

**Ecuador Financial Crisis, 1999**

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### **Abstract**

Ecuador underwent a severe financial crisis in 1999 on par with the Great Depression in terms of the devastation it dealt to society. Ecuador's economy had been experiencing deteriorating conditions throughout the 1990s and entered full-scale crisis mode in January of 1999 when its currency—and the currencies of neighboring countries—slid into a freefall.

Like other emerging economies undergoing economic crisis, Ecuador simultaneously experienced a banking crisis, sharp depreciation of its currency, loss of investor confidence and a net capital outflow. It also suffered from a sharp economic decline in terms of its Gross Domestic Product. Consumption fell as did employment. The economic crisis exacerbated political instability, making it hard for government leaders to implement reforms needed to secure outside help. While this paper does not cover political weaknesses within the system, it discusses them in regards to their impact on policy matters relevant to the crisis.

This paper examines the root causes of the financial crisis, looks at the underlying economic conditions preceding the crisis, and assesses policy responses by the government as well as the International Monetary Fund (IMF).

Although small in size, Ecuador's experience is large in relevance. Several pieces to this story make its crisis an interesting case study for international finance. What stands out the most is that after exhausting all other solutions to the crisis, the country adopted a rather extreme policy solution: full dollarization. Ecuador's story also illustrates why carry trade investments help sustain an economy despite its economic weaknesses and help destroy it when the investors change from a high-risk reward strategy toward risk-averse strategies.

## **Crisis Strikes**

A currency crisis is defined as a speculative attack on the currency consisting of massive selling of the country's assets by domestic and foreign investors.<sup>1</sup> It involves substantial depreciation of the currency and can lead to depletion of foreign reserves. In mid-January, Ecuador experienced this type of crisis in reaction to an external shock.

On January 13, the Brazilian government announced it would give up its attempts to maintain a fixed exchange system with the U.S. dollar. The news not only impact Brazil's real—which lost 8.3 percent of its value in a single day and 42 percent of its value in a week—ignited a major sell-off of investments all around the world.<sup>2</sup> The U.S. dollar took a beating, as did the London and European stock exchanges.<sup>3</sup>

Brazil was a major player in Latin America. Its economy made up 42 percent of regional GDP. So it follows that what happens in Brazil, happens to the region. Moreover, when the real collapsed, the entire continent trembled in crisis mode for most of the year that would follow. Ecuador would experience hyperinflation, collapse of the banking system, and significant political and social upheaval.

Investor uncertainty over the value of currencies caused a rapid rise in the risk premium in Ecuador, as well as Argentina, Mexico, Paraguay and Uruguay. Governments reacted quickly to try to defend their currencies and restore investor confidence. Argentina reaffirmed its commitment to a one-to-one peg to the dollar, fending off speculative attacks, cut tariffs on imports and provided help for domestic businesses.<sup>4</sup> Mexico tightened its monetary policy.

The Ecuador government reacted quickly. The central bank paid out \$70 million to defend the sucre, and it raised the ceiling on interbank overnight lending rate on loans that banks use to meet reserve requirements to an annualized 140 percent—a rate that had been at 58 percent the week before.<sup>5</sup>

Despite the efforts, investors were spooked and withdrew their money. Net capital flows reversed themselves from a positive to a negative by the first quarter of 1999—from \$571 million to negative \$407 million. The reversal in trends was due to an

outflow of \$526 million from “Other Investment Liabilities, n.i.e.” The IMF describes this subcategory as “financial transactions not covered in direct investment, portfolio investment, financial derivatives, or reserve assets.” It includes “transactions in currency and deposits, loans, and trade credits.”<sup>6</sup> This loss was partially offset by an inflow of \$146 million that went toward direct investments in the economy.

### Warning Signs

In contrast to the Asian financial crisis of 1997, the Latin American crisis did not come as a complete surprise. In fact, the region was ripe for speculative attack. Currencies like the real and Ecuador’s sucre had been losing value over the previous year. Some countries sought ways to devalue currencies in a controlled manner. Columbia, for instance, widened its exchange-rate band to allow for a measured depreciation in early September 1998. But most governments had been doing whatever they could to prop up their currencies.

