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# Economic and Social Effects of Dollarization in Ecuador

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**Abstract**

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## Overview

Commercial liberalization and market friendly policies, as well as expectations for a continental-wide trade bloc, led to an increasing influence of the US dollar in Latin America. In order to reduce inflation, eliminate fiscal deficits and promote economic stability, some countries shifted to fixed exchange rate policies (Argentina 1991-2001), or adopted the US dollar as their own currency (Ecuador 2000, El Salvador 2001). Ecuador became the first Latin American country to officially shift to the US dollar as a national currency. The Ecuadorian experience in the last four years can shed light on the economic and social effects of dollarization in small, open economies with scarcely diversified exports.

The objective of this paper is to analyze the social end economic effects of the recent Ecuadorian economic crisis and the adoption of the US dollar in January 2000. First, Ecuador will be presented in the Latin American context, followed by an analysis of the current cycle of crisis and recovery, the adoption of the US dollar, and the social and economic effects of recent policies. The concluding remarks include a discussion of the questions derived form the Ecuadorian experience, and the effects of dollarization on long term development perspectives.

## Ecuador in the Latin American Context

Two decades after adopting structural adjustment and export promotion policies, most Latin American countries have failed to overcome the economic crisis triggered by the Mexican debt moratoria in 1982. In spite of optimistic expectations of recovery in the early nineties, with regional soaring of export quantum and large scale integration into the global economy, economic growth remains largely evasive. As recent events in several Latin American countries suggest, political stability of democratic institutions seems to be threatened under conditions of pervasive poverty (43.8 % in 1999),[1] high structural unemployment and increasing social inequality.

Ecuador ranks among the less developed countries in Latin America, with a per capita income of US$ 1,461 in 2001, substantially below the regional average of US$ 3,864. A closer look reveals a poor economic performance of Ecuador, even within the weak regional context. While during the last two decades most Latin American countries had significant export expansion, but small income growth, and economic growth was high in the cases of Chile and Costa Rica, three Andean countries (Ecuador, Peru and Bolivia) shared with Guatemala, Nicaragua and other small economies the worst conditions in the region, with an average current per capita income lower than their 1980 level, and a per capita export purchasing power similar to the 1980 average.

In Ecuador, primary products still represent 88 % of exports, mostly composed of oil, bananas, shrimp, coffee, cacao and flowers. Social, regional and ethnic disparities, which have historically affected the country, remain pervasive. After significant economic growth and social improvement stimulated by banana exports in the 1950s and oil exports in the 1970s, Ecuador's economy is experiencing long-lasting stagnation. Recent Ecuador's economic performance is

[1] ECLAC. **Panorama Social de Am[erica Latina.** 2001.

characterized by a flat trajectory, aggravated by the recent crisis. In addition to a stagnant economy and limited export growth and diversification, Ecuador's economy has been affected by severe foreign indebtedness. In 2003, the total foreign debt (public and private) reached 16.5 billion dollars, equivalent to 61 % of GDP.

Ecuador is in a disadvantageous condition according to many comparative competitiveness indexes. According to the ONUDI, Ecuador placed 61 out of 87 countries studied in 1998 for competitive industrial performance (UNIDO, 2002). According to Indexes of international competitiveness elaborated by the *World Economic Forum in 2002*, Ecuador placed 73 and 78 out of 80 countries studied. This keeps Ecuador among the less competitive countries in the world (World Economic Forum, 2002), as a result of its institutional, technologic and macroeconomic conditions.

The quality of basic education has been rated the worst among 19 countries in Latin America (Fretes-Cibils, Guigsale y López-Calix, 2003). The Index of perception of corruption of 2002 has placed Ecuador in the 92nd position over 102 countries, behind all Latin American countries with exception of Haiti and Paraguay (Transparency International Web Site).

During the period of structural adjustment and export promotion policies –from 1982 onwards- social inequality, exclusion, and poverty remained pervasive in Ecuador. In 1995, poverty affected to 56 % of total population and reached 76 % in the countryside. These percentages were higher than the Latin American average. Income concentration, estimated by the Gini Coefficient (0.57) placed Ecuador in the third worst position in the region, only after Brazil and Paraguay (IADB, 2000). In 1994, 57 % of urban population had low productivity jobs (CEPAL, 2001), illiteracy affected 10.5 % of the population, and adult schooling averaged 7 years in 1995 (PNUD, 2001). In 1998, 26 % of children younger than five years suffered from chronic malnutrition (Larrea, Freire y Lutter, 2001).

