the role of the dollar was established. Moreover, since the dollar was already a domestic financial instrument, making it the only monetary instrument became conceivable and technically feasible.

However, this was a major step that would depend on domestic political factors, for there would be definite winners and losers with adoption of the policy. The countries where official dollarization has become policy illustrate some of the domestic political considerations. In Ecuador, political turmoil coupled with the disappearance of international capital flows forced the step as a last desperate attempt to stabilize a weak political administration. The Argentine convertibility program, another form of hard peg, was a similar effort in 1991 to rescue a failing Menem administration, two years into its term of office.

El Salvador and Guatemala provide a different panorama, one of de facto economic denationalization. Civil war pushed many of their citizens out of the country and the U.S. was willing to allow their entry, initially on political grounds and later because of the need for low cost and low skilled labor during the 1990s boom. The emigrants became part of the most rapidly growing segment of the U.S. population, those of Hispanic origin. Their dollar remittances became a central contributor to the balance of payments of the two countries. So access to and use of dollars became common across all segments of the societies, making dollarization a natural and relatively painless process. In addition, the nationalistic opposition to the step was diminished by the dual identification of many of their citizens.

There are many other domestic factors that can encourage dollarization. The Wise-Roett(2000) and Frieden-Stein(2001) case studies examine a number of them, while at the same time illustrating the complexity of linking domestic political conditions with choice of exchange rate regime. The history and objective conditions of each country will largely determine the choice, though political stability facilitates maintenance of any chosen regime. Among the factors that have favored fixed rate regimes in the past thirty years, and that could lead to official dollarization, have been hyperinflation, the degree the economy is open to trade, the existence of capital controls, and the scarcity of international reserves. Dictatorship, political instability and party strength all encouraged fixed rates, though in a very complex fashion. Theory suggests that those heavily engaged in cross-border activities, such as finance or commerce, and foreign debtors will
prefer a fixed rate. One new factor for many countries is the role of emigrants to the industrialized countries. Tight labor markets combined with geo-political openness to migration increased labor market integration to a degree that would have been inconceivable a decade before (Orrenius and Viard, 2000). The emigrants can exert an influence in favor of dollarization that had not existed before.

Of these factors, political instability, scarcity of international reserves, relative openness, party politics and interest group power are the most likely to influence the dollarization decision. They will interact with each other and with external factors to determine whether dollarization becomes the norm in the Western Hemisphere dollar bloc. Their interaction will be complex, so it will be difficult to predict whether the hard peg, dollarization, will become the norm. The best way to deal with this complexity will be to examine several possible scenarios of the dollar bloc’s evolution.

The one country that has dollarized, Ecuador, can provide the best case study of the effects of dollarization. Let us examine its decision and more importantly the structural basis for dollarization and the resultant economic performance.

EVALUATION OF THE EXPERIENCE OF DOLLARIZATION: A CASE STUDY OF ECUADOR

DOLLARIZE: IT CAN’T GET ANY WORSE

When President Jamil Mahuad announced a vague dollarization program on January 9, 2000, few of the criteria for entering an optimal currency area were met. The major exceptions were that Ecuador is a small, open economy and that its Central Bank had low credibility in economic policy matters. Indeed, no economic policymaker had credibility after sixteen months of Mahuad’s administration. In August 1998, he had inherited from interim President Fabián Alarcón an economy under pressure, with a fiscal deficit of seven percent of GDP demanding immediate action. A collapsing banking system and internal and external debt payments that absorbed 70.5 percent of government revenues in 1997 (Banco Central del Ecuador(BCE), 1998) would have challenged the best policy team. But this team only made the problems worse.

Beyond the continuing drain of external debt payments, the main problem was an accelerating deterioration in the domestic banking system. Despite the belated and flawed establishment of a deposit guarantee agency (AGD) in 1998 to take over failed banks and guarantee deposits, instability in the financial sector continued and extended to the rest of the economy. Mahuad declared an economic emergency in December 1998 and asked the Central Bank to free the foreign exchange necessary to pay a portion of the international debt, which the Bank refused to do under conditions desired by Mahuad. The Finance Minister resigned in early 1999, because the opposition demanded a one-percent financial transactions tax; and then the Central Bank unilaterally floated the sucre on February 12. It depreciated by 70 percent by the end of the year. The financial situation was roiled further when domestic bank accounts were frozen in March, in an effort to protect the failing banks. Access to international official resources can often stabilize such situations, and Ecuador hoped to gain receive $2 billion in such resources by mid-year. Congress stifled the required reforms and held up the loans, which led to a unilateral declaration that Ecuador would postpone payment on its Brady bonds in October 1999 and would restructure all of its debt, except that owed to multilateral institutions.
One of the most significant elements of the moratorium was the apparent acquiescence of international agencies in the step, consistent with their efforts to make private lenders bear some of the losses on bad loans. The IMF authorized a $400 million standby loan despite the moratorium. Ecuador may have been used as the guinea pig in this experiment. The private sector held the strongest hand, however. It forced an official default on one class of Brady bonds, and so Ecuador could no longer renegotiate and restructure portions of its debt. “Cross-default clauses” in agreements forced Ecuador into default on its external bonds, while closing its access to additional funds. One international financial player said: “The bottom line is that Ecuador won’t have access to private credit until the foreign debt is restructured…There is no question that the level of economic deterioration is going to increase very, very quickly.” (Vogel, 1999)

Deterioration did increase, leading to the desperate Mahuad dollarization gambit, over opposition from the Central Bank and despite the resignation of the Central Bank President and of the entire cabinet. The Central Bank had characterized dollarization as “rushed, crazy measures” (Notisur, January 14, 2000). The dollarization decree was not enough to save Mahuad, however. Amidst the turmoil, he was forced to resign and was ultimately replaced by the Vice-president, Gustavo Noboa, who announced he would continue the dollarization program. By September 10, 2000, the sucre became Ecuador’s balboa and the dollar became the official money.

There are several questions about the dollarization process that must be examined to understand it and its implications. First, what were the economic conditions that led to this desperate economic measure? Next, how can we explain its adoption by the country? Then, how has it performed in the transition period and since its adoption? The implicit question is how it will perform in the future. Let us take them in order.

**INTERNAL AND EXTERNAL ECONOMIC INSTABILITY ON THE ROAD TO DOLLARIZATION**

Ecuador has not been a strong economic performer in recent decades. Table 2 shows that only in the 1970s, when its first significant oil production came on stream, did Ecuador’s growth exceed the Latin American GDP growth rate average. The result was that per capita GDP in 1997 was almost the same as in 1980 and had fallen relative to average GDP in Latin America. Its investment pattern was similar.

On the other hand, the degree of disequilibrium in the economy was far less than average. Inflation rose after the 1970s but, on average, was relatively stable at 35 percent in the 1980s and 1990s. Government’s share of GDP was far less than average and the government actually ran a surplus, in contrast to the persistent deficits in other countries.

