

INTRODUCTION

Although a great deal has been written about the illicit drug trade in general, very little attention has been given to considering the future of the industry. To date, Ecuador's role in the illicit drug industry has been minor compared to that of its neighbors, specifically Colombia, Peru and Bolivia. There are several possible historical reasons for this, including that it was possible to eliminate it on religious grounds due to the strength of the Catholic Church in Quito (Thoumi 2003, 31; 33), that "...crops for ritual and traditional use ...were eradicated in the 16th century ... due to reasons of a structural nature related to the organization in the production in the colony" (Bonilla 1995, 270) or perhaps due to the relatively limited role of the mining industry during the colonial era, an industry whose harsh conditions led to increased coca chewing in Bolivia and Peru. These factors help explain why Ecuador has not been one of the principle players, in spite of its location at the heart of the Andean drug industry. Is it reasonable, however, to assume that Ecuador will continue to play such a minor role in the future?

The theory of the balloon effect has been used to predict that activities will relocate when pressure is put on their current location, but there seems to be little effort made to predict *where* the industry will reappear. The purpose of his paper is to demonstrate that conditions in Colombia and Ecuador now make it highly likely that many activities currently based in Colombia will be transferred to Ecuador and that Ecuadorians will likely become more actively involved in the industry. It will focus first on conditions pressuring participants to leave Colombia, such as improved law enforcement capability, judicial reform, fumigation campaigns and the activities of

Colombian guerillas and other armed groups. Next it will examine conditions in neighboring Ecuador that may attract participants from Colombia or that may increase participation of Ecuadorians in different aspects of the industry. The factors to be examined are: the weakness of Ecuador's institutions, the country's dire economic conditions, its weak financial system and some potential consequences of dollarization. This paper examines these issues from an international political economy perspective. The methodology used includes a review of academic literature on the subjects of the illicit drug trade and the drug war, data provided by Ecuadorian and United States government agencies, non-governmental organizations (NGOs), and multilateral lending institutions, several media sources and interviews with representatives from the Ecuadorian Embassy in Washington D.C., the Consejo Nacional para Sustancias Estupefacientes y Psicotr3picos (CONSEP), the International Monetary Fund, and the Ecuadorian National Police.

The goal of this research is to evaluate the potential risks the current circumstances create for Ecuador, keeping in mind that the illicit drug industry is a business and that industry leaders' decisions and strategies are based on criteria similar to what a multinational corporation would consider. Decisions made by players lower on the hierarchy, such as small-scale coca cultivators or the human mules who transport the drugs in their own bodies, may be part of a basic survival strategy given the lack of licit opportunities available to them. In short, all players weigh the advantages and disadvantages of involvement in the illicit drug industry relative to other opportunities, which makes seemingly indirect or unrelated factors important.

The Andean Drug Trade & the Rise of Colombia

When academics and policymakers talk about the “Andean drug trade,” they are generally referring to Bolivia, Peru and Colombia. Although Ecuador is located in the middle of these countries, in the heart of the “Andean” region, it is rarely mentioned with regards to the Andean drug industry. When it is mentioned, it is in the context of being the principle transport route for processing chemicals and cocaine base from Peru and Bolivia to Colombia, and for refined cocaine from Colombia to the consumer countries (Andrade 1995, 283; Páez Cordero 1995, 307; U.S. Department of State 2004a, b; Shifter 2004; and others). More recently, according to representatives of the Ecuadorian National Police, there is growing recognition of Ecuador’s important role as a storage center for the finished product (usually cocaine but this may also include heroin) and as a base from which to export it to consumer markets. So far Ecuador’s involvement has been largely “a function of Colombian illegal operations; therefore there is no challenge to state institutionality; there is no narco-bourgeoisie that tries to be part of the political system nor one that directly challenges the power of the state” (Bonilla 1995, 263).

The Balloon Effect

As we increase our efforts in Colombia, there will be a tendency [for the drug organizations] to find new areas, either in Colombia or outside Colombia, in which to move the cultivation and production of cocaine and heroin.

-- Undersecretary of State Thomas Pickering
(quoted in Carpenter 2003, 84)

When government campaigns against illicit drugs put pressure on those involved in cultivation or processing, many choose to simply relocate, creating what is known as the “balloon effect.” There are many examples of the balloon effect, such as the case of Colombia, whose involvement in illicit drug production began in the 1970s when eradication programs in Mexico caused marijuana cultivation to relocate to Colombia (Carpenter 2003; Ramirez Lemus et al 2005, 103). When pressure against marijuana farmers increased in Colombia in the 1980s, Mexico once again became the leading supplier of marijuana to the U.S. (Carpenter 2003, 116). While the laws of economics and the theory of the balloon effect predict pressure on the industry will cause it to relocate, there are no “laws” predicting where it will relocate to. When the marijuana business relocated to Colombia, Colombia had certain “advantages,” described by Thoumi (2003), that made it more attractive than other locations, specifically the existence of underground smuggling networks and a history of violence and weak state control. These conditions facilitated a Colombian takeover of the marijuana business which had previously been controlled by Mexicans. These Colombian traffickers then diversified into cocaine, an industry they proceeded to dominate and excel in.

Whether Legal or Illegal, Business is Business

Just like in any other business, the costs involved in carrying out operations are important to participants in the illegal drug industry. Factors such as competition, support of the political and regulatory environment, a readily available labor force with the needed skills or low wages, among others, all play a role in the development of an

industry in a given location. Given the high margins involved in the sale of the final product, increases in the cost of labor, materials, or lost product are likely less important to high level narcotraffickers, but they are still relevant to lower level actors such as peasant farmers. Costs that matter to the industry's leaders are related more to risk - specifically violence and imprisonment (particularly imprisonment in the United States through extradition). This is evident in the number of high-level drug kingpins, such as Pablo Escobar and "the Extraditables," who have taken extreme measures to avoid prison at incredible expense, or who have accepted imprisonment on the condition that they would not be extradited (Bowden 2001; Salazar 2001).¹ Participants at lower levels share these concerns regarding violence and imprisonment, but must also worry about basic economic survival

Factors that lower costs in this industry are largely factors that lower risk to participants. While corrupt public servants, law enforcement, judges and elected officials are considered a disadvantage in legal business, they offer a potential layer of protection to participants in illegal activities. The combination of weak rule of law, which weakens deterrence, with high unemployment, which increases incentives, helps to solidify a source of labor and collaborators willing to break the law.

COLOMBIA'S DECLINING COMPARATIVE ADVANTAGE²

Francisco Thoumi has provided a summary of factors he believes contributed to Colombia's development into a dominant actor in the illegal drug industry:

¹ Pablo Escobar reportedly stated "Better a tomb in Colombia than a prison cell in the United States" (Bowden 2001).

² A country is considered to have a "comparative advantage" in producing a certain good when it is able to produce that good at a lower relative cost compared to other countries.

Colombia was the lowest-risk location for the industry because it had the most propitious conditions among Latin American countries. These included a growing gap between de jure and de facto behaviors that condoned illegal economic activities and an extremely violent society in which people were quite comfortable using violence to solve conflicts; unique experience exporting black-market, illegally mined emeralds to industrial-country markets and exporting legally produced coffee illegally. Contravening the International Coffee Agreement limits; and exchange controls enforced during a period of 60 years (1931-91) (Thoumi 2003, 44).

Given these conditions, Colombia was positioned to emerge as a leader. However, Colombia's current role as the center of the Andean narcotics industry is only stable as long as Colombia remains the most attractive location for these activities compared to other countries and the difficulty of relocating to another country. Currently there is tremendous pressure on the Colombian drug industry, which, if successful, will encourage the industry to relocate. Sources of pressure include improved law enforcement capabilities, judicial reform, fumigation campaigns and the activities of guerillas and paramilitaries.

