

Dollarization in Ecuador

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Spring, 2008

My name is Miguel F. Ricaurte,
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And I studied in

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Content of the Presentation:

- Ecuador: some facts
- Exchange rates and *dollarization*
- Ecuador's crisis
- Costs and benefits: real vs. nominal economy
- Concluding comments

Ecuador: some facts

	Ecuador	USA
GDP (PPP 2006 est.)	\$61.52 billion	\$13,060 Billion
Population (Jul. 2006)	13,755,680	301,139,947
GDP Per Capita (PPP 2006 est.)	\$4,500	\$43,800
	283,560	
Size (sq km)	<i>incl. Galapagos Is.</i> (Minnesota: 206,000)	9,631,420
Currency	Before 2000: Sucre After 2000: US Dollar	US Dollar

Source: CIA World Fact Book, <https://www.cia.gov/library/publications/the-world-factbook/>

Ecuador: some facts

	Ecuador	USA
Main Exports	Crude Oil Bananas Shrimp, Fish Coffee Flowers	Capital goods Automobiles Industrial supplies Consumer goods Agricultural products
Main Imports	Machinery Equipment Fuels Consumer goods	Crude oil Refined petroleum Machinery Automobiles Consumer goods
Main trade partners	US 51.2%, Peru 8.1%, Colombia 4.4% Chile 4.1%	Canada 22.2%, Mexico 12.9%, Japan 5.8%, China 5.8%, UK 4.4%

Source: CIA World Fact Book, <https://www.cia.gov/library/publications/the-world-factbook/>

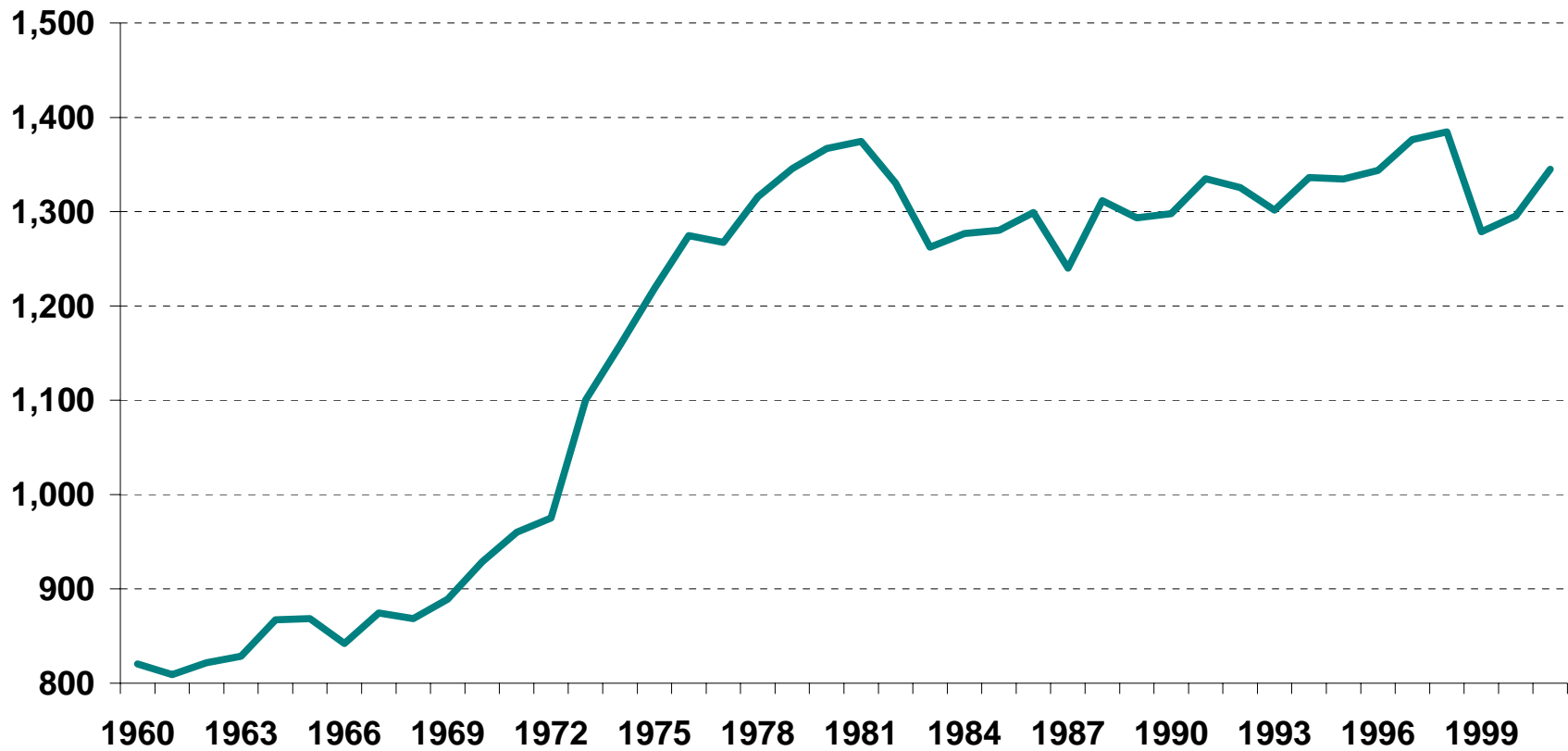
Ecuador: some facts

One of the poorest countries in S. America:

GDP per capita PPP US\$ (2006)	
Argentina	15,200
Chile	12,600
Uruguay	10,900
Brazil	8,800
Colombia	8,600
Venezuela	7,200
Ecuador	4,500
Bolivia	3,100

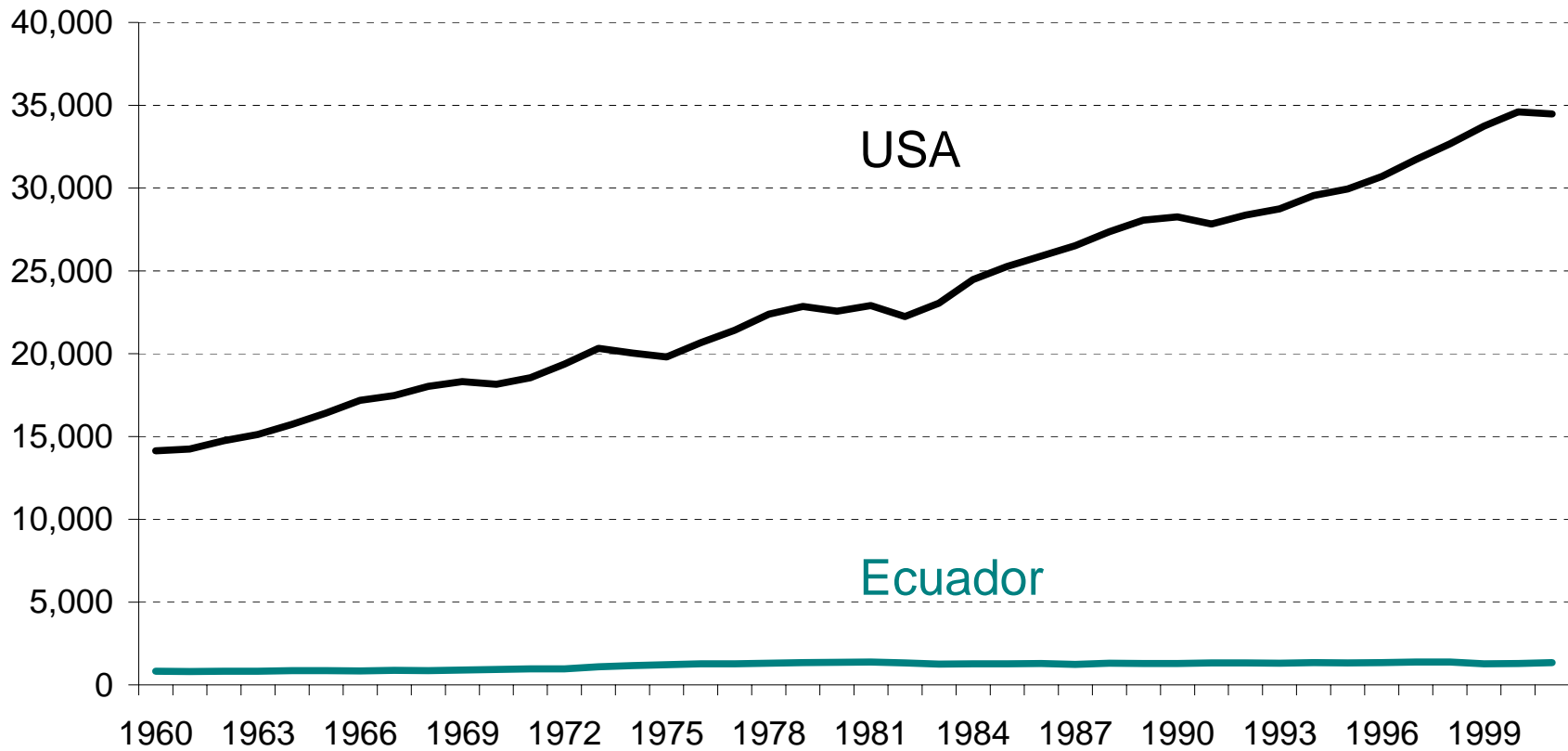
It has experienced slow growth in the last two decades:

GDP per capita, constant 2000 US\$



and it has been lagging compared to the US:

GDP per capita, constant 2000 US\$



Exchange Rates and *dollarization*

Exchange rates and *dollarization*

Flexible

Floating

No
intervention

US



Dirty
floatation

Some
intervention

Costa Rica

Fixed

Pegged to
another
currency

Venezuela,
China, EU

Inflexible

Dollarized

No local
currency!