Underlying the stability, however, were changes that would become the source of later problems. The external debt grew very rapidly from $600 million in 1973 to $16.4 billion in 1998. On a per capita basis it was $100 in 1973 and grew to $1360 in 1998; as a percent of GDP it grew from 20 percent in 1973 to 118 percent in 1998.

In addition, the international sector began to follow the Latin American pattern: dramatic fluctuations in current and capital account balances; growing foreign direct investment and portfolio investment; and instability in reserves, though with increases through much of the 1990s (Table 3). So Ecuador resembled the rest of Latin America in its insertion into the international economy. As a result, it became more open to the shocks transmitted through financial markets. Most notably, Ecuador’s international
reserves were subject to swings that were as wide as those of the 1980s. In 1996, reserves increased by $245 million as a result of capital inflows; in 1999, the outflow on capital account caused reserves to decline by $215 million.

The period 1998-2001 brackets the dollarization program. Let us examine 1998-99 economic performance in more detail, for dollarization was spawned in that period.

The deterioration after 1997 is dramatic (Table 4). Per capita growth was only .4 percent in 1998 and crashed to −7.3 percent in 1999. Inflation began to accelerate to 43 percent and then to 61 percent, as the exchange rate collapsed to 6,825 sucres per dollar and then to 20,242 per dollar in 1999, devaluations of 54 percent and 197 percent. The rate of investment halved to 12.9 percent of GDP, and unemployment increased from 11.8 to 15.1 percent.

The underlying causes of the deterioration lay in the international and financial sectors. Despite the devaluations and a depreciated real exchange rate, exports declined in 1998, mainly as a result of the oil price decline. They barely increased in 1999. The current account deficit of 11 percent of GDP in 1998 became a surplus of 6.9 percent, only because import demand collapsed along with the domestic economy. Imports nearly halved, to $2.7 billion from $5.2 billion. Foreign investment increased as a share of GDP, because of the decline in GDP. In amount, it rose from $69 million in 1997 to $82 million in 1998, but then fell to $63 million in 1999. International reserves fell by 40 percent in two years. International debt fell slightly, but increased as a share of GDP, to 118.3 percent. So the pressure that membership in the dollar bloc placed on Ecuador’s economy increased. The only way to remain current in debt payments, as demanded by the dollar bloc, was to draw down reserves. The one attempt to change the rules of the bloc, the default on the Brady bonds in 1999, failed resoundingly, despite the tacit approval of the IMF.

The financial sector also destabilized. Pressure came from the fiscal side, where the deficit increased from 2.6 percent of GDP to 6.1 percent, falling slightly to 5.9 percent in 1999. At the same time, the major banks became insolvent through a combination of diversion of funds and insider dealing. The uncollectibles rose from 9.6 percent of outstanding loans to 40.4 percent in 1998. Ecuador’s bond rating fell and the spread over international interest rates increased from 597 to 2754 basis points between 1997 and 1999. The government forced the constitutionally independent Central Bank to finance the deficit and to finance the bank rescue program of the AGD, which guaranteed far more types of accounts than was common, or sensible, in such programs. Thus the monetary base increased by 41 percent in 1998 and an incredible 174 percent in 1999. There was disintermediation as M2/GDP fell from 32.5 percent to 23.2 percent. The decline would have been far greater, but for the freeze on bank deposits imposed in March 1999.

As might be expected, the political situation destabilized as well. This led President Mahuad to make his desperate dollarization declaration, a step he had dismissed only days before. While drastic steps were necessary, there were other alternatives. Let us see why he chose that leap rather than another alternative.

**HOW DOLLARIZATION BECAME THE LIFE PRESERVER**

Joyce de Ginatta(2001), of the Chamber of Small Industry in Guayaquil, provides one chronology of the dollarization process on her web site. She dates the start of interest
in dollarization from a December 1995 study on “Ecuador: To the New Century and Millennium,” followed by studies of dollarization initiated in December, 1997. The implication is that the impulse came from Guayaquil, which is correct and to be expected. It is the most economically powerful area and much more linked into the international economy than the sierra. The eastern jungle is linked by oil, but that is already in a dollarized market, dominated by multinational firms.

However, de Ginatta omits one of those magic/real experiences Latin America provides. Abdal Bucaram of Guayaquil was elected president in 1996. Shortly after taking office in August, he met with Domingo Cavallo, until then Economy Minister of Argentina and architect of their convertibility program. Cavallo was enlisted to “transmit the Argentine experience.” Bucaram told critics: “I ask all you economic geniuses out there who are grumbling and questioning (Cavallo’s visit) just what medicine it is they take. If they take any medicine to save their lives, they found it abroad, not here.” History was certainly on Bucaram’s side. However, economic and political instability made his December, 1996, announcement of an argentine-style convertibility program, to go into effect in July, 1997, appear to be a desperate gambit to save his regime. He was removed from office in February, 1997, and free convertibility went with him to dollarized Panama. The economic basis for his program was not clear. Convertibility had succeeded in stopping Argentina’s hyperinflation; but Ecuador’s inflation was only 24 percent and had been relatively stable. Underlying fiscal, labor, production and political problems were in no way addressed by the program.

Nonetheless, interest in dollarization continued. DeGinatta put her organization on record in favor in September, 1998, and there were a series of conferences on dollarization in 1999, initially with Ecuadorian speakers from the “Economic Forum” that became the prime exponent of dollarization. Next came the international experts: Kurt Schuler from the U.S. who was working with Sen. Mack on legislation supporting dollarization,8 Jose Luis Cordeiro from Venezuela, Martin Krause of Argentina, and Juan Carlos Leal of Mexico (de Ginatta, 2001). As a result, and in a replay of 1996, a desperate politician facing mounting opposition proposed a radical exchange rate regime, dollarization. Radical action was necessary, and though there were alternatives, such as sucretization with capital controls, none of them had been developed and publicized so as to compete with dollarization.9 In any case, adoption of dollarization only hastened Mahuad’s departure.

The difference in this case was that dollarization stayed, at the behest of the new President, Gustavo Noboa, a former University President from Guayaquil. He was aided by congressional willingness to pass the necessary legislation and by immediate offers of technical assistance from the IMF. This promised a potential solution to Mahuad’s major failure, the inability to gain access to international financial resources. Dollarization seemed to be the “good housekeeping seal of approval” necessary to free up the long-promised IMF stabilization funds. Ecuador began to draw on a $304 million standby loan on April 1($114 million), which opened access to up to $2 billion from other multilaterals, despite opposition from private bondholders. This led to a successful restructuring of the external debt in 2000, exchanging the Brady bonds for bonds with a face value 40 percent less.

