DOLLARIZATION IN ECUADOR

A Process in Progress

Presented by Julián P. Díaz

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- Introduction to Econometrics
- Economy of Latin America
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My main research interests are:
- Monetary Economics
- International Economics and
- Growth Theory.

OUTLINE OF THE LECTURE

1. BACKGROUND

2. SOME DEFINITONS

3. THE CRISIS

4. BENEFITS AND COSTS

5. FOR THE FUTURE

BACKGROUND

	ECUADOR	U.S.A.
Area (sq km)	283,560 (Minnesota: 206,000)	9,629,091
Population	13 million	280 million
Currency	Sucre (before) US Dollar (after)	US Dollar
GDP (2000)	\$37.2 bn (PPP)	\$9.96 trn (PPP)
GDP per capita (2000)	\$2900 (PPP)	\$36,200 (PPP)

BACKGROUND

	ECUADOR	U.S.A.
Main Exports	Petroleum Bananas Shrimp Coffee Flowers Fish	Capital goods Automobiles Industrial supplies Consumer goods Agricultural products
Main Imports	Machinery Equipment Fuels Consumer goods	Crude oil Refined petroleum Machinery Automobiles Consumer goods

SOME DEFINITIONS

DOLLARIZATION (or official dollarization) is a monetary system in which a country renounces to its own currency and adopts a foreign currency (in this case the dollar) to use it as legal tender.

This means that not only private parties use the foreign currency to trade, but the government also uses it to make payments. The domestic currency remains only in the form of coins of small value.

Dollarization is often confused with:

UNOFFICIAL DOLLARIZATION (or *de facto* dollarization) which occurs when most of the people in a country carry a large fraction of their financial wealth in foreign currency, although it is not the legal tender.

Most of the important transactions (big purchases as appliances, cars, houses, rent payments, some wage payments and loans) are conducted in the foreign currency.

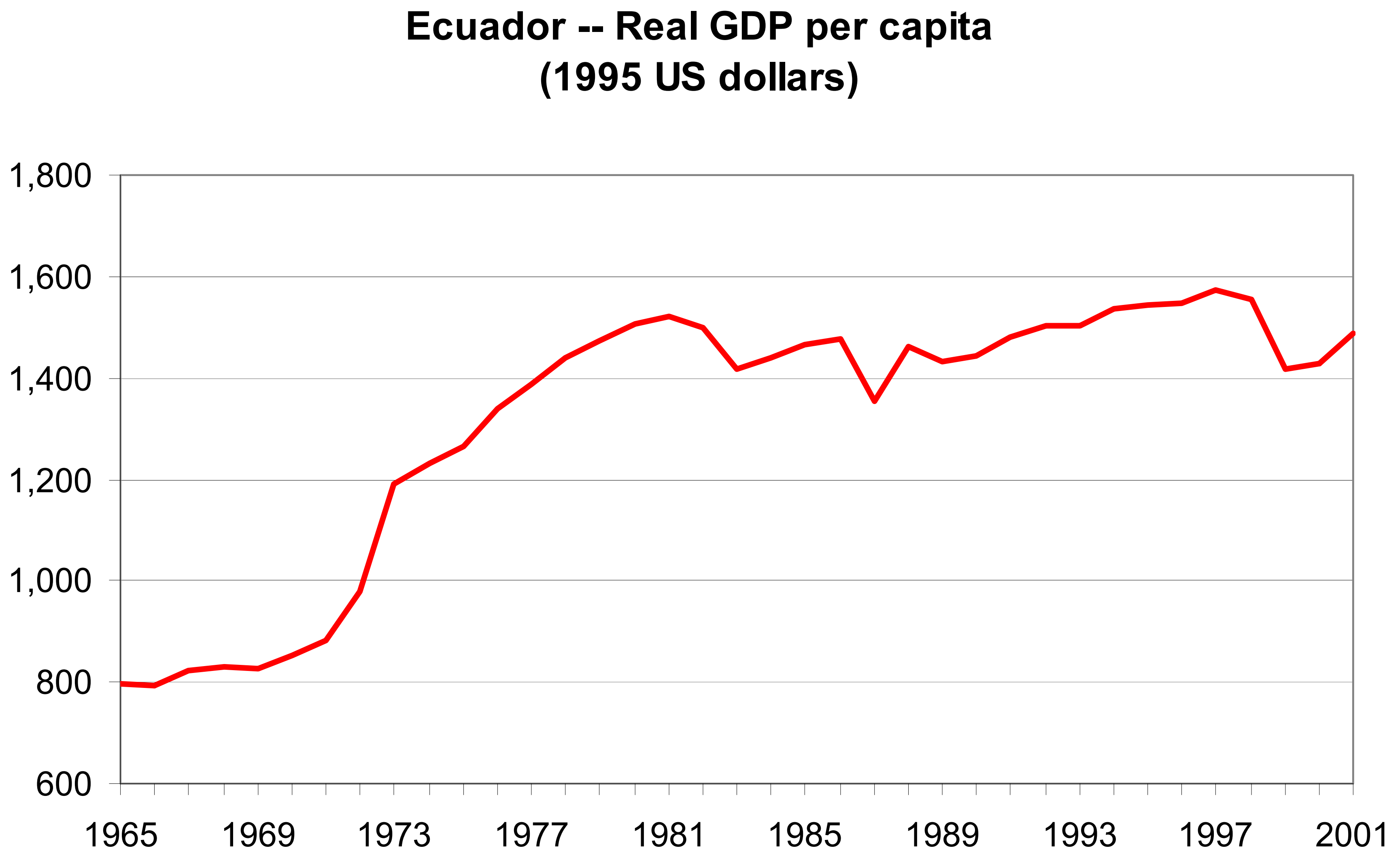
Also, people prefer to save in the foreign currency, because they feel that it will not lose its value rapidly.

NOTE: Before the year 2000, Ecuador was in fact an unofficially dollarized country (more than 40% of Ecuador's broad money was deposits in foreign currency).