**Ecuador's Economic Performance**

**External constrains, crisis and stagnation.** Structural adjustment and export promotion and expansion policies, implemented since the early 1980s, failed to restore economic growth and export diversification. The implementation of economic reforms has been slow and conflictive, lacking consistency and frequently leading to social conflict and political instability.

Nevertheless, and in spite of chronic political conflict, liberalization policies adopted in the early 1990's, have consistently been in place. These include dismantling protectionist policies and subsidies, market liberalization, adoption of floating exchange and interest rates, a partial deregulation of labor markets, and control of public spending and fiscal deficits.

**From crisis to dollarization.** During the late 1990s, a sequence of adverse events led to the most dramatic economic and social crisis in Ecuador, deepening the effects of prolonged economic stagnation. The first shock emerged from the most severe floods ever recorded in the Coast, as a result of a devastating "El Niño" phenomenon in 1998. As about 45 % of the national population and the bulk of export crops are located on the Coast, the economic and social costs of the floods therefore, were immense, including destruction of roads, crops and infrastructure, and the spread of infectious diseases. According to ECLAC estimates, economic loss reached 14.5 % of GDP. The second shock wave was the fall of oil prices, from 18 dollars per barrel in 1996 to 9.2 in 1998. The recovery started only in April 1999. Given that oil is the main source of fiscal revenue, accounting for about 40 % of total resources, the impact of plummeting oil prices on the Ecuadorian economy was strong. The fiscal situation, already affected by the reconstruction needs in the Coast, became critical.

The fragile situation turned into a collapse as a result of a third factor, the international financial crisis sparked in South East Asia in July 1997. The effect in Latin America was a sudden and massive withdrawal of short-term capital from the region. The public sector, with a regulatory framework weakened by market-friendly financial reforms in 1994, was unable to prevent or avoid a widespread financial crisis in 1998 and 1999, witch led to the bankruptcy and transfer to the state of 70 % of private banks in Ecuador. The massive freezing of private deposits and savings, and substantial transfers to the banks, were insufficient to save them. Per capita income dropped by 9 % in 1999, and according to the former President Osvaldo Hurtado, the cost of the financial crisis was about 22 % of GDP.

In the midst of the crisis, foreign exchange scarcity and speculation fuelled a rapid devaluation of the national currency. To prevent hyperinflation, the government eliminated the national currency and officially adopted the US dollar in January 2000. Although social unrest and political conflict resulted in a change in government, the next governments endorsed dollarization as a long-term strategic option.

During the last four years, public policies promoted economic and social recovery in the framework of dollarization. The primary goals were economic stabilization and promotion of foreign investment, particularly in the oil sector. Fiscal austerity and the improvement of fiscal revenue by a more efficient tax collection were pursued and achieved.

The backbone of the state strategy was the expansion of oil exports, based on foreign investment. The exploitation of heavy oil reserves in the central Amazon region and the construction of a new pipeline between 2001 and 2003, operated by a private consortium, led to a significant increase in oil exports, with the goal of doubling oil production in 2004.

The project, however, has been criticized from different perspectives. First, the selected pipeline route has a strong environmental impact on areas with the highest biodiversity in the world, such as the Mindo rainforest. Vanishing rainforests and biodiversity constitute one of the few strategic assets for sustainable long-term development in the country, while oil reserves are limited to about two decades of exploitation.

Secondly, as linkages of new oil investment with the national economy are weak, the impact of increased oil production on economic growth will be limited. Low labour demands (excepting the pipeline construction), limited national participation in the project and revenue taxes, and low quality of heavy oil contribute to reduce the expected economic effect of future oil exploitation.

Finally, the expected foreign investment in oil production was only partially achieved, and pipelines are currently operating slightly above 50 % of their installed capacity. Nevertheless, oil production increased by about 30 % in the first months of 2004, and a further expansion is expected shortly.

**Economic Effects of dollarization**

Ecuador became the first Latin American country to officially shift to the US dollar as a national currency. Although the similarity with the Argentinean "convertibility" is obvious, the latter country never eliminated its national currency. Panama also held a similar policy for a century, but this case is unique due both to the small size of the country and the large share of GDP linked to the service sector.

Advocates of dollarization argue that the policy will have positive effects in the long term, by adjusting domestic inflation and domestic interest rates to international levels, reducing transaction costs, and contributing to macroeconomic stability. The new environment will favour capital investment and lead to sustained growth in the future, particularly in the context of an emerging hemispheric trade bloc, led by the United States.

Critics argue that the adoption of a fixed exchange rate will be harmful for a small open economy, with a reduced basket of primary exports. Negative external shocks –quite frequent in the past- will result in increased unemployment or reduced real wages, increasing external vulnerability. Moreover, as inertial inflation declines slowly, increases in the relative prices of non-transable goods will affect international competitiveness, thus hampering future growth and export diversification.