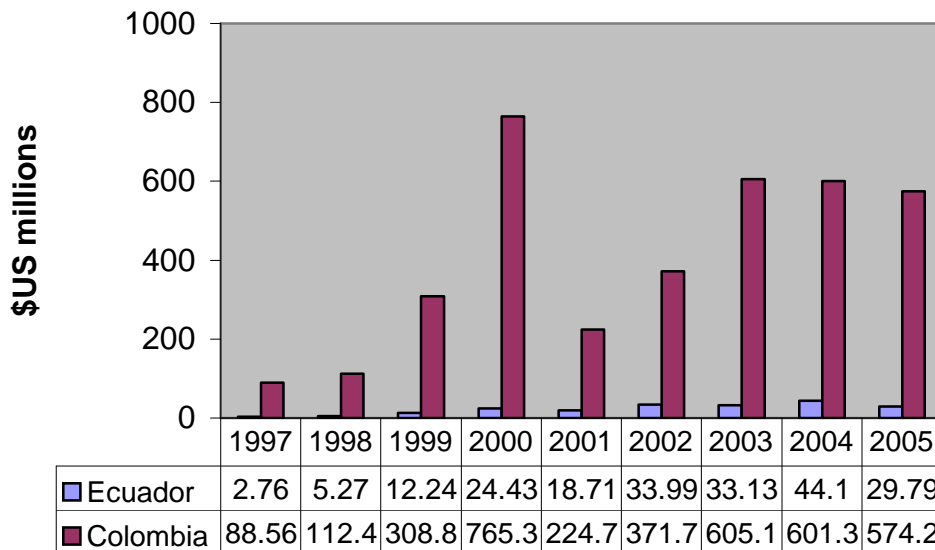
Law Enforcement

For several years the United States government has been dedicating enormous resources to combat the illicit drug industry in Colombia through Plan Colombia³ and the Andean Counterdrug Initiative (ACI), designating most of the funds to the police and

³ Plan Colombia is the name given to a plan designed by then President of Colombia Andrés Pastrana. The plan aimed at solving his country's economic problems and combating the illicit drug industry with funding for the program coming from the U.S. and other national donors and from multilateral lending institutions. Although the focus of Pastrana's program was primarily on economic development, the U.S. preferred to focus on combating the narcotics industry, providing \$1.3 billion to the Colombian government for this end. Since other international donors were slow to provide funding, the focus of the program came to be dominated by U.S. interests in the drug war and was ultimately quite different from what Pastrana had hoped (Carpenter 2003).

military.⁴ While some aid has gone to Colombia's neighbors, including Ecuador, in order to counteract the balloon effect, the amounts are not significant compared to the resources being given to Colombia (see Figures 1 and 2) and in comparison to the deep pockets of powerful actors in the illicit drug industry.

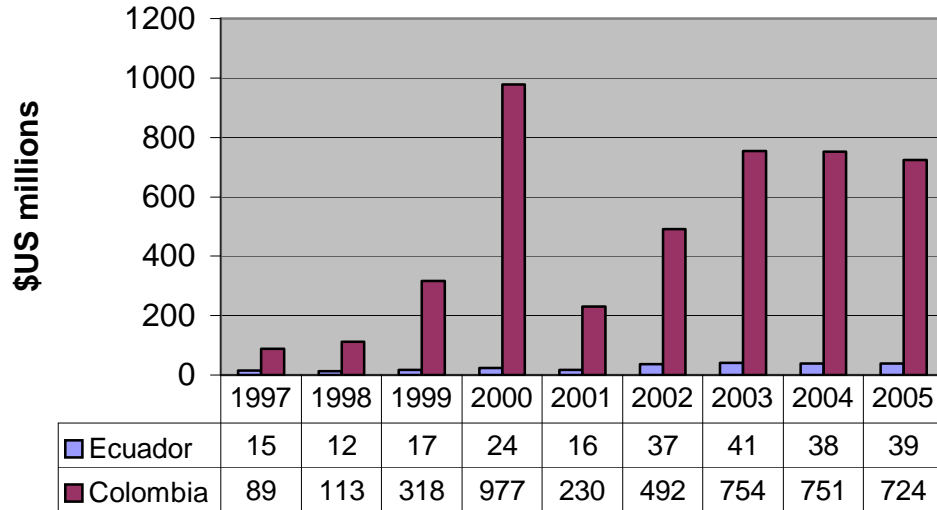
Figure 1: US Aid - Military & Police



Source: *The Center for International Policy*: www.ciponline.org

⁴ The U.S. aid package to Colombia is commonly referred to as Plan Colombia even though aid since 2002 has been provided as part of the Andean Counterdrug Initiative (ACI).

Figure 2: US Aid - Economic & Social



Source: *The Center for International Policy: www.ciponline.org*

Furthermore, Colombia’s current president, Alvaro Uribe, has taken an aggressive approach to the guerilla conflict (WOLA 2005, 111). His possible re-election would likely mean a continuation of this approach. Combined with U.S. aid, the Uribe administration will continue to put pressure on the narcotics industry and the guerillas, possibly motivating them to relocate some of their operations to the Ecuadorian side of the border where government forces are not as well funded and equipped.

Judicial Reform

Through Plan Colombia, the United States has provided significant funding to strengthening the Colombian judicial system. The U.S. aid package for 2005 includes at least \$6 million specifically for judicial reform in Colombia (Center for International Policy). According to an ONDCP Fact Sheet, approximately \$26 million has been

allocated specifically to improving "...Colombia's ability to identify and prosecute drug money laundering crimes, as well as forfeit the proceeds from these crimes. The funding will go to train prosecutors and police and to upgrade the technical capabilities of Colombia's Financial Analysis Unit" (ONDCP 2003). As Colombia strengthens its judicial system it may become less attractive as a location for activities related to the illicit drug industry, from production and processing to money laundering. The strength of the judicial system is also enhanced by the Colombian government's demonstrated willingness to extradite major players, such as Calí cartel leader Gilberto Rodríguez Orejuela, and FARC leader "Simón Trinidad," to the United States (South Florida Sun-Sentinel, November 24 2004; Diario Hoy, November 29, 2004). This makes the threat of prosecution and imprisonment much more serious in the eyes of major players. Meanwhile, as will be discussed later, Ecuador's judicial system remains weak both in terms of drug trafficking and in terms of money laundering and presents numerous opportunities, particularly for wealthy individuals, to avoid prosecution.

Fumigation

Fumigation of illicit crops, also referred to as aerial eradication, has been used in Colombia since the 1980s when it was used to destroy marijuana fields. The U.S. supports fumigation operations in Colombia through the State Department's Bureau of International Narcotics and Law Enforcement Affairs (INL) and through the U.S. embassy in Bogotá (Ramirez Lemus et al 2005, 112). The active ingredient in the herbicide used in these fumigation operations, glyphosate, is nonselective and will kill

most plants and trees if the dose is sufficient (Ramirez Lemus et al 2005, 113). This is of significant concern to anyone in the area being fumigated, not just those whose crops are targeted, because, according to the U.S. Environmental Protection Agency (EPA), the aerial spray can drift up to 600 feet downwind from the targeted area (Ramirez Lemus et al 2005, 118).⁵ According to Ramirez Lemus et al:

Under Plan Colombia, fumigation has been conducted on an unprecedented scale: from 2000 through 2003, the U.S. backed fumigation program sprayed herbicide on more than 380,000 hectares of coca, equivalent to more than 8 percent of Colombia's arable land (113).⁶

As a result of fumigation, coca cultivation has spread to new areas (Ramirez Lemus et al 2005, 101), making the overall effectiveness of this strategy dubious at best. Meanwhile it has a number of negative side effects, including damage to legal crops, pollution of streams and rivers and reports of health problems in people and livestock. Not only have these effects been felt on the Ecuadorian side of the border due to wind currents and the flow of water, but they have also added to the already large numbers of Colombians migrating to Ecuador, creating a humanitarian crisis along the border. One source estimates that more than 75,000 people were displaced in Colombia from fumigation in 2001 and 2002, many of whom have fled to Ecuador (118, 119). The large numbers of Colombians flocking to Ecuador has several implications relative to the drug trade. First, large numbers of Colombian peasants make it easier for coca growers to

⁵ This strategy is highly controversial and has been discontinued in Bolivia and Perú.

⁶ Meanwhile, as Ramirez Lemus, et al. point out, aid to support the cultivation of legal crops to replace the eradicated coca has been grossly inadequate. During the period from 2001 to 2003, when 340,000 hectares of coca were fumigated, the U.S. Agency for International Development (USAID) provided support for fewer than 39,000 hectares of legal crops (117). This further increases the probability of the balloon effect.

blend in and escape detection. Second, the humanitarian crisis may motivate some people not previously involved in the drug trade to become involved as a survival strategy.

Another unintended effect of eradication efforts is that, if they do succeed in reducing the supply, those farmers who succeed in harvesting their crops should receive higher prices. Clawson and Lee pointed out the similarity between voluntary eradication programs in the Andes and the crop reduction programs the U.S. government uses to increase the incomes of U.S. wheat farmers (Clawson and Lee 1998, 216-217). In fact, this comparison is valid whether eradication is voluntary or not because the same law of economics applies in either case: if demand remains the same, lower supply will result in higher prices. In this case, however, there is strong evidence that global demand can be expected to *increase* for the foreseeable future, regardless of demand trends in the United States (Carpenter 2003, 119). If eradication efforts are more intense on the Colombian side of the border than on the Ecuadorian side, farmers will face a double incentive to produce their crops on the Ecuadorian side: avoiding eradication and taking advantage of higher prices.