Ecuador,
El Salvador

Exchange rates and *dollarization*:

- ***Unofficial Dollarization*** (*de facto* dollarization) refers to the case when a large number of agents keep a significant fraction of their financial wealth in foreign currency, although this currency is not the legal tender.
- ***Official Dollarization*** refers to the case when a country's monetary authority renounces to its own currency and adopts a foreign currency (in particular, the dollar) to use it as legal tender

The Crisis

The Crisis

Ecuador suffered a severe shock in 1998-1999:

- *El Niño* weather phenomenon affected agricultural sector

The Crisis

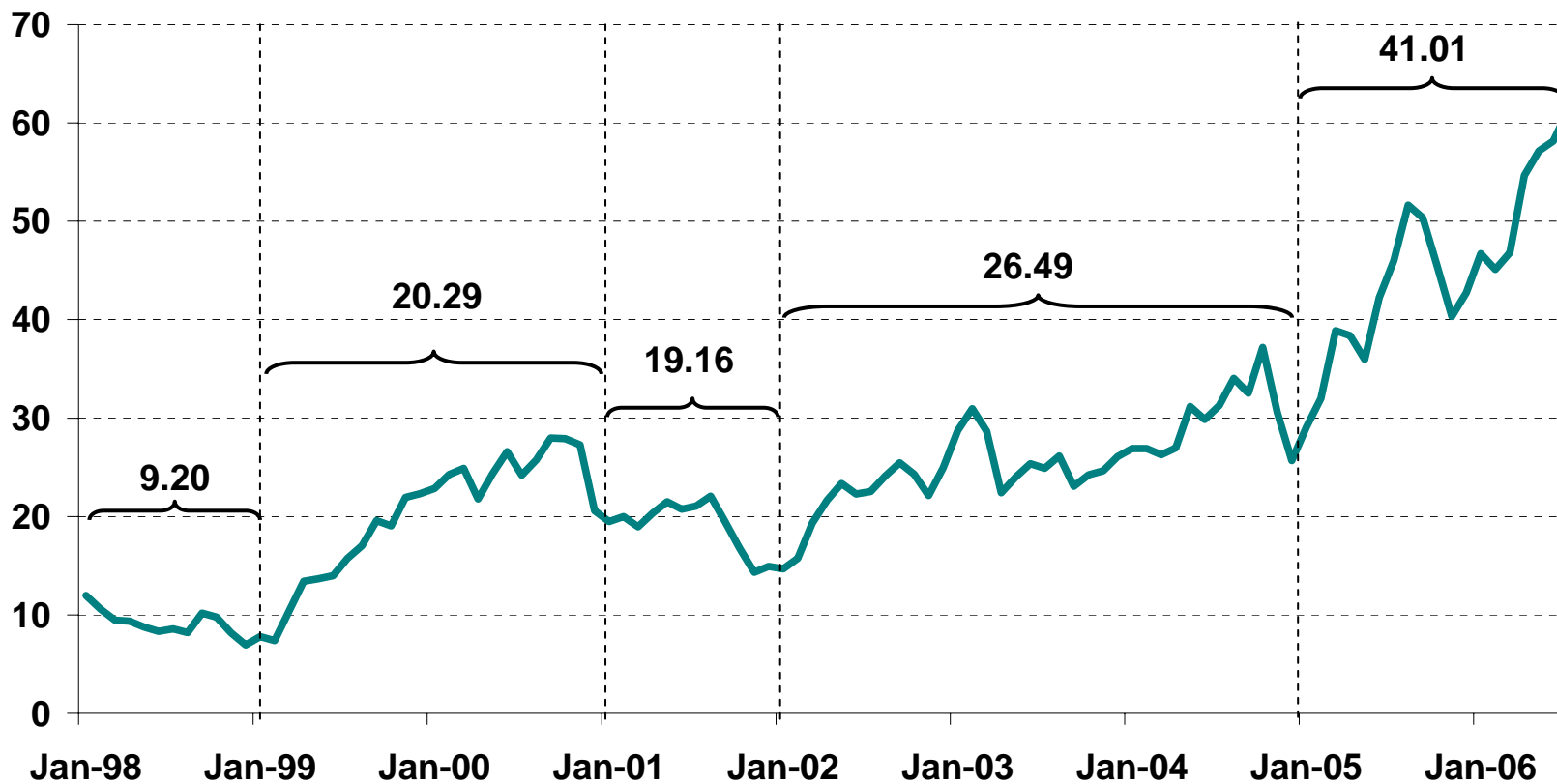
Ecuador suffered a severe shock in 1998-1999:

- *El Niño* weather phenomenon affected agricultural sector
- Oil price historically low, affected government's budget:

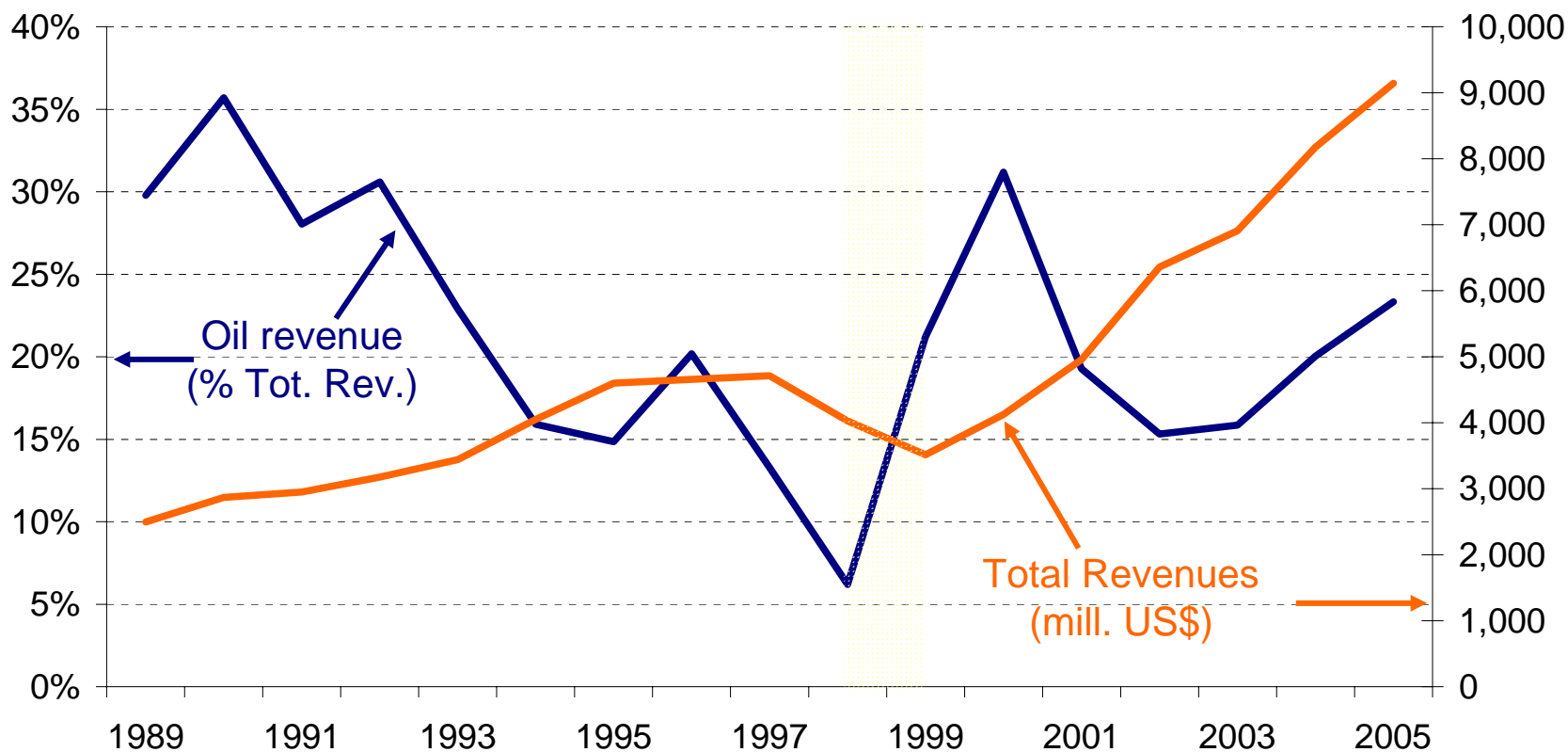
In 1998, the government's budget forecasted oil price to be at \$14 per barrel, but . . .

Historically low oil prices were observed in 1998 . . .

(effective prices for Ecuador)

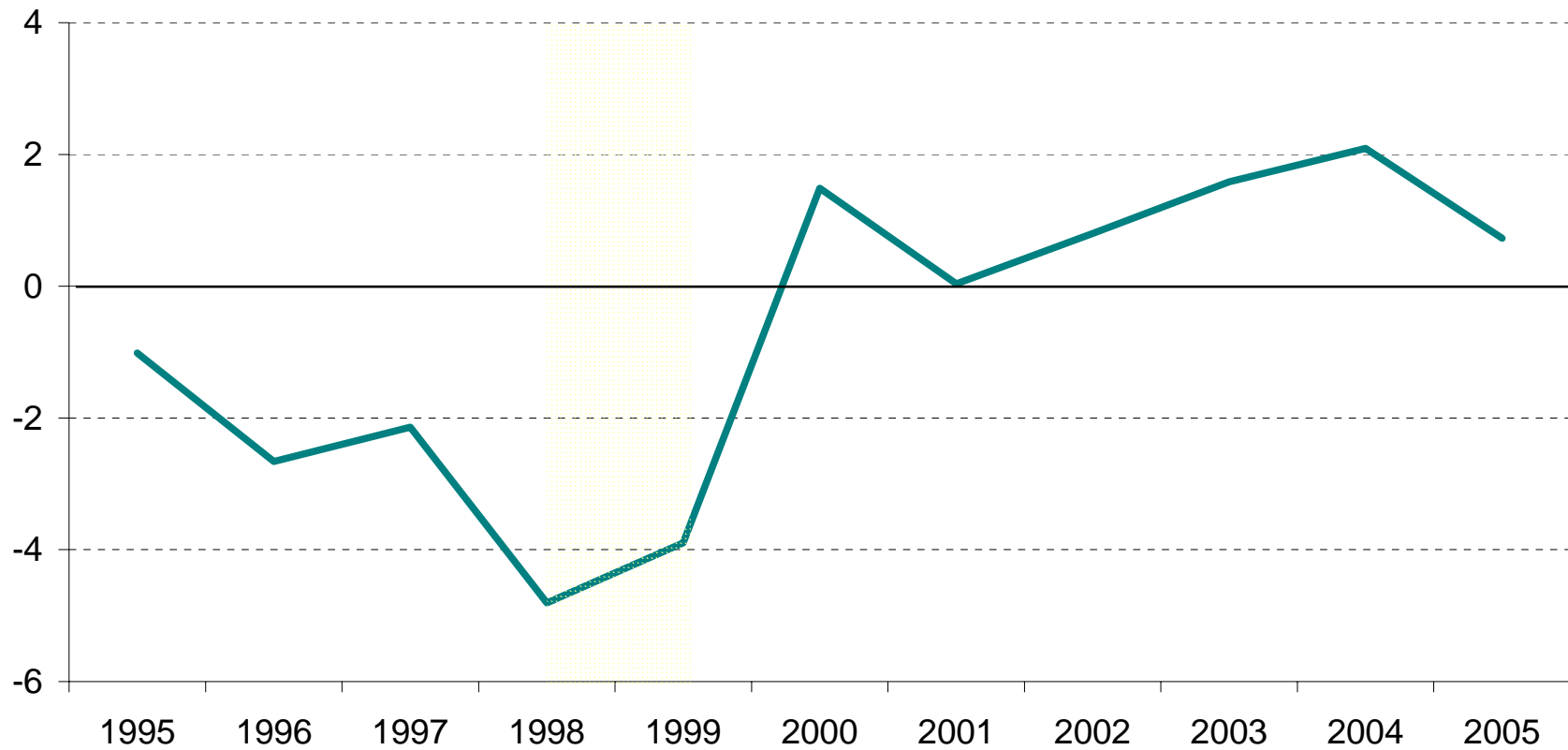


**. . . total government revenues dipped in 98-99
as well as oil revenues as a % of total revenues . . .**



... and the budget deficit was the largest in a decade

(government budget as a % of GDP)



