

Evolution of Dollarization in Ecuador & El Salvador

INTRODUCTION

For as long as explorers have set off on journeys to uncharted destinations, people have watched them leave and predicted they would meet with disaster, they would get lost, or they would soon turn back, having wasted time and resources and accomplishing nothing. Certainly many of these predictions were correct, but when they were wrong, the world often changed as a result. Ecuador and El Salvador have recently set out on a journey that has raised similar predictions: official dollarization. Two small Latin American countries that have at least as many differences as they do similarities now share one characteristic that sets them apart from their neighbors: they have both given up control of their national monetary policy, abandoning their national currency in favor of the US dollar. Both countries decisions contradict the reasoning behind optimum currency area theory, which argues in favor of retaining exchange rate flexibility in cases where countries face asymmetric shocks, and especially in cases where these countries are unable to adjust to shocks due to wage rigidity or limited cross-border labor mobility. According to this theory, Ecuador and El Salvador both stood to benefit from maintaining a flexible exchange rate as a tool for stabilization in the face of external shocks.

Due to their extensive differences, each country took a different path to arrive at dollarization. Ecuador dollarized in response to and in the midst of a national crisis, while El Salvador planned its transition carefully over many years, taking steps in

advance to pave the way. Due to the differences in the circumstances of each country, and the different paths they took leading up to their decisions, the results of dollarization have thus also differed in some respects. This essay will explore the evolution of dollarization in each country, along with the key differences between these two cases.

BACKGROUND

Ecuador and El Salvador shared two main characteristics prior to dollarization: their vulnerability to natural disasters, along with the economic and political instability such events can cause, and a heavy reliance on the U.S. dollar.

Ecuador faces several types of natural disasters due to its geography that increase uncertainty and financial risk. 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 which affects not only agriculture but also generation of electricity, 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 damages anything with a motor as well as damaging the cut flower exports.

Like Ecuador, El Salvador also suffers from the uncertainty and instability resulting from natural disasters, specifically earthquakes and hurricanes. Two major earthquakes struck the country in January and February of 2001. It is estimated that 1,500 people were killed and that approximately 25 percent of El Salvador's population,

about 1.5 million people, were left homeless. Economic damage was estimated at \$2 billion (Emmott 2002). Although perhaps not as vulnerable as some of its neighbors, El Salvador is also affected by hurricanes. In 1998 Hurricane Mitch caused extensive damage, including “the forced release of a wall of water from the country’s major hydroelectric dam, producing major mudslides on denuded hillsides and severe flooding in the coastal regions...” and causing economic damages estimated at \$600 million (USAID).

Another similarity is that both countries had a high saturation of dollars in their economies before switching to the dollar as their official currency. Because of its history of inflation, Ecuador experienced spontaneous dollarization as many Ecuadorians turned to the US dollar for stability in savings and contractual agreements once their own currency had become unstable (Beckerman 2001). Both countries also received remittances from emigrants living in the United States. Banks in both countries had been offering accounts and loans in dollars for several years prior to official dollarization.