Paramilitaries & guerillas

Violence between guerillas and government forces, guerillas and paramilitaries, paramilitaries and government forces, and forced conscription by guerillas all contribute to make Colombia a less desirable location to live and do business, even illegal business. Much of Colombia's coca is produced in southern Colombia, near the border with Ecuador, in areas controlled by the guerilla group Fuerzas Armadas Revolucionarias de

Colombia (FARC). Though guerillas and paramilitaries provide some protection to the drug industry, the escalation of violence with government forces increases the risk that others will be caught in the cross-fire between the two groups. This risk may motivate some to seek a safer base from which to operate, possibly on the Ecuadorian side of the border.

Another factor that affects the cost of doing business in Colombia, and thus its comparative advantage, is taxation of the drug industry by guerillas and paramilitaries. According to the Center for International Policy, about half of the FARC's income comes from its involvement in the illicit drug industry. While estimates range from \$100 million to \$1 billion, it is most likely between \$200 and \$400 million dollars (Ramírez Lemus et al. 2005, 106). It is conceivable that some actors may seek to avoid this taxation, especially in the context of escalating violence, by relocating their activities.

Based on these considerations, there are two different paths related to the violence in Colombia by which drug activities may spill across the border into Ecuador. First, Colombians involved in the industry may see Ecuador as an attractive location to escape the violence and taxation associated with guerilla and paramilitary operations in Colombia. Based on evidence that "...as coca cultivation has dispersed...the illegal armed actors have followed the new production..." (Ramirez Lemus et al. 2005, 116) the FARC in particular may not be long in following one of their key income sources across the border into Ecuador.

The second possibility is that guerillas may gradually take over territory in Ecuador as a safer base from which to plan and coordinate their operations, clearing the

area of Ecuadorian law enforcement, as they did in Colombia, creating an environment in which drug traffickers can set up operations. There is already some evidence of guerilla expansion across the border into Ecuador, including increasing incidents of kidnappings and extortion, as well as the discovery of labs and bases used by the guerillas (Ecuadorian National Police data 2004). For example, in 2001, a drug lab was discovered in Ecuador and 6 armed men killed by Ecuadorian troops at the lab were determined to have been FARC members. Also in 2001 more than 500 Ecuadorians fled their homes in the Amazon after they were threatened by armed Colombian rebels. Later that year the military reportedly “clashed” with ELN guerillas within Ecuador (Carpenter 2003, 82). More recently, FARC leader “Simón Trinidad” was captured in Ecuador in January 2004 (Diario Hoy, November 29, 2004). According to interviews with members of the National Police, kidnappings and extortion are scaring wealthy land owners into selling their land. While some such crimes are likely committed by criminals not associated with the guerillas, police are confident that many are related to guerilla activities. This belief is strengthened by suspicions that the same actors who are scaring people into selling are the ones purchasing their properties, supported by anecdotal evidence provided by the police regarding high selling prices in the area in spite of the threats. Members of the National Police also explain that a newly constructed highway along the border is too dangerous for them to patrol with their limited resources⁷ due to the risk of attack by guerilla forces.

⁷ For example their lack of bullet-proof vests.

In summary, evolving conditions in Colombia are affecting its comparative advantage in the drug trade relative to Ecuador in a number of ways. First, resources from Plan Colombia and the dedication of the Uribe administration have increased the capabilities of law enforcement, making it both more physically dangerous to be involved in the illicit industry and increasing the probability of arrest and legal consequences. Second, judicial reform and funding from Plan Colombia may strengthen the judicial system, making legal consequences and extradition greater probabilities. Third, fumigation campaigns have caused coca growers and farmers of licit crops to relocate, and creates a double incentive to produce coca on the Ecuadorian side: avoiding fumigation while enjoying the higher prices from the reduced supply. Fourth, violence surrounding the guerillas and paramilitaries, as well as strategic decisions by the guerillas to locate bases on the Ecuadorian side of the border, further increase the probability that the Colombian drug industry will relocate to Ecuador.

ECUADOR: THE OTHER SIDE OF THE EQUATION

To date, Ecuador has remained the only Andean country not heavily involved in the illicit drug industry, in spite of its location in the heart of the region and its large border with Colombia. However, several conditions are in place that make Ecuador increasingly attractive as a location for participants in the illegal drug industry. Just as Thoumi described Colombia at the time its illicit drug industry began to develop as the “lowest risk location for the industry” and as the Latin American country with the “most propitious conditions” (Thoumi 2003, 44), a similar statement could be made about

Ecuador today. First, it has both weak institutions and weak rule of law. Second, numerous economic factors exist that can either motivate Ecuadorians to participate, or that make it more difficult to prevent participation. Third, weaknesses in the financial system make it difficult to prevent money laundering. And finally, there are several consequences of being a dollarized country that make Ecuador more attractive as a location for money laundering. Each of these factors will be examined in detail. While no single factor alone would likely make a significant difference, their convergence in one place at the same time in history magnifies their consequences and makes each factor much more difficult to address.

THE ROLE OF ECUADOR'S INSTITUTIONAL⁸ WEAKNESSES

The weakness of Ecuador's institutions plays an important role in creating an environment that is attractive to participants in the illegal drug industry. The weak institutions to be examined here are the political system, the judicial system and rule of law, systemic corruption, and the legal framework.

Political Instability

The first issue to be considered is the political instability that has become a chronic problem for Ecuador. Ecuadorian society is deeply divided along the lines of class, ethnicity, ideology and region, resulting in little social cohesion. Regional rivalries

have been heightened by clientelistic, caudillo-style leaders whose patronage to regional supporters often comes at the expense of the other region due to the disparity in national resources between regions (Thoumi 1990, 50). Conflicting regional economic interests have contributed to political divisions based on regional loyalties first and ideology second. Even populist movements have been split along regional lines because the interests of workers in Guayaquil conflict with the interests of peasants in the Sierra (Thoumi 1990: 55). The large number of small, regional parties “inhibits the development of coherent policies” and “makes the country's Congress virtually unmanageable” (Shifter 2004). The most striking result of the country’s lack of social cohesion is that the last three elected presidents (Bucaram, Mahuad and Gutierrez) have all been thrown out of office by coups d’etat. It has been eight years since an Ecuadorian President was allowed to serve his entire term of office. One consequence of this is that the Ecuadorian executive branch is constantly focused on political survival, rather than on the challenges facing the country itself. The high degree of social and political fragmentation prevents formation and implementation of coherent policies to confront the drug industry itself as well as other areas, such as the economy and the financial sector (areas that will be discussed in greater depth later in this paper), that indirectly affect the country’s vulnerability to the drug industry. It also focuses political resources on specific regions while neglecting others, without consideration for the consequences of these policies at the national level. By giving priority to regional demands, larger issues such as the international illicit drug industry, can drop off the political radar.

Weak Rule of Law & the Judicial System

One of the greatest challenges Ecuador faces is that it suffers from weak rule of law. The judicial system has suffered from long-term under-funding and was described by Páez Cordero in 1995 as being “in a permanent crisis,” having been actually shut down more than five times in the previous three years (Páez Cordero 1995, 305). More recently the IMF stated that Ecuador’s “...judicial system is highly politicized, and the rule of law is unreliable. The citizens have unequal access to the law, and even policy makers face judicial insecurity, which weakens policy commitment” (IMF 2003, 12). Most recently, President Gutierrez’s decision to remove eight out of nine members of the constitutional tribunal, five out of seven members of the supreme electoral council and 27 out of 31 supreme court judges in December 2004 provides further evidence that the judicial system is far from independent (Lapper 2005). This decision, made in reaction to an attempt by the President’s rivals in Congress to impeach him, demonstrates how the political divisions discussed earlier directly weaken the judicial system. And just as political instability prevents formulation of coherent policy, instability in the judicial system creates an obstacle to consistent and fair interpretation and application of the law. Among the numerous implications of this, there are consequences for the illegal drug industry. Together with obstacles presented by the legal framework, to be discussed later, the instability in the judicial system opens up opportunities to actors in the illegal drug business to escape legal consequences for their activities. The problems associated with weak rule of law are also intricately related with almost every other challenge this country faces, including policy towards the illicit drug industry and the other factors

analyzed in this paper that also contribute to the country's vulnerability to the drug industry, such as the financial system.

Corruption

Another important factor affecting Ecuador's institutions is the country's systemic corruption. Transparency International has consistently ranked Ecuador as one of the most corrupt countries in Latin America. The 2004 Transparency International Corruption Perceptions Index ranked Ecuador number 112 out of 145 (Transparency International 2004).⁹ To participants in the illegal drug industry this is the equivalent of a low country risk rating for businessmen in the legal economy: it identifies a land of relatively low-risk opportunity. Ecuador's high level of corruption creates an environment that facilitates illegal activities, including drug trafficking and the laundering of illicit profits.