The second installment of the IMF loan, $41 million, accompanied the completion of dollarization on September 10. But policy turmoil did not end. The Economy Minister
resigned in December because of disagreement with the IMF on the size of the Value
Added Tax (VAT) hike, and the IMF held up the third disbursement of $42 million. Street
demonstrations erupted against IMF-mandated adjustment steps; calm was restored only
when they were partially rolled back. The carrot of $240 million from the World Bank
and IDB, and a $1.3 billion debt restructuring by the Paris Club did not mobilize
congressional action. Finally, the government implemented an increase in the VAT to 14
percent and this freed $49 million from the IMF and $70 million from the World Bank. So
dollarization has become a reality, and its end result for Ecuador’s economic
criminLaneS has been greater access to international capital flows. Political fatigue has
diminished protests and allowed a return to some semblance of normality——without
dealing with any of the fundamental underlying problems of the country. This is not a set
of circumstances one would choose for an evaluation of the economic success of
dollarization; but it is the reality. Nonetheless, let us examine the effect of dollarization
with the information and experience available in mid-2001.

EARLY ASSESSMENT OF DOLLARIZATION

Given the short time period since dollarization was adopted and implemented, it
will be difficult to provide an assessment that will be convincing. How can dollarization
be separated from the political turmoil of the times, and was its implementation of a
variety that will give dollarization a viable opportunity to succeed? Steven Hanke, an
exponent of dollarization, called Ecuador’s law “vaguely worded and foolishly
ambitious” and added: “Success will hinge on the implementation and whether someone
in the government actually takes a leadership role and gets the momentum going.”
(Notisur, March 24, 2001) In addition, DeGinatta(2001) listed a series of barriers the
Central Bank put in the way of dollarization, ranging from poor publicity to failure to
emit change for small transactions.

In any case, economies rebound after shock-induced recessions, so improvement
in the economy after 1999 would be expected. This has been the case, and 2001 promises
further improvements. Whether this implies that the Ecuadorian economy is on a
completely different and positive path as a result of dollarization is the underlying
question. Let us examine the current performance and the most likely trajectory in the
next two years.

The data in Table 4 show that increased access to foreign dollar flows, to foreign
saving, has been the crucial factor in the recovery. So dollarization has succeeded in that
regard. The current account balance improved to 10.1 percent of GDP, as oil exports
increased and imports increased more slowly. However, in 2001 imports accelerated,
especially in durable goods, which should result in a current account deficit of 3.5 percent
of GDP in 2001. One startling contribution to favorable performance has been the
remittances from emigrants, which rose to $1.4 billion in 2000 and became the second
largest earner of foreign exchange. Foreign investment increased and will show further
increases in 2001, when electricity companies are sold and work on a new oil pipeline
accelerates. The debt drain decreased somewhat as a result of the debt restructuring and
of inflows of resources from the IMF and other official providers. This should allow an
increase in international reserves of $210 million. The fiscal pressures have also
diminished as a result of greater revenues from oil sales and improved tax collections,
particularly of the value added tax.
As a result, GDP grew by 2.3 percent and is likely to grow by more than 4 percent in 2001. Investment has returned to previous levels and unemployment has decreased to 10.3 percent, aided by the continuing emigration of skilled and unskilled labor.

But all is not rosy. Inflation accelerated to 90 percent for 2000, which obliterated the competitive benefits of the maxi-devaluation of January 2000. The real exchange rate has appreciated to its 1997 level. The inflation was not induced solely by increases in the money supply. It was the result of the inflationary effects of the devaluation, of inertial inflationary impulses, of changes in relative prices toward international prices, and of price setting behavior by monopolistic sectors in the economy, including public utilities. Inflation has decreased month to month and is estimated at 30 percent in 2001, which will further undermine competitiveness. In 2000, non-petroleum exports had already fallen by one-third from the 1997 level, and their trajectory for 2001 was further downward.

Financial indicators have not improved and the failure of what was the largest bank, Filanbanco, in July, 2001, after efforts to keep it afloat that began in 1998, will add to that instability. Bad loans were to fall to 30 percent of the loan portfolio, but that failure will affect the overall rate and payments to depositors will affect the fiscal situation. Ecuador’s debt rating is poor, Caa2, in the middle of the third from lowest category. The interest rate spread has declined, but remains quite high. Real interest rates were negative in 2000, which provided added stimulus; but by mid-2001, they have become positive once again. In the finance area, the major improvement from dollarization was the decline in interest rate spread from 2700 basis points to 1435, because dollarization greatly reduced exchange rate risk. This may be the most important improvement directly attributable to dollarization. Nonetheless, country risk obviously remained high.

So what can we conclude about dollarization’s effects? From a political economic standpoint, it has succeeded in providing access to international dollar resources, foreign saving. In part this was a result of the program, i.e. the debt renegotiations and the renewal of official flows of loans and new investment projects. Inflation does appear to be moving down, towards international rates. In addition, the entire process, including the pressure from the IMF, has reduced the fiscal deficit toward balance and has prevented the government from monetizing the most recent bank failure. However, the latter is likely to require creation of $350 million in government bonds, which will put pressure on the fiscal accounts.

In the medium term, how is the economy likely to function? For the moment, access to foreign saving is supportive: loans from Spain, oil pipeline funds, debt forgiveness by Italy, oil income, and remittances. The list suggests how insecure these sources are, however. Oil’s price is falling, though increased production is likely to offset this and turn it into a positive. Emigrant remittances are likely to remain stable, unless there is a major slowdown in the industrial countries that costs their jobs. However, new capital flows, especially loans, are reaching their limits. They will soon become more of a drain on the economy, and that will lessen only if there is another restructuring or repurchase/default on the loans. Finally, exports that are price-sensitive are declining and should continue downward. This will remain true since other countries competing for the U.S. market will be able to aid their producers by changes in the real exchange rate. So in the medium term, the economy will continue to improve; however, it will progressively
move toward the limit of its access to foreign saving. Decreased remittances or lower oil prices would hasten the arrival of the date.

How sustainable will this situation be? The underlying political problems remain: unequal income distribution, both size and regional, deteriorating public services, peasant unrest, and political instability. The medical doctors who have not already emigrated were on strike for much of the middle part of 2001, protesting salaries in the public health system, whose maximum was $180 per month. After paralyzing Quito in February 2001, a new mobilization began in late July, unifying the popular sectors, indigenous groups, and unions in protest at tax, privatization, dollarization and equity policies of the government. Demonstration fatigue limited its immediate effects, but it could provide a basis for increasingly disruptive demonstrations during the rest of the year.

So the medium term future of Ecuador under dollarization does not seem to differ greatly from its past. The most optimistic scenario for the next two years would predict performance somewhat lower than the average for Latin America, which may be insufficient to change the underlying political/economic dynamic of the country. What is the long run prospect for Ecuador’s economy?

Most elements of political controversy remain, and new ones are being added. Prices for basic goods are still set by the government, and removal of subsidies, which affect large portions of the population, occasion demonstrations, resistance, and rollbacks of price increases. Salaries of government employees are low and are often not paid, and so strikes are common and continual. The government succeeded in raising the VAT, but not through agreement with Congress, and so they were forced to retreat. The new issue will be increasing unemployment, as independent monetary policy disappears and the economy depends entirely on its international position for its monetary base. The Central Bank can affect the monetary system through changes in bank regulations, but given the weakness of the banking system, there is little room for maneuver in this regard. This is especially true given the scrutiny that the economy is subject to on the part of international organizations and international capital providers. The continuing difficulties that Argentina faces are only likely to make the situation worse.