Some analysts predicted that it was only a matter of time before crisis would erupt throughout the area. In Ecuador’s case, it appears that signs of turmoil were evident in very early days of 1999. One week before the Brazilian real collapse, Ecuador’s sucre suffered wild swings, at times reaching a new low of a 20 percent decline against the dollar.<sup>7</sup> In hindsight, one might argue that the financial crisis started during the previous year. Data suggest that Ecuador’s Balance of Payments (BoP) was in disequilibrium throughout 1998.<sup>8</sup> Under normal circumstances, the Current Account Balance (CAB) and the Financial Account (FAB) would equal zero.<sup>9</sup> Such was the case during the third quarter of 1996.<sup>10</sup> In contrast to that time of relative normalcy and consistent accounting, the fourth quarter of 1998 shows inconsistencies in Ecuador’s reported BoP:

CAB:	-\$453.8 million
Financial Account:	\$570.8 million
<u>Net Errors and Omission:</u>	<u>-\$237 million</u>
Overall balance:	-\$120.8 million

Something was askew. Either the CAB surplus was overvalued, the FAB deficit was undervalued, or both. Furthermore, the overall balance was off by negative \$120.8 million, suggesting the economy was in disequilibrium. (See Table, Pg. 8)

Looking closer at the data, one can see that Ecuador's holdings of foreign currency had fallen into negative territory by the end of 1998. Reserve assets deteriorated, from \$250 million in the third quarter of 1998 to negative \$40 million in the fourth quarter. That suggests that the central bank was buying its own currency using foreign holdings in an attempt to sustain the sucre's value against selling pressure.

The BoP inconsistencies are not surprising given the fiscal situation and economic decline. By the end of 1998, economic growth had slowed to 1 percent; inflation had reached 45 percent; the fiscal deficit exceeded 5 percent of the GDP; and the current account deficit reached 8 percent of the GDP.<sup>11</sup> Its foreign reserves had declined from \$2 billion at the end of 1997 to \$1.6 billion by the end of 1998. (See Table, Pg. 3) The new President Jamil Mahuad promised to put the fiscal house in order. And amid pressures of currency devaluation, he put together a fiscal austerity package to reduce spending.

Despite the new president's efforts to introduce fiscal order, Ecuador's problems only mounted. It was hit by two unexpected and uncontrollable events: a collapse in the global price of oil and anomalous weather conditions caused by El Niño. Both events had a devastating impact on Ecuador's economy.

### **Oil and Water**

Ecuador was heavily dependent upon its exports of oil. It was not only the largest export, it provided more than a third of the government's revenue because its industries were primarily state-owned.<sup>12</sup> When oil prices were high, they encouraged dependence upon the commodity for resources and upon the state for management of the economy. When oil prices were low, they threw the fiscal and trade balances into arrears.

In response to the Asian financial crisis, oil prices started falling in 1997, from a high of \$20 per barrel to a low near \$10 per barrel by the beginning of 1999. (See Table,

Pg. 5) By some estimates, the drop in prices reduced export earnings by \$600 million over a year.<sup>13</sup> The loss of commodity sales to Asia and the related drop in price shows that fears of contagion were valid.<sup>14</sup>

Meanwhile, Ecuador's other primary exports—agriculture—also took a hit. (See Table, Pg. 10) Reports suggest that El Nino-related floods and storms hitting coastal areas in 1997-98 caused \$2.8 billion worth of damage to Ecuador's agriculture sector and additional harm to infrastructure.<sup>15</sup>

The government tried to respond to the series of internal and external shocks. It reduced energy and corporate subsidies, raised gasoline prices and raised interest rates to attract financing. But the damage had already taken been done. The value of exports fell to \$4.2 billion in 1998 from \$5.3 billion in 1997.<sup>16</sup> Ecuador ran a trade deficit of \$1.7 billion in 1998, and its foreign liabilities increased.<sup>17</sup> Private consumption declined, as did employment rates. Yet inflation continued to spike upwards. The economic contraction from the loss of exports led to a massive increase in Ecuador's external debt. Overall, the El Nino reduced the annual GDP by 13 percent.<sup>18</sup>

### **Capital Inflows**

Despite the weak underlying macroeconomic conditions in 1998, Ecuador continued to attract foreign capital. In fact, more than \$1.4 billion flowed into the country in 1998, mostly in the form of direct investments (\$870 million) but also unspecified "Other Investments Liabilities" (\$666 million) and loans to monetary authorities (\$230 million).