In recent years the media has reported on numerous examples illustrating how systemic corruption in Ecuador is leading to involvement of law enforcement, the judiciary and political leaders in the illicit drug industry. Examples include sales of Ecuadorian army weapons to armed groups such as the FARC (Rivera Vélez 2005, 255). Conversations with members of the Ecuadorian national police confirm evidence of this, reporting confiscating weapons originating from the armed forces in the hands of both guerillas and narco-traffickers. Other examples include the involvement of CONSEP employees in the theft of several hundred kilograms of cocaine from a CONSEP evidence warehouse in Guayaquil in 2003, the arrest of a judge who stole cocaine evidence he

⁹ That same year Colombia was ranked 60 out of 145.

claimed to have destroyed, and the arrest of the former governor of Manabi Province, Cesar Fernandez, who was caught red-handed preparing packages that were part of a 429-kilogram cocaine shipment destined for Mexico that was interdicted by police (U.S. Department of State 2004a). This scandal even touched President Gutierrez when it was reported that he had received campaign financing from Fernandez and the President's sister and her husband, head of the President's party, admitted they had dined with Fernandez's Mexican "friends" (The Economist Nov 27 2003).

Legal Framework

Within Ecuador's legal framework there are a number of obstacles and potential loopholes that prevent prosecution of cases related to drug trafficking in Ecuador. One example was provided by a prosecutor in Esmeraldas who stated that:

[...] a large number of trafficking cases are not tried because CONSEP has no office in the provincial capital, and the lab tests to identify illicit substances take longer than the ninety days the prosecution has to investigate. As a result most evidence is not admissible and cannot be used in court proceedings (Rivera Vélez 2005, 253).

Another obstacle to prosecution stems from laws that are unclear or open to interpretation. For example, when possession of drugs for personal consumption was decriminalized in 1997, lawmakers neglected to define a limit for what amounts could be included in this category (Rivera Vélez 2005, 253). This allows judges significant flexibility and provides a potential loop-hole for traffickers. In a country where corruption is systemic, this is particularly problematic. The 2001 Code of Criminal Procedures has also caused confusion amongst police, prosecutors and judges who all

disagree on how it should be implemented, “which hampers effective investigation and prosecution of all types of crimes” (U.S. Department of State 2004a), including crimes related to the illegal drug industry.

Another potential loophole exists in the Ecuadorian law requiring that detainees be released if they are neither tried nor sentenced within one year of their arrest. As a result, some detainees escape prosecution through simple judicial inefficiency. Others, particularly wealthy individuals “...can, via bribes, remain in prison past the time limit and then obtain their freedom based on this technicality, thus avoiding prosecution” (Rivera Vélez 2005, 254).

Another issue is that Ecuador’s legal framework does not prohibit money laundering. The U.S. State Department stated in 2004 that Ecuador “...lacks an effective anti-money laundering regime” and details the numerous obstacles to cracking down on money laundering in Ecuador, including, specifically, numerous conflicting laws and regulations that prevent cooperation between the police, financial institutions, the Banking Superintendency, the judicial system, the Superintendency of Companies, the Central Bank, the Ministry of Finance and CONSEP (U.S. Department of State 2004b). Conversations with Christian Córdova, Executive Secretary of CONSEP, and with representatives of the National Police, confirm these challenges. According to Cordova, one of the greatest challenges faced by his agency is that there is no law specifically against money laundering. Although financial institutions are required by law to report deposits exceeding a specific amount (similar to Suspicious Activity Reports, or SARs, currently required of U.S. financial institutions) to CONSEP, prosecution for money

laundering is only possible once an individual has been convicted on charges of drug trafficking.¹⁰ As was already described, there are numerous ways to avoid actual convictions on drug charges, severely limiting the effectiveness of CONSEP's efforts against money laundering. In addition, proper incentives for bank employees are also lacking. According to the U.S. State Department, "There are no due diligence or banker negligence laws that hold individual bankers responsible if their institutions launder money." Although a bank's board of directors, "...can be held legally responsible if drug money laundering occurs in their institution" (U.S. Department of State 2004b), there is ample reason to doubt whether bank directors are sufficiently motivated by the threat of legal consequences: given the amount of political and economic power concentrated in their hands they have a high probability of never facing the consequences allowed within the legal framework. Furthermore, additional opportunities for money launderers come from a lack of reporting requirements regarding currency brought into or taken out of the country, regardless of amount, and weak regulation of currency exchange businesses (U.S. Department of State 2004b).

Finally, although Ecuador has cooperated with the U.S. government in the extradition of non-Ecuadorian nationals, its constitution does not allow extradition of Ecuadorian citizens (U.S. Department of State 2004a). As was mentioned previously, the threat of extradition to the U.S. is of much greater concern to Colombian drug king pins than imprisonment in their own country. Ecuador currently does not have a comparable

¹⁰ According to the U.S. Department of State (2004b), the Narcotics and Psychotropic Substance Act of 1990 (Law 108) provides for the following money laundering crimes in connection with illicit drug trafficking: illegal enrichment (Article 76), conversion or transfer of assets (Article 76, 77), and prosecution of front men (Article 78).

tool to use against Ecuadorian nationals in its efforts to combat the illicit drug trade within its borders.

As a result of the numerous problems facing efforts to prevent money laundering, there have been no serious investigations of drug money laundering in Ecuador for at least the past five years (U.S. Department of State 2004b). Furthermore, it appears that law-makers are not significantly motivated to change the status quo. In 2003 a draft of an interagency “stand-alone money laundering law,” created with technical assistance from the Organization of American States (OAS) was completed and submitted to President Gutierrez in November for subsequent introduction to the Congress early in 2004 (U.S. Department of State 2004a). The fact that Congress has not taken any action towards approving the law may be an indication that money laundering is not considered a high priority by the country’s political leaders. Cordova was enthusiastic about the changes that would be possible under this law, but was not encouraged by what he perceives to be a lack of interest in Congress. Although it is not possible to know for certain why the Ecuadorian Congress has not given this item higher priority, certain issues already addressed in this paper, including political factionalism and instability and the high level of corruption, may play a role. Until there is a legal framework to prosecute money-laundering crimes, efforts by CONSEP and law enforcement will be seriously hampered and those looking for an easy location to launder illicit proceeds will likely consider Ecuador as one of their most attractive options based on the low risk of facing legal consequences.

Finally, even if an individual is successfully arrested, prosecuted and convicted on drug trafficking charges, prison escapes are common. In April 2004 fifty prisoners escaped from Quito's prison complex commonly known as the García Moreno prison (Diario Hoy, April 14, 2004) and seven escaped from the *Centro de Rehabilitación de Varones de Cuenca*. In June, there were several more incidents of escaped prisoners. In one incident prison officials estimated that 30 prisoners had escaped after taking four guards hostage and forcing the guards to open the main door of the prison facility, through which they exited. It was reported that the prisoners had in their possession arms, cell-phones and police radios (Diario Hoy, June 29 2004). The high frequency of prison escapes is a symptom of corruption and lack of resources and makes the threat of imprisonment less powerful as a deterrent to criminal activity, including participation in the illicit drug industry. This is especially true for high-level traffickers with plentiful resources and connections to facilitate an escape, significantly undermining any progress made in other areas of law enforcement.

Ecuador's weak institutions seriously undermine any efforts to prevent or punish involvement in the illegal narcotics industry. Political instability prevents the development of coherent policies. Rule of law is weak and the judicial system faces numerous obstacles to cracking down on drug trafficking and money laundering. Furthermore, the legal framework related to the illicit drug trade is insufficient and unclear. Finally, corruption further undermines the application of the law. These factors make Ecuador increasingly attractive as a location for activities related to the illicit drug

industry. This is particularly true if efforts described earlier to strengthen Colombia's judicial system and law enforcement capabilities are successful.

THE ROLE OF ECONOMIC FACTORS

A number of economic factors also play a role in both weakening Ecuador's ability to curb the illicit drug industry and in creating opportunities for participants in different areas of the industry. The economic factors to be examined here include widespread poverty and a large informal sector, a heavy dependence on volatile commodity markets, economic instability resulting from natural disasters and Ecuador's international debt burden.

Poverty

The first economic factor that makes Ecuador a likely candidate for future activities related to the illegal drug industry is the country's widespread poverty and high unemployment and underemployment. According to the most recent data provided by the World Bank, poverty rates in Ecuador increased from 40 to 45 percent between 1990 and 2001, representing the worst growth performance in Latin America during this time period (World Bank 2004, i; 6). As of 2004, according to the IMF, "the income of about half of [Ecuador's] population is still below the cost of the basic consumption basket and GDP per capita remains below its 1980 level in real terms" (IMF 2004, 5). Nor does the future look promising with respect to poverty reduction efforts, according to a study regarding countries' chances of reaching their poverty reduction targets (based on the

Millennium Development Goals).¹¹ This study determined that Ecuador was one of only four countries in Latin America to have experienced increasing inequality during the 1990s, and that if the observed growth rates of the 1990s continue, poverty would continue to increase indefinitely and there would thus be no progress made towards the Millennium poverty targets at all. Colombia, on the other hand, was one of seven countries that, according to this study, will meet the poverty reduction target by 2015 if it continues to perform as it did in the 1990s (UNDP et al 2002, 12). Although the financial and banking crisis at the end of the 1990s may give projections regarding Ecuador's future an overly pessimistic slant, there are plenty of challenges on the horizon that will make progress towards increasing the growth rate or decreasing inequality daunting challenges.