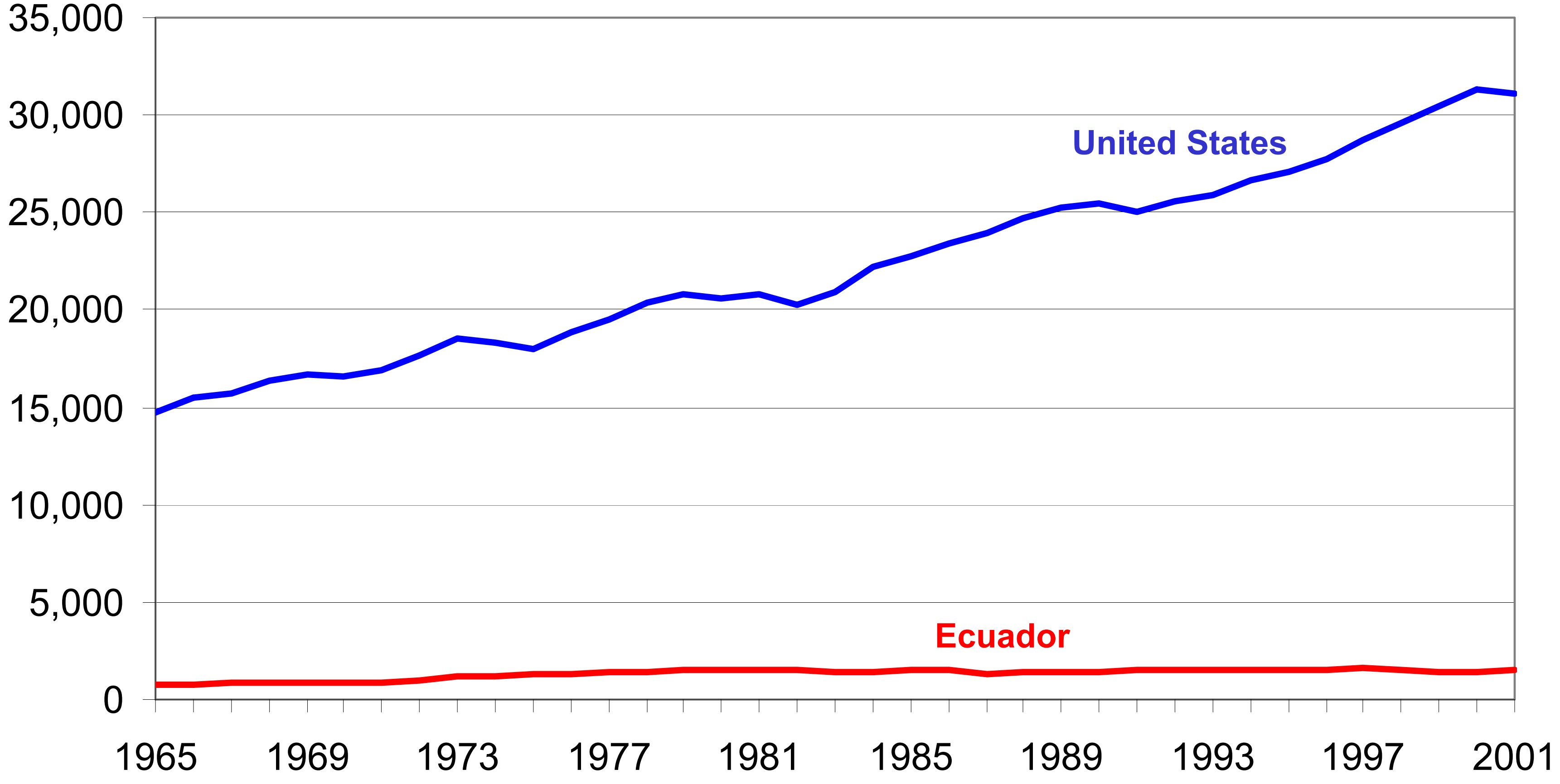
FACT

Ecuador is one of the poorest countries in South America

	GDP per capita (2000, PPP)
Argentina	$ 10,601
Bolivia	$ 2,600
Brazil	$ 7,332
Chile	$ 14,155
Colombia	$ 6,800
Ecuador	$ 2,900
Paraguay	$ 4,750
Peru	$ 5,059
Uruguay	$ 9,300
Venezuela	$ 8,490


Ecuador -- Real GDP per capita
(1995 US dollars)
1,800
1,600
1,400
1,200
1,000
800
600
1965
1969
1973
1977
1981
1985
1989
1993
1997
2001

Ecuador, US -- Real GDP per capita (1995 US dollars)



THE CRISIS

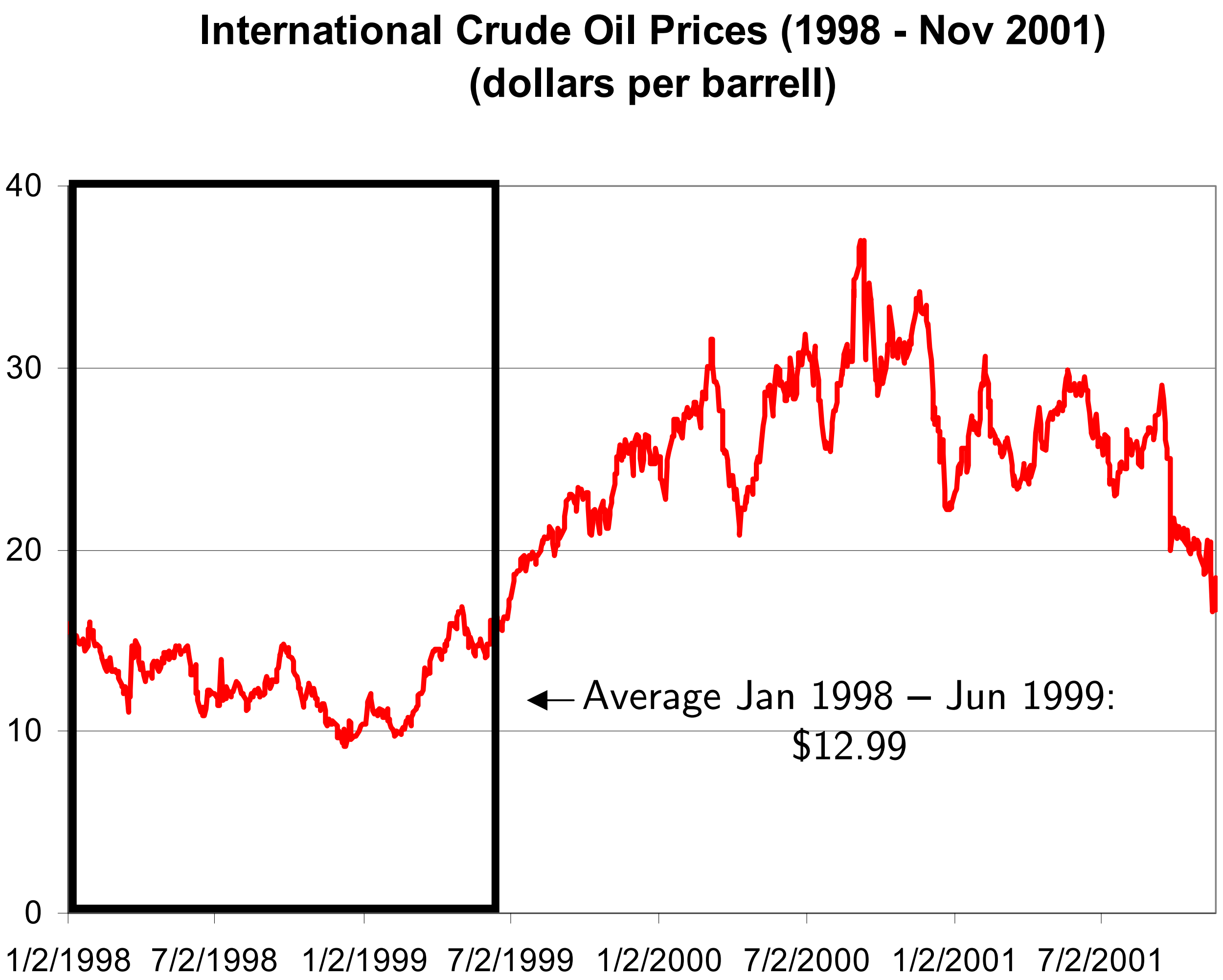
Between 1998 - 2000, Ecuador suffered a series of shocks that deteriorated even more its already precarious situation:

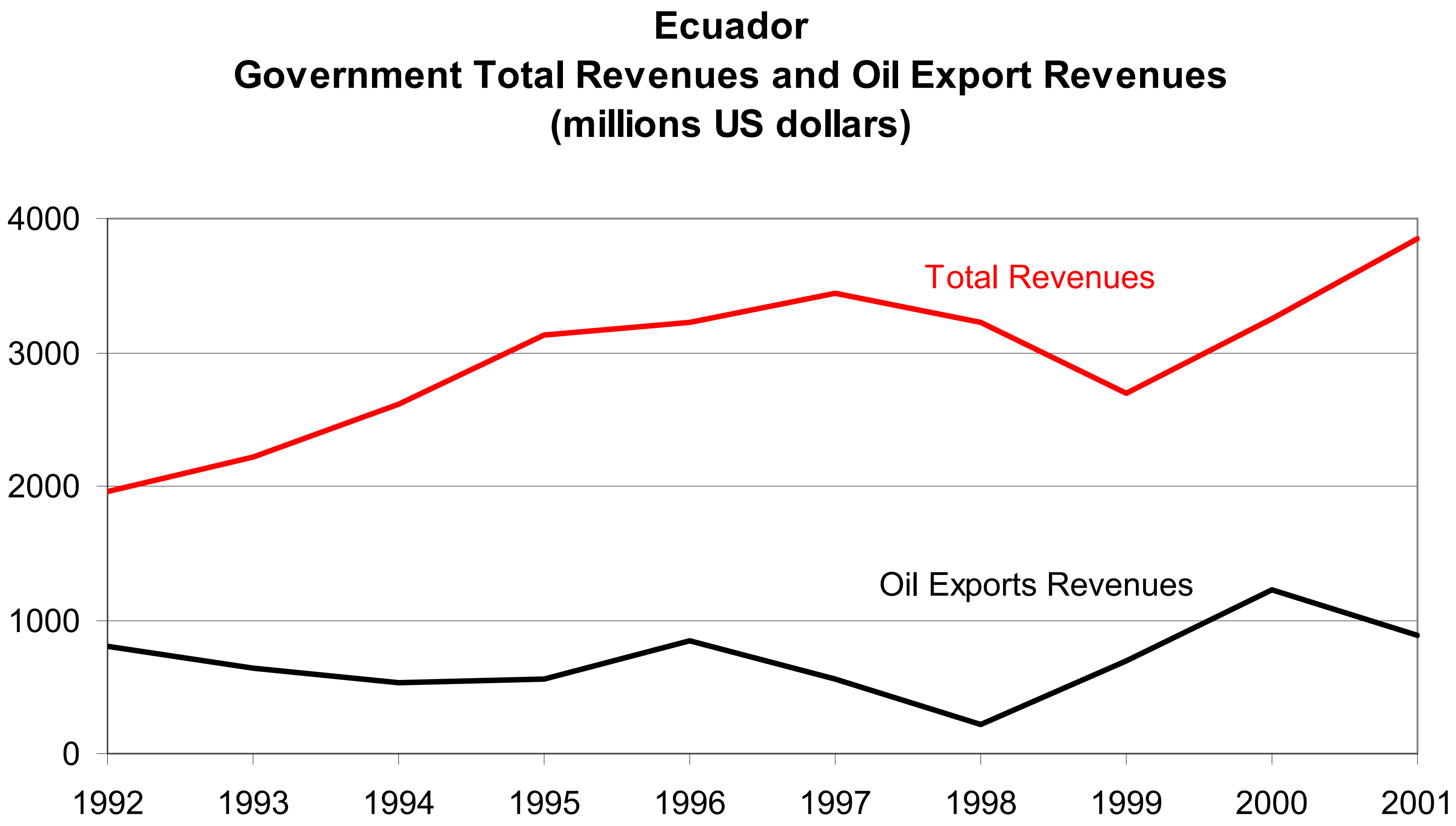
- El Niño weather phenomenon

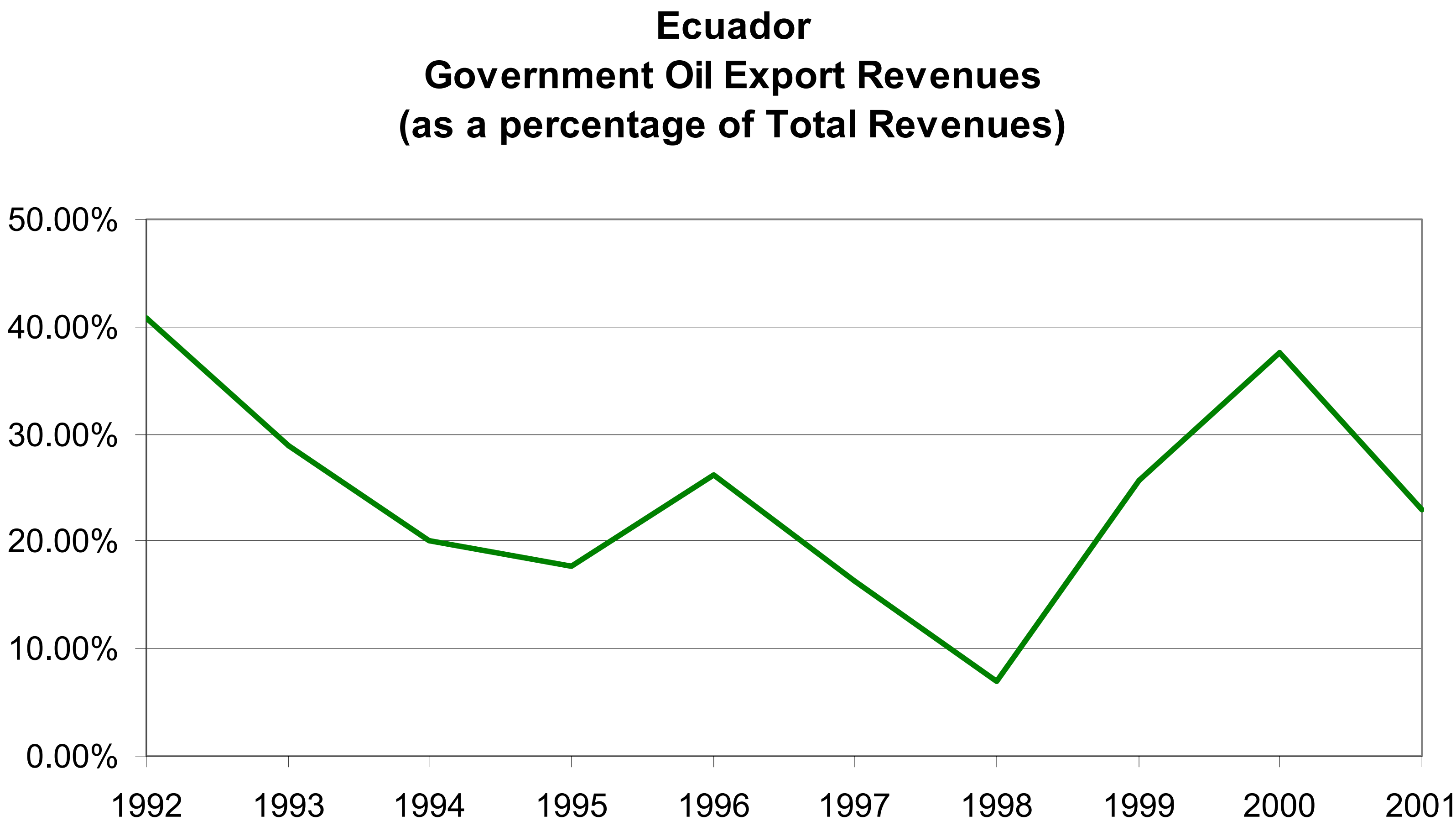
- Low oil prices
  (Petroleum is Ecuador's main export and is also the main source of its government revenues)

- A feeling of distrust in emerging markets from foreign investors, as a consequence of the South East Asia economic crisis. This was widespread all over Latin America, and foreign investors preferred to withdraw most of their assets from these countries.

Oil prices fall to almost record-level lows:




Ecuador