Carry trade investors who specialize in taking advantage of interest rate differentials saw opportunity in Ecuador. As they weighed the cost of annualized currency devaluation against the benefit of a rate of return on deposits, they saw a money-making opportunity in developing countries with high interest rates.<sup>19</sup> Specifically, investors saw that although the Ecuadorian sucre lost 24 percent of its value in 1998, the central bank paid a return of 44 percent on its debt. Thus, they could expect a gain of 20 percent by borrowing funds at low rates from U.S. institutions and investing them in

Ecuador. In short, despite the high risk of investing in an uncertain climate, opportunity for profit overrode risk concerns.<sup>20</sup>

Nevertheless, by the end of 1998, it was clear the carry trade strategy could not last much longer. In an article published in "On Wall Street" just two weeks before the collapse of the Brazilian real and Ecuadorean sucre, an analyst named Gary Scott warned that the end of the emerging market boom was near. He suggested that emerging markets simply do not produce solid returns, and therefore cannot repay lenders. The problem was that the huge interest rate differentials between U.S. and emerging economies attracted savings from relatively safe but modest investment climates to higher risk environments. Savings flowed "by the bucketful into wasted efforts abroad," Scott said, and that waste would not produce the returns needed to repay investors.<sup>21</sup> Sooner or later, investment boom would rupture. Countries that print too much money would end up paying in terms of devaluation.

The Uncovered Interest Rate Parity condition backs the idea that leveraging interest rate differentials is risky business. UIP says that high interest rates take into account investors' expectations of a currency depreciation. Ecuador's interest rates started climbing at the beginning of 1998, suggesting that investors demanded a higher return on deposits because they calculated a higher risk premium into their investment strategies. (See Table, Pg. 6) The lending rate also spiked and maintained highs of 40 to 60 percent throughout the 1990s. (See Table, Pg. 7)

The investment climate was precarious throughout the 1990s, and the economy could have collapsed at any point in the decade. But, as IMF First Deputy Managing Director Stanley Fischer noted much later, investment money kept pouring into the country because investors were caught up in the "emerging market euphoria" of the time.<sup>22</sup> Ecuador's oil sector made the country particularly attractive.

### **Spiraling Currency & Loan Defaults**

As noted earlier, the euphoria turned into despair when the sucre and other Latin American currencies came under speculative attack. Ecuador's currency began its descent in 1997 and then came under even more serious pressure in 1998. Responding

to falling oil prices and a loss of investor confidence, the government allowed the sucre to undergo two devaluations in 1998: a 7.4 percent fall and a 14 percent fall. (See Table, Pg. 2)

The sucre's depreciation only made fiscal matters worse for private and public borrowers. Specifically, it made it harder for the government to repay lenders on existing loans. Soon, the public sector began crumpling under the weight of its debt to foreign creditors. By September of 1999, Ecuador became the first country to default on a coupon for a Brady Bond—a U.S. dollar-denominated bond used by countries that have a history of default on loans.<sup>23</sup> President Mahuad canceled interest payments that were due and he announced plans to renegotiate a \$5.9 billion debt.<sup>24</sup> That sent the sucre tumbling further.<sup>25</sup> Within two weeks time, the sucre lost another 17 percent of its value against the dollar. (Note: the bilateral sucre-dollar exchange is used repeatedly throughout this report because the United States is Ecuador's largest trading partner.)

The debt default also arrested capital flows in and out of the foreign exchange market in Ecuador and its neighbors.<sup>26</sup> Multiple news reports suggest that the debt default cut off these flows. The data for Ecuador affirms these reports. Capital outflows shrank to \$133 million in the fourth quarter of 1999, indicating that financial exchanges had frozen.

### **Bad-News Bail In?**

Making matters worse, Ecuador also defaulted on a Euro bond and said it would stop servicing past-due bonds, PD bonds. The double default on top of the non-payment of Brady Bond interest spurred a rather large controversy among international investors and economists about the role the private sector should play in a country's debt restructuring. While IMF officials working with Ecuador swear they had no influence over the government's decision to default, the Fund was nevertheless blamed. The reason is simple: IMF economists were negotiating a possible aid package with Ecuadorean fiscal and monetary policymaking officials.

In the late 1990s, the Fund had provided a series of bailout packages conditional upon reforms to Asian countries. Shortly thereafter, the IMF came under fire for

rewarding risk via the bailout packages. Most likely, investors expected the Fund to continue the rescue strategy, despite the criticism that it was creating a moral hazard, which encourages risky investments. What came to be known as the Ecuador “bail in” came at time when multilateral talks on revising international rules regulating debt restructurings were stalled. That is why the Ecuador loan default was of central interest around the world.