The Crisis

Ecuador suffered a severe shock in 1998-1999:

- *El Niño* weather phenomenon affected agricultural sector
- Oil price historically low, affected government's budget
- Financial crisis in Latin America (triggered in SE Asia) decreased loanable funds available to the government and private banks

The Crisis

- More than 20 - half - of the banks went bankrupt
- The government took over them, making its situation even harder

The result:

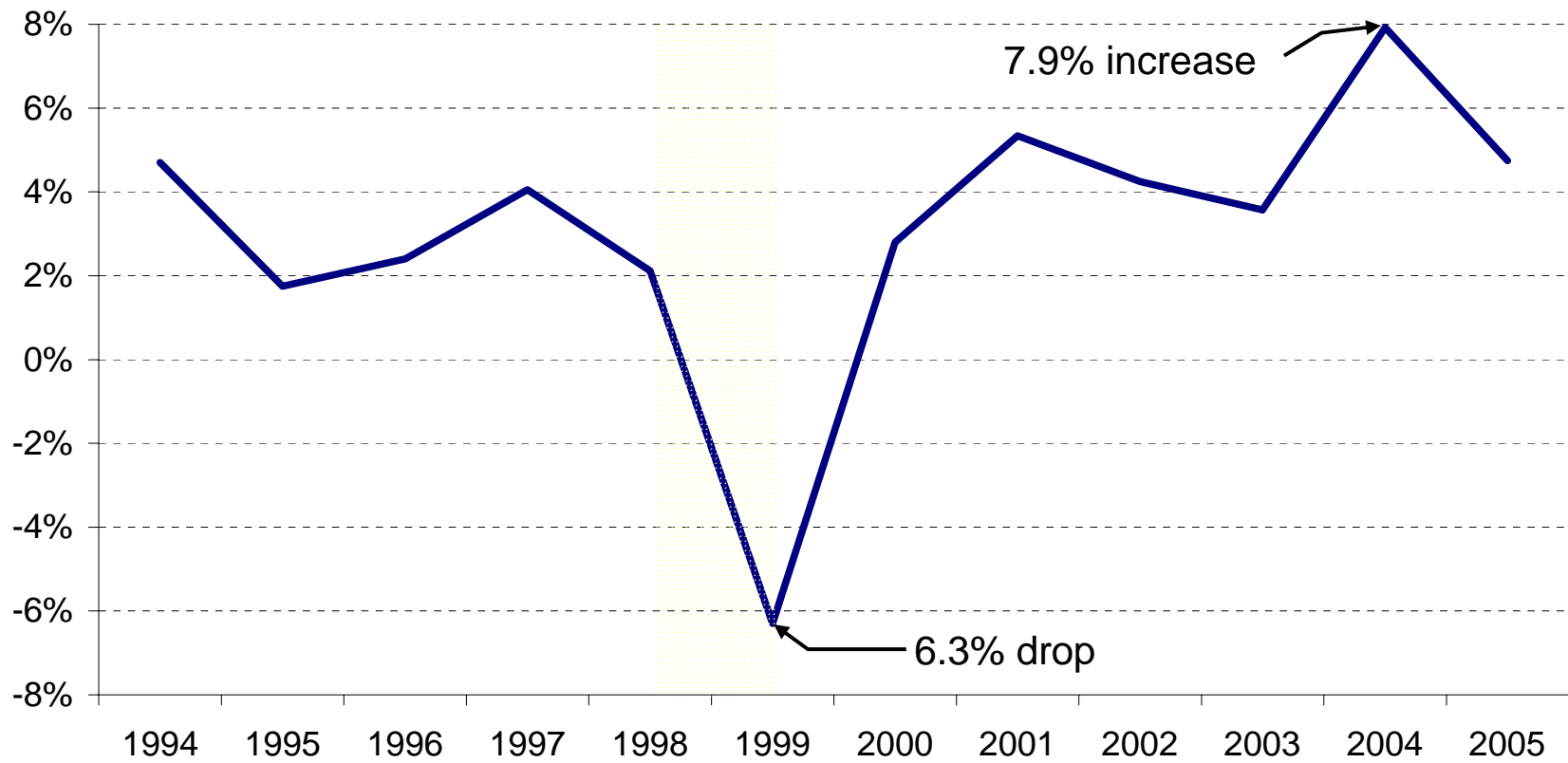
- The worst economic crisis in Ecuador's history

Real consequences

- Real GDP per capita fell 7.65% between 1998 and 1999 (from \$1384 to \$1279 in 1999 in 2000 US Dollars), and
- Real GDP fell by 6.3%

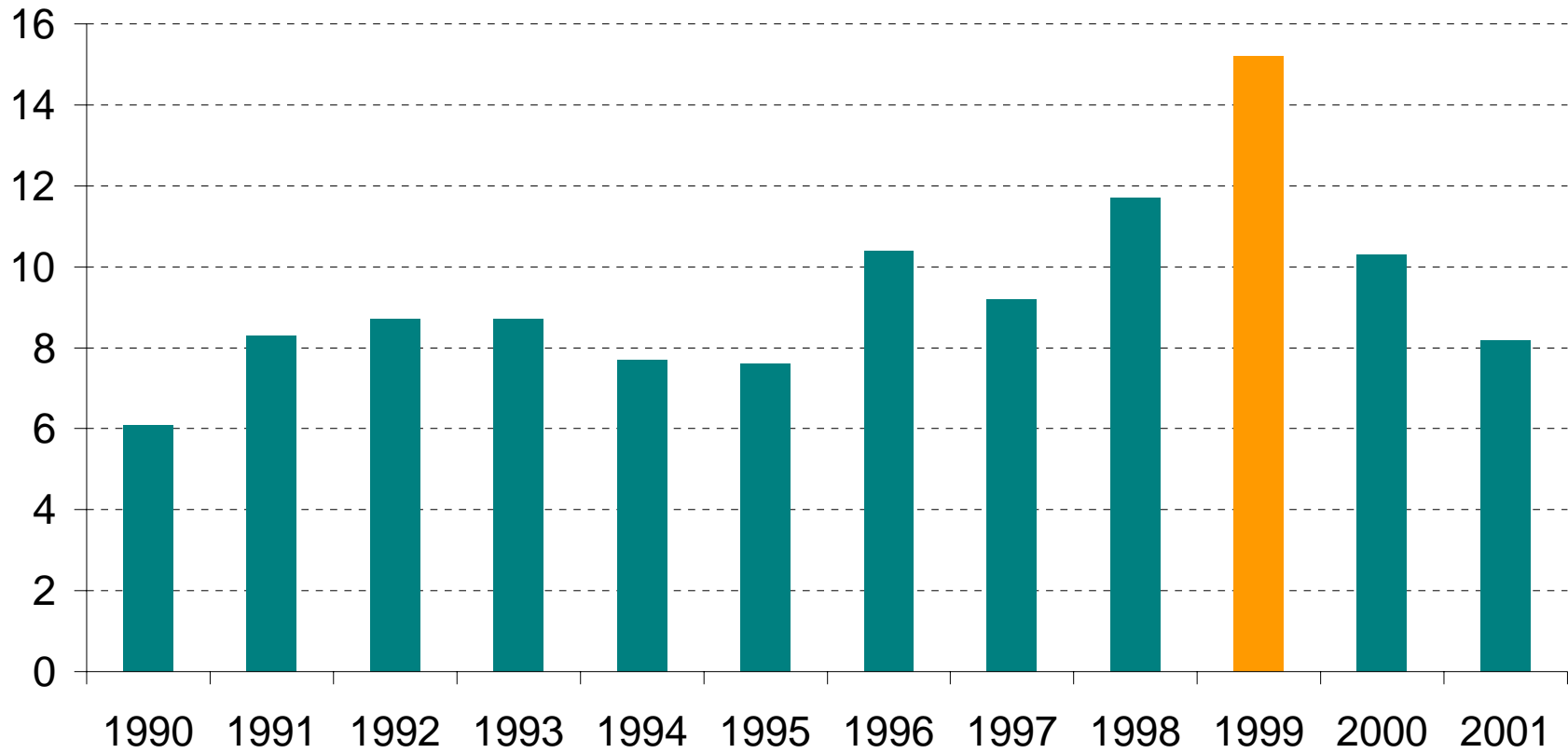
Real GDP Growth

(Minimum reached in 1998)



Employment

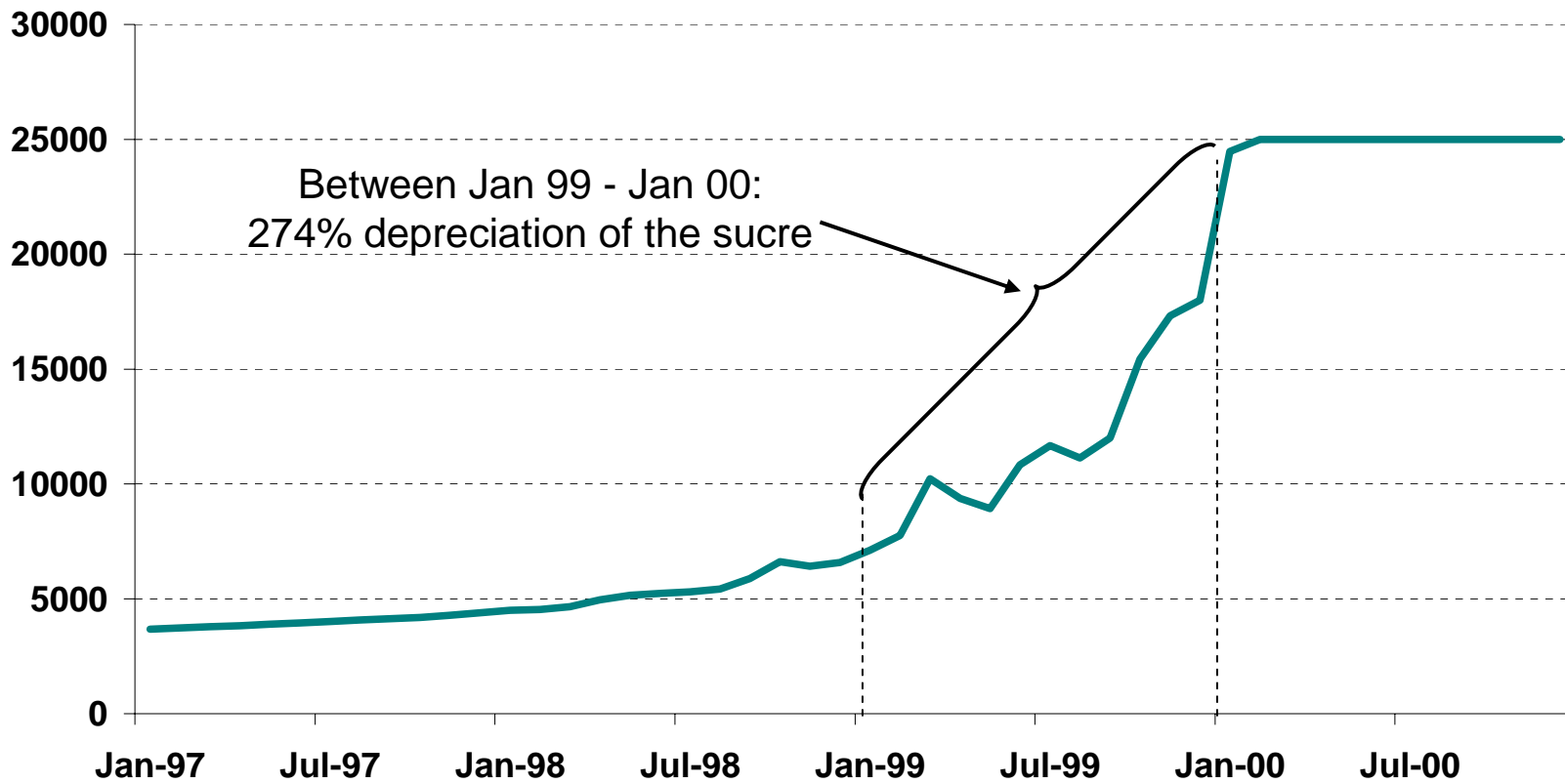
The magnitude of the crisis resulted in an increase unemployment rate:



Nominal consequences

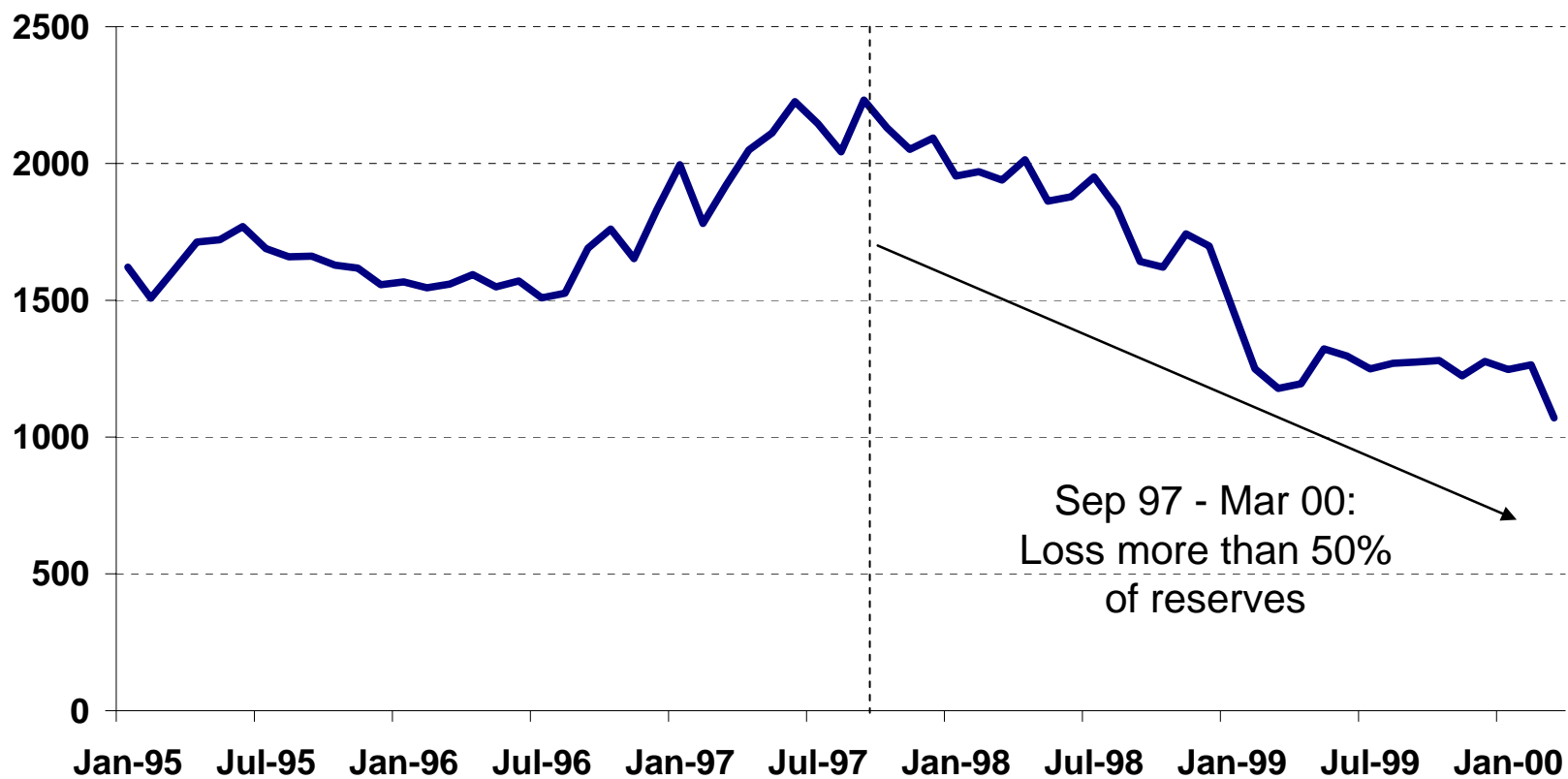
People didn't trust the Sucre and this caused depreciation

(Suces per US\$)