The solution to all problems is increased productivity and competitiveness. Most observers feel Ecuadorian agriculture could improve its productivity. However, it is very unlikely that, even with low inflation and a stable exchange rate, Ecuador will become an “Andean Tiger.” The best case for Ecuador may be the “Bolivian pattern,” a relatively stable but stagnant economy in which incomes grow minimally, and then only in response to international market conditions. For example, if the price of oil remains high, growth may continue. But Ecuador will have to compete for foreign exchange with countries that can use their exchange rate to improve their international competitiveness in products like cut flowers, bananas, or shrimp. It is unlikely that productivity increases in Ecuador would be so great as to allow its products to compete at its likely real exchange rate.

Ecuador has always been three economies. It is possible that the most productive coastal region could attain the levels of productivity necessary to compete internationally in some products, though not likely. The sierra is likely to see its incomes deteriorate as its ability to operate in a dollarized economy is found to be inadequate. Finally, the jungle area with its oil production may “prosper” along with oil, though a very small segment of the selva population will be affected positively.
ARE THERE ALTERNATIVES FOR DOLLARIZED ECUADOR?

Dollarization has removed one element of conflict from the political scene: the exchange rate. However, Ecuador will find that dollarization has not measurably improved its economic performance. In the long run, based on the analysis of this paper, the only way performance can improve is through reducing the burden of the debt that it owes to the international financial system and that commands resources that cannot be dedicated to its own domestic needs. Dollarization promised increasing inflows of capital to Ecuador, since exchange rate risk disappeared with the sucre. In the short run, it delivered on the promise. However, larger economic forces will dominate and will disadvantage Ecuador in the long run.

Domestically, dollarization did not deal with the underlying economic problems and may have only exacerbated them. For example, some analysts suggest that the dollarization exchange rate should have been 16,000 sucre/$1. If so, the final exchange rate of sucre for dollars, 25,000 sucre/$1, had substantial distributional effects. Those who were in the sucre economy entirely were highly disadvantaged in receiving only $1 for each 25,000 sucre multiple of their assets. Those in the dollar economy suffered no such effect. Similarly, debtors benefited, as the dollar value of their debts was lower, while creditors were disadvantaged. Since much of the domestic debt was owed by the national government, there was a real transfer of assets to the government as its debt burden was reduced. This distributional effect is another chapter in government transfers to powerful groups. The other notable case is the ongoing bank bail-out that has been widely perceived as protecting the interests of certain powerful political and banking interests at the cost of the common depositor. The loss of seigniorage that was estimated as $897 million or 6.2 percent of the GDP of the country (Baquero, 2000) reduces government’s ability to effect an improvement in income distribution through its expenditure policies.

If we accept this analysis, are there any alternatives? Let me simply summarize the suggestions that have been made.

The mainstream suggestion is that structural transformation of the economy must continue and be completed, that “illiberal enclaves” must be rooted out and full integration of Ecuador into the international economy will provide improved economic performance. As Beckerman (2001: 35) put it: “The structural reform agenda remains large. Much of it involves changes to mitigate the vulnerability of the fiscal accounts and banking system to Ecuador’s unusually broad array of contingencies.” Ecuador should also learn from Panama that “it needs to ensure solid international backing for its banking system.” (36)

De la Torre (2001: 3) suggests that the economy requires labor market flexibility and institutionalized cushions. The first would facilitate within-country mobility and downward wage adjustment. The second would implement rules for fiscal discipline, some fiscal stabilization, internationalization of the banking system with prudential norms, and diversification of the risk of natural disasters. The goal would be to avoid the “high cost/low productivity trap” that our analysis suggests is Ecuador’s future.

Pachano (2001) carried the cushion concept further in the suggestion for a “New Ecuadorian Economic-Financial Architecture.” He proposed diverting the increased oil revenues from the new pipeline and putting them into several stabilization funds: Fund
for External-Fiscal Stabilization, part of whose efforts would be to buy back external
debt, Fund for National Saving, Fund for Financial Stabilization, and Fund for Production
Stabilization. Such a step would allow stabilization policy and would direct resources
into areas that could increase productivity. Pachano also faced the reality that Ecuador’s
overvalued exchange rate will destroy domestic production by suggesting that Ecuador
must protect segments of import competing industries using escape clauses and
modifying the rules of international integration in Ecuador’s favor.

There is still controversy in Ecuador about dollarization, and opponents are
developing alternative programs. This effort will accelerate as next year’s presidential
election grows closer. At this point the most interesting proposals have come from the
“Foro Ecuador Alternativo,” in Quito (Valencia, 2001). They note that currently the only
way to actively stimulate the economy is through added external borrowing or more
government spending financed by higher taxes. Their central proposal is to restore to the
Central Bank the power to create money, sucres, Andean pesos, or Ecuadorian dollars,
under strict limitations and at a one-to-one parity with the dollar. This would stimulate
efforts to develop a common money among the Andean countries. Much of the rest of
their sixteen point program specifies how these funds would be used to raise productivity,
especially through regional and social development, how oil revenues could be used to
buy back debt and raise capital formation, how domestic industry should be protected,
and how productivity could be increased by better economic policy and knowledge
formation. There are two questions about these proposals. First, could this expansion of
the Central Bank’s ability to stimulate the economy be carried out without further
reducing Ecuador’s access to the international capital that has become its basis for
growth? Second, is there any reason to believe that the stimulus such a program could
provide would actually result in higher productivity and greater competitiveness, in
contrast with the experience of the country to date? The latter question brings to the fore
the political factor in any policy change for the country.

Finally, the strongest political force in the country at this point is the “indigenous,
campesino and social organizations,” represented most forcefully by The Confederation
of Indigenous Nationalities of Ecuador (CONAIE). They have opposed all elements of the
neo-liberal program, from dollarization to paying the external debt to privatizations. After
playing a central role in the removal of Pres. Mahaud in 2000, they forced the
government into a dialogue on a 23 point program, agreed to on February 11, 2001 in
order to end the occupation of Quito (CONAIE, 2001) Interestingly, de-dollarization is
not part of the program. There was an agreement to have a “National Dialogue” on those
issues, but most of the points had to do with decentralization, completion of irrigation
projects, and recovery of money lost to the banks. In addition, CONAIE sent a
representative, a CHASKI, directly to the Paris Club asking for debt forgiveness. The
CONAIE positions signal the unaddressed and continuing issues of the Ecuadorian
economy and society. However, they also suggest that those issues may take precedence
in the political battles that will be forthcoming, and that there will be little focus on
dollarization per se.

Will dollarization be reversed, with Ecuador following Argentina in its retreat
from convertible? My sense is that that is not likely, for there is a realization that it is
neither the root nor the solution to the problems of Ecuador. Most of the energy in
coming years will be spent in addressing those issues.
Let us turn finally to how the dollar bloc may evolve in coming years, as the experience of Ecuador is assimilated, along with that of El Salvador and Guatemala.