Soon, the public-private debate turned to the issue of burden sharing, particularly as Latin America and other emerging economies became starved for funding. The money supply in those countries simply shrank. Joseph Stiglitz, chief economist for the World Bank, made the case that private lenders should be willing to continue lending to emerging markets, which are dependent on the developed world for needed resources and are impacted the most by shifting capital flows.<sup>27</sup> The private sector, meanwhile, continued to pull financing from currency deposits, loans and trade credits in Ecuador through mid-year 2000.

### **An Impactful Crisis**

The drastic withdraw of liquidity might have slowed the steady slide of the sucre, but it threw the economy into a tailspin.

**Trade Balance:** Initially, the depreciation of the sucre and economic contraction heightened Ecuador’s current account balance (CAB), from a \$714 deficit in 1997 to a \$2.17 billion deficit in 1998. That is likely due to the valuation changes of exports and imports. The following year, the CAB changed course as consumption and the demand for imports plunged. The CAB deficit of \$2.17 billion in 1998 turned into a \$955 million surplus in 1999.<sup>28</sup>

Unfortunately, the improved CAB did not relieve economic tensions. Quite the contrary, the economy suffered the most in 1999. The domestic output contracted as consumer spending, government expenditures and investment shrank. Exports held relatively firm in terms of volume, but the sudden and severe depreciation of the sucre made imports more expensive. Overall GDP fell by 7.5 percent in 1999, from \$23.3 million in 1998 to \$16.7 million in 1999.<sup>29</sup>

**Societal Impact:** People were profoundly affected. The portion of the population living in poverty grew to 45 percent. Unemployment reached 15 percent in 1999, up from 7 percent in 1995.<sup>30</sup> Consumer prices, which had already been climbing over the previous years, climbed even higher. The Consumer Price Index increased by 52 percent in 1999 over the previous year's price index.<sup>31</sup> Producer prices nearly doubled over the same time period, putting pressure on employers to cut labor and wages.<sup>32</sup> Meanwhile, the sucre lost 80 percent of its value over a 16-month period, raising the cost of imports and inflationary pressures.<sup>33</sup>

### **Banking Sector Collapse**

As interest rates rose and liquidity shrank, the financial sector became squeezed. As a consequence, most of the nation's largest banks simply collapsed. They could not pay their debt, and the government agency set up to help them was also strapped for cash. The nation panicked. Savers rushed to their banks to seize their deposits. In most cases, it was too late. The government responded to run on banks by freezing all bank accounts. While foreign creditors turned to lawsuits for help, domestic savers were virtually locked out of the system.

Bank closures forced millions of account holders into poverty because they lacked access to funds and employers lacked the means to pay workers. The government agency (AGD) responsible for guaranteeing deposits lacked the capital it needed to restructure the system and supply cash. The high interest rate and deep decline in the value of the sucre against the dollar exacerbated debt liabilities for private banks. By 2000, 16 of the country's 42 banks, including four of the five largest, had shut down. Most all banks came under the control and ownership of the government.

The banking crisis had a devastating effect on society. Employers could not pay their workers, and consumers could not buy even the most basic household items. The populace lost confidence in their economy and elected leaders.

### **Chaos and coups**

Not surprisingly, as the economy plummeted, so did politicians' popularity. President Jamil Mahuad's approval rating dropped from high of 60 percent to 7 percent. The lack of political support mattered it became virtually impossible to enact fiscal austerity measures needed to secure an aid package from the IMF. The Fund was pushing the government to raise taxes and cut spending to curb what had become uncontrollable deficits.

Mahuad had proposed fiscal reforms when he took over as president in mid-term 1998, and he reportedly meant to follow through on the plans. However, in spite of his initial popularity gained after securing a peace deal with Peru, the president's hands were tied when it came to fixing the fiscal disorder he inherited from his predecessors. His training as a politician and lawyer were of little use in combating the masses of protestors who turned out in the streets to oppose the reforms. Mahuad's finance minister, Ana Lucia Armijos, resigned under the pressure.

At times, Mahuad's cabinet considered dissolving the legislature and forcing the reforms through by executive decree. The panic and fury in the streets had grown to such violent levels that Mahuad declared a state of emergency.<sup>34</sup> The unstable political situation made it impossible to complete a deal with the IMF, and the lack of aid made it impossible to restore economic health.