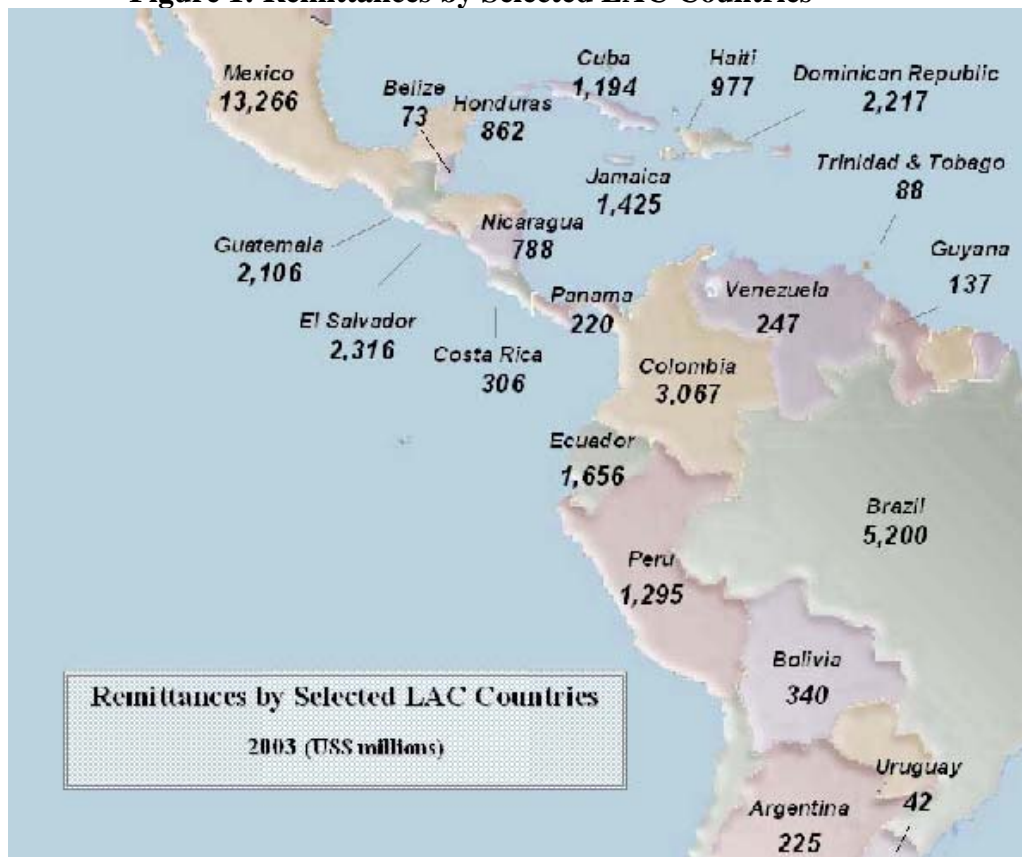
In spite of these important similarities, the two countries differed in many ways that affected their decisions to dollarize, the way in which they dollarized, and the results they have seen since making the transition.

For both Ecuador and El Salvador remittances from emigrants living in the United States constitute an important source of income and dollars. Where they differ significantly is in the amounts they receive in remittances and the significance of these amounts compared to each country’s GDP. In 2002 it is estimated that \$1.6 billion in

remittances were sent to Ecuador, mostly from Spain (44 percent) and the United States (38 percent). Total remittances received equal approximately 8 percent of Ecuador's gross domestic product (GDP). Remittances from the United States equaled \$608 million in 2002 (IDB 2003), equal to approximately 3% of GDP. El Salvador, on the other hand, was expected to receive approximately \$2 billion in remittances from the United States alone in 2002, an amount equivalent to 13% of the country's GDP (Emmott 2002).

Figure 1 compares remittances received throughout the region in 2003.

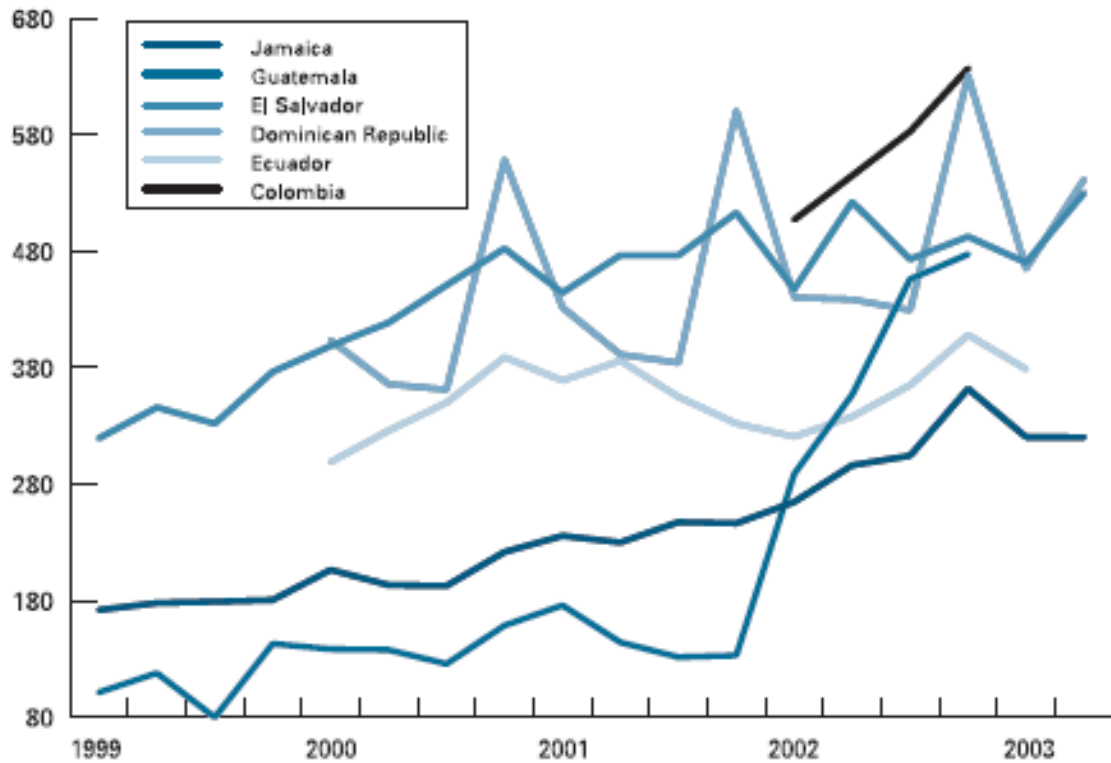
Figure 1: Remittances by Selected LAC Countries