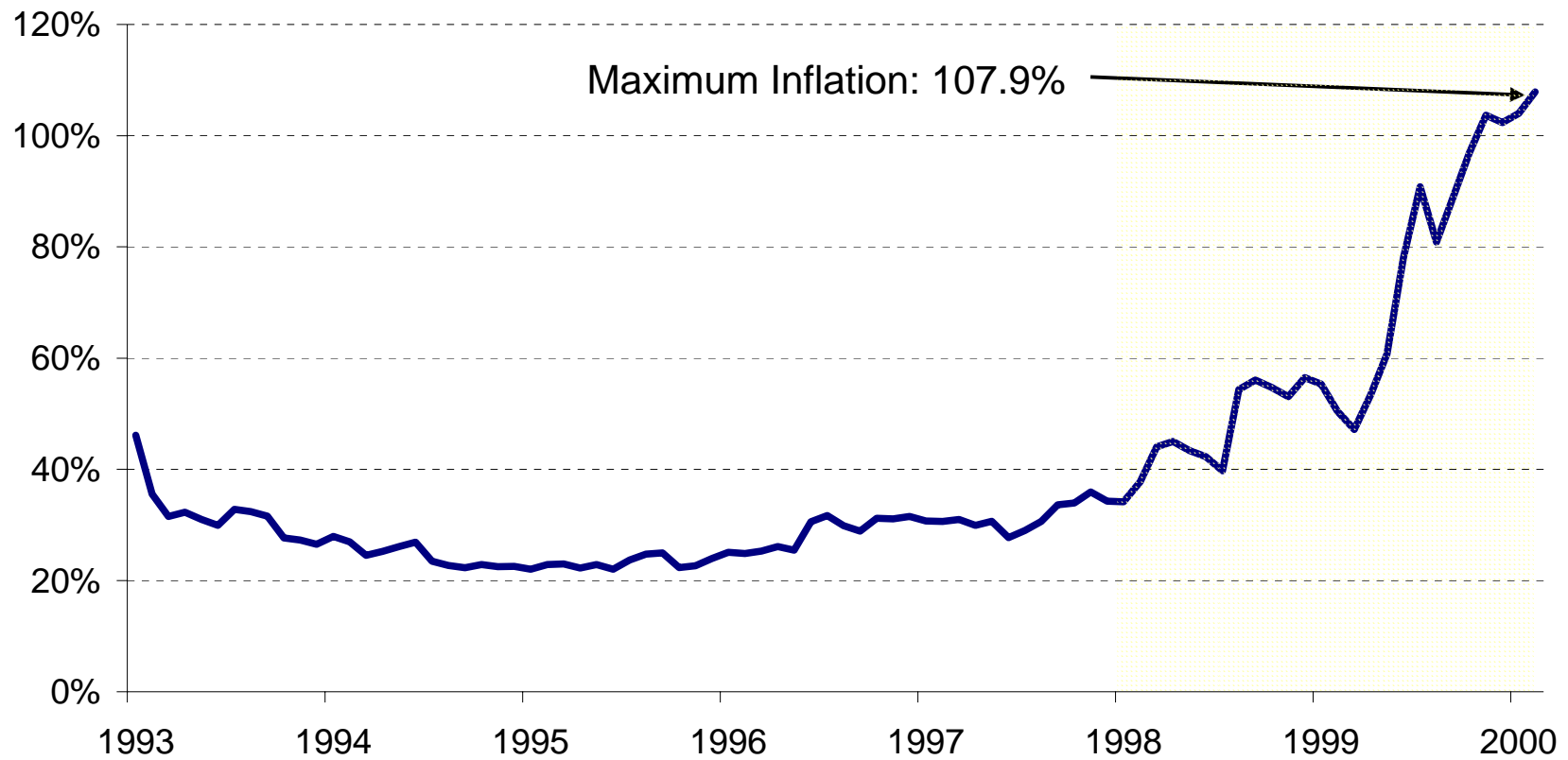


The resulting financial crisis caused affected foreign reserves

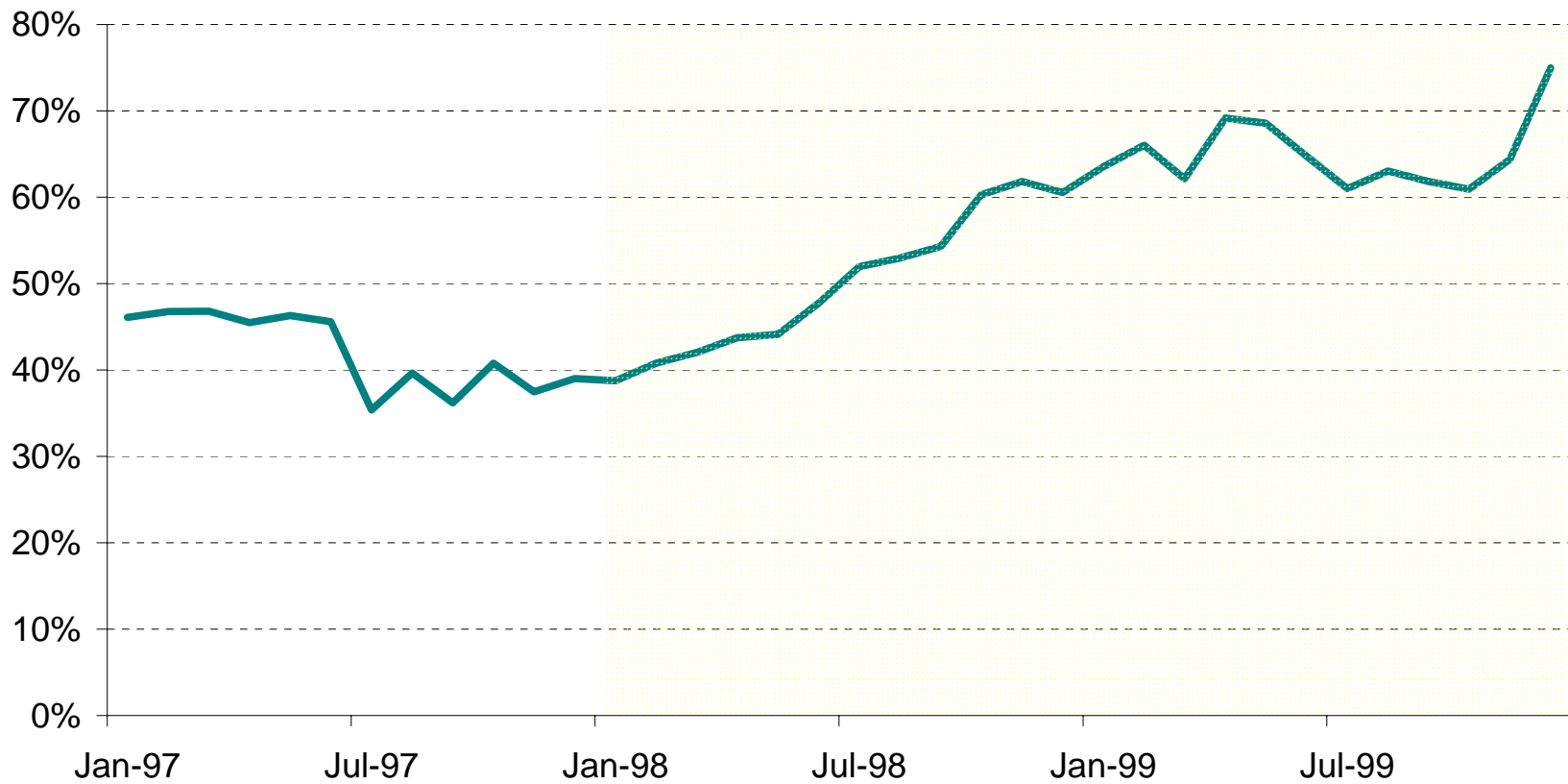
(International Foreign Reserves, Mill. US\$)



. . . with increasing import prices, inflation jumped . . .
(12-month change in the CPI)



. . . so the Central Bank increased nominal interest rates:
(Nominal Interest Rate)



An Unofficially Dollarized Economy

By the year 2000, Ecuador was **unofficially dollarized**:

- Most transactions of durable goods (*e.g.*, cars, housing) as well as rental payments and loans were denominated in US Dollars
- 40% of broad money (savings and checking deposits, as well as other liquid assets) were held in US Dollars

Dollarization

The Official Dollarization

- January 11, 2000: official dollarization applied by President Jamil Mahuad
- The exchange rate fixed at 25,000 Sucres per Dollar
- January 21, 2000 : Mahuad deposed, Vice-president, Noboa, ratified his predecessor's decision
- Central Bank began to exchange Dollars for Sucres
- March - May 2000: savings and checking deposits were converted to Dollars
- September 2000: transactions conducted in Dollars

The defunct Sucre



The defunct Sucre



Gave way to the dollar



Costs and benefits

Why *dollarize*?

- **Decrease inflation**, imported goods do not become more expensive in local currency;

which in turn causes reduction of nominal rate:

$$i_{\text{nom}} = i_{\text{real}} + \text{expected inflation}$$

- **No chance of currency a crisis** (no depreciation), which in turn causes decrease of local nominal rate:

$$i_{\text{ECU}} = i_{\text{US}} + \text{country risk} + \text{expected depreciation}$$

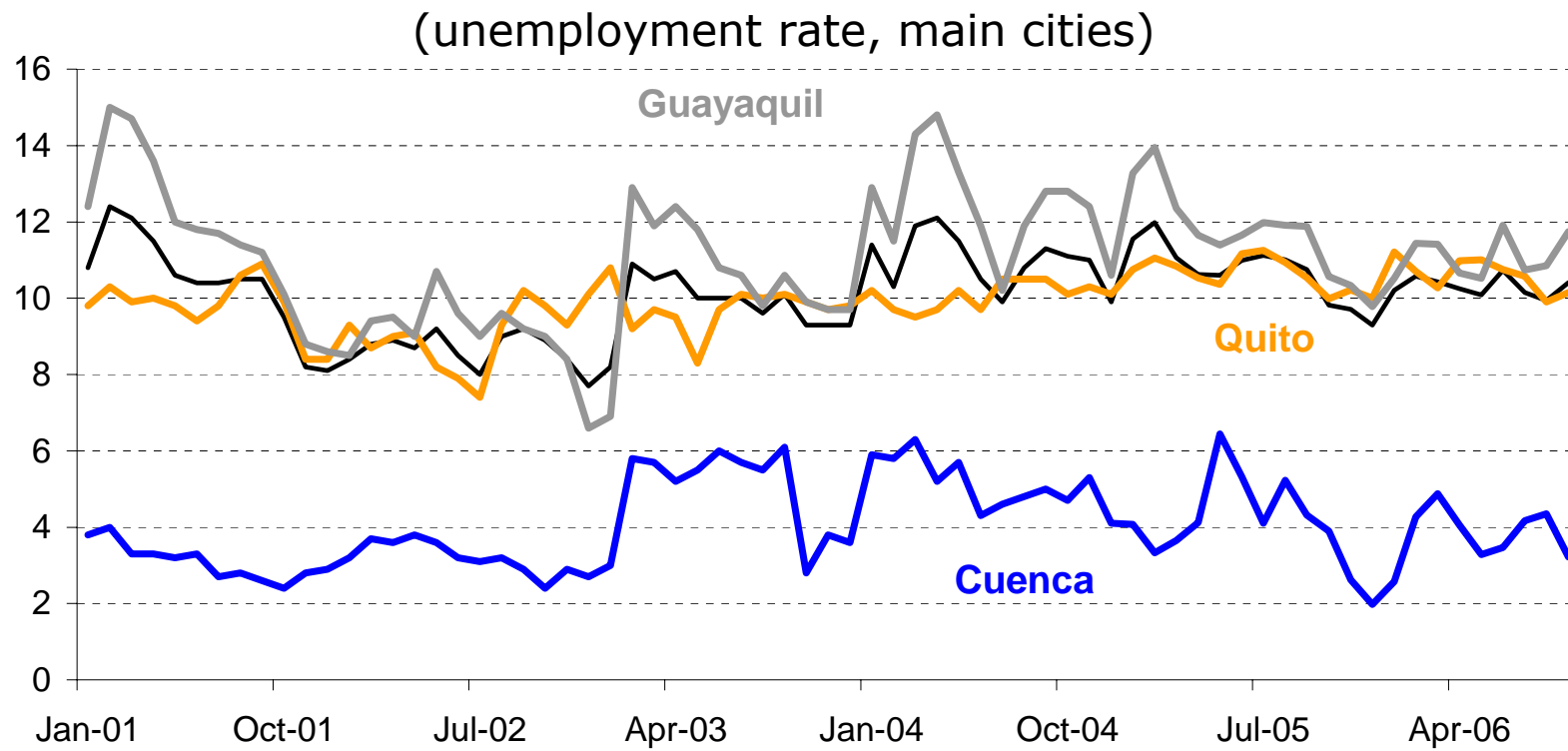
- **Promotes fiscal discipline** (since printing money cannot be used to finance deficit anymore!)

Why not *dollarize*?

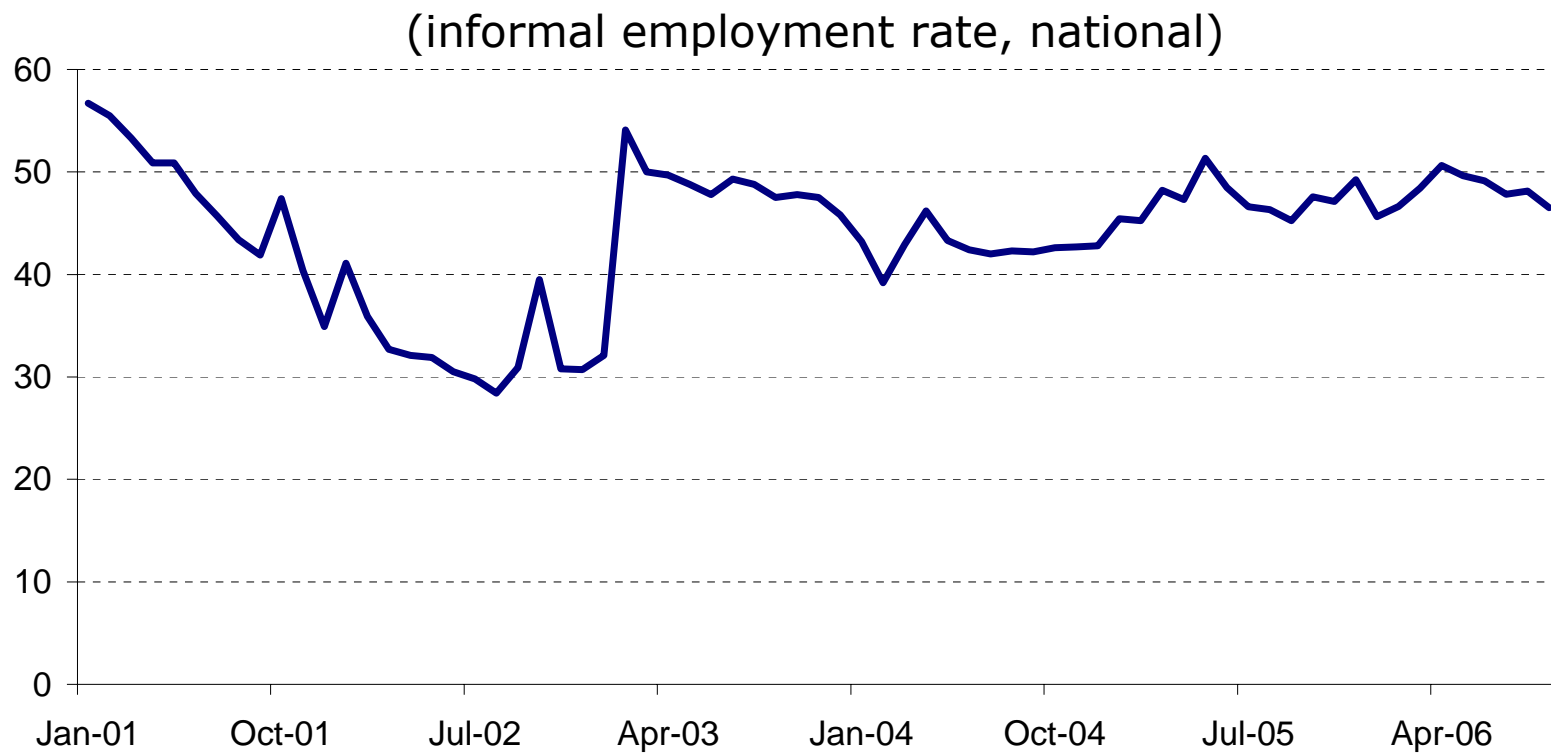
- **Loss of monetary independence** - not a cost when monetary authorities are not responsible -
- **Loss of Seigniorage** (for Ecuador: around 7% GDP)
- **Central Bank cannot be lender of last resort** - no money printing minimizes this possibility
- Cost of **re-setting accounting systems** to Dollars
- **National pride**: can be a big thing. For example, England does not want to give away the Pound in exchange for the Euro

Why not *dollarize*?