Government Total Revenues and Oil Export Revenues
(millions US dollars)
4000
3000
2000
1000
0
Total Revenues
Oil Exports Revenues
1992
1993
1994
1995
1996
1997
1998
1999
2000
2001

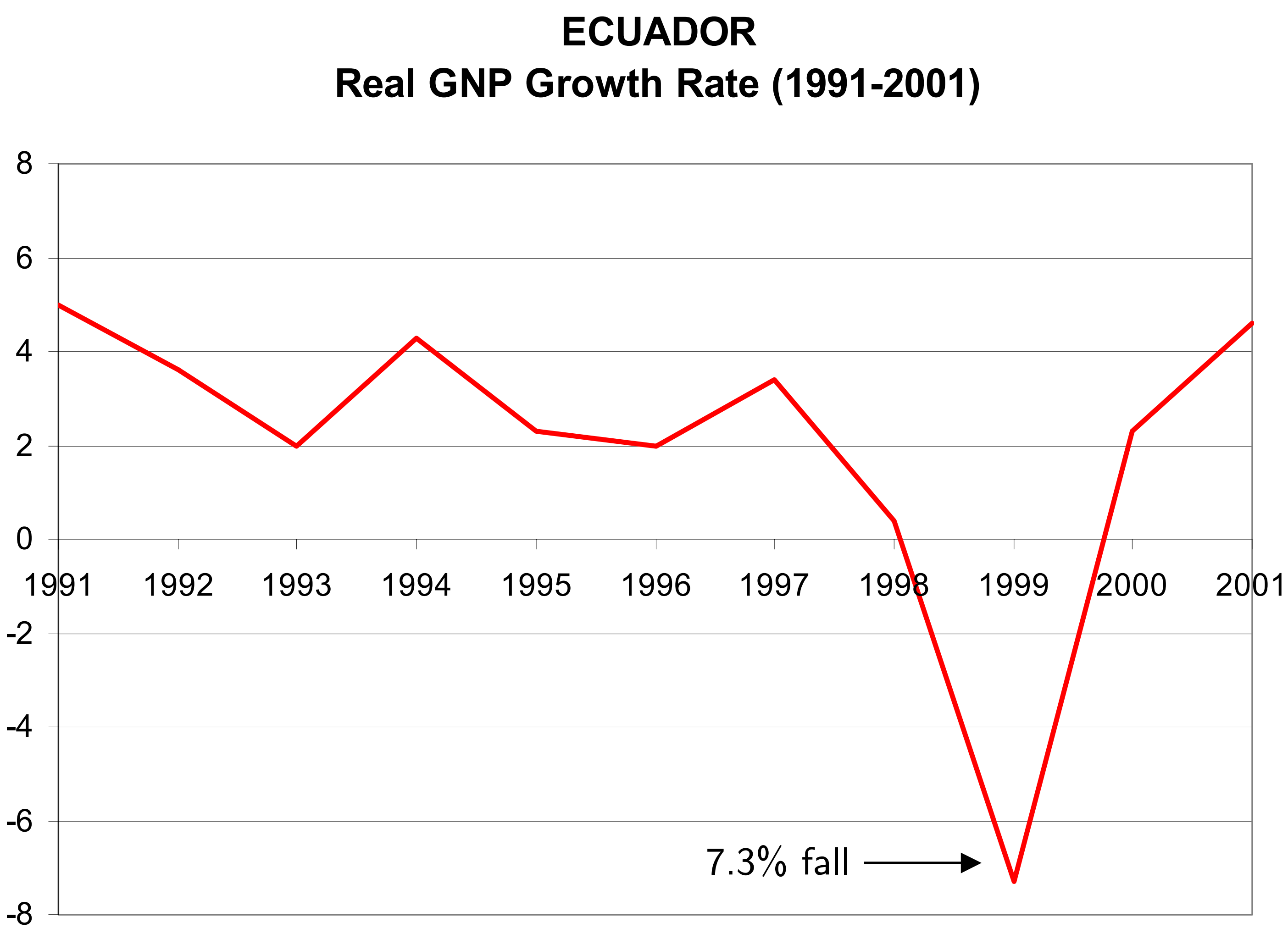

Ecuador
Government Oil Export Revenues
(as a percentage of Total Revenues)
50.00%
40.00%
30.00%
20.00%
10.00%
0.00%
1992
1993
1994
1995
1996
1997
1998
1999
2000
2001

- Almost half of the country's financial system went bankrupt, and the government had to assume full responsibility for these banks, creating an extra burden on its tight budget.