### **Desperate Times, Desperate Actions**

By the end of 1999, Mahuad was desperate for a solution. The sucre had lost almost 80 percent of its dollar value in the 16 months since he had taken office.<sup>35</sup> By the end of 1999, Ecuador turned to its neighbors for advice about stabilizing the currency. Argentina had a currency board. Panama had long ago adopted the dollar as its official currency. Ecuador considered both moves as options, and Mahuad reportedly leaned heavily on advice from an Argentine consulting group called Mediterranea. The IMF, apparently, was not included in the discussions.<sup>36</sup>

A currency board seemed impossible because Ecuador's reserves were weak. Reserves had fallen from \$1.6 billion at the end of 1999 to \$545 million in the beginning

of 2000. (See Table, Pg. 3) The central bank had drained the reserves in its attempts to prop up the currency.

Dollarization seemed more feasible, although it too carried risks. Only a handful of countries had thus far tried it, so it had not been fully tested under the strain of external shocks. But there were clear advantages to adopting the U.S. dollar as the official currency. It would achieve the primary goal of stabilizing the currency and protecting it against speculative attack. That effect alone could encourage investment by local and foreign savers.<sup>37</sup> Another benefit to dollarization is that it could instill stability in a country that has a history of irresponsible or ineffective fiscal and monetary policy making. The dollar was the only real choice because the United States is Ecuador's largest trading partner. On average, the United States receives more than 38 percent of Ecuador's exports and provides more than 30 percent of Ecuador's imports.<sup>38</sup> It might have also mattered that oil is traded in dollars in the global marketplace.

The disadvantage to giving up the national currency is that the policymakers lose autonomy—the country loses ability to affect the money supply via monetary policy as well as its ability to act as a lender of last resort for banks. Yet that might be exactly what Ecuador needed. Its volatile turnover and disruption in its governance structure was in need of outside help.

In early January of 2000, it seemed unlikely that President Mahuad would give up the sucre. After all, he had described dollarization as “a jump into the abyss.” But the president knew that he had little control over the spiraling collapse of his economy. He needed help, and he needed it quickly. Social unrest had only grown stronger. Workers' unions and indigenous groups demonstrated in the streets by the thousands to vent frustrations against the collapsing economy and to protest the fiscal austerity measures meant to fix it. Thousands of indigenous protestors took over the congress and stormed the presidential palace.

On January 9, Mahuad announced plans to dollarize the currency. The announcement spurred excited and exploratory talk of trading blocs, dollar zones and treaties among analysts in the trade press. Closer to home, it only drew further ire among student and worker protestors. Mahuad's monetary cabinet immediately

resigned. Shortly thereafter, Mahuad would enter the abyss he had foreseen. On Jan. 21, 2000, a civilian-military coup ousted President Mahuad from office, leaving his vice president in charge.

Nevertheless, Ecuador stayed with the dollarization plan, allowing Mahuad's last act as president to stand.

### **Dollarization as a Last Resort**

Before Ecuador settled on dollarization, it had experimented with different exchange rate systems throughout the 1990s.<sup>39</sup> Prior to 1993, the central bank managed the foreign exchange and intervened in the currency market. Then it moved to a crawling peg, which allowed the sucre to move within a band of rates. A crawling peg combines flexibility with stability. It is typically used by emerging economies to allow the domestic currency depreciate in a relatively stable manner. In 1994, the government introduced a currency exchange-band system, which allowed the sucre to move up and down within a Su50 spread against the central parity rate.<sup>40 41</sup> According to the *Economist*, the crawling peg enabled the central bank to maintain some stability and minimize interest-rate volatility. However, some adjustments took place as they were needed.

In 1997, the government said it would move to a currency board system that would anchor the sucre to the dollar.<sup>42</sup> It appears, however, that system was never put into place.<sup>43</sup> For a currency board to work, a central bank must own enough foreign reserves to cover the entire monetary base to ensure full convertibility. In 1997, Ecuador's reserves holdings of \$2 billion were at their historic peak. (See Table, Pg. 3) But so was political instability. The primary backer of the currency board—President Abdala Bucaram—was dismissed from office after the public protested his embezzlement of millions of dollars in public funds.