(Source: IDB <http://www.iadb.org/mif/V2/graphics/map2003eng.jpg>)

Figure 2, taken from a report by the Inter-American Dialogue titled *All in the Family: Latin America's Most Important International Financial Flow*, effectively illustrates the trends in remittances for several countries in the region, including Ecuador and El Salvador.

Figure 2: "Quarterly Flows to Selected Latin America Countries"
(© Inter-American Dialogue)



Source: Central bank of each country.

While the trend in El Salvador has been steadily upwards, Ecuador's flow of remittances has been less consistent and has not increased as dramatically.

The countries also differ in terms of their level of dependence on commodity exports. In Ecuador, oil exports represent between 25 to 30% of total revenues (Jácome

2004; 7). As a result, government revenue inflows are highly volatile and the rise and fall of world oil prices creates boom and bust cycles.

Like Ecuador, El Salvador used to be heavily dependent on a single commodity for export: coffee. As late as 1990 coffee made up 60 percent of total exports, leaving the economy vulnerable to the rise and fall of world coffee prices. Today however El Salvador has succeeded in developing a more diverse export base. Coffee exports now represent only 8 percent, while exports from maquiladora assembly and export processing plants have gone from \$790 million in the early 1990s to \$2.5 billion in 2001 (Emmott 2002).

Although both countries share the challenges of deep political divisions, the nature of these divisions differs greatly, and therefore they present very different challenges.

Ecuadorian politics and economic policy are dominated by regional rivalry between the Coastal region and the Sierra. Because their climates are radically different, their economic activities are also distinct. The Coast is dependent on production of commodities for export, while the Sierra produces almost exclusively for domestic production. As a result of these differences, economic policies affect the two regions differently, specifically with regards to the real exchange rate: real depreciation would benefit the Coastal region's exports, while hurting the Sierra's production base (Jácome 2004). This conflict seriously complicated the management of the exchange regime prior to dollarization.

In the case of El Salvador, the country's 12-year civil war (1979-1992) left deep divisions in the society that persist today. The Peace accords were aimed at incorporating the former rebels into the political sphere so that they would be able to compete for political power without having to resort to violence. Progress has been made in this direction, with the leftist Farabundo Marti National Liberation Front (FMLN), made up largely of former rebels, assuming the role of a key political party (Kendrick). The country continues to address the legacies of the war, including the economic costs as well as issues such as human rights and improving the judicial system.

Ecuador and El Salvador also differ in the levels of debt relative to GDP each country was facing prior to the transition. In Ecuador total public debt equaled more than 98 percent of GDP in 1999 (IMF 2003). In contrast El Salvador's total debt in 1999 equaled 29.9% of GDP (World Bank 2002; 15). By 2002 total debt to GDP ratio had risen to 35%, still low by Latin American standards, requiring only 10% of export revenues to service its debt (Emmott 2002).

Although the United States is the most important trading partner for both countries and both rely heavily on exports to the United States, they differ in terms of how significant a percentage of their exports are destined for U.S. markets. No more than 40% of Ecuador's exports went to the United States from 1998 to 2002 (IMF 2003; 106). By contrast, approximately two-thirds of El Salvador's exports are destined for the United States (The Economist 2002).