- Additional real flexibility needed, labor market.

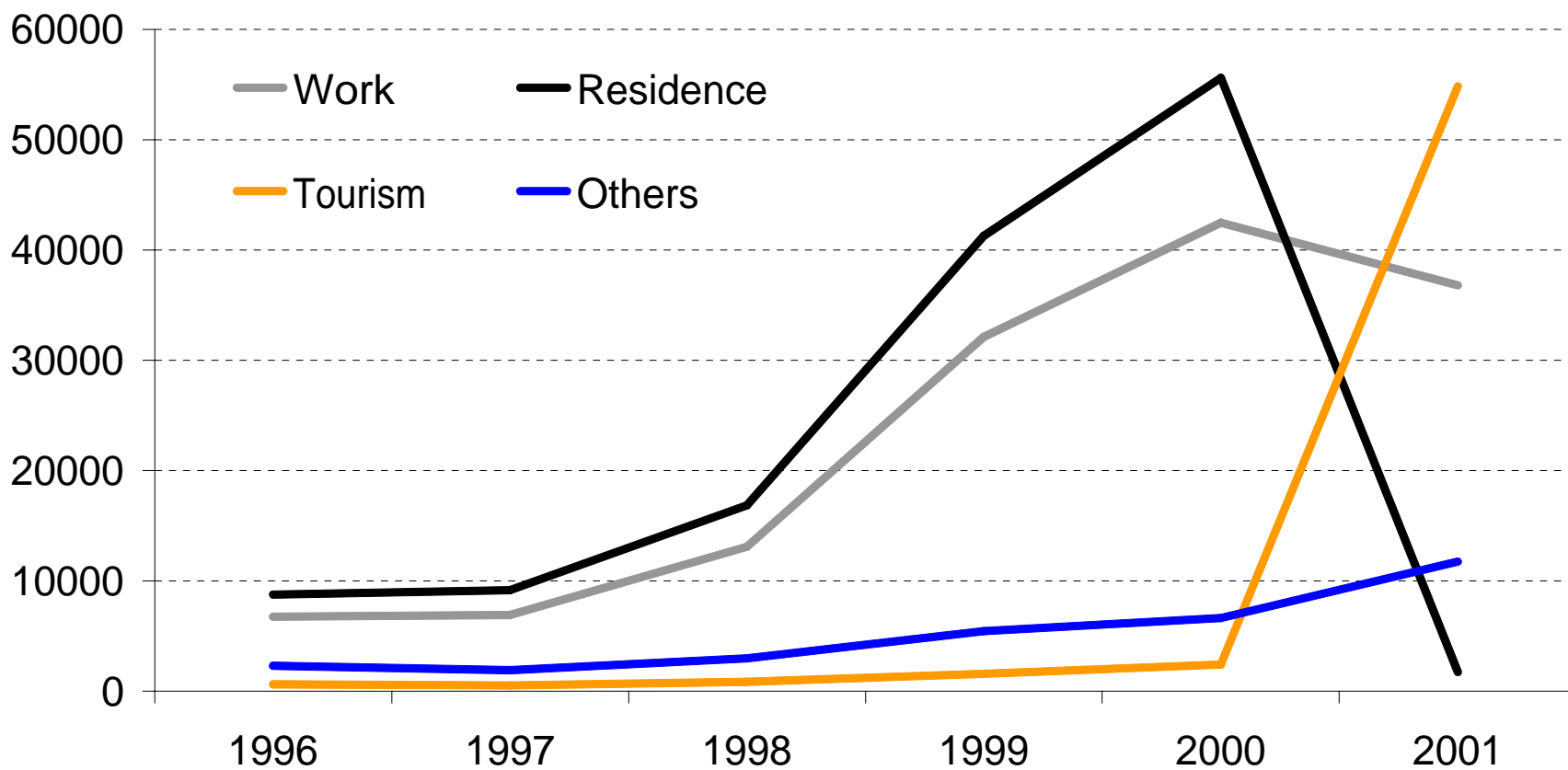


**. . . unemployment seemed to go down,
but informal employment jumped!**



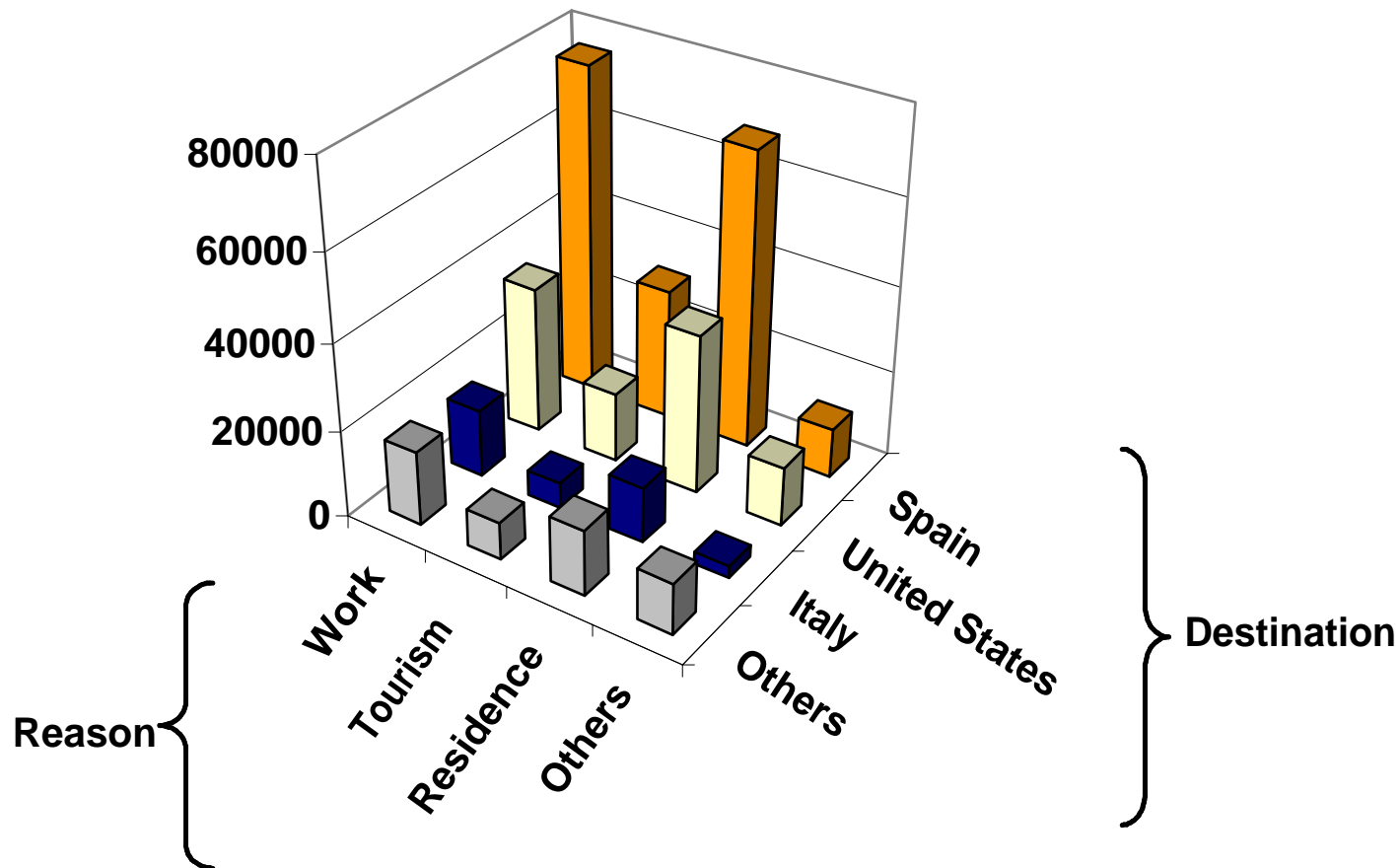
. . . as well as the exodus of migration . . .

(number of migrans 1996 - 2001)



. . . as well as the exodus of migration . . .

(total number of migrants 1996 - 2001)



As a product of the crisis:

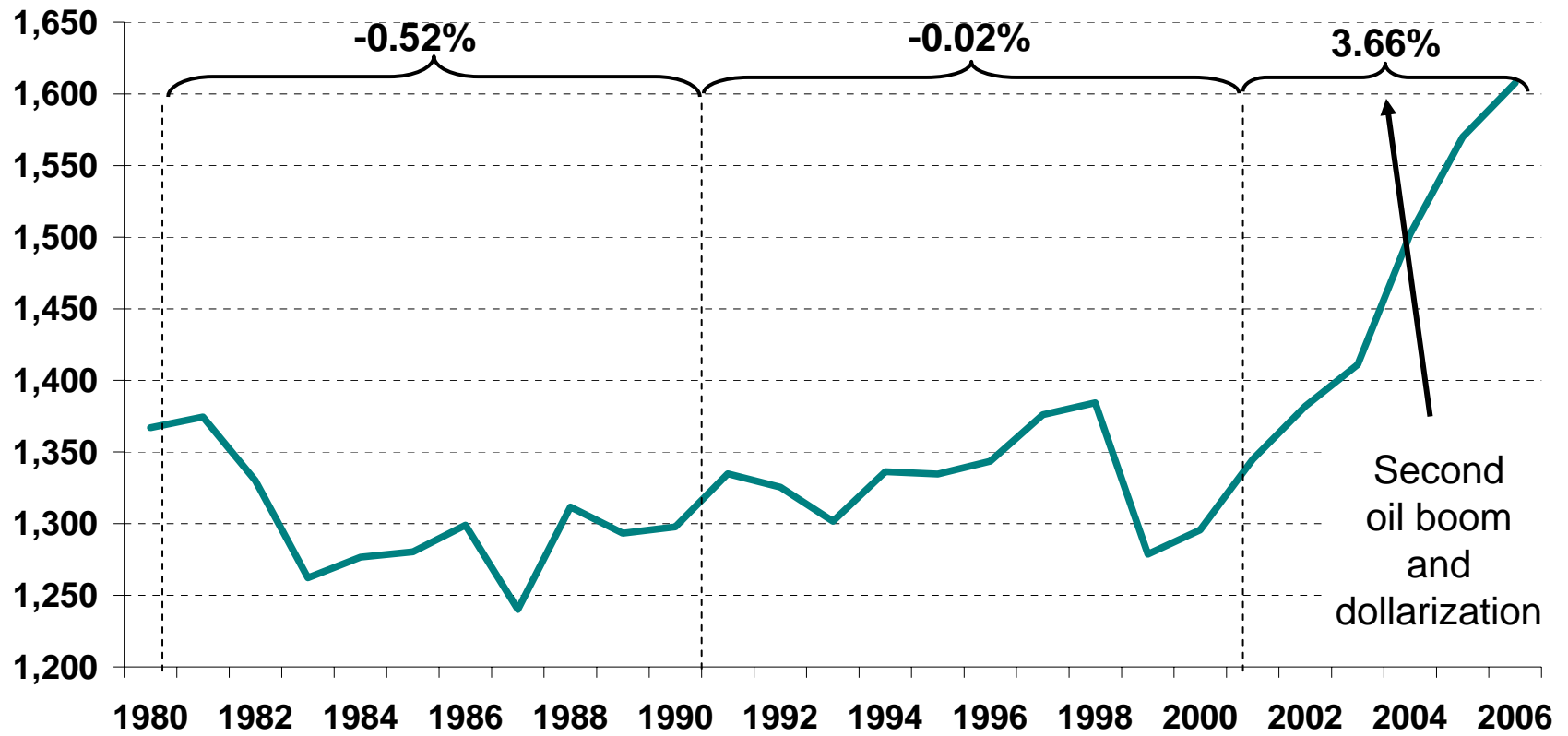
- **350,000** Ecuadorians migrated between 1996 and 2001. Unofficial figures set at 2 million the number of Ecuadorians abroad!
- That is: roughly **3%** of Ecuadorians left the country.
- (if 3% of US citizens left the US, that would mean that 8 million people would leave the country!)
- Migration slowed down in 2002 when Spain enforced a tourist visa for Ecuadorian citizens and the US less lenient in granting visas.