High levels of poverty and under-employment are significant when considering the future of the illegal drug industry because these conditions render "much of the population susceptible to illicit activities" (US Department of State 2004a). When people cannot find employment in legal areas, involvement in illicit activities may become a basic survival strategy. Therefore it is conceivable that a country facing such high levels of poverty as Ecuador would be attractive to leaders in the drug industry as a source of labor. While high levels of poverty are found in other Latin American countries, when Ecuador's poverty is considered within the context of the other factors examined in this paper, it has greater potential to make Ecuador particularly susceptible to the illegal drug

¹¹ This study, conducted by specialists from United Nations Development Programme (UNDP), the Economic Commission for Latin America and the Caribbean (ECLAC) and the Institute for Applied Economic Research (IPEA), assessed 18 Latin American and Caribbean countries' chances of reaching their poverty reduction targets based on the Millennium Development Goals (MDGs) commitment to halve the proportion of the population living on less than one dollar a day in 1999 by 2015.

industry. Low wages of public employees and law enforcement agents also contribute to their susceptibility to corruption, as was discussed previously. Furthermore, the region around the border with Colombia has "...not received an equitable share of state resources, since power and economic decisionmaking [sic] are centralized in Quito and Guayaquil" (Rivera Vélez 2005, 246-7). As Rivera Vélez describes below, there is evidence that this is already motivating Ecuadorian's from the border region to become involved in the industry:

Regional poverty levels of over 60 percent, lack of job opportunities, the recent crash in international coffee prices, and the generally weak farm economy along the border have forced Ecuadorians to temporarily cross into Colombia in search of jobs in Colombia's illicit drug industry. In short, poverty pushes Ecuadorians into an illegal business (Rivera Vélez 2005, 235).

Meanwhile, increased Colombian migration to Ecuador may make re-establishing illicit networks on the Ecuadorian side easier and help Colombian participants at all levels blend in with Colombian migrants not involved with illicit activities.

*Large Informal Sector*¹²

Another important issue is the size of Ecuador's informal sector. According to the U.S. State Department, the "majority of [Ecuadorian] workers [...] work in the large informal and rural sectors" where they lack "recourse to the minimum wage or legally mandated benefits" (U.S. Department of State, 2000). As a result of the high degree of informality in the country, only about 25% of the working population is covered by the

¹² The World Bank provides a relatively simple definition of the informal economy, dividing it into 4 categories: home based workers, street traders and street vendors, itinerant, seasonal or temporary job workers (on building sites or road works), and "those in between the streets and home, e.g., waste collectors" (World Bank 2001).

pension system, (IMF 2004). According to World Bank data, Ecuador's informal economy equaled 34.4% of GNI in 2003. While this is low by regional standards (the average for the region is 41.5%) it is still high when compared to the OECD average of 16.8% (World Bank 2004).¹³ In the context of the future of the illicit drug industry in Ecuador, the size of the informal economy is important for two reasons. First, it indicates that approximately one third of the country's GNI is circulating through the economy with little or no formal regulation. Having such a large amount of money circulating informally may make it easier for illicit profits to pass unnoticed.

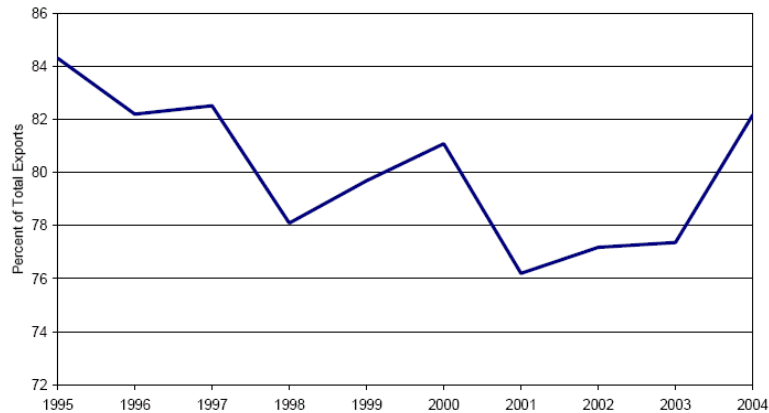
Second, many workers in the informal economy face high levels of uncertainty (in terms of income, job stability and safety) and many struggle to subsist on what they earn. They also lack access to minimum wage, employee benefits, or health and safety standards that workers in the formal economy have (U.S. Department of State 2000). Due to the high levels of instability and insecurity involved in informal employment, it would not be surprising if some of these workers would be more likely to take work in illicit activities, such as the drug industry, if a lucrative opportunity presented itself.

Dependency on Commodities

Another important factor is the country's high degree of dependence on commodities for export revenue and government revenue (see Figure 3).

¹³ Due to variations in the definition of "informal sector" between researchers and countries and the challenges in obtaining data about this sector, comparisons across countries must be made cautiously.

Figure 3: Commodities as % of Ecuador's Total Exports



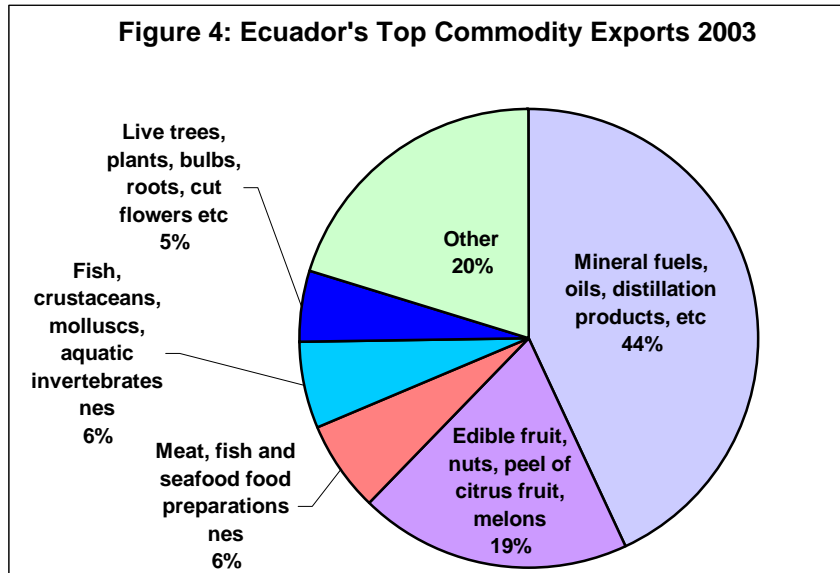
Source: IMF 2004 (from Central Bank and IMF data)

This high degree of dependence on volatile commodity markets results in a highly unstable economy. When commodity prices drop, Ecuador's economy is significantly affected in terms of government revenues, employment and wages. Serious shocks to the price of exports, and the subsequent economic hardships these shocks cause, could increase incentives for Ecuadorians to become involved with the illicit drug industry.

The heavy dependence on commodity exports also complicates fiscal planning and budgeting and exacerbates the political tensions already challenging the country's stability. According to the World Bank, "volatility in fiscal revenues induced by macroeconomic instability [have] led to pro-cyclical social expenditure, which [has] compromised the effectiveness of such spending and its capacity to help those who needed it most" (World Bank 2004, 11). Dependence on commodities also has serious implications for the banking system, which will be discussed later in this paper.

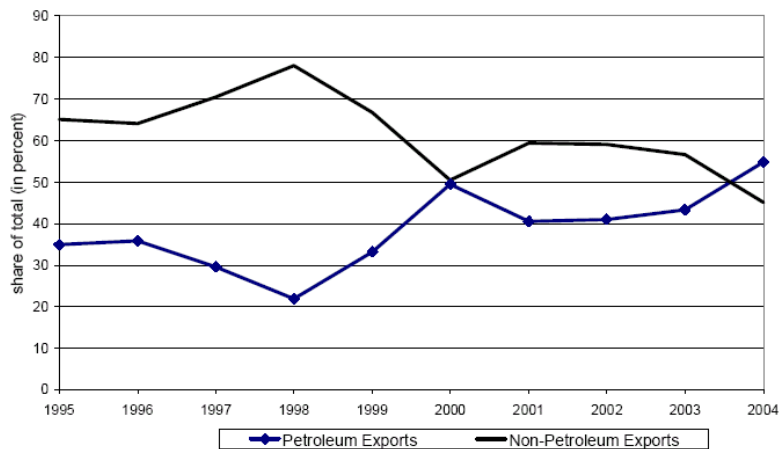
In addition to the instability inherent in all commodity-dependent economies, Ecuador's economy faces another challenge due to its heavy reliance on revenue from oil

exports. Figures 4 and 5 illustrate the importance of oil compared to other exports: in 2004, oil and related products accounted for more than 50% of the country's exports.