**ALTERNATIVE SCENARIOS FOR LATIN AMERICA**

What is occurring in Latin America is an adaptation to the reality of the Western Hemisphere dollar bloc, to the economic and financial power of the United States. That system is again generating instability throughout the hemisphere. The process was costly to Latin America in the 1980s; the 1990s saw significant improvements. The first decade of the 21st century appears to be more like the 1980s than the 1990s. The Brazilian real has crashed, going from a stable 1.9/$ to 2.55/$. The Chilean peso has hit new lows, and the Mexican peso has depreciated. Growth projections for Latin America have been lowered several times since the start of 2001, e.g. Mexico is likely to see no growth at all after almost 6 percent growth in 2000. This is all in response to fears about Argentina’s ability to repay its $130 billion debt. This should frighten foreign capital from other Latin American countries, except for projects such as the oil pipelines or some privatizations.

What are possible scenarios that Latin America might follow to avoid a repeat of the 1980s? Let us suggest several, in hopes of bracketing the possibilities. As a starting point, we need to realize how atypical the 1990s were in the U.S., and by extension in Latin America: a time of unprecedented growth that is unlikely to be repeated, also a time of restructuring in corporate organization and ownership and in the geographic location of production facilities. The result was increased MNC involvement in Latin America, partly because of privatization efforts but also because of the globalization of finance and production (Jameson, 2001). The dollar bloc analysis suggests that the key to stability and growth is the ability of countries to balance their dollar incomes with the dollar demands, represented largely by their debt repayment obligations. New capital flows of equity or portfolio investments, remittances from migrants, and of exports provide dollar inflows. Thus the challenge is to find some mechanism that generates those resources and can protect the economy from the drain on its savings, which can allow it to function as a national economy, rather than as a dependency of the U.S.

What is the likely outcome for Latin America if the status quo continues without change?

**STATUS QUO**

Latin American economies are for the most part liberalized and most of the available assets have been privatized. Thus they have been integrated into international capital markets, and, in most countries, economic actors have gained access to a dollar economy.

If this remains the situation, the countries will continue to be at the mercy of international capital flows. A shock in one country or area can easily affect capital flows to many other areas, as is currently the case. This view was not accepted by the Bush administration. Treasury Secretary Paul O’Neill stated: “Exaggerating the possibility of contagion leads to too-frequent intervention because, in effect, we convince ourselves we don’t have a choice.” (Phillips, 2001) The Argentinean situation has tested O’Neill’s self-assurance, and by August the U.S. was favorably disposed to proposals that the IMF provide additional “intervention” funds to lessen the obvious contagion to Brazil and other countries.
However, without any fundamental changes, we can expect a continuation of the pattern seen during the last twenty years: instability generated by capital flows, with the domestic economy forced to adjust to those shocks. Often the capital flows do not respond to the underlying reality of the economy, but to international perceptions. As the 1990s progressed, capital calmed somewhat, and disruptions were less profound and long lasting. However, if Argentina does in fact default on its debt, there may be a change in the mentality, which would make the disruption as severe as it was during the 1980s.

In any case, Latin America is likely to experience continued instability along with continuing inability to deal with the distributional imbalances that grew during the 1990s. The mediocre performance of the 1990s would be the best that could be hoped for, and the likely outcome is much worse (Birdsall and de la Torre, 2001).

**UNILATERAL DOLLARIZATIONS**

Dollarization is the extreme of the hard peg. International capital markets have insurance against exchange rate risk and thus dollarized economies are attractive. It is possible that the momentum imparted by Ecuador, El Salvador, and Guatemala will encourage other countries to follow the same path.

On the other hand, there are other risks to foreign capital. Argentina’s default risk has been the story of 2001, and dollarized economies have no immunity to this risk. This may be a far larger consideration for owners of capital that should be able to hedge their exchange rate risk. So default risk, country risk from economic and political instability, may be far more important considerations.

Thus the experience of Ecuador with dollarization may play an important role in signaling dollarization’s implications. If the above analysis of Ecuador is correct, that it may be reaching the limits of its debt-carrying capacity and that its overall economic activity is likely to be stagnant in coming years, the attraction of dollarization for most economies will be relatively minor.

This will be influenced in part by U.S. economic performance, for Ecuador has hitched its cycle to the dollar’s at a time when the U.S. economy has weakened. So if the U.S. economy continues in the doldrums, the appeal of dollarization may be even less.

This will be even truer if international agencies, the IMF and the World Bank, fail to climb on the dollarization bandwagon. The IMF seems to have been quite willing to allow Ecuador to be the guinea pig in defaulting on its Brady bonds and in dollarizing. However, recent pronouncements by Stanley Fischer, First Deputy Managing Director of the IMF, indicate a softening of the “bipolar” view that countries need either floating rates or hard fixes (2001b). This implies weakened support for dollarization.

The real question is whether dollarization will act as the “seal of approval” for the international system that would give an implicit default guarantee to international capital. In some sense, Ecuador’s dollarization has played that role, freeing up both private and public capital flows that contributed to improved performance in Ecuador in 2000. However, it is not a given that such a guarantee would be effective for other countries or for the hemisphere as a whole. Simply because a country dollarizes says nothing about its ability to repay international obligations. The situation of El Salvador or Guatemala would seem to be more favorable, since dollar remittances are so much larger in those cases. Again, those could be disrupted by changes in the U.S. labor market and foreign capital could be frightened as that source diminished.
So unilateral dollarization, with the consequent loan from the Latin American countries to the U.S., does not seem likely to change the underlying nature of the relationship nor to solve the problem of instability and mediocre economic performance.

DEBT MORATORIUM AND FORGIVENESS

The underlying problem of the countries is the need to generate revenues, often 50 percent or more of their government revenues, to remain current with their international debt obligations, no matter how or when those debts were incurred. There has been some admission that this impoverishes poor countries, and so some debt forgiveness has been provided to the Highly Indebted Poor Countries (HIPC). However, the problem is much more widespread than just the poor countries, as the Argentina imbroglio indicates. One part of the Ecuador workout was a debt rescheduling, including Brady bond debt. However, the turmoil and difficulty of this process made it less than satisfactory. As one analyst said: “The likelihood of default is still there. They still have the same economic problems, the same social problems, and they still have the same international political standing, which will not allow them to get a lot of support for their debt.” (Notisur, August 18, 2000)

So a consistent, well-managed and well-funded effort in this regard would be the only way that success could be assured for such an effort. This would take a major rethinking and reorientation of international capital markets. It is not clear where that might come from, unless anti-globalization forces grow much stronger and gain the ability to force changes, such as the Tobin tax on international financial transactions.

Of course, from a Latin American standpoint, the best scenario would be full debt forgiveness for all countries, with the acquiescence of private capital owners. This would allow continued access to private as well as public capital markets. It is difficult to imagine that this will occur. How this scenario evolves is likely to be determined by the Argentine case. The crisis has already allowed renegotiation of the terms of the debt, extending its maturation and lowering the immediate repayment requirements. In addition, multilateral disbursements have been accelerated, with the support of European and U.S. presidents.