Needless to say, the exchange rate system was irregular. The government abandoned its crawling peg several times to allow the sucre to depreciate within a band. In 1998, the central bank implemented two adjustments, devaluing the sucre by 7.4 percent and 14 percent, in response to tumbling oil prices and loss of confidence in the

sucre. Overall, the sucre fell by a moderate amount in 1997 and then started a steep fall by mid-1998. (See Table, Pg. 2)

Speculation that the currency would fall raised the risk premium for Ecuador assets in the mid-1990s. That speculation caused the central bank to repeatedly act to keep the sucre within the band. It maintained high interest rates, ranging from 37 percent to 60 percent, to attract foreign capital and prevent outflows. (See Table, Pgs. 6-7)

Pegged currency regimes are the norm in Latin America so it is no surprise that Ecuador favored a partial-fixed exchange. The fixed exchange rates enabled countries to maintain stability despite having budget deficits. The downside is that pegged regimes are often accompanied by an appreciation of the real exchange rate, and that is not offset by productivity gains.<sup>44</sup> The net effect is inflation, and inflation matters. That was the price Ecuador paid for its fixed exchange system. Consumer prices rose from 14 in 1997 to 78 in 2001 (based on a Consumer Price Index of 100 in 2005). (See Table, Pg. 9) Producer prices rose too, from 13 in 1998 to 70 in 2001. Inflation hit 100 percent in 1999.<sup>45</sup>

Furthermore, the combination of pegged exchange rates, current account deficits and fiscal deficits left Latin American economies susceptible to changes in investor sentiment in the mid-1990s. Although Latin America was not excessively exposed to short-term credit, it was overly dependent on foreign savings.<sup>46</sup> By 1999, Ecuador moved to a free floating system—a system that allowed the sucre to fall to an all-time low.

### **Analysis of Dollarization**

At the time Ecuador was considering its options, it seemed that nearly everyone who mattered was opposed to dollarization. The Economist wrote an opinion piece outlining its flaws. Moreover, Jeffrey Sachs, an influential international economist, discouraged developing countries from moving to dollarization. In an article written with Felipe Larrain, Sachs argued that dollarization is an “extreme” and “reckless” solution to market instability in developing countries.<sup>47</sup> He suggested that it is better to allow exchange rate depreciation because the devaluation helps an economy absorb shock.

Sach's argument is essentially a competitiveness issue. His point is that if a currency depreciates, the country's exports become more attractive in a global market. He suggests that if an oil-exporting country faces an external shock of a drop in global oil prices, an exchange-rate depreciation will boost non-oil exports. This view does not take into account Ecuador's situation. The country's production capacity was largely undeveloped because it was—and is—overly dependent on the state-owned oil sector for its exports. Oil made up a third of Ecuador's exports in 1999. Agricultural products, such as bananas and shrimp, made up the remaining shares. (See Table, Pg. 10) Since the global market determines commodity prices, particularly for oil, Sach's argument does not hold in Ecuador's case. Moreover, the competitiveness argument will not hold in cases where an entire region is in crisis mode because a country's exports may not be priced below its competitors.

Sachs does make a good point that a country that dollarizes gives up ability to affect money supply and inflation. Monetary policy is made in the United States, which has different economic concerns and patterns than most developing countries. (It seems to work for Panama, but that country has long had close ties with the United States.) Sachs disagrees with the case that dollarization instills discipline. He said that is not a valid point because monetary authorities in developing countries are more responsible than they receive credit for being. It is far more important for them to maintain control of money-supply tools, such as its ability to act as a lender of last resort.

It is noteworthy that although IMF helped government officials implement the plan to adopt the dollar, it did not encourage Ecuador to move to dollarization. In fact, IMF officials opposed the idea on the grounds that Ecuador was not prepared for such a drastic change in its exchange rate regime.

"If they had asked us, we would have said that the preconditions for making a success of dollarization were not in place," said Stanley Fischer, IMF first deputy managing director, in a May 2000 speech to the Hoover Institution.<sup>48</sup> Ecuador's weak banking system and fiscal position were the obstacles to implementing the plan.

By the time Ecuador put the plan into fully place on September 9, 2000, the economy had started to recover. Oil prices had climbed to record highs and the

agricultural sector had recovered. Consumer prices were still high and rising, but interest rates had fallen to reasonable levels. It appeared the economic recession had hit its trough and would recover in time.