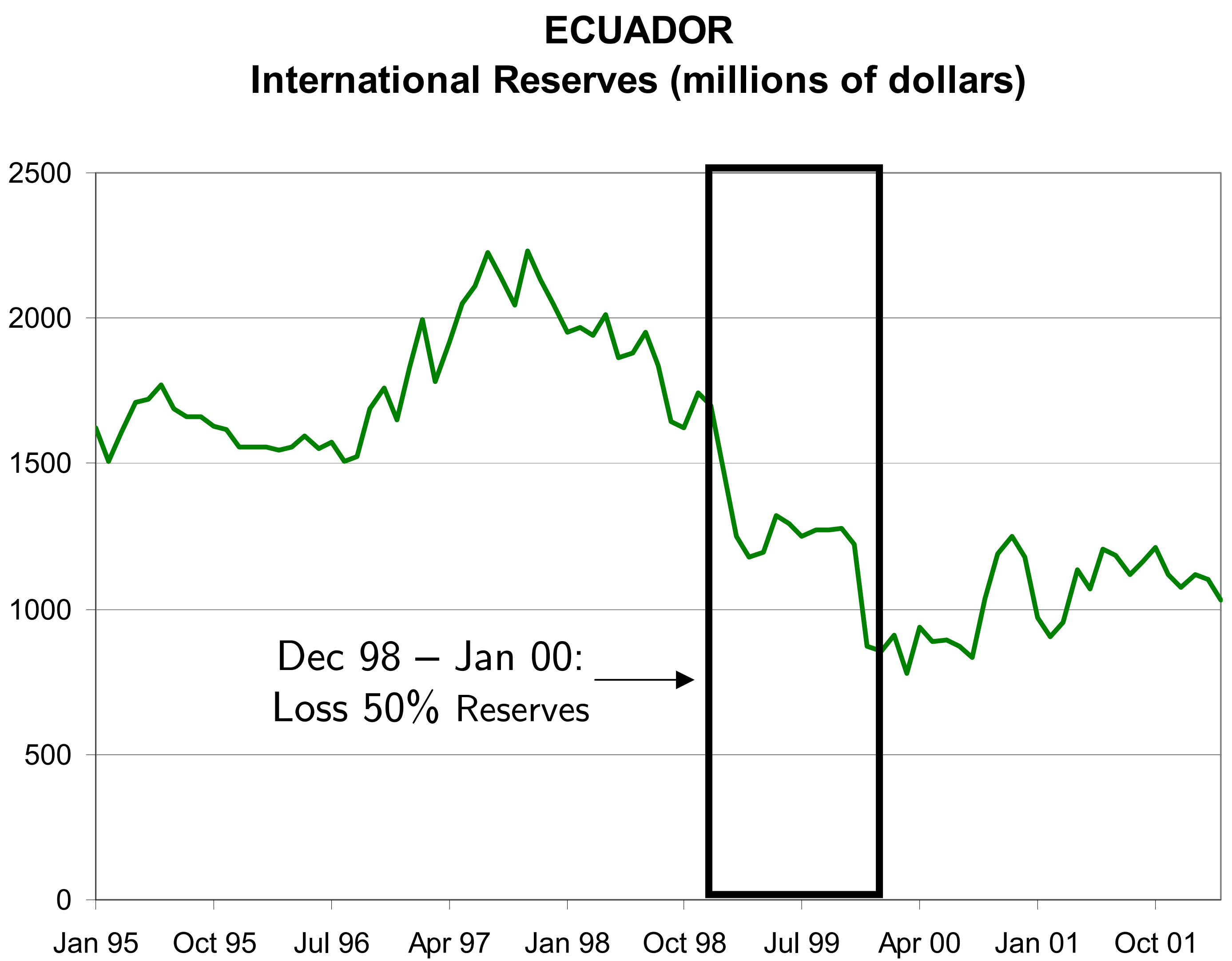
All these events combined created Ecuador's worst economic crisis in its history.

As a result of this, all the leading economic indicators went in the wrong directions:

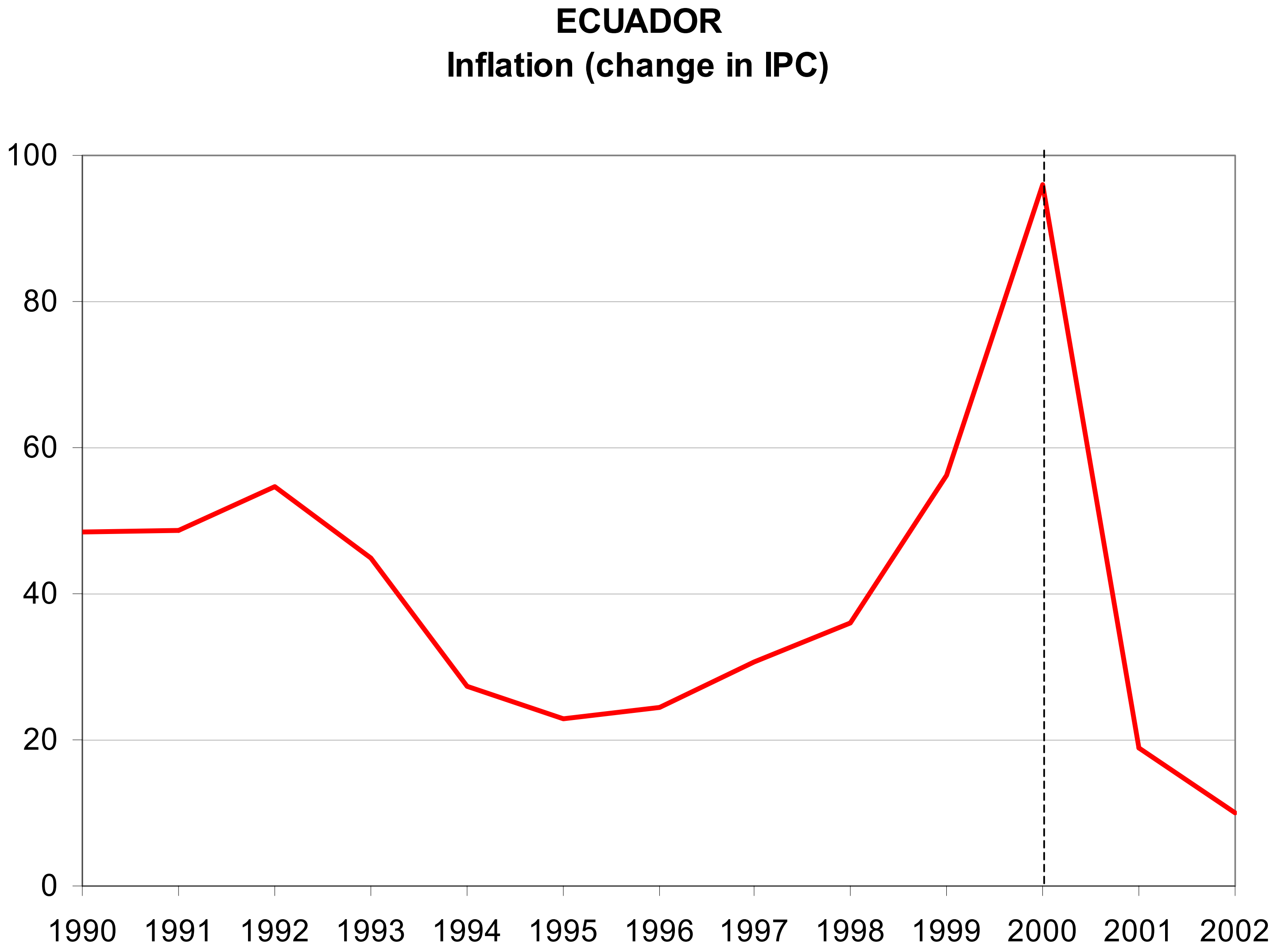
Output went down



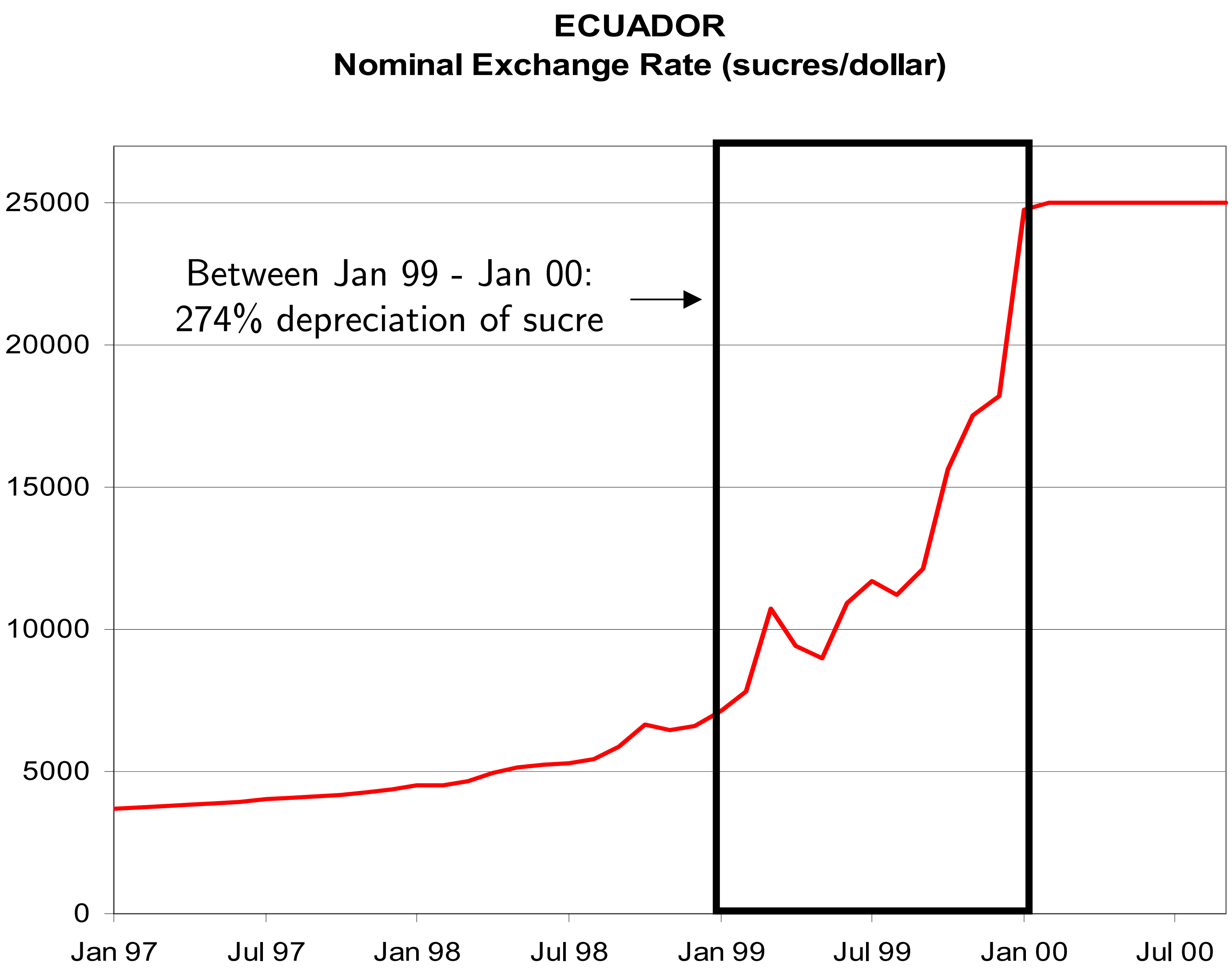
International Reserves flew out of the country