However, despite reductions in government expenditures and increases in taxes, it is not clear that Argentina can generate the funds it needs for debt repayment. If that is the case, we will return to 1982 and the international hardball that was played at that time (Jameson, 1990). The creditors were the winners in that case; not only was sovereign debt honored, but governments assumed the international obligations of the private sector as well. The most threatening alternative was a debtors’ cartel, and the same would be true today. That does not seem likely, as there has been little groundwork laid for such steps. In addition, such collaboration would be directly contrary to the reigning policy stance of virtually all governments. Unless alternative sources of funds had been established, the foreign sector in the defaulting country would be brought to a standstill, with consequent detrimental impact on the domestic economy. Only a widespread economic collapse would be likely to increase the small probability of successful formation of a debtors’ cartel.

Thus, at this point it appears that the key rule in the dollar bloc will be maintained. There may be de facto defaults that will require complex workouts, but the debts will remain, as will the repayment obligation of the Latin American debtors.
REGIONAL CURRENCY SYSTEM

The formation of the European Monetary Union has provided a model for regional currency unions. Its political dimensions were as important as the economic, and only time will tell whether the Euro becomes a currency that can rival the international importance of the dollar. Although its early weakness has been surprising, the internal stability of Europe and the adhesion of new countries will only strengthen the currency and make it more likely to compete successfully with the dollar.

A regional currency system among the Latin American countries would be much more difficult to establish, though it would generally satisfy the requisites of an optimal currency area. It would have important political significance and would seem to be consistent with the improving political relations among the countries, such as the peace treaty between Peru and Ecuador. One benefit would be greater agreement on macro policy convergence, which could in turn lead to more homogeneous economic performance. It could also provide a basis for collaboration in the export sector, rather than the competitive devaluations that may be the preferred policy under conditions of foreign exchange scarcity. This mechanism would be much less radical than dollarization, but could provide the kind of discipline to economic policy that has often been absent in Latin America.

Is there any likelihood of such an effort? Despite some support from individual analysts (Valencia, 2001), there does not seem to have been any serious discussions of the possibility at a governmental level. Each country is attempting to adapt to the dollar bloc in its own way. Perhaps if economic performance deteriorates notably and the dollar drain grows, there will be increased interest in such a possibility.

FORMAL WESTERN HEMISPHERE DOLLAR BLOC

The next approach would accept the reality of the Western Hemisphere dollar Bloc and would attempt to formalize it and set up norms and rules that would be fair to all who are part of it. This is in the spirit of the legislation sponsored by former Sen. Connie Mack (U.S. Senate, 1999) whose purpose was to encourage dollarization.

Unless there were significant concessions on the part of the U.S., this would have the same impact as dollarization. Concessions by the U.S. would improve the terms for Latin America. They could share seigniorage, could have the Fed as the lender of last resort under certain circumstances, and could have an influence on western hemisphere economic policy. As an example, one proposal for a North American Monetary Union suggests adding a member from Mexico and from Canada to the Federal Reserve Board (Courchene and Harris, 2000). If other countries joined, they too could have their seat.

The boldness of this outline suggests how unlikely it is to become reality. That would only occur if the U.S. accepted its terms, and if it was coupled with debt relief. This was certainly not part of the last Summit of the Americas, but should be in the future. Again, the reality is that there appears to be very little willingness on the part of the U.S. to treat Latin America as an equal. Thus the likelihood of a formal western hemisphere dollar bloc is small.

On the other hand, in the end, this may be the only way that monetary stability can return to the hemisphere: the success of the U.S. must be shared with the other countries who are de facto members of the dollar bloc. The integration of labor markets
that is taking place makes this more feasible. It would, on the other hand, require a new
administration to implement the proposal. The unilateralism that has characterized the
Bush administration to date has succeeded in uniting the world—in opposition to the U.S.
Therefore, it might be hard to get countries to join unless there were significant changes
in orientation. This approach could conceivably provide the common growth and
development that all countries wish, and thus could be the best solution to the current
situation.

A TRULY FREE MARKET AMERICAS

One factor providing some stability to the current dollar bloc is the rapid increase
in emigrant remittances to their home countries. In the case of Ecuador, they have
increased from $70 million in 1990 to $1.3 billion in 2000, second only to oil.

If the liberal economic model were to be followed to its logical conclusion, there
might indeed be a basis for dollarization. This means that there would have to be truly
free movement of goods, services, finance, and labor. Agricultural subsidies and import
restrictions in the U.S. would have to be removed. They will reach $24.5 billion in the
2002 budget, more than half of net farm income in the U.S. More importantly, free
movement of population would have to be permitted. If that were to be the case, there
could indeed be a western hemisphere system of equals, and it could logically move
toward a unified currency. Short of this, the asymmetry of the dollar bloc will continue,
to the detriment of Latin America.

CONCLUSIONS

Whether dollarization becomes more common in Latin America will depend on
the functioning of the Western Hemisphere Dollar Bloc. Certain scenarios of reform in
the international monetary system could make that more likely. However, current policies
and the experience to date of the newest dollarizing country, Ecuador, suggest that there
is unlikely to be an upsurge in the number of dollarized countries. Some analysts and
policymakers are urging dollarization on Argentina. Perhaps that will become the de la
Rua government’s last gambit; that would certainly change the nature of the dollarization
debate. But there is very little that Argentina would gain from such a step, and it would
be unlikely to lower the high unemployment nor to stimulate the sluggish growth the
economy has experienced. In the end, the direction of evolution of exchange rate regime
in the Western Hemisphere will hinge on what set of policies can confront the underlying
structural problems built into the system, the most important of which is the external debt
drain. When that issue is joined and tied in with some preferred exchange rate regime,
there may be a more unified movement in that direction.
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<th>Year</th>
<th>Latin America</th>
<th>Ecuador</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Disbursed External Debt</td>
<td></td>
</tr>
<tr>
<td>1973</td>
<td>48000</td>
<td></td>
</tr>
<tr>
<td>1980</td>
<td>220256</td>
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</tr>
<tr>
<td>1985</td>
<td>377615</td>
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<tr>
<td>1990</td>
<td>458777</td>
<td></td>
</tr>
<tr>
<td>1995</td>
<td>620329</td>
<td></td>
</tr>
<tr>
<td>1996</td>
<td>646048</td>
<td></td>
</tr>
<tr>
<td>1997</td>
<td>668150</td>
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</tr>
<tr>
<td>1998</td>
<td>749310</td>
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Table 2: Three Decades of Latin American Economic Performance