Source: U.N. Comtrade Database

Figure 5: Oil vs. Non-oil Exports, 1995-2004

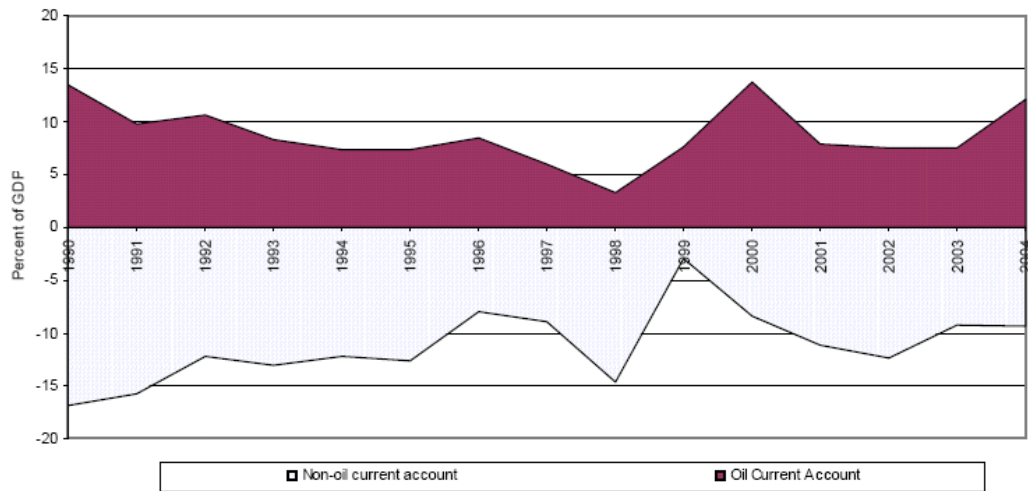


Source: IMF 2004 (from Central Bank data)

The degree of Ecuador's dependence on oil is also illustrated by the country's non-oil current account deficit, which has averaged around 10 percent of GDP since 2001 (see

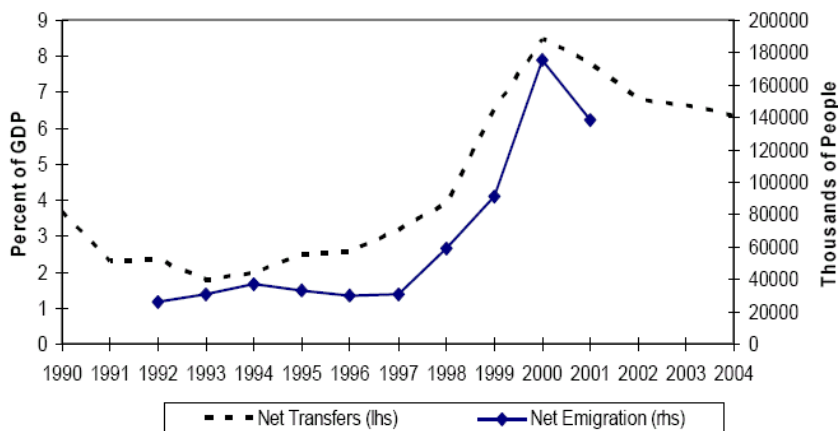
Figure 6) (IMF 2004). According to the IMF, this deficit can be expected to increase as flows of remittances stabilize due to a leveling off of emigration (IMF 2004).

Figure 6: Ecuador's Oil vs. Non-Oil Current Account Balance



Source: IMF 2004 (from Central Bank and IMF data)

Figure 7: Net transfers from abroad



Source: IMF 2004 (based on government and IMF data)

The heavy dependence on oil has several negative consequences for Ecuador's economy. First, it exposes the country to shocks from volatile oil prices. The IMF estimates that "for every one dollar decline in the international oil price, Ecuador's current account is estimated to deteriorate by a little under 0.5 percent of GDP" (IMF 2004, 41). It is unclear how long the current high oil prices will continue, but if they decline, Ecuador will once again have to face the effects this has on the country.

Second, such heavy dependence on a non-renewable resource has serious implications for Ecuador's future economic well-being. Based on recent estimates, Ecuador's oil reserves are projected to run out between 2020 and 2030, depending on the discovery of new reserves and the rate of extraction (IMF 2003, 11). When the oil industry comes to an end, Ecuador will lose an important source of dollars (see dollarization) and a major source of government revenue. Oil exports currently represent between 25 to 30% of total revenues (Jácome 2004, 7). Loss of government revenue will decrease funding for many already under-funded areas, including social services and law enforcement, opening the doors even wider for the entrance of the illicit drug trade. Furthermore, the loss of the oil industry will also have a more direct effect on the armed forces and the national police: currently both provide security services to the petroleum companies "as one way of earning additional resources to offset their limited budgets" (Rivera Vélez 2005, 251). When the oil industry disappears, this source of revenue will also go with it.

Loss of the oil industry will also result in the loss of Ecuador's primary source of foreign direct investment (FDI). According to the 2003 IMF Selected Issues and Statistical Appendix:

Despite an open regime, Ecuador has had little success in attracting FDI outside the oil sector. According to UNCTAD (2001)¹⁴, Ecuador ranked last in the CAN¹⁵ in terms of FDI inflows relative to GDP during the 1990s. In absolute terms, even Bolivia, with a much smaller economy, received more FDI than Ecuador. The share of non-oil FDI, which averaged 20-40 percent during the first half of the 1990s, has fallen under 5 percent since 1999. Judicial insecurity, frequent changes in the rules of doing business, corruption, and lack of full enforcement of FDI legislation are mentioned by foreign companies as important factors in deterring them from setting up or expanding operations in Ecuador (61).

Furthermore, Ecuador will be forced to become an oil importer, negatively affecting the country's balance of payments and presumably increasing costs to consumers who are accustomed to subsidized fuel prices.

Attracting other types of investment and income to replace oil will be a challenging task. Ecuador generally scores quite low on international competitiveness indices (see Figure 8)¹⁶ (IMF 2004). Also, although the international oil industry is willing to tolerate relatively high levels of insecurity, most other industries are not so tolerant. Ecuador's security challenges present a formidable challenge to attracting other types of investments to replace oil in the economy. In this case, increased insecurity that may accompany greater involvement in the illegal drug industry would create a vicious

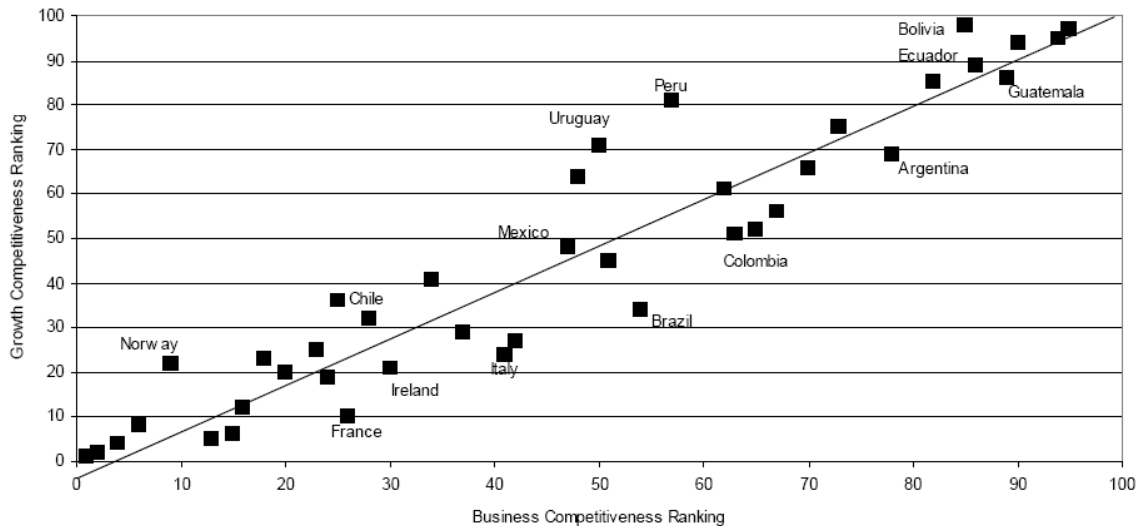
¹⁴ UNCTAD, *Investment Policy Review: Ecuador*. Geneva: United Nations, 2001.

¹⁵ Community of Andean Nations

¹⁶ Figure 8 shows Ecuador with one of the worst rankings based on a survey that took into consideration the macroeconomic environment, technology innovation and diffusion, human resources, health, labor, education, general infrastructure, public institutions, contracts and law, public institutions and corruption, domestic competition, cluster development, company operations and strategy and environment.

circle. In addition, as was mentioned in the introduction, many of the same factors that reduce Ecuador's ability to attract licit business activities are the same factors that are attractive to illicit businesses, such as weak public institutions and high levels of corruption, creating another vicious circle in which, for example, corruption deters legitimate businesses but attracts participants in the illicit drug industry to the area, and illicit activities then result in even more corruption.