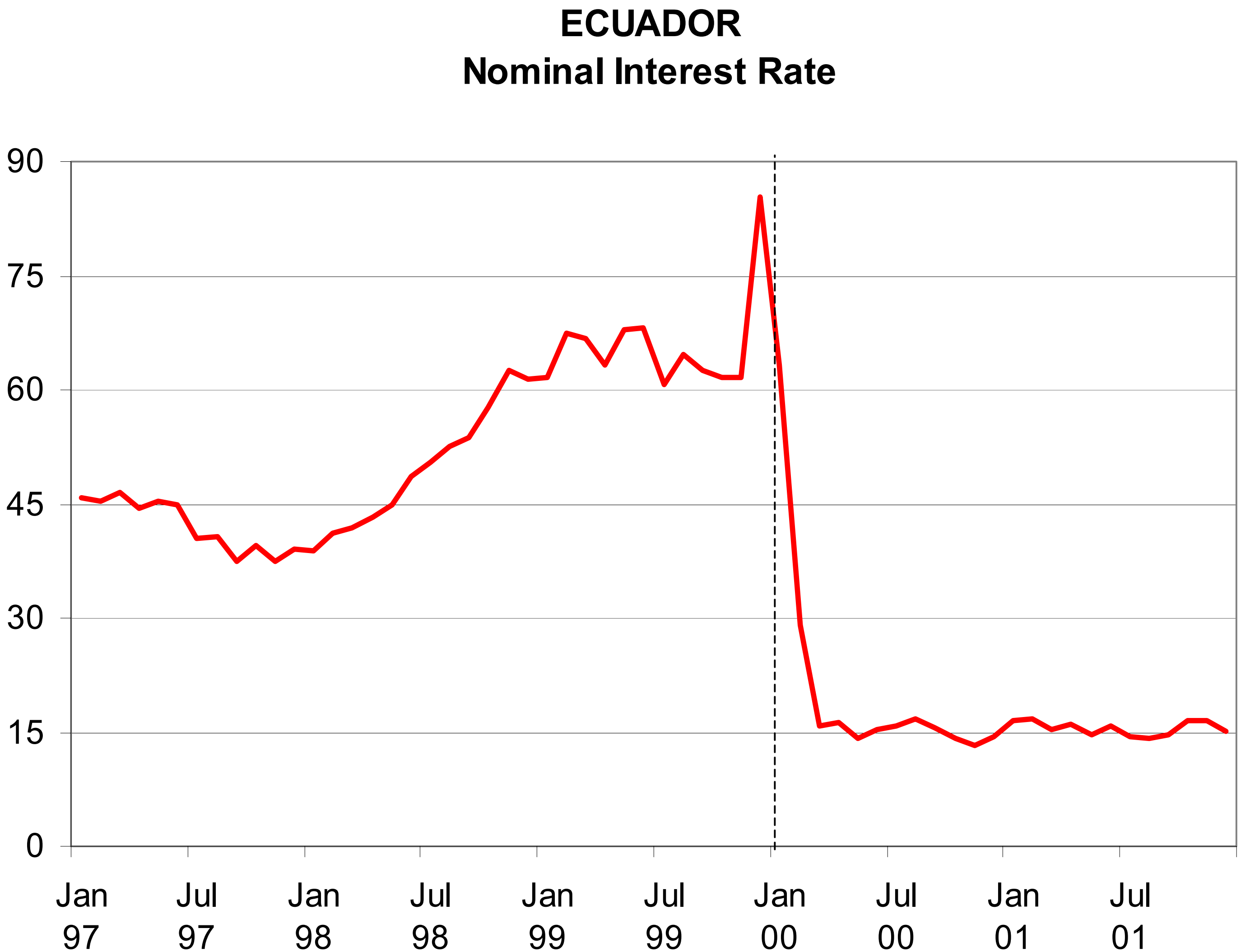
Inflation went up



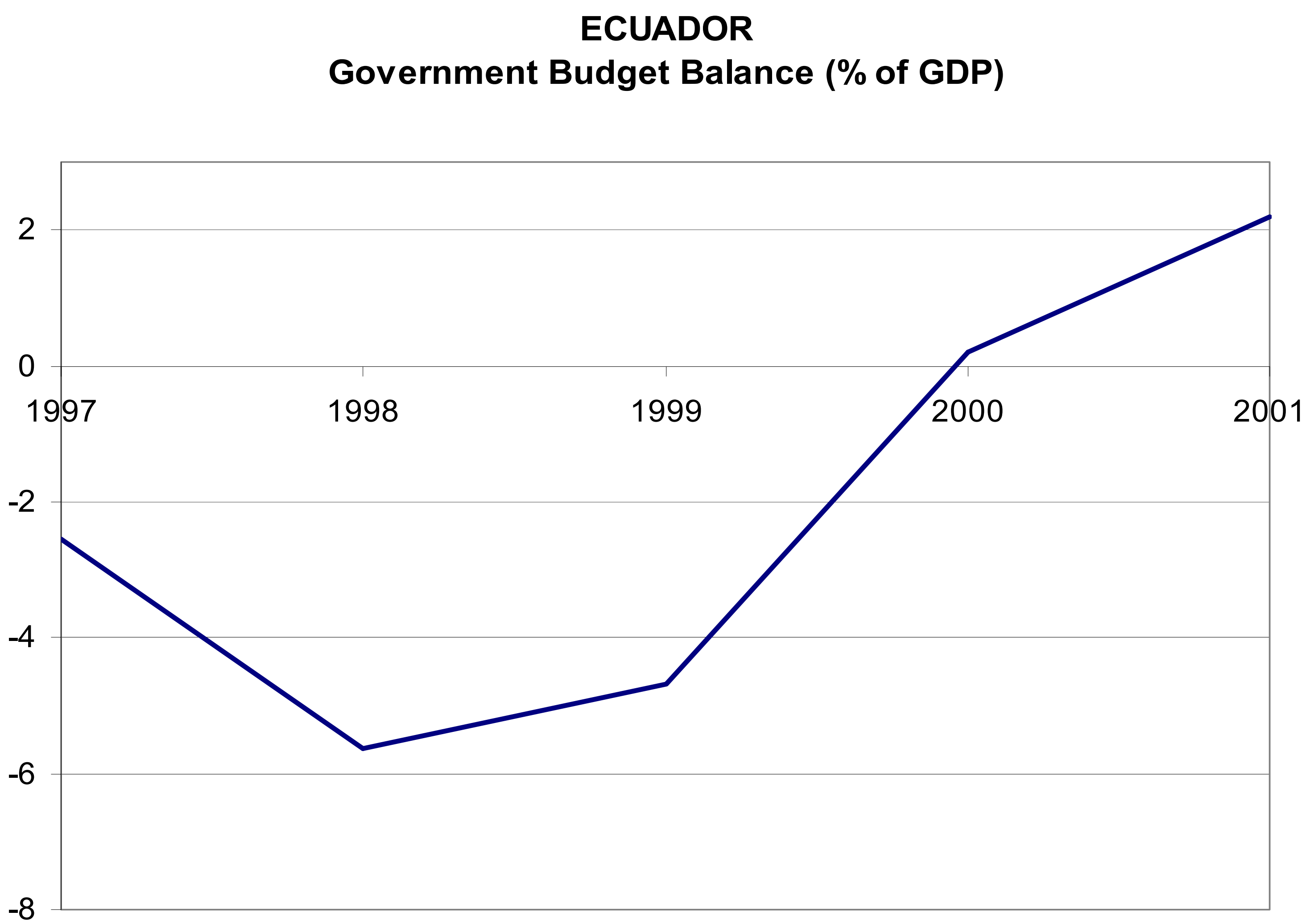
The exchange rate (the value of a dollar in terms of sucres) went up