DOLLARIZATION

The decision by the Ecuadorian government in January 2000 to officially dollarize was made in the midst of a “triple banking, currency and fiscal crisis” (Jácome 2004; 1) that had been building throughout the 1990s. Bank failures resulted when several external and internal shocks caused customers to lose confidence in the banking system and the sucre (Jácome 2004).



Natural disasters such as the floods caused by El Nino in 1997 and 1998 that destroyed agricultural areas not only reduced exports and access to foreign exchange, they also seriously impaired assets of banks (Jácome 2004).

The country was also forced to deal with the 1999 eruption of the volcano Guagua Pichincha, the fall of world oil prices, rapidly rising inflation, and numerous bank failures. Simultaneously the government’s liabilities were increasing and it was

defaulting on debt (Jácome 2004). A tax imposed on all financial transactions as of January 1999 caused further reduction of bank deposits and contributed to the difficulties faced by banks (Jácome 2004). Lack of confidence in the sucre led to increased demand for the dollar, and soon the Central Bank was no longer able to defend the exchange rate band and was forced to switch to a clean float in February 1999, resulting in a rapid depreciation of the sucre (Jácome 2004). The government declared a bank holiday in March 1999 and then imposed a widespread freeze on deposits, undermining the public's confidence in the economy and the government (Jácome 2004). As the crisis continued to unravel it appeared that Ecuador was headed towards hyperinflation. To avoid this, the government announced on January 9, 2000 its decision to fix the exchange rate to the dollar and to submit legislation to Congress to officially dollarize the economy. In the days following the announcement several different methods of "dollarization" were considered:

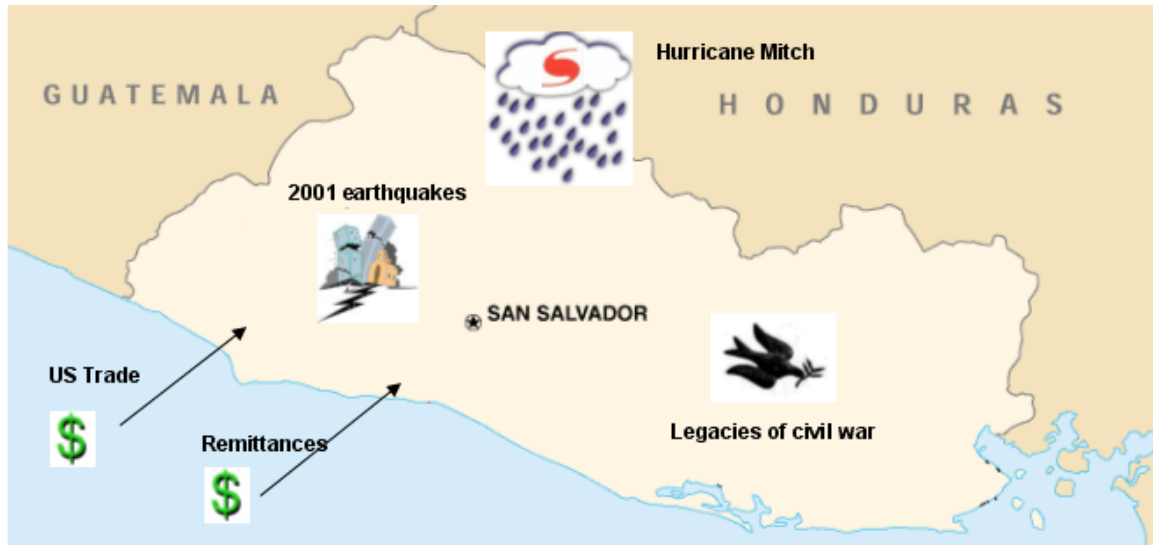
(i) a conventional fixed exchange rate; (ii) "loose" convertibility, under which the Central Bank could carry out a broad range of transactions so long as it maintained full foreign-exchange backing for all local-currency issues at a fixed exchange rate, (iii) "strict" convertibility, under which the only allowable Central Bank transactions would be purchase and sale of foreign exchange at a fixed exchange rate; (iv) complete substitution by the dollar for the sucre, but with the Central Bank retaining some functions; or (v) complete substitution of the sucre by the dollar, with the Central Bank closed and liquidated (Beckerman 2001; 24).