The recovery process

Since then, the economy is now (slowly)
recovering:

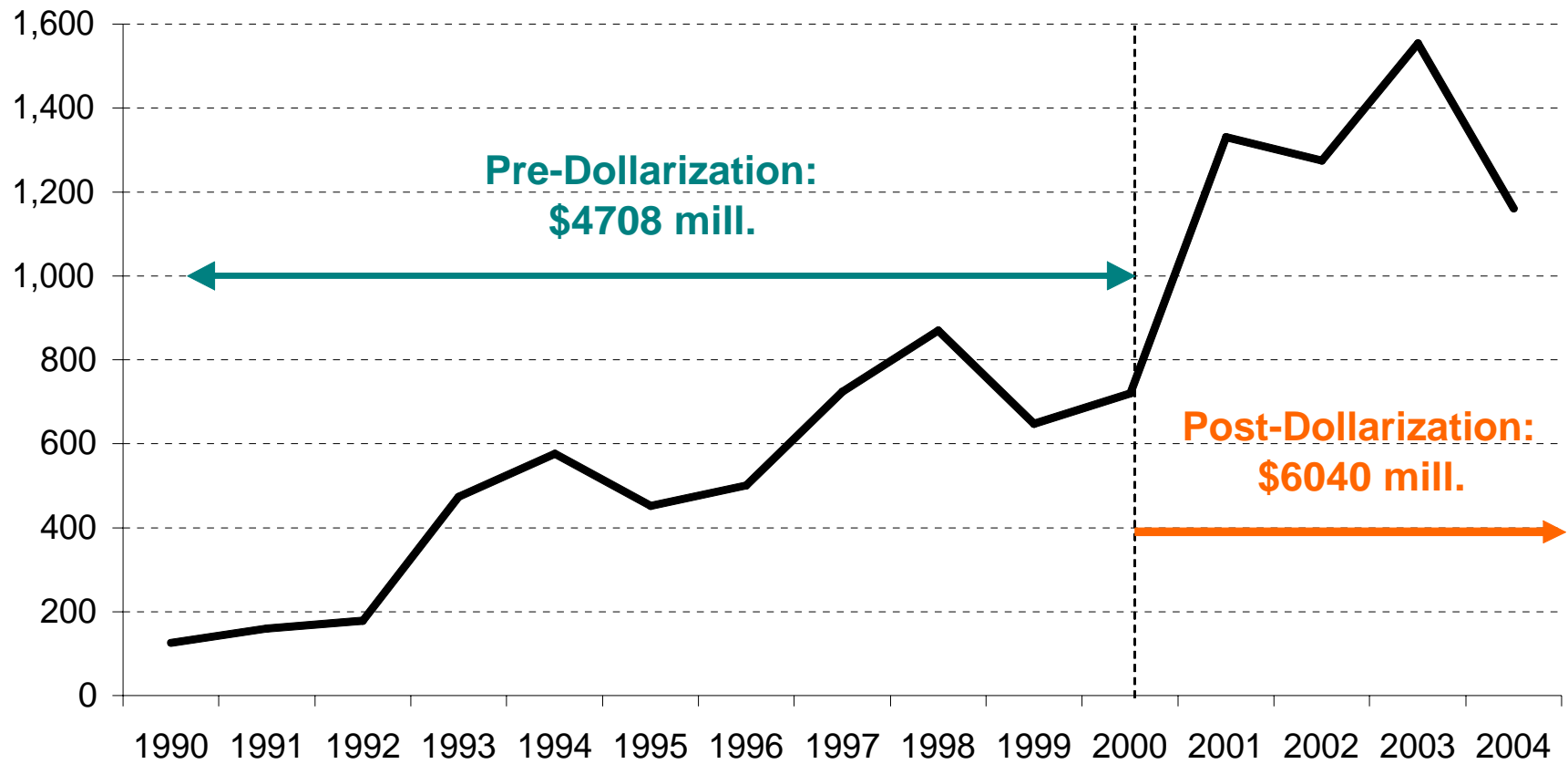
The economy has recovered

(GDP per capita US\$, and average growth rate)

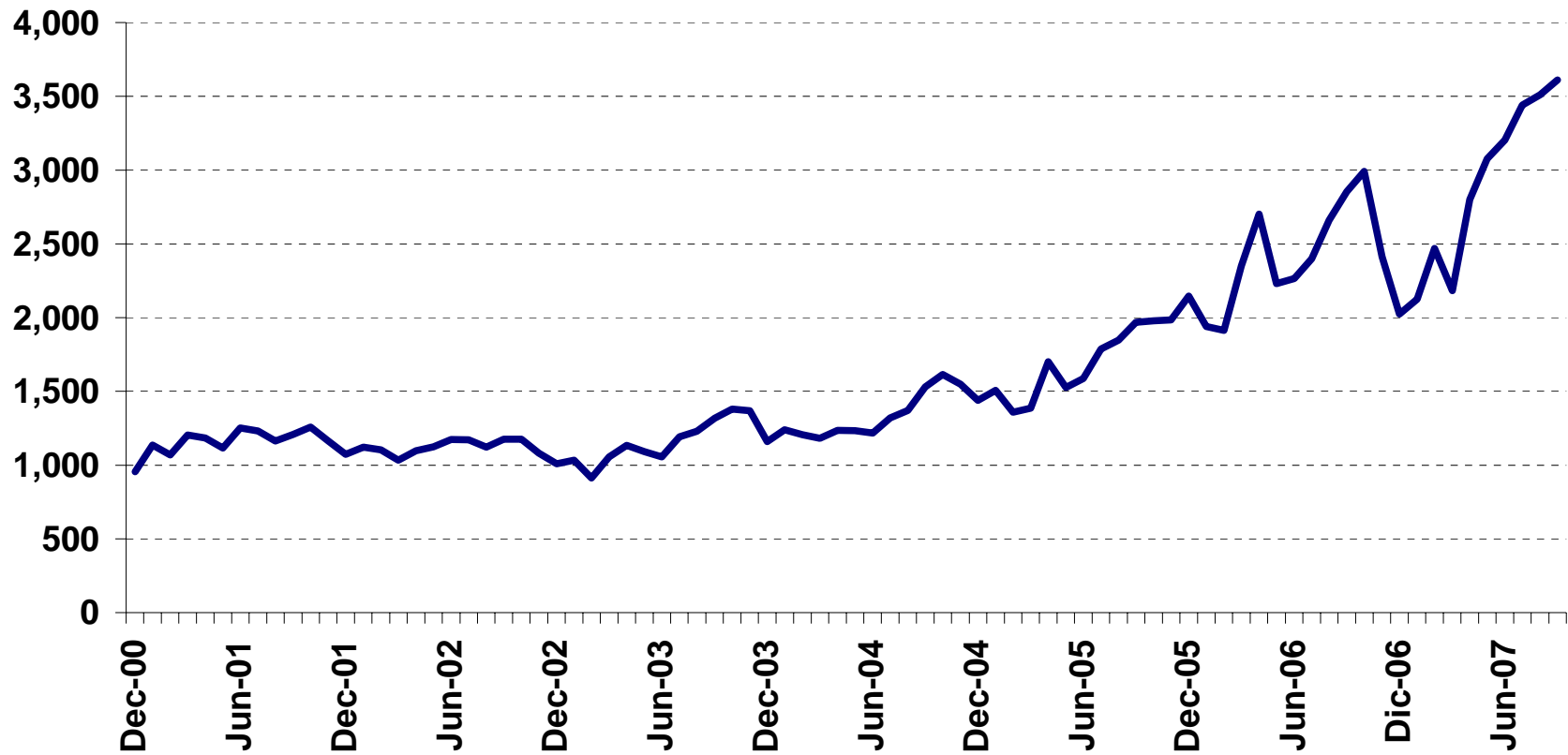


. . . partially fueled by the inflow of fresh resources: FDI and other transfers (more on this later) . . .