Obviously, the time elapsed since dollarization in Ecuador is still too short to allow for an adequate empirical assessment of its economic and social impacts, and from the purely theoretical perspective, the topic remains controversial. Nevertheless, available information provides at least reasonable basis for a tentative evaluation.

As a starting point, it is important to take into account the unfavourable initial conditions of dollarization in Ecuador. The policy was not adopted as a part of an integrated long-term development strategy. It was, rather, a short-term emergency measure, adopted to avoid hyperinflation and further economic deterioration in the midst of a deep crisis.

Moreover, relative price unbalances were high, particularly as a result of plummeting wages and subsidized gas and fuel prices immediately prior to dollarization. Given the scarcity of dollars in the monetary reserve, the exchange rate adopted to convert sucres (former national currency) into dollars was about two times higher that the real shadow price of the US dollar.

In spite of the elimination of monetary emissions after dollarization, inflation remained high, given the necessary adjustments of prices to their real production costs, the monopolistic structure of the economy, and the partial elimination of government subsidies. Inflation rates in US dollars reached 91 % in 2000, 22 % in 2001, 9 % in 2002 and 6 % in 2003. Monthly inflation rates in 2004 are still well above international levels, with an annual projection of 7.6 %. Moreover, active interest rates remained above international levels, while passive rates lagged behind domestic inflation, thus discouraging domestic savings.

As a result of rising prices of non-transable goods and services, the real exchange rate became undervalued and the country lost competitiveness. During 2000 and 2001 relative prices were favourable to exports, and from 2002 onwards the situation reversed. The Central Bank Index of Real Exchange Type dropped from 147 in 2000 to 106 in 2001 to an average of 93.8 from January 2002 to April 2004, reaching its lowest values since 1986, when exchange rate liberalization was adopted. The recent collapse of convertibility in Argentina further illustrates the risk and adverse effects that fixed exchange rates may have on competitiveness.

The problem in Ecuador is serious, given its compromised ability to compete in the world market in such aspects as institutions, human capital, and technology, to name a few. According to the latest international indices of competitiveness, the country ranks among the less competitive in the world. The last report on global competitiveness ranked Ecuador in position 72 among 75 countries.[2]

Despite declining real exchange rates, non oil exports recovered remarkably well, with a real annual growth of 6.7 % from 2000 to 2003, and a even higher rate of non traditional items (11.5 %). However, non-oil exports are still below their pre-crisis level (1997).

Recent information suggests, however, that the expansion is coming to and end and even reversing. Most items in non-oil exports persistently declined since mid 1993, with a 20 % drop in total non oil exports between the first quarters of 2003 and 2004.

In addition to unfavourable real exchange rates, two key factors may explain the recent adverse export performance. First, available credit for productive investment is still scarce and expensive, as real interest rates remain high and consumption absorbed the lion share of credit. Second, constrains in access to adequate job training and education affect prospects for increasing productivity.

Despite unstable non-oil exports, several favourable conditions helped to provide foreign exchange flows to the Ecuadorian economy from 2000 onwards. High oil prices – 25.3 dollars per barrel in 2003, compared to 9.2 in 1998 – which recently soared to 35 dollars per barrel and are expected to remain elevated in the near future stabilized and strengthen dollarization. Additionally, remittances from Ecuadorian workers who migrated abroad during the crisis (estimated at 1.5 billion dollars in 2003, up from 200 million in 1993) were also of strategic importance. Finally, investment in the construction of the new pipeline, the most important foreign investment in 20 years, was significant.

The negative effect of undervalued exchange rates manifested itself on a dramatic expansion of imports, which became cheaper. Total imports in 2003 were 30 % higher than their pre-crisis levels (1997), with the fastest growth in consumer goods. As a result, a critical and persistent trade deficit emerged from 2001 onwards. As foreign debt service requires about 2,000 million dollars per year, the situation is potentially critical.

Per capita income improved slowly from the 1999 crisis, with an average annual growth of 1.5 %, remaining in 2003 below its 1997 value. In spite of expected expansion in the oil sector, prospects for future growth in the non-oil economy are modest in the following years (0.3 % per capita in 2004).

As several of the favourable conditions which prevailed during the first years of dollarization have weakened or disappeared, future prospects are uncertain. In fact, favourable real exchange rates were reversed by inflation, affecting prospects for export expansion and diversification, domestic credit remains scarce and expensive, and as international emigration became more difficult, foreign remittances will not continue growing and may begin to decline.