Figure 8: Growth and Business Competitiveness Ranking



Source: World Economic Forum 2003.

Natural Disasters

Another factor that must be considered is Ecuador's vulnerability to natural disasters and the effects these disasters have on the economy. First it has suffered repeatedly from earthquakes. In 1987 an earthquake left the country unable to export oil for close to six months (Beckerman 2001). Drought is another recurring problem

affecting not only agriculture but also the generation of electricity (Ecuador relies heavily on hydroelectric power), leading to forced rationing of electricity at times (Beckerman 2001). The periodic flooding rains of El Nino also destroy agricultural crops and can cause extensive damage to infrastructure through landslides. The eruptions of volcanoes also periodically paralyze regions of the Sierra where the fine ash affects everything from transportation to generation of electricity. This vulnerability to natural disasters adds to the challenges Ecuador faces in improving its economic situation by disrupting exports and discouraging FDI.

Debt

Ecuador's economic challenges are further complicated by its debt burden, which diverts government funds away from investment in productive sectors or social safety nets. Preliminary data for 2003 showed Ecuador's external debt as equal to 42.6% of its GDP (IMF 2004) and debt service equaled 29% of exports of goods and services (WDI 2005). These statistics would be much worse if high oil prices were not bolstering both GDP and exports of goods and services. By law, surplus oil revenues should go to a special fund for buying back public debt or to pay for health and education projects, but given the never-ending political crisis there is always pressure to divert this money to gain political support (The Economist Oct. 7, 2004). This is likely to plague future presidents, given the political forces that lead Ecuadorian politicians to focus on short-term political survival rather than preparing the country for the eventual dissipation of oil

revenues. This only adds to the serious economic challenges the country will have to face within the not-so-distant future.

There is also the risk that the government might again default on its debt, as it defaulted in 1999 on its Brady bonds. This would have a large negative affect on the rest of the economy, especially on the banking system, which will be discussed in the following section of this paper.

In summary, Ecuador's dire economic circumstances limit income opportunities for the poor and may potentially motivate more Ecuadorians to turn illicit activities. These economic challenges are facilitate money laundering, increasing the potential for its illicit drug industry to grow. The economic conditions examined here are also related to conditions in Colombia that were analyzed earlier, in particular the flow of refugees into Ecuador which are adding to the number of impoverished people and putting additional strain on Ecuador's "rudimentary social services and infrastructure" (Rivera Vélez 2005, 231). Furthermore, the institutional weaknesses discussed earlier weaken the government's ability to improve economic conditions. As was mentioned previously, the high degree of political instability has a negative impact on economic policy. According to a World Bank Poverty Assessment report, "lack of consistency in domestic policies or high volatility in domestic policy outcomes can hamper economic efficiency" (World Bank 2004, 5). Ecuador's chronic political instability leaves little room for optimism regarding the country's economic challenges.

As Thoumi stated: "The relationship between poverty and the illegal industry is...is indirect and quite complex. Poverty and inequality are likely to contribute to the

growth of the illegal industry, but they are not per se determining factors” (Thoumi 2003, 48-49). It is therefore important to consider the role of Ecuador’s economic challenges within the context other interrelated factors such as the country’s institutional weaknesses discussed in this paper. Together these economic challenges present barriers to combating the illegal drug industry and create incentives to participate in the industry, making Ecuador an increasingly attractive to current participants considering relocating their business activities.

Finally, by keeping in mind that the illicit drug trade is a business, not just a criminal activity, many projects aimed at helping legal businesses may also benefit the drug industry. One example that has been observed is that of highways built to improve transportation for legal goods that also facilitate illicit activities, in some cases even serving as runways for aircraft (Fabre and Schiray, 2002). According to interviews with the National Police, a new highway built along the border with Colombia is considered too dangerous for them to patrol, which implies the highway is currently of greater use to those involved in illegal activities than to participants in the legal economy.

WEAKNESSES IN THE BANKING SYSTEM

Due to their involvement in the laundering of illegal profits, the financial sector and banking system play an important role in creating an environment that is either hostile or attractive to participants in the illegal drug industry. In the case of Ecuador there are several reasons to be concerned that the overall environment is relatively attractive for money laundering. As was already mentioned, there is no law against

money laundering, and the Ecuadorian government has not made passing such a law a priority. In addition, there are other reasons to doubt whether banks and regulators are sufficiently motivated to prevent money laundering. Banks face serious challenges to attracting and retaining deposits. First is a lack of confidence in the banking system that lingers on from the banking crisis. Second, they are all competing to attract a small population of elites. Given the difficulties involved in attracting deposits, banks may feel less motivated to check on the origin of funds deposited by customers. Concentration of wealth presents other challenges.

The first issue is that confidence in the banking system is low. This is in part due to the legacy of the banking crisis in 1999-2000. Closed banks were slow to return deposits, and as of early 2003, about \$275 million had not yet been returned (IMF 2003). Furthermore, given the high level of corruption and the weak rule of law, there is reason to doubt regulators are performing their duties any better than they were prior to the crisis. According to the IMF, some improvements in banking regulation have been made since the banking crisis, but “a weak judicial system and political interference tend to be obstacles to strong and timely enforcement of the regulations.” Another challenge faced by banks is that they have government bonds in their portfolios and the government is not considered a good credit risk, particularly after it defaulted on its Brady Bonds in 1999. When the government delays payment on these bonds this negatively affects banks’ soundness, making the political instability discussed earlier of particular concern to banks. A banking system that lacks the confidence of the public will have a difficult time attracting depositors who have the option of depositing their funds elsewhere. In the case

of Ecuador, wealthy depositors frequently choose to keep large deposits in other countries. Among the depositors who lack this option are depositors of illicit profits.

With the low-level of investor confidence in mind, another facet that should be considered is whether or not the government is motivated to crack down on banks to prevent money laundering. There are several plausible scenarios in which the government may have incentives to allow money laundering to continue. For example, if cracking down on money laundering would require closing accounts of important customers, and if these were seen to present any risk of affecting depositor confidence, the government may not be willing to take action for fear of damaging the already weak banking system. Another possible conflict is if actions against money laundering would significantly affect banks' balance sheets, limiting the supply of credit to fuel economic growth. This could also limit credit available to the government, which has limited financing options since the 1999 default. As a result, the banking system is critical as a source of credit to both the private and public sectors due to Ecuador's limited access to international capital markets. The government needs banks to make loans to fuel the economy, and for this the banks need deposits. Given the chronically unstable political situation, fueled by the already impoverished state of the economy, the government may be motivated to fuel the economy at any cost, even if it means turning a blind eye to dirty bank deposits. Additionally, in an environment of rampant corruption, some government players may also receive compensation for not being too diligent, while others may be

connected through personal ties to bankers or to clients suspected of laundering funds.¹⁷

Any of these factors may prevent the government from taking action against known money launderers.

Another factor is that Ecuador is a small, poor country, with a tiny elite class that controls most of the country's wealth. As a consequence, banks must compete to attract and hold onto these wealthy elites who are critical to their survival. In such a small country, these elites are closely related, as are their commercial and financial interests. In a hypothetical scenario, if a bank were to choose not to accept money from a wealthy customer, based on suspicion of money laundering, they would risk losing that customer, as well as potentially the customer's family and close friends. Given the concentration of wealth in the hands of a few, this could represent a significant amount of lost business, and could even affect the bank's liquidity and solvency. This is particularly true when considering the high number of large depositors that keep money in overseas banks due to their lack of confidence in the banking system. This raises the possibility that a significant number of large depositors in Ecuadorian banks have their money there because it would be at higher risk in other banks, meaning it would be identified as laundered funds and potentially confiscated. Given that there is no longer a lender of last resort, holding on to deposits and avoiding anything that might inspire a bank run is of even greater importance to banks.

The economy's vulnerability to the various natural disasters, as described previously, seriously affects the Ecuadorian banking system's loan portfolio. Most

¹⁷ For example, if an individual known to have close ties to the president is suspected of laundering money, it would not be surprising if the president himself would pressure bankers and regulators not to expose this individual's activities in order to avoid a scandal similar to the case of Fernandez and Gutierrez.

significantly, the country's most important industries, including oil, cut flowers, shrimp and bananas, can all face debilitating challenges from floods, landslides, volcanic eruptions and earthquakes. For banks this is important because one of these events can affect several, or even all four, industries at the same time. This makes it difficult for Ecuadorian banks to diversify risk in their loan portfolios. In addition, any event that affects the oil industry will have negative effects on government revenues and may affect the government's ability to pay its debt to the banks as well as to international creditors. As a result of these factors, the strength of the financial system is undermined by the volatility of the economy, which may deter many savvy investors from keeping large deposits in the Ecuadorian banking system. If this is true, banks may be motivated to accept deposits from any source they can, even if it means accepting money that was obviously gained through illegal means.