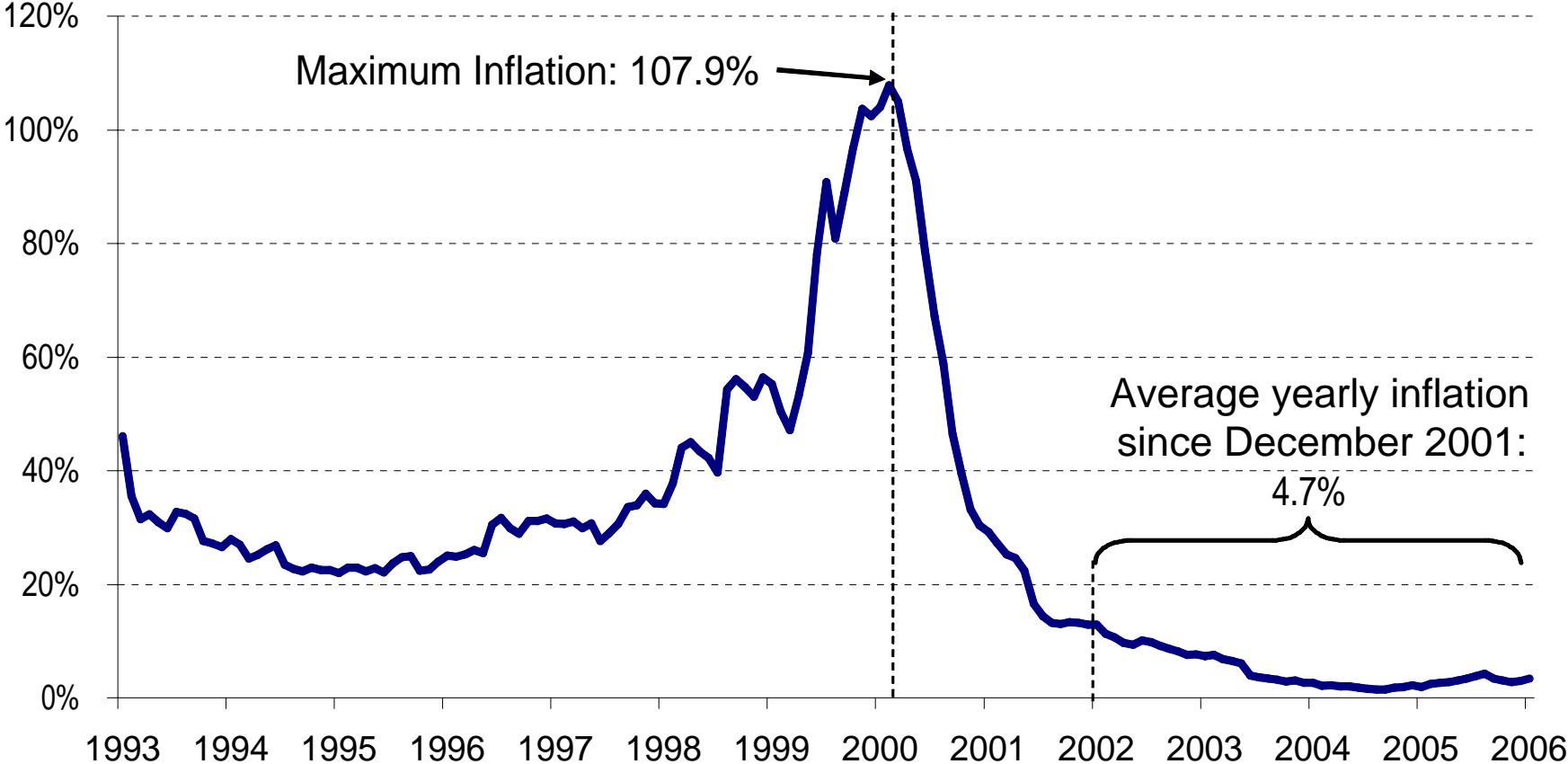
(FDI, millions of US\$)



. . . which have strengthened foreign reserves
(AIFR, millions of US\$)

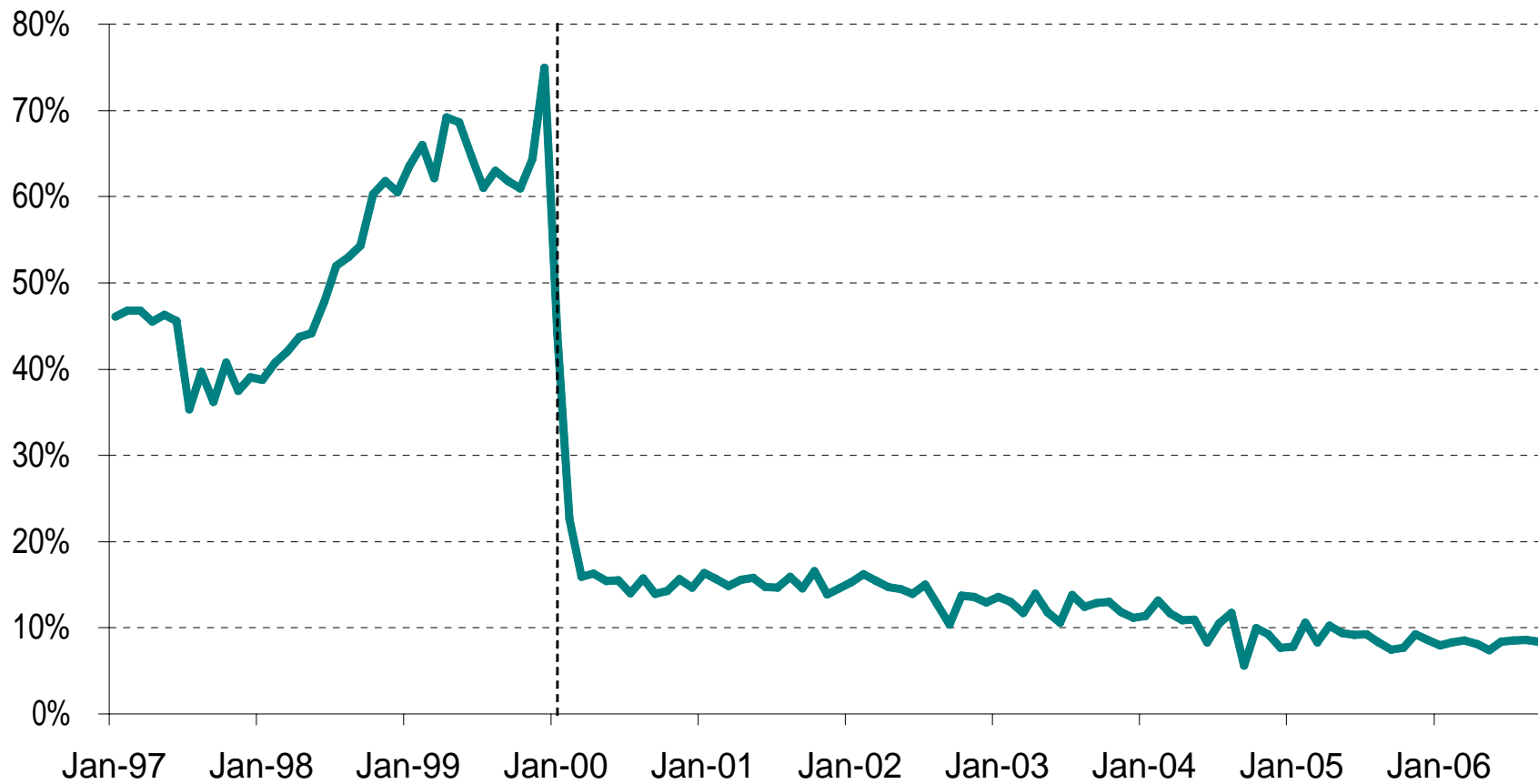


Inflation dropped within a few years . . .
(12-month change CPI)



Nominal interest rates have also dropped . . .

(Nominal Interest Rate)



Since then, the economy is now (slowly) recovering:

- Major changes in the labor laws were introduced in 2000 to make the market more flexible, but
- Unemployment and informal employment remain relatively high:
 - unemployment rate: 10 and 12%
 - informal employment: 50%
- Few migrants have returned to Ecuador

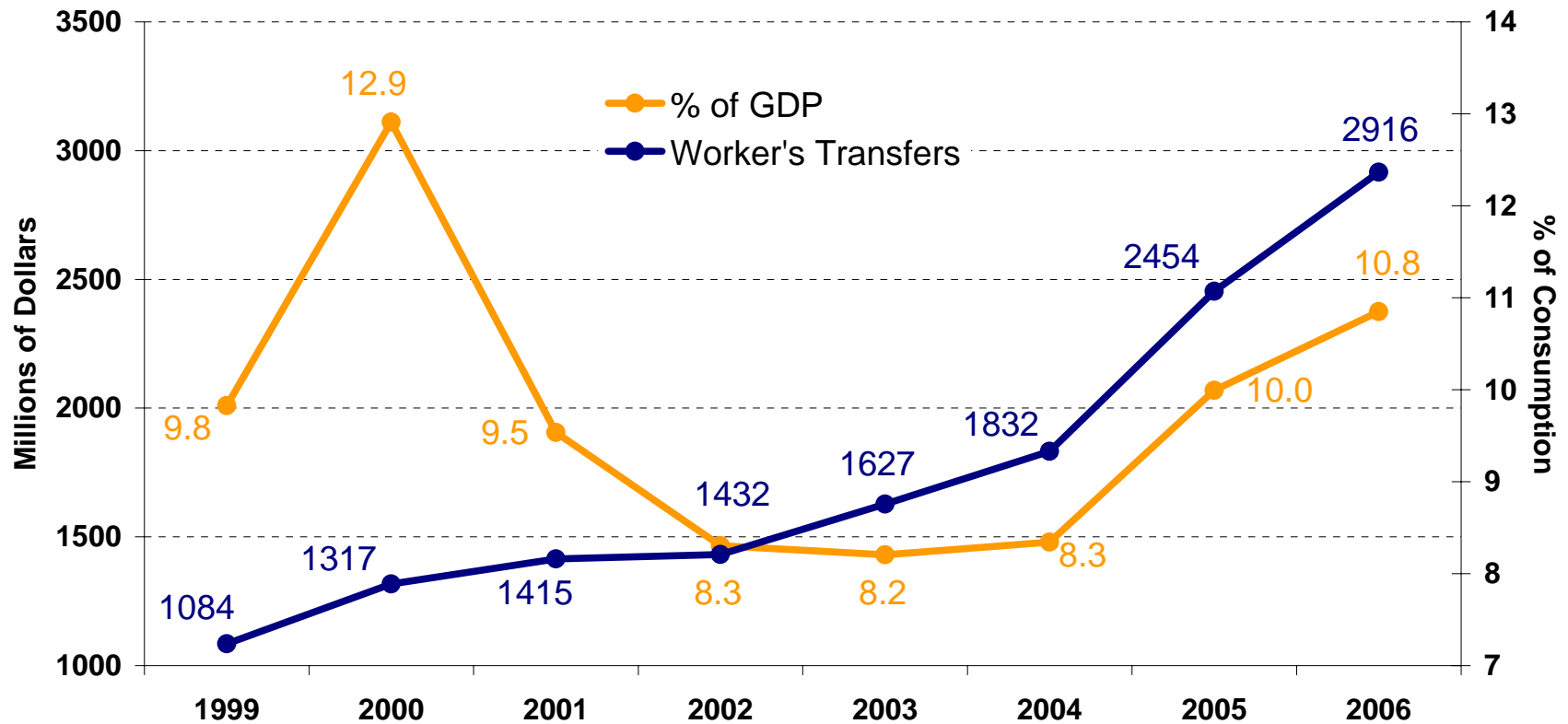
Why did Ecuadorians migrate?

The real market is inflexible!

- There were no private or public safety nets
 - unemployment insurance
 - private insurance schemes (*e.g.*, family savings)
- Ecuadorians who could not find jobs sought ways to make money abroad
- The impact of migrant workers is huge: transfers to Ecuador accounted for more than 8% of Ecuador's private consumption in the last five years.

Workers remittances (transfers) have been very large

(Millions of US\$ and % of household consumption)



What to do next?

- Ecuador needs to make markets more dynamic; task for both the government (laws, taxes) and the private sector (R&D, efficient management)
- Guarantee inflow of dollars (through exports and foreign investment), no other way to "print" money
- Ensure there is political stability