The central bank had started the transition to dollars in March, just two months after Mahuad had announced the plan. Runs on banks ended. Ecuador struck a deal to restructure its loans, and the IMF supplied a one-year stand-by credit package of \$300 million. Reserves remained relatively low. But that was to be expected. To make the transition at the declared peg of Su25,000:US\$1, the central bank needed to purchase as much as \$450 million worth of sucres in circulation.<sup>49</sup>

What is interesting, and unfortunately unexplainable, is that Ecuador experienced a massive capital outflow at about the same time it transitioned its currency to U.S. dollars. The data shows that during the third quarter of 2000, roughly \$5.5 billion was withdrawn from Ecuador's "Portfolio Investment Liabilities" – which the IMF defines as "transactions with nonresidents in financial securities of any maturity (such as corporate securities, bonds, notes, and money market instruments) other than those included in direct investment, exceptional financing, and reserve assets." The yearly data for 2000 shows this outflow in both the portfolio investment liability category and in the debt securities category. This data reveals an area where further research could be undertaken to examine possible relationships between adopting a foreign currency as one's own and outflows of securities.

In the end, Ecuador's experience with dollarization provides a lasting legacy to economic analysts, especially those who favor the idea of optimal currency areas. It was hailed as an early success because it stabilized the economy. Examination of dollarization as an effective policy is beyond the scope of this paper. But it is clear Ecuador could provide an excellent test case for dollarization.

## Endnotes

- <sup>1</sup> Pg. 2 <http://www.sis-statistica.it/files/pdf/atti/RSMi0602p537-540.pdf>
- <sup>2</sup> “Investment banking: Emerging into the shadows: The emerging debt market has suffered some cruel blows in the past 18 months.” By ALISON WARNER. *The Banker*. March 1, 1999.
- <sup>3</sup> The FTSE 100 index fell by 183.5 points—the fourth largest drop in its history up to that date. “Shares dive as Brazil devalues.” By Alasdair Murray and Oliver August. *The Times of London*. January 14, 1999.
- <sup>4</sup> “Argentina. Cool Menu.” *The Economist*. Jan. 30, 1999.
- <sup>5</sup> “Ecuador likely to suffer from fallout Central bank boosts overnight rate in move to ease pressure on currency.” By Thomas Vogel Jr. *Globe and Mail*, Jan. 15, 1999.
- <sup>6</sup> IMF Statistics Explanation. <http://www.imfstatistics.org/imf/>
- <sup>7</sup> ECUADOR: Mahuad unveils dollarsiation plan. (2000, January). Oxford Analytica Daily Brief Service, 1. Retrieved November 28, 2009, from ABI/INFORM Global. (Document ID: 1687875441).
- <sup>8</sup> Does Overall Balance Show disequilibrium? The overall balance=current account (line 78ald), capital account (line 78bcd), the financial account (line 78bjd), and net errors and omissions (line 78cad) (i.e., line 78ald, plus line 78bcd, plus line 78bjd, plus line 78cad).
- <sup>9</sup> quarter with no inconsistencies, the following should equal zero: CAB + FAB + NEO (net errors and omissions)<sup>9</sup>
- <sup>10</sup> The third quarter of 1996 represents a time of relative consistent accounting. CAB=\$30.45 (TB on goods and services, NFIA-income and transfers) Financial Account=-\$36.4 million. Net Errors and Omissions=\$2.86 million. Overall balance= -\$3 million.
- <sup>11</sup> “Ecuador. Picking up the Pieces.” Dec. 12, 1998. *The Economist*.
- <sup>12</sup> EIU Country Report. 2000.
- <sup>13</sup> *Wash. Post* (March 17, 1999)
- <sup>14</sup> “Is Latin America Less Vulnerable?; Largest Cloud Hangs Over Brazil.” By Conrad de Aenlle. *International Herald Tribune*. October 3, 1998.
- <sup>15</sup> *Wash. Post* (March 17, 1999):
- <sup>16</sup> IMF IFS
- <sup>17</sup> *Ibid.*
- <sup>18</sup> “Ecuador and the IMF.” Speech by Stanley Fischer, First Deputy Managing Director, International Monetary Fund, to the Hoover Institution Conference on Currency Unions. Palo Alto, Ca. May 19, 2000. <https://www.imf.org/external/np/speeches/2000/051900.htm>
- <sup>19</sup> “Hidden Devaluation: If it's true that history repeats itself, beware of what's to come in world markets.” By Gary Scott. *On Wall Street*. Jan. 1, 1999.
- <sup>20</sup> Incidentally, the *Economist* suggests that the peak years that investors exploited arbitrage opportunities in Ecuador were between 1994-97. (see pg. 33 EIU Country Report 2000)
- <sup>21</sup> *Ibid.*
- <sup>22</sup> “Ecuador and the IMF.” Speech by Stanley Fischer, First Deputy Managing Director, International Monetary Fund, to the Hoover Institution Conference on Currency Unions. Palo Alto, Ca. May 19, 2000. <https://www.imf.org/external/np/speeches/2000/051900.htm>
- <sup>23</sup> (pg. 13 4th Q report 1999 © The Economist Intelligence Unit Limited 1999)
- <sup>24</sup> Pres. “Mahuad announced a partial moratorium at the end of September that maintained servicing of Brady pars. But he cancelled scheduled interest payments of \$ 44.5 m on Brady discount bonds while seeking to renegotiate the entire \$ 5.92bn in Brady exposure.” “From Bad To Not So Bad - **Ecuador's Banks** Are Hoping For A Better Start To The Year. But Things Could Not Have Got Much Worse Anyway.” By Robert Taylor. *The Banker*. **January 1, 2000**
- <sup>25</sup> EIU 1999 Fourth Quarter Country Report. Pg. 14
- <sup>26</sup> “IMF Meetings: Burden Sharing in the Big Picture.” By Savita Iyer. Oct. 4, 1999. *Emerging Markets Debt Report*.
- <sup>27</sup> “IMF and Private Lenders Continue To Spar Over Ecuadorian Default.” By Savita Iyer. *Investment Dealers Digest*. Oct. 4, 1999.
- <sup>28</sup> EIU Country Report. 2000.
- <sup>29</sup> IMF IFS.