<table>
<thead>
<tr>
<th>Latin America/Caribbean</th>
<th>71-80</th>
<th>81-90</th>
<th>91-97</th>
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<tbody>
<tr>
<td>Per Capita GDP Growth</td>
<td>3.3</td>
<td>-0.4</td>
<td>1.6</td>
</tr>
<tr>
<td>Per Capita GDP (US$)</td>
<td>2900</td>
<td>2653</td>
<td>3025</td>
</tr>
<tr>
<td>Average Inflation</td>
<td>46.7</td>
<td>192.1</td>
<td>268.0</td>
</tr>
<tr>
<td>Gr. Dom. Invest. Growth</td>
<td>7.6</td>
<td>-1.7</td>
<td>5.9</td>
</tr>
<tr>
<td>Gov't Exp. (% of GDP)</td>
<td>19</td>
<td>22.5</td>
<td>23</td>
</tr>
<tr>
<td>Gov't Deficit (% of GDP)</td>
<td>2.2</td>
<td>1.7</td>
<td>1.5</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Ecuador</th>
<th></th>
<th></th>
<th></th>
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</thead>
<tbody>
<tr>
<td>Per Capita GDP Growth</td>
<td>6.3</td>
<td>-0.6</td>
<td>1.5</td>
</tr>
<tr>
<td>Per Capita GDP (US$)</td>
<td>1378</td>
<td>1264</td>
<td>1392</td>
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<tr>
<td>Average Inflation</td>
<td>13.8</td>
<td>36.6</td>
<td>34.9</td>
</tr>
<tr>
<td>Gr. Dom. Invest. Growth</td>
<td>10.7</td>
<td>-5.1</td>
<td>2.3</td>
</tr>
<tr>
<td>Gov't Exp. (% of GDP)</td>
<td>14.2</td>
<td>15.6</td>
<td>18.5</td>
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<tr>
<td>Gov't Deficit (% of GDP)</td>
<td>-1.4</td>
<td>-2</td>
<td>-1.3</td>
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a: last year of period

Sources: IDB, Economic and Social Progress in Latin America, 1998;
Table 3: Latin America's International Dollar Flows

<table>
<thead>
<tr>
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</thead>
<tbody>
<tr>
<td>Trade Balance</td>
<td>-1548</td>
<td>33082</td>
<td>30509</td>
<td>2197</td>
<td>-19700</td>
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<tr>
<td>Service Balance</td>
<td>-29333</td>
<td>-38149</td>
<td>-6582</td>
<td>-11806</td>
<td>-14650</td>
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<tr>
<td>Income Balance</td>
<td>-20285</td>
<td>-35416</td>
<td>-35564</td>
<td>-42902</td>
<td>-54455</td>
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<tr>
<td>Current Account Balance</td>
<td>-29508</td>
<td>-1440</td>
<td>-1541</td>
<td>-37115</td>
<td>-56370</td>
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<tr>
<td>Cap/Fin Account Balance</td>
<td>35005</td>
<td>2584</td>
<td>16807</td>
<td>63745</td>
<td>43490</td>
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<tr>
<td>Direct Investment</td>
<td>5709</td>
<td>4132</td>
<td>7029</td>
<td>37824</td>
<td>70725</td>
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<td>Portfolio Investment</td>
<td>13565</td>
<td>-1669</td>
<td>-1586</td>
<td>-12276</td>
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<tr>
<td>Change in Reserves(=Inc.)</td>
<td>-2321</td>
<td>1142</td>
<td>-15123</td>
<td>-27015</td>
<td>3480</td>
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<table>
<thead>
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<tbody>
<tr>
<td>Trade Balance</td>
<td>303</td>
<td>1294</td>
<td>1009</td>
<td>1220</td>
<td>1655</td>
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<td>Service Balance</td>
<td>-974</td>
<td>-1225</td>
<td>-112</td>
<td>-91</td>
<td>-145</td>
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<tr>
<td>Income Balance</td>
<td>-524</td>
<td>-936</td>
<td>-1374</td>
<td>-1308</td>
<td>-1725</td>
</tr>
<tr>
<td>Current Account Balance</td>
<td>-642</td>
<td>149</td>
<td>-360</td>
<td>111</td>
<td>885</td>
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<tr>
<td>Cap/Fin Account Balance</td>
<td>980</td>
<td>-203</td>
<td>345</td>
<td>1449</td>
<td>1485</td>
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<tr>
<td>Direct Investment</td>
<td>70</td>
<td>62</td>
<td>126</td>
<td>447</td>
<td>655</td>
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<tr>
<td>Portfolio Investment</td>
<td>79</td>
<td>0</td>
<td>219</td>
<td>995</td>
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<td>Change in Reserves(=Inc.)</td>
<td>270</td>
<td>-24</td>
<td>-195</td>
<td>-245</td>
<td>215</td>
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Source: IDB, Economic and Social Progress in Latin America:
ECLAC, Preliminary Overview of the Economies of Latin America and the Caribbean,
1999(Santiago, Chile, 1999): 1999-estimated
TABLE 4: Ecuadorian Macro Performance, 1997-2002 (est.)

