

Ecuador: Dollarization in Danger?

Is dollarization threatened by Ecuador's radical new president, Rafael Correa — or is Correa threatened by dollarization?

Joachim Bamrud

Latin Business Chronicle

Monday, January 15, 2007

As Rafael Correa assumes Ecuador's presidency, the country's foreign debt is not the only thing in danger, some experts warn. Also Ecuador's dollarization may be affected. "Bad economic and political policies will undermine dollarization," says Dora de Ampuero, who heads up Ecuadorian think-tank Instituto Ecuatoriano de Economía Política (IEEP). "Government spending will increase to comply with the electoral campaign promises while production and investment will be reduced. These are negative factors to maintain monetary stability."

Jose Luis Cordeiro, a Venezuelan economist and the author of a book on dollarization in Ecuador, agrees. But he sees dollarization surviving. "Obviously, bad economic decisions will have a negative impact on dollarization," he says. "However, unless dollarization itself is attacked, there is no reason for it to collapse. The government of Ecuador could even go bankrupt and declare default without eliminating dollarization, just as some dollarized economies have declared default without having to devalue the currency. This has already happened before all the way from Panama to cities and counties in the USA."

CORREA THREATENED

One leading expert sees the opposite happening. "Most observers have the story backwards. It is dollarization that threatens the dangerous economic policies that Correa has proposed, not the other way around," argues Steve H. Hanke, a professor of applied economics at The Johns Hopkins University in Baltimore who served as an adviser to Ecuador's Minister of Economy and Finance when Ecuador dollarized six years ago. "Dollarization was adopted to stabilize the economy by putting a ring fence around Ecuador's politicians and their serial economic bungling and corrupt ways, and that is exactly what it has done. In consequence, Correa has inherited an economy that is in the best shape it has been in decades."

Panama and El Salvador, along with Ecuador, are the only countries in Latin America that formally use the U.S. dollar as their only currency, although the greenback is also used de facto as a leading currency in the rest of Latin America, especially in countries with unstable currencies and rising inflation.

Several countries have considered dollarization, but so far failed to advance further.

Dollarization in Ecuador was formally implemented in September 2000 and helped contain inflation during several years of political instability, experts say. Ecuador's inflation went from 96.1 percent in 2000 to 37.7 percent in 2001 and 12.6 in 2002. In 2005 it reached a historic low of 2.1 percent, which was the lowest in all of Latin America. Last year it reached an estimated 3.3 percent and is expected to end up at 3.0 percent this year, according to the International Monetary Fund.

"Regardless of the political situation, Ecuador has had monetary stability since dollarization in 2000," Cordeiro points out. "While Ecuador has been changing presidents every two years, and president Correa himself might last only two years if he does not behave well, the currency has remained stable and predictable."

LUKEWARM SUPPORT

Correa has been a critic of dollarization, but has pledged not to replace it. "Correa has announced that he will maintain dollarization, but many people doubt of his real intentions," Ampuero says. "Even if he sincerely maintains dollarization he will not take advantage of the full potential of this monetary regime because he favors protectionist policies against free trade, and he is not friendly to foreign investment."

Correa is inclined to big government and his fiscal policy will be oriented to expand government intervention in the economy and to increase subsidies, she adds. And a loose fiscal policy and a closed financial sector will keep domestic interest rates relatively higher than abroad, according to Ampuero.

If Ecuador does end dollarization, it will have significant negative consequences for the economy, experts say.

"If Ecuador lifts dollarization we will have an economic disaster," Ampuero says. "Inflation will jump again as well as prices of goods and services, business activities will be seriously affected, people's income will be destroyed again. Unemployment and poverty will increase because economic growth will be reduced."

Ecuador lost confidence in a national currency because of past consequences that brought misery to the people and Ecuadorians will resist any intention to abandon dollarization, she adds.

Correa has scared local and foreign investors with his talk of a debt default, attacks against multilateral institutions, local banks and the new national assembly, protectionist economic policies and close alliance with Venezuela's president Hugo Chavez, who last week stated his plans to create a fully socialist economy through nationalizations and other policies. Moody's rating agency last week changed the outlook on Ecuador's sovereign debt ratings from positive to stable as a result of the likely debt default.

"Correa's proposed economic policies will certainly move things in the wrong direction, undermining the economy," Hanke says. "This could pose serious problems for Ecuador's banking system, which is not well integrated into the international financial system."

HELP FROM CHAVEZ

Meanwhile, Correa will likely get assistance from Venezuela in its debt plans, according to Walter Molano, head of research at BCP Securities. "Chavez is also moving aggressively to increase his influence in Ecuador, by deepening his ties with president-elect Correa," Molano said in a recent report on Latin America. "He is promising to help support Ecuador during its debt restructuring and offering to refine Ecuadorian crude free of charge."

The probable debt default comes as Ecuadorian exporters already worry about the lack of a free trade agreement with the United States, as neighbors Colombia and Peru have signed. The U.S. Congress has extended the Andean Trade Preferences and Drug Eradication Act until July. The ATPDEA provides dutyfree access for around 5,600 products from Ecuador and the other ATPDEA beneficiaries, Bolivia, Colombia and Peru. But without a free trade agreement, Ecuador stands to lose more than \$300 million, according to María Gloria Alarcón, president of the Guayaquil Chamber of Commerce. Total trade is expected to decline this year. Ecuador's exports will likely grow by 1.1 percent to \$9.1 billion, while imports should fall by 8.0 percent to \$8.0 billion, BCP Securities forecasts.

And, ironically, the debt default comes despite Ecuador having no problems servicing its debt load, experts say. "President-elect Correa is utilizing a less-than-precise fiscal accounting measure to present a view on the capacity of Ecuador to pay its debts," Bear Stearns analyst Alberto Bernal said in a recent commentary. "The reality is that Ecuador has one of the lowest debt loads in the Latin America region ...The country spends less than 3 percent of GDP paying interest, compared to 4.5 percent in Colombia and more than 5 percent in Brazil."