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- <sup>30</sup> EUI Country Report 2000 (Original source: Instituto Nacional de Estadística y Censos (INEC), *Encuesta Urbana de Empleo, Subempleo y Desempleo, 1998-99.*)
- <sup>31</sup> EIU Country Report. 2000.
- <sup>32</sup> Ibid.
- <sup>33</sup> <https://www.imf.org/external/np/sec/pr/2000/pr0032.htm>
- <sup>34</sup> “Ecuadoran Economy Near Collapse; Bank Closures, Proposed Austerity Measures Trigger Widespread Protests.” By Anthony Faiola, March 17, 1999. Washington Post.
- <sup>35</sup> “Ecuador and the IMF.” Speech by Stanley Fischer, First Deputy Managing Director, International Monetary Fund, to the Hoover Institution Conference on Currency Unions. Palo Alto, Ca. May 19, 2000. <https://www.imf.org/external/np/speeches/2000/051900.htm>
- <sup>36</sup> Ibid.
- <sup>37</sup> <http://www.investopedia.com/articles/04/082504.asp?viewed=1>
- <sup>38</sup> EIU Country Report. 2000.
- <sup>39</sup> EUI Country Report (see pg. 43 of EUI 2000)
- <sup>40</sup> The central parity rate is based on the average free-market rate of the previous week.
- <sup>41</sup> At times, the band was between Su2,875-3,176:\$1.
- <sup>42</sup> Ecuador abandons currency board. (1997, March). FX Manager,9. Retrieved November 29, 2009, from ABI/INFORM Global. (Document ID: 11366926).
- <sup>43</sup> Ecuador abandons currency board. (1997, March). FX Manager,9. Retrieved November 29, 2009, from ABI/INFORM Global. (Document ID: 11366926).
- <sup>44</sup> EIU 1998 Risk Ratings review.
- <sup>45</sup> “Ecuador’s dollar success shows buck stops nowhere.” By Elliot Blair Smith. USA TODAY. October 12, 2000.
- <sup>46</sup> EIU 1998 Risk Ratings review. pg. 21-22.
- <sup>47</sup> Jeffrey Sachs, & Felipe Larrain. (1999). Why dollarization is more straitjacket than salvation. Foreign Policy,(116), 80-92. Retrieved November 28, 2009, from ABI/INFORM Global.
- <sup>48</sup> “Ecuador and the IMF.” Speech by Stanley Fischer, First Deputy Managing Director, International Monetary Fund, to the Hoover Institution Conference on Currency Unions. Palo Alto, Ca. May 19, 2000. <https://www.imf.org/external/np/speeches/2000/051900.htm>
- <sup>49</sup> “Ecuador’s dollar success shows buck stops nowhere.” By Elliot Blair Smith. USA TODAY. October 12, 2000.