Summarizing, although dollarization favoured price stability, economic recovery has been slow and insufficient. Interest rates did not converge to international levels, and credit scarcity hampers

[2] Ecuador ranks in position 72 according to the Current Competitiveness Index, and in position 68 by the Growth Competitiveness Index, among 75 countries. In Latin America, only Bolivia and Honduras ranked worse. See: World Econokmic Forum. **Global Competitiveness Report. 2001-2002.**

productivity growth. Inflation declined slowly and current real exchange rates affect competitiveness and limit prospects for future growth and diversification. Under the rigid framework imposed by dollarization, recessive adjustments to potential external shocks are likely in the future.

**Social effects of the crisis and dollarization**

The social effects of the crisis and recent economic policies can be evaluated mostly from household surveys, width emphasis on poverty, real wages and employment. In spite of the lack of reliable, consistent and periodical national household surveys, the evolution of poverty can be inferred from available surveys in 1994, 1995, 1998, 1999, 2001 and 2003.[3] A series of monthly household surveys for the three main cities of Ecuador (Quito, Guayaquil and Cuenca) will complement the analysis.

In this analysis, a poverty line equivalent to the minimum cost of a basket of goods and services able to satisfy household basic needs was adopted. Extreme poverty occurs when household income (or consumption) lies below the cost of a minimum food basket required to satisfy nutritional requirements.[4]

Broadly speaking, three phases can be differentiated in the crisis-recovery cycle from the social perspective.

**Deterioration.** From 1998 to mid 2000 a severe process of social deterioration took place. National poverty went up from 56 % in 1995 to 63 % in 1998 and 69 % in 2000. In Quito, Guayaquil and Cuenca poverty also soared from 35 % in March 1998 to its peak of 68 % in May 2000, four months after dollarization. Urban unemployment followed a similar pattern, from 8 % to 17 % in the same period, while real wages plummeted by 40 %.

**Recovery.** From May 2000 to December 2001 social conditions partially recover. National poverty receded from 69 % to 61 %, and so did urban poverty in the three main cities, with a rate of 49 % for December 2001. Urban unemployment bounces back to 8 % and real wages recover to almost its pre-crisis values.

**Post-crisis stabilization.** From early 2002 the pace of recovery slows down, and a new scenario with different social traits began to emerge. Poverty continues declining slowly, to its current values around 45 %, while unemployment rises again from mid 2003 onwards to 11.9 % in March 2004. Real wages recover their pre-crisis values.

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[3] The series corresponds to Living Standard Measurement Surveys (LSMS) up to 1999, and national employment surveys later. The 1999 survey does not have complete national coverage.

[4] National poverty estimates for 1995 and 1998 are based on aggregate consumption and fromm 2001 onwards are based on income, with a poverty line of around US$ 700 per person per year, at 1995 prices, adjusted for regional variation in the cost of living. Urban poverty estimates are based on household income, with a poverty line of about US$ 600 per person per year, at January 2000 prices.

Poverty began to decline only when monthly inflation receded and a limited recovery in real wages started. The evolution of poverty depends also on the employment structure. The crisis led to an unprecedented expansion of open unemployment, affecting mostly young unskilled workers in small and medium enterprises. The following recovery, however, is not the result of an expansion of productive employment in the modern sector. In fact, the share of the modern sector in total employment declined. It dropped from 65 % in March 1998 to 56 % in December 2003. Therefore, both the informal sector and domestic service partially absorbed the reduction in open unemployment.

The second –and most important- factor explaining the improvement in the labour market is a dramatic spurt in international migration during the crisis. Although international migration of Ecuadorian workers to developed countries began in the 1950s, this phenomenon is now occurring for the first time on a large scale, including both unskilled and skilled workers. Flows of migration towards Spain and the United States dominate. Although there are no reliable estimates of the number of migrants, according to several sources the magnitude of recent international migration has reached at least seven hundred thousand workers.

According to initial estimates, almost half of migrant workers are women. Most of them search jobs in Spain, Italy and France as domestic servants or agricultural workers. Generally, women have been affected by higher open unemployment and underemployment rates than men. Additionally, female wages are about 13 % lower than men's, under similar conditions of qualification, experience and labour insertion. [5]

In sum, the cost of the crisis was high in terms of increasing poverty, unemployment and underemployment, and declining real wages. According to available information, a partial recovery took place mostly from mid 2000 to 2001, and latter flattened out. However, poverty and extreme poverty remain still above their pre-crisis levels, and the reduction in open unemployment has had mostly the effect of a massive spurt in international migration, as well as the expansion of the informal sector. In spite of the temporary positive effect of the new pipeline construction, no clear signs of job expansion in the modern sector appear.

