Ecuador Needs More Than A Dollars-for-Sucres Exchange

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Ecuador's 1999 banking crisis forced the government to take control of 70% of the country's banking sector and to freeze deposits. At present 41.3% of the banking system's loans are nonperforming. Ecuador also defaulted on $13.6 billion in foreign debt last year. In addition, the country has been through a currency maelstrom. Since December 1998, the sucre has lost 74% of its value against the dollar and, as a consequence, per capita gross domestic product has fallen by about 41% measured in dollars.

While a 1995 border war with Peru, the weather pattern known as El Niño and weak commodity prices are often cited as reasons for this crisis, the fact is that Ecuador's problems can be traced to utter incompetence at the finance ministry and the central bank over the past few years.

Indeed, earlier this week, Jorge Guzman, Ecuador's new finance minister, asserted that the majority of Ecuador's ruling political class suffered from a "problem of stupidity" and pledged that Ecuador would not repeat past sins. The first step in delivering on that promise is the dollarization of the economy. Once the paper sucre is permanently retired and dollars become the unit of account -- a process already underway -- stability and some recovery can be expected.

Yet if Ecuador is to reap the full benefits of dollarization it must do
more than simply replace sucres with dollars. It must remove the power of the central bank to act in the monetary sphere, achieve international financial integration and provide for a rule of law. As usual, the devil resides in the details.

An authentic shutdown of the central bank needn't be considered radical. Central banking began with the establishment of Sweden's Riksbank in 1668, but by the end of the 19th century, there were still only 18 central banks in the world. In the 20th century central banking continued to spread slowly and in 1945 there were just 44 central banks. Today 173 central banks dot the globe.

The record of central banking in developing countries has been dismal when compared to those countries in which monetary authorities are straightjacketed by currency boards or in which a foreign currency is legal tender. Since 1950, developing countries with central banking have experienced average GDP growth rates 35% lower, average annual inflation rates five times higher and average budget deficits as a percentage of GDP 65% higher than countries with "straightjackets" or no central bank. Currency and banking crises are also standard occurrences in developing countries with central banks.

During the 1990s five countries actually reined in their central banks with currency-board rules. When, in January 1999, Argentina's former President Carlos Menem suggested that Argentina dump its national currency, the peso, and replace it with the U.S. dollar, a radical turning point occurred. Although Argentina didn't dollarize -- Mr. Menem's economic team studied the proposal to death -- the idea got legs. In September 1999, Kosovo legalized the German mark and a month later Montenegro did the same. East Timor became the 31st political entity to officially adopt a foreign currency -- the dollar -- as legal tender in January 2000.

The new Ecuadoran law, which retires the paper sucre, is called the Trolley-Bus Law because it links a number of reforms. But dollarization is the linchpin. All paper sucres in circulation will be exchanged at a rate of 25,000 to $1, and then destroyed. The government will only issue sucre coins for amounts less than the equivalent of $1. This will produce sound money and stability.

Although stability is not everything, everything is nothing without stability.

Unhappily though, after providing for the dollars-for-sucres exchange, the law deteriorates. First, the central bank is retained as a quasi-lender of last resort. This represents a deviation from orthodox dollarization. It will be counterproductive because the central bank will be able to meddle in monetary matters.

Ecuador's central bank, acting as a lender of last resort, set off the
1999 banking panic by extending credit to shaky banks and shady bankers. Evidence of this is now surfacing as the country's chief government prosecutor is pursuing eight Ecuadoran bankers for fraud, claiming that they took the money and ran. Panama, a dollarized country with no central bank or lender-of-last-resort facility, has been immune to banking panics.

A second flaw in the law is that it is missing the elements necessary to integrate Ecuador's financial system with the world financial markets. Such integration can only occur rapidly if Ecuador is able to attract a large number of international banks as Panama has done. (Panama has 64 foreign banks but at present Ecuador has only four.) This can be accomplished if the banks held by the Ecuadoran government are fully privatized and bought by international banks.

But what international banks would buy into Ecuador? The rub here reveals a third problem with the new legislation: It fails to address a weak rule of law. Indeed, a 1999 survey of international investors compiled by Syracuse, N.Y.-based Political Risk Services rated Ecuador among the world's worst performers in the "rule of law" category. The survey took into account quality of bureaucracy, political corruption, the likelihood of government repudiation of contracts and risk of expropriation. Germany's Transparency International ranked Ecuador 82nd out of the 99 countries it reviewed for corruption in 1999.

This dismal situation can be partially corrected by amending the Trolley-Bus Law, which proposes to privatize 51% of many state-owned enterprises. The government's retention of a minority interest in privatized enterprises is an invitation for political mischief and corruption. The law should be amended to require full privatization.

Moreover Ecuador should change its laws as necessary to allow for the international arbitration of contracts retroactively. Turkey did this in January 2000 to ensure the success of its new privatization program and encourage direct foreign investment. As a result, it anticipates that direct foreign investment will jump from its current low level of $500 million to $2 billion annually.

Ecuador is clearly on the right track. To reach the station, it must sweep out all vestiges of central banking, ensure financial integration and establish the rule of law without waiting for an overhaul of its own courts.