Another important factor is the high degree of reliance on cash. It is common for both large and small payments to be made in cash for everything from utility bills to purchasing a home or piece of land. As a result banks receive a large number of cash deposits from legal transactions, making it easier for cash transactions from illegal activities to blend in and go undetected, even if banks are reporting all large cash transactions to CONSEP.

While the fact that there are no laws against money laundering is an important factor creating opportunities for money laundering, the weakness of the financial system provides reasons to suspect that even if a strong legal framework were implemented, many challenges would remain to prevent Ecuador from attracting illicit profits.

However, there is one important reason for optimism with regard to the motivations of bankers. According to Christian Cordova, Ecuadorian bankers are very concerned with the threat of losing their correspondent banking relationships with U.S. banks (Cordova 2004). Since the events of 9/11 and the implementation of the Patriot Act, the U.S. government has given increased importance to cracking down on money laundering. The new environment has already resulted in scandals and serious complications and costs for several banks in the U.S., making this a credible threat to bank owners and directors. The threat of losing business with U.S. banks if they do not make sufficient efforts to prevent money laundering through their institutions may play an even more important role than a law against money laundering would, given that the rule of law is so weak.

In short, Ecuadorian banks have to perform a complex balancing act involving gaining public confidence and attracting deposits, competing with each other over a relatively small, concentrated market and keeping up appearances to U.S. regulators. It is clear the banking system and government regulators face some conflicting incentives with regards to money laundering. These conflicting incentives can be seen as opportunities for those looking for a place to launder their profits from the illegal drug industry.

THE ROLE OF DOLLARIZATION

The final factor to be considered is Ecuador's status as a dollarized country and the consequences of this as they relate to the illegal drug industry. First, Ecuador's decision to officially dollarize, eliminating the sucre and adopting the U.S. dollar as the country's official currency, has made it easier to launder money in Ecuador compared to

other countries. Second, it has complicated certain aspects of the economy and the financial sector that may lead to increased Ecuadorian participation in the illicit drug industry.

The first issue is how dollarization has increased “the attractiveness of Ecuador as a money laundering site” (U.S. Department of State 2004b). When Ecuador adopted the U.S. dollar as its official currency, it made laundering of drug profits through the Ecuadorian banking system, and economy in general, one-step easier. In his discussion on Mexico and its potential to become even more corrupt than Colombia, Carpenter points out that in Colombia the U.S. dollar is not negotiable currency, which means drug traffickers wishing to repatriate their profits earned in U.S. dollars face the challenge of converting those dollars into domestic currency, as well as how to introduce them into the legal economy. Although Mexico is not officially dollarized, Carpenter described how money laundering is significantly easier there when compared to Colombia because it is not necessary to change dollars into pesos in order to launder profits (Carpenter 2003, 190). In the case of Ecuador, illicit profits earned in dollars do not need to be converted into another currency in order to be introduced in the financial system or the general economy. This makes laundering drug profits specifically, which are mostly earned in dollars, easier to accomplish in Ecuador than in other countries.

The second issue is that dollarization has hurt some communities and sectors more than others, most significantly the region bordering Colombia, possibly creating greater incentives for Ecuadorians to turn to illicit activities as a means of economic survival or prosperity. One consequence of dollarization was a steep rise in prices of

most goods and services. While this affected the entire country, dollarization affected the northern border region particularly hard due to this region's dependence on trade with Colombians, whose domestic prices had previously tended to be significantly higher. Dollarization reversed this situation, causing many Ecuadorians to lose their livelihood and to turn to importing Colombian contraband. While this region was already facing economic hardship, dollarization has made conditions even worse (Rivera Vélez 2005, 234-5).

It is not clear how dollarization will affect the economy over the medium- to long-term. According to the World Bank, although it may have several positive effects in the medium term,

Dollarization ... could also impair the Ecuadorian government's capacity to implement countercyclical economic policy, while doing very little to eliminate growth volatility – most of which is associated with variation in the price of oil and other external shocks, and natural disasters. Similarly, the dollarization could have lasting effects on the level and structure of employment associated with losses in competitiveness due to sustained RER appreciation, and with changes in the relative prices of both inputs and final goods (World Bank 2004, 16).

This World Bank report also explains that many of the potential positive outcomes of dollarization have yet to be delivered:

For example, dollarization will most likely lead to the expansion of the range of services offered by the financial sector. Likewise, firms that survived the 1999 crisis and that have adjusted to the dollarization are probably now in much better shape to undertake efficient investment projects, raising productivity levels, employment levels, and real wages (World Bank 2004, 23).

Although medium- to long-term benefits may be achieved from dollarization, short-term economic hardship may be enough to increase long-term participation in the illegal drug industry. As discussed in the section on economic factors, economic hardship can be a contributing factor to an individual's decision to become involved in the illicit drug industry. When faced with limited choices, it can become the most viable survival strategy. This creates a labor source for the industry's leaders. There is evidence that this is already happening in the border region, as documented by Rivera Vélez. What is unclear, however, is whether or not, once an individual becomes involved in this often violent industry, they are free to choose to leave it and return to the legal economy. Although this paper has focused on the market incentives that affect the drug industry in ways similar to legal industries, in the end there is one important factor that sets the drug industry apart, which is the widespread use of coercion and violence. As a result, new opportunities in the market may not be sufficient to bring some people back out of the drug industry once they have begun.

CONCLUSION

In conclusion, the illicit drug industry is under strong negative pressures in Colombia through improved law enforcement, judicial reform, fumigation, and widespread violence. These pressures may motivate participants in the illicit drug industry to consider relocation. Meanwhile, neighboring Ecuador is becoming increasingly attractive as a location for activities related to this industry, due to the combined effects of its weak institutions, numerous economic challenges, the struggles of

the banking system and some of the consequences of dollarization. This is especially true for money laundering activities, but may also apply to other areas of the business. While it is likely that participation of Ecuadorians in various levels of the industry will increase, there is little evidence that Ecuadorians will come to dominate the industry. Instead it appears likely that Colombians will continue to dominate the industry but will conduct more of their operations inside of Ecuador, likely leading to increased involvement of drug leaders in Ecuadorian politics and increased corruption and violence.

The likelihood of increased involvement in the illicit drug trade has serious implications for Ecuador's future. In 1995, Bonilla included the following statement in his conclusion:

...given the dimensions of the country's economy as well as the institutional fragility of mechanisms for representation that continue to recur to the clientelistic and patrimonial practices, the Ecuadorian political system is highly vulnerable to the influence of drug trafficking (Bonilla 1995, 274).

Based on the issues examined in this paper, Ecuador is even more vulnerable today than it was 10 years ago. As the case of Colombia illustrates, the illegal drug trade has the potential to hold the political system hostage once it becomes sufficiently entrenched in a country, making it very difficult to fight. The possibility that guerillas may follow their income source across the border into Ecuador or that they may bring the drug industry with them further increases the seriousness of the risks Ecuador faces. The implications for the economy are also quite serious given that increased involvement in the drug industry would add to the numerous challenges Ecuador already faces in attracting investment.

There is significant disagreement about the effectiveness of U.S. aid in the fight against drugs. But if we assume that the U.S. government's strategy in Colombia *is* effective, making it increasingly difficult for drug traffickers to operate in Colombia, then the laws of economics and the theory of the balloon effect predict the industry will relocate.¹⁸ Therefore it is important to consider the consequences for other countries in the region if it hopes to prevent the industry from simply relocating. Unfortunately for Ecuador, U.S. policy does not seem to reflect this: In addition to receiving only a fraction of the aid received by Colombia, Ecuador lost \$7.5 million in aid budgeted to them for fiscal year 2004 because the government has refused to sign an agreement granting immunity from trial in the International Criminal Court to U.S. military personnel operating in Ecuador (El Comercio Nov 26, 2004).

This paper has demonstrated that conditions are ripe for Ecuador to play an increasingly greater role in the illicit drug trade. However, it would be a mistake for Ecuador to turn to the same strategies used in Colombia, (particularly the emphasis on military and police to the neglect of other issues.) While the effectiveness of those strategies is questionable, the negative effects are clear. Ecuador cannot afford the problems associated with these strategies anymore than it can afford to have the drug trade take a tighter hold on the country. Ecuador's greatest threats are the numerous internal weaknesses it faces. Significantly increasing aid to the military and police without first addressing, or at least simultaneously addressing, other weaknesses, will lead Ecuador into new and very frightening problems.

¹⁸ Although this paper focuses specifically on the case of Ecuador, several countries present attractive options, in particular Colombia's neighbors, Venezuela and Brazil.

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