Once the decision was made to pursue the fourth option, the transition happened very quickly. This was in spite of the political upheavals that led to President Mahuad's removal from office amidst accusations of corruption. The "Fundamental Economic

Transformation Law” received Congressional approval and was signed into law by Mahuad’s successor, President Gustavo Noboa in March. Within months sucres were largely out of circulation (Beckerman 2001).

In contrast to the path taken by Ecuador, El Salvador’s journey towards dollarization was much more gradual and was based on careful planning. In 1994 the colon was pegged to the dollar (The Economist 2002). According to Steve Hanke, an economics professor at Johns Hopkins University, El Salvador was already considering complete dollarization as early as 1995 (Peterson 1999). After Brazil’s 1999 devaluation, many countries in Latin America began thinking about better ways to manage their exchange rates. A 1999 article in Euromoney explained that the President at that time, Armando Calderon Sol, had been holding meetings with representatives from the private sector to discuss the future of El Salvador’s monetary policy. Included in these discussions was the issue of how to implement the economic strategy that Chilean economist Sebastian Edwards had designed for the country, which required either a freely floating currency or a rigid exchange rate, as well as numerous reforms affecting the fiscal side, the banking sector and the labor market that were to be implemented first in order to prepare the country for this change (Peterson 1999). On November 22, 2000, President Francisco Flores announced the decision to dollarize. The new Monetary Integration Law came into effect January 1, 2001 and began the gradual phasing out of the colon (The Economist 2002). The new law freed up circulation of the dollar, making it the official monetary unit used by the banking system and suspended the emission of colons. The law also set a fixed exchange rate of 8.75 colons to the dollar (Munoz 2001).

According to Juan Jose Daboub, the finance minister, "El Salvador decided to dollarize to armor-plate its economy. It is an integral part of our reforms..." (Emmott 2002).



Neither country has done away with its Central Bank, although they now have very limited roles. In Ecuador the Central Bank uses its foreign exchange holdings for liquidity management and as a lender-of-last-resort, although its ability to act in either area is limited by its foreign exchange resources and liabilities (Beckerman 2001). The bank can also “recycle” resources from banks with excess liquidity to illiquid banks (Beckerman 2001; 26). Loans received from the International Monetary Fund, the Inter-American Development Bank and the World Bank in 2000 helped boost the Central Bank’s foreign exchange base (Beckerman 2001).

According to its website, El Salvador’s Central Bank is currently active in three main areas: the financial system, monetary stability and public finance. It is still

responsible for distributing bills and coins to banks among other administrative tasks. In terms of monetary stability, the Central Bank exports old bills and imports new ones. It also produces information upon which economic decisions are often based. In the area of public finance the Bank continues to serve as the financial agent of the government and as its economic and financial advisor. It is also responsible for acting as the government's representative to international organizations such as the IMF and the World Bank, among others (Banco Central de Reserva de El Salvador).

CONSEQUENCES OF DOLLARIZATION

Both countries were able to achieve lower inflation through dollarization. In the case of Ecuador, the country was able to avoid slipping into hyperinflation. Because the exchange rate was deeply depreciated at the moment of conversion, prices needed to rise approximately 120-140 per cent over their December 1999 levels in order to reach parity with world prices. Real wages had been declining over the course of the crisis and price increases led to demands for wage increases. Even with the wage increases made by the government formal-sector wages lagged behind price increases in relative terms. However, this was part of "a one-time price level increase, not a true 'inflation'" (Beckerman 2001; 30).

El Salvador also saw dramatic results in terms of reducing inflation. From inflation as high as 25% in the 1980s, it was down to 1.4% in 2001 (Emmott 2002).