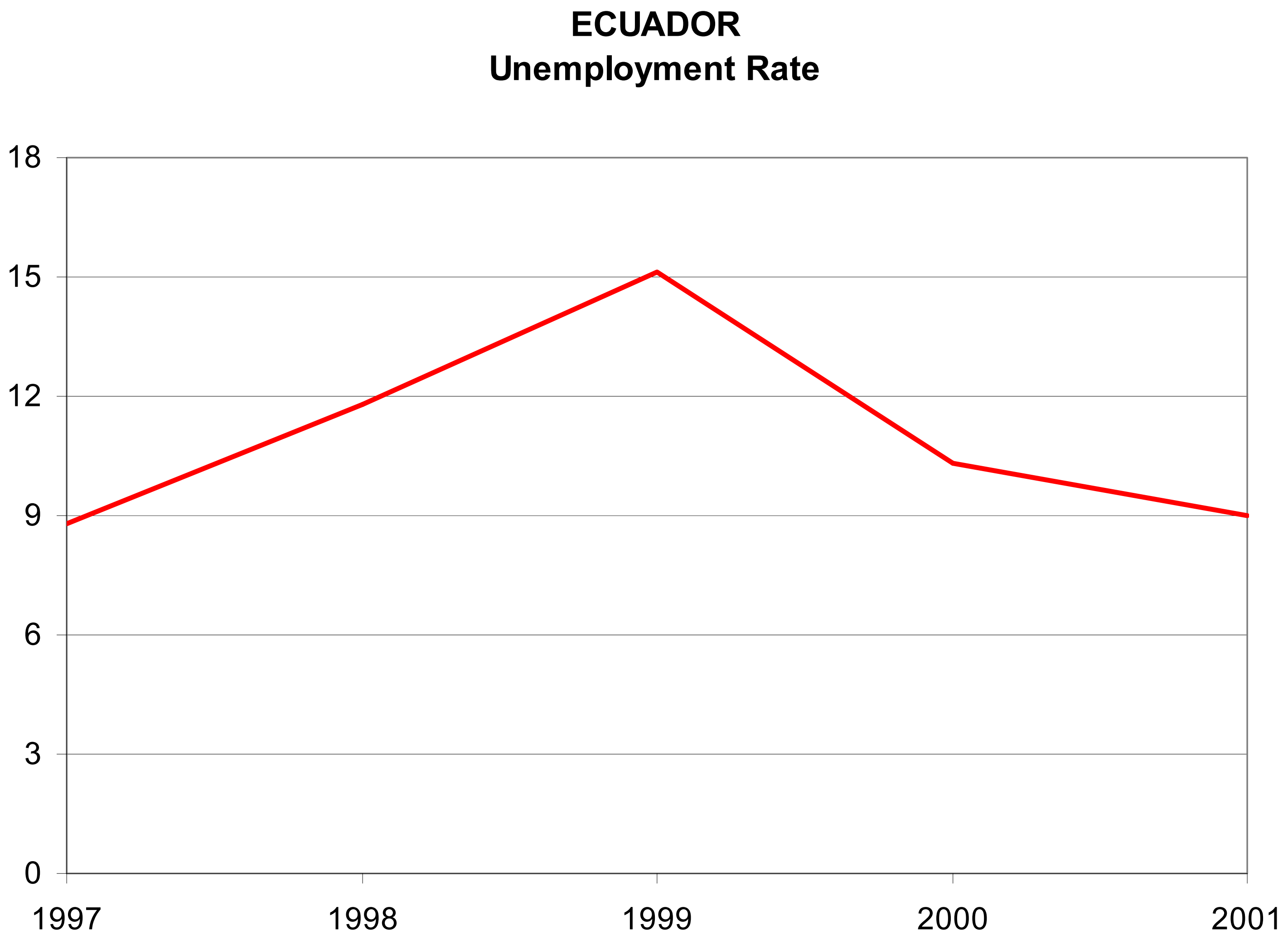
Nominal Interest rates went up



Government deficit went up



Unemployment increased



- In a desperate measure to revert this crisis, President Jamil Mahuad announced in January 11, 2000, that Ecuador was adopting the US dollar as its official currency.

- The exchange rate at which the local currency would be exchanged for US dollars was <u>fixed</u> at 25,000 sucres/dollar.

- From that date, Ecuador became the largest economy that dollarized (among other dollarized countries are Panama, El Salvador and until a few years Liberia).

- Mahuad was thrown out of office in January 22, 2000 (just 11 days after announcing dollarization!) mainly because of the economic crisis and because of the controversy that dollarization brought.

- However, his successor, current President Gustavo Noboa ratified during his inaugural speech that the dollarization process would continue.

- Since then, a number of steps have been taken in order to implement dollarization in Ecuador:

  – Late January, 2000
    The Central Bank of Ecuador and the private banks start exchanging the sucres in people's possession for US dollars at the fixed 25,000 sucres/dollar rate.

  – March 13, 2000
    President Noboa signs the dollarization law.

  – March - May, 2000
    All checking and savings accounts, as wells as credit cards operations are expressed in dollars.

The Conversion

+

25,000 sucres = 1 US dollar

– April - May, 2000
  Public employees start earning their salaries in dollars. Shops and stores must now show prices in dollars.

– May 13, 2000
  ATMs provide only US dollars, no longer sucres.

– June 13, 2000
  Last deadline for banks to transform all activities to US dollars.

– August, 2000
  The Central Bank of Ecuador starts circulating the new 1, 5, 10, 25 and 50 cents coins (coined by the Central Bank of Ecuador and backed by its International Reserves).

The New Coins

50 cents 25 cents 10 cents 5 cents 1 cent

- September 13, 2000

  This is the last day in which Ecuador citizens can exchange their sucres for dollars.

  From that date on, no more sucres circulate in the Ecuadorian economy. Ecuador has become a fully dollarized country.

- From September 13, 2000

  All services and commodities are traded in US dollars, just like in the US.

BENEFITS AND COSTS

•Dollarization brings both benefits AND costs to the country:

•Among the BENEFITS:

– REDUCTION OF THE INFLATION RATE
(...and eventually convergence to the anchor country's rate of inflation).

Ecuador's inflation has dropped from 96% in 2000 and an average of 25-30% in the last 20 years, to 19% in 2001, and then to a projected one-digit inflation from 2002 on (6% in 2003, 3-4% expected in 2004).

– ELIMINATES POSSIBILITIES OF A CURRENCY CRISIS

No domestic currency, no crisis!

– REDUCTION OF THE NOMINAL INTEREST RATE

$$i_{ECU} \approx i_{US} + \text{country risk} + \text{expect. depreciation}$$

Since expectations of devaluation disappear.

– ELIMINATES TRANSACTION COSTS OF EXCHANGING ONE CURRENCY INTO ANOTHER

Especially important in an unofficially dollarized country and good for the exporting/importing sector.

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Taxes Debt Printing Money

The government can no longer print money to finance its deficits.

– PROVIDES LONGER HORIZONS FOR INVESTORS

The country is more “stable” in a sense.

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- Among the <u>COSTS</u>:

  - LOSS OF MONETARY INDEPENDENCE

    As an instrument to manipulate external shocks.

    ⟹ Is this really a cost?

  - LOSS OF SEIGNIORAGE

    (Seigniorage: the revenues that the government makes by printing money).

    ⟹ For Ecuador, around 7% of GDP!

    The dollarization decision was taken UNILATERALLY by Ecuador, and there are no signals of seigniorage revenue sharing from the US government.