## Concluding Remarks.

Ecuador, a less developed country in the Latin American context, has been affected by a lasting economic stagnation since 1982. Few primary products, with oil dominance, still account for most of exports. A sequence of adverse circumstances –devastating floods, plummeting oil prices and the collapse of the private banking system- triggered a deep social and economic crisis in 1998 and 1999. To avoid hyperinflation and further economic instability, the government officially adopted the US dollar as the national currency in January 2000.

The theoretical assessment of advantages and risks of dollarization in a small open economy with dominance of primary exports remains controversial. From an empirical perspective, the expected convergence of inflation and interest rates to international levels has been slow and costly, affecting export competitiveness. Although private export performance is still poor, the economy recovered somewhat as a result of fresh foreign investment in oil exploitation and the construction of a new pipeline, though this too was accomplished at an environmental cost.

[5] Larrea, Carlos and Sánchez, Jeannette. **Pobreza, Empleo y Equidad en el Ecuador. Perspectivas para el Desarrollo Humano.** Quito: PNUD, 2002.

Prospects for a sustained recovery based on oil exports are devious, given the limited reserves and the reduced trickle down effect of future oil exports.

The high toll of the crisis in terms of poverty and employment is still felt. Although poverty declined from mid 2000 and most of the social deterioration has been reversed, extreme poverty remains higher than its pre-crisis values, particularly in the countryside, and open unemployment is rising again. Massive international migrations of both unskilled and skilled workers strongly contributed to the recovery, given the lack of employment creation in the modern sector of the economy.

Obviously, the disappointing economic and social performance of Ecuador since 1982 is the result of a complex set of structural factors, which probably continue to affect the country in the near future, at least under the current development strategies. The question about the potential impact of dollarization on long-term development prospects is critical for the future.

Hypothetically, the rigid framework of a fixed exchange rate may affect the long-term capacity of the country to overcome its chronic external vulnerability and create solid basis for a sustainable and equitable growth, preserving the country's valuable resources and biodiversity, and promoting eco-tourism and environmental services. The institutional long-term requirements for development, as well as human capital formation, demand an active role of the public sector. Those goals may be harder to achieve under the constraints of a fixed nominal exchange rate.

**Evaluation and Perspectives: Dollarization and Development**

As pointed out by Amartya Sen, enhancing of human capabilities is the main goal of development. In the cases of Ecuador and other less developed countries, poverty reduction and universal satisfaction of basic needs remains a priority.

In spite of its abundance and diversity of natural resources and high growth potential, Ecuador ranks among de less developed countries in Latin America, with a social structure affected by pervasive poverty and inequality. As per capita income is about twice the poverty line of 700 dollars, the productive capacity of the country suffices for universal basic needs satisfaction, assuming an adequate distribution of welfare. In spite of significant economic and social progress, Ecuadorian society remains deeply fragmented along regional, social and ethnic lines. Social inequality is still as a main hindrance to human development.

Colonial society, consolidated in this region during the sixteenth and seventeenth centuries, was based on a concentrated pattern of land ownership and exclusionary social institutions whose heritage still prevails. Since the mid nineteenth century, the insertion of the national economy into the world markets was mostly based on traditional comparative advantages, mostly natural resource availability and abundance of unskilled and cheap labor. As the country became a primary product exporter, its economy became highly dependent of unstable and frequently stagnant international markets. Moreover, international insertion consolidated social inequality and promoted a non sustainable extraction of natural resources.

In the last three decades, technological change and globalization deeply changed the role of traditional comparative advantages, enhancing the importance of human capital, technological innovation and knowledge as the most important sources of international competitiveness, In the current international context, Ecuador needs to develop an alternative insertion into international markets, based on an environmentally sustainable access to its natural resources, the generation of productive employment, the promotion of education and health as means to improve labor productivity and export diversification. Fortunately, Ecuador's biodiversity –regarded as one of the highest in the word – its cultural richness and other factors provide a great potential for tourism, ecotourism and other sustainable activities.

Conventional structural adjustment and export promotion policies failed to provide basis for economic growth and social distribution. After two decades of economic stagnation and increasing social inequality, the 1999 crisis led to dollarization as a way to stabilize the economy, avoid hyperinflation, and reduce external vulnerability.

After four years of its application, dollarization failed to provide macroeconomic stability, economic growth remains evasive, and new imbalances have emerged, mostly the undervaluation of exchange rates, the deepening of dependence on primary exports, and the erosion of competitiveness.

In the medium and long term, only a sustained effort to increase labor productivity, promoting education, labor training, social distribution and employment generation, will be able to overcome the current trends towards a recessive adjustment, and create conditions for sustainable human development in Ecuador.

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