Both countries will face the disadvantages of official dollarization. First, they will both now be vulnerable to changes in US monetary policy. As Jeffrey Sachs and

Felipe Larrain wrote in their article “Why Dollarization is More Straitjacket Than Salvation,” “...what is good for the United States is not necessarily good for other countries” (Sachs and Larrain 1999; 81). Second, both are now in a weaker bargaining position relative to the US. If the US wants to pressure or punish an officially dollarized country it can do so through controlling the flow of dollars into these countries and of assets held in U.S. banks, as was done with Panama in 1988-89 (von Furstenberg 2000). Third, neither country can rely on exchange rate depreciation or appreciation as a shock absorber for the economy. In addition, both have forfeited seignorage income, as explained by Sachs and Larrain, in the sense that they no longer receive the income produced when the value of the currency exceeds the cost of producing it (Sachs and Larrain 1999). Finally, both countries initially faced challenges getting used to the new currency. The transition was especially difficult for the illiterate because the U.S. dollars were all the same color, making it difficult to distinguish the different denominations.

Ecuador and El Salvador have had dramatically different levels of success towards attracting foreign direct investment (FDI). In spite of the transition to the dollar, and its relative openness to FDI, Ecuador has had little success outside of the oil-sector. While non-oil FDI averaged 20-40 percent of GDP during the early 1990s, it has fallen below 5 percent since 1999 (IMF 2003). In El Salvador the results have been very different with FDI in 2001 rising to \$200 million, 10% more than in 2000 (Emmott 2002).

As mentioned earlier, El Salvador has had an advantage over Ecuador due to its greater access to dollars through remittances sent from Salvadorian emigrants living in

the United States. This meant that prior to official dollarization most Salvadorians had experience handling dollars, making the transition easier (The Economist 2002). It is also an important source of currency for a banking system now dependent on dollars. El Salvador also has greater access to dollars than Ecuador through trade with the U.S. In the case of Ecuador, with less access to dollars through remittances and trade than El Salvador, it is feared that the banking system's need for dollars and the country's proximity to Colombia, combined with the international crack-down on money laundering and the drug trade, will lead Ecuadorian banks to accept "narcodollars" driven out of other countries in order to stay afloat.

CONCLUSIONS

Not surprising due to the conditions under which Ecuador made the transition to the U.S. dollar, the country still has a long way to go before realizing all of the advantages of dollarization, and to minimize the disadvantages. As Paul Beckerman stated in a World Bank report:

In retrospect, Ecuador had little choice but to dollarize when it did. The authorities had lost the capacity to control the money supply and, hence, the sucre's dollar or purchasing-power value. By dollarizing, they gave up no policy instruments they had not in reality already lost. Dollarization is perhaps best regarded as a structural reform ending an unmanageable dual-currency system (Beckerman 2001; 35).

Ecuador will always be vulnerable to natural disasters which can be especially devastating to domestic agriculture and the oil industry. The potential for disasters to occur and negatively affect these key sectors adds to the risk of bank loan portfolios because numerous large bank customers can potentially all default on their loans at the

same time. Regional differences will continue to plague the country, but now they will not be able to dominate exchange rate policy.

Now that it can no longer rely on a flexible exchange rate to affect competitiveness Ecuador's economic policies will have to focus on fiscal policy and improving productivity in order to be competitive. One step in this direction was the adoption of the *Fiscal Responsibility and Transparency Law* which sets limits on the growth of public expenditures. In January 2003 the government began "a bold program aimed at strengthening the fiscal balance and help eliminate arrears" (IMF 2003; 8). This program could further improve competitiveness. Investments in education and health will be key to improving future productivity. Improved banking regulation will be key to improving confidence and encouraging higher domestic savings which can then be used to finance economic growth. Steps that remain include diversifying the economy so as to limit the reliance on the volatile price of oil and to prepare for the eventual exhaustion of domestic oil reserves, which are expected to last no more than 20 to 30 more years (IMF 2003; 34). At least inflation has been tamed, eliminating problems caused by the dual currency system that existed previously, and allowing the country to focus on other important issues that will affect its future. .

Overall El Salvador seems to have been better able to reap the potential benefits of dollarization, due at least in part to the planning and preparation prior to the transition to the dollar. Consumer credit is growing (The Economist 2002), and interest rates have dropped from 14% to 7.5% in 2002 (LatinFinance 2002). The improved economic stability even allowed El Salvador to successfully launch two bond issues in 2002,

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becoming the first Central American country to issue a 30-year bond (Emmott 2002).

This sets it apart from Ecuador, whose debt rating remains in junk-bond status (Ashwell, 2004). Overall the future for El Salvador, though certain to involve numerous challenges, looks relatively bright compared to the more uncertain future of Ecuador.

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