<table>
<thead>
<tr>
<th></th>
<th>1997</th>
<th>1998</th>
<th>1999</th>
<th>2000</th>
<th>2001(E)</th>
<th>2002(E)</th>
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<td><strong>EXTERNAL SECTOR</strong></td>
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<tr>
<td>Exports, mm$</td>
<td>5,264</td>
<td>4,203</td>
<td>4,451</td>
<td>4,846</td>
<td>4,660</td>
<td>5,168</td>
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<tr>
<td>Imports, mm$</td>
<td>4,666</td>
<td>5,198</td>
<td>2,786</td>
<td>3,212</td>
<td>4,224</td>
<td>4,897</td>
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<tr>
<td>CurrAcct/GDP</td>
<td>-3.6</td>
<td>-11.0</td>
<td>6.9</td>
<td>10.1</td>
<td>-3.5</td>
<td>-3.6</td>
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<tr>
<td>For. Inv./GDP</td>
<td>3.5</td>
<td>4.2</td>
<td>4.6</td>
<td>5.2</td>
<td>8.2</td>
<td>6.5</td>
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<tr>
<td>For Debt, mm$</td>
<td>15,099</td>
<td>16,400</td>
<td>16,282</td>
<td>13,458</td>
<td>13,600</td>
<td>13,640</td>
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<tr>
<td>For Debt/GDP</td>
<td>76.4</td>
<td>83.2</td>
<td>118.3</td>
<td>98.6</td>
<td>78.1</td>
<td>69.2</td>
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<tr>
<td>Reserves, mm$</td>
<td>2,093</td>
<td>1,698</td>
<td>1,276</td>
<td>1,180</td>
<td>1,390</td>
<td>1,548</td>
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<tr>
<td>Reserves, mos.</td>
<td>4.3</td>
<td>3.2</td>
<td>4.4</td>
<td>3.5</td>
<td>3.3</td>
<td>3.2</td>
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<td><strong>FISCAL %GDP</strong></td>
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<tr>
<td>Revenues</td>
<td>23.8</td>
<td>20.4</td>
<td>25.5</td>
<td>29.0</td>
<td>25.0</td>
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<td>Expend.</td>
<td>26.3</td>
<td>26.5</td>
<td>31.5</td>
<td>28.6</td>
<td>26.8</td>
<td>24.8</td>
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<tr>
<td>Fiscal Surplus</td>
<td>-2.6</td>
<td>-6.1</td>
<td>-5.9</td>
<td>0.4</td>
<td>-1.8</td>
<td>-1.6</td>
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<td>PrimarySurplus</td>
<td>2.5</td>
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<td>2.7</td>
<td>8.2</td>
<td>5.0</td>
<td>4.5</td>
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<td><strong>MONEY SECTOR</strong></td>
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<td>Inflation-Dec.</td>
<td>30.7</td>
<td>43.4</td>
<td>60.7</td>
<td>91.0</td>
<td>30.0</td>
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<tr>
<td>Exch Rate-Dec</td>
<td>4.428</td>
<td>6,825</td>
<td>20,423</td>
<td>25,000</td>
<td>25,000</td>
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<td>Devaluation</td>
<td>21.8</td>
<td>54.1</td>
<td>196.6</td>
<td>23.5</td>
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<td>Money Base Growth</td>
<td>31.6</td>
<td>41.2</td>
<td>174.0</td>
<td>-58.1</td>
<td>-42.6</td>
<td>-50.0</td>
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<td>Credit Growth</td>
<td>49.6</td>
<td>37.0</td>
<td>144.1</td>
<td>-1.2</td>
<td>12.0</td>
<td>15.6</td>
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<td>Bad Loan %</td>
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<td>9.6</td>
<td>40.4</td>
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<td>21.0</td>
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<td>M2/GDP</td>
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<td>32.5</td>
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<td>27.6</td>
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<tr>
<td>Sov. Debt Spread</td>
<td>597</td>
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<td>2,754</td>
<td>1,435</td>
<td>1,400</td>
<td>1,350</td>
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<td>Moody Rating</td>
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<td>B3</td>
<td>Caa2</td>
<td>Caa2</td>
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<td>Real Exch. Rate-'97=100</td>
<td>100.0</td>
<td>99.6</td>
<td>138.3</td>
<td>155.4</td>
<td>106.9</td>
<td>92.8</td>
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<tr>
<td>Real Return-$</td>
<td>2.5</td>
<td>22.8</td>
<td>144.8</td>
<td>-59.8</td>
<td>-22.5</td>
<td>-5.3</td>
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<tr>
<td><strong>REAL SECTOR</strong></td>
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<td></td>
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</tr>
<tr>
<td>GDP, mm$</td>
<td>19,760</td>
<td>19,710</td>
<td>13,769</td>
<td>13,649</td>
<td>17,424</td>
<td>19,708</td>
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<tr>
<td>GDP per cap $</td>
<td>1,655</td>
<td>1,619</td>
<td>1,109</td>
<td>1,079</td>
<td>1,353</td>
<td>1,503</td>
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<tr>
<td>Real GDP Growth</td>
<td>3.4</td>
<td>0.4</td>
<td>-7.3</td>
<td>2.3</td>
<td>3.6</td>
<td>3.4</td>
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<tr>
<td>Inv./GDP</td>
<td>19.0</td>
<td>24.7</td>
<td>12.9</td>
<td>16.8</td>
<td>19.2</td>
<td>20.1</td>
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<tr>
<td>Saving/GDP</td>
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<td>13.7</td>
<td>20.0</td>
<td>26.9</td>
<td>15.7</td>
<td>16.5</td>
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<td>Urban Unemp</td>
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<td>11.8</td>
<td>15.1</td>
<td>10.3</td>
<td>9.0</td>
<td>9.5</td>
</tr>
</tbody>
</table>

ENDNOTES

1 In an ironic turn, the dollar resumed its importance in Cuba in the 1990s after the fall of the Soviet Union. One of the primary tensions in the Cuban economy is the effect that simple access to dollars has on relative real incomes.

2 The Corrales study of Venezuela in Wise and Roett(2000) provides one example of successful resistance to international pressures for a maxi-devaluation. There are not many other examples in recent years.

3 The debt problem reflects Latin America’s tendency to rely on foreign saving to offset its own low domestic saving rates. (Hausmann and Reisen, 1997) Disruptions to flows of foreign saving are reflected in domestic economic performance.

4 It is also interesting that Guatemala and El Salvador, the two dollarizing countries, would not be the first candidates for dollarization, based on their results.

5 The next sections draw on a series of reports from the Latin American Data Base, Notisur{ http://ladb.unm.edu/notisur/ } and from international news reports archived in “Academic Universe of Lexis-Nexis” { http://web.lexis-nexis.com/universe } 

6 Beckerman(2001) provides a readable and very careful economic interpretation of this era. He focuses on “semi-dollarization” as the accelerant in this debacle. I find the main source in the continuing international debt drain and the constraints it imposed on domestic economic performance and policy.

7 Some of the potential alternatives were political, e.g. dismissing Congress in a “Fujicoup” such as Pres. Fujimori undertook in Peru in 1992. Mahuad’s political incompetence probably precluded such political steps. A convertibility program or a currency board that could have attacked inflationary expectations were among the economic alternatives. Perhaps the most viable alternative was a direct attack on the financial liberalization that was at the center of instability through sucretizing financial accounts and restricting capital flows.

8 His talk was entitled “Dollarization Is the Only Option.” (de Ginatta, 2001)

9 Perhaps the most telling quote on the underlying political pressures for dollarization was by former Vice-President, Alberto Dahik, from his exile in Costa Rica. He said: “Society needs to understand that this is not a change in the monetary and exchange rate system. It is a reconquest and renewal of ecuadorian society, just as in the Julian Revolution. It is a new order insisting in privatization and elimination of the privileges of bureaucratic sectors.” (Pallares, 2000)

10 In August, 2001, the Constitutional Tribunal ruled the VAT hike unconstitutional and the government rolled it back to 12 percent. Increased tax revenues from oil and economic recovery had provided a fiscal cushion that removed fears that the fiscal deficit would spiral out of control.

11 The face value of $6.65 billion in Brady and Eurobonds was reduced by 40 percent, to $3.95 billion. However, this only reduces the debt service on the total debt of $13.4 billion by 10.8 percent annually over the 2001-2005 period (Ecuadorian Economy at Cornell, April, 2001, p. 4).

12 The closure of Filanbanco after being taken over by the AGD in December 1998 led Pres. Noboa to claim that he had been misled on its status until October 2000, an admission that sparked widespread comment.
The basis for the choice of 25,000/1 is murky. One analyst suggested it was based simply on a calculation of the foreign exchange available to purchase the outstanding sucres. Others suggested that the market exchange rate was closer to 32,000/1. Another suggested that the stability of markets after the dollarization decree was proof that 25,000 was the proper rate.

Increased out-migration and the apparent decline in real wages suggest that the labor market has already made major adjustments, without changing overall economic performance. For example, the May 2001 real minimum wage was 20 percent below its value of August 1996.

By mid-2001, the election had led to discussions about forming coalitions on the part of many former political enemies and had stimulated virtually every former President to suggest that he might be a candidate for the presidency. Even Abdalá Bucaram had momentarily resurfaced.